

Tight-Penny News

VOLUME 7 • NUMBER 12 • SEPTEMBER 1989

Bad Condo Loans: Growing Trend or False Alarm?

A surplus of condos, some unfortunate business and banking decisions, and a leveling economy have resulted in a growing number of bad condo-development loans at savings banks in northern Massachusetts and southern New Hampshire. The bad loans—and in a few cases, allegations of fraud—have some people comparing the situation to a similar one in Texas in the early 1980s, when poor loan management and overbuilding led to a real estate crash and the ruin of dozens of savings and loan institutions and scores of developers. Others say such comparisons are out of line.

But warning signs abound. The J.P. King Company, a Gadsden, Ala., auctioneering firm specializing in retail real estate auctions, opened an office near Boston. The firm's presence—and the image of whole condo developments falling under the auctioneer's hammer—helped spur the comparisons with Texas.

Vern Petersen, a sales agent for the company, argues that auctions are not so much a sign of trouble as a way of avoiding it. "A lot of the problem here is people making some bad business decisions, holding out for top dollar. You can't sell for over market price. And market price is by definition the price people are willing to pay. Auctions are a way of finding that price quickly."

Also spurring the debate is a recent study that Veribanc, a Wakefield, Mass., consulting firm, conducted for the Boston Globe. The study found that in Massachusetts, problem real estate loans (those 90 days past due, past due and not incurring interest, and restructured loans) and write-offs (loans the banks have resigned themselves to not collecting) more than doubled in 1988. The study also found that area banks have more than doubled their loan reserves (the money they set aside to cover bad loans)—a sign that they expect more trouble. Finally, some people cite high CD rates in the area as further evidence that banks are anticipating losses they'll need to cover.

Don Inscoc, chief analyst for Veribanc, says "Nobody knows how bad it is yet. The numbers themselves aren't alarming, but the trend is. If the trend continues, there could be trouble. What happens depends mainly on the ability of the banks to convert the construction loans on bankrupt projects into single-family loans. That depends on a continued influx of people, which Depends on a continued healthy economy."

But Inscoc thinks comparisons with Texas are invalid. "If things get worse, it could wipe out the profits of a few institutions around here, and we might lose two or three. Construction loans will become harder to get, and banks will want builders to have more at stake in a project before they loan money for it. But I don't see a problem of wholesale bankruptcy or complete market collapse. The banks here are fundamentally healthy, the economy is well diversified, and the market is still essentially in balance."

That point of view is seconded by Robert Sennott, principal of Market Intelligence, a Hopkinton, Mass., consulting firm, and general manager of Century 21 Westward Homes. He sees the bad loans as signs not of an impending real estate price collapse, but as the result of some "poorly conceived" projects. The general relationship of supply and demand in the area, he says, "is still in a healthy balance." he believes that while prices will level or drop somewhat, it will be more of a correction than a crash.

"Without exception, well-planned, well-built, well-managed projects in good locations are selling well. There is tremendous demand for affordable housing. It may be a buyer's market now, but there are buyers. The units aren't selling because they are priced too high, and this is usually because they were built on overly expensive land. But if in a given town you try to sell anywhere below the median price, you will sell."

Vern Petersen feels many developers are carrying finished projects too long and falling deeper in debt because they hold out for the prices they originally envisioned getting.

"It's a buyer-driven market now," he says. "The question is not what you think you have to get, but what you can get. You have to sell based on what the market is now, not what it was in 1987, even if that means taking a short-term loss. These loans are only going to get harder to carry."

Not all observers are as pessimistic as Peterson. But most everyone agrees that the market will stay flat at best, and that the thing for overstocked developers to do is sell quickly. In the meantime, wise builders will be choosing sites and projects more carefully, spurred on by banks that are more wary and conservative than the were two years ago.—David Dobbs

Historic Preservation Activity Declines

Changes in the tax laws as a result of the Tax Reform Act of 1986 have been the major cause for a decline in use of the historic rehabilitation tax credit. Use of the credit declined 43% in FY88 as compared to FY87. Only 1,092 projects and \$866 million in investments occurred; this is the lowest level of historic rehab activity in over seven years and is one third of the 1985 level of over \$2.4 billion.

A report by the Preservation Assistance Division of the National Park Service cites the reduced benefits of investing in historic projects and the limited pool of investors who can use the tax credits as the major cause for the decline. Smaller projects (less than \$250,000) are now more common, with individuals or corporations controlling ownership.

