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Special Report

Real Estate Review and Outlook 1989

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SOLUTIONS
THROUGH RESEARCH

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Real Estate Center

Director

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Solutions Through Research

Contents

Summary

- The modest economic recovery begun in 1988 is expected to continue as Texas decreases its dependence on the petroleum industry and diversifies into areas such as high technology. Construction will not play a large role in recovery.
- Problems confronting growth are debt, the federal budget deficit, the threat of recession and the reorganization of the state's financial institutions.
- Fewer savings and loan institutions will mean reduced competition among lenders. Fewer mortgage bankers might mean higher loan costs and fewer available loans.
- There is much concern over the narrowing of the yield curve, which could signal a recession or that the market expects long-term interest rates to fall.
- Despite higher mortgage interest rates, the number of homes sold in Texas increased in 1988, though total dollar volume fell slightly.
- Houston finished 1988 with a strong gain in sales and was one of the few markets with a modest increase in average sales price, which may foretell growth in other markets.
- Overall, Texas land prices tumbled in 1987. However, cropland sales began to improve and irrigated land and dryland with sufficient moisture had higher net farm incomes. Rangeland markets remain stagnant.
- Despite support, a bill requiring licensure of real estate appraisers failed to become law. The Office of Management and Budget probably will stipulate appraiser requirements.
- Texas will gain considerable political clout as George Bush assumes the presidency.
- Entrepreneurs are needed who can lend stability and prudent decision making to the market. Emerging leaders will face close public scrutiny.

The Real Estate Center research staff meets annually to discuss the trends of the previous year and speculate on the immediate future. The results are published in the yearly *Real Estate Review and Outlook.*

This year, the report's format is slightly different: the first section provides a narrative and statistical review and puts into perspective the trends of the recent past and the second section offers an outlook for the new year.

Review of 1988 Trends

Trends are examined as they affect various real estate sectors. Where appropriate, regional variations are highlighted.

Construction

Construction permit activity continued to shrink during the past year, as it has since the price of oil plunged in 1986. The decline has been especially steep in nonresidential building, which is not surprising because building activity historically lags the economic cycle. Moreover, this extreme decline is a legacy of the building boom of several years ago. The boom, which also affected multifamily housing, was the result of builders rushing to accommodate investor demand for projects. Over-optimism for continued growth and detachment from market realities induced by tax law incentives created an almost insatiable investor demand.

Residential construction appears to be nearing a maintenance level. Activity is continuing to decline but at a slower rate. In fact, some slowing is to be expected because of higher mortgage loan interest rates in 1988, regardless of the Texas economy. The state's economy is starting to generate some momentary growth so housing construction should pick up, even though most markets still are oversupplied.

Houston appears to be leading the state in residential construction. Residential permits in the city were estimated to be significantly higher than in 1987. Gains in multifamily construction appeared early in 1988, while single-family construction surged during the summer, the prime building season.

The bright spot in nonresidential permits was Lubbock. Activity in office, industrial and retail construction there increased during the second and third quarters of 1988. Extensive hospital construction brought increased activity to Galveston.

One factor of interest to home builders will be the maturing of the "baby boom" generation—those born between 1946 and 1964. This highly influential group is reaching the point when it might be expected to fuel a surge in move-up home buying, assuming that baby boomers will behave as prior generations have. However, this assumption may be unfounded. This group has confounded analysts in the past—it purchased homes earlier in life

Table 1. Authorized Construction in Texas

Sector	1986	Percent Change	1987	Percent Change	1988*	Percent Change
Nonresidential ($000,000)	$4,088	-29	$2,690	-34	$1,800	-33
office	1,163	-46	415	-64	250	-40
retail	1,401	-21	722	-48	530	-27
Residential ($000,000)	4,744	-26	3,388	-29	2,900	-14
Total ($000,000)	$10,897	-24	$6,952	-36	$4,600	-34
Dwelling units (number)						
single-family	53,882	-16	40,849	-24	31,000	-24
multifamily	29,132	-50	5,012	-83	3,100	-38
Total	86,500	-37	46,920	-46	35,600	-24

