

## Condo Conversion: Boom or Bubble Waiting to Burst?

The condo conversion market is largely played out for this housing cycle. Due to strong structural fundamentals, we are likely to experience a soft landing in most major metro markets, but less gentle in others. However, we do not foresee a national burst as some observers are predicting.

### Structural Fundamentals

Why might this cycle allow for a soft landing, even with excessive condo production and conversion? Five reasons, in our view:

1. Continued high levels of job growth and housing demand over the next several years, in contrast to say 1975 and 1983 when the condo craze last crashed.
2. Continued low interest rates and mortgage liquidity over the next several years, in contrast to say 1983 and 1990 when the housing market last took a dive.
3. More demand for condos due to a severe housing affordability problem in this cycle that has encouraged condo ownership as an affordable

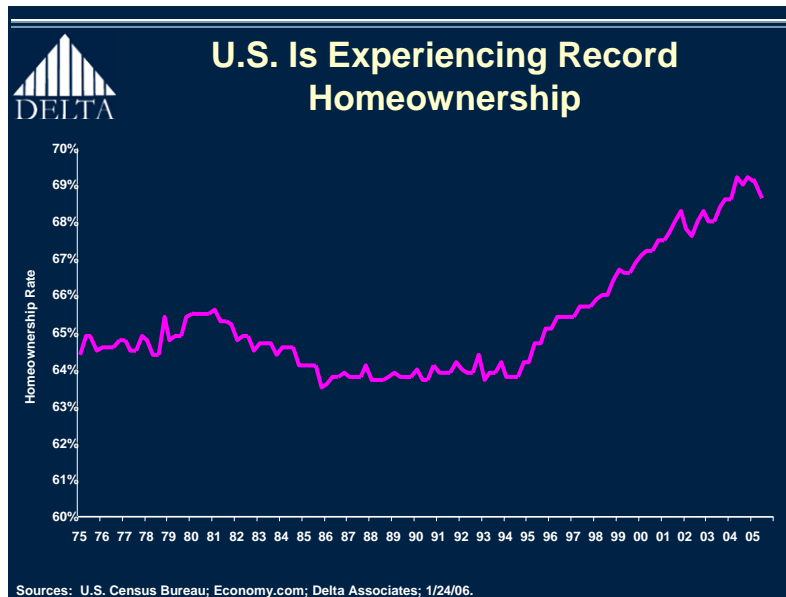
alternative, after an unprecedented five-year run-up in housing prices.

4. Greater acceptance of urban and new urbanist living – where condos tend to be located. In part a lifestyle preference. But also an attempt to avoid worsening traffic congestion.
5. No emergence of a better investment alternative to real estate – yet.

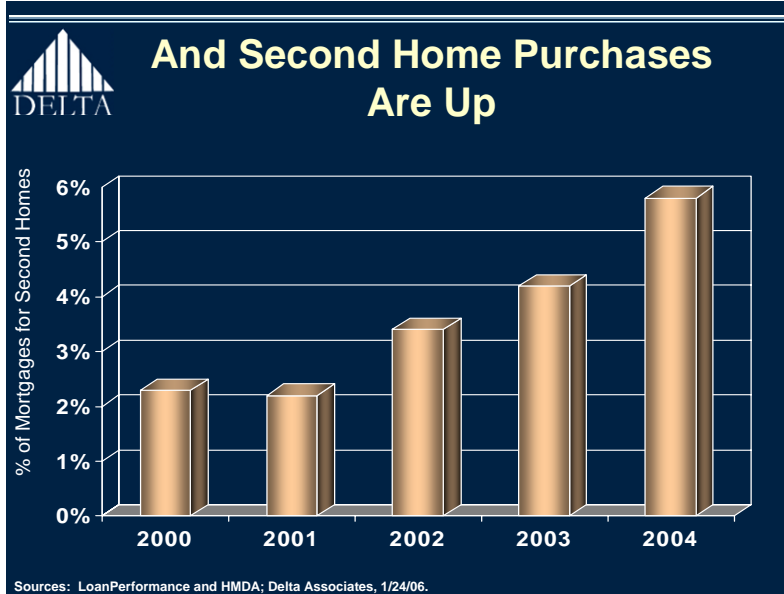
### How Did We Get Here?

