



Web Exclusive Subprime Crisis Creates Opportunity for Workforce Housing Developers

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The increase in subprime mortgage default rates that is rippling through the economy has created a growing financial strain on a number of families in blue-collar markets. It has also created a growing opportunity for owners of workforce housing. As the number of foreclosures increase due to delinquencies in mortgage payments, not only will the supply of single-family homes rise, but the demand for workforce housing apartments will also increase.

Delinquency rates on subprime mortgages with variable interest rates, which account for about 9 percent of all first-lien mortgages outstanding, steadily increased in the first half of 2007 and have reached a level more than double the past record in mid-2005. In the first quarter of 2007, an estimated 325,000 foreclosure proceedings were initiated, which is up from an average quarterly rate of 230,000 over the preceding two years; about half of the foreclosures this year were on subprime mortgages. In recent months, credit has become less easily available in the subprime-mortgage market, as investors in subprime-mortgage-backed securities reportedly have scrutinized the underlying subprime loans more carefully and lenders have tightened underwriting standards.

What this means for blue-collar markets like Richmond, Atlanta, Denver and Greensboro, SC, for example, is an increase in demand for workforce housing for residents who can no longer put money down on a house and are now more likely to stay in apartments for a longer period of time. Many developers are purchasing C properties in these B markets, at 40-60 percent of replacement costs, putting in small but important renovations, and converting the properties to a B class property.

Although this is a growing trend, there are currently a few key players on the institutional side who have been doing this for some time, which means that the marketplace is getting more competitive, especially as more players enter the game. As such, it's become more important than ever to know the market and what type of property to invest in.

If you're ready to make the move to workforce housing, it's imperative to find not only the right market, but the most appropriate property in that space. It's important to look for the oddball—a property that is in a good location as compared to its competitive set. In addition, buildings that are built before 1975 in general should be avoided because of certain features such as flat roofs, aluminum wiring and wood siding. Furthermore, seek out buildings with block or concrete construction. If a building has the ability to expand the number of units, you have a better shot at adding income.

Identifying the right property is the hard part; improvements are simple. Small aesthetic changes make all the difference. New paint in the halls, nicer landscaping and updates to internal units and entrances, such as new carpeting and countertops, are usually enough to move a C property to a B property. It's also good to remember that most residents are looking for the same thing: safety and convenience.

Recently, we worked with an owner in Atlanta to convert a 132-unit building from a C to a B property over 18 months by replacing the carpet, brightening the look with fresh paint, and updating units with new countertops. Outside we improved the overall outward appearance by planting new landscaping, paving key areas and adding a fresh coat of paint to the exterior of the building. Because the general upkeep of most of these buildings has fallen by the wayside, these seemingly minor changes make a huge difference. The owner is planning to charge 8-12 percent more in rents after the upgrade.

Workforce housing is often a good candidate for agency financing such as a Fannie Mae or Freddie Mac loan. In addition, other balance sheet lenders, regional banks, and life company lenders can also be a good fit for projects such as these. Although most balance sheet lenders and life companies will often underwrite a more conservative DSCR than conduit lenders, they also have the ability to be more flexible with reserves and holdbacks. Good workforce housing deals can be a great investment compared to other apartment deals as returns are often greater than 25 percent IRR. At BlueStone Real Estate Capital, we look for returns similar to this within our sponsor level equity fund.

As the demand for workforce housing increases, at least through the end of 2007, smart investors need to be savvy about property purchases but can also be confident that small changes go a long way.

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