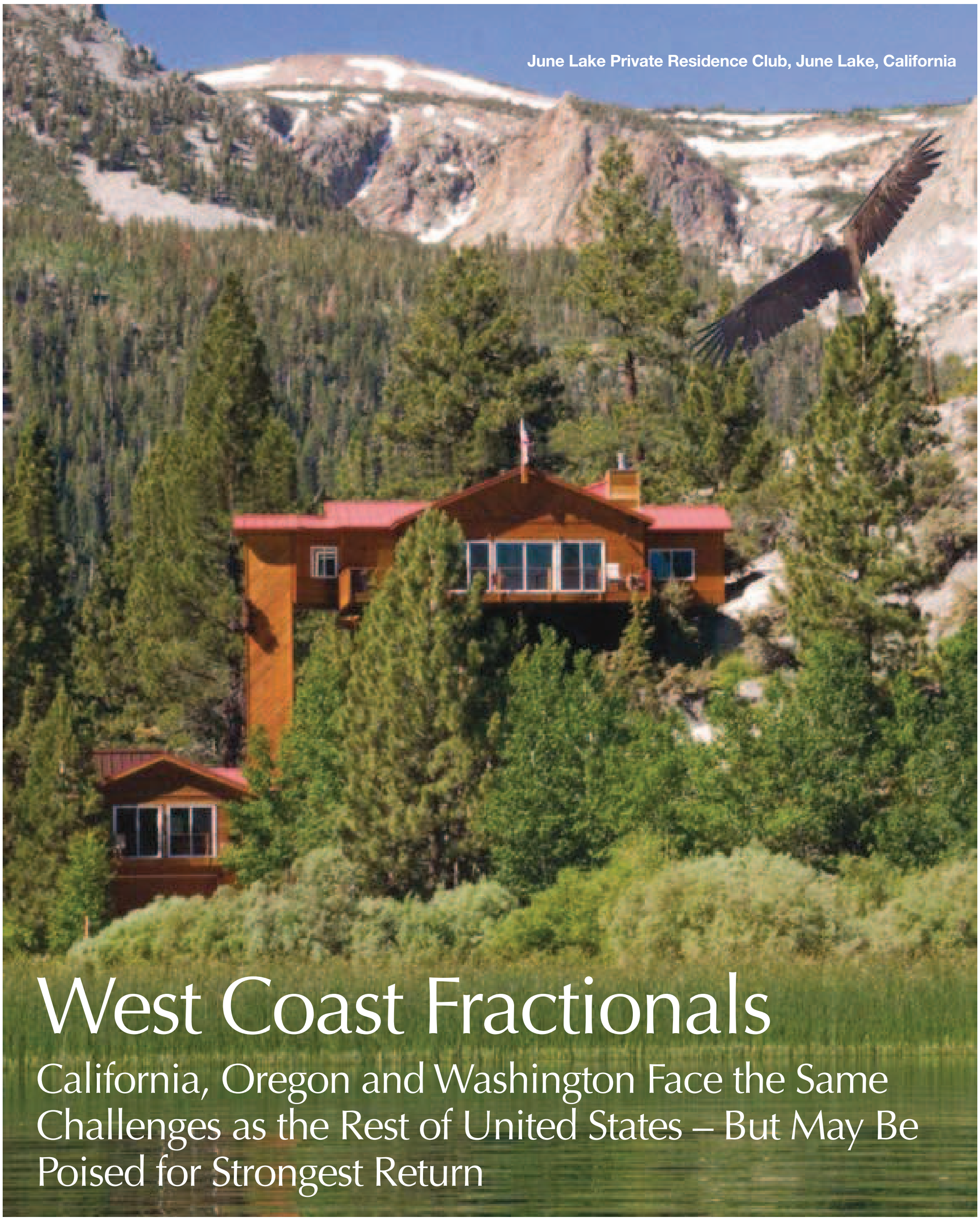


June Lake Private Residence Club, June Lake, California

West Coast Fractionals

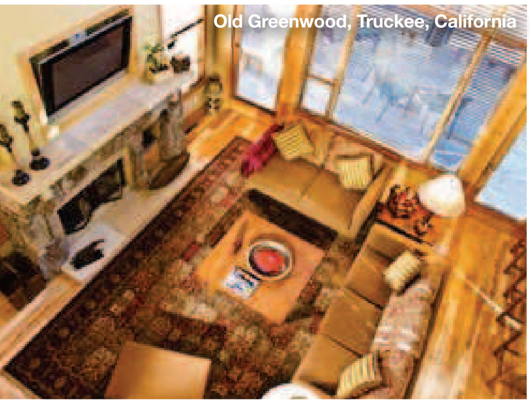
California, Oregon and Washington Face the Same Challenges as the Rest of United States – But May Be Poised for Strongest Return

Perspective Magazine takes a look at the U.S. fractional residences scene and finds that while things are bad all over, certain West Coast markets may eventually prove to be the bedrock of future development. To gauge the present situation and investigate what might be to come, we spoke to Gregg Anderson, global vice president, The Registry Collection; David C. Gilbert, executive vice president, Interval International/Preferred Residences; Mel Grant, president and CEO, The San Francisco Exchange Company (SFX) ; Steven D. Peterson, partner, Ballard Spahr; Richard L. "Dick" Ragatz, president, Ragatz Associate; and Andy Sirkin, attorney, Sirkin & Associates. Read on to see what these people with an interest in West Coast fractionals have to say, keeping in mind that the definitions of the terms fractional interest and fractional resort may vary somewhat among participants.

Looking at the U.S. West Coast, which we're defining as California, Oregon and Washington, how would you describe the overall state of the fractional industry?

Gregg Anderson: Exchange is a pretty good barometer of how fractional overall is going. Based on the number of affiliates that are in our program, the number of transactions going into those properties and deposits made from those members, it's strong from a usability standpoint. Our members are depositing more inventory out of our West Coast resorts and our members are exchanging into those resorts at higher numbers than ever. Now that doesn't necessarily reflect on whether properties are making more sales or not, but the fact that many of the properties are in sales is important.

David Gilbert: It's weak in the West Coast of California, Oregon and Washington, and it's a


Old Greenwood, Truckee, California


Casa Verde, Orcas Island, Washington


Casa Verde, Orcas Island, Washington

