

Real Estate: Buy, Sell, or Hold?

by Shawn Tully

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FORTUNE
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That's the question homeowners are asking in the midst of the worst real estate slump in decades. Our exclusive calculations can help you figure out what your house will be worth in coming years.

You can't blame America's homeowners for feeling hopelessly confused. From suburban porches and city terraces, they're gawking at a housing world gone mad. Just 18 months ago, folks on a tony Linden Lane or a leafy Boxwood Court were astounded to see the colonial their neighbors bought for \$600,000 in 2000 sell for \$1.5 million after multiple bids. Now they're just as bewildered to watch the same model across the street go begging for months at \$1.1 million without a single offer.

The millions of Americans who believed yesterday's happy talk about housing are now paying the price, from couples who stretched to buy second homes, to true believers who drove the Florida condo craze, to executives who can't take that great new job in Charlotte without suffering a huge loss on the house purchased at the bubble's peak in Sacramento.

Now that the gilded forecasts have proved spectacularly wrong, homeowners don't know what to think about real estate's future. The dizzying rise sure didn't make sense. And the sudden slump doesn't seem any more logical. How can you make reasonable financial plans for the future if you have no idea what your house is worth?

Take a deep breath. We can't tell you what your house would fetch tomorrow. But we can help you through the fog of whipsawing prices and vacillating views to develop a clear picture of what your house will most likely be worth in five years or so. Over long periods housing, like stocks and bonds, follows a set of economic fundamentals. No matter how far prices get unhinged in a speculative craze - and we've just witnessed a blowout - those basic forces eventually regain their grip.

Many factors determine the value of a house. A family would consider the quality of local schools, the number of bedrooms, the size of the yard. Economists assessing a region look at interest rates, employment, and population growth. But over time the most reliable guide to home values is rents.

In most markets people won't lay out much more in monthly costs to own a house or condo than they would to rent a similar property unless they expect a huge profit when they sell. Indeed, speculators chasing quick profits did a lot to inflate the recent bubble.

But once the fervor fades, prices must fall to restore their normal, long-term relationship with rents. Rents exercise a kind of inevitable gravitational pull on prices. The ratio of prices to rents "behaves much like price/earnings ratios for stocks," says Yale economist Robert Shiller. "Like P/Es, price-to-rent ratios are mean-reverting." In other words, while prices soar from time to time, sending the ratio to exceptional heights, sooner or later the relationship is bound to return to its historical average.

So what are rents saying about home values today? To answer that question, *Fortune* worked with Moody's Economy.com to estimate adjustments needed to get prices and rents back in

balance. We'll go into detail below, but the headline is gloomy: According to our calculations, prices in most markets will fall by double digits over the next five years.

Here's how we reached that disturbing conclusion. We started with the median price of existing homes in 54 metropolitan areas, using numbers from the National Association of Realtors. We then compared those prices with the annual rent on similar properties - houses, condos, and apartments with the same number of square feet as the median-priced house in each market - using figures prepared by Property & Portfolio Research, a commercial real estate research firm. That gave us a price/rent ratio for each area. [Economy.com](#) then compared the current P/R ratio with its average over the past 15 years and calculated how much it would have to decline to return to its historical norm. The average drop for all the markets we surveyed is 28%.

But that's not the whole story. The adjustment doesn't come exclusively from a fall in prices - rising rents also help close the gap. To complete the picture, Economy.com assembled a forecast of rental growth in each market; the average rise in our 54 markets is a total of 12% over the next five years. So to reach the average correction of 28%, prices need to drop only about 16%.

Of course, that's still a big bite. And in many areas the outlook is far worse. In the major Florida cities, Orlando, Miami, and Tampa, prices need to fall 28% to 34%. It's a similar story in inland California markets such as Sacramento (-26%) and the East Bay (-31%). In East Bay boom towns like Walnut Creek, a four-bedroom house that might have fetched \$1.56 million in the spring may go for less than \$1.1 million in five years.

Areas With the Largest Forecasted Price Decreases

Here's Fortune's forecast for the value of an upscale home (one that sells for double the local median price) in five years.

