Learning Curve

The State of Timeshare Securitization and Finance

An Attractive and Underappreciated Asset Class

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Introduction and Overview

Vacation timeshare ("timeshares") loans have been securitized since the 1980s. Over $14B of timeshare securitizations have been issued from 2002-2011 alone, with almost $5.9B of this issuance occurring from 2008 through 2011. Four timeshare securitizations totaling $815M have been issued so far in 2012, with more in the pipeline. More than 60 individual transactions have been placed since 2002.

Despite this volume, timeshare is an underappreciated asset class that offers premium returns relative to its risks. Why? Despite their long track record, and their passing largely unscathed from the great recession—no timeshare securitizations defaulted, the few that had moderate rating downgrades were more than matched by those with moderate upgrades and the monoline-wrapped received their shadow ratings—the market for timeshare securitizations is impacted by (a) the complexity of analyzing both the timeshare loan, and the industry that generates it, (b) a stigma that a timeshare is one of the ultimate discretionary purchases and falls very low in a consumer's payment priorities, and (c) a taint that remains from aggressive marketing practices that were prevalent in the industry's early years.

Like other esoteric assets, timeshares can require more analysis to understand and ensure that risks are mitigated. A thorough analysis of timeshare securitization requires analysis of both an asset – consumer analysis and commercial risk analysis – and an industry – timeshare companies have aspects of real estate, lodging, and finance company companies.

Timeshare securitizations' performance in the recent great recession demonstrates the robustness of their structures, the quality of their assets, and that the collective knowledge built in this asset class has been applied prudently.

The Timeshare Industry

The timeshare industry, which began in the 1960s, has grown dramatically from its inception. Despite the industry's early challenges resulting from (a) instances of questionable marketing practices, (b) many poor quality properties offered, (c) difficult marketability due to timeshares being almost exclusively "fixed weeks" at a single resort, and (d) the absence of substantial exchange companies for owners to utilize, by 1980 annual U.S. sales volume alone was ~$500 million and several significant independent timeshare developers began their operations.

Beginning in the early 1980s, the industry gained credibility and volume as (a) more formal sales practices were established, (b) weaker developers and products were weeded out, (c) the product sold became more attractive, with greater flexibility and exchangeability of use, and (d) the entry of prominent branded lodging companies (beginning with Marriott's entry into timeshare in 1984) into the industry.

These factors drove the timeshare industry to a double-digit annual growth rate from the mid-1980s until the great recession hit. This market growth continued through recessions and real estate downturns and even through the aftermath of 9/11. The growth numbers of U.S. timeshare sales during this extended run are striking.

Timeshare Sales by Year	
1995	$1.9 billion
2000	$4.2 billion
2005	$8.6 billion
2006	$10.0 billion
2007	$10.6 billion

(source: American Resort Development Association data)

Sales volume dropped in 2008 (to $9.7 billion) and 2009 (to $6.3 billion) and, while beginning to recover, has yet to reach previous levels (2010 sales of $6.4 billion and 2011 sales of $6.5 billion). This precipitous fall and the industry's slow recovery are due in large part to the industry's financing challenges. The extent to which lenders and investors take advantage of very attractive opportunities to finance the timeshare industry, will determine the future growth of this market.

The timeshare industry includes major branded lodging companies (including Marriott, Wyndham, Hilton, Starwood, and Disney, and others) and significant independents (including Bluegreen, Diamond Resorts, Shell Vacations, Westgate, and others). They have grown both organically and through acquisition; for example, Wyndham (NYSE:WYN) has grown its early acquisitions (including Fairfield, Equivest, Trendwest, and Shawnee) to its position as the largest timeshare company and Marriott (Marriott Vacations Worldwide Corporation (NYSE:VAC), spun off from Marriott International Inc. (NYSE: MAC) in November 2011), has grown to its position as the largest timeshare "pure play" company largely organically. One of the leading independents, Diamond Resorts Corporation, for example, has grown its business through a series of acquisitions including that of Sunterra, ILX, Tempus Resorts, and Pacific Monarch Resorts.

What is a timeshare?

A timeshare is the purchase of one or more vacation weeks or the purchase of a flexible vacation package that can be utilized at one or more resorts within a "club." Consumers buy vacation "points" (or weeks), which give them the right to stay at a vacation resort, generally within a network of resorts, for a defined period (a week, or a several day time period controlled by how many points have been acquired, are available, and are associated with the related time period) for perpetuity or an extended number of years.

