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Letter From Public Accountant Brian R. Gordon, to Commissioner Heather Muren and Bryon Gerorgiou

Brian R. Gordon

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August 31, 2010

Commissioner Heather Murren
and
Commissioner Byron Georgiou
Financial Crisis Inquiry Commission
1717 Pennsylvania Avenue, NW, Suite 800
Washington, DC 20006-4614

Sent via email (hmurren@fcic.gov and bgeorgiou@fcic.gov)

RE: Financial Crisis Inquiry Commission Hearing | Written Testimony

Dear Commissioners:

In response to your letter dated August 25, 2010, requesting written testimony for the upcoming September 8, 2010 meeting of the Financial Crisis Inquiry Commission (the "FCIC"), please accept this letter as written testimony, including the attached exhibits. In your letter, you requested information about the impact that the financial crisis had on the real estate market in Nevada with a particular focus on: (1) the causes of the financial and economic crisis; (2) the length and depth of the economic downturn in the state of Nevada; and (3) the impact the crisis had on the Nevada real estate market. Each of these topics is addressed in turn below.

WRITTEN TESTIMONY

As a principal and analyst with Applied Analysis, I have prepared and managed a number of market analyses, feasibility studies, and on-going research efforts focusing on the real estate market in Nevada. Prior to joining Applied Analysis in 2000, I was an audit and business advisory manager with Arthur Andersen. Additionally, I am a native Nevadan and attended the University of Nevada, Las Vegas, where I graduated *Cum Laude* with a bachelor of science degree in Business Administration. I am also a certified public accountant. My experience and assignments conducted while a principal at Applied Analysis provide a reasonable basis for my testimony that follows.

Causes of the Financial and Economic Crisis

The initial request regarding the causes of the financial and economic crisis is not easily addressed, with much of the available information coming from the FCIC's own hearings. What is clear is that there were a number of factors contributing to the national crisis rather than a single cause. Primary among them was an environment driven by unprecedented liquidity, an aggressive lending climate and decision-making processes that seemed to disregard or discount risk, historical performance, and other market-based dynamics. Unsustainable levels of investment, development, and consumer spending followed. The ensuing fall-out from these decisions has been

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significant and well documented, resulting in economic challenges and fiscal shortfalls. Nowhere is this more apparent than in Nevada.

Length and Depth of the Economic Downturn in Nevada

The best available data would tend to suggest that the length of the current downturn is three years and running. The magnitude of the decline is without a modern comparison.

The statewide unemployment rate currently stands at 14.3 percent (seasonally-adjusted), which reflects an all-time high during the modern era. Additionally, establishment-based industrial employment totals 1,108,300, the lowest level since September 2003 and well below the peak of 1,303,800 reported in May 2007. While seasonality may play a role, there is no question that a 15.0 percent reduction in employment is not only challenging for those looking for work, but creates new challenges for those that continue to be employed. It is also worth noting that in September 2007, the state reported its first annual decline in employment since August 2002. Assuming the September 2007 timeframe established the start of the downturn (three months in advance of the national recession (December 2007)), the contraction in the job base has persisted for nearly three years.

While different sectors of the economy have responded differently, the state's core tourism industry and construction industry were some of the hardest hit. Employment in the leisure and hospitality sector, which currently accounts for 27.5 percent of total employment, stands at 304,600 and is 11.4 percent lower than the peak reported in June 2007 (39,000 jobs lost). The construction industry peaked earlier with a high of 148,800 workers in June 2006 (11.5 percent of the workforce). Today, the construction industry employs 61,200 workers (5.5 percent of jobs), a decline of 87,600 jobs (58.9 percent) from the peak. Combined, leisure and hospitality and construction account for approximately two-thirds of the 195,500 jobs lost during the past several years. Other sectors have been, and will continue to be, impacted but not to the extent of these two sectors.

The Nevada Real Estate Market

Understanding the broader economic climate is important when discussing trends in the Nevada real estate market. It is also worth noting that when discussing statewide trends, Clark County¹ accounts for approximately 72 percent of the total population.

