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Economic Forecast for South Florida Residential Real Estate Market 2008 – 2013

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I offer this analysis because I am convinced that a plunge in Florida housing prices is coming that is of unprecedented severity. There are clear signs that the market decline of the past year is going to get far worse than anything any of us have ever experienced in the past 75 years. I am not a prophet or an economist but I do understand basic finance and remember lessons learned from the past, a past that has covered enough years to be a useful resource. What that past experience suggests is that there is an urgent need for our real estate based economy to return to realistic market principles.

I believe that there is a common element of denial, in some quarters, of the severity of the market conditions in Florida, predicated upon baseless optimism. The “wait and see” approach to this crisis may be acceptable for the fortunate few whose properties have an affordable financial burden, e.g. owner occupants with no mortgage, “save our homes” exemptions from high real estate taxes, and insurance that is outside the high cost coastal coverage zones. *The problem is that the period of time for a recovery of residential values may last an average of more than five (5) years.* This portends a period of sustained deflation that is longer than any we have experienced in this marketplace. Absent the advantages of affordable carrying costs, this presents a dilemma for prospective buyers, intended homeowners, landlords and investors. It is a dilemma to all those who intend to sell in the next few years. It is a dilemma to lenders, insurers, contractors, realtors, service providers and all others who are involved in Florida real estate.

The analysis that follows is based, in part, on a seven page article published in FORTUNE November 12, 2007 by Shawn Tully, a free lance writer for FORTUNE. Mr. Tully may or may not agree with my analysis – I did not ask his opinion, but I am obliged to credit him for the information in his article, as it seems very prescient. In further part, this analysis is based upon empirical information provided by certain of my clients in Florida and in Europe and upon a reasoned analysis using common sense and simple math.

The problems of escalating *insurance* costs and government overspending that has led to very high *real estate taxes* (averaging 2% or more of past market values) are issues that are part of the equation. Solutions to those problems must be found by Florida regulators, the legislature and by local governments. It is not my intention to address those issues here. Moreover, solving those problems will not avoid the coming crash in prices.

What I am addressing in this analysis is the basic question of bridging the gap between unrealistic expectations and economic reality as they pertain to market values of residential properties. I believe that the sooner we all realize the extent of the impairment in historical values, the sooner we can work through the inventory of unsold residential properties, get the losses behind us and move forward.

In the 1970s the real estate collapse was driven by extremely high interest rates and a lack of investment capital. The banks that financed developers and the REITs dragged their feet for years before biting the bullet, acknowledging their losses and moving forward to complete unfinished distressed projects and dispose of them. Only then did we move out of a depression in the real estate market. In the 1980s values plummeted 30% when Congress enacted tax reform denying deductions to passive investors for real estate write offs. Savings and Loans got the blame for bad loans when the values of the underlying collateral fell sharply following the tax legislation. The RTC was then formed by the Federal government, which stepped in and bailed out the S&Ls. The RTC then sold off the defaulted S&L properties at “bargain” prices. The result was that the markets returned to normal much faster than in the 1970s.

Today interest rates are low, but credit for real estate loans has become very difficult to find and difficult to qualify for. Homeowners who are over-borrowed on credit cards can no longer turn to readily available home equity loans to bail out their over-extended consumer debt. By one account this credit card debt roughly equals the problem element of the subprime mortgage debt—worse, it is totally unsecured. The pace of defaults is accelerating with no end in sight. Defaults are not only coming from marginal, low equity, low income borrowers, but also on high-end properties, many of which are held by speculators.

The decline in real estate values that has already been seen means that borrowers with existing loans often owe more than the properties can be sold for. A general recession is widely expected by end of 2008. The dollar is at an all time low and falling. Consumer confidence is descending. Oil and gas are at all time highs and rising, as is the price of gold. The only bright spots for now are the stock market and the jobless rate, but with all that is going wrong, is this just the calm before the storm?

