

Timeshare Industry Consolidation, Negative Cash Flows, and Access to External Financing

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This article proposes remedies to a problem unique to the time share industry. Although these projects are frequently profitable in the long term, in the near term sales produce negative cash flow. The length of the project's sales cycle, the substantial marketing costs, and the considerable use of expensive forms of financing all combine to produce several years of negative cash flows even for the most profitable resorts. The article examines industry trends, then proceeds to an in-depth analysis of the relationship between sales, release fees, and negative cash flows. Financing arrangements commonly used in the timeshare industry are examined next, followed by suggested innovations which may solve the cash flow dilemma, especially for the small-scale independent time share developer.

Industry Trends

During the past 30 years the timeshare industry has overcome image problems and a strict regulatory environment to become the fastest growing segment of the tourism industry. Because time has become the new money, households have shifted their vacation dollars away from cabins and cottages and into timeshares. They pay a fee for the convenience of having others do the maintenance and for the ability to sample resort life around the globe. In short, consumers are willing to pay for the benefits of owning an interest in leisure real estate. Useful facts about the timeshare market in the United States include:

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Number of timeshare resorts	1,668
Average size	94.4 units
2004 sales volume	\$7.87 billion
Average price of a timeshare week/points equivalent	\$15,789 ²

New entrants to the market have also contributed greatly to the rapid growth of the timeshare industry. Marriott was the first national brand to enter the industry when the hotel firm purchased a timeshare resort in the mid-1980s.³ Other prominent hospitality brands and public corporations such as Hilton,⁴ Disney,⁵ and Cendant⁶ soon followed. These public companies, familiar to most Americans, have provided new respectability to timeshares making the product more acceptable. With their access to Wall Street capital, they have been able to add significant quality to this vacation product and bring it to market. The following table shows how timeshare resorts are distributed throughout the United States.⁷

State	Resorts	% of Total
Florida	376	22.5
South Carolina	130	7.8
California	126	7.6
Hawaii	91	5.5
Colorado	90	5.4
Other states (41)	855	51.3
Total (47 states)	1,668	100.0

The United States timeshare industry appears to have a competitive edge relative to the rest of the world, which by American Resort Development Association (“ARDA”) data set at 5,425 timeshare resorts for 2002. Nearly 30% of all timeshare units are located in the U.S.⁸ Measured by timeshare weeks

² The (“ARDA”) provides biennial updates of timeshare data at www.arda.org. This association also provides a monthly magazine with articles of interest to the industry.

³ Marriott’s timeshare site, ‘Marriott Vacation Club International,’ is at www.vacationclub.com.

⁴ Hilton Grand Vacations Club, at www.vacationownership.com/hilton.

⁵ Disney Vacation Club, at <http://dvc.disney.go.com/dvc>.

⁶ Cendant Timeshare Resort Group, at www.cendant.com. See Cendant’s 10-K for 2004 (on the SEC site at www.sec.gov/Archives/edgar/data/723612/000104746904006115/a2129356z10-k.htm).

⁷ American Resort Development Association, “U.S. Industry Snapshot (2004)” (www.ardafoundation.org/AM/Template.cfm?Section=Industry_Fact_Sheet).

⁸ $0.293 \times 5,425 = 1,590$, using 2002 figures. The preceding table uses 2004 figures. (See data at www.ardafoundation.org/AM/Template.cfm?Section=Industry_Fact_Sheet).

sold, the U.S. market commands just under 60% of global market share.⁹ According to a Bear Stearns analysis,¹⁰ the U.S. resort community is more efficient because the average American resort has more than 80 units versus a global average of only 60 units. Also, the U.S. timeshare industry has better brand recognition, market demographics, and financial strength.

Marriott, Hilton, and Starwood brands produce about 20% of all worldwide sales and 30% of all domestic sales.¹¹ Access to quantities capital at bargain rates has allowed these Fortune 500 companies to rapidly expand their resort operations which in turn permitted them to gain economy of scale advantages over independent developers and also permitted them to enter new markets that had been dominated by independent companies. Secondly, it led to the beginning of consolidation in an industry that has historically been quite fragmented. Still today the majority of developers are privately held, however, the pace of acquisition by public companies has been rapidly increasing.

Timeshare Sales and Negative Cash Flows

Timeshare resort developments are characterized by revenue and cost structures unique to the real estate field. Although timeshare developments can be very profitable, the developer must be able to sustain a series of negative cash flows which occur early in the life of the project. First, we turn to a discussion of revenue and then to a discussion of costs.

According to Robert Miller, president and general manager of Marriott Leisure, an effective balance of these sources of income are 60% from interval sales, 30% from financing activities and 10% from management fees.¹² Thus, a successful project can earn profits from customers in three different ways:

1. Selling vacation ownership interests (VOIs).
2. Financing sales.
3. Property management fees.

⁹ 0.585 = \$5.5b/\$9.4b.

¹⁰ Joseph R. Greff, "Timeshare: The Big Three Share in the Good Times," Bear Stearns Research (2005).

