Tracking Shadow Inventory

Alternative supply impacts both sales and rentals.

By PATRICK S. DUFFY

If there is one mysterious unknown hiding in the corner of the building industry, it would definitely be shadow inventory, or that glut of distressed homes held back by banks which could be dumped onto the market at any time. Nationally, these unsold units total as many as 1.8 million homes, which at current sales rates could add another 9.0 months to unsold supply. Add to that total known REO listings as well as homes bought by investors to either flip or rent out, and you have a fairly significant portion of competition to both homes for sale or rent that often remains hidden from traditional metrics.

For a home builder, this kind of inventory is usually impossible to compete with on price alone, as it typically sells for less than replacement cost, which is why builders are now competing based on better locations, greener construction methods and improving technology. For an apartment builder or investor, deciding where to build or buy takes on even greater risk if a renter for a typical apartment can find a condominium, townhome or even a single-family home at a competitive price.

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Fortunately, there are tools available today to track different markets and submarkets in order to decide where to allocate capital and other resources. Recently, we were asked by an apartment investor to track various regions of Southern California to not only review the health of the multi-family rental market, but to also track potential competition in the form of rental shadow supply. The results were quite interesting.

For example, in just Los Angeles County alone, over one-fourth of all home sales during the first quarter of 2011 were REO units previously owned by banks, which sold at discounts of 24 percent single-family homes, to 27 percent condominiums — versus the entire existing housing market. For new home sales, however, although the difference in pricing according to Hanley Wood Market Intelligence was about the same for single-family homes, for attached homes it was over 5 percent.

Even for the one-fifth of non-owner-occupied homes bought by investors that weren't necessarily foreclosures, the units they bought were a bit smaller than those purchased by owner-occupants, and thus could be flipped or rented out for a lower — and more competitive price. Compared to owner-occupied homes, these potential rental units sold for a discount ranging from 20 percent in condominiums to 25 percent in single-family homes.

So just what does this mean for builders of new homes or apartments? In the case of home builders, it means continued competition for buyers shopping on price alone, so demonstrating the value proposition of a new home is more important than ever.

For apartment builders and owners, today's low interest rates means that potential tenants can often find a nicer and larger home for close to what they would otherwise be paying to live in a typical apartment. In some cases — such as when putting 20 percent down and borrowing the rest at 4.5 percent or so for 30 years — the monthly payment for both attached and detached homes plus taxes and HOA fees could still be up to 25 percent less than what a tenant would pay for that traditional apartment.

Fortunately for builders of both homes for sale or for rent, this current environment will not last forever. As prices eventually stabilize and rebound, buyers will likely tire of buying fixer-uppers with higher power bills in challenging locations. And, as mortgage interest rates rise and the better deals disappear, investors in individual homes will have a tougher time competing against the rental rates charged by owners of larger apartment projects. For now, however, it remains a game of patience.

Patrick Duffy *is a Principal with MetroIntelligence Real Estate Advisors (www.metrointel.com), a division of Beacon Economics (www.beaconecon.com), and authors The Housing Chronicles Blog (www.housingchronicles.com). He can be contacted at pduffy@metrointel.com or at 888-82-DEVELOP.*

Fast Facts

- Shadow supply impacts both homes for sale and for rent.
- Nationally, REOs make up about 1/3 of total sales.
- Current REO inventory would take about 9 months to sell.
- Due to low interest rates, it often costs less to buy than to rent.