Prices are way up because demand is at record levels. And the market simply can't keep pace with enough supply. Demand is up due to three factors:

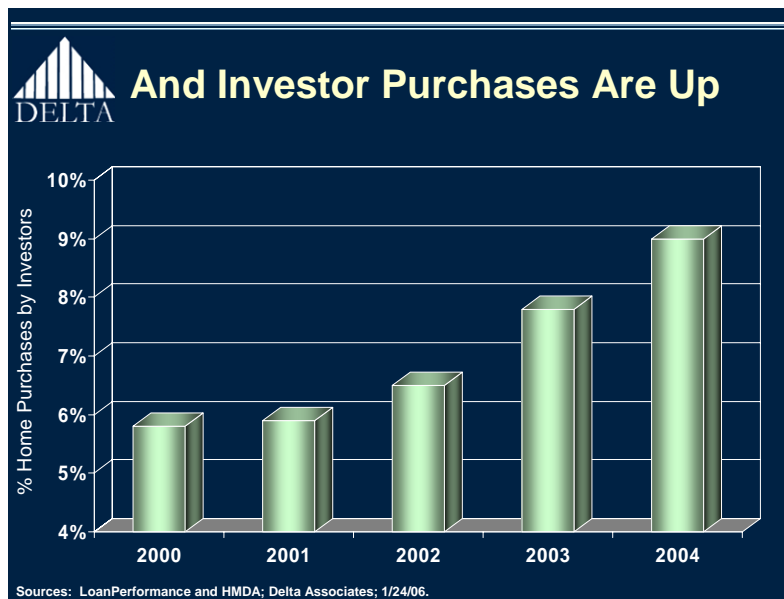
1. Homeownership rates are at an all time high, thanks to demographic shifts and an accommodating mortgage market. For most of the post-war era we were a nation characterized as 65% home owners and 35% renters. That began to change in the mid-1990s. By 2005 the ownership rate had climbed to near 70%.