¹¹ See N. Rarnachandran, "Home Sweet Time Share," October 10, 2005 (U.S. News & World Report, www.usnews.com/usnews/biztech/articles/051010/10eevacate.htm); Orlando Sentinel, "Timeshares Become a Rapid-Growth Industry," May 1, 2006 (excerpt of story at http://portal.arda.org/Newsbriefs/arda_newsbriefs_060517.html). See also Starwood Hotels & Resorts Worldwide, Inc., "Company Overview and SWOT Analysis" Datamonitor (March 1, 2004).

¹² Diane R. Suchman, "Developing Timeshare and Vacation-Ownership Properties." (Washington, D.C.: ULI-the Urban Land Institute, 1999) ("Suchman 1999").

After covering costs for construction, sales and marketing, and general overhead, a profit margin of 15% on new sales is a common goal.¹³ Second only to potential income derived from sales is interest income on financed sales. According to a PricewaterhouseCoopers survey conducted on behalf of ARDA the average interest rate charged to new sales in 2003 was 14.1%.¹⁴ Although these receivables are commonly sold or pledged as collateral to lenders there remains a sizable spread between the interest rate charged to the customer and the interest paid to the lender. The final source of revenue is the management fee. This is an ongoing source of revenue for the developer so long as the owner's association continues to renew the management contract. There is no assurance that this will occur, however anecdotal evidence suggests that as long as the property is effectively managed and maintenance fees remain reasonable it is unlikely that the association will look for another property manager. Costs can be summarized in four components:

1. Property acquisition and development.
2. Sales and marketing.
3. Administrative.
4. Resort maintenance subsidizing during the process of selling out the inventory of intervals.

The ability to effectively manage these costs is critical to the success of a project.

Continual acquisition and development is necessary for a timeshare company to grow and remain a viable business. Since the developer is essentially selling out the total position in each project, once a building is completely sold out the source of revenue ceases. Thus, new development projects are continually being sought. Timeshare projects are usually built in phases, which affords the developer the luxury of assessing the demand for intervals. If demand is weak the project can be stopped or delayed until economic conditions improve. If demand is strong the project can be moved along more quickly.¹⁵ However, the construction loans, used for acquisition and development, can have a significant negative impact on cash flow, making the early stages of a project risky for both the developer and lender.

The acquisition and development loan is repaid as each interval is sold and, since most timeshare sales are financed, there is an instant negative cash

¹³ Interview of Joe Cox, Chief Accounting Officer Grand Crowne Resorts (July 6, 2005).

¹⁴ PricewaterhouseCoopers, *Financial Performance 2004 Edition: A Survey of Timeshare & Vacation Ownership Resort Developers* (available for fee from the research library of the American Resort Development Association, at www.arda.org/AM/Template.cfm?Section=Chronological_listing) ("PricewaterhouseCoopers 2004").

¹⁵ Edgar B. Madsen, "Timeshare Tax Assessment: Price versus Market Value," pp. 1-6, *The Appraisal Journal* (January 1999).

flow. These loan payments, called release fees, can range from 20% to 30% of the interval sales price. Based on a \$10,000 sales price and an average of a 15% down payment, or \$1,500, the developer would have a negative cash flow of at least \$1,000 prior to paying any sales commissions. Obviously, this leads to the developer's reliance on outside financing throughout the term of the project.

Sales and marketing costs make up the bulk of the four primary expense components. According to the survey conducted for ARDA, the average spent on sales and marketing in 2003 by the responding resorts was 47.6% of the net sales volume. Public companies reported a 45.7% cost, while private companies reported 51.0%.¹⁶ The difference between the costs for public and private companies provides evidence that public companies enjoy economy of scale advantages in the sales and marketing process over private companies. According to its 2004 10-K, Equivest Finance, Inc. (now Resort Funding International) reported that sales and marketing costs are the primary problem in the timeshare industry.¹⁷ The magnitude of these costs result in high-risk loans. Therefore, lenders tend to be wary of lending to a developer that doesn't have a proven track record of effectively managing the sales and marketing process.

The marketing efforts are directed at generating a sales presentation, known as a tour. One method of generating tours is the telemarketing of qualified prospects to sell them a vacation to the resort area, at a discounted price, with an obligation to attend a sales presentation. This is often referred to as a "mini-vac." "Do not call" legislation has deteriorated the effectiveness of this type of program and has driven up the cost. Another commonly used method is "off-premises-contact." This is usually a booth set up to provide tourist information and also obtain a commitment to tour a resort. To take the tour the prospect is generally given a gift such as show tickets or a dinner certificate.¹⁸

¹⁶ PricewaterhouseCoopers 2004.

¹⁷ Form 10KSB40, stating:

Relatively high cost of sales and marketing activities is a major impediment to achieving attractive shareholder returns. Controlling and reducing such costs requires sustained efforts to utilize new technologies and to build brand identity.

...

To support growth in its portfolio, the Company is seeking to expand its capital base through increased borrowings from financial institutions and the issuance of debt, equity or asset-backed securities in the capital markets.

(SEC filing available at www.sec.gov/Archives/edgar/data/820917/0001005477-00-002743.txt).

¹⁸ Suchman 1999.

