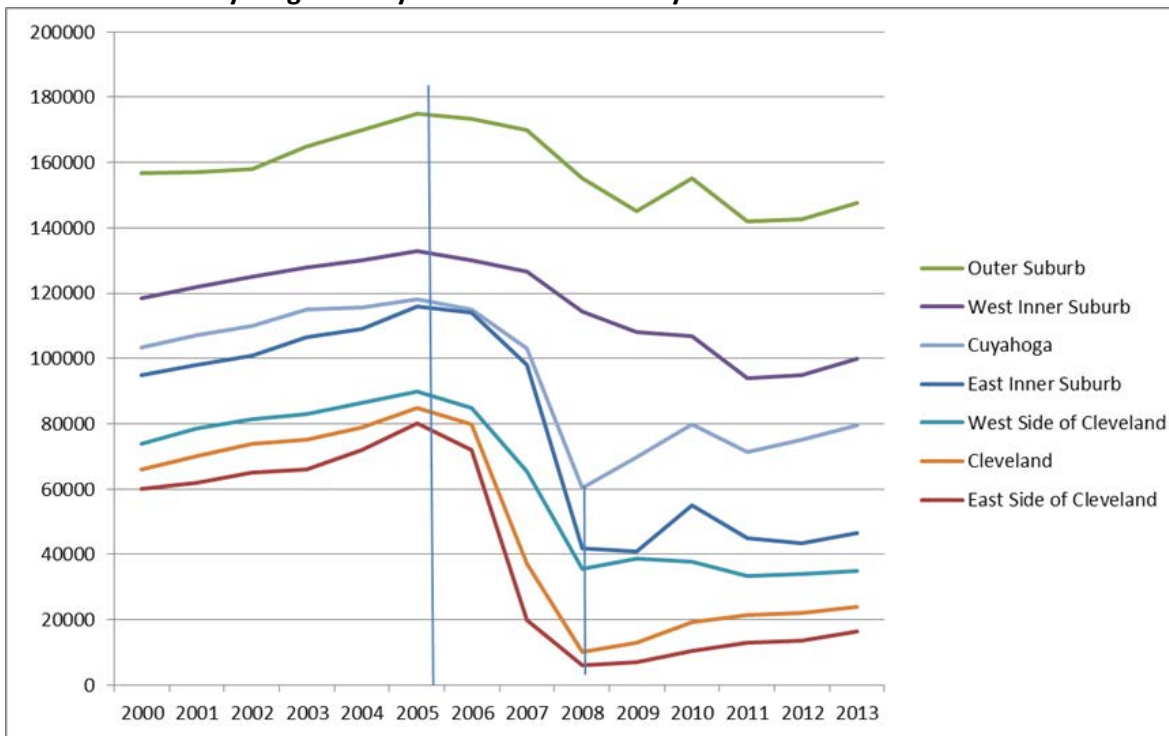


Providing a Framework For The “Rehab vs Demo” Debate: Findings from a Harvard University Study Frank Ford and Jeff Marks November 9, 2014

Background

The foreclosure crisis of the past 15 years did more than disrupt the lives of tens of thousands of Cuyahoga County homeowners who were foreclosed upon. The blight caused by abandoned homes also caused an unprecedented fall of home values and home sale prices that affected all segments of the county. The vast majority of Cuyahoga County homeowners were not displaced by the foreclosure crisis – yet they saw their home values, and their equity, slip away before their eyes.