*Estimated from first nine months of data
Source: Real Estate Center at Texas A&M University

Table 2. Total Construction Authorized in Ten Most Active Markets, 1988

Rank	Market	Volume* ($ millions)	Percent Change 1987	1987 Rank
1	Dallas	$1,420	-31	1
2	Houston	990	-10	2
3	Fort Worth	580	-35	3
4	Austin	345	-43	4
5	San Antonio	325	-40	5
6	El Paso	140	-32	6
7	Galveston	74	-22	7
8	Lubbock	63	-4	13
9	Brazoria	60	-16	11
10	McAllen	55	-6	14

*Estimated from first nine months of data
Source: Real Estate Center at Texas A&M University

Table 3. Nonresidential Construction Authorized in Ten Most Active Markets, 1988

Rank	Market	Volume* ($ millions)	Percent Change 1987	1987 Rank
1	Dallas	$530	-31	1
2	Houston	360	-21	2
3	San Antonio	210	-31	5
4	Fort Worth	175	-44	4
5	Austin	140	-60	3
6	El Paso	45	-38	6
7	Lubbock	26	65	16
8	Beaumont-Port Arthur	24	-19	9
9	Galveston	20	12	13
10	Amarillo	17	-41	10

*Estimated from first nine months of data
Source: Real Estate Center at Texas A&M University

Table 4. Residential Construction Authorized in Ten Most Active Markets, 1988

Rank	Market	Volume* ($ millions)	Percent Change 1987	1987 Rank
1	Dallas	$920	-24	1
2	Houston	650	16	2
3	Fort Worth	420	-21	3
4	Austin	210	-2	4
5	San Antonio	120	-35	5
6	El Paso	95	-23	6
7	Galveston	55	-24	7
8	Brazoria	50	-4	9
9	Killeen-Temple	44	-26	8
10	Lubbock	38	-17	10

*Estimated from first nine months of data

Source: Real Estate Center at Texas A&M University

than expected, then had trouble keeping them during the family formation years. Baby boomers have not benefited from the kind of appreciation that would make moving up affordable. They also have delayed having children so that the need for more space is not as pressing. Expectations of a housing boom because of move-up buyers may prove disappointing.

Housing Markets

Despite higher mortgage interest rates in 1988, the number of homes sold in Texas increased. However, lower average prices caused the total dollar volume of sales to fall slightly. Price concessions by anxious sellers and extensive foreclosure sales undoubtedly contributed to the lower prices and probably were responsible for increased sales. This may be a sign that housing markets are beginning to clear. As of October 1988 an estimated 15-month backlog of homes existed, based on the prior 12-month average rate of sales.

Houston's renewed construction may foretell the near future for other markets. The city produced record sales volume during the summer, the prime house buying season, and finished 1988 with a strong gain in sales. Houston was one of the few markets with a positive—though modest—increase in average price.

Also notable was the San Antonio market, which produced a strong increase in sales, though on a decreasing average sale price.

Homebuyers seem cautious, apparently waiting for stronger economic recovery before purchasing or upgrading homes. As long as prices slide, time appears to be an advantage for the reluctant buyer. Ironically, a significant rise in prices or interest rates could motivate many of these buyers and fuel a surge in market activity. More markets should post gains this year as companies such as J.C. Penney relocate to Texas.

Finance

The problems continuing to face the state's savings and loans are evident in reduced lending activity and negative net worth (see Table 7) and in increasing numbers of loan foreclosures (Table 8). Mergers and liquidations are common and probably will continue as federal regulators pursue their "Southwest Plan."

The question remains concerning who will bear the cost of weeding out insolvent institutions. Federal taxpayers are expected eventually to be required to pay for rescuing the FSLIC. Higher costs for surviving associations will result in increased deposit insurance fees.

