Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – August 2005

Hawaiian Vacation Homes

Last month I made the case for investing in retiree destinations, including Hawaii. This month I spent a week in Hawaii investigating the local market to provide you with specific recommendations for this market. There are four main destination islands: Oahu, Maui, Kuai, and Hawaii (also known as Big Island). Honolulu and Waikiki beach are on Oahu and this is by far the most populated and developed island. This is where the Hotel Condo market is white hot. Big Island is the least developed of the 4 islands. It is much larger than the others and is still growing. In one week I could not cover all 4 islands so I looked at the most developed and the least developed.

Oahu

The cheapest units you can buy are the Hotel Condo units. A studio with an ocean view is rumored to trade at around $300,000 if you were lucky enough to hear of a sale before anyone else. These rent for $130 per night. Occupancy is 90-99% peak season, 50-80% low season and works out to about a 77% annual run rate recently. In my prior newsletter, I talked about such units being leased by the operator from the owner so as to eliminate operating risk. Apparently this concept has yet to catch on in Hawaii. Instead Hotel managers charge 50% of revenue to manage and maintain the units. While this sounds high, you can break-even on cash flow with 80% financing if the loan has 6% interest-only payments and you average 75% occupancy. Because these are the cheapest units, they sell in hours, and it seems that the rapid price increases have attracted momentum players speculating on continuing increases. Given the volatility of hotel room rates and occupancy, and the possibility of management fee hikes, I'm not enthusiastic about the risk versus return trade-off here.

Regular Condos in Oahu often have prohibitions against renting for less than 30 days. I.e. they don't allow vacation rentals. Monthly rental rates are much lower than daily vacation rates and thus the economics don't work. The cheapest Condo in Oahu is listed at $395K and it cannot be rented for less than a month.

This would probably rent for no more than $1,800 per month. Thus it has a gross rent multiplier of 18.3. This is on par with San Francisco and probably doesn't make sense as an investment.

Condos in Oahu without the restriction on vacation rentals are worth much more than $400K. Given the vacancy rates and management costs you'll need to pay no more than 9 times gross potential rents to give yourself a chance to reach break-even cash flow in year 2 assuming you finance 75% of purchase price. Paying more than 9 times gross rent raises your risk level and would only be advisable after a more detailed analysis of supply and demand forecasts.

Big Island Geography

This is my main focus in Hawaii because it is relatively undeveloped and therefore I believe there are more opportunities to add value. The island is dominated by two volcanoes which means that the center of the island is elevated above the coastline. The eastern half of the island is the windward side. Although this side has the biggest city, Hilo, it rains quite a bit on this side and that tends to reduce its attractiveness to tourists. The west side is the leeward (dry) side of the island. The major center of development on this side is the Kona coast. (See the attached maps). The lower elevations (below 500 feet) are almost always sunny. Between 500 and 1,000 feet elevation there is a reasonable amount of sun. Above 1,000 feet, the rain clouds are spilling over from the windward side and it is overcast a larger portion of the time. This is not desirable for most tourists even though the cooler temperatures at this level are sought by the locals.

There are two main areas that tourists stay for sun. The first area is bounded by Kailua Bay in the north and Keauhou Bay in the south. This is the length of Alii drive (about 6 miles) which runs along the water and forms the western boundary. Most hotels and Condos are along this road. The eastern "boundary" is highway 11 which can be elevated up to around 1,000' along this stretch. The area below Kuakini Highway (which runs from Alii parallel and then diagonally up the hill to highway 11 for 3 miles) is most developed – this is the main part of the town. When considering more remote locations such as the towns south of Keauhou Bay, keep in mind that the infrastructure is very poor – especially the roads. This will limit the appeal to locals and tourists alike.

The other main area sun-seeking tourists stay is the Kohala Coast resorts in the South Kohala area, about 30-40 minutes drive north of Kailua-Kona. This area has several groupings of major resort hotels, golf courses, and condominium resorts. The southern end has the fabulous Hilton Waikoloa Village with its own man-made lagoon and an internal transportation system. The northern end is anchored by the luxurious Mauna Kea Beach Hotel and Golf Course. Along the way sits the quiet little town of Puako which features the only other significant beach front road in the tourist areas (besides Alii Drive in Kona). Every house in

Puako is on Puako Beach Drive which stretches about 3 miles. Most of these houses are very ordinary and rather old. Most are probably occupied by locals rather than rented to vacationers.

Another place I need to mention is the area along Kaiminani Drive which connects the airport to the highland town of Kalaloa. The houses here are well located with spectacular views. The problem with investing here is that the homeowners association strictly enforces rules against vacation rentals.

