Why the Impact of Facebook's IPO on Silicon Valley Home Prices will be Short-Lived

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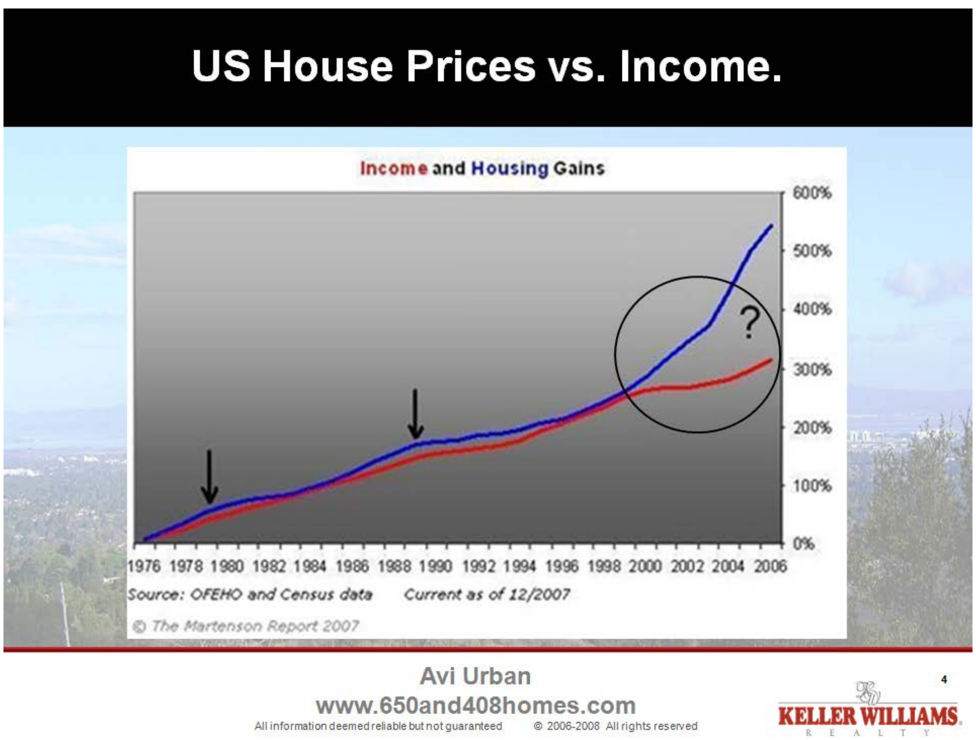
Published February 3, 2012
Modified Feb 24, 2012

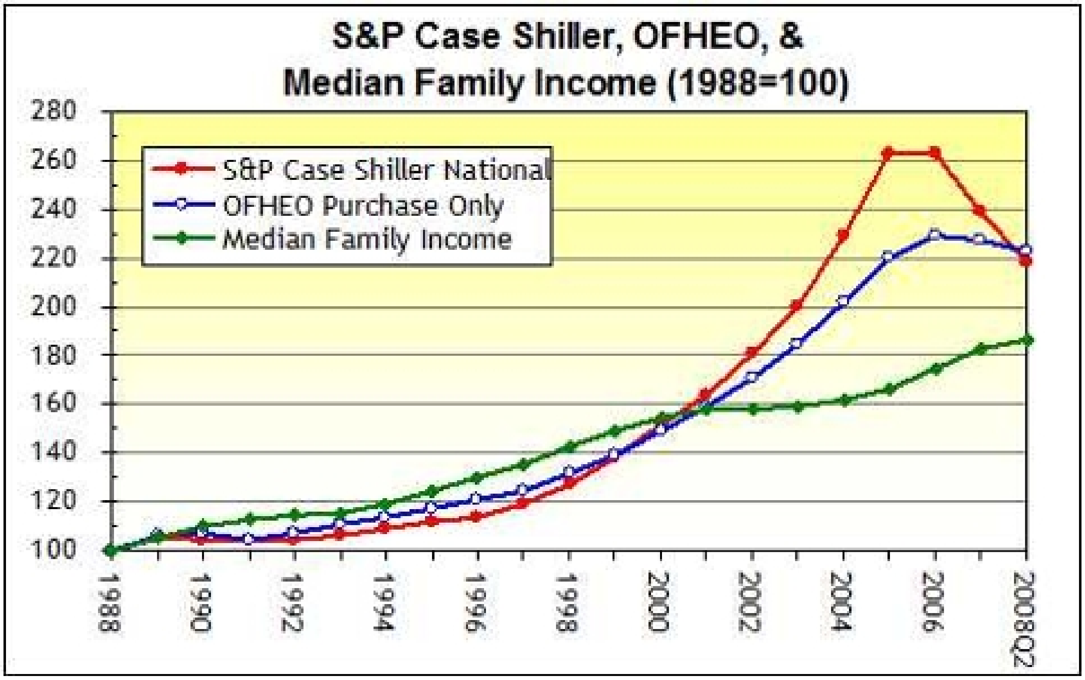
I believe that the Facebook IPO hype currently sweeping Silicon Valley is only a blip in time. This is especially true of its impact on select local neighborhoods such as Palo Alto, Menlo Park, Los Altos, Sunnyvale, Mountain View and others. Let me explain what I mean.

