



Breaking News in the Real Estate Industry

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How is the Housing Crisis Affecting the Apartment Rental Market

Grisenia Matos
President

The answer to this question seems simple and straightforward...

demand for rental units will continue to rise at an increasing rate. Rental market demand will come from three relevant directions. First, fewer people today qualify for a home mortgage either due to the lack of a larger required down payment or because of more stringent credit guidelines, which are finally being enforced. ("You mean we need to show proof of our income?")

Secondly, many qualified buyers, worried about catching the proverbial "falling knife" as housing prices continue to decline, are choosing to sit on the sidelines and rent until the housing market once again seems stable. It was recently reported on Bloomberg news that over 8.5 million homeowners owe more on their homes than their property is worth - which is almost 11 percent of all American homeowners. The same source estimated that the number of people underwater in their homes may rise to as high as 12 million, almost a 50% increase from the current level. This creates continued pricing weakness because as these homeowners seek replacement financing they may be forced to sell into a weak market, or worse, may not be able to sell at all.

Finally, people are losing their homes at an increasing rate as foreclosures and job losses continue to mount with the weakening home market, resetting ARM rates, and the general slowing down of the economy.

These factors mentioned above contribute to a continuing increase to the demand side, i.e. the number of available renters. Increased demand equates to more renters, higher rents and better profits for apartment investors, right?

Unfortunately, the story is not so simple and the answer to the above question varies dramatically by market and property. Remember also that demand is only half of the equation. Let's consider supply.

If demand for rentals is increasing then why are collections trending down in those hot markets which have been most affected by the housing crisis? Market darlings like Phoenix, Las Vegas, the Inland Empire, Sacramento, and South Florida have all been damaged badly from an occupancy, rental income and total cash collections standpoint. This is not because of weak demand but rather because of a huge increase in the available supply of rental units. Don't blame the apartment developers this time, though.

So much of the housing boom and bust was caused by rampant speculation and the bubble chickens have finally come home to roost. In an effort to ward off true financial pain (or maybe to just put off the inevitable), many of the would-be speculators in these markets have thrown their condos, town homes and single family houses into the rental pools in these markets to try and make a dent in their ever increasing (thanks to those ARM rates) mortgage payments. (The condo converters and developers are also in this bunch of speculators, but on an even grander scale at a cost basis that in some cases is even more absurd.)

Remember, these were the housing markets that had people camping overnight to wait for lot releases from builders for new houses. We guess there was a lot of speculating gold miners camping out with the folks who just wanted a small piece of America, at whatever the cost. Many of those who weren't speculators would have been, under historical lending practices, considered unsuitable borrowers. But due to favorable and less strict standards by aggressive lenders they pre qualified for sub-prime and Alt-A (no doc or "liar") loans.

Speculators who have become accidental landlords have created a shadow rental market. This shadow market has become a formidable competitor to suburban apartment complexes, particularly higher- end condominium like communities in some parts of this country.

How then, do investors seize the opportunities created by increased rental demand while protecting themselves from the lurking shadow market supply? The answer lies in that 3-pronged banal law of real estate investing: Location, Location, and Location.

Even in these troubled markets, islands of tranquility exist where infill assets may not feel the harsh effects of increased supply because of a superior location where nothing in the immediate area was converted to condominiums or newly developed and the existing housing stock is high quality where the values have held up well.

Observe that two of the three factors causing rental demand to increase are widespread, whereas the problems created by housing supply are remarkably concentrated. Specifically, it is harder for everybody everywhere to qualify for a mortgage today than it was 2 years ago. Secondly, many people across the country are choosing to rent rather than purchase while the housing markets stabilize.

Note also that the factors that favored increase rental demand prior to the housing bubble are still pertinent. First, the gap between what it costs to rent and what it costs to own is wide, has been wide, and may continue to widen for some time even with some weakening in house prices. Secondly, construction costs have risen dramatically in the past few years. Existing apartments can still be bought at a discount to replacement cost which means that rents will have to rise before new apartment supply will enter the market in any dramatic way. Apartment communities that stand to benefit the most from the effects of the housing bubble will be in markets where there was not a huge increase in the "shadow market." Markets included in this category are markets like San Antonio, Austin, Seattle, Portland, Salt Lake City, and even Houston and Dallas.

Clearly, it is an exciting time to invest in apartments. Yet because of the risks, fundamentals are more important than ever. Investors should seek solid infill locations in markets where job growth is strong and supply is somewhat constrained. As the housing crisis finds its bottom and the "shadow markets" begin to improve, the fundamental economic story of the local economy and job creation in each market will be ultimately critical. (copyright 2008 Cottonwood Capital. Used with permission)

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From the desk of:

Grisenia Matos, MBA

President—Broker/Realtor®
Registered Representative—Welton Street Investments

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Questions or comments? E-mail us at Grisenia@weltonstreet.com or 1-888-868-1031.

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