Table 5. Sales Volume in Ten Most Active Residential Markets, 1988

Rank	Market	Sales Volume ($ millions)	Percent Change 1987	1987 Rank
1	Houston	$2,660	12	1
2	Dallas	1,850	-4	2
3	Austin	530	-4	3
4	San Antonio	470	20	4
5	NE Tarrant Co.	315	-9	5
6	El Paso	250	-15	6
7	Fort Worth	230	-11	7
8	Arlington	185	-20	8
9	Lubbock	136	-7	9
10	Corpus Christi	115	-3	12
State-wide volume		$7,700	-1	

Note: Texas had a total of 89,530,000 sales in 1988, up 2 percent from 1987.

Source: Real Estate Center at Texas A&M University

Table 6. Top Average Sales Prices, 1988

Rank	Market	Sales Price (000)	Percent Change 1987	Rank 1987
1	Dallas	$116	-11	1
2	Irving	103	4	5
3	NE Tarrant Co.	103	-5	2
4	Arlington	101	-4	3
5	Austin	94	-9	4
6	Houston	83	2	8
7	San Antonio	80	-7	6
8	Corpus Christi	78	4	11
9	Fort Worth	78	-9	7
10	Midland	74	-3	10
State-wide price		$86	-3	

Source: Real Estate Center at Texas A&M University

Table 7. Texas Savings and Loan Association Performance

Item	1986* ($ millions)	1987* ($ millions)	1988* ($ millions)
Mortgage loans closed	$16,044	$9,156	$7,587
percent of total loans closed	82	74	67
construction loans	na	$1,724	$1,277
permanent loans	na	7,432	6,310
residential	na	5,404	4,791
other	na	1,992	1,485
Net new deposits	na	57	-98
Mortgages held	$64,046	$58,254	$54,087
percent of total assets	66	59	50
Deposits	$79,544	$83,034	$88,159
percent of total liabilities	83	80	77
Regulatory net worth	$1,860	-$4,825	-$6,111

na = data not available

*Data are for first nine months of year.

Source: Federal Home Loan Bank of Dallas

Table 8. Percentage of Mortgage Loans Foreclosed to Number of Loans Held

Market	1985	1986	First half 1987	Second half 1987	First half 1988
Austin	4.2%	9.8%	14.5%	26.9%	22.0%
Dallas	2.0	6.7	12.1	19.9	21.6
Fort Worth	2.5	20.0	17.7	31.7	17.1
Houston	3.7	8.3	11.4	11.1	12.2
San Antonio	1.6	6.8	7.8	9.6	10.8
Texas	2.6	8.0	12.6	15.8	18.9
U.S.	--	--	2.6	2.7	2.6

Source: Real Estate Center at Texas A&M University

Fewer savings and loan associations will mean reduced competition among lenders. In addition, the number of mortgage bankers dropped following the surge in 1986, which might result in higher loan costs and fewer available loans. Secondary markets can provide some relief, especially because the introduction of Real Estate Mortgage Investment Conduits (REMICs) has reduced tax and regulatory obstacles to loan securitization. However, there are suspicions that Texas real estate suffers a poor reputation in national markets, particularly as collateral for new loans.