Metro area	June 2007	Five-year projection	Percent decrease
Orlando	\$522,000	\$343,000	-34.2%
Miami	\$759,000	\$514,000	-32.2%
East Bay, Calif.	\$1,562,000	\$1,078,000	-31.0%
Tampa	\$444,000	\$320,000	-28.0%
Baltimore	\$565,000	\$408,000	-27.8%

In a handful of cities, our formula suggests that prices will actually rise. Home values should increase slightly in Dallas, Indianapolis, Cleveland, and a few other locales the bubble missed. In Detroit houses are so cheap - the median is around \$100,000 - that even a shift in the economy from disastrous to mediocre is all that's needed to lift both rents and prices.

You can see the results for 54 areas around the country in [this table](#). We also show the impact of the projected adjustment on a typical high-end house - one that sells for double the local median price - and indicate what that price will likely be five years from now.

We specify how much of the adjustment in each area will come

from rent increases, and how much from price declines. Our forecast assumes moderate economic growth and job creation, and fairly stable interest rates. An unexpected boom or severe recession, of course, would change the picture.

One more note about our methodology. The home prices we used are taken from June data. At that point prices in many areas had already declined from their peaks. Since then, of course, we've had the subprime crisis and credit crunch, which have put further pressure on prices. So in many cities and towns, they have already started on the painful path back to rational levels.

To understand why the big price declines are inevitable, it's important to appreciate the giant chasm that opened between prices and rents, and how fast it happened. All through the 1990s the multiple of prices to rents nationwide remained between 14 and 15.

Then prices exploded for reasons that are now highly familiar. The most important was easy money. The 40-year-low interest rates that prevailed from 2003 to 2005, especially the irresistible teaser rates on adjustable loans, brought a flood of investors into the market. Lax lending standards allowed subprime borrowers, people with poor credit histories and erratic employment records, to suddenly afford to buy houses, further stoking demand.

By 2005 the Fed was aggressively raising rates to slake the coals. But the banks and Wall Street kept the party raging until late 2006 by concocting exotic mortgages that held down monthly payments for the first year or two and enabled buyers to keep paying outrageous prices. Then rising defaults forced lenders to scale back on loans to the high-risk borrowers driving the market. In July the subprime meltdown dealt the market a stiff blow by erasing the bargain rates that started the entire boom.

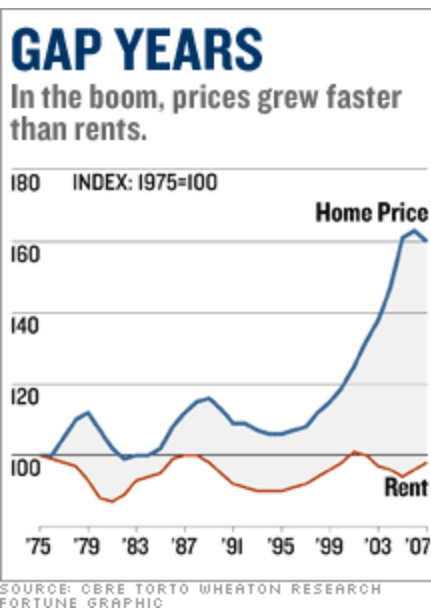
While prices rocketed, rents barely budged. From 2000 to 2006 they rose a total of about 10%, not even keeping pace with inflation. For a while, part - but only part - of the rise in prices relative to rents made sense. The drop in rates genuinely made houses far more affordable for millions of buyers. Between 2000 and early 2005 average mortgage rates, adjusted for inflation, declined from 5.5% to less than 4%.

But the tailwind from low rates is now over. The turning point came with the credit crunch this summer, when rates on jumbo loans jumped almost one percentage point. Today average real rates for all mortgages, fixed and adjustable, stand at 4.7% (adjusted for inflation), which is roughly in line with the long-term average. "For a time, higher than normal ratios of prices to rents were justified because of low real mortgage rates," says Mark Zandi, chief economist at Moody's Economy.com. "Today that justification is gone."

