

Foreclosures: Is California In For a Second Wave?

Rising unemployment, interest rates and residential defaults could all collude to stall housing, commercial real estate recovery

By KARI HAMANAKA, CREJ Staff Writer, April 5, 2010

Right sizing for all the wrong reasons - this seems to be the sentiment of the California housing market.

"What you're seeing are signs of things turning positive for all the wrong reasons," said Bruce Norris, president of **The Norris Group**. "You have the positive signs of low inventory, price firming and ridiculously low interest rates. The problem is you have a record number of people not making their payments so you have a record number of delinquencies. You're looking at the most artificial market we've ever had."

The question housing market watchers are asking is whether California, which became steeped in a subprime mortgage mess with the onset of the credit crunch, is set for another wave of foreclosures. And, if residential stumbles, many expect that commercial real estate's recovery would be held off for that much longer.

The numbers tracking the California housing market are mixed.

MDA DataQuick reported in March that Southern California home sales continued to remain above year-ago prices in February, the eighth month in a row this has been observed. Median prices for a Southern California home stayed the same between January and February at \$250,000, according to DataQuick. This was down from the \$408,000 median recorded during the year-ago period.

Real estate agents also appear to be seeing an increase in sales and interest from buyers. At the same time, public builders appear to be reemerging in the market, scooping up finished lots - possibly only to retain market share - but the activity still is viewed positively.

But several unknowns remain.

According to **ForeclosureRadar**, California notices of defaults, which are the first step in the foreclosure process, increased 19.7 percent in February. Factors such as unemployment and housing prices could exacerbate this situation.

"You have the problem again with delinquencies soaring," Norris said. "You have people getting further and further behind and at some point you have to deal with people over a year late and we haven't dealt with all of that."

Unlike the initial subprime meltdown, experts expect the foreclosure impact to be with prime borrowers in higher-priced product.

"You are going to be seeing this with another price range of house," Norris said. "The subprime was very damaging to the inexpensive inventory, and a lot of what's coming is going to be more damaging for the more expensive inventory."

Mark Brandemuehl, vice president of marketing at Redwood City-based **Movoto**, said the market is working through the problems of 2006 loans, with the median origination date of defaulted loans around July 2006. This situation has not changed in the past six months.

"There are two factors to it," he said. "One is that there are still a lot of loans to reset. The Option ARMs kind of disappeared in 2007, but you've got the five-year resets coming up and then people in more prime kinds of loans are having issues because of the unemployment rate. Then there are a certain number of people so far into the water that they're choosing to walk away."

Entering the Market

As some give away the keys, some are in the market to buy.

"I would say it's cautious," said Louis Cammarosano, general manager of **HomeGain**, about real estate agents sentiment toward the housing market. "Last year at this time, it was the worst and everyone realized in the last year that home prices had gone down and they were expecting further drops. Now there has been some stability in the market but real estate agents are still concerned about the pricing." And while there is the homebuyer tax credit incentive for buyers, Cammarosano pointed out California is grappling with an unemployment rate that could still rise and a foreclosure rate that has not slowed down substantially.

"It's still less dire than it was last year," Cammarosano said.

HomeGain released in late March its quarterly home prices survey of real estate professionals nationwide. Thirty-seven percent said they felt prices would increase in California in the next six months.

"It really varies a lot by area still," Brandemuehl said. "In places like the Central Valley, Sacramento and the Inland Empire builders are facing a tough time selling off communities and building up their war chest of new communities. I think, in general, it's bad, but there are certain areas where demand is pretty strong."

In February, **Trumark Homes** opened two model homes, the first of its 39-home Wyeth Cove project. Six homes were released in the project's first phase. Five of those homes were sold in less than a month, closing at the end of March. The sixth sale was in the process of being written up at the end of March. These initial six sold for between \$370,000 and \$428,000.

"At Wyeth Cove, these are single-family, detached homes," said Marianne Browne, vice president of sales and marketing at Trumark Homes. "It's an infill site where there hasn't been anything new built in several years. There's this pent-up demand where if you want to buy something new and want to live in Upland, we are without a lot of competition."

The developer also saw condominiums move at its HighLights project in Granada Hills, which are attached units aimed at first-time homebuyers. Units that sold have gone for between \$320,000 to \$360,000.

According to Browne, the company plans to invest in constrained infill markets.

"We don't want really outlying markets," Browne said. "We want markets that are commuter-close and we just really don't want a lot of competition. We like to be unique in our marketplace."

As for the impact of a possible second wave of foreclosures, Browne does not see it as being significant to the California market.

"I don't believe so because it does add some competition to the market, but I'm hearing initially that with mortgage companies it was very difficult to do loan modifications," she said. "They pretty much had to let homes go into foreclosure before talking to a lender about adjusting interest rates."

Based on the sales Trumark has seen, Browne said the market appears to be leveling off.

"I think that the consumers are regaining confidence slowly - very slowly - because there still is a fear of unemployment or underemployment that still is a factor," she said.

Commercial Delayed

If the second wave of foreclosures does hit, it could delay commercial real estate's recovery, especially in the case of master-planned projects where filled homes fund infrastructure improvements and sometimes help drive demand for retail or office space.

"I'm definitely not seeing new communities [being built] right now," Brandemuehl said. "Those are pretty rare. Builders are continuing to build out communities that they have fully entitled, but I have seen very few built."

Even with some glimmers of hope on the residential side, signs do not point to development of commercial product any time soon.

"I could only speculate on it," Brandemuehl said, "but I personally would be really careful about kicking off any commercial development project in the next couple of years."

More questionable than a rise in foreclosures is what the banks will do with their shadow stock of housing and whether product will be dumped on the market later this year.

According to a report from **Standard & Poor's** released in February, it will take 33 months to absorb the national supply of shadow inventory. According to the report, any positive signs about home prices can only be attributed to a shortened supply of available foreclosures.

"If the banks, for whatever reason, began mass dumping, clearly supply and demand would be out of balance again," said Michael Vairin, president of **Builders Development Group Inc.** and president of the **Building Industry Association of Southern California**. "That would force pricing down. What I'm hearing is that banks likely would not do that unless pressured to do that by regulators. They'd have no reason to dump those and experience compelling losses."

Historically, Vairin added, commercial growth is followed by residential growth.

"The converse is that as residential erodes, then commercial follows," he said. "They're always sort of a lagging factor to the residential market. If the residential market continues to be slow or erode, that would impact small business and commercial real estate. You can see a lot of see-through office buildings right now."

Norris said there is hardly a need for new commercial construction at this time.

"You've got a record number of loan resets coming to the commercial market and you have high unemployment," Norris said. "Companies need less square footage. It shouldn't be pleasant for the commercial market either."

Too many unknowns are out there for both residential and commercial real estate - employment, interest rates, expiration of the homebuyer tax credit, continued foreclosures and the shadow stock - all of which could cause a relapse in the market.

"The outlook is uncertain," Cammarasono said, "given that there are certain certainties out there that you just don't know the extent of what they're going to be."