In general, home prices are derived from the strength of the local economy, the type of jobs available and the area's future outlook; these typically track local Annual Household Income (AHI) as depicted by the chart below.

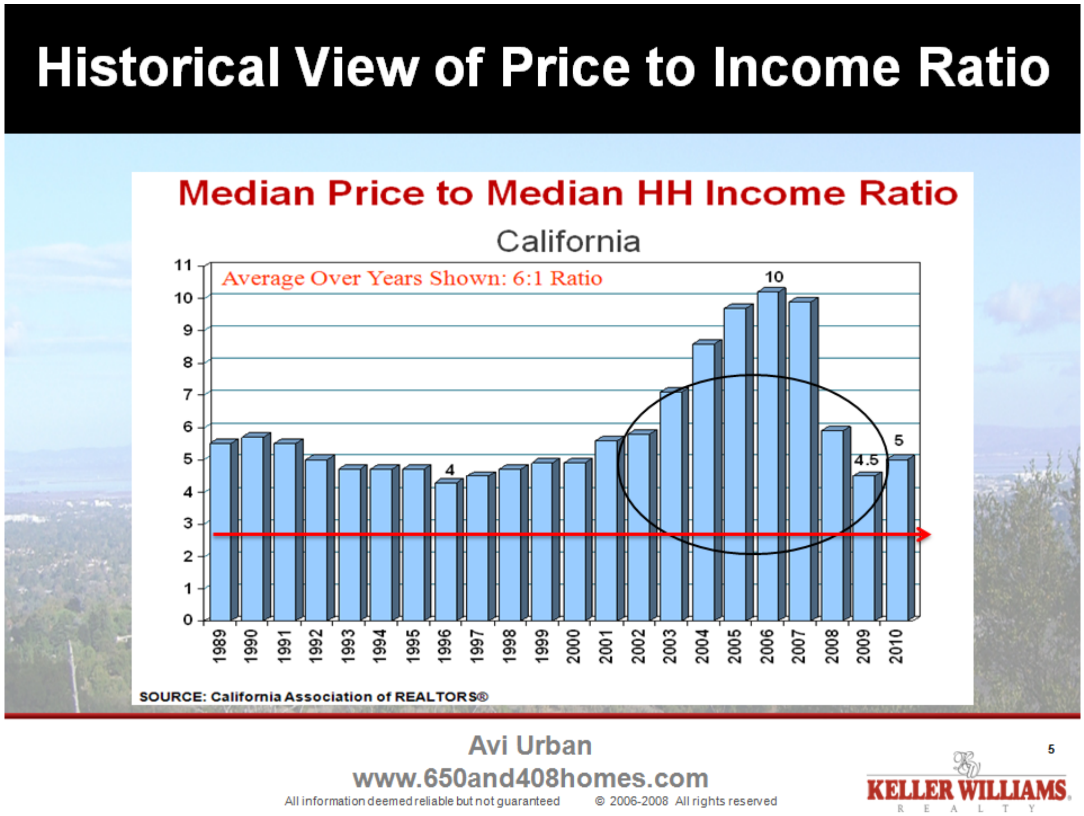


The reason housing prices track AHI is simply because the overwhelming majority of people who buy homes borrow money to buy those homes. Lenders have strict lending requirements as to how much they are willing to lend to potential home buyers. The amount they are willing to lend depends on the AHI, available down payments and other financial obligations (yes, there are other considerations, but not directly related to this discussion).