Residential Market

The residential market has been characterized by a typical "boom-bust" cycle. Prior to the 2000s, housing values reported only modest pricing movement, not unlike the national housing market during the same timeframe. By the early- to mid-2000s, the state experienced some of the strongest population and employment growth in its history and at the same time speculation in residential real estate began to increase.

By late-2002, the median resale home price in southern Nevada surpassed \$150,000 and reported annual price appreciation in excess of 10 percent for the first time. This

¹ Includes the Las Vegas Metropolitan Statistical Area (MSA) and is also referred to as "southern Nevada".

level of price increase was only a fraction of what was to come. As speculation in the market became rampant, availability on the resale market shrank to less than 30 days of effective inventory and offer prices were exceeding seller asking prices on a regular basis. Price points were rising by as much as 47.1 percent year-over-year in June 2004 when the median price had reached \$240,000, approximately double where it stood just five years prior. As the rate of price appreciation slowed, the median price continued to climb, reaching a peak of \$290,000 during mid-2006. Exotic financing techniques and still-increasing investor speculation contributed to the inflated market demand. During the 2005 and 2006 timeframe, it was not uncommon for homes to contract and subsequently appreciate by \$10,000 to \$20,000 before the new owner obtained title to the property.

During the 12-months ended May 2006, over 43,000 residential units had been permitted for construction, a figure materially more than longer-run historical averages, as the number of new home communities actively selling homes escalated beyond 550. As a supply-demand imbalance began to emerge from excess housing construction, many property owners looked to divest their assets, further magnifying the gap between the need for houses and the available supply. Inventory levels skyrocketed toward nearly 29,000 homes in the fall of 2007, reflecting effective inventory in excess of one year in the resale market. Notably, just three years prior a home would only remain on the market for days, and in some instances only hours.

Coinciding with the downturn in the national and local economy and the housing market, many homes entered the foreclosure process. With over 50,000 homes completing the foreclosure process in southern Nevada since the beginning of the national recession, the state quickly became the nation leader in residential foreclosure activity. According to RealtyTrac, a national provider of foreclosure market information, Nevada reported 1 in every 17 homes (64,429 properties) received at least one foreclosure filing during the first half of 2010, ranking the state highest in the nation.

Lack of market demand and distressed sales activity has pushed the median price down to approximately \$125,000 where it has remained for the past year. While shifts within different price points continue to take place, overall pricing appears to be bouncing along a bottom.

According to CoreLogic, approximately 23 percent of all homes with a mortgage in the United States are “underwater” or “upside down”. In Nevada, that figure is 68.1 percent of borrowers, reflecting the nation’s highest rate. Las Vegas ranked as the most “underwater” city with 72.8 percent of borrowers owing more than their property is worth. CoreLogic also estimates that the total amount owed on mortgages in Nevada reflects 120 percent of total property value. Nevada was the only state to report a value above 100 percent; the national average is 70 percent.

These market dynamics are not isolated to the for-sale residential market, as investment-grade apartment communities are also being impacted by the downturn. With apartment pricing trends generally lagging the for-sale market by 12 to 24 months, average asking rents have also turned down sharply. By the close of the second quarter of 2010, average rents reached \$765 per unit per month, a 14.0-percent decline from the \$890 reported in the third quarter of 2008. Occupancy levels have also plunged to 90.7 percent, off the peak of 95.2 percent in the first quarter of 2005 and the 10-year historical average of 93.7 percent. Fundamentals are expected

to remain weak as distressed sales of apartment properties are likely to depress pricing further, impacting the rental market.

Overall, housing market conditions continue to be impacted by the downturn as supply levels remain elevated and end-user demand remains sluggish. Near-term expectations for population and employment growth are limited, suggesting the housing market will continue to moderate.

Commercial Market

The commercial real estate markets have experienced much of the same trend lines discussed in the residential market above. Supply has far outstripped market demand, resulting in excess inventories and declining price points.