Activity is underway, however,

to change the tax laws and once again make historic rehabilitation more inviting. In February, bills were introduced into both the House and Senate to amend the Tax Reform Act of 1986. The amendments would remove rehabilitation and low-income housing tax credits from the passive activity rules. In addition, these tax credits would be treated like all other business tax credits, with a reduction in the existing limitations on their use. The bills have broad support with 86 co-sponsors in the House and 25 in the Senate.

—Karen Kummer

R.S. MEANS REPORT



UNIT PRICE COSTS FOR GUT REHAB

Location Multipliers	
Boston, Mass.	1.12
Albany, N.Y.	.96
Portland, Maine	.89
Concord, N.H.	.93
Hartford, Conn.	1.02
Burlington, Vt.	.90

Job Description	Labor Hrs./Unit	BARE COSTS (not incl. Overhead and Profit)		
		Materials	Labor & Equipment	Total
Masonry renovation				
Cleaning, high pressure water only	.027/S.F.	—	\$.54	\$.54
Repoint brick, soft old mortar, running bond	.080/S.F.	\$.19	1.77	1.96
Cornice renovation				
Demolition, selected portions	.018/L.F.	—	.30	.30
New Framing, 2x8 spruce	.032/L.F.	.57	.71	1.28
Three-piece cornice, built-up, pine	.123/L.F.	3.30	2.63	5.93
Roof				
Slate repairs, individual pieces, scattered	.421/ea.	3.50	8.35	11.85
Remove old, edge hung aluminum gutters	.040/L.F.	—	.67	.67
Install wood gutters, clear treated fir, cedar or hemlock 3"x4"	.080/L.F.	4.00	1.71	5.71
Scaffolding				
Steel tubular, rent, 1 use/mo., no plank, building exterior, 1 to 5 stories	1.43/C.S.F.	13.00	31.00	44.00
Foundation				
Excavating, by hands with pick and shovel to 6' deep, heavy soil	2/C.Y.	—	34.00	34.00
Water proofing, asphalt, brushed on, 1 coat	.012/S.F.	.08	.24	.32
Insulate, extruded polystyrene 2.2 #/C.F.	.011/S.F.	.67	.23	.90
1-1/2" thick, R-8				
Backfill, by hand, heavy soil	.727/C.Y.	—	12.25	12.25
Compaction in 12" layers, hand tamp layers hand tamp	.235/C.Y.	—	3.96	3.96
Interior Demolition				
Gutting residential building interior including disposal	.089/S.F. (floor)	—	2.50	2.50
Partitions				
8' 2x4 wood studs with single bottom plate and double top plate, no waste, std. & better lumber, 16' o.c.	.160/L.F.	2.56	3.57	6.13
Drywall				
Standard, 1/2" thick, taped and finished on ceilings	.021/S.F.	.25	.45	.70
On walls	.017/S.F.	.25	.35	.60
Floors				
Subfloor, CDX plywood, 3/4" thick	.013/S.F.	.52	.28	.80
Wood strip flooring, white or red oak, 26/32x2-1/4", clear quartered	.047/S.F.	1.65	1.01	2.66
Sanding and finishing, fill, polyurethane	.27/S.F.	.50	.58	1.08
Trim				
Baseboard, stock pine 9/16x3-1/2"	.033/L.F.	.70	.71	1.41
Door trim including stops and casings, 2 sides, pine, 2-1/2" wide	1.36/Opening	20.00	29.00	49.00
Window trim including casings, stops, stool and apron, 2-1/2" wide.	.80/Opening	15.00	17.10	32.10

The above costs are based on a national average of unit price costs for typical repair and remodeling jobs. The jobs compiled here are a selection of possible items that might be included in a gut rehab of a brick row house. Any renovation project may also incur additional costs for cutting and patching to match existing work, dust protection, material handling and storage, temporary shoring and bracing, and other factors. Each project should be evaluated individually. These costs assume the work is of sufficient quantity so that minimum labor and equipment charges are not necessary. For small jobs, costs may be significantly higher.

This report is adapted from the 1989 edition of Means Repair and Remodeling Cost Data, published by the R.S. Means Company. Means publishes a wide range of construction cost data and related guides for the construction industry. For more information, contact R.S. Means Company, Inc., 100 Construction Plaza, Kingston, MA 02346; 617/585-7880.

N.J. Mandates Tests of FRT Plywood

New Jersey is about to become the first state to require testing of Fire Resistant Treated Plywood (FRT) before it may be certified for use in construction in the state. But even with rules on future FRT use, the state is not likely to head off a battle over replacement of the material already in place.

