Real Estate Market Fundamentals in South Florida

Lenders and investors in the South Florida real estate market are currently caught up in a game of "musical chairs," hedging against the impending bust.

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FROM 1992 TO 2005, six factors contributed to the U.S. housing boom: mortgage rates decreased to generational lows; financing innovations lowered homeownership costs; home listings were centralized on the Internet (to minimize transaction costs); lenders gave priority to minority homeownership; demographic influences strengthened housing demand; and real estate was perceived as a safe haven for household wealth compared to the stock market, which offered poor investment returns.

These factors, combined with record-volume home sales, increased home appreciation, record homeownership rates, and sizable increases in mortgage originations,

have lead many economists to the conclusion that there is a national housing boom. Industry economists recognize that price gains have been unusually strong in recent years because of robust housing demand and increasingly stringent supply constraints in some areas, which have boosted price appreciation above the rate of income growth. A stable relationship between income and house prices over time suggests the absence of a nationwide housing bubble, especially when placed in the context of a national unemployment rate below 6 percent, extremely low mortgage rates, and the acceleration of a broader economy.

Federal Reserve chairman Alan Greenspan has said, "The national housing market is better understood as a collection of small, local housing markets." According to Greenspan, local conditions dominate home prices; therefore, any bubbles that might emerge would tend to be local. It is possible that valuation bubbles exist in regional housing markets, where homes are selling above list prices, buyers are quickly flipping properties, and prices continually gain even as unsold inventories rise. Is that what is happening in South Florida?

A real estate bubble about to burst could take two forms. First, home prices could decline due to a substantial imbalance between supply and demand. Symptoms of such an imbalance would include all or some of the following: a supply overhang; anemic demand leading to a substantial and growing inventory of unsold homes; or a surge in new construction in an area of weak housing demand. In other words, home prices decline when prices have gone up counter to underlying fundamentals. Second, home prices could exceed what the average family in a given geographic area can "afford."

A real estate market bubble is analogous to any other asset valuation bubble. In fact, the recent tech bubble has led many analysts to search a variety of asset classes for signs of another bubble. An asset will be subject to a valuation bubble under the following three conditions: when the uncertainty of future returns on the asset increases; when the transaction costs of acquiring or selling the asset decrease (inviting speculative buying); and when the holding period of the asset becomes shorter than historical norms. How do these warning indicators apply to the South Florida condo market?

During the most recent real estate boom, South Florida has been characterized by a marked contradiction: Miami, with its large immigrant and refugee population, is the poorest per capita metropolitan region in country, yet the region also has one of the most expensive housing markets. In 1997, the average price for a new condo in Miami-Dade County was $199,000. By 2004 it had risen to

$308,000, a 53 percent price appreciation. Existing condominiums also enjoyed a rapid price appreciation. For example, in 2004 the average sales price for an existing condominium in Miami-Dade was $194,000 compared to $98,000 in 1997, an almost 97 percent increase. Housing prices in Hialeah, a Miami suburb, shot up 26 percent in 2004, making this gentrified middle-income community one of the nation's hottest housing markets. Housing prices in the Miami area were widely expected to moderate in 2005. However, in the second quarter of 2005, *all* of the top three national areas in terms of home price appreciation were in South Florida. According to the National Association of Realtors, some areas in South Florida have seen 46 percent price appreciation in the past year, compared to a national price appreciation of 9 percent for the same period. The average home price in the second quarter of 2005 in Miami was $315,700, up 28 percent from a year prior.

Given South Florida's rapid price appreciation, the question is to what extent the supply-demand fundamentals support the price increases. The determinants of demand for housing include household income, the cost of homeownership, and demographic growth. The supply of housing is also determined by construction costs, the price of a house on the secondary market, and the inventory of homes. For instance, following the 2004 hurricane season, construction costs in South Florida increased by roughly 9 percent. This translated to an actual increase for new products closer to 15 percent. In addition, a lack of inventory and the resulting demographic displacement stemming from the 2004 hurricane season on the west coast of south Florida drove up prices on the east coast.

In Miami-Dade County in 2004, the average price of a new condo unit was $308,000 ($194,000 for an existing unit), or 7.7 times the region's median household income of approximately $40,000. Evidently, the Miami condo market is not aimed at local buyers; rather it targets the many high net-worth European and South American equity investors who seek to capitalize on the region's housing boom. Europeans, in particular, have been taking advantage of the drop in value of the euro, while Latin Americans have been motivated by a stable equity alternative to their domestic equity markets. In many condominium developments, international buyers represent half of all buyers. Since these purchases are often cash deals, the local housing economy is less susceptible to Fannie Mae's tightening underwriting standards.