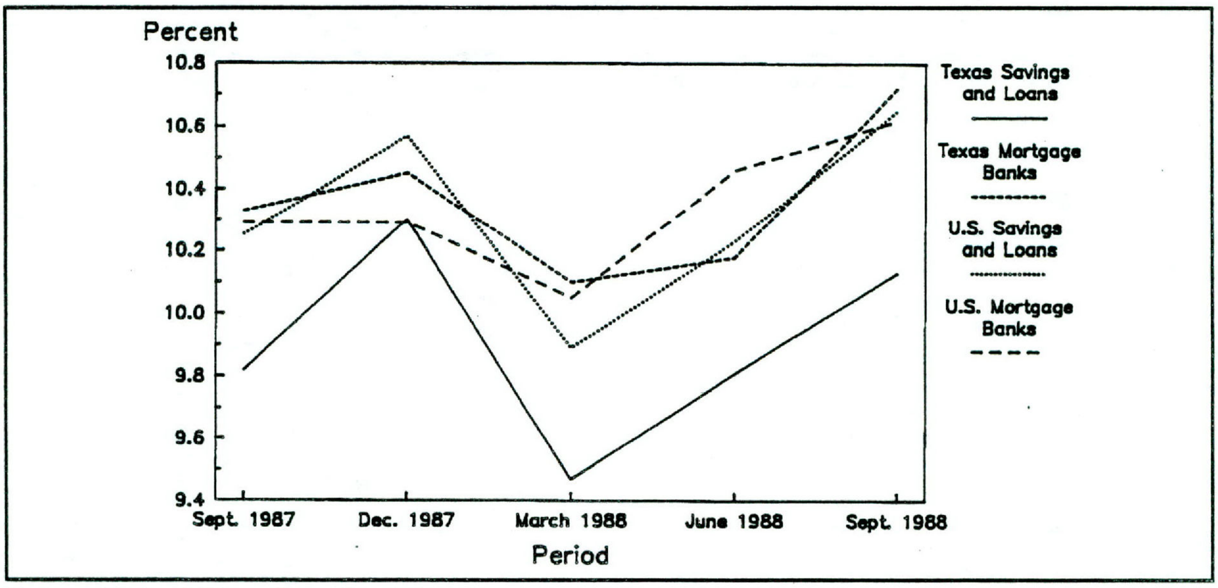
Mortgage interest rates rose in the latter half of 1988 after falling during the first half (see Figures 1 and 2). This increase was caused primarily by the Federal Reserve's tightening of the money supply and the subsequent increase in short-term interest rates rather than by the reduced number of lenders.

Concern is growing in financial markets about the narrowing of the yield curve (see Figure 3). The yield curve measures the difference in yield as the maturity of securities is lengthened. An inverted yield curve, in which short-term yields exceed long-term, generally signals a recession. However, a narrow yield curve also indicates that the market expects long-term interest rates to fall. If the market is correct, mortgage rates (at least fixed interest rates) will subside. This could help support property values, assuming a recession does not take place. Real property markets will be precarious in 1989.

Land

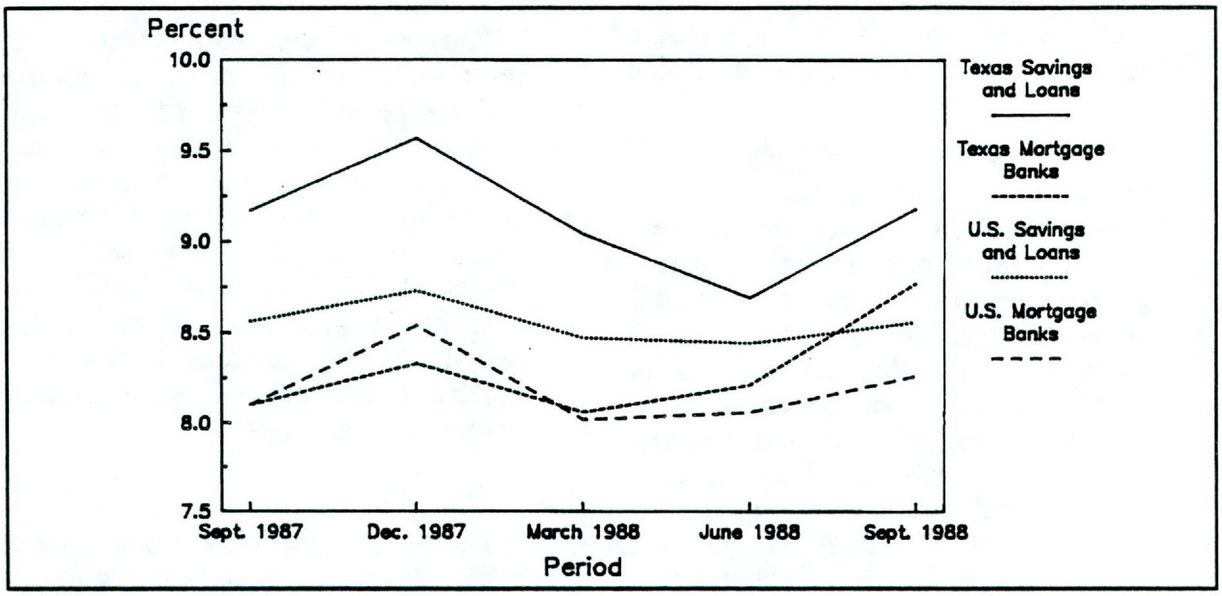
Overall, Texas land prices tumbled in 1987. The decline continued trends established in 1986 following state-wide economic woes. However, amid the general gloom, regional experiences varied. Buoyed by high agricultural income and investor interest in Conservation Reserve Program (CRP) lands, sales of cropland began to improve. Buyers concentrated on quality land and resisted less productive acreage. Lenders worked down inventories of acquired properties and foreclosure rates lessened in cropland regions. These

