

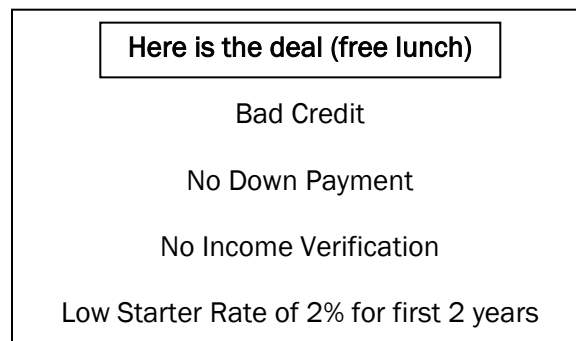
## Where Have the Apartment Tenants Gone?

by Joseph DeCarlo, MBA, CPM, CCIM, CRE

Housing prices are dropping, foreclosures and delinquencies have risen dramatically, sub-prime meltdowns have forced homeowners out of their houses so Apartment owners should have a huge waiting list of potential rents and should be raising rents 10-15%. This has not happened the price per unit has increased from 80,000 to 150,000 or 87.5% in the past five years; however, rents have only increased 4-5% per year that has created a huge "gap" between values and rental income to support these high apartment values.

We will look at jobs, the sub-prime meltdown, migration, immigration, rental rate and vacancy rates to analyze why the rental rates are not dramatically increasing and the vacancy rates decreasing to zero.

### Sub-Prime Meltdown



The above referenced was the enticing offer of sub-prime lenders to new homebuyers and those who wanted to refinance. There is little or no downside risk to the borrowers as they could refinance again, when interest rates increased after two years if the value went up and they would have cash in their pocket to buy a new SUV or Plasma TV. If the value went down, they did not have to make any payments or rents for 4 to 6 months and just walk away. In Santa Ana and Rialto 57% of homes were sub-prime mortgages. The lenders got points, prepayment penalties and higher interest rates in turn receiving high returns as long as home values increased.

We hit a housing downturn and home values did not increase, houses took 6 months or more to sell and sub-prime lenders went out of business so borrowers could not obtain a down payment or low interest loans with bad credit without verifying sufficient income.

### Sub-Prime

The housing prices in Central Santa Ana were overpriced (2 bed 1 bath for \$499,000) and the prices may fall 20-40% in these areas, as potential buyers are unable to get financing. Fanny Mae's top limit is \$417,000, which is the maximum they will buy loans from mortgage brokers. The rate for apartment loans has also increased from the sub-prime meltdown.

The real question is where are the people who are being displaced going to live? We have not seen a big surge in demand for apartment rentals in Santa Ana, thus not allowing for a substantial raise in rents. Some may have moved to the Inland Empire or moved back to other States.

## Jobs

The finance and construction industries have had severe job losses in the past year with many layoffs due to the sub-prime melt down. Last year, Orange County added 29,200 new jobs compared to the past 12 months with only 2,900 new jobs. The large sub-prime and mortgage companies like Impac, Countrywide, Ameriquest, New Century Financial, Option One, Conquest America, et. have had major layoffs or gone out of business.

The rule of thumb is one-half housing per job. Using this formula, we needed  $29,200 \div 2 = 14,600$  new units last year, however, only  $2,900 \div 2 = 1,450$  units are needed this year. This is a huge difference of 13,150 needed for supply in one year.

## Migration

According to the California Department of Finance estimates, California's population growth rate has dropped substantially. In the past year, it has dropped 1/3 from the 2000 annual rate. Orange County dropped 65%, San Diego dropped 57%, and Los Angeles dropped 69%. Between 2000-2006 California suffered a net outward domestic migration of more than 950,000 people. Most of these outgoing people have job skills, pension income, educated, and spoke English (Middle Class). They are going to take advantage of the lower home prices and state income taxes in areas such as Nevada, Florida and North Carolina.

## Immigration

An influx of illegal and legal immigrants who had lower job skills, little education and or trade training, couldn't speak English, lowered the median household income and types of housing they could afford. If a person makes \$10.00, per hour (minimum wage is \$8.00) and works a 40-hour week their gross monthly income is only \$1,733, using 30% for housing they would only be able to afford \$519 per month for an apartment. This has lead to tenants doubling up and over crowding of apartments and homes in Southern California.

## Rental Rates & Vacancy

It is difficult to track rental rates and vacancies as different sources use dissimilar bases. For example, "average rents" which is the sum of all rents divided by the total sample size. This figure is usually higher than medium rent in which half of the rents are above and half are below. Another factor is concessions such as free rent. If the stated rent is 1,200 per month the effective (real) rents is  $1,200 \times 11 \text{ months} = 13,200 \div 12$  or only 1,100 per month, which was the reported rent at \$1,200. Another drawback is the size of units surveyed. Most survey units are only large (100+) unit buildings which distorts the real numbers.

Let us try to focus on the trends of 20+ units rather than exact number to mitigate the above problems. Using Henrick & Partner's, a large apartment broker, the following estimations in trends are observed:

Orange County	Rent growth is estimated to be 2.2% in 2007 and 1.7% in 2008 with vacancy increasing to 5.8%
Inland Empire	Rental growth of 4 - 5% in next two years with vacancy of 5 - 5.5%
San Diego	Rental growth of 4 - 4.5% in the next two years with vacancy rate of 4%
Los Angeles	Rental growth of 4 - 5% in next two years and 4% vacancy rate.

We do not see any major jump in rental rates or reduction in vacancy rates that should be occurring with the housing slump and the sub-prime melt down.

Another area that should have increased demand for apartments was the converting of existing apartment units into condominium projects. Some of these condominiums were however, leased out as rentals by investors. Some investors also bought single family homes and leased them out to tenants.

### Summary

Sub-prime meltdowns has occurred and is continuing; however, residents that are being foreclosed on are not yet making an impact on the rental market. New jobs in Orange County and Southern California have dropped dramatically reducing the need for new housing units (supply) number of people migrating out of California by the middle class was 950,000 in the past 5 years. The annual population growth rate (demand) has dropped by 1/3 in Southern California reducing the number of potential renters. Rental income is projected to increase slowly 2 - 4.5% per year which does not close the gap between the high apartment values and the economic benefits (rents) coming off the apartments. An excess of negative cash flow and zero cap rates for some present owners will continue and prices of apartments will fall as lender want at least a 1.2 debt coverage ratio so financing will be restrained.

### Conclusion

In past articles, I predicted jobs, population growth and interest rates would be the reasons for shrinking real estate values. The perfect storm has arrived. Buyers can now negotiate lower prices on apartment units and demand higher cap rates.

Joseph DeCarlo, MBA, CPM, CCIM, CPM  
JD PROPERTY MANAGEMENT, INC.  
Costa Mesa, CA  
joe@jdproperty.com  
(714) 751-2787 Ext. 210  
www.jdproperty.com