The Issue

A Publication of CFOs2GO

Volume 7, Issue 4 **Fall 2017**

What is the value of housing, and why is there a "Housing Crisis?"

By Bill Klein
Partner, CFOs2GO

Everyone values housing. When we think of value, we think of how highly something deserves to be regarded, i.e., its importance, worth or usefulness. Although this is not an objective standard because it is influenced by personal lifestyle choices, everyone wants an affordable place to live. When shopping for a new home, whether renting or buying, people are faced with how much they can afford to pay given their life style, income and other financial resources; what are the acceptable trade-offs in location, size, neighborhood, proximity to essential services, schools, commercial centers, churches, commute time, etc. In making these decisions, they are placing a value on their choice of housing. We also must recognize the subjective nature of value. We often place a higher value on our own possessions or points of view than we place on those of our neighbors or people we don't even know.

As more and more people want to live in California, more housing is needed to accommodate them. Fundamentally, housing is subject to the same dynamics as other segments of the economy. In a pure economy, unaffected by outside influences, when supply lags demand prices go up and when demand lags supply, prices go down. But housing is a bit more complicated in that it involves other factors - politics and attitudes. What is often described as a housing crisis is an overly simplified way of saying that not only is there not enough housing to go around, and not enough of it is being built to meet the demand, but there is also a disparate relationship between the ratio of low, moderate and high-income housing in any given region to the ratio of low, moderate and high-income residents who wish to live in that region.

Construction of "enough" housing to meet the demand is constrained by both typical economic factors such as labor and material costs and non-economic factors. Because of high demand and insufficient supply, prices will continue to increase until supply meets demand. If there were no constraints on housing construction, according to the latest UCLA Anderson Forecast released September 27, 2017, achieving a modest ten percent reduction in housing prices would require a supply increase of over 20%. To add some perspective to this number, at the end of 2015 the East Bay had about 995,000 residential units. It would have to build around 199,000 new single-family homes to increase supply by 20%. Such a pace would require 22 years to reach the estimated target and roll back prices by 10%.

How is it decided how much moderate-income housing is appropriate for a given community? Is it acceptable for the shortage of housing to be felt equally among the low, moderate and high-income residents? Is a shortage of low income housing more unacceptable than a shortage of other housing? Is a community's obligation to provide its fair share of low- or moderate-income housing met when the demand for such housing equals the supply, or when demand is greater than supply but equal to other income strata?

For decades California has required local communities to provide their fair share of affordable housing. So, the concept is well rooted. The practice however, is not.

First, let's look at overall housing demand. What are the factors influencing demand? First, in the case of the San Francisco Bay Area, as well as other regions, there are more people moving into the region than there are new homes being built. If that is not enough to increase demand, younger generations want to leave home but not leave the region, so they contribute to the increase in population that far exceeds the housing supply. Those living here already want to live as close to work as they can afford. Mortgage lenders want to lend money to buyers and entice them with lower interest rates, faster closing.

People are tired of agonizing commutes that result from having to live far away from their income centers. To top off the shear distance and time of commutes, there is insufficient investment in infrastructure to maintain the commute corridors. As they fall into disrepair, distance and time are supplanted by consistently uncomfortable travel experiences over pothole-stricken highways. So, the demand for close-in affordable housing, housing that is close to the income centers that people can actually afford to rent or buy, increases.

Demand is not only high, it is insatiable, and lenders want to lend. Look at the indicators:

- Interest rates are below 4%.
- Innovative loan products are emerging such as 90% (and more) loan-to-value in order to get buyers into the most expensive home they can afford to make payments on.
- Credit score requirements are drifting down, now around 620;
- The secondary market is hot – lenders can close a loan and sell it virtually simultaneously.
- The economy is warming – jobs are up, unemployment is down

Granted, these indicators are not without risk. But lenders are betting, as they did in the early and mid-1990s, that home prices will continue to rise; if not at the current pace, at least enough to protect their investment in home mortgages.

According to Andrea Riquier of MarketWatch.com (April 5, 2017), the 20% down payment is a relic: the median down payment in 2016 was 10%, and for first-time homebuyers, it was 6%. First-time buyers and other buyers of less expensive homes are more leveraged now than they were at the height of the housing bubble a decade ago. Also, in early 2017, the Mortgage Bankers Association reported the median mortgage size has grown from 3.3 times the median annual income in 1990 to more than 5 times the median in 2016.

