The Distressed Property Market and Shadow Inventory in Florida: Estimates and Analysis

Introduction

Florida was one of the states hardest hit by the real estate downturn. Delinquencies, foreclosures and short sales have become a significant part of the real estate market in Florida. The terms “underwater” mortgages and “shadow inventory” are also part of the marketplace. But to date, there has been no systematic look at the dimensions of this issue, the current role of distressed properties in the market and the potential future of this segment. The analysis attempts to close that gap.

In conducting the analysis, we are using both data from the multiple listing services around the state and data provided by CoreLogic, a statistical analysis company. We look at the recent history of distressed property listings and transactions relative to normal market data as well as estimates for the shadow inventory, and come to some conclusions about the likely course of the distressed property market in the future.

Our conclusions are:

- Florida has been and remains one of the hardest hit states for distressed property sales and listings.
- Sales and listings of distressed properties have been declining since late 2010, with the exception of short sales of single family homes.
- Average prices for distressed property sales and normal sales have been stabilizing.
- In general, Realtors and lenders appear to have learned how to cope with distressed properties in a way that stabilizes the market.
- The highest percentage of distressed property listings to total listings occur in the I-4 corridor and Southeast Florida; the lowest percentages occur in Northwest Florida.
- Currently, the shadow inventory (The number of distressed properties—defined as any properties that are 90+ days delinquent, in the foreclosure process, or are REOs—minus the number of distressed properties identified as being on the market—any MLS properties that are listed as short sales, foreclosures, or REOs) for the state of Florida was 550,000 units at the end of 2011. This represents a
decline of about 9 percent from its peak in the first quarter of 2010. CoreLogic reported that nationally shadow inventory declined from 1.8 million units in January 2011 to 1.6 million units in January 2012. Our estimates are in line with CoreLogic and somewhat higher than those of the National Association of Realtors®, which is using a different and less comprehensive sales data base than we are.

- Currently, the flow of new seriously delinquent (90 days or more) loans moving into the shadow inventory has been offset by the roughly equal flow of distressed sales (short sales and sales of real estate owned).

- The number of foreclosures and the number of units in the possession of lender (REO) was significantly lower in February of 2012 than it was a year earlier, suggesting that the flow of properties into shadow inventory is slowing.

- Distressed properties will remain a significant feature of the market the next ten years, but as another property type, with its own special sales techniques and documentation.

This report covers three areas. First, we look at the current market for distressed properties in Florida. This includes listings, sales and prices for foreclosures, REOs and short sales beginning in January 2008. Second, we look at the shadow inventory in the state, as it exists currently and as it has developed in the same time period. In developing our estimates we use MLS data as well as data supplied by CoreLogic. Finally, we draw some conclusions about distressed property and shadow inventory in Florida and describe the potential future course of the market.

The Distressed Property Market in Florida

Florida was racked with mortgage and property failures in the wake of the recession and financial meltdown. The law of gravity prevailed as prices that had began soaring in January 2005 and plummeted in 2008. The result was a wave of defaults, foreclosures, and mortgages that exceed in value the properties they secured. One of the perversities of the market is that rising closed sales in a normal market signals market improvement, in a market significantly affected by distressed properties (here including foreclosures, real estate owned by lenders and short sales), the reverse is actually true. Falling sales suggest a diminished influence of troubled properties. Chart 1 displays the number of closed sales of distressed properties, broken out by short sales and foreclosures and
real estate owned by lenders (REO) between January 2008 and the end of 2011. This is the period when most of the disasters came onto the market.

The number of closed sales for foreclosures and REOs peaked in April 2011 and has declined significantly since. Part of the reason for this is the deadlock that has tied up large numbers of foreclosures in judicial proceedings. But part of it lies in the rising line for short sales. Both lenders and Realtors have learned a great deal about dealing with the distressed property market in the last three years and have worked to market properties before ownership of those properties was transferred to the lender.

**Chart 1**

In essence, lenders have discovered that the loss associated with a short sale is less than the loss from taking a property into inventory and absorbing the cost of holding that property and then selling it later. Realtors, for their part, have learned how to market short sales in an efficient fashion.
We can see this effect in Chart 2, which contains active listings for short sales and foreclosures and REOs. While both have declined through most of 2011 (a potential sign of a recovering market), the number of short sale listings peaked at about three times that of foreclosures and REOs and remains at about that ratio.

Chart 2

As one might expect, the largest single property type in both sales and listings of short sales and foreclosures and REOs is single family homes. Some areas of southern Florida have seen a high volume of condo loans fail, and in these markets, condos tend to be much higher percentage of listings and sales than they are statewide, but by and large the growth of the distressed property market has been a single family home event.

The entire state has been significantly affected by the housing downturn and many places are still suffering the after effects of the recession and financial collapse. In relative terms, however, the hardest hit areas remain in the I-4 corridor and the in the
southeastern part of the state. The most lightly affected areas are generally more rural counties in the northwestern part of Florida.

Finally, how have prices been affected by the volume of distressed properties in the market? Clearly, these properties are selling at discounts even below the price reductions we have seen in normal properties. Additionally, the presence of distressed properties in the real estate market will restrain any price recovery we are likely to see over the next several years. We return to this theme in the last section of the report.

**Chart 3**

![Chart 3: Foreclosures and Short Sales: Average Price Trends](image)

Chart 3 shows the pattern of prices since the beginning of 2008 for distressed properties and normal properties. From the beginning of the period, foreclosures and REOs sold at a discount below the market average. The gap has remained fairly constant in dollar terms (about $80,000), suggesting that there has been little change in the relative valuation placed on these properties by the market. Short sales, however, show a different pattern. For a period in the second half of 2008, short sale average...
prices tracked the market almost exactly. After that, they diverged from market averages and followed a pattern similar to foreclosures and REOs but at prices closer to the market average.