reflection of it being weak in North America. It's not like those markets are doing poorly compared to the rest of North America or the rest of the world; they're just doing poorly because of overall market conditions. The fundamental issue driving the challenges with market conditions is really twofold: one, the second-home vacation product is down so drastically in price that it's really put pressure on the fractional and private residence industry. And the second issue also putting downward pressure on the industry at large is the access to capital. So what we're seeing fractional developers doing, people are moving to smaller increments; people used to see a lot more quarter shares, or sixth or eighth shares. They're moving down now where people are doing tenth or twelfth shares. So size of the increment is moving downward pretty significantly.

Mel Grant: Unfortunately, the overall state of the fractional industry is very depressed and virtually nonfunctioning, primarily because of the state of the economy. There are still a lot of people out there with a lot of money – but just because they have a lot of money doesn't mean to say they're spending as freely on luxury lifestyle items as readily as they were prior to the economy crash. Although the economy will get better, the fractional industry in an improved economy at best will be a slow rebound.

Dick Ragatz: There are no fractional resort projects in sales in Washington. In Oregon, there is one in sales, Cape Kiwanda, and that is really a fascinating one, because it's the best-selling fractional in North America during the first six months of 2010 in terms of total shares sold – it's above everything else by a third. That's one of the biggest pieces of news in the fractional industry. There are probably about six projects in sales in California, and for the most part they did no better or worse than anyplace else in North America, with very, very slow sales.

Andy Sirkin: I would describe it as still depressed. If you look at the golden years, as people are now reflecting on 2005 to 2007, there is a lot less activity now at all levels, meaning less development activity in terms of new projects and less sales activity on existing projects. So overall I would say the performance is much worse than the potential. There are bright spots; there are people who are going ahead with projects whereas a year-and-a-half to two years ago, there was complete paralysis. So the market is starting to recover – but I would still describe it as poor overall.