If a resort is unable to provide an adequate volume of tours for its sales force, or if the tours are obtained at an excessively high cost, the viability of the project could come into question. A common goal for the cost of the marketing component is to be below 30% of the net sales volume. However, there are several factors that could drive costs significantly higher than this goal. First, if customers develop intolerance for these forms of marketing programs the efficiency of the marketing department diminishes because fewer tours will be generated. Due to the fixed cost nature of the marketing departments, the cost per tour increases substantially as the tour flow declines. Secondly, increased competition, due to new entrants into a market, can spread the available tour flow over more participants, effectively increasing the marketing costs for all involved. Thirdly, the timeshare industry is sensitive to the economical condition of its target market. If discretionary income declines among the targeted group the efficiency of the sales force will likely decline, which correspondingly increases the percentage of revenue that is consumed by marketing costs.

General and administrative costs are much lower as a percentage of revenue than the previous two components. However, again we see an advantage for public companies in this area, which reported an 8.8% G&A level in 2003 compared to a 10.7% expense level for private companies.¹⁹ This suggests that public companies are able to spread these fixed costs over a higher volume of sales. Most public companies operate between ten and twenty resorts, which can be administrated from a central corporate office. This provides a clear advantage over private developers, which rarely operate more than five resorts.

The size of the final cost component, the subsidy of resort operations during the sales processes, is directly impacted by how quickly the resort inventory sells out. This cost is incurred by the developer as an assurance to the first interval owners that they will not have to cover all of the maintenance expenses of the resort until there is an adequate owner base to absorb this burden. Since most developers also become property managers this seems to be a way for the developers to establish their presence among the new owners and increase the likelihood that the home owner's association, comprised of all of the interval owners, will select the developer to manage the day-to-day resort operations. The property manager earns a management fee based on a negotiated percentage of the annual maintenance fees collected from the interval owners.²⁰ Over the long-term, this revenue should far exceed the subsidy paid during the early phases of the project.

¹⁹ PricewaterhouseCoopers 2004.

²⁰ Suchman 1999.

Bear Stearns Example

Researcher Joseph Greff presented a very thorough example of what he termed a “typical” timeshare project, which consists of 150 units, each 1,000 square feet in size built on ten acres of land in three phases during a seven year cycle.²¹ The average week sold is projected to sell for around \$24,000 and each unit is allocated 51 weeks to sell. Cash flows lag earnings by many months, even years. Revenues can be booked immediately if the buyer pays at least 10% down and the project (or phase of a project) is essentially complete. Costs are booked on a proportionate basis as units are produced.

The example estimates that the construction and management phase run for about seven years concurrently. The financing phase runs concurrently with the other two plus an additional four years. Therefore, an entire project start to finish can run for about a decade with the bulk of the positive cash flows occurring in years 4 to 7. Management fees are not significant in this example and are not considered. The present value at the end of the seventh year of cash flows from securitization in years 8 to 11 is about \$2 million. This is omitted for purposes of brevity. The average internal rate of return (IRR) on resorts produced by the Big Three firms is about 20% annualized. The following shows the cash flows attributed to the seven-year life of the project.

Cash Flow Estimates for a Typical Timeshare Resort

Total Sales during 7 years:

150 units x 51 weeks per unit x \$23,900 price per week \$183 million

Total Costs during 7 years:

Production costs	\$58	
Sales costs	82	
Administration	<u>9</u>	
		<u>\$149 million</u>

Pre-tax profit: \$ 34 million

Pre-tax profit from financing customer purchases: \$ 14 million

Total Profits: \$ 48 million

²¹ Joseph R. Greff, “Timeshare: The Big Three Share in the Good Times,” Bear Stearns Research (2005) (“Greff 2005”).

A complex of 150 apartments might sell for as much as \$75,000 per unit when completed and occupied. This would produce a gross sale price of \$11,250,000. The same complex, fitted out for timeshare sales, produces \$183 million in gross sales because each unit can be sold fifty-one times, once for each week of the calendar year with one week held out for repairs and maintenance.

However, as shown in the table below, sales costs exceed production costs (hard costs) by a factor of 1.4 (\$82/\$58). Sales costs comprise 55% of all costs and eat up nearly 45% of total sales. These facts demonstrate that timeshares have not quite achieved the “mainstream” acceptability their promoters sometimes suggest.

Timeshare developers charge buyers about 13% per annum to finance the purchase of each timeshare week. The developer pays its credit facilitator about 5%. The net spread between the two rates (net of all related expenses) is estimated to produce a pre-tax profit of \$14 million, as shown in the preceding table.

This example closely examines the use of credit resources on the part of timeshare resort developers. The following table shows the first year cash flows for the typical resort and continues the example from the previous table. Gross sales in the first year are \$6.4 million, based on the estimated sale of 268 weeks. “Cash Interval Sales” works out to only \$5.8 million. Over 55% of cash interval sales²² are provided by the credit facility which lends purchase money to buyers. Cash buyers provide almost 38% of cash interval sales,²³ while down payments related to financed sales bring in a mere 7%²⁴ of cash interval sales. A small portion of the financed sales (\$0.57 million) is deferred. Each year during the sales cycle this line item accumulates, based on financed sales, and by the end of year seven it becomes almost \$27 million.