The overhang of unsold condo units in South Florida is more than 25,000 with another 10,000 expected to come onto the market soon plus at least that many single family homes for sale and resale. At the level of sales of condo units six months ago, the inventory represented at least a 31 month excess supply of units and the level of sales has fallen even further since then, suggesting that it could be three to five years until supply and demand are brought into alignment. There is nothing in any data that supports an optimistic outlook for the housing markets over the next 3- 5 years.

What I offer here is not a prediction of future events. I assume no responsibility for any act that anyone takes as a result of what is written here. It is merely a perspective that I strongly suggest you consider in determining whether to buy or sell and at what price. Many, many imponderable events could completely change this picture and I have not undertaken to deal with any of them other than those described. The only thing certain about the future is that it is uncertain.

The Future According to Mr. Tully:

Using a reasonable barometer of values; the 15 year average ratio of price to rentals, the writer has made a forecast that housing property values looking 5 years hence will be down over June 2007 values by sometimes significant percentages.

Importantly he sees 37.2% declines in Orlando; 41.1% declines in Miami; 35.9% in Fort Lauderdale; 32.2% declines in Tampa; and 35.1% in Palm Beach. These declines are projected for upscale homes double the median prices in each locale.

Largely because of the overhang of unsold residential units (he places the number at 60,000 in Miami alone) He quotes Mark Zandi, chief economist of Moody's economy.com that "In... Florida, it's highly possible that most of the correction (i.e. tumbling of prices) will happen by the end of 2008."

A post script on the use of *median* prices in this analysis: A friend of many years who is a major developer of single family houses noted recently that there is a recent trend that may likely continue for some time that will influence the comparison of future "median" prices to historical median prices. Developers will be trying to appeal to buyers with a more affordable product which will mean fewer frills (like granite counters) and smaller sized houses in order to focus on lower prices. This does not mean that demand for housing "units" will fall as sharply as "price demand" falls. What it may mean to the market place is that these lower priced new homes will be competing with the deeply discounted larger pre-owned homes, something we have not seen in the marketplace for years.

A reasoned analysis of the economics of buying and holding for 5 years

If you are a prospective buyer who is an intended owner/occupant as a 5 year investment. (This example applies whether or not you intend to use a mortgage to buy) The above projections tell you that you are in a buyer's market that will benefit you if you plan to buy at the end of 2008 or later when the market forces have driven prices further down. If you believe the projections, you need not rush into a purchase since the market will take up to 5 years before it turns upward.

(CAUTION - the availability of cheap mortgage money may be very short lived if, as many believe, we are entering a recession. Delay and you may find affordable loans no longer available). You should, on average, expect to be able to buy at a price one third or more below mid 2007 prices. Any seller with whom you are dealing should be expecting no better price than a one-third discount from mid 2007 prices, so a house that sold for \$600,000 in mid 2007 should fetch a price of not more than \$400,000. CAUTION: because many of the buyers in the market are buying to rent with or without mortgage financing, their limitations described below may establish a lower price yet, so be cautious in offering a price with a mere discount of one-third. You may get a better price.

If you are an investor who intends to rent the property to others as a 5 year investment. (This example applies if you use no mortgage to buy) The market conditions are the same as above, with significant added concerns as a landlord/investor. If you expect to rent the property to others, realize that much of the overhang of unsold units is now entering the rental market **driving rental prices down**. You need to be realistic and not expect that rentals will generate more cash flow than enough to pay taxes, insurance and homeowner's dues and assessments or routine maintenance. Since any profit you are to realize on your investment is dependent upon growth in value, assuming you target 5% annually as an acceptable profit, you will need to pay at least 20% below the market value being paid by the intended owner occupant described above. Moreover you will need to allow for a 6% real estate commission on your ultimate sale to protect your profit. **This means that a house that sold for \$600,000 in mid 2007 must fetch a price from you of less than \$300,000---a 50% reduction from the mid 2007 price.**