Where are the relatively strongest markets?

Anderson: I'll call out one particular area that is probably a very good statement of the industry, and that's North Tahoe – particularly in the Northstar area where you have a number of fractional properties in sales. Because of that, you see that area of the country, while they may be competing against one another, as a group really pushing the fractional concept forward. That area is world-famous from a ski perspective, but it's also got a great summer season and it's got a very good spring and fall season because it has a village and different activities. It's a place you can go most of the year, and that's been a big selling point.

Gilbert: No one [U.S.] market is really doing better than another. California, of the three that you mentioned, has always been one of the most highly demanded vacation destinations for people interested in shared ownership. We did a 2010 Market Profile and California came out the third-most desired domestic destination for people that are interested in purchasing shared ownership, with about 68% of prospective purchasers listing that as a desired destination.

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Old Greenwood, Truckee, California

Grant: I would have to say the strongest markets are San Francisco and Napa Valley. There's a great deal of wealth and affluence – but even though these are the strongest markets within the West Coast region, sales are still depressed.

Sirkin: in terms of what we're seeing in our practice, the strongest market seems to be the Tahoe area in terms of how rapidly things are selling – the rate of sales for a month or two-month period, the number of buyers who seem to be interested and the number of projects that are actually going forward. After that, I would say other ski-related areas in California: June Lake, Mammoth – places like that are relative to the overall market doing pretty well. Overall, after these mountain areas, the next best segment market is what I would describe as hunting/fishing places, places where people have been returning routinely to lakes and particular bends in rivers that are good hunting or fishing spots. There's a built-in market because you have a large group of people that return year after year.

If you look at who's selling what right now, it appears that the one-off small developers are doing a little better … at least that's what we're seeing.

What is the trend with pricing/multipliers?

Anderson: My advice to developers is to be realistic. Gone are the days when you can get 20% appreciation every year – we'd all love to get back to that, but realistically, it isn't going to happen. So you have to look at it and say, what will people be able to afford today, and what will people be able to afford two years from now when you come out of the ground? Look at that and say, what can I deliver that is going to give people the basic experience they want while they're here? It doesn't necessarily have to be every bell and whistle. My argument is to come off it a little bit so you can price it to where people say it's a value, and when it goes up in value, people are pleasantly surprised – as opposed to making it just to the edge of what people can afford, and their worry is what happens to them if it goes down.

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I look at it from a pricing perspective two ways: Make sure you're delivering something that is going to be able to attract the largest audience that's in your target. That's by pricing it fairly. And equally important, pay attention to your maintenance fees, because a lot of developers are covering the lower cost by charging huge maintenance fees. A lot of people will look past the one-time cost of the fraction, but when they get hit with these huge annual dues they decide it just doesn't work for them.

Grant: There will always be a market for high-end luxury goods, in a good economy or a bad economy there's always people with a lot of money, but it comes back to how easily they spend that money. What we have seen is a tightening up of spending even though people have the discretionary income.


One Village Place, Truckee, California

Ragatz: A lot of people say that multipliers have gone way down, and some people are using multipliers of 1.2 to 1.3, which to me makes no sense at all, because if you don't have a multiplier of at least 1.4, 1.5 there's no use in selling [fractional interests] because of the high markup in sales costs. Our multipliers really haven't changed much because they're based upon the existing sales price of comparable whole ownership units. If whole ownership prices go down, then fractional prices go down, but the ratio remains the same. Maybe our ration has gone down from 1.8 to 2.0; rarely do we use anything over 1.75 anymore, but we never go under 1.4 or 1.5.

