

# Shadow Inventory

## Judicial vs. Non-Judicial States

April 25, 2014

The size of the shadow inventory<sup>1</sup> rose rapidly during the U.S. housing market crash, reached its peak of 5.2 million (10.3% of all outstanding mortgage loans) in January 2010, and has since been on a steady decline. As of January 2014, the national level shadow inventory stood at 2.8 million, representing a 25% drop year-over-year and a 46% drop from its peak. The overall reduction has been substantial, due in large part to strong demand for distressed properties from private and institutional investors, increasing modification activity, as well as recovering housing environment. It is important to note however, that the magnitude of the decline has varied greatly across individual states. The uneven improvement can be clearly seen when comparing the level of distressed properties in judicial vs. non-judicial states.

As depicted in Figure 1, judicial states experienced a much slower decline in the size of the shadow inventory than non-judicial states. As of January 2014,

- There were roughly 1.2 million distressed properties in non-judicial states, a 28% drop year-over-year and an impressive 58% drop from the peak of 2.8 million,
- While the level of the shadow inventory in judicial states was assessed at 1.6 million, a 22% drop year-over-year and a 33% drop from the peak of 2.4 million.

A further analysis demonstrates that all three components of the shadow inventory (REO, foreclosure and 90+delinquencies) have declined at a faster pace in non-judicial states (Figure 2). Comparing year-over-year changes:

- REO inventory declined 17% in non-judicial states vs. a 13% increase in judicial states,
- Foreclosure inventory declined 38% in non-judicial states vs. a 33% decrease in judicial states, and
- 90+ (seriously delinquent loans) declined 25% in non-judicial states vs. a 13% decrease in judicial states.

The differences in the shadow inventory trends can be mainly attributed to judicial foreclosure processes and resultant longer liquidation timelines prevalent in judicial states. Additionally, the share of the distressed sales relative to the distressed inventory levels has been higher in non-judicial states, as shown in Figure 3. Over the last 12 months, averagely 13% of the REO inventory is liquidated through REO sales on a monthly basis in judicial states. This number is much higher, at 18%, in non-judicial states.

Figure 1. Trends in Shadow Inventory (in million)

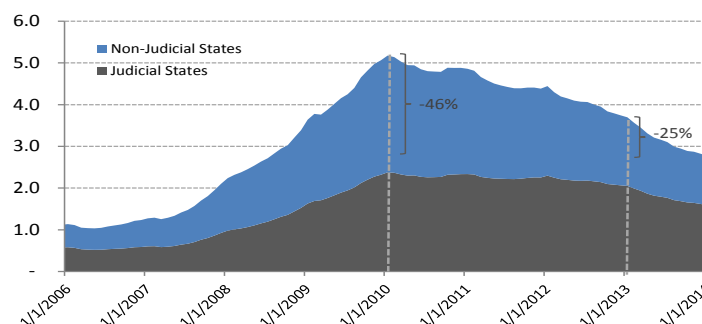


Figure 2. Trends in Shadow Inventory Components (in million)

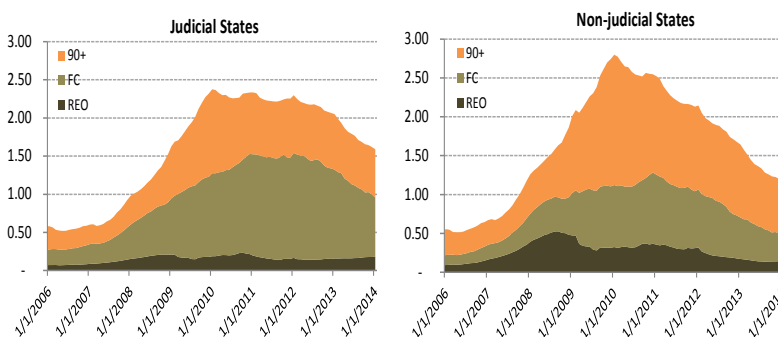
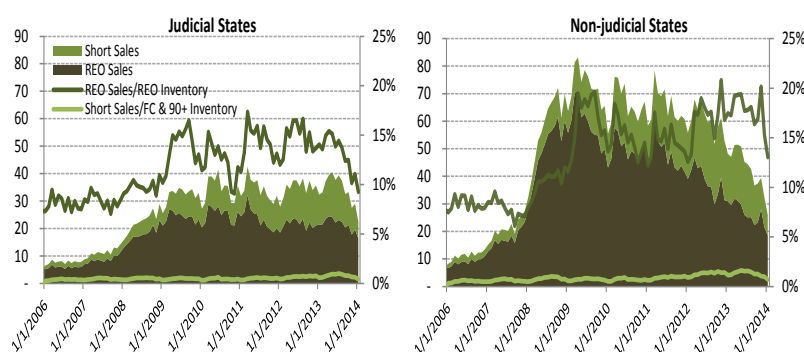