Specifically in the commercial office market in southern Nevada, the vacancy rate climbed from a cycle low of 8.1 percent in the third quarter of 2005 to a record high of 24.1 percent at the close of the second quarter of 2010. In square footage terms, vacancies increased four-fold from 3.0 million square feet to 12.0 million square feet during the same timeframe. During each year from 2005 to 2007, the market expanded by more than three million square feet, while the amount of net absorption, or market demand, failed to keep pace. Rising price points, capital availability and longer-run concerns about land availability contributed to the feverish pace of development. Today, construction activity in the professional office market has come to a near standstill.

Correspondingly, as demand slowed, vacancies climbed and lender acquisitions and loan restructurings impacted pricing. Average asking rents have reached \$2.13 per square foot from a peak of \$2.38 per square foot per month in the third quarter of 2008, down 10.5 percent. Effective pricing, or rents that account for concessions and other incentives, are reporting price points 20 to 30 percent below the peak.

With regard to anchored retail centers, the southern Nevada market has been hard hit by not only the local conditions, but also the national economy. Reorganizations and liquidations of national retailers such as Circuit City and Linens N Things played a role locally, as the major anchor spaces they occupied remain vacant. Historically averaging vacancies in the three to four percent range, vacancies in anchored retail centers currently stands at 10.4 percent. Again, as demand turned negative, construction stalled and prices plummeted. With average asking rents of \$1.68 per square foot per month, prices are 23.8 percent below the peak of \$2.20 reported in the fourth quarter of 2007 and first quarter of 2008.

The industrial real estate market has been similarly impacted by the latest downturn. With six consecutive quarters of negative net absorption, vacancies have climbed to 16.2 percent from a low of 3.3 percent in the fourth quarter of 2005. Pricing is down 29.5 percent as average asking rents dipped to \$0.58 per square foot per month from a high of \$0.82 in the second quarter of 2007. With all of these figures, it is important to note that the mix of available space can impact the average, but the directional trends are clear.

Vacant Land Market

With reduced demand for new construction in the residential and commercial sectors, there are few uses for raw, undeveloped land. Once thought to be an endangered species in Nevada (particularly in the Las Vegas valley), speculators, investors, and lenders are holding vacant property only worth a fraction of its previous value. Stripping out the investor speculation component of market demand for a moment, the intrinsic value of any raw land becomes the value, and potential profit, associated with its improvements. Today, there is very little demand for raw land, barring a few build-to-suit projects that require a ground-up development.

Land values in southern Nevada, for example, are a fraction of their peak price points. During the second quarter of 2010, the average price of property changing hands was \$154,700 per acre (non-resort property), which is 83.5 percent below the peak value of \$949,400 per acre reported in the fourth quarter of 2007. While sales volumes have picked up in recent quarters, primarily due to distressed sales, overall demand is well below levels reported during the boom period.

EXHIBITS

The exhibits included on the following pages provide graphical depictions of key economic and real estate trends in Nevada and smaller geographies where appropriate.

SOURCES AND LIMITATIONS

As part of this testimony, a number of data sources and providers were utilized. As it relates to employment-specific information, the Nevada Department of Employment, Training and Rehabilitation was utilized while population statistics were derived from the Nevada Demographer. Housing-related data is generally sourced to Home Builders Research, SalesTraq, Foreclosure.com, RealtyTrac and Applied Analysis. The commercial market information and vacant land sales data is sourced to Applied Analysis' proprietary research and databases.

Market and economic information furnished to us and contained in this submission or utilized in the formation of the findings were obtained from sources considered reliable and believed to be true and correct. However, we did not perform any audit or other assurance procedures on the data; and as such, no representation, liability or warranty for the accuracy of such items is assumed by or imposed on AA, and all submissions are subject to corrections, errors, omissions, and withdrawal without notice.



Thank you for the opportunity to participate in this important process. If you have any questions or comments, I can be reached directly at (702) 967-3333 or via email at bgordon@appliedanalysis.com.

Sincerely,

A handwritten signature in black ink, appearing to read 'Brian R. Gordon', written over a horizontal line.

Brian R. Gordon, CPA
Principal

EXHIBITS

[INCLUDED ON FOLLOWING PAGES]