As we can see in the above chart, home prices (blue line) rarely divert from income (red line) and even if they do, they'll correct. For prices to divert from income, at least one of the following situations must occur. (The chart below reinforces what happened after 2006.)



1. **Lenders must be willing to relax their lending requirements,** allowing a higher Debt To Income (DTI) ratio such as that depicted in the chart below (ref 1).

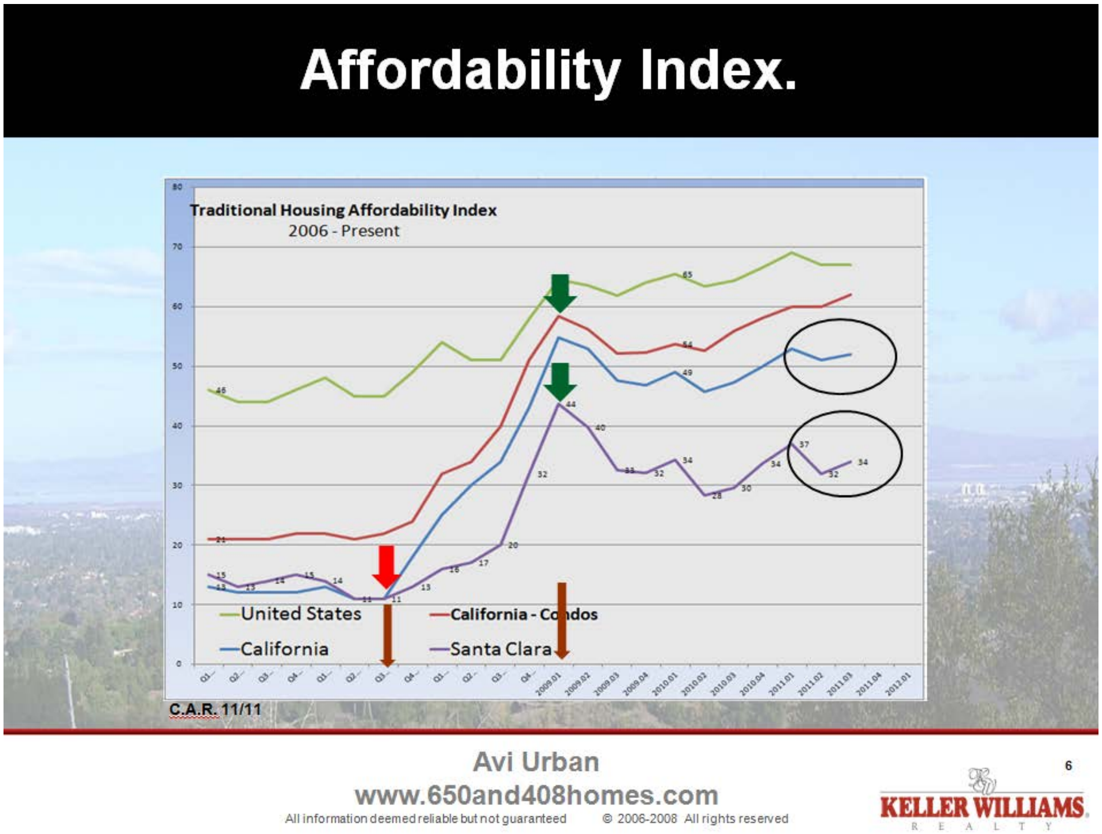


Historically, lenders will lend to worthy buyers approximately five times their AHI with a 20% down payment. For example, if a household's income is $100,000 per year, a family's maximum purchase price will be $500,000, the down payment is approximately $100,000 (20%) and the loan amount will be up to $400,000 (80%). For this family to buy a house with a purchase price of $600,000 with only $100,000 of AHI, lenders would need to relax their lending criteria and lend to this buyer at a ratio of six-to-one (as mentioned earlier, there are other important criteria).