Figure 1. Effective Interest Rates on Fixed-Rate Mortgages



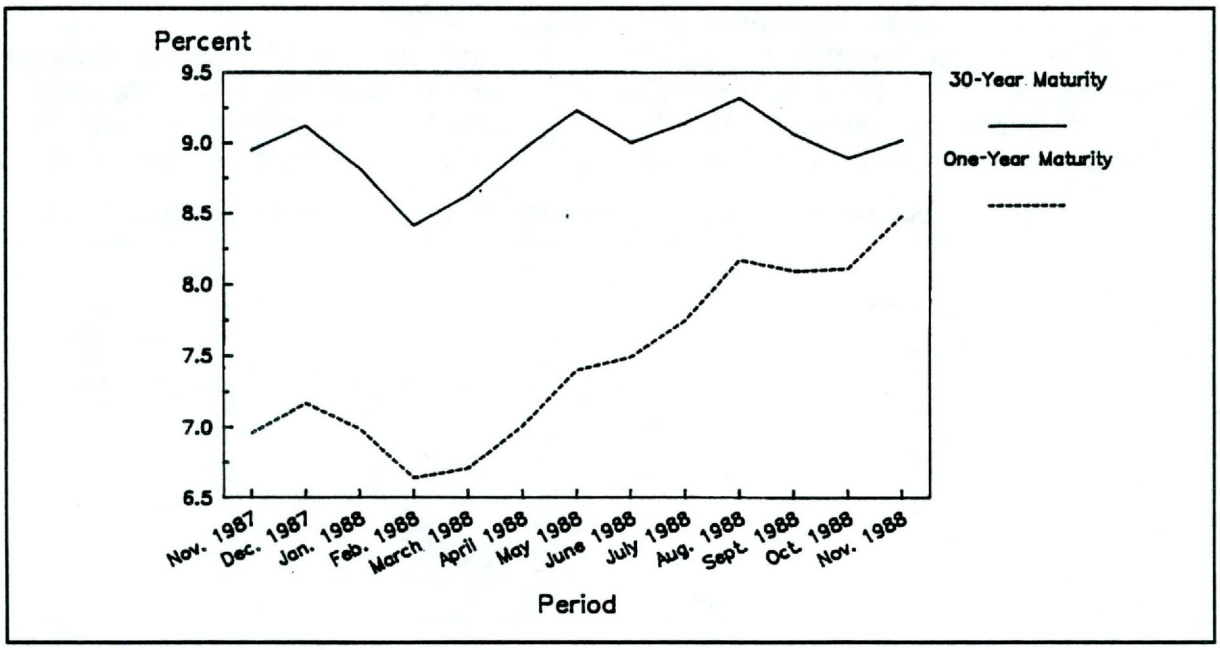
Source: Federal Home Loan Bank Board

Figure 2. Effective Interest Rates on Adjustable-Rate Mortgages



Source: Federal Home Loan Bank Board

Figure 3. Constant Maturity Yields on Treasury Securities



Source: Federal Reserve Board

factors point to a potential strengthening of cropland prices in coming months. However, observers fear this may not continue as total CRP acreage approaches mandated limits.

Prospects for increasing agricultural exports and rising crop prices indicate higher net farm incomes for irrigated land and dryland with sufficient moisture. In addition, most remaining producers are strong enough financially to survive, indicating increasing demand for cropland. Further, denial of special capital gains tax treatment makes selling less attractive to landowners. Thus, supplies should become less plentiful while demand grows. Emerging effects of the drought create the greatest uncertainty concerning short-term trends in cropland values.

