

Inside the Valuation of the Yellowstone Club

By Darius Hatami

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In early 2009, HVS was hired by the debtors-in-possession, represented by FTI Consulting, to perform a valuation for the United States federal bankruptcy court in relation to the Credit Suisse loan that was secured by assets of the Yellowstone Club. While the HVS valuation assignment for the Yellowstone Club had its share of twists and turns, the financing process that surrounding the assignment was anything but ordinary. This perspective shares the numerous historic facts and events that played into the appraisal.

THE YELLOWSTONE CLUB

The assets of the Yellowstone Club included an enormous 13,775 acre parcel, home to the world's most recognized private ski and golf club, and inclusive of an exclusive luxury resort residential development. In total, the Yellowstone Club has an approved master plan for ±864 dwelling units, of which 476 had been fully entitled, and only 37 of these entitled remained within the control of the Yellowstone Club. The array of amenities at the Club is impressive and is anchored by a private ski area that at build-out will include over 60 total ski runs (19 miles) and 16 ski lifts, including: a gondola; Nordic ski facilities with 12 miles of trails; an 18-hole Tom Weiskopf championship golf course; fly-fishing lakes and streams; an outdoor basketball court; tennis courts; a swimming pool; and an equestrian club. As of the appraisal date, the following amenities were in place:

- The 143,000-square-foot Warren Miller Lodge, with improvements that include

- two restaurants, a ski shop, outdoor terrace, locker room, spa, and fitness center;
- Parking structure—referred to as the “parkade”—with 270 spaces as part of the Warren Miller Lodge, which has been engineered and planned for above-ground condominium units;
- Timberline Café (±4,443 square feet) located near the summit of Pioneer Mountain;
- Rainbow Lodge (±9,200 square feet) with restaurant, lounge and deck areas, steam room, heated outdoor swimming pool and Jacuzzi;
- Rainbow Cabins (20) ranging in size from 416 to 1,080 square feet;
- 18-hole championship golf course designed by Tom Weiskopf;
- Partially-constructed 20,740-square-foot golf course maintenance facility with 32 employee units (in addition to the approved density);
- Future commercial/retail development known as “Big Springs Village” located adjacent to the Warren Miller Lodge; and
- Common area infrastructure including an entry gate station, 40 miles of paved roads, a modern and well-equipped fire and paramedic station, telecommunications and utilities (electricity, water and sewer).

Longer term revenue opportunity would come from the platting and sale of the remaining 388 developable residential lots/units and the development or sale of non-residential land currently intended as the commercial town center.

The purpose of the valuation was in determining the “as is” market value of the Yellowstone Club in relation to the sale and auction of

the Yellowstone Club as dictated by the bankruptcy court. The appraisal included the development and sale of the land, but did not include any proceeds or potential profit from the vertical construction of the units.

The Yellowstone Club had entered bankruptcy and was set for auction. Prior to auction the client determined a need for an independent valuation of the assets due to the existing valuation performed by Cushman Wakefield (C&W), and the probability that the auction price was unlikely to reach the value estimated in the C&W appraisal. While C&W had been appraising the property since the origination of the Credit Suisse loan in 2005, the first C&W "market value" appraisal, dated November 10, 2008, valued the Yellowstone Club at \$310 million. This valuation estimate was coincidentally almost identical to the outstanding balance owed to Credit Suisse by the Yellowstone Club. This valuation estimate was also far in excess of the stalking horse bid of \$100 million by Cross Harbor Capital Partners. Without a third party appraisal, and the likelihood of a strike price far lower than valuation estimate in the C&W report, the stage would be set for an appeal should the strike price end up below the C&W valuation. The HVS contract to perform the appraisal was approved by the US federal bankruptcy court in Montana.