Steven Morger, a real estate lawyer at Wendel Rosen Black & Dean, LLP in Oakland California and adjunct law professor at the University of California law School, Bolt Hall, specializes in the legal aspects of mortgages and foreclosures. He has observed financing arrangements where the lender supplies part of the down payment for the buyer so that the buyer can get into a home for only 2% to 3% down. It is his opinion that although innovative loan products such as this can work in a healthy economy they can, and do, result in losses if the borrower cannot make the payments. Why would a lender take this risk? Because, says Morger, the secondary market is so hot, that a primary lender can sell the loan as soon as they close it and make their fee immediately. This entices lenders to make as many loans as possible, as fast as possible, to qualified buyers (who have lower, but acceptable, credit scores). Unlike the housing bubble of the last decade, today's borrowers are better qualified. They just don't need as large a down payment, and the secondary market is better equipped to spread risk.

Let's look at supply. So why is housing production down? Why not build more homes?

Partly because of cost: it is more profitable for a builder to build one 3,000 square foot home than three 1,000 square foot homes. So, builders are trending toward larger homes. Lenders are helping by providing mortgage loans at interest rates less than 4% for upwards of 90% of the value of the home.

The Statewide Housing Assessment produced through the California Department of Housing and Community Development published in January 2017, maintains that over the last decade, housing production has averaged less than 45% of the demand. From 1955 to 1989 California builders produced an average of 200,000 homes per year. But, in the past ten years the report says while demand was down somewhat to around 180,000 per year, an average of only 80,000 homes per year were built. The sharp drop in production has naturally resulted in higher purchase prices and higher rents. For people looking for affordable homes, it has also resulted in harder choices in where to live, and longer commutes. So not only is there a shortage of affordable housing, but the is a direct correlation to the significant increase in traffic on our highways. This in turn contributes to increased road maintenance requirements that are not being met. Public transit cannot keep up with commute volume. Inadequate transportation leads to social disconnects. A worker who has to drive upwards of two hours each way each day to and from work ends up leading two different lives. The fortunate ones are those who believe that is temporary, that they will be able to move closer-in someday.

The reason affordable housing is generally located so far from the income centers, is that the cost of land, construction materials and labor are all lower. Conversely, close-in land is more desirable and therefore more expensive. Most homebuilders cannot afford to develop a residential project consisting of only affordable housing on desirable land near income centers. To build affordable housing, a builder must also build higher cost housing making the project larger. Making the project larger results in an economy of scale that allows lower costs housing to be included. But it also results in higher density that many existing residents, and even some municipalities, find objectionable. The difficulty in getting approval for higher density construction is resulting in builders trending towards high-end luxury homes that are easier to get approved and have higher profit margins.

Even where higher density construction is approved, construction isn't happening at a pace required to keep up with the demand for affordable housing.   Why not? Because of local barriers to development. Public attitudes toward homebuilding. How communities and residents think about the value of new housing. Local planning and zoning laws are often outdated, restrictive and difficult to change, which fosters a sense in the community that there is no need for more housing. New development that includes a small number of affordable units is frowned on by existing residents who don't want their neighborhood to change.

When people move to a community because it both promotes and reflects their lifestyle, they often do not realize that they are inheriting land use decisions that may have been made a generation ago. So, while no significant building has gone on in an area that residents find appealing because it is quiet and sleepy and free of choking traffic, eventually land owners will succumb to development pressure. Contrary to widely held beliefs, a land owner has the right to construct anything that is permitted by the zoning ordinance. This is because the right of land ownership carries with it the right to put the land to its highest and best use within the constraints of existing land use planning and policy. The planning agency cannot prevent the development if it is otherwise permitted in the zoning ordinance.

Also, invariably, builders choose private land that is either already zoned for a certain density of housing, or can be changed through the permitting process. Changing zoning to accommodate a project is expensive and usually relegated to very large projects that are outside of the core urban center or town center.

Many municipalities and other regional governments allow developers to increase density in multifamily projects in return for allocating a percentage of the new units to moderate income residents. This policy is one way to increase affordable housing in an otherwise unaffordable neighborhood.

According to the Building Industry Association Bay Area, the City of Palo Alto charges a Housing Impact Fee based on unit square footage for rental housing and detached single-family homes. And the City of Santa Clara requires new developments of for-sale housing of 10 or more units to provide at least 10 percent of units at below market rates for moderate income households.

Mortgage rates have been dropping until recently and although they are trending up, they are below 4%. While home prices keep going up with multiple offers and sale prices exceeding list prices, worries are growing that the housing market is getting too hot. The market is always cyclical and continued rapid growth is not sustainable, but the concern is how much will prices fall when they start.