FRT plywood is plagued by premature deterioration. The problem is that the wood is engineered to artificially char in the event of fire (thereby retarding the spread of fire), and it is charring at far lower temperatures of 160° to 200°F—temperatures typically found on roof surfaces. The results are roofs that have sagged, buckled, rippled, and cracked within three years of the FRT's installation. Code does not require FRT plywood but allows it as roof sheathing on 4 feet to each side of a firewall that ends at the roofline. It's a popular option because it's cheaper than extending the firewall 32 inches above the roofline in townhouse units—a design that is inherently more prone to leaks.

In the high-cost New Jersey market, where townhouse construction has boomed as the affordable housing alternative, FRT plywood has been used as roof sheathing in an estimated 30,000 to 40,000 residential units. Many of those are townhouses. As a result of complaints and documented problems with FRT, the Division of Housing of the state's Department of Community

Affairs has ordered warranty companies to process requests to repair roofs with FRT sheathing.

Warranty dispute. Whether warranty companies will comply is uncertain. Home Owners Warranty Corp. (HOW) spokesman Ken Kanline says his firm, which is the biggest insurer of new homes in New Jersey (next to the state itself), will not. "Our position," Kanline says, "is that if it's under the first year, workmanship and materials would be covered. The builder would connect it, and if he can't correct it in the first two years, we would." But after that, HOW says, only major structural defects are covered. Roof sheathing is specifically not covered as a major structural component. "We stick to that," Kanline says.

If deteriorated FRT roof sheathing leads to a covered problem, Kanline says, that's a different story. "If a truss deteriorated or was likely to become unstable, we would make repairs," he explains. But so far, HOW has received only one FRT complaint, and it hasn't been resolved.

The magnitude of the FRT problem is the dilemma for insurers. "The estimate is that \$15 million to \$90 million is just HOW's share," Kanline says. HOW is insuring about 40 percent of the New Jersey new home market. How can the state expect HOW and other insurers to pay for repairs that are specifically excluded from their warranties, Kanline asks, when the state itself approved the language of the war-

ranty? "You can't go out and pay claims on items not covered," Kanline says.

Searching for new methods. This summer, the Division of Housing is expected to announce its testing standards for FRT plywood. This will determine which materials can be used in new construction. It's also looking for acceptable remedies on structures where the wood has deteriorated. Consulting engineer Marshall Frost of Frost, Christenson & Associates in Florham Park, N.J., isn't sure either is so easy to do. Frost has run tests on FRT plywood after examining roofs for condominium associations in the state. He's also working with the Division of Housing on its new standards.

One problem with standards is that not all the data is in. The Forest Products Laboratory, for instance, is not expected to release its findings until the fall. And the problem with remedies is that the treated plywood in some cases extends only 4 feet from each firewall. The center sections between firewalls are untreated plywood. Half-inch drywall would have to go under untreated sheathing that replaces treated sheathing to meet fire standards. That would create an uneven roof. Some shimming might be necessary, Frost says. New materials are being evaluated but they present problems too. "We've been looking into Homasote," Frost says. "It has the fire retardancy and it's water resistant,



A 1 3/4-inch deflection of this FRT roof sheathing causes a cracking over the truss, left.

but there are some problems with thickness that have to do with the span rating.

Another product, Tectrum, is a possibility for new construction. Although it also is about 1-inch thick, special roof trusses can be obtained to accommodate it, Frost says. He's concerned that both products are susceptible to moisture at the ends of sheets.

Ventilation needs. What is clear, Frost says, is that the chemicals in FRT plywood have reacted with heat and moisture to cause deterioration.

In some cases, Frost says, sloppy builders accelerate the problem by defeating ventilation designs. In his examinations for condo associations, he's found ridge vents inoperable because they are covered with felt paper. He also has found soffit vents defeated by

poorly fitted fiberglass batt insulation.

The findings so far leave builders in a quandary. Andrew Cattano, director of technical services for the New Jersey Builders Association, says the manufacturers indicate to him that builders need to improve their ventilation. But Cattano says that's unfair if builders are meeting code—and he believes they are.

Since late 1987, the American Plywood Association does not recommend the use of FRT plywood as roof sheathing. Code, however, continues to allow it, and builders who want to keep costs down and roofing simple continue to embrace it. New Jersey's forthcoming decisions likely will influence the material's viability in the market.

—Gary Mayak

Tax Talk:

Qualified Plan Benefits

by Irving Blackman

Qualified plans (pension and profit-sharing plans) have always been a tax-saving leader. They still are. But over the years Congress has been hacking away at the benefits the owner of the successful, closely held business can salt away into a qualified plan for his own benefit.