The cheap and easy money is gone, but the inflated prices it created are still here. No other factor was as important in driving the price-to-rent ratio to its current, unsustainable heights. From 2000 to 2007 the nationwide P/R jumped from 15 to 24, an increase of 60%. The figure went from 12 to 21 in Tampa, 11 to 26 in Washington, D.C., and 28 to 51 in California's East Bay, an area that includes Oakland and the area east of the city.

Naturally, every market is subject to different dynamics, governed by factors as diverse as local restrictions on building, job growth, and cultural pedigree. But in general cities fall into one of two broad categories when it comes to housing. The first we'll call the "classics," the urban centers that economist Christopher Mayer of Columbia lauds as "superstar cities." They're marquee names like New York, San Francisco, Los Angeles, and Chicago. To be sure, their housing prices have risen sharply. But they've benefited from excellent rental growth in the past, and the trend will continue, buoyed by their cultural cachet, job creation, and appeal to overseas buyers. As a result, steadily advancing rents will mitigate the price declines needed to make housing broadly attractive once again - keeping in mind that people are willing to devote a lot more of their income to shelter in New York City than in Pittsburgh or Cincinnati.

In these classic cities prices will still fall. But in most cases the drops will be relatively modest, a projected 14% in New York, 10% in San Francisco, 5% in Boston, and 4% in Chicago. The decline will also be slow and orderly, chiefly because it's extremely difficult to build new housing in these areas. Sellers will lower prices only grudgingly, keeping the supply of bargains to a minimum.



Manhattan, for example, largely escaped the invasion of speculators. No less than three-quarters of its owner-occupied housing stock consists of cooperative apartments governed by strict boards that ban investors. Nor can buyers choose from a vast array of fresh construction. About 4,000 newly built co-ops and condos have been hitting the Big Apple market annually, says Jonathan Miller of research firm Radar Logic. By contrast, more than 60,000 new homes and condos swamped the Phoenix area last year, according to RL Brown Housing Reports.

Three other classic cities won't fare nearly so well. In Washington, Los Angeles, and Miami prices rose far more than in San Francisco or Chicago, making housing unaffordable for a vast coterie of potential buyers. In Los Angeles it costs less than half as much to rent a house or condo than to own one, according to a study by real estate analyst Lou Taylor of Deutsche Bank. Annual housing expenses, after factoring in all tax savings, now absorb 34% of the average family's income in Los Angeles, twice the figure in 2000.

Miami is notorious for its skyline of unsold condos. What's less appreciated is that a large number of them - 60,000 units either completed or under construction in the Miami area - will be transformed into rental units. "That will prove a big drag in rental growth in the future," says Lewis Goodkin, an analyst who works with developers and lenders. Result: Price declines will bear the brunt of the correction in Miami.

Along with the classics, there is a second group of cities that we'll call the "boom towns." Among them are well-known disaster areas such as Las Vegas and Phoenix, and inland portions of California, notably the East Bay, the Sacramento region, and the Inland Empire, the sprawling suburbs east of Los Angeles, as well as Florida cities like Orlando and Tampa.

The overbuilt zone is characterized by rapid population growth, mile upon mile of new subdivisions and communities, and ample land for expansion. In the past the common wisdom held that despite all the open land, California was practically immune to overbuilding. The idea was that it was far too expensive and time consuming to transform vast swaths of raw acreage into building lots. The lesson of the bubble is that when prices climb high enough, builders - if it's humanly possible - will find a way to flood the market with new homes until the glut proves its own undoing.

It's in the boom towns that the correction will be both fastest and deepest. One reason is that the Southwest and California, along with Florida, posted the steepest rises in price. At the peak almost 40% of the buyers in places such as Sacramento, the East Bay, and Phoenix were either investors or families armed with subprime mortgages. "When the investors disappeared, so did about 20% of the demand in California and other hot markets," says Robert Toll, CEO of homebuilder Toll Brothers ([TOL](#)).