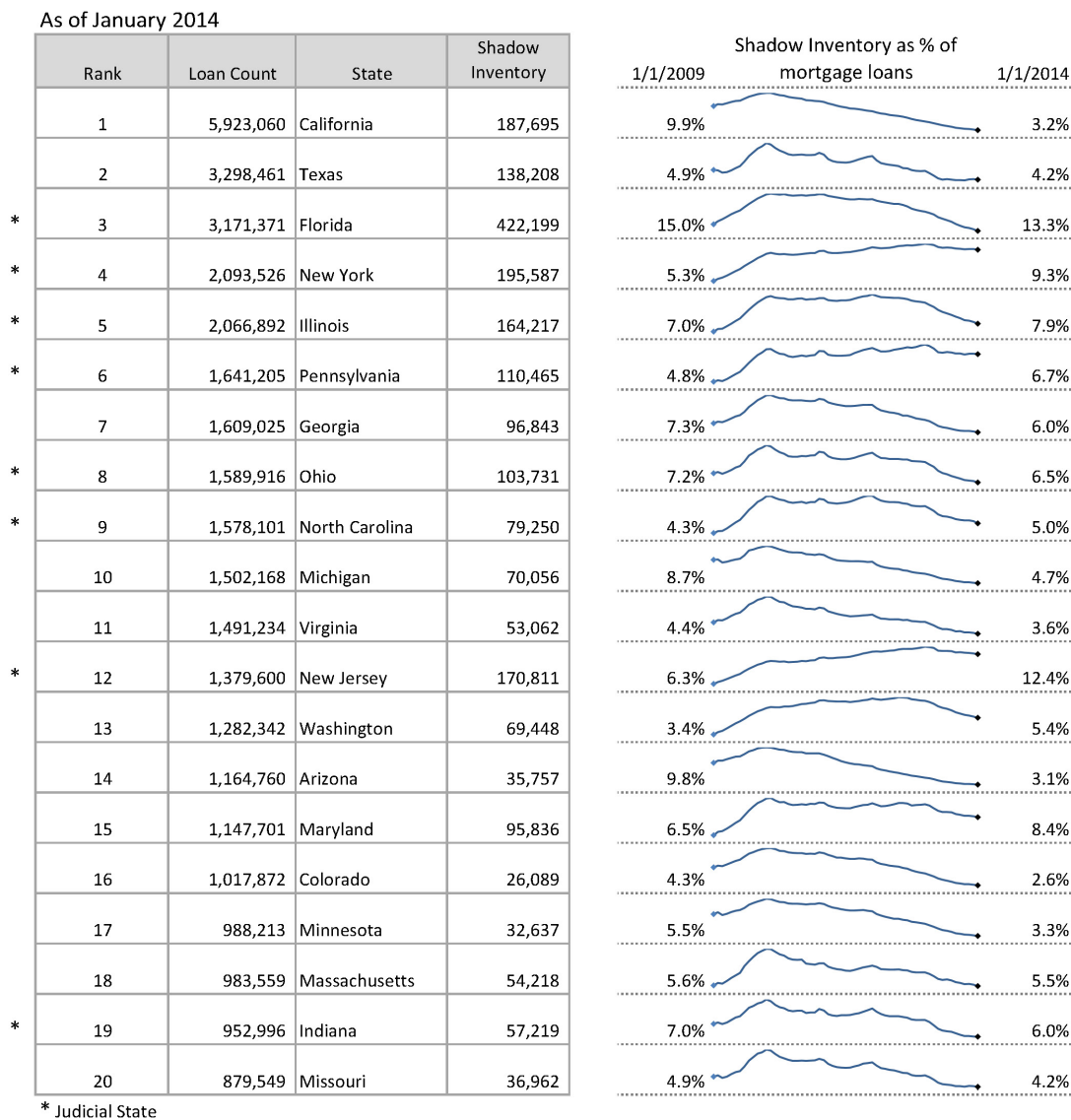
Figure 3. Trends in Distressed Sales (in 000s)



<sup>1</sup> Shadow inventory consists of foreclosed homes and mortgages delinquent for 90 days or more.

In the following chart (Figure 4), we illustrate trends in distressed properties across the top 20 states, which comprise approximately 80% of the national shadow inventory. As discussed in the above sections, most areas show significant improvements, while certain judicial states (New York, Pennsylvania, and New Jersey) experience persistently high levels of pending distressed inventory.