Sirkin: What we've seen in the last three years is that the Europeans have been way out ahead of the Americans in terms of perceiving that the old pricing model for fractional interests, where you had a very large pricing multiplier, was not going to work well under the current financial conditions. The Europeans correctly perceived that in this market, fractionals should really be viewed simply as another way to sell products, rather than as a way to sell products for more. We saw the Europeans understanding that maybe we don't need to even mark these up at all, or maybe we only need to mark them up 10-15% over our whole ownership project because it's not really a way for us to make more money. It's a way for us to simply sell more product, get traffic coming into the sales office, get people buying things, give our sales agents activity, get bodies on the project and so on. The U.S. developers were much slower to understand that. Even today I would say that the predominant attitude in the industry is that we're going to go back to the heyday of multipliers at 1.7, 1.8, 2.2, 2.4 that we had in the mid-2000s, and that we just need to hold out until that day returns. And so they end up sitting on a lot of inventory. There is a segment of the U.S. market that's starting to realize that maybe that's not the only way to look at the world of fractionals; maybe we need to look at it as not necessarily markup product at all, but just another product that is going to be beneficial to us even if we don't have a big markup.

Which are the emerging markets?

Anderson: An emerging market on the West Coast has got to be San Diego – emerging only in that it's right for this type of concept because it has perfect weather, it's pretty easy to get to, it's well known, and it's a place people can easily spend a week and feel completely comfortable. If you're looking at where your growth opportunities are, San Diego is clearly strong. The right part of L.A. would be strong. More in Napa and that whole Carmel area would be terrific. I think a sleeper location would be the Santa Barbara/ Santa Maria area – the wineries are great, the climate is pleasant, there's great surfing, shops and restaurants, and it's a fabulous lifestyle. If you're a developer, you've probably got three or four really good West Coast choices to make a stand at.

Seattle is another cool place, but the question becomes is it strong enough as a tourism destination that people will come for more than just the summer season. It's a pretty challenging place to go some times of the year, and I don't know whether from a fractional standpoint whether a developer would see that he could make that go.

Gilbert: It's really back to these vacation-destination markets; we're starting to see already second-home condominium and condo-hotel projects that have stalled are going to be converting to fractional and timeshare product. And so they're taking something that they were trying to sell in its entirety as a second home and dicing it up into a small fraction to make it more affordable for consumers. They're repurposing the asset. It's happening everywhere; there's no one specific market. And this has happened in our industry before; there have been a couple cycles where we've seen oversupply in a condominium product and a lot of conversions into the industry.


Northstar Club, Truckee, California

Grant: The emerging market that I see is super-high-end timeshare – fractional equivalent in quality but sold more traditionally by the week, such as the Hyatt property in Carmel.

Ragatz: L.A., Seattle and downtown San Diego are right for an urban fractional product. All the fractional projects in San Diego are on the beach, and there's nothing in L.A. or Seattle. The Napa Valley is an emerging market as well. Maybe Palm Springs/Coachella Valley, moderately priced, and eastern Washington in the Sun area. We've been working in project in Carmel, and that will be a very significant project if the zoning comes through – I would love to see a project in Monterrey or Carmel.

Are West Coast fractionals less likely to be urban?

Grant: The only true urban fractionals on the West Coast are in San Francisco; you have the Fairmont, you have the Odeon, and then you have the Ritz-Carlton private residence club, which really is a different product.

Peterson: When people buy a second home, the concept is they're going to return to it again and again. It has to be a unique location. Other than certain key urban locations like New York – which makes sense for urban fractionals and even urban timeshare – a lot of people don't return to certain cities over and over again, and that's why urban is very specialized.

Ragatz: A massive growth will be non-urban, but there will be a few products that will do well in urban areas. But the bulk of the market will still be in resort destinations.

What about West Coast legislation? How different are the legislations and regulations by state?

Sirkin: California has a relatively new timeshare and fractional scheme; it's probably the newest in the country, enacted in 2004. Because it is so new, it reflects a lot of evolution of knowledge in terms of how best to regulate and approve [the fractional product]. My personal viewpoint is that it is the best comprehensive regulatory scheme in the country. Some people don't like it, because they're comparing it to states that have either no regulation at all or very light regulation. But of the states that have comprehensive legislation, California has both the best law and the best regulatory authority. I like the California scheme because you know exactly when it applies and when it doesn't, you know what's expected of you, and you know how long it's going to take you to get through it. To me, as a lawyer, those are the most important things – you don't want gray areas, you want to know what's going to happen and when.