Now investors are throwing their unoccupied homes and condos on the market. To make matters worse, developers kept putting up houses at a breakneck pace well into 2006. "We were all building to investor demand that had disappeared," admits Toll. As a result the housing industry faces an enormous overhang of unsold, unoccupied homes - a total of 2.6 million nationwide. In a normal market the number would be about 1.6 million, and most of those would be homes that the owners recently left because of moves for a new job or retirement.

And they would be expected to sell quickly without deep price cuts. Today, though, many of the new vacant homes for sale are in the hands of builders, older homes that speculators are trying to dump, and foreclosed properties that banks are desperate to shed.



FROM: GETORLANDOREALESTATE.COM

The value of an upscale home in Orlando is forecasted to drop from \$436,000 to \$372,000 in five years

In California builders alone have 40,000 vacant houses and condos for sale. "We've never seen an inventory overhang that big in California," says Mike Castleman, CEO of Metro-study, a firm that monitors builders' projects nationwide. "The builders are paying full freight on those houses in interest costs to the bank and taxes. They've got to move that inventory for whatever price they get."

In San Bernardino County, about 60 miles east of Los Angeles in the Inland Empire, Kent Phillips, president of Storm Western Development, is selling houses for \$330,000 that last year went for \$400,000. "It's dreadful," says Phillips. "Last year we were selling four houses a month. Now it's one a month. The end came just like turning off a water spigot." Despite the steep discounts, Phillips is still holding six houses that haven't sold in a 16-home development he completed in January.

But Phillips sees an opening to revive the stricken business: plunging construction costs. He says that prices of finished lots, equipped with roads and utilities, have fallen from around \$135,000 to \$75,000. The cost of construction has gone down around 35%, from \$85 to \$54 per square foot. "Developers can now sell their houses for at least 20% less than a year ago and still make decent margins," says Phillips.

It's a similar story in California's Central Valley. Paul Roman, vice president of operations for the Empire Cos., a land development and construction firm, is building a new community in the rural town of Tehachapi. His edge: prices ranging from \$230,000 to \$280,000 for three-bedroom stucco homes, between \$80,000 and \$100,000 lower than the prices for similar houses at the peak. "The play is making the project affordable," says Roman. "A year ago, if you asked about cost, the subcontractors would hang up on you. Now they're willing to do the job at cost just to keep their employees busy."

The combination of steep discounts to move inventory and a stream of new communities built at a much lower cost will keep prices far below their peak levels in the boom towns. And they'll keep falling until builders work off the massive inventories.

The tumbling prices of new homes, in turn, will put enormous pressure on the far bigger existing-home market, already under stress from two desperate groups of sellers, investors and banks. Hence, the adjustment needed to bring the ratio of prices to rents into alignment will happen far faster than in most housing downturns. "In the most vulnerable places in California and Florida, it's highly possible that most of the correction will happen by the end of 2008," says Zandi.

There's one more factor that will prevent housing prices from recovering as quickly as they might have: the gargantuan rise in property taxes. In many affluent urban and suburban markets, property taxes have doubled since 2000. That's because they're based largely on the assessed value of homes for tax purposes, and those assessments are based on market value.

As housing prices doubled in places like Westchester County, N.Y., and Fairfax County, Va., property taxes soared. "My taxes went from around \$2,800 a year to \$5,600," says John Irons, a Fairfax resident who works as a commercial real estate broker at Long & Foster Realtors. "If you raise taxes on a commercial building, its value falls. The same is true for housing."

In California tax increases are capped until an owner sells the house. Then the new buyer is faced with a whopping bill. "Taxes on a \$1.8 million house in my neighborhood are \$23,000," says Phillips, "and that isn't even a fancy house." Nationwide the numbers are big.

Property taxes on houses and condos total roughly \$200 billion a year - about half as much as mortgage interest payments - and they have been rising by 8% a year, more than double the rate of inflation. It's a good bet property taxes won't go up nearly as fast in the future. But they're

unlikely to go down either. So homeowners face a burden they didn't have when the boom started. And one that won't end when it goes away.

Reporter associates Doris Burke, Telis Demos, Julie Schlosser, Christopher Tkaczyk and Jia Lynn Yang contributed to this article.