THE ORIGINATION OF THE CREDIT SUISSE LOAN

The story of the Credit Suisse loan is incredibly interesting, and gives additional insights into the events that led to the global financial crisis, and clearly extended beyond the housing market. For the origination of the loan, the court reported that "Credit Suisse was seeking to sell its syndicated loans 'to non bank institutions.'" As a direct result, the original C&W valuation was not subject to the requirements of FIRREA. The C&W appraisals for loan origination, as well as ongoing asset valuation for the Yellowstone Club, did not require an estimate of market value, and instead the appraisal utilized several terms to describe value conclusions such as "Net Sales Value Method" or "Total Net Proceeds." This valuation method was something that HVS had never seen utilized in this manner. The total net proceeds was essentially the proceeds from real estate sales less development and operational costs, but without the application of any discount rate. Cushman & Wakefield performed quarterly valuations and the reported "net sales" valuation in the C&W reports was in excess of \$1.1 billion. The C&W valuations were in turn utilized by Credit Suisse

to sell the debt for the origination of a \$375 million loan for the Yellowstone Club.

The criteria utilized to underwrite the loans were unclear, but any significant barriers appeared to be non-existent. While the "market value" of the Yellowstone Club was in question at the time of the loan origination, the loan to value was likely in excess of 75 percent. It is also clear that the proceeds from the loan greatly exceeded any loan to cost measures typically employed in development lending, as they were in excess of the costs required to complete the entire project. Furthermore, it was understood that this was a non-recourse loan, and by mutual agreement, the developer was allowed to pull \$209 million, which was utilized for purposes "unrelated to the Yellowstone Club." It was also known that a large portion of the remaining proceeds were utilized to acquire properties around the world for the future development of a World Club. As such, there were insufficient controls in place to assure that there would be funds to complete the development of the Yellowstone Club. In essence, the developer was being offered a non recourse buyout based upon the developer's projections and a "paper value" utilizing the "Total Net Proceeds" valuation of the Yellowstone Club, with no requirements to reinvest in the collateralized real estate. This loan in fact was similar in nature to a home equity loan, as the borrower was allowed to do whatever was desired with the proceeds. The bankruptcy court judge in his final ruling stated: "The naked greed in this case combined with Credit Suisse's complete disregard for the Debtors or any other person or entity who was subordinated to Credit Suisse's first lien position, shocks the conscience of this Court."

This same financing process also provided loans to a number of other high end developments including: Tamarack, Promontory, Lake Las Vegas, Turtle Bay and Ginn Resorts, all of which have ended up in bankruptcy as well.

It is interesting to note that a portion of the money was spent on the prospects for the development of the Yellowstone World Club, a concept that never materialized. While the prospects for a world club in retrospect seem a bit of a stretch, there were several other World Clubs concepts that were already underway at that time. These include a successful model such as Exclusive resorts, as well as the alternative model of the Jack Nicklaus Golf Club, although it must be noted that the financial structure of these ventures was significantly different from that envisioned at the Yellowstone Club. The developer bought numerous properties around the world in an effort to bring this dream to realization.

HISTORICAL VALUATION

While the C&W valuation reports for Credit Suisse utilized the "Total Net Proceeds" valuation method, the valuations prepared for bankruptcy court utilized the more traditional "Market Value" methodology, were subject to FIRREA and applied discount rates to the "Total Net Proceeds." By the trial date, the appraisal, dated April 1, 2009, had indicated an estimate of market value of \$232 million, and therefore a diminution of market value of around 25 percent from the \$310 C&W market value of November of 2008. Before the financial crisis had fully been realized, an estimate of the June 2008 "Total Net Proceeds" valuation in excess of \$1.1 billion was reported in the C&W report. If this cash flow stream was converted by utilizing the same discount rate as in the November 10 appraisal, a value of around \$385 million would have been the equivalent. Thus, the C&W appraisals implied a diminution in value of 40 percent over peak pricing.