Cuyahoga County Residential 1-3 Family Home Sales 2000 - 2013¹

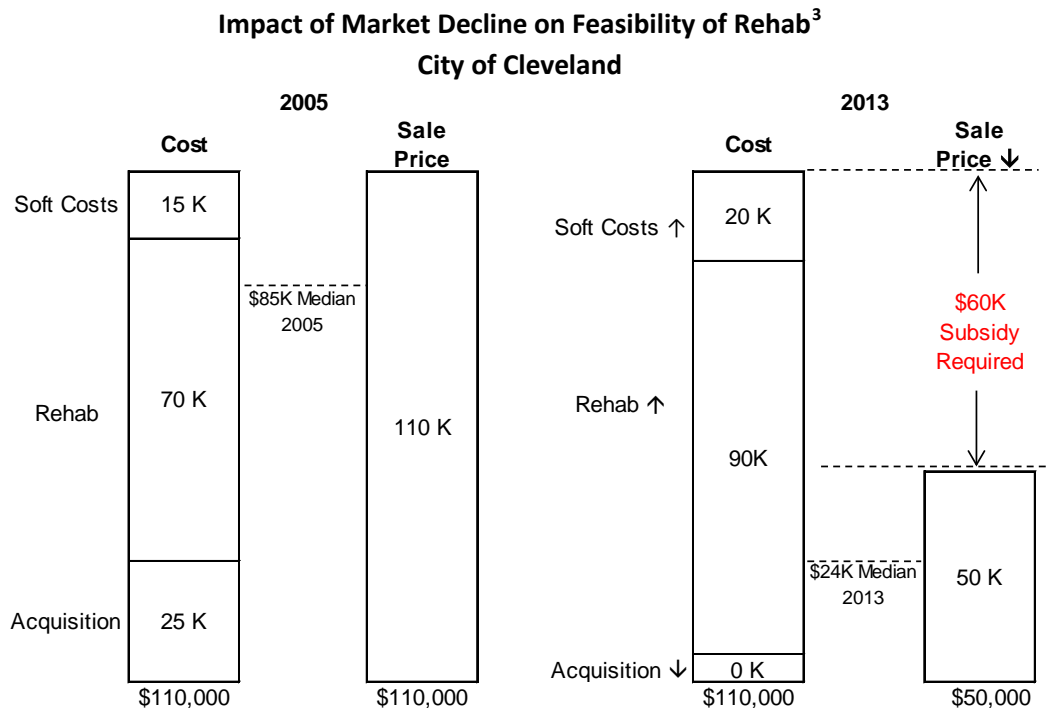


The County now faces a “Catch-22” dilemma – abandoned homes need to be renovated so the housing market can recover, but low sale prices make it impossible to recover the cost of renovation. Case Western Reserve University’s NST data system estimates that there are 24,000 vacant homes in

¹ “Arms Length Transaction” data provided by NEO CANDO at Case Western Reserve University. Arms Length Transactions exclude Sheriff Sales, sales to banks and Federal agencies, and \$0 dollar transactions. Although Sheriff Sale transactions are excluded, the data does include sales on properties with a prior Sheriff Sale in the chain of title.

Cuyahoga County. Further, it is believed that 10,000 of those are the most severely distressed homes that are undermining housing values in the county².

The following illustration compares the renovation of a home in Cleveland in 2005, before market prices collapsed, with the renovation of a home in 2013. The examples in both cases are based on a fully renovated home selling for a price above the median home sale price. No subsidy was required for the rehab in 2005. But because of the drastic decline in home sale prices between 2005 and 2013, significant subsidy is now required.



Cleveland and its suburbs, as well as land banks and community development advocates, now face a dilemma – 10,000 severely distressed homes need to be addressed. They can demolish these homes at an average subsidy of \$10,000 per home (a cost of \$100 Million or more) or they can renovate them at a subsidy that might be five times that amount. Since there is not even \$100 Million available, let alone \$500 Million, public officials have tended to remove blight by demolition because it is the most cost effective means of eliminating the blight that is undermining housing markets. Yet the decision to demolish thousands of homes has created controversy.

The Harvard Study

A team that included researchers from Case Western Reserve University and Cleveland State University was invited by Harvard University to do a study of the business models of investors who purchase

²The City of Cleveland estimates there are 8,000 condemnable homes in the City; a recent study by Thriving Communities Institute estimates there are 1,030 condemnable homes in East Cleveland. The number of condemnable homes in the balance of the suburbs is unknown but could be 1,000 or more.

³ Median home sales date provide by CWRU. Costs are examples for illustration only.

properties coming out of foreclosure⁴. As part of the study, and in the hope of shedding light on the controversy, we conducted an analysis of the feasibility of renovation as an alternative to the demolition of abandoned homes.