First Year Cash Flow

Sales: 268 weeks sold x \$24,000 each	\$6.4 m	
Cash sales: 0.35 x \$6.4 m		\$2.2 m
Financed sales: 0.65 x \$6.4 m	\$4.2m	
10% down		\$0.4 m
Cash advanced from credit unit:		
.15 x (\$4.2 m - \$0.4 m)	\$0.57 m ²⁵	
.85 x (Fin'd. Sales – Down Pay.)		<u>\$3.2 m</u>
Cash interval sales		\$5.8 m ²⁶

²² $0.55 = \$3.2/\5.8 .

²³ $0.379 = \$2.2/\5.8 .

²⁴ $0.069 = \$0.4/\5.8 .

²⁵ Deferred until the end of year 7.

²⁶ The figure in the Greff report is \$5.9 million due to differences in rounding.

Costs (cash):

Production (planning, land, building, FF&E)	\$26.6 m	
Sales and Marketing	\$10.5 m	
General & Administrative	<u>\$1.3 m</u>	
First year cash costs		<u>\$38.4 m</u>

First Year Cash Flow (pre-tax) \$32.6 m

So, for a common, garden-variety 150 unit timeshare located in the U.S., the first year pre-tax cash flow is negative \$32 million. According to the example, the developer has already borrowed \$3.2 million to finance a portion of the initial sales. A closer reading of the example indicates that the developer obtains another \$22 million of debt financing from individual investors. Therefore, sometime during the first year of this typical project, the developer must come up with about \$7.4 million of equity finance capital ($\$7.4 \text{ m} = \$32.6 \text{ m} - \$3.2 \text{ m} - \22 m).

Typical Financing Options

Obtaining sufficient and reasonably priced external sources of financing is critical to the continued growth of the timeshare industry. Access to external financing is especially important to independent, privately-held developers. There are three primary aspects of the business that timeshare companies seek to support with external financing:

1. Property acquisition and development.
2. Consumer financing.
3. Resort operations.

Over the past decade the financing products have changed to meet the various needs of developers and additionally the cost of funds have diminished as lenders have learned the intricacies of the industry.

The typical acquisition and development loan is much like a standard construction loan. Based on an approved budget for the land purchase and construction costs a funding cap is set. As expenses are incurred the lending institution reimburses the developer. According to a loan document obtained for the purposes of this paper, the lender retains 10% of the amount to be disbursed. Once construction is completed the retained portion of the loan is released to the borrower.²⁷ The loan document used for research purposes was obtained from an independent company with annual net interval sales exceeding \$25 million, it is not known if public companies experience the

²⁷ Resort Funding, LLC, "Construction and Development Loan Agreement" (2005, www.resortfunding.com).

same retention percentage on construction loans. While the building is under construction the developer can begin to pre-sell intervals, as long as the first interval owners will be able to use their unit within twelve months of the purchase date.²⁸

From the time that funds are advanced to the developer the lender has a lien on the condo units and the intervals that will be available for sale. The loan is paid back as each interval is sold. This is referred to as the release fee. The amount of the release fee per interval is negotiable but it tends to be around 20% to 30% of the interval sales price. Most lenders structure these loans so that they will be paid back after two to three years of sales. If sales levels fail to meet projections the repayment would be delayed and the loan could go into default, in which case the lender can make the note immediately due.

The payment of the release fees can put a developer in a cash crisis because the size of the down payment is usually exceeded by the sales and marketing expenses and the portion of loan repayment that is due for the interval sale. Therefore, developers attempt to balance the sales of inventory between buildings that are paid off and those that still have loans outstanding. The danger here is that if the sales department is not selling enough intervals in the new buildings then the developer will fall behind the repayment schedule and the lender will begin to exert pressure to ensure the loan does not go into default.²⁹

Other than the possibility of obtaining a lower interest rate, there does not seem to be a particular advantage gained by public companies over privately held companies regarding acquisition and development loans. However, since this type of loan contributes to a significant negative cash flow on new sales, it becomes imperative that other sources of capital be available to maintain resort operations and the sales and marketing efforts. Therefore, acquisition and development loans can be viewed as the catalyst for companies seeking to obtain loans secured by receivables as well as unsecured working-capital loans.

The financing of receivables is the area that has seen the greatest increase in sophistication within the timeshare industry. Due to the fact that developers, whose average interval sales price was between \$10,000 and \$15,000, financed approximately 88% of their sales volume in 2003 it is reasonable to assume that receivables financing is the lifeblood of many organizations.³⁰ Because of the critical nature of this type of funding it is vital that a company obtain the absolute best financing terms if they are to remain competitive.

²⁸ Edgar B. Madsen, "Timeshare Tax Assessment: Price versus Market Value," pp. 1-6, *The Appraisal Journal* (January 1999).

²⁹ See Equivest Finance Form 10KSB40 (SEC filing available at www.sec.gov/Archives/edgar/data/820917/0001005477-00-002743.txt).

³⁰ PricewaterhouseCoopers 2004.