Rangeland's prospects are less clear. Historically, many purchasers of rangeland have supported their acquisition with income from nonagricultural sources. Most felt that land values would never decline and bought land for nonagricultural reasons. State-wide lack of income available for rangeland purchases substantially reduced effective demand. A return to urban prosperity must precede a rebound in rangeland values.

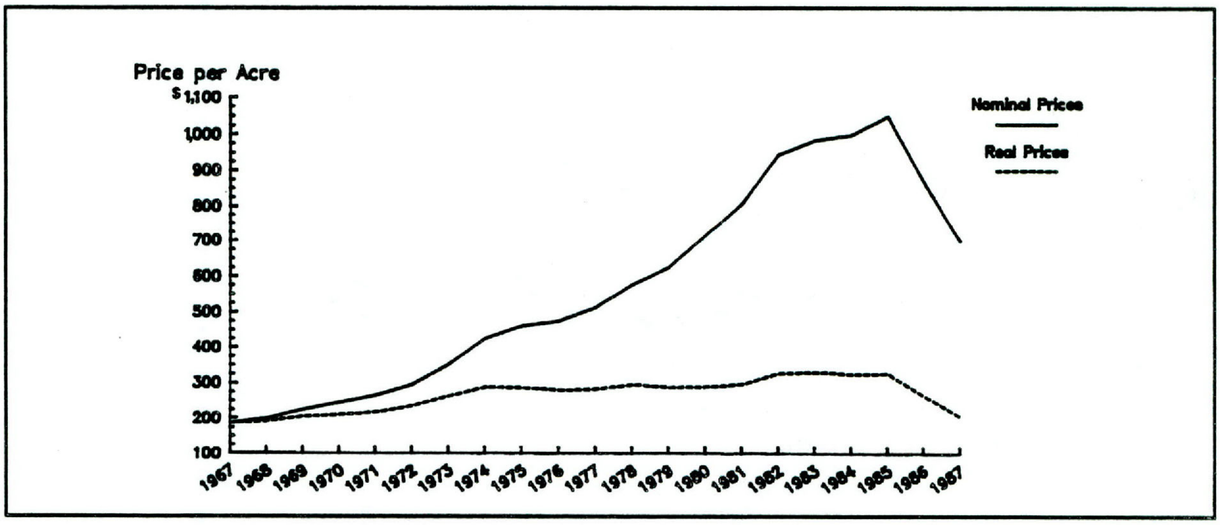
Thus, rangeland markets remain stagnant and oil income no longer contributes to large pools of capital for land acquisition. In addition, unemployment and urban real estate vacancies remain high throughout Texas. Demand for rangeland will depend largely on livestock income potential. Prices based on livestock operations are substantially below recent historical values in most areas. Lack of nonagricultural buyers presages sluggish markets with weakened prices.

Policy

The federal government and appraisal trade organizations are moving towards requiring licensure of appraisers. Appraisers have faced much criticism in lenders' problems with real estate loans, and many believe that unethical practices and lack of expertise contributed to these difficulties.

Representative Barnard of Georgia introduced the Real Estate Appraisal Reform Act into Congress in 1988. The bill would have required states to develop ap-

Figure 4. Nominal and Real Median Price per Acre for Texas Land, 1967-87



Source: Real Estate Center at Texas A&M University

praisal certification procedures overseen by a special federal council of financial regulatory agencies. Certification guidelines are being developed by the Appraisal Foundation, a new entity formed by eight major appraisal organizations.

Even with backing, the bill failed during the 1988 session and there is some doubt that it will succeed if reintroduced in the new Congress. Debate on the banking crisis has moved from appraiser-bashing to second-guessing FSLIC tactics. The Office of Management and Budget probably will intervene on behalf of federal agencies to require that appraisals be conducted by certified appraisers, meet certain standards or both. This likely will become the industry standard.

