LANDFALL NEWS

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land·fall: *an approach to or sighting of land*

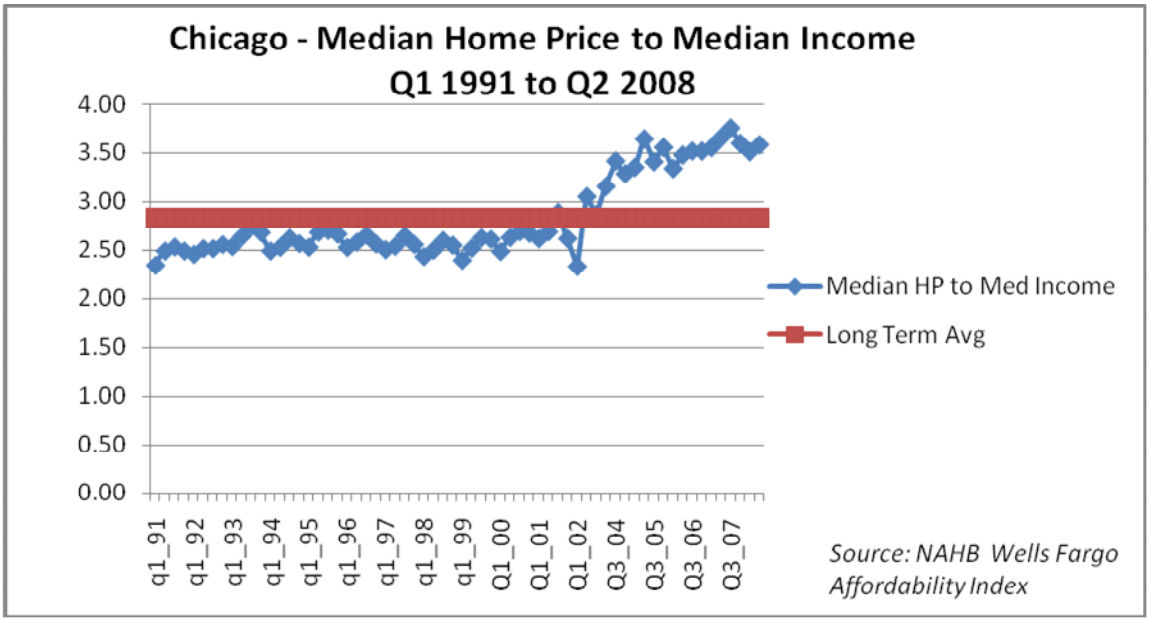
What Really Caused the Housing Bust?

By Dan Flanagan

Over the past year or so, I have heard people state a wide variety of causes for the downturn in housing. Some of the reasons I have heard include tight credit and a lack of financing for buyers, frightened consumers, no job growth, burdensome municipal requirements, as well as plain old fashioned bad luck and the nature of cyclical markets. Although many of these reasons ring true, my belief is that the most significant and challenging problem with the Chicago housing market, as well as the national market, and the greatest obstacle to a recovery, is *affordability*.

From 1991 to about 2004, the median home price to median income ratio in the Chicago market averaged around 2.8. Put another way, median home prices (including both existing and new homes) were about 2.8 times the median income level. For the better part of 15 years, that statistic remained relatively constant. However, beginning around 2004, the ratio began to grow rapidly, escalating from the long term average of 2.8 to over 3.5 in 2005 and finally reaching a peak of 3.7 in early 2007. From the 1st Quarter of 2002 to the 4th Quarter of 2006, the median home price jumped from $176,000 to $254,000, for an increase of over 44%, while median incomes barely budged.

The following graph more clearly illustrates this trend:



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Based on the NAHB Wells Fargo data, the median income for Chicago area residents as of the 2nd Quarter of 2008 was $71,100. Using the long term average median home price to median income ratio of 2.8, the median home price for the Chicago market should be about $201,000, compared to the current median price of $255,000.

In their 2nd Quarter Market Update for the Chicago New Home Market, Metrostudy indicated:

> "*The most dramatic trend over the past five years (other than the precipitous drop in the housing market) has been the shift from being a relatively affordable market to builders offering new product primarily above the $350,000 threshold…. there has been a significant decline in housing starts in all price ranges below $300,000. Most notably, the under $200,000 home price segment has gone from nearly 12,000 annual starts, to a current annual starts total of just under 3,000 units. The same trend is evidenced in the $200,000 to $250,000 and $250,000 to $300,000 price segments. If product were available in these price ranges, the downturn experienced over the past two years would likely have been less severe.* (Chris Huecksteadt, Metrostudy, 2008)

A closer look at conventional mortgage underwriting standards provides strong support for Metrostudy's conclusion. By considering how much of a mortgage the median income earner can qualify for based on conventional underwriting standards we can better understand why affordability is such a critical issue, and why it has enormous implications for the future.

