Second Homes 411
Blogging about the 2nd Home Lifestyle

Are Fractional Replacing Second Homes?

- In this current economy… for those unwilling to give up their vacations and uneasy about holding onto cash, fractional ownership may be an inexpensive option
- When the economy comes back, fractional ownership will take up a huge demand
- Banks have historically been more willing to lend to second-home and fractional ownership investors, as opposed to timeshare and condo hotel investors, because they have the potential for appreciation

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In this current economy, Americans are scaling back on luxury items like vacations, while others are defaulting on second homes that were purchased for tax reasons and the prospects of major profits. For those unwilling to give up their vacations and uneasy about holding onto cash, fractional ownership may be an inexpensive option.

The fractional ownership market emerged as an ideal investment in 2008 because it allowed investors to (partially) own high-end properties in a luxury resorts for a low price and without any maintenance responsibilities. For example, a three-bedroom unit in Vail, Colorado — a popular fractional ownership location — may cost $4 million to purchase outright. But an investor who is interested in securing vacation time and confident that the unit will appreciate over the long-term may only have to pay an initial $400,000, plus yearly fees of approximately $10,000, which cover maintenance and services costs. Though fractional ownership may seem like a great way to secure top-notch lodging and make enough money on the sale of the fraction to make those vacations essentially free, there are many caveats that go along with fractional ownership.

Like Real Estate Investment Trusts (REITs), fractional ownerships offer investors the opportunity to own an asset that they may otherwise never be able to afford. With fractional ownership, however, not only are you able to invest in a high-quality asset but you can actually enjoy that asset while you own it — something that's difficult to do if you're part of a REIT that invests in office buildings. Another perk of investing in a fractional ownership is that many of the hospitality chains that offer this investment are upscale resorts with five-star amenities. By paying the yearly fees, owners are not just covering the costs of repairs and upkeep, they are also paying for high-end services that are not normally offered to hotel guests. Owners can have groceries purchased and stocked, family pictures displayed and dining reservations made. Some resort communities even offer free spa treatments and rounds of golf to its owners.

One advantage that many fractional owners believe they have over second homeowners is that, instead of paying for a mortgage that would cost the same whether they lived there all year long or only visited for one week, fractional owners only pay for what they use. "Fractional ownership allows you to buy just the amount of time in a vacation home that you can actually use," said Dr. Richard Ragatz, president of Ragatz and Associates, a research firm that focuses on the worldwide resort industry. "Research shows that the typical household uses their wholly owned vacation home no more than four to five weeks a year. The rest of that time it sits idle, accumulating maintenance costs, taxes and repair fees."

Most fractional owners are allotted anywhere from two to 13 weeks a year, depending upon the number of owners. Timeshare investors are typically allowed a maximum of two weeks per year, which usually must be used consecutively. Another advantage fractional ownerships have over timeshares is that owners receive a deed for their fraction of the property, allotting them a share in the property's equity. "The day after you buy a timeshare you've lost, on average, 55 percent of what you've paid for," Ragatz said. With a fractional ownership, you're able to share in any profits the property makes due to appreciation, just as a second homeowner would. Ragatz also noted that there is a large difference between where an investor's funds go in a fractional ownership versus a timeshare. His research shows that 75 percent of a timeshare investor's money goes toward the timeshare company's administration, marketing and sales efforts, meaning only a quarter of these funds actually go toward the property. In the case of a fractional ownership, 65 percent of the money goes directly into property.

Speaking of marketing, Ragatz also believes that the demand for fractional ownership is growing because of the small supply. There are only 254 properties in the world that offer fractional ownership. Right now, only 60,000 fractional owners exist due to this low inventory. "There is very high interest in fractional ownerships," he said. "Because there was significant untapped demand when most of these properties were being built. When the economy comes back fractional ownerships will take up a huge demand.