Outlook for 1989

After several sluggish years, prospects appear bright for a gradual rise in Texas employment and income. The state comptroller's office projects that the economic growth of 1988 will continue in coming years. Although burdened by excess supply in almost every sector, eventually real estate should follow the economy. As Figure 5 indicates, residential markets generally respond first (although interest rates are most influential) and nonresidential markets lag.

Several factors could derail this upturn. Texas, once somewhat insulated, is now more influenced by the national economy. Many believe the nation is ripe for a recession after one of the longest expansions in history. To be sure, this is one forecast that has been put on hold for several years. The economy could continue to grow, particularly if Congress does not try to balance the federal budget with major tax increases.

Economic analysts have stated throughout the recovery that debt represents the most serious threat to continued growth. The federal budget deficit, Third World debts, farm debts and leveraged buyouts loom as potential crises. Of major concern now is the problem of insolvent banks and thrifts. Resolution of the problem will be costly and may require additional tax revenues.

Banking and thrift problems exist nationwide but are especially acute in Texas. The cost of past bad loan decisions has yet to be paid. Furthermore, lenders' inventories of superfluous and nonproductive properties have not been released into the market. These properties will be a dead weight on the economy and a special problem for real estate markets. In addition, the lending industry's reduced size may not be adequate to finance expansion. Forced mergers of institutions, like leveraged corporate buyouts, may show signs of unraveling in a more competitive environment.

Now may be the time to digest fully the lessons of the state's real estate development debacle. Much of the boom of the early 1980s was based on investment decisions removed from the realities of the marketplace. Downside risk seems to have been completely ignored, while the search for abnormally high returns pushed aside any concern for the risk of failure.

Many factors contributed to this manner of thinking. Tax incentives meant to revitalize the national economy attracted investors without regard for economic rationale. Severe pressure to attract high-cost funds encouraged lenders to take on maximum-yield, high-risk projects. At the same time, depositors were lulled by the protection of federal deposit insurance. Deregulation provided investors the leeway to pursue these ventures without the experience needed to evaluate possible repercussions. Inflation and oil-boom optimism gave the impression of never-ending prosperity.

Some point to the lack of strong control in the real estate market, decrying the largely individualized decision-making process that they allege leads to excess. The natural extension of this argument is a call for government intervention. However, there is no guarantee that government policy makers would anticipate demand swings any better than market participants. More than likely, such policy would attempt to serve diverse and often contradictory political objectives, as the Federal Reserve Board has as facilitator of national monetary policy.

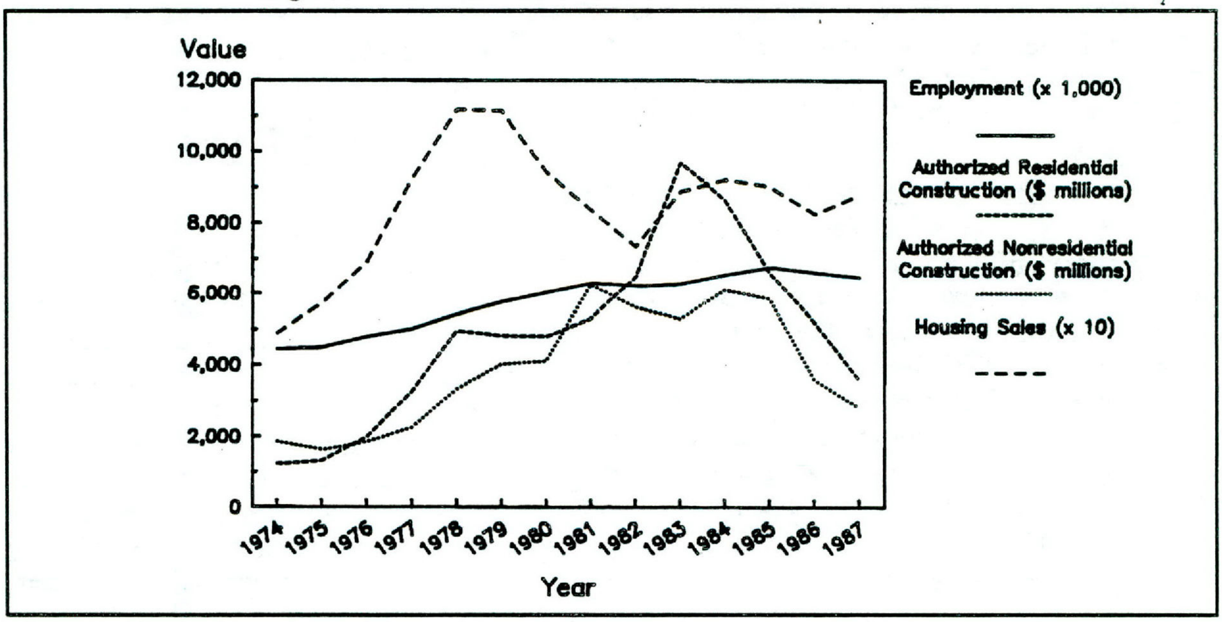
Government policy recently has brought about fundamental, rapid changes, and mistakes by those involved are to be expected. Entrepreneurs who can learn from the past and build the future are needed to lend stability and reintroduce prudent decision making into the market.

