Debunk the Bubble

Explain to your borrowers what to expect from the current multifamily market

BY **Michelle Edwards** assistant vice president of mortgage originations,
AND **Courtney E. Cox** marketing communications manager, Technology Credit Union

Is the real estate bubble about to burst? It's a question on the minds of many novice real estate investors — and they are turning to their mortgage brokers for answers. With so much speculation about the residential market, it's hard to pinpoint the answer for the multifamily market. This makes would-be investors nervous about expanding their real estate portfolios.

By helping investors understand the complex factors involved in determining what defines a "bubble," however, brokers can also help them determine what type of investment is right for them.

Learn market realities

First off, is there a real estate bubble? Rather than a national bubble, it appears that we should really be looking for "bubblettes," according to a recent study by a large commercial lender. These bubblettes are unstable, regional pockets where real estate prices potentially can outpace market values. According to Richard DeKaser, the chief economist involved in this study, we should examine metropolitan statistical areas individually to understand the factors involved within a particular market. In his review of 99 different U.S. metro areas, DeKaser found that many are overvalued, but many are at or even below expected values.

Just as indicators for residential real estate bubblettes exist on a regional level, varying regional influences affect multifamily real estate. In an extreme example, commercial real estate has seen a tremendous upsurge in demand in the undamaged areas around the hurricane-ravaged South and Southeast. The National Association of Realtors (NAR) expects to see tremendous short-term multifamily rent growth in these metro areas as businesses and residents relocate. Cities such as Houston, Dallas, Atlanta, Miami and Tampa, Fla., will likely be affected significantly. Property values in these areas increase tremendously, which could put them into bubblette territory — even in the short term — and boosting rents.

Although most contributing factors for the Gulf Coast are more severe than normal, the complexities of supply, demand and pricing appreciation exist in any market. Such complexities could contribute to your investors' reservations. Your best bet for combating their fears is to educate them. Give would-be investors the honest scoop about the opportunities and challenges that await them in the multifamily-property market.

Set expectations

Different borrowers have different goals when it comes to commercial investments. Everyone wants to make a profit, but many people's timelines and profit expectations can be off-kilter. They've seen such dramatic appreciation in the past few years that they now are getting into the market and expecting to become rich overnight. These potential investors might be living in a hot multifamily-property market, but if they think they're going to see the same gains seen recently, they could be in for a rude awakening.

That's not to say that the multifamily market doesn't have a sunny forecast.

Continued …

According to a release from the NAR this past September, vacancy rates are projected to drop to 5.1 percent in the fourth quarter and to 5 percent by the end of 2006. This is significantly better than the 6.2 percent vacancy rate from 2004. Although rents rose a modest 1.5 percent in 2004, they are expected to climb 2.7 percent in 2005 and another 3 percent in 2006.

As the Federal Reserve continues to raise rates, fewer renters will be jumping into the residential real estate market. As a result, multifamily-property-owners will see higher rent rolls. At the same time, however, multifamily-property-loan rates will be higher. This means fewer people may be interested in buying such properties. Consequently, it may be more difficult for investors to turn around properties for a quick profit. Explain to your borrowers that the market is changing and that at this point, multifamily properties might be better long-term investments.

Understand your local market

Your borrowers and investors are looking to you as their real estate market expert. It's up to you to help them understand the factors that could affect pricing in your area. Examine these top three indicators of what's really going on in your community.

- **Employment:** Conventional wisdom used to be that the biggest predictor of risk for a loan default was credit scores. The actual primary reason for defaults, however, is unemployment. If employment in your market is based largely on a single industry, there's a much greater chance that housing prices in your market are fragile. Layoffs could mean the difference between a pricing appreciation and a plunge.
- **Quality of life:** Why do people want to live in your market? Is it because of the thriving, multi-industry employment? Are you located near a major university? Does your community boast tourist attractions? Sometimes, prices are high simply because an area attracts many people. The San Francisco Bay Area, for example, ranks highly on the bubblette study. Many people want to live in the Bay Area to enjoy its moderate weather, diversity and job growth. You must examine these layers of attraction, though. If one attribute goes away, will the demand for housing go with it?
- **Housing stock:** What drives prices in many markets is the short supply of housing. Sometimes the short supply results from the high employment levels and quality of life. Other times, cities have ecological concerns that impede development. These can include protected wildlife preserves or greenbelts where building is prohibited. Aging housing stock is another factor; older areas might need revitalization, which could suppress property values.

TOP 25 Residential 'Bubblettes'

The regional factors that create residential real estate bubblettes can also affect multifamily real estate. These figures of metropolitan area single-family home over-valuations are estimates from 2004.

- CHICO, CALIF. 43%
- STOCKTON, CALIF. 34%
- SANTA BARBARA, CALIF. 34%
- LOS ANGELES 32%
- SAN FRANCISCO 30%
- MODESTO, CALIF. 30%
- SAN DIEGO 28%
- WEST PALM BEACH, FLA. 26%
- SACRAMENTO, CALIF. 25%
- LAS VEGAS 24%
- PORTLAND, ORE. 24%
- MIAMI 23%
- SARASOTA, FLA. 22%
- DETROIT 22%
- SAGINAW, MICH. 21%
- BELLINGHAM, WASH. 21%
- FRESNO, CALIF. 19%
- RENO, NEV. 19%
- NEW YORK 16%
- ST. LOUIS 16%
- GREENVILLE, S.C. 15%
- BOSTON 14%
- HONOLULU 14%
- DENVER 14%
- SEATTLE 14%

Source: *National City, "Real Estate Study Finds Growing Risk of Housing 'Bubblettes,'" Feb. 10, 2005*

By helping your borrowers understand what's going on in your market, they'll be better-prepared to accept potential risks and gains on a multifamily investment. If the population density isn't there or the housing supply is too high, your borrowers may want to consider a different type of investment in that area.

Manage their risk

Your market's prospects might appear strong, but novice investors still could be nervous. Helping them manage their risk is essential. If borrowers want to purchase a multifamily property, they aren't going to get a loan from a reputable lender unless they can show that the property will be solvent.

Commercial lenders examine property with a fine-tooth comb. The borrowers' financials are important. But if the property can't pay for itself and make a profit on top of that, borrowers' wealth or FICO scores won't make a difference. In short, if their debt-servicing ratios, property appraisals and collateral reviews aren't painting a profitable picture, a reputable lender isn't going to give them a loan.

Continued ...

As their broker, you are looking out for their best interests. You want them to work with a lender that isn't going to put them in a bad situation. Be sure to help your borrowers choose a lender that offers flexibility without sacrificing responsibility.

Be candid. If your novice investors come to you with a property and the numbers don't work, tell them. Help them to understand the market, its potential and its challenges. This is just another way of establishing yourself as their trusted adviser. Those who heed your good advice will thank you — with return business and future referrals.

Michelle Edwards, assistant vice president of mortgage originations for Technology Credit Union, has leveraged her vast mortgage sales and operations expertise to build Tech CU's hassle-free wholesale product suite and simplify the commercial (more than five units) apartment-lending process.

Courtney E. Cox, marketing communications manager for Technology Credit Union, oversees the company's promotional and channel marketing efforts and has written numerous articles for marketing and mortgage industry publications.

E-mail medwards@techcu.com or ccox@techcu.com, or visit www.techcu.com.