While the concept of fair share in housing has been around for decades, many communities are behind on conforming to the mandate. The Legislative Analyst's Office (LAO) has noted that residents often disfavor updates to local zoning and planning laws to accommodate more housing because many of them see the changes that new housing would bring as a threat to their wellbeing. This mindset cannot be legislated away. Unfortunately, "well-being" can take the tenor of NIMBY – not in my backyard. So, while local governments and regional planning agencies may wish to attract more housing, and indeed must do so in order to shoulder their fair share of low- and moderate-income housing, until residents understand that more homebuilding could substantially improve the lives of future generations of residents, California will continue to be an unaffordable place to live.

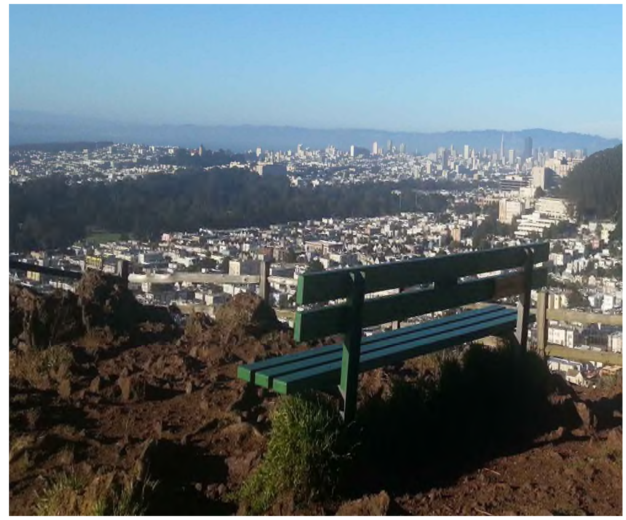
Local agencies feel pressure to provide their fair share of affordable housing, but also pressure from constituents to control or even stop building. In some cases, (Pleasanton) the local governing agency actually passes the decision to the courts rather than offending their voter base, by forcing a builder or residents or special interest groups to sue hoping to get their way, then accepting the court decision to permit the project to be built.

Local agencies, city councils and planning commissions, have great discretion. Because they are empowered to shape their cities the way they want, the burden is heavy on those interests that wish to overcome local decisions regarding land use planning. This discretionary power along with NIMBY attitudes of their constituents are the strongest forces countering the law of supply and demand.

So, what do cities do to comply with fair share mandates? Some can partner with pro-housing organizations if there is available land. For example, Alameda point in the city of Alameda, California is being constructed on land that was a former military base. Other cities must look to outlying areas adjacent to their boundaries to promote growth. Unfortunately, such land is already expensive and may require coalitions of developers and public agencies to share the risk of building below market housing.

Summary

The daunting task of building enough homes to exert meaningful downward pressure on prices seems insurmountable. Even recent legislation that directly addresses the problem may have little impact. After years of inaction, the California legislature just passed a $4 Billion housing bond that will go before voters in 2018. It will provide funds for affordable housing. Other measures aimed at streamlining the development process will remove some of the local obstacles to affordable development. Even a YIMBY (Yes In My Backyard) movement is gaining steam in San Francisco. But, until people realize the benefits of having residents of all economic strata in their communities, the activist mentality to veto everything that suggests sprawl and high density will continue to exacerbate the crisis.



If you need assistance in assessing your real estate holdings or are facing a uniquely challenging business situation requiring subject area expertise, please contact Bill Klein at CFOs2Go (bklein@CFOs2GO.com) or by calling him at (925) 890-7521.

Bill Klein leads the real estate development and construction practice group with CFOs2GO. As a former real estate development and construction controller and CFO, he provides business advisory services and financial consulting for both large and small developers and contractors. He has significant experience dealing with all facets of accounting and financial management and has particular expertise in bank and private financing, project budgeting, investor waterfall modeling, construction cost accounting, internal controls, reporting, and project management.

Practice Areas: Real Estate Development & Construction (Lead); Small Business

www.2gocompanies.com/cfos2go/team/practice-groups/

CFOs 2GO Partners is a hand-picked team of leading practicing CFO consultants who customize and provide financial management solutions for client companies. The company was founded and is still managed by a former CFO. Each of the consultants have, in addition to themselves and the other consultants, access to specialty financial management executive search and placement services to assist in quickly fulfilling on client company requests both in the U.S. and abroad.