Whether the regulations need to apply to very small projects is another question. I personally think having an exemption, as we do in California, for project of 10 or fewer fractions – that's a good thing. You don't need to do, for example, what Washington State does, which is go all the way down and say that if you're going to market four fractions in a house then you need to go through registration. Oregon's law, which also has an exemption for smaller projects, is less developed and, because there are fewer projects, there is less certainty as far as the timing and how long it will take to go through the process – but it seems relatively straightforward.

What are the particular challenges by region and/or state?

Anderson: It has to be an already established resort destination for a fractional development to have a chance in succeeding, because the resort infrastructure is already there. For Washington that doesn't exist today on any grand scale. Going down the list to Oregon, you could argues that it exists in Sun River or Bend – they already have the infrastructure and they've got great golf and are well-known resort areas. But are they big enough to handle a few [fractional resorts]? Is the area big enough to be able sustain more than a couple? I don't know – I would like to think that really good developments can help one another.

For California, it's a totally different story. You've got these incredible, already established, mature destination locations like Napa, Tahoe, San Francisco, L.A. and San Diego – you've got a lot of places people already identify with great vacations and now it's a question whether you

Marriott Grand Residence Club, Lake Tahoe, California

can create a resort real estate platform that gets people to go back and own part of it. California today is probably where your better opportunities are. The challenges for California are the typical things, like getting it financed and getting it through the incredible environmental and governmental hurdles for development, which are very strong. It costs more to build; therefore, it costs more to sell. Does that box out people who might be your audience if you didn't have those same costs to deliver? I don't think these problems are insurmountable – a good developer can deliver a product that people want to buy because they're already in a location where people want to go to.

Gilbert: Those three states are experiencing the same thing – the financing [challenges] and the [decreased] purchasing power of the consumer. A lot of people would take a home equity loan [or take money out of their portfolio] to pay for their fractional. Well, a good portion of the home equity has been lost and the portfolios are still down from the the pre-Great Recession highs of 2007.

Peterson: "There is an additional layer of time anytime you want to do something in California relating to entitlement. The most challenging U.S. destinations to register in are definitely New York and California."

Getting financing from a lender is extraordinarily challenging, and then the consumer having access to the financial resources has also been impacted. Commercial access and private individual access have both been compromised.

Grant: I think it's safe to blanket the biggest challenge as the economy. Of course, financing has always been a key to these things; the lack of funding hasn't been a help.

Peterson: Permitting in California takes a lot longer. It's more difficult to get into the marketplace in the locations there and developers face significant entitlement issues, and if the project is on the coast, you've got the Coastal Commission. There is an additional layer of time when you want to do something in California relating to entitlement. The most challenging U.S. destinations to register in are definitely New York and California. There's more of an environmental feel on the West Coast; a concern to protect the environment and make sure that projects aren't being developed that would negatively impinge and impact it.

Ragatz: Not so much Washington, but for Oregon and California it's the economy, the uncertainty of where the state, especially California, is going economically. For some reason Washington has not been hit as much as Oregon and California. In some of the emerging markets, like Napa, Monterrey and Carmel, it's really hard to get zoning through. In San Diego and L.A., a real problem is a surplus of whole ownership condos with price cutting going on.

Final Thoughts

Gilbert: In the long term, fractionals are going to do well. People used to look at second homes and say, I'll buy this second home and I'll own it for 24 or 36 months and flip it, and I'll make $100,000 or $200,000. That mentality has changed, the whole paradigm has changed, and you're not going to see the really significant appreciation in second-home real estate that you saw pre-Great Recession – and so people are going to have second thoughts about buying that full-ownership interest, which bodes well for the fractional product.

Ragatz: I suspect it's going to be at least a year, perhaps 18 months, until the fractional industry turns around. Even with the economic problems, over the next five or 10 years the West Coast is going to be one of the strongest markets in North America for fractionals because of the size of the population and all the vacation destinations. The long-term future looks really good.