Forms of Receivables Financing

There are three primary forms of receivables financing in the timeshare industry:

1. Hypothecation
2. Portfolio sales.
3. Securitizations.

Hypothecation. The hypothecation of receivables occurs when receivables are pledged as collateral for debt financing. According to a survey conducted by ARDA, hypothecation is the most frequently used form of receivables financing in terms of the number of transactions completed. In 2003 there where \$902 million worth of receivables hypothecated. The weighted average interest rate for companies that responded to the survey was 6.1%.³¹

In a hypothecation transaction the recourse for defaulting contracts remains with the developer. Therefore, if a particular contract enters into a default status, even though it may not be completely uncollectible, it is sent back to the developer and is replaced with a performing contract. Lenders withhold a portion of the total amount of the loan as a form of protection against the non-performance of the loan. This creates an over-collateralization, which limits the lenders risk if the developer would be unable to replace defaulting contracts in a timely manner.³² Hypothecation transactions do not need to be as large as portfolio sales or securitizations, therefore, it is the most commonly used form of receivables financing for smaller companies. The interest spread between the consumer financing terms and the hypothecation agreement is retained by the developer. However, the monthly servicing fees and the interest paid for the loan offsets a sizeable portion of the interest income. According to a hypothecation loan agreement used in this research, there is a monthly charge of \$4 per contract plus a one-time administrative fee of \$10 for each new contract.³³

Hypothecation offers advantages to developers, especially smaller operations, which portfolio sales and securitizations cannot match. First, once a solid relationship has been established with a lender, financed contracts can be grouped according to the loan requirements, sent to the lender and funding received within a matter of one or two weeks.³⁴ Such a quick turnaround from the inception of the transaction to the funding allows developers to overcome

³¹ PricewaterhouseCoopers 2004.

³² Lacy Chandler, Loan Administration Manger Grand Crowne Resorts, Interview (July 6, 2005) ("Chandler 2005").

³³ Loan agreement, Peoples National Bank of Kewanee (2002).

³⁴ Chandler 2005.

the dangers of an unforeseen cash short-fall. Secondly, the advance rate received and the interest rate paid are more favorable than with portfolio sales. In 2003 the weighted average advance rate for hypothecations was 86.1% compared to an advance rate on portfolio sales of 85.8%. The weighted average interest rate on hypothecations, during the same period, was 6.1% compared to 6.9% for portfolio sales.³⁵ Both the advance and interest rate for hypothecations were worse than was received on securitizations, however, the third advantage of hypothecations is that the transaction size can be much smaller than securitizations or portfolio sales without the transaction costs making the transaction uneconomical.

There are several disadvantages of hypothecations that diminish the advantages previously mentioned. First, the fact that the recourse for the performance of the underlying contracts remains with the developer presents a two fold problem. Developers run the risk of having to use contracts such as same-as-cash deals, which they could have kept in-house, to replace contracts that have become unacceptable to the lender. The other problem is that as developers hand over the contracts they have hypothecated they are giving up control over the collection process until a contract begins to perform poorly. If the developer's loan administration department maintained contact with the purchaser it is possible that fewer contracts would default and thus need to be replaced. According to Lacy Chandler, the loan administration manager at a mid-sized privately owned resort, the fact that the lender assumes the responsibility for the servicing of the contracts does cause problems. There are frequent customer complaints as to how they are treated by the lenders loan administration department. This could have a negative impact on the retention rate of interval owners and the opportunity to upgrade them into a more expensive condo or points program in the future.³⁶

The second disadvantage of hypothecating receivables is that it is a short-term solution to the long-term negative cash flow problem. The speed and ease of using this type of financing may prevent a developer from pursuing other options which, though they may be more complicated, could potentially offer a cheaper and more bountiful supply of capital.

The third disadvantage is that this financing method causes a developer to become dependent on one lender for the majority of their capital needs. From the review of a couple hypothecation contracts it appears that it is common for lenders to require exclusivity in regards to receivables financing. Therefore, if the lender determines that a borrower is unable to satisfy certain loan covenants the developer may be left to scramble to try to obtain sufficient capital to maintain operations.

³⁵ PricewaterhouseCoopers 2004.

³⁶ Chandler 2005.

Portfolio Sales. Another method of financing receivables, the selling of a portion of the receivable portfolio, is a transaction in which the recourse for defaulting loans is transferred to the portfolio purchaser, unless the sales agreement stipulates that they seller must buy back all non-performing contracts. According to the survey conducted for ARDA, there were 17 portfolio transactions conducted by four companies in 2003 for a total of \$79 million. Though the dollar volume of the portfolio sales increased from \$27 million in 2002, this form of receivables financing remains by far the least used of the three methods discussed here.³⁷ In a true sale the developer will no longer have any involvement with the performance of the underlying contracts. However, there are instances in which the developer will continue to service the loans and thus earn a servicing fee and perhaps even maintain a residual interest in the portfolio.

The primary advantage of converting receivables into cash through the selling of a portfolio is that the developer is no longer responsible for the performance of the portfolio. This can give the company the ability to reduce the size of their loan servicing department and therefore lower collection costs, administration costs and the cost of attaining capital through loan servicing. Additionally, without the collection responsibility, the developer can focus on areas of the business that are the core competency of the organization, such as the construction and sales of resort property.

