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Investment Newsletter – October 2006

New Mexico Real Estate Update October 2006

Last year we devoted the June Newsletter to our analysis of the Albuquerque/Rio Rancho New Mexico real estate market. This market has been developing in line with our expectations and so this month's newsletter is devoted to an update on the local economy of this market.

Our initial excitement about Albuquerque was inspired by the presence of Eclipse Aviation, a corporation building the world's very first VLJ (very light jet). The Federal Aviation Administration certified the Eclipse 500 in September and the company has begun production at its temporary facilities at the Albuquerque airport. Touted as the world's quietest jet, the Eclipse 500 met its performance goals with a speed of 431 miles/hour, it traveled 1125 nautical miles with 6 people at 41k feet, without refueling. Many expect that this jet will revolutionize jet travel by making it accessible to a new class of pilots and passengers. As of the end of August 2006 Eclipse had earnest deposits for 2500 orders. Eclipse expects to sell 1,000 planes annually in the next 3 years and do an IPO in 24 months. For more information on Eclipse, see www.eclipseaviation.com.

Eclipse Aviation has committed to build its new plant on one half of the 300 acre aerospace technology park at Double Eagle Airport by 2009. Their campus will include office buildings, training facilities, and a full production line. More than 2,000 jobs will be created at this facility. The city and state will provide Eclipse with property and sales tax abatements. The property tax savings alone could be \$250 million over the next 20 years. The other half of the Double Eagle Air Park will be occupied by Utilicraft Aerospace Industries. This company will build an aircraft designed to haul cargo efficiently in short haul feeder route structures. It will have the highest percentage of useful load to gross weight in its class. They have \$1.2B in confirmed orders and project strong job growth over the next two to five years. To learn more see their web site at www.utilicraft.com. These companies are turning the Albuquerque - Rio Rancho area into a major aerospace industry hub.

In addition to the favorable aviation industry developments, the city of Rio Rancho is moving ahead with plans to develop a 160 acre pedestrian friendly City Center. This will be New Mexico's premier commercial retail, dining, entertainment venue as well as the home of the new University of New Mexico western campus. The project includes a 6,500 seat multi purpose stadium, Santa Ana Center, which will celebrate its grand opening this fall. City hall, a 60,000 square foot building should be completed by June of 2007. Lion's Gate Entertainment (Open Water, Fahrenheit 911) plans to build a production facility on a 53 acre site in the city center. They expect to hire 900-1500 employees at this facility. The new University of New Mexico (UNM) western campus will cover 216 acres near the Rio Rancho city center and will include a medical center. Land brokers estimate that land values have soared 25% to 50% in anticipation of the city center's construction schedule.

Albuquerque has become a magnet for businesses seeking a favorable business climate. Forbes ranks Albuquerque best in the nation for business and careers because of the "pro-business" climate, diverse new enterprises, and highly skilled and well paid manufacturing jobs. Kurt Badennausen, Associate Editor Forbes Magazine, ranked Albuquerque number 1 for low business costs in labor, energy, taxes and lifestyles and careers. Kiplinger's Personal Finance that ranked Albuquerque number 3 on its list of the nation's smartest places to live.

As a result of the favorable business environment, a varied set of industries are already moving in, including Venture Capital and Entertainment. Venture capitalist include:

- Vspring Capital, an early stage Venture firm with over \$200M under management, Southern UTE Growth Fund with assets approaching \$2B,
- Wassatch Venture Fund, an information technology and life sciences investment firm with a 160M under management,
- CMEA Ventures with \$770M under management specializes in life sciences, and alternate energy

Such firms provide the financing necessary to create new local companies with high paying professional jobs. Job growth in the Albuquerque metropolitan statistical area (MSA) has been very strong. The MSA added 10,400 jobs from June 2005 through June 2006, a 2.7% growth rate. Manufacturing employment grew by 3.9% over the same time frame. There were job gains in 10 of 12 industry sectors.

Demand Analysis

We analyze Rio Rancho since it is where properties we're interested in are at though some developments are actually within the city limits of Albuquerque. Rio Rancho is growing much faster than the Albuquerque MSA. Over the last year the population of Rio Rancho grew 6.5% while Albuquerque City's grew 2.1%.

Annual growth over the last five years was 5% in Rio Rancho and 1.9% in Albuquerque. Although the City of Rio Rancho projects its population will grow 14% annually out to 2010, we prefer to use a more conservative assumption of continued 5% annual growth. This implies a gain of 3,480 in 2007. Assuming 2.5 persons per household, this implies that demand for new houses would be at least 1,392 units. We say at least because this does not take into account houses lost to demolition nor does it account for houses bought as second homes.

Supply Analysis

In the first 9 months of 2006, Rio Rancho issued building permits for 999 units according to the monthly data reported. Permits are down about 30% year to date versus 2005. Based on this data, I project that roughly 1,200 units will be completed over the next 12 months. Thus it appears that builders are reacting to the potential for buyers to delay purchases in the face of the national news about home prices. The fundamentals are strong in this market yet builders are still being cautious. This is excellent news for us as potential investors. Although current inventory in the resale market is elevated as it is everywhere, the reduction in new house construction going forward should mitigate the downward pressure on prices.

New Construction Investment Opportunities

We are recommending purchase of townhouses in Northwest Albuquerque near the border with Rio Rancho. The model we like is priced at \$180,000 and should rent for \$975 per month. While this represents an increase of 18% from last year, we continue to like the risk versus return trade off here. Assuming a 20% down payment this should have positive cash flow in year 1 on an after-tax basis. In year 2, property tax will rise to reflect the purchase price. We estimate the property would then have slightly negative (-550) cash flow after taking into account tax benefits for an investor paying a marginal rate of 28%. Over two years you would be roughly breakeven on cash flow. Appreciation in this area should provide investors with returns on equity of at least 30%¹ over the two years.

Increasing the leverage would cause the carrying costs to go higher but some of the extra borrowing can be set aside to cover the negative cash flow. Given the likely appreciation in this market, investors should see excellent returns. We are recommending a 5 year holding period to allow time for the economic effects of the Eclipse jet to boost values in the area. If you are interested in buying, contact Rick as soon as possible.

¹ This return would be achieved on an after tax basis if appreciation is 3% annually and the property is not sold. Selling costs at 6% would eat up virtually all appreciation and therefore returns. We recommend holding properties a minimum of 5 years.

Conclusion

Although prices in Albuquerque and Rio Rancho have seen a large run up, they are still reasonable in relation to rents and incomes in the area. We do not see the increase in interest rates having anything close to the impact here as they have had elsewhere. The relative lack of speculation in the market implies that the change in market psychology will have much less impact on demand here. The bottom line remains very significant potential upside with limited downside. We think the returns here are very good relative to the risks.

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