The reason for this pattern of prices lies in the learning curve Realtors and lender had had to scale. For most of 2008, both lenders and Realtors were confused as to the rules of the game for short sales. The necessary paper work, lender policy toward short sales and the time it took to move a short sale to settlement were all a bit of a mystery and varied from lender to lender. So the only short sales (see Chart 1) that closed were the best properties. In short, the lack of clear rules in the market forced the participants to “cherry pick” the properties that would enter into a short sale. Over time, both Realtors and lender began to understand how the process should work, and lenders became more willing to entertain short sales. The result has been a significant increase in volume, but at prices that were discounted from the normal market.

The Shadow Inventory and its Future

There has never been a topic that has caused so much concern to Realtors as the shadow inventory. This seemingly vast iceberg has appeared on collision course with the Titanic of the real estate market. The fear for all practitioners is that the inventory of delinquent and foreclosed loans held by lending institutions will be released in a sudden spate of properties on an already weakened market. The result: depressed prices, fewer sales and more underwater loans, a vicious spiral downward to a permanently injured real estate market.

The reality, even in Florida where distressed properties make up a significant portion of the market, appears to be different. Logically, it should be: no business person would flood the market with his inventory just to drive prices downward. Much of the behavior we have seen from lenders—the behavior which has spawned the fears of a market devastated by the release of large numbers of distressed properties—was largely the result of confusion over the rules of the game and thus missteps by the lenders. Compounding this has been the scandals surrounding robo signings and the like that have tied up potential foreclosures in a judicial snafu (It should be noted that in non-judicial foreclosure states like California and Arizona, the process of dealing with foreclosures and REOs has gone much more smoothly).

In practical terms, the numbers we described earlier for sales, listings and prices suggest that the market is beginning to handle distressed properties as one property type among others. In fact, it appears that the market for distressed properties has stabilized. As CoreLogic noted in its March 2012 report, “Currently, the flow of new seriously delinquent (90 days or more) loans into the shadow inventory has been offset
by the roughly equal flow of distressed sales (short and real estate owned).” It seems that this will be the long term future of the market.

Chart 4

And long term it will probably be. Chart 4 shows the shadow inventory for Florida. The bottom band shows foreclosed loans and REO inventory and the upper band seriously delinquent loans. There are two striking features to the chart. First, the shadow inventory peaked in the first quarter of 2010 and has trended down since then. This suggests the ability of lenders to manage the inventory. An example of how this is done is Bank of America. They have offered bounties for any potentially defaulting household to engage in a short sale of the property. More recently, they have announced a program to allow households to remain in the foreclosed property as renters. In the
former case, the property never makes it into the shadow inventory; in the latter, the property remains in the inventory longer before it goes on the market.

Recent CoreLogic data confirms these trends. For February 2012, ninety day plus delinquencies were down eleven percent from February 2011. In addition, foreclosures were down 7 percent for the same period, and REO was down nearly 40 percent. This points to a growing reluctance of lending institutions to take property into inventory, and an increasing willingness to do whatever it takes to smooth the transition back to a “normal” market. But there’s still a long way to go. As of February 2012, about 28 percent of the housing stock in Florida carried mortgages that were greater in value than the property that secured them. In other words, nearly two out of every seven Florida homeowners were “underwater” in their homes.

Where Do We Go From Here?

The second striking feature of the shadow inventory in Florida is its size. Florida has nearly a third of the total shadow inventory nationwide. Part of this is due to what happened here during the housing recession. Part of it is due to the tie-up of potential foreclosures in the courts. In any case, the size of the inventory means that it will take years to work off. How many years depends upon the revival of the economy and the real estate market, the decisions in the courts, and the shape of regulation that comes out of the current policy debates over the future of Fannie Mae and Freddie Mac.

At the moment, the real estate market in Florida is in a revival. Investors, looking to the long term and impressed by the bargain prices on Florida real estate, are buying up distressed and other lower priced properties, and converting them into rentals with an eye toward selling at a profit in five to seven years. This has caused an emergence of multiple offers on lower priced properties and the sharp reduction in the inventory of properties for sale. For March 2012, the state had 5.9 months of inventory on the market, down from nearly 12 months a year earlier. Some local areas had even less supply available.

We do know that distressed properties (short sales, foreclosures and REOs) will remain a visible and significant part of the market for the balance of this decade at least. As long as these properties are present on the market, they will compete with normal properties and put a brake on potential real estate price increases. So if the market would be appreciating at a 4 percent rate without distressed properties, the actual measured increase with distressed properties would be 2.5 percent.

The good news here is that distressed properties are now just another property type, like town houses or mobile homes that have their own rules and processes. Most
lenders and Realtors now understand and abide by those rules and processes, and this makes the submarket work better. For Realtors to profit from this market, there are four keys:

- Get an education (or even a designation) on the rules and processes of the distressed property market. It will be worth the outlay.

- Forge strong relationships with lenders to enable distressed property transactions to go smoothly.

- Differentiate your normal listing from comparable distressed properties. Without a compelling reason to the contrary, buyers will go with price.

- Cultivate investors with patient money. It should be noted that the majority of the shadow inventory is made up of properties priced under $200,000 and these are precisely the properties now being bought up by investor groups with five to seven year time horizons.