Why the Home Flipping Industry is Now Flopping

By Alex Chazen

More so than ever before, the economic downturn in 2008 created a cottage industry within the Real Estate industry. When the housing market turned from 2008-2015 and 1 out of every 2000 homes in California was falling into foreclosure, those who had enough capital to swoop in on those foreclosure sales began making a lot of money by "flipping" these houses. Investors would purchase these foreclosed properties for record low prices merely to renovate them and resell at a significant markup. This flipping trend became sensationalized with several television programs such as "Property Brothers", "Flip or Flop" and "Flipping Out" to name a few. The popularity of these programs inspired several investors to make cosmetic repairs such as new paint, new appliances, upgraded countertops and floors, etc. and re-sell the homes for significant profits. This house flipping trend was extremely profitable for investors until 2016.

When looking at the current state of the real estate market, however, all of the fundamentals that made it so profitable to flip homes in the recent past have shifted – for the better for most, but not necessarily for home flippers. The number of foreclosures is drastically down despite a tick up in January 2019. Further, the most recently available data shows that in the fourth quarter of 2018, the year over year number of active listings in Orange County was up 15% but the sales volume was down 10.3%, meaning that supply was high and sales were low, possibly due to the current pricing of that inventory. When this is combined with the fact that the average profit on a flipped home hit four year lows in 2018, the number of days it took to get a flip to market in Newport Beach was way up to 255 days in 2018, and only 5.3% of total local sales came by way of flips, you can see that this current market isn't easy for a flipper.

If you're still with me at this point of the article, (I promise there won't be much more math) you may be thinking, "Why is the Real Estate attorney giving me a breakdown of the flipping market fundamentals?" The answer is because while we have seen a downturn in the number of flips, we have simultaneously seen a large increase in the number of "failure to disclose" cases filed against sellers in Southern California (this while the average number of total lawsuits, believe it or not, has actually dropped slightly). This doesn't necessarily mean that there are more lawsuits on flip sales than on traditional sales. However, the average home seller has owned their home for 8.3 years at the time of sale (the highest tenure for homeowners since this statistic began being tracked), while the average flipper has owned the home for less than a year. It is only common sense that the person living in a home for nearly a decade will know more about the property than the flipper who is looking entirely (or mostly) at the bottom line.

This hypothesis is furthered when you look at who these flippers are. Over the last 10 years, Venture Capital and Wall Street firms have started to bundle loans given to home flippers into bonds the same way they do with mortgages in order to create mortgage-backed securities. At the same time, silicon valley has started to allow investors to invest directly into a piece of an individual home flip. While they would scoff at being called a hive for flipping, Opendoor and Offerpad (as well as other "iBuyers") buy houses at a "fair market price," renovate them, and then sell them much in the way a traditional flipper would. The difference though is that a traditional flipper takes more time to actually visit and inspect the property rather than outsourcing as much of the work as possible.

When a buyer notices something wrong in their home after the purchase, they often only have recourse against the person they bought the home from, and their lawsuit is governed by the terms of the sale. But the seller has no real protection against these lawsuits. Most insurance policies exclude "fraud" from coverage, and therefore if you used the sale proceeds to buy a new home, or your next targeted flip property, there is not a pot of money for the buyer to go after to try to resolve the case. In some drastic cases, we have even seen the buyer be able to fully unwind the sale of the home through litigation due to the failure of the flipper to disclose all of the information required at the time of the sale. In California, a failure to disclose or a disclosure of incorrect information is considered fraud in the eyes of the courts.

There is also a significant risk of liability to home flippers when major home defects are discovered after the sale of the renovated property. For older homes, larger ticket items such as roofs, plumbing, electrical or windows which may require simple repairs but which do not impact the look of the home are ignored as cost prohibitive in favor of the cheaper and more visible cosmetic repairs. There are also instances when the renovations cause more damage or cover up damages to the home or are done without the proper permitting. It is imperative that companies who specialize in flipping houses have licensed, bonded, and insured contractors to perform the work necessary to ensure that the homes meet all current building and safety standards, and in the event of litigation from buyers that there is another party to help shoulder some of the burden.