Scoping Out the Condo Market

Look at the big picture nationwide, and then look at local dynamics for insight into this market

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The residential-condominium market remains the best of times for some markets and the worst of times for others.

To understand how the condo market is doing nationwide, look to the classic “three Ls” of commercial real estate — location, liquidity and land. To grasp how condos are faring in your market in particular, know how to analyze market demographics and demand trends.

Location

If you’re trying to take the temperature of a particular area, start with location. It is a tale of more than just two cities.

Residential-condo units continue to sell well in markets such as Nashville, Tenn.; Seattle; Tucson, Ariz.; and Austin, Texas. These cities are smaller than recent hotbeds of condo activity like New York, Los Angeles and Miami.

Examples of markets that are holding steady with supply and demand almost in equilibrium are Philadelphia and Chicago.

Sacramento, Calif.; Birmingham, Ala.; and Memphis, Tenn., are exhibiting slowing buyer demand. Developers in these cities haven’t started to convert existing condo units into rentals, but owners of condo projects must consider this as a plan B if sales continue to slow.

The Boston market continues to display strong demand of luxury units, with some weakening at lower price points.

Markets such as Las Vegas and Washington, D.C., are not in the midst of the best of times. Many developers appear to have overestimated demand for converted and new units in these areas.

Two prominent examples of markets with an oversupply of inventory and a lack of demand are on opposite shores of the continent: Orlando, Fla., on the East Coast and San Diego on the West Coast.

Liquidity

Drawing some general conclusions in national submarkets, the most reliable demand is for units at the lower end of the pricing spectrum. Given the prevailing buyers’ market for single-family homes, the days of condo units competing head-to-head with single-family residences are over.

Current condo-buyers often are first-timers seeking entry into homeownership. Because mortgages are not as readily available as they were a year or even six months ago, however, the pool of prospective buyers has been reduced with a decline in the liquidity.

Many condo projects are designed to include a range of unit prices. The lower-priced units attract immediate buyers (and presales, which can drive financing), while the higher-priced units bring more developer profit. In some of these price-tiered projects, however, sales of upper-end units have stalled because potential buyers prefer to buy only where all units are uniformly upper-end.

Land

Where can condo-developers build their projects or find suitable properties for conversion? In some communities, such as Phoenix, the conversion process consists of filing the proper paperwork and paying a fee (in some parts of the country the cost is as low as $75). The likelihood of regulatory approval is high in most of these markets.

On the other hand, cities such as San Francisco have highly regulated conversion processes. San Francisco has an annual lottery for the 200 units (not properties) that may be converted each year, and conversions are only permitted in buildings with two to six units. Property-owners have less than a 10-percent chance of being granted permission on their first attempt. And if they eventually obtain approval, the next stages of the process can last 12 to 18 months longer.

Some communities make their permitting process contingent upon a percentage of condo units being sold below market rate to qualified buyers. Obviously, the price to meet these requirements reduces a developer’s overall profit.

In Salt Lake City, developers have elected to build up as well as out. This is the “vertical urban neighborhood” concept — constructing one or more towers containing residential-condo units over retail and office space, often with swimming pools and other amenities. Because commercial tenants typically sign long-term leases, their presence can make project-financing more viable.

Currently, many lenders require that between 20 percent and 50 percent of residential-condo units be presold (under contract with a “hard” nonrefundable deposit) before construction begins. Presales are problematic in states that do not permit developers to book nonrefundable contracts on units that are not ready for occupancy.

To obtain the required presales, some developers have gone beyond artists’ renderings with elaborate marketing campaigns that include three-dimensional digital “tours” and complete model units in another building.

Successful residential projects tend to be located either in downtown areas or in suburbs with easy access to downtown. Outlying commuter suburbs don’t often have sold-out condo properties.

Buyers tend to be attracted to areas with restaurants, shops and other services available. Downtown residents generally want commercial establishments in their area to remain open in the evening and on weekends.

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Market demographics
Brokers trying to shepherd a client’s project successfully must know how to evaluate the markets in which they are involved. Tried-and-true analytics continue to be useful in this process.

Is the overall population increasing or decreasing? Is the population aging or getting younger? What are the local employment and job-growth rates? And more important, what are the historical trends of these two key indicators?

What is the local market rate of household formation? This is an often-overlooked, yet reliable predictor of future demand. More households being formed indicate continued strong demand for residential real estate. Conversely, reduced household formation will tend to predict reduced buyer demand and higher inventory numbers. Demographics can dictate the future of income property.

Who are your project’s prospective buyers? Nationally, approximately half of buyers are well-paid, young, professional singles and couples seeking their first home or retired people buying either a second residence or a new home convenient to restaurants and shopping.

The other buyers generally do not intend to live in the unit. They are either investors or speculators. The primary differences between these two groups are how much cash they have into the property and how long they plan to own it. Investors tend to have larger down payments and plan to hold the property for more than 12 months. Speculators frequently purchase with little or no cash in the deal and hope to sell quickly.

The nonowner-occupiers in many cities have been unable to liquidate their units. Now they must seriously consider renting them out to meet their obligations.

Sales, inventory and price
Another useful method for analyzing the local condo market is to look specifically at sales, inventory and price. You must assess what the local market for your product is today and what it will look like when your units are available. Depending on the timeline for your project, the answer to the second question could be based on the market 12 or 18 months from now.

What is the pace of condo and single-family-residential sales today? What is the ratio between units coming on the market and those being sold? Is the trend improving from a seller’s perspective, or is it slowing?

Inventory is a crucial part of your market analysis and probably the most difficult factor to understand correctly. First, you must identify the competition — existing new condo units, condo units that have been converted from apartment units and single-family residences. Are new properties already in the pipeline — whether still at the building-permit stage or actually under construction?

Not every property with a building or conversion permit will be completed, of course. You can reasonably expect everything now under construction will eventually reach the market — although perhaps not with its original owners.

There is another aspect of inventory — the “shadow inventory,” also known as the market overhang. For example, condo units currently being rented out but that will ultimately be sold are part of the shadow inventory.

In terms of price, what are units being sold for today? And are prices climbing or declining? If your research shows prices for comparable units are relatively stable, the market may actually be in decline. Chances are only the most-sought-after units are being purchased, and sellers may be offering concessions.

Property-owners with significant inventory and slowing sales may offer real estate brokers much higher-than-normal commissions to keep units moving. There are property-owners in San Diego offering a new car to any broker who can sell a condo unit. These non-purchase-price concessions tend to not upset previous buyers in the same building, and they don’t establish new, lower purchase-price benchmarks for appraisal purposes.

You may be approached by the owners of a number of individual units in a large property who want to refinance their acquisition. This can be a difficult loan to close because your clients only own a portion of the project. Lenders tend to be more receptive to applicants who are in complete control of the asset.

If you are working on financing one of these projects, be sure to check if the initial sold units were part or all of a below-market-rent requirement. Also, carefully analyze your clients’ financial statements. Applicants with a significant portion of their net worth tied up in either projects that have not sold out or projects that are still in development will be scrutinized by lenders.

Ultimately, there are strong and weak condo-development properties in every region. We’ve taken the liberty of generalizing some markets as a means toward discovering an overall picture. When it comes to your own market, be sure to conduct your research thoroughly.