Portfolio sales have a lower advance rate and a higher cost than both hypothecations and securitizations. However, there are other disadvantages that companies pursuing portfolio sales should consider. First, by selling the right and responsibility to service the financed contracts the developer may alienate their customers. Second, the servicing company may not handle the customers with the same level of respect as the developer's staff would in most cases. Because the timeshare industry is still trying to overcome a poor reputation it is important that new owners have positive experiences with their home resort from the sales processes all the way through repayment of the loan. If the relationship starts to sour it could result in bad word-of-mouth advertising disseminated amongst sales prospects. The third disadvantage from this form of financing is that the company is forgoing future residual income for a one-time cash infusion.

Securitization. The final type of receivables financing to discuss in this section is the securitization of a portfolio of consumer loans, known as asset-backed securities ("ABS"). In terms of dollars transacted, this is the largest form of financing used within the industry. Again, according to the respondents of the ARDA survey there were \$1.2 billion in receivables securitized in 2003 through only twenty issues, for an average of \$60 million per issue.

³⁷ PricewaterhouseCoopers 2004.

It is interesting to note that this volume was generated by only eight respondents, meaning that they each averaged total securitizations of \$150 million for the year. In total the survey received responses from 43 companies which, combined, reported net sales of \$4.7 billion. Factoring in the average down payment received of 14.6%, there would have been \$4.0 billion in financed volume and so the securitization of \$1.2 billion represents 30% of the financed sales reported.³⁸

The ABS market grew substantially during the 1990s when traditional real estate lenders, such as commercial banks and insurance companies, tightened their underwriting policies. They toughened their lending restrictions in response to a market downturn that followed a period of excessively speculative building. The result of the speculative building was an oversupply of commercial real estate, leading to asset value reductions and loan defaults. Securitizations were effective in this environment because they allowed the risk to be diversified, in terms of the default risk of the underlying assets, and then spread among a large base of investors.

There are two methods most commonly used to securitize timeshare receivables; through the creation of special purpose entities (SPEs), and through private placements with institutional investors. The use of institutional investors, similar to a private issue, gives the institutions involved the discretion over how to distribute the credit risk of the portfolio. The disadvantages to the developer of using institutional investors to securitize the portfolio include the loss of control of the loan servicing and increased loan administration fees.

Use of Special Purpose Entities. The use of SPEs can eliminate those disadvantages. When a SPE is used the portfolio is sold from the originator to the entity, which is established by the originator but maintains a bankruptcy remote status from a liability perspective. For a securitization through an SPE to work effectively, the finance and legal departments of the originator must be sure that they attain a bankruptcy remote status and that the sale of the portfolio can not be ruled to be an asset transfer. If either of these criteria is not met the transaction will likely not go through and all administration costs incurred will have been wasted.

The SPE will usually manage the payment processing of the receivables, any collection efforts deemed necessary and the payment of principal and interest to the investors. For this service the entity receives an administration fee. Therefore, the originator of the loans can benefit by receiving favorable funding terms, retain a residual interest in the receivables through the interest spread between the consumer loan and the rate paid to the investors and earn a servicing fee which should offset the loan administration costs.

³⁸ PricewaterhouseCoopers 2004.

This form of financing suits the timeshare industry particularly well because the geographic and credit diversity of the underlying consumer loans allows for a well diversified security issue. The securitization of receivables is the most evolved form of financing in the timeshare industry, and though it requires sophistication on the part of the developer's finance and legal departments it offers several benefits over the tradition forms of financing.

The first benefit gained from this form of financing is the low cost of the capital that is raised. From the transactions that were reported to ARDA in 2003 the weighted average advance rate was 86.5% and the average interest rate paid was 3.6%. The advance rate in 2003 was actually down from an average of 91.1% in 2002 but the interest rate on the issue improved from 5.6% in 2002.³⁹ The economic environment of low interest rates in 2003 likely had an impact on the lower percentage of interest paid on securitizations, however, the fact that this form of financing receivables is significantly cheaper than the other methods shows that there is a willing market for this type of credit exposure.

The second benefit derived from the securitization of receivables is that once a developer has access to the public capital market they will have significantly diversified and increased their available sources of funds. This benefit can not be overemphasized, because the industry is in constant need of outside capital. Additionally, once the legal filings have been completed on the first securitization issued a company can use them as a template for subsequent transactions and thus decrease the completion time of the future transactions.

The third benefit gained through the ability to securitize loan portfolios is that a greater amount of financing can be obtained. The financial market has a greater capacity for absorbing a large issue than the specialty lenders that are typically used in hypothecation loans. Therefore, a company can get more funds through fewer transactions which will decrease the overall cost of capital.

Though there are significant advantages that companies can obtain through the use of securitizations there are negative aspects that may make them infeasible for certain organizations. First, they take much more time than standard hypothecation loans. The complexity of SEC filings and the financial reporting and due diligence required by credit rating agencies are the main contributors to the lengthy time it takes to finalize a transaction. The fact that these issues can take up to six months to complete means that developers must have reliable methods of projecting cash flows to insure that operating capital remains at sufficient levels while the transaction is in process. They must also be able to build up a large pool of loans to be used in the securitization and therefore, forgo funding while the pool is developed.

The second disadvantage to consider is that there are higher legal and administrative costs incurred due to the sophisticated nature of the issue. The

³⁹ PricewaterhouseCoopers 2004.

cost of securitization can become uneconomical if the size of the issue size is not adequate.