That is unlikely to occur in the near future given what happened as a result of the recent relaxation of lending criteria. Quite the contrary, we are actually witnessing increasingly tougher lending requirements.

2. **Household income and down payment will have to increase**. For the family above to be able to purchase a $600,000 home with a conventional loan, their household income will need to increase to $120,000 per year (a 20% increase) and the down payment to $120,000 (20% of additional cash). This is not a very likely scenario over the next two to three years in Silicon Valley.

3. **Buyers will need to come with higher down payments**. To close the affordability gap (see the chart below) buyers will need to increase their down payment.



For a household with an annual income of $100,000 per year and a purchase price of $600,000, the buyers will need $200,000 in down payment (plus reserves) in order to obtain a conventional loan of $400,000.

So, where is this money going to come from?

1) **Family gift, or the sale of a previous home** – Those fortunate enough to be in this position will be able to realize their dreams and buy a house above their affordability limit. This is not a broad phenomenon and will not sustain prices at above-affordability rates for a long period.

2) **All-cash buyers** – The all cash-buyers phenomenon is prevalent at both ends of the market. At the lower end, investors buy foreclosed homes and REO in order to flip them within a short time, while at the very high end financing is limited so those with cash at hand prefer to use their own capital (lost opportunity cost is very low) rather than borrow at higher rates. As a reference, the following table (Ref 2: DataQuick Information Systems) depicts the 2010-2011 trends as well as long-term trends. It's interesting to note that for homes selling for $5 million and up, over 60% paid in cash.

Percentage of homes sold to buyers paying cash

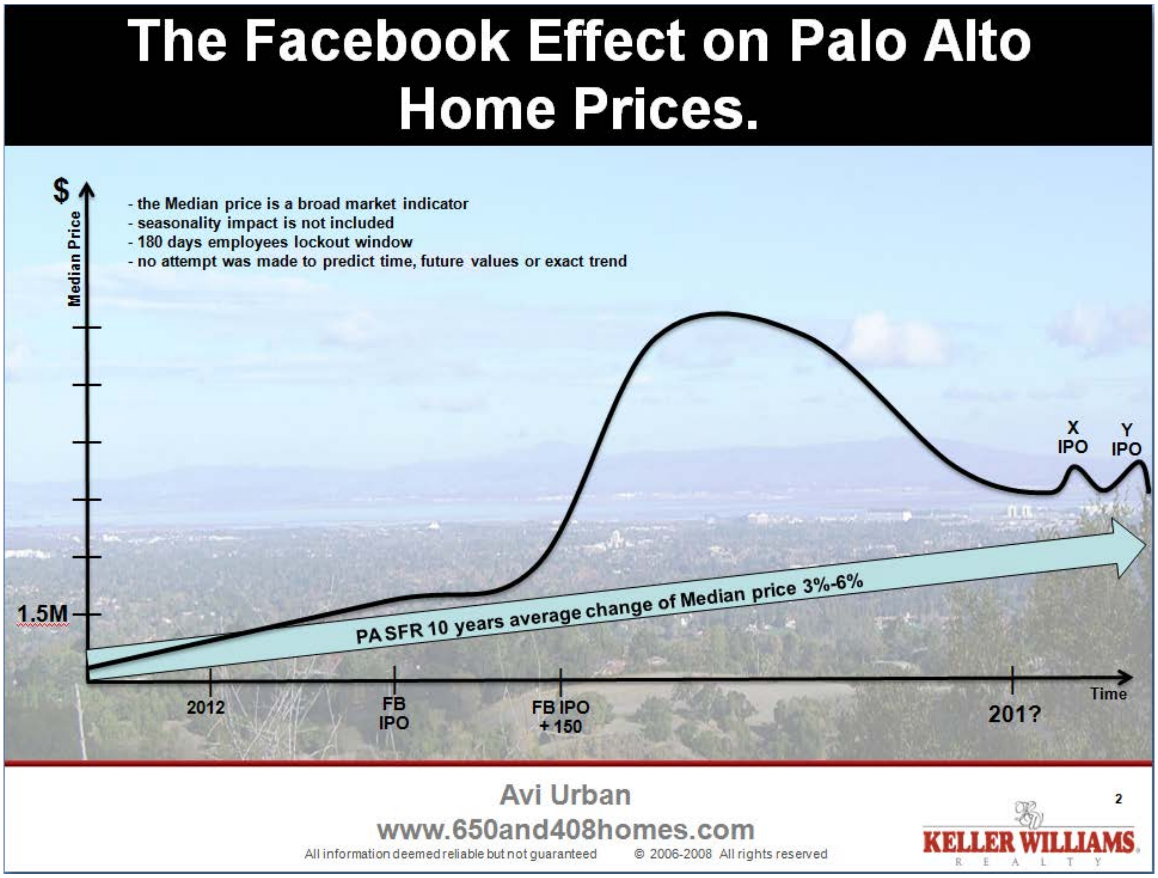
County/Region	Jan-10	Jan-11	Peak month since 1988	10-yr monthly avg
Alameda	25.40%	25.50%	28.10%	10.40%
Contra Costa	29.60%	32.00%	32.00%	12.60%
Marin	26.10%	29.90%	32.20%	15.80%
Napa	32.20%	31.90%	33.70%	13.30%
Santa Clara	22.20%	26.30%	26.30%	12.50%
San Francisco	25.40%	21.90%	25.60%	13.10%
San Mateo	24.50%	25.40%	25.50%	10.70%
Solano	27.90%	35.90%	35.90%	13.30%
Sonoma	27.50%	28.30%	34.60%	14.80%
Bay Area	26.00%	28.70%	28.70%	12.40%

