Minimizing Risk in a Changing Market

Are both the business plan and the numbers sound?

By William Charlton

"Home values are increasing $500 a day!" "House prices dropped $20,000!"

These are actual headlines from media newspapers in the Calgary area this past year. Amazing what the difference of a year can make on the perception and pressure of real estate prices! However, with such a transformation comes potential risk to both real estate entrepreneurs and lenders. It is during these market adjustments that we witness the effects of purchasing or holding properties in particular market segments.

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Obviously our local real estate market is currently experiencing a turn from a hot sellers' market toward a quiet buyers' market. Active listings are at historically high levels while sales are not keeping pace at absorbing the new listings. This is creating pressure on both the prices and the days on market to sell a property, both of which are especially crucial to the real estate entrepreneur. However, it is in this type of market change that the investors who purchase and/or hold property in a specific property segment often fare better through the tougher market. Specifically - properties in good locations and properties in the lower price range.

When it comes to either lending on a property or investing in a property, it has been beneficial to be secured on properties in good locations. Lenders often limit their lending criteria to properties that are 'most marketable'. What does this mean? Well, in our experience, it alludes to the very same principles which many real estate investors strive for – a property that will sell relatively quickly with as little cost input, and is habitable in any market condition. Specifically, the most marketable real estate is typically located as close to amenities as possible, is preferably near the center of a city, has good access, is near transit, has a lower price point, is not on or backing onto major roadways, is not in remote locations and is not considered a vacation property.

Properties that are located along major roadways or in remote towns or rural locations often suffer larger price drops and take considerably more time to sell in a difficult or even balanced market, as buyers have more choice. Vacation properties are usually the hardest hit during market adjustments as housing necessity overtakes luxury.

Our company has always focused on the lower-priced real estate. This segment of the market has numerous advantages from a business and lending perspective. The low end of the real estate market can be defined as the bottom 25-30% of resale purchase prices. These houses tend to be in the first-time home buyers' market with smaller square footage.

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When an economy changes to more difficult times, demand for lower-priced homes surge as people in larger homes downsize, while others move into rental situations and the overall price point to enter the market becomes more significant. For both the lender and investor, the lower-priced properties carry less risk due to the potential price variance of these houses being minimal during markets where prices are falling.

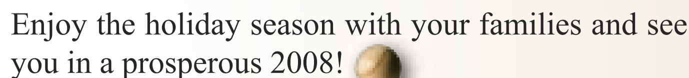
Another benefit of purchasing lower-priced homes is the ability to rent the properties if your initial plan changes. Maintenance costs are less expensive and this segment of the market is less restrictive and less time intensive. Lower-priced homes also require less of an investment in capital which allows the investor to have more cash on hand to deal with repairs, vacancy, or unforeseen problems. As well, the lower carrying costs ease the cash flow issues during an unanticipated change in the business plan.

So why would a lender care about these factors if the equity is secured anyway? We certainly can't speak for other lenders, as many lenders have different philosophies, but to put it simply: in the event of defaults, we want to maximize potential solutions to the problems such as refinancing, selling the property quickly, or renting the property. With lower-priced real estate, there is a greater chance to be able to help the home owner come to a solution without foreclosure, because it is typically a more marketable home with less price variance and therefore the urgency isn't as prevalent. Either the home owner or lender can rent out the basement or rooms to help with costs while a solution can be made. In any event, it is a smaller amount outstanding on a more marketable property.

In summary, from a lender's perspective, properties should be marketable and usable. From a real estate investor's perspective, properties should be marketable and usable. I didn't accidentally type the same sentence; the philosophy is the same no matter what your numbers show. Your business plan needs to be adaptable to account for market changes. That less desirable property bought in the spring of 2007 because it looked like it had a big profit isn't looking very good sitting vacant and un-sellable today!

We lend on properties the same way real estate investors purchase properties – if both the business plan and the numbers aren't sound, then move on to the next deal!

Enjoy the holiday season with your families and see you in a prosperous 2008!



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