Third, Wall Street is reluctant to work with issues that are under \$50 million. This effectively eliminates developers with annual sales of less than \$30 million, and therefore the majority of the industry participants do not have access to this form of financing.⁴⁰

Working Capital Loans/Lines of Credit

The last funding type that timeshare companies try to acquire is working-capital loans or lines of credit. The purpose of these sources of capital is to insure that there will be enough money to continue operations if the business goes through a stretch of diminished cash flow. Such loans or credit lines are often secured by a portfolio of receivables. Therefore, the company must be of sufficient size so as to be able to retain a significant portion of their receivables in-house to utilize this type of financing. Having access to quick sources of cash that can be paid back once the liquidity position improves is important for companies to have at their disposal. Otherwise, a company may find that its options are limited to turning to a higher cost and more restrictive financing source.

In the timeshare industry, it is apparent that public companies have an advantage in the financing of their receivables due to the sheer magnitude of receivables that can be generated through the operation of multiple resorts and sales facilities. Since Wall Street will not consider an issue of less than \$50 million, only the largest players are able to tap the public market. Public companies also have an advantage in obtaining working-capital loans or revolving lines of credit. Banks are often reluctant to loan money to an independent developer unless the developer personally guarantees the note. On the other hand, public companies have many stakeholders that are personally interested in the success of the enterprise and therefore hold management accountable for their actions. This fact makes the option of loaning to a public company more appealing to banks.

Remedies and Innovations

Six different innovations are offered below to address the negative cash flow dilemma, with special emphasis on any methods which might offer support to the small-scale developer.

Reduce Sales and Marketing Costs. As shown previously, sales costs eat up nearly 45% of total sales. In previous generations, households with effective buying power gladly spent several weekends each year driving through the back woods of Wisconsin, Minnesota, upstate New York, and

⁴⁰ Suchman 1999.

elsewhere seeking out the perfect weekend hide-away. In other words, second homes were main stream, so much so that buyers actively sought them. Not so the second home buyer today. People must be cajoled and nagged to take a “tour” just so the timeshare developer’s sales force can play the odds and find effective buyers. Shopping for a timeshare is about as popular as going to the dentist.

The marketing model must be inverted so that buyers seek out the properties. This can be done through increased broadcast advertising and discounted vacations at timeshare resorts without the obligatory two-hour high pressure sales session. It is worth noting that the only broadcast support for timeshares is sponsored by Time Shares Only, a web-based company that re-sells weekly units for families who no longer want them. What a terrible testimony!

Securitization. The securitization of a portfolio of receivables is the most cost effective method of obtaining receivables financing, if the issue is of a sufficient size. The challenge faced by the majority of timeshare developers is that they do not have sales levels that produce enough receivables to tap into the public market. This leaves them dependent upon specialty lenders that focus on the small to mid-sized companies in the industry. Since there are many private developers with sales under \$30 million per year and not that many specialty timeshare lenders, there is not much need for lenders to compete with one another by cutting interest rates to borrowers. If these developers could obtain, or create, large enough pools of receivables they would be able to obtain lower cost financing in order to compete with the specialty lenders that currently possess much bargaining power.

Independent timeshare companies, even if they compete against each other for sales, could form special purpose entities that are designed to purchase the receivable portfolios of each of the participating resorts. In this way they could amass a large enough pool to make accessing the public market economically feasible.

Agreeing to pool assets together, in an effort to lower funding costs, would benefit participating resorts in several ways. First, the companies would be able to lower their weighted average cost of capital by obtaining funding for their receivables at less expensive rates than they could through traditional hypothecation loans. This would allow them to increase their interest income because the spread between the underlying consumer loans and the rate paid to investors would be larger than if their portfolios were hypothecated. According to the study of the industry produced by the Urban Land Institute, large timeshare companies earn spread income of 400 to 600 basis points while smaller companies earn 100 to 250 basis points.⁴¹ Therefore, it is conceivable that each of the participating developers could at least double their net interest income.

⁴¹ Suchman 1999.

Secondly, the companies could increase the average advance rate received on their portfolios. The weighted average advance rate received on securitizations in 2003 was 86.5% or 40 basis points higher than the advance rate received on hypothecated portfolios. However, the highest rate received on a securitization was 94% while very few hypothecations even reached the 90% rate.⁴² If a cartel is comprised of resorts with strong credit histories and from geographically diverse locations, their perceived risk may be significantly lowered, allowing them to attain an advance rate of over 90%. This would have an enormous impact on each resort's cash flow.

Third, the companies would be able to retain interests in the security issue. For example, according to Starwood Hotels & Resorts Worldwide, Inc.'s 2004 10K they earned \$15 million on the sale of \$133 million worth of notes in 2003 and \$14 million on \$181 million worth of note sales in 2004. The retained interests were in the form of interest only strips and were treated as trading securities for the purposes of financial reporting.⁴³

A real-world example of how a securitization transaction could be structured can be seen by looking at Vistana's issue placed in 1998. Vistana, a large publicly traded resort developer, was able to raise \$66 million by pledging \$71 million of consumer contracts. This equated to a 93% advance rate. The securitization was issued in two tranches. There was a AAA-tranche of \$32 million and a A-tranche of \$34 million. Vistana, in effect, held a \$5 million junior subordinated tranche that would be used to offset the first losses of the portfolio. In total the cost of the transaction was 6.3%, which would likely be cheaper in today's low interest rate environment.⁴⁴

Fourthly, the participating companies would be able to divide the administrative costs of the transaction and loan servicing. Because the proper establishment of a SPE, the required SEC filings and the requisite credit ratings can make such transactions costly, sharing these expenses among the members of the cartel would further increase the economical benefit derived from this pooling activity.