a) **Foreign buyers** – In recent years we have seen many foreign investors purchasing homes in Silicon Valley for cash (typically they cannot obtain a loan) for reasons such as currency diversification and historically low prices resulting from the 2008 financial crisis, as well as possibly gaining staying status. This phenomenon, in my humble opinion, is not broad enough to sustain prices at above-affordability rates for a long time.

b) **The super-rich** – Silicon Valley has plenty of extremely wealthy individuals (in the heart of the land of opportunity) but this essay does not address this market segment.

3) **Exercising of stock** – This is the result of the Facebook bump and other future IPOs, as well as other well-to-do public companies (Apple, Google, et al.).

To analyze the impact of these equity-rich-buyers, I'll focus on the Palo Alto real estate market, which, since the late summer of 2011 (due to impressive performances by companies like Apple and Google, as well as pre-IPO employees selling into the secondary market) has been experiencing price appreciation and competition not seen since 2007.



I'm not making any attempt to predict the new levels of pricing, when the hockey-stick behavior will start, the length they will last or the levels at which prices will eventually settle. I believe that Facebook employees will start getting into contracts approximately 30-45 days before the Facebook IPO lockout date.

Obviously there are other factors that can substantially affect the actual response of the market, such as the European debt crisis, U.S. politics and the presidential election, the success of Silicon Valley's 150 largest companies and their stock performance, and more.

I anticipate that the market will continue be competitive in anticipation of the Facebook IPO (in select neighborhoods and price points due to the broad spectrum of employees' stock holdings). Moreover, the sales price will be well over asking due to the lower-than-typical inventory levels (sellers may be anticipating higher prices down the road) and buyers trying to stay one step ahead of what they may think the future will bring.

I'd like to point you to a discussion at Insidefacebook.com (ref 4) regarding the expected implication of the Facebook IPO on actual employees' capital gains taxes and net equity.

As the New York Times article (Ref 5) points out to the history of recent IPO's, in the near future there are no other companies in the IPO pipeline that may have such a large impact on

Silicon Valley real estate market as the Facebook IPO may have. As such its impact may be noticeable for some time and so may be the adjustment when returning to historical appreciation trends.

4) **And my favorite, winning the lottery** – I have been working on this for over 50 years, and am just about to lose hope!

As this possible Facebook scenario unfolds, the key question to you, whether you are a potential buyer, seller or investor of Silicon Valley real estate, is HOW should you re-evaluate your strategies?

Your comments and questions are welcome.

Essay by

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