The Changing Dynamics of Real Estate Investment

By Mark L. Stockton

In today's recovering residential real estate market, investors have played an important role, accounting for more than 20 percent of all purchases in recent months. As noted in an article that appeared on RISMedia.com on August 28, entitled "A New Breed of Real Estate Investor; The Value Investor," there's been a noticeable shift in the motivation of investors from those seeking deep discounts to those seeking sound investments in stable markets to hold for longer terms. This change in strategy signals an increasing need for good analytical tools to help investors make prudent decisions.

The abundance of properties that can be purchased for deep discounts has dwindled, which means proper evaluation of home values has gained importance as inventories have declined. As the anticipated holding period of the investments increases, the need to be able to evaluate the stability of individual markets takes on greater significance.

For example, a resident of Riverside, Calif., recently lost her home. She purchased it in May 2005 for $305,000, and at the time, the price was reasonable when compared to other homes in the immediate area. While I haven't seen the appraisal that was done at purchase, I cannot deny that a reasonable appraised value for the property in May 2005 would have been approximately $305,000. What I can say with authority is that the appraised value at the time of purchase was unsustainable.

There are meaningful relationships in real estate markets just as there are in other markets (stocks, commodities, etc.) that must be monitored to support prudent lending and investing decisions. For example, we know there's a relationship between rents and sale prices that should be considered—especially from the investor's standpoint.

Another important relationship that's been long overlooked that will help us understand the sustainability of property values is the relationship between the market value of a home and its depreciated replacement cost (RCNLD). There's an old (often forgotten) adage that no prudent buyer would pay substantially more for a home than the cost to rebuild it on a similar site. This concept was once recognized by the appraisal industry and acknowledged in the cost approach to value. There was a time, not long ago, when appraisers had to provide commentary to support any cost approach in which the site value represented an excessive portion of the overall value. It was recognized at the time that a large disparity between the value of the improvements (depreciated replacement value) and the value conclusion (the market estimate derived from the cost approach) could be indicative of an unsustainable market value.

History has, in fact, shown us that when the gap between RCNLD and sale price begins to exceed its previous high in any given market, values are approaching unsustainable levels and we can be relatively certain that a correction in home prices is imminent.

When this individual purchased her house in 2005, the ratio between RCNLD and home prices (Market Experience Ratio©, or MER©) in the immediate area was in excess of 220 percent, meaning homes were selling for considerably more than twice their depreciated replacement costs. Her home and the neighboring homes were being sold very near the high point of what would become known as the housing bubble. For those of us who watch relationships closely and have developed a means of monitoring them on both a broad scale and granular basis, this was obvious. Each time this occurs, as it has on several occasions in the past 30 years, market prices respond by declining to a level that more closely approximates depreciated replacement cost. The current MER for homes in this area is averaging about 120 percent, and prices have reached reasonably sustainable levels for that locale.

Here's the bad news: At purchase, this homebuyer was able to secure a 95 percent loan with payments structured to start off small and increase over time as her income and equity grew.

Ecstatic at the prospect of being able to own a new home with a modest down payment, she was unaware of the danger that lay ahead. So too was her lender, apparently. She can be forgiven; she was not what is sometimes referred to as a "sophisticated investor." How can an average consumer be expected to understand market dynamics and complex financial dealings? Isn't that why they rely on professionals?

The lender, however, should have known better. What happened to real estate markets nationwide soon thereafter was not an anomaly. It has happened often in the past, and it will happen again in the future. Every time investment dollars become more abundant and credit restrictions relax, you can bet this same scenario will play out in real estate markets across the country.

This homebuyer then lost her job in 2010. She was forced to confront the fact that she was unemployed and would have to compete with tens of thousands of other unemployed individuals for a position that would probably pay less than her old job—if she could find employment at all. The value of her home had declined by nearly 50 percent in the years since she had made her purchase. Instead of building equity, she was underwater on her mortgage. Eventually, her home was foreclosed and she found herself in a position that is all too common today. While not homeless, she faced bankruptcy and the inevitable emotional and financial difficulties that ensue.

If the proper tools and analytics had been available to the lender in 2005, chances are things would have turned out better for all parties. It is reasonable to assume that the lender, recognizing the instability in the housing market, would have modified its lending practices, and terms offered to borrowers would have become more restrictive. In fact, there's a high probability that the instability would have never reached such extremes; lenders and investors might have acted promptly and prudently to put downward pressure on rapidly inflating sale prices, and subsequent losses might have been significantly reduced.

This unfortunate homebuyer might not have qualified for a loan at all, and would have perhaps been forced to continue renting until she accumulated a suitable down payment. If, and when, she was ready to make a purchase, she might have had to settle for a "starter home" rather than opting to buy her dream house. These, by the way, are not bad things. Until recently, this was regarded as the appropriate path to homeownership in America.

So here's the message: Prudent lending and investing must be based on more than just accurate appraised values. Values must be scrutinized for their sustainability as well. As all parties to this transaction discovered, an accurate value for a home yesterday might differ substantially from an accurate value for the same home today. That doesn't make either value conclusion less accurate, but it does reveal that markets fluctuate and values must be viewed within the context of current market trends and long-term sustainability.

If your current valuation solution does not provide you with both a reasonably accurate value conclusion—supported by industry standard analytics—and a reasonable measure of sustainability, you need a solution that does.

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