BANKRUPTCY AND CROSS HARBOR

The other interesting aspect of the history of the Yellowstone Club, and the HVS valuation involved Cross Harbor Capital Partners, a Boston-based investment firm. Cross Harbor and its founder, Sam Byrne, were the largest retail investors in the Yellowstone Club. From initial purchases of lots, Cross Harbor's primary investment in the Yellowstone Club grew to include several individual lots, 31 platted and developed golf course lots as well as a major investment in the Sunrise Ridge project, which included the development of 43 duplex and triplex units in June 2006. Cross Harbor ultimately built all of the Sunrise Ridge units on a speculative basis. Following these investments, in early 2008, Cross Harbor Capital Partners' interest in acquiring the property grew, and the firm reportedly sought to purchase the Club for approximately \$450 million, though the sale was never consummated.

As described, the scope of the Yellowstone Club is immense, and includes 16 ski lifts, a golf course, and 40 miles of private roads, as well as a 143,000 square foot lodge, of which about 43 percent is devoted to the Club. As such, the operating expenses for the project are also immense. Historic financial statements illustrated annual losses of around \$20 million. Thus, the only avenue to facilitate the continued operation of the Yellowstone Club was the real estate sales potential. While there were circumstances internal to the Club that were impacting real

estate sales, the economic crisis quickly over rode any of these concerns.

Following a divorce settlement in mid-2008, the developer's wife retained ownership control over the Club. Over the course of the coming months, the large operating costs became untenable, and the Yellowstone Club was ultimately placed into bankruptcy. While there is debate and additional intrigue as to how it ended up there, the combination of the Credit Suisse debt and financial crisis combined to leave little doubt it was headed towards bankruptcy. While the Credit Suisse loan was secured by the real estate and the Club grounds, the 143,000 square foot Warren Miller lodge was not part of the collateral for the loan. A secondary aspect of the HVS appraisal involved the valuation of the common areas of the Warren Miller lodge.

Once placed in bankruptcy, the ability of the Yellowstone Club to continue to operate through the coming ski season was in doubt. Without additional funding, the resort would be unable to operate for the coming year, diluting the value for all of the stakeholders. Ultimately, it was Cross Harbor that provided a debtor-in-possession loan to keep the Yellowstone Club operating, and did so to protect its investments in Sunrise Ridge and the Golf Course lots.

The bankruptcy court ultimately decided that the Yellowstone Club was to be sold via auction. As Cross Harbor was the largest investor in the project, and held the greatest risk, it was not a surprise that Cross Harbor ended up as the stalking horse bidder and set the bid price at \$100 million.

The stalking horse bid presented an interesting piece of evidence as to the value of the Yellowstone Club. HVS's first impression of the magnitude of the stalking horse bid, was that because of the huge investment and associated risk involved, it was likely that Cross Harbor would pay more for the Yellowstone Club than any outside party. An alternative HVS internal theory was that the stalking horse bid was a floor that would be sufficient to assure that an outside buyer could not significantly undercut the pricing on the existing properties, and thereby devalue existing Cross Harbor holdings.

ESTIMATES OF NET PROCEEDS

The HVS valuation assignment was first to determine the market value of the Yellowstone Club as of the auction date, and the second was to determine the contributory value of the lodge on the auction date. The lodge at the Yellowstone Club is a massive building that totals about 143,000 square

Inside the Valuation of the Yellowstone Club

feet, and includes 21 privately owned condominiums, as well as the fire station and a large variety of amenities for the members and their guests.

As with any private resort real estate development, the market value of the Yellowstone Club was determined by a multitude of internal and external forces. In the case of the Yellowstone Club, as with most heavily amenitized developments, real estate sales were clearly the driving force for profits and the market conditions surrounding the real estate were of primary importance. The second potential source of income is through generating ongoing operating income.