Because resorts will continue to need to receive funding on their receivable portfolios it is important that developers become creative in an effort to obtain the lowest cost of capital possible. The fierce competition and consolidation that is going on in the industry right now makes such efforts even more critical if small privately owned resorts are going to remain viable businesses. The formation of a cartel for the purpose of obtaining low cost funds appears to be an option worth pursuing.

⁴² PricewaterhouseCoopers 2004.

⁴³ Starwood Hotel & Resorts Worldwide, 10-K (2004, www.sec.gov/Archives/edgar/data/48595/000095015305000427/p70255e10vk.htm).

⁴⁴ Suchman 1999.

Revolving Credit. Public companies usually have access to lines of credit that can be drawn upon to maintain sufficient liquidity in times of low cash flow. These lines are usually obtained through large financial institutions and secured by an equivalently sized receivable portfolio. Many independent developers, however, have to hypothecate the majority of their paper shortly after the contract has been written to maintain operations. Therefore, there is little left over to serve as collateral on a revolving line of credit. To obtain this type of financing the developer usually has to personally guarantee the loan. If a lender believes that the developer is over-leveraged they will be reluctant to write the loan.

Because the construction loan in a timeshare development is paid back after a building is 70-75% sold out and timeshare owners often sell their inventory back to the developer there is usually a significant amount of unsold inventory that exists in buildings that have no debt. These unsold intervals could then serve as collateral for short-term loans to be used in times that cash flow is tight. Such a loan agreement would be particularly useful during a resort's low season. Due to the seasonal nature of the travel industry most resorts, other than in destinations such as Hawaii, experience a time of year when there is much less demand for units. During these seasons timeshare companies scale back operations to bare bones and push off investments to ensure that cash reserves do not fall to dangerously low levels. The need to conserve cash can lead to undue stress being placed upon management as well as deterioration in critical vendor relationships. Being able to obtain a source of cash, secured by future sales in debt-free buildings, would go a long way towards making the low season more bearable for all stakeholders.

Mezzanine Financing. Mezzanine financing is often used in commercial real estate to reduce the percentage of capital that a developer has tied up in an investment. For example, if a lender will write an 80% loan, leaving the developer to come up with 20% of the purchase price, the developer may be able to obtain mezzanine financing of 10% so that they can reduce their contribution to only 10% of the total investment. Though the mezzanine portion of the financing is generally obtained at a considerably higher interest rate than the first mortgage, if the project is successful in creating value the returns on the developer's capital can be increased to a degree that makes the costlier financing economical.⁴⁵

Though there doesn't appear to be a considerable amount of mezzanine financing used in the timeshare industry, it does seem that it could be a valuable source of capital. Access to this type of financing would allow a developer to retain more of their capital which could be used to subsidize the

⁴⁵ Micheael Fickes, "The Many Faces of Mezzanine," National Real Estate Investor (May 1, 2001).

negative cash flow nature of the business or, more likely, used to pursue other investment opportunities. Additionally, tapping into the mezzanine market would be less restrictive than bringing in an equity partner. Turning to an equity partner usually leads to more reporting requirements and slower decision making capabilities, which could prove to be costly in the fast paced nature of the business.

Discounts to Buyers. For the small-scale independent timeshare developer, a simpler and less-expensive solution may be the buyers of the units: An offer from the developer to discount the loan balance to the buyer upon the first anniversary of regular, timely payments as an incentive to payoff early. The discount offered could be as little as \$1 below the average cost per contract of the alternative financing methods listed above. Why spend money which effectively leaves the property? If the developer is compelled to incur the costs of special financing, converting such costs into a benefit (i.e., the discount on the loan balance) for the loyal buyer-borrower-property owner produces good will which enhances the property.

Lease Options. Leasing the time units deemed less desirable by the market would permit the developer to generate fee income without, perhaps, having to pay a release fee to the construction lender. Most customers purchasing a lease option will likely not exercise it anyway, so the developer can always be assured a supply of some units to promote. Since these units might not ever have sold in the first place, there is little marginal cost to using the lease option in such a targeted manner.

Conclusion

The timeshare industry is a rapidly growing and fast paced business that can be lucrative for developers that are able to compete for projects in desirable locations. The acquisition and development costs in locations that experience high tourist demand will be prohibitive to an under-capitalized organization due to the competition for potentially successful resort sites. As the public timeshare companies continue to expand through the development of new and acquisition of existing resorts it will become even more difficult for the privately owned firm to grow revenues and profits over the long-term. Unless these small firms innovate, perhaps through the use of targeted discounts to borrowers and lease options on less desirable time intervals, publicly traded competitors will either buy them out or force them out of business. Before timeshares can become acceptably “main stream” industry leaders must provide better support via broadcast advertising and more pleasant sales episodes.

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