The study posed the question: **“Can a model for vacant house renovation be developed that provides safe decent housing, is beneficial for the surrounding neighborhood, but does not require subsidy, or, at minimum, does not require any more subsidy than the \$10,000 required to demolish a house in Cleveland?”** To explore this question the following methodology was developed:

1. Identify 6 neighborhoods with different market characteristics.
2. Identify a vacant house in each neighborhood to which access could be gained to develop complete rehab specifications and cost estimates.
3. Develop 4 rehab scenarios for each house, with budgets and specs.
 - A high level whole house gut rehab
 - A moderate level rehab
 - A “code plus” level of rehab
 - A minimum “code-only” level of rehab
4. Use an established Realtor to identify comparable sale prices and develop resale pro formas for each house and each rehab level to see if subsidy would be required, and how much.
5. A project was deemed “Feasible” if there was either no subsidy required, or the subsidy, or “gap”, was no greater than \$10,000.

The following six homes were selected, four in the city of Cleveland and two in the inner ring suburbs.

- 4107 W. 48 (Old Brooklyn)
- 15615 Trafalgar (North Collinwood)
- 3655 E. 54 (Slavic Village)
- 5628 Pacific (Stockyards)
- 19400 Ormiston (City of Euclid)
- 3866 Salisbury (City of South Euclid)

An important operating assumption we made was that for any model to have a significant impact on market stabilization it would need to be one that would induce responsible private rehabbers to “get into the game”, and not be a model that would only work because a government or non-profit was in some respect providing “off the books” subsidy through staffing, etc. Accordingly, our analysis assumed the following:

- All required permits would be applied for and obtained.
- All work would be inspected and meet local housing codes.
- Labor and material costs would be the costs experienced by a private rehabber.

The table that follows provides a summary of what we found.

⁴ *“The Role of Investors in the One-To-Three Family REO Market: The Case of Cleveland”*, December 2013.
<http://www.jchs.harvard.edu/research/publications/role-investors-one-three-family-reo-market-case-cleveland>

Subsidy Analysis – Harvard Study Test Homes

Subsidy (red) or Surplus (black)					
Neighborhood	Address	Gut Rehab	Mod Rehab	Code Plus	Code Only
Old Brooklyn	4107 W. 48	(29,296)	(5,308)	9,339	31,006
North Collinwood	15615 Trafalgar	(55,146)	(42,375)	(30,999)	8,875
Slavic Village	3655 E. 54	(70,504)	(49,739)	(28,871)	3,980
South Euclid	3866 Salisbury	(61,274)	(41,060)	(24,440)	6,229
Euclid	19400 Ormiston	(64,909)	(32,929)	(20,177)	(1,464)
Stockyards	5628 Pacific	(73,239)	(52,985)	(40,517)	(16,740)

*Code Only = Replace mechanicals and finishes **only** if code not met. E.g. 20 yr furnace stays if it works. No sidewall or attic insulation. No Green Standards.*

As noted earlier our premise was that a rehab model would be successful if the subsidy (in red above) would be no greater than the \$10,000 subsidy required for demolition.

A full **Gut Rehab** did not work in any of the neighborhoods we studied, including Old Brooklyn.

Moderate Rehab (not shown above) only worked in the stronger Old Brooklyn neighborhood.

Code Plus rehab also only worked in the stronger Old Brooklyn neighborhood.

Code-Only rehab was feasible in of the neighborhoods but Stockyards but offers little sustainability, and does not provide for green standards.

After completing our analysis of the 4 different levels we were disappointed to see that the only successful model was “Code Only” which we believed to be an unsustainable level of renovation. For example, in the code-only model, a furnace that is 20 years old, and still operating, would meet code and thus not be replaced. We question whether it is advisable to put a family into a home with mechanical systems that could fail at any time and put an unstainable financial burden on them. This prompted us to ask the following question. With respect to the code-only level, what would happen if we reverse-engineered the Code-Only specs – and put back into the project enough additional work to arrive at exactly a \$10K gap? We found that this often provided for significant upgrades which might include items like a furnace, wiring upgrades, sidewall and attic insulation, or window repairs.

Our study has led us to make the following recommendations to municipalities and housing and community development advocates.

- Re-think traditional notions of an acceptable rehab standard.
- Consider relaxing regulations that mandate green standards or other amenities that are not at present financially feasible – at least until market conditions improve.

- Use caution when lowering renovation standards to the point where permits are not pulled or a home buyer is left with old and unreliable mechanical systems.
- Increase rehab feasibility by boarding vacant homes earlier, using stronger boarding methods, and mounting aggressive campaigns against stripping.
- And finally, consider applying the methodology we developed as a means of evaluating each home for appropriateness for renovation or demolition.