The historical pricing of the real estate was evident based upon the sales history of the property, but given the global economic financial crisis, the pricing on future product was more speculative. Given the current market conditions, the impact on existing pricing levels was apparent, with most retail lots in competing communities showing discounts of 20 percent to 40 percent. The estimates of future real estate pricing were fairly uncertain due to the fact that the lots had not been platted, and major decisions relating to the development of the property had not been completed. Further adding to the uncertainty was a lack of pricing for any of the future development parcels. While the C&W report had a table illustrating developer pricing, there was no source, but apparently came from management interviews. Nothing verifiable was obtained from the Club management.

There were two main concepts for the development of the Yellowstone Club moving forward, and they both dealt with the development of Eglise, the last parcel that could accommodate the remaining approved density. It seemed unbelievable that a site that totaled over 13,000 acres could be restrained in the development potential of just 864 units, but that remained the case at the time of the valuation. The development of the Eglise parcel held not only the prospects for future single family development, but also the best prospects for expansion of the ski area. Thus, two separate ideas had emerged for the development of this parcel. One concept involved the development of Eglise with single family development, and a large number of ski-in ski-out properties, while the second saved the Eglise for the ski area, and developed the base area in a high density pattern similar to Vail or perhaps Snowmass. While the high density concept had a lot of appeal in terms of its vision of additional skiing, it was clear that the maximally productive use of the land was for a greater portion of single family development. This consideration was further enforced by the HVS

analysis which determined that the financial feasibility of building and selling the new attached product was marginal, and, in fact, HVS had concluded that there was very limited profit on the majority of the historic attached product that was constructed by the developer.

As such, historic pricing provided a proxy for future pricing of the lots, while construction costs determined the minimum pricing for attached product. The uncertainty regarding the absorption levels promised to be a much larger factor in the valuation. Sales had virtually ground to a halt in advance of the financial crisis, and the majority of the most desirable properties had already been developed and sold. Many of the remaining 37 lots still held by the developer were of inferior quality and several had significant development challenges. It became clear to HVS that even if the existing list pricing and "developer pricing" noted by C&W were accurate, the impacts to absorption would result in much lower volume, and a significantly longer absorption period, resulting in a significantly decreased estimate of market value. Not only was the lack of demand due to the economic crisis impacting demand for real estate and changing the face of the market for luxury real estate, the Yellowstone Club had several significant obstacles to overcome. There were a significant number of built and unsold units, a large number of developers sold, but still vacant lots, a large number of improved listings, as well as nine properties in bankruptcy. It was clear that the secondary market for real estate within the Yellowstone Club assured that developer sales in the project would be difficult. High levels of absorption could be achieved only through deep discounting. Either pricing or absorption would have to give, and it would likely be both.

The other important factor in the absorption schedule is that as the number of units in the project grows, the number of competing resales grows as well, dictating that overall sales need to grow to keep developer sales inline. Thus, it would be difficult for the Club to ever return to the annual absorption rates of developer product that occurred during the peak of sales at the Yellowstone Club.

On the operating side, the Yellowstone Club faced a number of challenges. The operating costs were huge, as the sprawling ski area includes miles of catwalks that give all the area residents access to the ski area. In addition to the main ski areas, these trails had to be maintained. The maintenance costs for the lodge are also extensive and include an inordinate amount of staffing to keep customer service levels high, and then there is the golf course.

Inside the Valuation of the Yellowstone Club

As with all high end luxury private resort real estate projects, the project creates value through providing a desirable lifestyle experience and regulating it through pricing and exclusivity. And, in fact, the exclusivity, both perceived and actual, is a significant factor in the ultimate success of these luxury projects. While there are many factors that influence exclusivity, when a highly desired location is combined with scarcity, social status, a high level of service and lifestyle opportunities, the end result is the ability to drive lot pricing higher. At its peak, the Yellowstone Club possessed the majority of these characteristics. While the location may not have been optimal, as the world's only full service private ski club, with its secluded and remote environment, excellent service, private powder, golf and a host of additional amenities, the lifestyle proposition was strong. The developer had also managed to achieve an environment where the very wealthy could be anonymous. With notable members including Bill Gates, Greg Lemond, Annika Sorenstram, Barry Sternlicht and Peter Chernin, the development hit hard on this front as well.