If you are an investor who intends to rent the property to others as a 5 year investment. (This example applies if you do use a mortgage to buy) Market conditions present the prospective buyer/borrower with same concerns as described above for an owner/occupant and for a buyer who does not intend to borrow, plus additional major concerns in terms of the economics of the deal. Not only will you need a 20% discount to provide you with a profit as in the above example plus a 6% discount to cover selling expenses when you sell, but if you are paying 5% interest on your mortgage, you need to cover that cost with another major discount below market price when you buy. **This means that a house that sold for \$600,000 in mid 2007 must fetch a price from you of less than \$250,000---a nearly 60% reduction from the mid 2007 price.**

During the past three real estate recessions we have experienced in Florida, foreign investors were major players in bringing values back up from the trough. Generally they emerged as buyers when the prices had dropped and were on the way back up, not during the decline. The strong Euro seems to make prices in the U.S. look like bargains when viewed in the European currency. However, the real decline in values to date is a fraction of what I believe is on the horizon. That tells me that the Europeans will not enter the market for some time yet and then at much lower prices than are now being asked. Perhaps they will hold off until the dollar is on the rise and the housing market begins to recover on its own. The message is, do not look to the Europeans to lead us out of this mess this time. If one looks to South America for a rescue, historically, the flight capital into the Florida market has come from Venezuela in large numbers, which has been heavily tapped out with the rise of Chavez now being several years old. Brazil is a heavy favorite to produce investors, but the buying pressure is not driven in the same manner as flight capital, rather it is similar to European investors who are looking to diversify their risk exposure. For that reason, Brazilian investors are likely to follow the pattern of the Europeans. The Brazilian and Canadian currencies are following the trend of the Euro against the Dollar. Do not expect a flood of those currencies into our market until both the market and our Dollar have at least stabilized and are in an upward trend.

Beyond five years, and as early as three years from now, there is some reason to expect prices to recover much of the losses we have yet to suffer. Why? Even though there is a massive excess inventory now, there are few new starts. The inventory overhang in Palm Beach is half what it is in Broward and Broward is marginally better off than Miami-Dade. As of last November, Reinhold P. Wolff Economic Research Inc. published a study that showed only about 3500 condo units planned but not started in all of South Florida. This is a simple factor of supply and demand indicating higher prices in the future as existing units are absorbed and not replaced.

However, for the supply and demand conditions to work the way they should work, after the overhanging inventory is sold, the buyers must be *able* to buy. To be sure, the sub-prime mortgage crisis needs to be solved and the banking system needs major recapitalization to enable loans to be made. Real estate taxes and insurance costs need to be held in check to enable the kind of demand for homes in Florida that existed several years ago. The new Florida constitutional amendment passed this year creates local buyer demand for many owners who have been “trapped” by their “save our homes exemption.” They now have portability of the exemption up to \$500,000. Of course, this means more existing homes entering the market, but most sellers will also be buyers, a zero sum gain for the demand side of the equation.

Finally there is the prospect of inflation. Even if inflation does not produce *economic* gain, it means higher prices on virtually everything, including houses, *if* the supply of houses is in balance with demand. Of course it also means higher interest rates on mortgages, higher taxes and higher insurance rates. If our economy returns to inflationary conditions, this may simply mean that it does not mean better market conditions for houses. It may mean unaffordable monthly payments. On the other hand inflation may indicate another view of the situation. One of my long-term European-American clients who has been an investor in and developer of real estate and is sitting on the sidelines now, observed that property on deep water (because it is a limited commodity like gold) may be the best inflation hedge of all and one of the best places to store your deteriorating dollars. He does not embrace real estate as a whole. He sees the specter of partially empty, brand new, well located condominium complexes with bankrupt developers failing to fund maintenance fees, and after double and triple sized assessments go unpaid with the result that the windstorm and fire policies go unpaid, catastrophic results are inevitable; not the least of which is massive defaults on the many mortgages of owners due to unpaid insurance. Such a condition is very likely to dampen any enthusiasm for condominiums as an investment.

CONCLUSION

All of this says that this is a buyer’s market. If you buy now, buy low because it will likely be a long time before you are able to sell at a profit. If you are a seller, be realistic about the situation. It may be best to get out now at a price you would not have considered even a few months ago. It will be very costly to hold on long-term, looking for a price that is above where the market is headed.