2. Second home sales are at record levels thanks to the aging baby-boomer cohort.

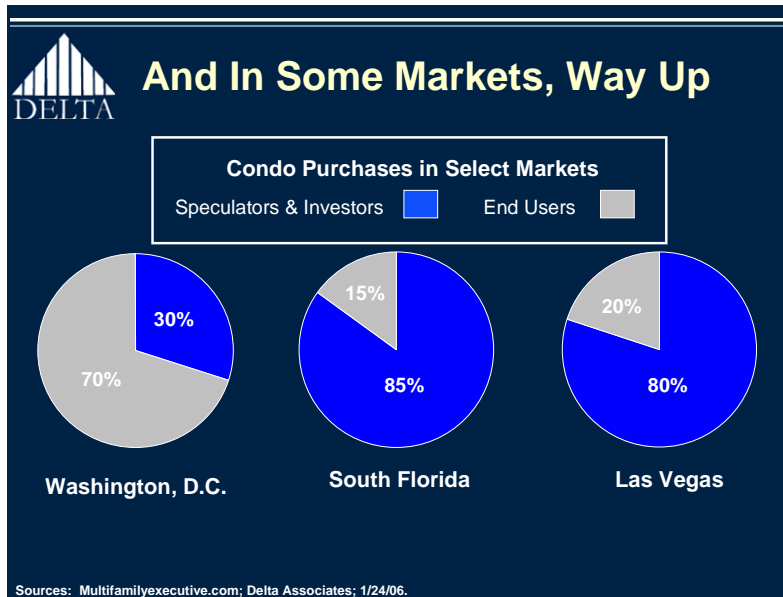


3. Investor purchases of homes are at record levels, especially in select metro markets for condos.

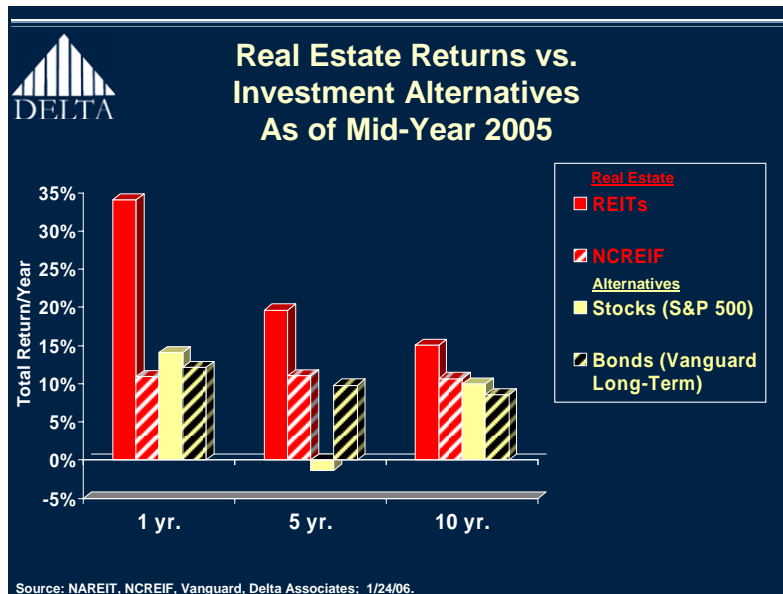


# Delta Outlook

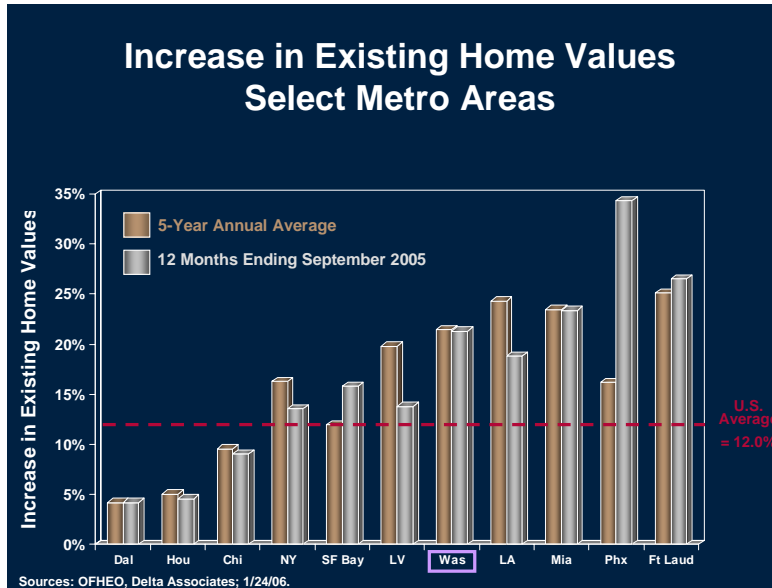
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Investor sales are at record levels because there have not been attractive alternative investment opportunities to real estate since the year 2000.



The result has been an unprecedented run-up in home prices, led by condominiums.