While timeshares were first sold as "fixed weeks," with the purchaser buying a fixed week in one particular timeshare complex (or even one fixed week in a specific unit) and which still constitute a substantial part of the market, more and more timeshare sales have moved to "floating weeks" and "points."

Timeshares are exchangeable. Two substantial exchange companies (RCI (owned by Wyndham) with ~3.7 million members and Interval International ("II", owned by Interval Leisure Group (NASDAQ: IILG) with ~2 million members), a number of smaller exchange companies, and developers' "clubs", provide wide exchange options.

The very thin timeshare resale market continues to be a concern.

Industry Cash Flow and Revenue Generation

Timeshare companies typically have four primary sources of revenue – timeshare sales, consumer financing, property management fees, and rental fees. Timeshare sales typically contribute around half of a company's revenues, with the bulk of the balance derived from interest revenue on the timeshare loans generated and property management fees. Despite this mix of revenue, timeshare remains a negative cash flow business; the biggest ongoing challenge is financing this.

Timeshare's negative cash flow stems from its sales/cash generation model and its cost model. The majority of timeshare sales are developer financed. The purchaser pays a minimum of 10% (with an industry actual average of ~15% down payment) of the purchase price in cash and borrows the rest, typically for 7 or 10 years, at rates that generate significant ongoing spread income to the developer. While this provides the developer with steady cash streams, it must find the means to finance its heavily-weighted upfront costs. A typical timeshare cost structure includes marketing expenses equal to 40-60% of the sales price and cost of goods sold of 20-30% of the sales price. These expenses are incurred, and must be paid, long before a majority of the sale's cash flow is generated.

The timeshare industry has historically financed its operations – its acquisition and development, working capital, and receivables financing needs – primarily through finance companies, a concentrated community of lenders experienced in this space. There has always been a limited universe and capacity of other direct lenders to the industry. Financing has typically been at defined advance rates at rates in excess of the Prime Rate and is extended through the product cycle. Particularly with the growth of securitization, and with several of the larger, primarily branded lodging companies, limited inroads have been made by banks and the capital markets in financing timeshare.

With the exit of the industry's major lender and constrained capacity at others, the opportunity for high margin investment and lending opportunities – and securitization takeouts – is robust.

2008 and Beyond

The precipitous fall in timeshare sales in 2008 and 2009 was caused primarily by financing drying up, not by a dramatic reduction in consumer demand.

With lenders either exiting the market or reducing the availability and advance rates on new or amended facilities, and the unavailability of the timeshare securitization market in the 2nd half of 2008 (and the general reduction of new securitization advance rates in 2009), the majority of developers chose or had to downsize their operations. Sales offices were closed, many positions were eliminated, new development was put on hold and CAPEX dedicated to timeshare was reduced.

A number of developers, primarily as a result of losing their funding or having it greatly reduced, failed.

Advance rates and availability have also been reduced by the general application of credit scoring in developer's approval process for timeshare loans. With the cost of marketing so high in the industry, and the ability to put the timeshare interest behind a defaulted loan back into inventory for sale to another consumer, most developers historically did minimal credit underwriting and did not credit score their customers. In the new environment, credit score requirements, and tranching of advance rates based on scores, is the general rule. While this change is a positive for credit quality and enhances the protection provided to lenders, it is arguably a negative for developers, impacting their sales efforts and reducing revenue numbers.

Developer's efforts to increase their cash flow and to deal with reduced availability on their credit lines, have also moved them to focus their sales on existing owners and referral sales and to require higher down payments on timeshare loans. These sales have a significantly higher closing rate than the industry's ~15% historic closing rate and, hence, are far less costly to generate.

The Performance of Timeshare Securitizations

As a result of robust structures - incorporating significant credit support (subordination for senior tranches, overcollateralization, funded reserve accounts with floors, and considerable excess spread) and well defined program triggers – and portfolio performance that did not deteriorate to unacceptable levels, timeshare securitizations performed well.

With the incorporation of minimum credit scores, the common trend of requiring (or encouraging through lower interest rates) higher down payments, and increased repeat sales, the performance of timeshare receivables pools going forward should be further enhanced.