Figure 4. Shadow Inventory Trends of Top 20 States



Sources: CoreLogic, FBC

In the years ahead, we anticipate the levels of shadow inventory to continue trending down, albeit at a slower pace. The majority of the seriously delinquent loans (57%) is located in judicial states and therefore will follow lengthy liquidation timelines. Additionally, we expect the demand from investors to decline going forward amid recent home price increases. Overall, dropping volume of distressed properties, along with low inventories of existing and new homes, should support modest home price appreciation. It's important to remember that the performance of the local housing markets will depend on the areas' individual factors and may not follow the national trends.

For questions or additional information, please contact:

Guey-Mei You, Ph.D.

Aga Brazil

gyou@falconbridgecapital.com

abrazil@falconbridgecapital.com

(925) 979-4257

(925) 979-4291

• BY ACCEPTING A COPY OF THIS CONFIDENTIAL PRESENTATION, THE RECIPIENT AGREES THAT NEITHER IT NOR ANY OF ITS EMPLOYEES OR ADVISORS SHALL USE THE INFORMATION FOR ANY PURPOSE OTHER THAN EVALUATING THE SPECIFIC TRANSACTION DESCRIBED HEREIN OR DIVULGE TO ANY OTHER PARTY SUCH INFORMATION. THIS CONFIDENTIAL PRESENTATION SHALL NOT BE PHOTOCOPIED, REPRODUCED OR DISTRIBUTED TO OTHERS WITHOUT THE PRIOR WRITTEN CONSENT OF THE PRINCIPALS.

• NOTWITHSTANDING ANYTHING TO THE CONTRARY CONTAINED HEREIN, THE RECIPIENT (AND EACH EMPLOYEE, REPRESENTATIVE, OR OTHER AGENT OF THE RECIPIENT) MAY DISCLOSE TO ANY AND ALL PERSONS, WITHOUT LIMITATION OF ANY KIND, THE TAX TREATMENT AND TAX STRUCTURE OF THE TRANSACTIONS DESCRIBED HEREIN) AND ALL MATERIALS OF ANY KIND THAT ARE PROVIDED TO THE PROSPECTIVE INVESTOR RELATING TO SUCH TAX TREATMENT AND TAX STRUCTURE (AS SUCH TERMS ARE DEFINED IN TREASURY REGULATION SECTION 1.6011-4). THIS AUTHORIZATION OF TAX DISCLOSURE IS RETROACTIVELY EFFECTIVE TO THE COMMENCEMENT OF DISCUSSIONS WITH PROSPECTIVE INVESTORS REGARDING THE TRANSACTIONS CONTEMPLATED HEREIN.

• THE FINANCIAL PROJECTIONS INCLUDED HEREIN HAVE BEEN PREPARED ON THE BASIS OF ASSUMPTIONS STATED THEREIN. FUTURE OPERATING RESULTS ARE IMPOSSIBLE TO PREDICT AND NO REPRESENTATION OF ANY KIND IS MADE RESPECTING THE FUTURE ACCURACY OR COMPLETENESS OF THESE FORECASTS.

• THIS DOCUMENT AND THE RELATED ORAL PRESENTATION IS NOT AN OFFER TO SELL OR A SOLICITATION OF AN OFFER TO BUY SECURITIES.

• THE INFORMATION INCLUDED HEREIN IS PRELIMINARY, AND WILL BE SUPERSEDED BY A DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.

• WE WILL NOT ACCEPT ANY OFFER BY YOU TO PURCHASE SECURITIES AND YOU WILL NOT HAVE ANY CONTRACTUAL COMMITMENT TO PURCHASE SECURITIES UNTIL AFTER YOU HAVE RECEIVED THE DEFINITIVE PRIVATE PLACEMENT MEMORANDUM.

• DISCUSSIONS OF FEDERAL TAX ISSUES IN THIS PRESENTATION ARE NOT INTENDED TO BE RELIED UPON BY INDIVIDUAL INVESTORS. EACH INVESTOR SHOULD SEEK ADVICE BASED ON THEIR PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

• THERE CAN BE NO ASSURANCE THAT PROJECTED RETURNS WILL BE ACHIEVED OR THAT THE FUND WILL BE ABLE TO IMPLEMENT ITS INVESTMENT STRATEGY OR ACHIEVE ITS INVESTMENT OBJECTIVES.

• GROSS IRRs DO NOT REFLECT MANAGEMENT FEES, CARRIED INTEREST, TAXES, TRANSACTION COSTS AND OTHER EXPENSES TO BE BORNE BY INVESTORS IN THE FUNDS, WHICH WILL REDUCE RETURNS.