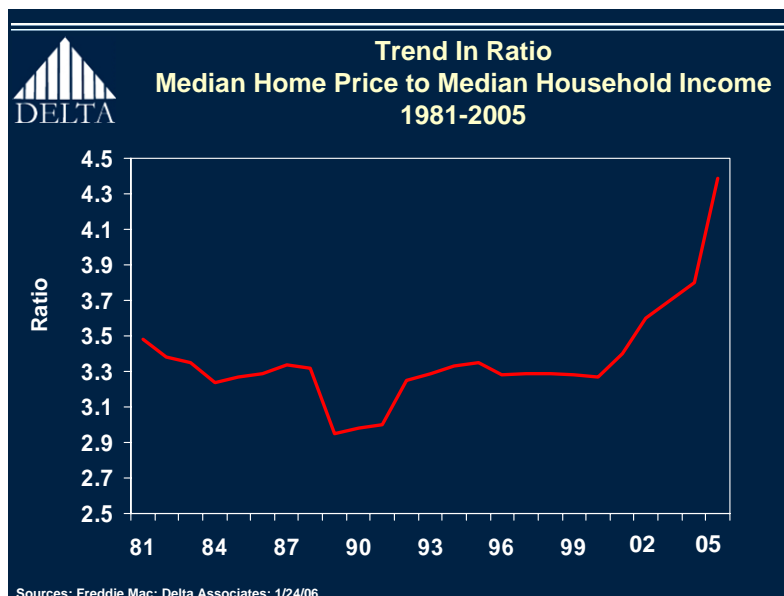


#### Are These Prices Sustainable?

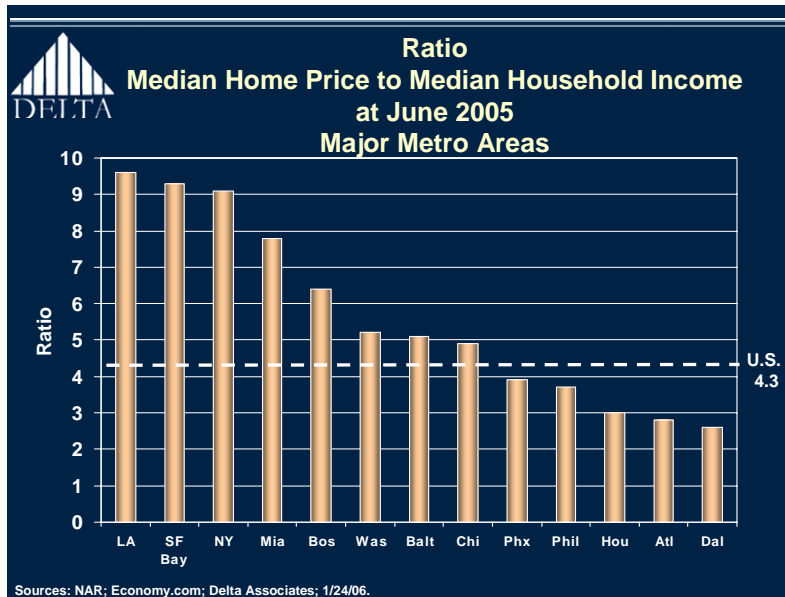
No. And we are already seeing a slow down in the rate of escalation in house prices across the nation. And in our view it is not because the production pipeline has caught up with demand, although there has been a lot of progress on that front. Rather, the slowdown in price

appreciation is largely due to price fatigue. Buyers either can not afford or are not willing to pay these prices.

For decades, we as a nation spent about 3.5 times our income on a house. Starting in 2000, that ratio began to increase, rising to 4.3 by 2005.



And in many metro areas that ratio is above 6 – including such desirable places as Boston, New York, San Francisco, and LA. Surprisingly, Washington and Chicago are rather affordable by this measure.



## What Cities Are At Risk?

Those cities with the greatest risk of a hard landing are those that have the following characteristics:

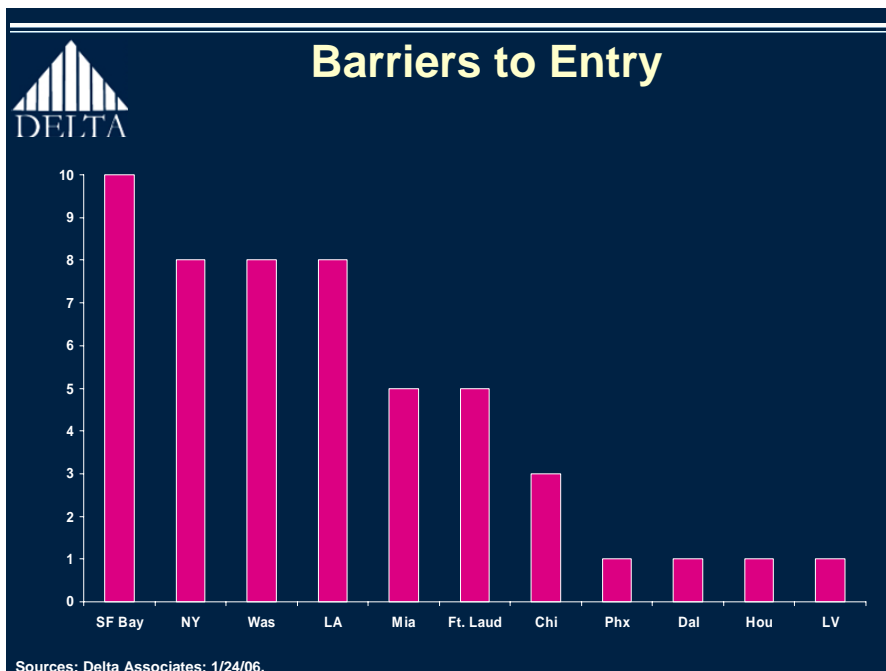
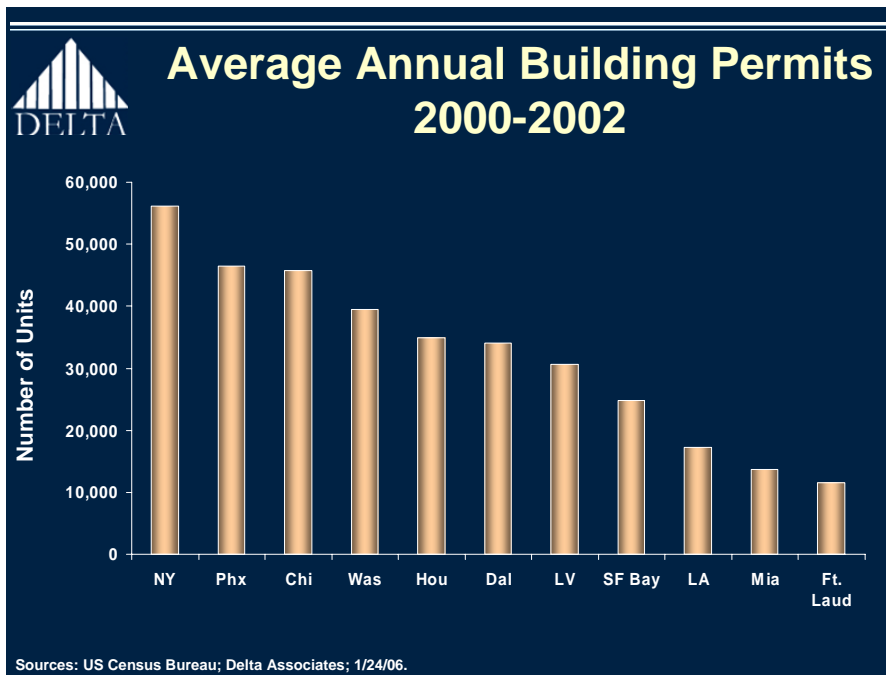
1. Low barriers to entry and a lot of housing production and conversion activity.
2. Modest levels of job growth or prospects of a trauma to, or an interruption in, the regional economy.
3. High levels of speculator activity in the condo market.