The Yellowstone Club, like most other luxury private resort communities tied membership to lots sales. In other words, memberships are allocated based upon the total number of units at the Yellowstone Club, and access to the private amenities is only gained through the purchase of real estate within the development. This is important for a number of reasons, including maintaining exclusivity, as well as setting a bar in terms of ability to join the Club. But the most important financial aspect of this tie in was to capitalize on the lifestyle amenities and exclusivity of the Club through the sale of real estate.

The decision to sell offsite memberships is a difficult proposition for these resort developments because although it provides additional income through sales, as well as ongoing revenue through dues and facility usage, it lowers the price of entry, decreases the exclusivity, and negatively impacts real estate sales. The result of the sales of non resident memberships is that it effectively transfers the value of the amenities to adjacent developments. In the case of Yellowstone Club, Spanish Peaks, a step below the Yellowstone Club, is adjacent, and while the potential exists to sell memberships to residents of Spanish Peaks, the negative impacts to real estate pricing and sales at the Yellowstone Club would be significant. According to the membership documents, the Yellowstone Club has the ability to sell 150 of these memberships. In this case, the assessment was that it would negatively impact both the sales prices as well as absorption of the lots

to try and sell these non resident memberships while real estate sales were ongoing. This assumption was solidified by discussion with management as well as historical data which showed that to date only nine of these memberships had actually been secured. The sales of these national memberships were stopped by the Yellowstone Club sales staff to retain the exclusivity of the Club, and indications were they were not to offer them for sale any time soon.

Another controversial issue concerning the valuation of private non equity clubs is the reversionary value of the club at the end of the holding period or at stabilization. One widely held theory is that the membership deposits paid by prospective members are in fact compensation to the developer for building the club amenities, and that the club should be turned over free of charge to the members at the completion of the sellout and converted to an equity club. While some developers come to this realization, most membership documents are structured so that the developer has the right to sell the asset in the market place, and will use this fact as leverage to generate additional proceeds from the members through the equity conversion process.

While it is commonly understood that the club is a loss leader for real estate development, the expectation is that the amenity will eventually pay its own way and achieve, at a minimum, break even revenues. In the case of the Yellowstone Club, it was clear that it was likely to be a very long time before there would be a positive income stream from the Club operations. In fact the C&W appraisal projected negative income in perpetuity, even after the sellout of all the real estate as well as all the non resident memberships. If the C&W projections were correct, the reversionary value, or the sale of the Club at any point in time would be speculative. The lack of the ability to achieve a positive net income at any point in the projection period made it clear that there would be no interest from third parties to purchase the Club in the foreseeable future. It was HVS's conclusion that the reversionary sale of the Club was speculative, and that there would be no incentive for the members to pay to own a club that was losing money. HVS did however assume that the sale of the non resident memberships, as well as the reversionary sale of the Club, could be achieved in the longer term, but that the impacts to value would be minimal.

ESTIMATING VALUE

Apart from the mechanics of the development cash flows and Club operating income, a number of questions remained in terms of how the individual market participants

Inside the Valuation of the Yellowstone Club

and potential buyers would view this asset given the global economic crisis and the great uncertainty in the market.

In the case of the Yellowstone Club, HVS employed significant internal discussions in regard to both appraisal definitions as well as the nature of the market and the sales process for the Yellowstone Club. The court had determined that the Yellowstone Club would be auctioned and had defined the sales process and timing. The marketing time period for the sale of the Yellowstone Club was to be 60 days, where typical marketing times for a resort master planned development such as the Yellowstone Club would be between one and two years, and in fact, it is rare for healthy projects to even change hands. The question remained as to whether the court defined sales process was adequate to achieve full market value. The sale process was led by the CBRE golf group, and with a robust data room and an equally robust Rolodex, it was clear that through the marketing process, in conjunction with the high public profile of the case, that any party that was interested in the Yellowstone Club, would know about the offering and have a chance to respond. Jeff Woolson, managing Broker at CBRE described the conditions of sale best when he said "it was not the marketing time that was an issue, but the timing of the marketing." Given the great uncertainty in the market, it was unclear as to whether a longer marketing time would have been beneficial, and that given the very fluid nature of the economy and capital markets, in six months, the market conditions would have inevitably changed, and as such so would the underlying value.