There appears to be an excess supply of new and pipeline units, although exact numbers are unknown. Based upon public and private sources, we estimate that the number of new condo units delivered

in 2003 in Miami-Dade was 8,000, while the number of units delivered in 2004 was 9,000. Approximately 50,000 condo units are either planned or under construction in 2005. With an absorption rate of at best 12,000 units per year, it is hard to justify these numbers, especially when condo conversions in Miami-Dade will produce another 13,000 units. Some argue that there is nothing to worry about, because low interest rates are fueling demand in excess of supply. What this bullish analysis ignores is the large number of speculative investors who will ultimately have to sell their units or add them to the rental market. According to some estimates, between 40 percent and 80 percent of pre-sale buyers in Miami are investor-speculators. The result is a valuation bubble driven by non-resident demand, fueled by low mortgage rates and exacerbated by aggressive lending practices.

SCENARIOS

A condo bubble is a deviation of the market price of a housing unit from its underlying fundamental value. The fundamental value is a combination of the physical fabric of the building, environmental amenities, location, public services, marketing image, occupancy rate, and the availability of financing. But identifying a bubble is neither easy nor exact. It is possible to compare recent price appreciation with the behavior of housing markets at similar stages of past cycles, or to assess whether house prices are high relative to their rental value.

Rising mortgage rates would impact the Miami condo market by reducing demand for non-cash deals. Moreover, because Miami has low income growth and an increasing supply of unsold condo units in inventory, a price adjustment seems inevitable. A good comparison to Miami's condo market is Las Vegas, where price appreciation has been as high as 45 percent per year. When the "flippers" could not sell, they tried to rent the units to cover carrying costs, causing rents to decrease. As a result, owner-investors were forced to sell and prices declined by 1.2 percent.

Another scenario for Miami is similar to a margin call. Some experts predict that in approximately two years, when the unsold condo inventory reaches 10,000 units, "flippers" will be forced to sell and developers will have to match their prices. This situation occurred in South Florida in the early 1980s, when thousands of vacant and foreclosed condos were sold in bulk by foreclosing banks.

Some experts estimate that the South Florida market is overpriced by as much as a third. If true, this means net losses for investors, or in an alternative "best-case" scenario, prices merely sliding sideways for

three to five years. However, it is hard to imagine such a best-case scenario due to the large number of speculators in the market. Since there are so many speculators with no corresponding buyers, it is possible that in the event of a downturn investors who have put down 5 percent to 10 percent to reserve a condo unit that will be built in 18 months will simply walk away or sue to prevent developers from taking their escrow deposits. Such suits for the enjoinment of the release of escrow deposits could be argued on a number of fronts. If depositor/investors argue that they were sold the units based on estimated stated economic returns, state and federal securities laws might prevent the developers from taking the escrow deposits. Alternatively, depositor/investors could have a common law fraud claim against the developers, although this is less likely given the limiting language stated in the reservation (deposit) agreements. In any event, the exodus of investor/depositors would leave developers swamped with unsold units and could result in non-recourse developers walking away from their projects.

BUST

If the condo-driven real estate market takes a downturn, the most immediate impact would be that some planned condo projects would not get built, as construction lenders tightened their underwriting standards. For those projects that have not secured construction or permanent financing, tighter pre-sale requirements would prohibit new projects being financed. Even projects that met initial pre-sale requirements might no longer be economically feasible. This would be particularly important because many developers take their profits on the unsold units in inventory. Many purchase-sale contracts that were executed two years ago do not reflect the same price margins for the developer due to increases in construction costs.

For projects that remain economic, there are additional impediments to starting and completing construction. First, permanent lenders would raise the equity requirements for projects. Institutional structured equity financing, or mezzanine financing, which thrives in today's boom market, would no longer be as readily accessible. This would be partially due to the risk involved as subordinate mortgagees in an uncertain market. So, for projects that had secured construction financing contingent upon a take-out, it would not be possible in a downturn to secure a take-out given relative loan-to-cost and loan-to-value ratios. In cases where a project is not built due to economic impracticability, it is not entirely a loss for the developer, as the permitted land may bear a substantial residual value,

which serves as a floor for valuation in the event of a downturn.

What about units that are currently constructed and occupied? We assume that any downturn in the market would be immediately characterized as a point in time when the secondary market is flooded with speculative buyers attempting to flip their properties. In this event, speculative owners would initially attempt to rent their units, in order to generate cash flow. The market psychology at this point would still be one of optimism in the face of an inability to realize capital gains.

With time, the oversupply of rental units would drive rents downward. It can be assumed that property taxes will be constant as a function of assessed value relative to the absolute decline in fair market value. A dramatic decline in rents would cause speculators to struggle to meet debt service, tax, and insurance requirements. It should not be forgotten that in the midst of the 2004 hurricane season, all of Florida is a state of record high insurance premiums. It is at this juncture, if they have not already done so, that the speculators would put their properties on the market for sale. Subsequently, an over-supply of units on the market would dramatically drive the market value of the units below the investor's break points. At this juncture, a true bust would occur.

South Florida has long built its economy on the foundation of the real estate industry. In fact, boom and bust has been in the Miami lexicon since the mid-1920s. However, the complexities of externalized capital flowing into an inherently local market have placed the South Florida market in a precarious position. The relative lack of guidance in the market is exacerbated by irrational market exuberance and an industry campaign of misinformation.