The new 1988 tax law takes a fresh swing that narrows the benefits even further. For tax

years beginning in 1989, a \$200,000 limit is placed on any qualified plan participant's compensation that is used to determine the benefit (for a typical pension plan) or contribution (for a typical profit-sharing plan). This applies to all plans—even plans that are not top-heavy. Prior to 1989, only top-heavy plans were subject to the \$200,000 limit.

What does this mean to high-

earning business owners? Consider this example. Joe Success owns 100% of Little Company and earns \$300,000 per year. Little Company has many other employees, each earning \$25,000. Prior to 1989, Little Company had a non-heavy 10% profit-sharing plan. Joe received a contribution of \$30,000 (10% of \$300,000) while each of the other employees received \$2,500 (10% of \$25,000). For 1989, Joe will only receive \$20,000 (10% of \$200,000) while the other employees will receive their same \$2,500 contribution. Sure, Joe could kick the plan up to 15% and still get the same \$30,000 (15% of \$200,000) but that would raise the cost to \$3,750 (15% of \$25,000) for each employee.

Wait, there's more. The \$200,000 limit is subject to the so-called "family aggregation rules." Any 5% owner and most highly compensated employees are subject to the rule. The salary of a husband, wife, and their children or grandchildren under the age of 19, who all work for the same company are all considered one unit for the purpose of the \$200,000 limit. For example, if Henry Owner earns \$200,000, his wife earns \$50,000 and his 18-year old daughter earns \$25,000, the salary may total \$275,000 but only \$200,000 will be considered, and the contribution must be split among the family.

What should you do if you think you may be caught by the new rules? Meet with your plan

consultant to determine if your present plan or plans should be amended, your contribution policy changed, a new plan started, or some other strategy employed.

Qualified plans are only one of the dozens of ways for business owners to take money out of their closely held corporations. ■

Irving Blackman, CPA, J.D., is with Blackman, Kallick, Bartelstein, Chicago, Ill. He specializes in closely held businesses. For more information on other ways to get cash out of your business, send \$25 for How to Take Money Out of Your Closely Held Corporation, to Blackman Kallick, Bartelstein, 300 South Riverside Plaza, Chicago, Ill. 60606.

Remodelers Sound Off

Here's what a few of you are thinking. These comments appeared in the NAHB Remodelers Council's First Quarter Economic Survey.

Skilled labor is extremely difficult to get. Even the vocational schools train for new construction only. Workers then have to be trained by us regarding the different practices required for remodeling.

—Merrimack, N.H.

Insurance rates are too high for the area I work in (northern N.H.). I cannot charge enough in the labor

rates to be able to make a satisfactory profit margin.

—Berlin, N.H.

Too many unlicensed contractors. Unknowledgeable builders trying to become remodelers, bidding too low then screwing up. Architects and suppliers not taking small contractors seriously. Remodelers need to be made aware of NAHB, NARI, etc. Architects and homeowners need to perceive remodelers as professionals and not as some dumb contractors with hammers.

—Silver Spring, Md.

This timber area is depressed. People can't afford to remodel or do new work due to poor local economy.

—Klamath Falls, Ore.



Computer Bits:

Design professionals can get detailed vendor information on design software from the Professional services Management Journal's (PSMJ) PSMJ 1989 A/E/P Software Directory. For more information, contact PSMJ, Ten Midland Ave., Newton, MA 02158; 617/695-0055.

Mechanical contractors can get help estimating with Turbo Mechanical 1.0. Contractors can take off fixtures, equipment, and specialty items from an electronic touch menu. For more information, contact Quick-Pen International, 384 Inverness Dr. South, Suite 200, Englewood, CO 80112; 303/799-6500.

For office personnel who need presentation-quality output of data, spreadsheets, charting, and more, Access Technology, Inc. offers Trapeze and other programs. For more information, contact Access Technology, 200 Heritage Harbor, Suite G, Monterey, CA 93940; 408/648-4000.

Estimators may be able to do their job more efficiently with R.S. Means Company, Inc.'s Means DataSource, an IBM compatible program that allows access to 20,000 costs lines. For information, contact R.S. Means Company, Inc., 100 Construction Plaza, Kingston, MA 02364; 716/585-7880.

2D drafting, 3D drafting, and database management are all available on one program, DRAWBASE, a CAD software system. For more information, contact SKOK Systems, Inc. 222 Third St., Cambridge, MA 02142; 617/868-6003.