The last benefit of fractional ownership is an important one, especially during a credit crunch. Though the lending atmosphere remains hostile across all property types, banks have historically been more willing to lend to second-home and fractional ownership investors, as opposed to timeshare and condo hotel investors, because the former two have the potential for appreciation. It is also easier for fractional owners to obtain a loan because they only need to supply a percentage of the property's overall price — usually 10 percent to 25 percent, or $100,000 to $500,000.

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A common problem that besets any investment with multiple participants is that they must be in agreement before any action, such as selling the property, can be taken. Sharing costs and responsibilities, such as abiding by the rules of the property's Homeowner's Association or charter, can also prove problematic. If one investor fails to keep the property in working order or damages the unit, the group will receive a bill that must be divided amongst them. Remember that just because a fractional owner does not have to perform routine maintenance or change the sheets does not mean that the investment and use of the investment is free of responsibility.

A group of fractional owners may also suffer if one member fails to make his monthly mortgage payment. Again, the group must decide how to get the mortgage payment up to speed and whether that will affect that owner's usage or share in the property. Note that most developers offering fractional ownerships have laws in place that allow an owner accused of a violation to contest the violation, which may result in resolution or the selling of that owner's share. In such times of economic instability, it is not inconceivable that there may be a point in time when one or more investors are unable to make their portion of the fractional ownership payment. To prevent such instances from dramatically affecting the other owners, experts recommend that the group create a back-up fund that each contributes to equally that can act as a form of insurance in case an owner fails to make his payment or wracks up other fees and expenses.

Another common issue amongst group members is usage of the property. Like a timeshare, the owners of a fractional ownership must still work out a reservation system that ideally allows all owners to use the property during on- and off-seasons. Rules about who, other than the owner, can use the property should also be ironed out before any contracts are signed. Many investors purchase this property so that both themselves and their families and friends can use it, but many investors are not comfortable with people who have no vested interest in the property or its upkeep utilizing it for their pleasure. To the other owners, this is more of a risk, as friends and relatives may not be familiar with — or choose to respect — all of the property's rules, resulting, again in added fees for the group.

Even with the most scrupulous owners, however, a fractional ownership can still fail. And poor management is usually to blame. Part of the appeal of fractional ownerships is that they are relatively worry free because the developer's management and maintenance teams take care of its general upkeep and any other tasks the owners may require. However, poor management can result in a dirty unit, unappealing appearance and nonfunctional amenities. Though a management company can always be taken to court, most investors know that this can be a long, drawn out and risky process, especially if the contract affords the management company significant control over the unit and how it is maintained. For fractional ownerships inside resorts, poor management can not only result in a less than ideal unit, but also in a bad reputation that chases away guests and other potential investors. If this occurs, it is unlikely that the fractional owners will be able to sell their share or the entire property for a profit, if at all.

Investing in a fractional ownership with reputable investors and a fabulous management company still does not guarantee success. Like all homes, vacation properties are subject to economic upheaval and the normal ebbs and flows of the real estate market. So even though you're investing less money into a fractional ownership than you would a wholly owned vacation home, the success of both investment vehicles is tied to many factors, including its maintenance, location, size, amenities and surrounding neighborhood.

"There's no real investment opportunity in a fractional ownership any more so than there is with any other property," Ragatz said. "The anecdotal evidence shows that the appreciation of a fractional interest is the same as with the whole ownership of a vacation home." Ragatz also noted that many individuals have changed their mentalities when it comes to buying real estate, thanks to the housing bubble burst and the recession. "People don't buy for appreciation anymore," he said. "They buy for use. They feel that they're much better off spending $200,000 on a permanent, very high-end, quality vacation than on something [like a second home] that sits vacant most of the year."

Whether you're goal is to invest in future vacations or a small piece of high-end real estate that may appreciate over time, the key to any successful fractional ownership is understanding the terms of the contract. That all begins with the developer, as a legitimate developer and owner will allow the owners to negotiate the level of control they want over a property and how much they're willing to pay for that. After that, it's all about choosing a fractional ownership that will be surrounded with financially sound, responsible investors. For every investor knows that a partner can make or break an investment.