Table 9. Texas Economic Outlook

Item	1987	1988	1989	1990
Gross state product				
(billions, 1982 $)	$270.3	$276.8	$287.1	$296.2
annual percent change	-3.1	2.4	3.7	3.2
Personal income				
($ billions)	$227.4	$241.2	$259.5	$278.8
annual percent change	0.8	6.0	7.6	7.4
Employment (000)	6,480.4	6,570.7	6,691.2	6,823.1
annual percent change	-2.0	1.4	1.8	2.0
Population (000)	16,776.8	16,929.6	17,192.7	17,511.1
annual percent change	0.8	0.9	1.6	1.9
Percent unemployment	8.8	8.0	7.4	6.9

Source: Bob Bullock, Texas Comptroller of Public Accounts

Figure 5. Texas Real Estate and Economic Growth



Source: Real Estate Center at Texas A&M University

These new decision makers will have to prove themselves in an environment of public skepticism. Financial deregulation is commonly believed to have allowed lenders to gamble recklessly with government-insured funds. Official sentiment is moving in two directions: some want to remove governmental support by reducing deposit insurance or imposing risk-adjusted premiums and others want to retract some of the discretion granted under deregulation. Regardless of the outcome, emerging leaders in the lending industry will face closer scrutiny.

Despite potential hazards, Texas has considerable basis for optimism. The economy slowly is finding strength in several sectors: high tech industry and research and development work in urban centers, the petrochemical industry on the coast and *maquiladora* programs in which U.S. and Mexican industries work together to boost the economy along the border. In addition, the state's educational system is poised to assist growth through human capital development and research.

Furthermore, physical growth is no longer dependent on growth itself. During rapid expansion, construction activity can become a major segment of the economic base. Yet such activity is transitory, dependent on continued growth to maintain a steady level. Construction will not play a large role in the recovery, which in itself will strengthen the economic base.

The current oversupply of developed space and depressed values can be an advantage. Businesses such as J.C. Penney are being drawn from crowded, high-cost areas of the country, many of which are attempting to restrict further expansion. Texas' willingness to welcome growth should be a magnet for business leaders.

Not to be discounted is Texas' newfound political influence. President Bush considers the state his home base and states that have elected native sons traditionally have enjoyed economic benefits. Texans play prominent roles in the Cabinet, thereby controlling a vast array of governmental programs. Both senators promise to be even more influential in the new Congress. Texas' clout in Washington, D.C. also is evident in the awarding of the supercollider project to the state. Protecting the project's funding during budget deliberations will require political skill of the state's representatives.

Other issues also will affect the real estate industry in coming years. Real estate professionals must determine how best to serve the growing Hispanic market. Environmental limitations will grow more important as growth is renewed. Water availability may restrict growth in western cities while groundwater pollution may become a larger problem in East Texas. The problem of toxic ground contamination may change the handling of real estate transactions and could impose substantial costs on landowners. These issues will become even more important in the future.

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