Back in the "good old days" before subprime mortgages, a borrower was typically allowed to have total monthly housing costs (including taxes, insurance, and association dues) equal to approximately 28% of monthly income. Assuming a 6.5% fixed interest rate on a 30-year conventional loan, with a 20% down-payment, and assuming $5,000/year in property taxes and $75/month in homeowners association dues and insurance, the median income buyer can afford a home priced at approximately $215,000. This equates to a home price to income ratio of approximately 3.0, which is reasonably close to the long term average of 2.8 for Chicago.

How is it possible that new home prices surged so dramatically and sales continued to rise to record levels while median income levels generally remained flat? The answer: **creative financing**.

In a March 2008 presentation to the Value Investing Congress, fund managers Whitney Tilson and Glenn Tongue of T2 Partners LLC provided an analysis of how much additional purchasing power was available to borrowers by subprime or other nontraditional mortgage programs. Tilson and Tongue provide a specific example of how an individual earning only $39,581 in pre-tax income would be able to qualify for a $362,000 mortgage based on higher debt-to-income levels, relaxed down payment requirements, and an interest-only loan product. T2's analysis indicates that from 2000 to 2006, <u>the borrowing power of a typical home purchaser more than tripled</u>. Tilson and Tongue go on to indicate that some of the key factors leading to this astounding increase in purchasing power during this time period were the fact that lenders were willing to allow much higher debt-to-income ratios, interest-only mortgages (vs. fully amortizing), and no-money-down mortgages. Thus, using nontraditional financing, our Chicago median income earner was able to qualify to purchase a home in the $600,000 range. T2 goes on further to explain that in the absence of subprime financing, purchasing power had tumbled by well over half by the beginning of this year, and has tumbled even further more recently. (T2 Partners LLC, 2008)

With new single family home prices typically exceeding $350,000 and builders having a difficult time delivering product that is affordable to the median income level, it should come as no surprise

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that sales velocity has dropped off dramatically. When the incredible purchasing power that was provided by subprime financing and relaxed lending standards is removed, and more traditional underwriting becomes the norm, the median income buyer is largely priced out of the market. Of equal concern is the fact that new home sales are not likely to return to the more typical historical levels until such time as the market is able to deliver more affordable homes. Even after the market recovers we will not see a return to the sales rates or prices experienced during the boom years (more on what that is likely to look like in future issues). The near elimination of subprime mortgages and other nontraditional mortgage products, and the resulting challenges to affordability, have and will continue to have a dramatic impact on home building and on residential land values.

The implications of this new reality for the Chicago housing market, especially for land, are enormous. In the coming months and years, builders, land developers, municipalities, and in many cases lenders, will need to evaluate and reposition their residential land to fit a new market that is poised for dramatic change. What will that new market look like, and what are the implications for residential land and land values? Forthcoming issues of this newsletter will address a variety of topics relating to the new reality in home building and residential land, including the following:

1. How Home Prices Impact Sales Rates - and Land Values
2. What is Residential Land Really Worth Today and What Does the Future Hold?
3. What Are the Obstacles to A Meaningful Recovery?
4. When Are We Likely to See a Recovery - and What Will It Look Like?

All of these factors have a major impact on the decisions you face in your business, and especially on your strategy with respect to residential land. We look forward to the opportunity to help you answer these and other difficult questions and to plot a course through the stormy seas ahead.

WELCOME ABOARD!!

Welcome to the first issue of Landfall News, a quarterly publication by Flanagan Realty, LLC. According to Random House, landfall is defined as "***an approach to or sighting of land.***" Since the majority of our business is land-related, it seems appropriate to use land in the title of this newsletter. In addition, since much of our business involves helping people find or "*sight"* land for various purposes, and to help people with their *approach* to land, the definition seems to fit what we do. Of course, one of my passions is spending time on my boat with my family so Landfall for the title of this newsletter seemed like a good fit.

I am pleased to announce that the new offices of Flanagan Realty, LLC are open! If you have never set up a new office, I have some important advice that will help you avoid some of the challenges that I faced in getting this ship to leave port in an orderly manner.

First, never under any circumstances provide a 4 year old with paint and a roller. The results, although amusing, were far from pretty. At the end of the day, we painted a lot more than we had originally anticipated, and my youngest son was able to sport a nice coat of fresh paint to his first day at pre-school.

Second, never believe anyone who tells you something is "plug and play" or that following the instructions will help in setting up any type of electronic equipment. After a few challenging days and some helpful advice from some tech-savvy friends, I am pleased to say that everything is fully operational.

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Flanagan Realty, LLC is a real estate brokerage and advisory company focusing on land-related issues. Dan Flanagan, the founding principal and managing broker, has extensive experience in land acquisition and disposition, market analysis and strategy, entitlements, and financial analysis for land developers, home builders, lenders, and property owners. Our experience and capabilities include residential, commercial and industrial land, as well as special use land sites such as Brownfields, quarries, and power and gas facilities. If you are seeking to acquire or sell land, or are facing other land-related problems, we can help transform your challenges into opportunities.

For more information about our services or available properties, please contact us by telephone at (630) 388-8522, or by email at flanaganrealty@yahoo.com.

We also visit invite you to visit our website at www.flanaganland.com

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