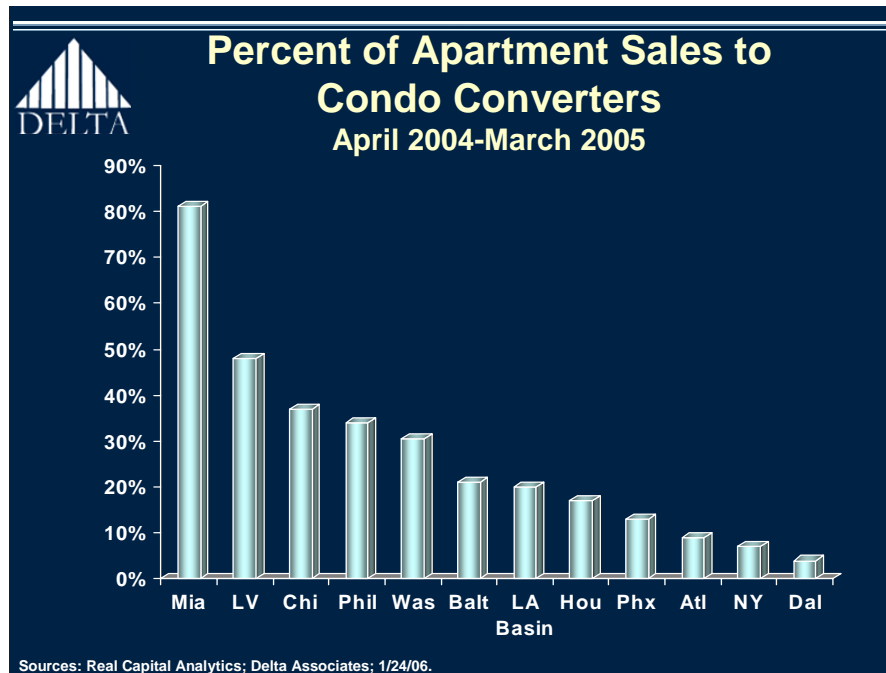
We think cities to watch include Las Vegas, Miami, and Phoenix. On the other hand, we would be more confident of a soft landing in Washington, Boston, and LA.



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## Delta Associates

Delta Associates, the research affiliate of Transwestern Commercial Services, is a firm of experienced professionals offering appraisal, consulting and data services to the commercial real estate industry for 25 years. The firm's practice is organized in three related areas:

1. **Appraisal** and valuation services for commercial real estate assets, loans secured by same, and real estate companies and fractional interests in them.

2. **Consulting**, research and advisory services for commercial real estate projects, including market studies, market entry strategies, asset performance enhancement studies, pre-acquisition due diligence, and financial and fiscal impact analyses.
3. **Subscription Data** for select metro regions for office, industrial, retail, condominium, and apartment markets.

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