As with any appraisal, the selection of a discount rate is the ultimate culmination of the real estate investment market forces as well as specific conditions relating to the subject, in this case the Yellowstone Club. Clearly the forces affecting the discount rate were fluid given the timing of the valuation and the ongoing turmoil in the financial markets. Although the major earthquakes of the financial crisis had passed, the financial aftershocks were still fresh and damage assessment and uncertainty was still the market norm for master planned communities. Given the state of the financial crisis, the state of the capital markets, and the general lack of liquidity, it was clear that applying historical discount rates to projected income would be insufficient to account for current market conditions.

There were also multiple market and valuation factors that had changed and that would impact value at the Yellowstone Club as a result of financial crisis. The market for resort real estate is discretionary, and the purchase of resort

real estate was moved further down the priority scale for a large number of potential buyers. In addition, one of the main motivations for the purchase of resort real estate is the potential for financial return from the investment. While there were forces in place for price appreciation in advance of the financial crisis, there was clarity afterward that the potential for appreciation from the purchase of the real estate had significantly deteriorated.

An even larger concern related to the significant risk for the Yellowstone Club due to the enormous operating deficit needed to keep the Yellowstone Club alive. This fact dictated, that in a market with illiquidity, the prospective purchaser would be required to provide capital to purchase the Yellowstone Club, as well as additional capital to see the Yellowstone Club operate through the financial crisis. Also apparent was the fact that there was little appetite for debt on a project like this, assuring a lower loan to value, if a loan could even be secured. Thus, the discount rate would have to increase due to the higher returns required by the equity investors.

Clearly the financial risks of purchasing the Yellowstone Club were significant, but additional factors were at play as well. Much of the allure of the Yellowstone Club was due to its exclusivity and its ability to selectively confirm social status. For many buyers, the purchase was not only related to financial return and utilization of the Club's significant amenities, but ultimately related to social status and the desire to be associated with this leading group. The financial crisis had in fact turned this factor on its head. It was now possible that a purchase within an exclusive Club could have the opposite impact, and by being associated with a troubled asset, unnecessary and unwanted attention was brought to the Club and many of its members, which is exactly what they were hoping to avoid by joining the Yellowstone Club. The financial crisis had in effect struck a blow to the psychology of the luxury real estate purchase. Instead of looking savvy, the purchase could now make one look naive. At the Yellowstone Club, this made the proposition for purchase due to social status more difficult.

In the end, HVS estimated the market value of the Yellowstone Club at \$113 million, less than a third of the original loan by Credit Suisse and about a quarter of the original bid by Cross Harbor a year and a half earlier.

From the HVS perspective, the mechanics of the valuation reconciled the prospective purchase price of the Yellowstone Club before the financial crisis, through the value conclusion. The necessity of price capitulation for

Inside the Valuation of the Yellowstone Club

the sale of real estate, the inevitable slow down in absorption, projected increases in the number of years that the Club would show annual operating deficits along with the capital market requirements necessary to consummate the purchase, dictated a significant decrease in the market value of the Yellowstone Club. The prospective cash flows from the Yellowstone Club had clearly diminished, and the time frame to generate the returns had increased.

THE END RESULT

In the end, the extensive marketing process saw no outside bids, and left the \$100 million stalking horse bid of Cross Harbor, and the credit bid of Credit Suisse as the only potential bidders of the Yellowstone Club. The end result of the auction was a sales price of \$115 million to Cross Harbor, and a market confirmation of the \$113 million HVS valuation estimate.