Kona Vacation Rental Economics

Many of the planned unit developments with homeowners associations have rules against vacation rentals. Most of the time, these rules are not enforced and may or may not be of practical importance depending on the situation of a particular subdivision. For example, I stayed in Lakohouse (www.LakoHouse.com) in the Komohana Kai subdivision. Technically, vacation rentals are restricted here but in reality many such rentals are openly advertised. This house sleeps 10 in the main house and 2 in an in-law unit. It has a pool, a hot tub, and a fantastic view. The main house rents for $695 per night and the in-law goes for another $100. This property is priced a bit above market to deliberately keep occupancy low and limited to only the most well-off guests.

An example house in this neighborhood listed by Property Network (www.hawaii-kona.com) sleeps 10 in 4 bedrooms and rents for $375-$460 per night. Overall occupancy over a year is around 75%. High season (12/15- 4/1) is around 90%. Low season runs 50-80% occupancy. According to the owner of Property Network, this example house is probably worth about $1.5 million. I estimate this property would have a cap rate of 3.3% at this price. Since late 2001 there has been a boom in price appreciation not yet matched by rent increases.

A three-bedroom house on Alii Drive rents for $175-215 per night. A two-bedroom condo across from the popular White Sands beach would rent for $118-167.

A new development called Alii Cove shows the value of new condo development: www.AliiCove.com. These units go for $500K (two bedrooms) and up. Situated on the uphill side of Alii, they are in a position to have great views though I did not check for myself.

Out at Waikoloa Colony Villas near the Hilton Hotel in South Kohala area, a two-bedroom, 2.5-bath condo with 1,446 s.f. (pool and volcano views) went for around $650K. Such a unit would rent for $250-$350 per night according to the broker. A unit with a golf course view has a listed asking rent of $175-260.

Occupancy varies greatly by season. In high season, December 15th to April 1st, expect 90-100%. In low season, occupancy runs 50-80%. Overall economic (the percentage of potential collected) occupancy will generally run between 70-80%.

Development Opportunities

All the numbers used in this section are summarized at Exhibit A.

In general, buildable lots with utilities and roads in the desirable Kailua-Kona area sized between 15,000 s.f. and 1 acre can be had for $400-600K. Example listings include a 15,000 s.f. lot in Komohana Kai subdivision for $399K and a 17,000 s.f. lot with a view in Hualalai Heights, listed at $465K. In Hawaii you can generally build two houses on one lot, with up to five bedrooms each if the lot is large enough. This can increase efficiency of land use and a proper configuration is rentable to large parties for weddings, etc. An existing property with two houses on five acres rents for $2,000 per night with 50% occupancy. A lot like this in Hoomalu would cost $725,000. Building costs would run at least $150 per square foot constructed. If total costs are $2.15 million and net operating income is around $160K, you've created significant value. These numbers work!

Properties zoned V-1.25 are for resort/hotel development with density of one unit for every 1,250 s.f. of land. Height limit is 90'. These units can be sold as condos. One property for sale had 33,979 s.f. of ocean-front land and so could hold 27 units. Asking price is $4.9 million. Based on $150/s.f. + $50K for a common area pool, I estimate the cost of building 27 three-bedroom two-bath (1,500 s.f.) units at $7.67 million. Such units would be worth roughly $15.2 million at $600K per unit – net of commissions. Profit = 21% of costs.

Another resort zoned lot, with 14,897 s.f. at 78-6689 Alii Drive, could theoretically have 11 units. Practically this would be difficult. This lot is listed at $1.5 million and already has three units on it: two 2/1 & a studio. Because of the current configuration of units, you would probably need to tear the house down and start from scratch to get more than 3 or 4 more units. Demolishing the buildings and putting up 11 units would cost $3.44 million. Net value would be at least $6.2 million, so profit = 26% of costs. This property was very secluded - up a long and winding shared driveway off Alii Drive. The square footage is just below the 15,000 required by the zoning code to be buildable, so you would need the planning commission's permission to build a denser set of units here.

A 15,739 s.f. lot, zoned V1.25, right on Alii at 78-6659, was listed at $1.8 million. This place is about 120 yards north of Kahaluu beach and would have fantastic views. According to Lonely Planet: "Kahaluu beach is the island's best easy-access snorkeling spot. The bay is like a big natural aquarium loaded with colorful marine life." White sands beach is about .8 miles north of the property. This lot has all utilities available and twelve units are theoretically possible.

Assuming all units were 3 bedrooms, 2 baths, with 1500 s.f. and parking for 24 cars, total cost to build would be roughly $5.4 million. These units would be worth $600K each. After paying sales commissions the net proceeds would be $6.8 million, implying profit of $1.4 million. You could probably do this with as little as $640K in equity. It would require substantial management time to complete the project.

All properties will be required to be connected to public sewer systems by 2007; many on septic tank systems will pay big dollars to get connected. Other issues to consider in development are:

1. You must notify neighbors within 300' and they can contest your plans.
2. You need water commitments sufficient for the density from the dept. of water
3. There are parking, yard, and setback requirements.
4. If it's in the Special Management Area (SMA) along Alii Drive you must fill out a SMA application and go in front of the planning commission. They can disapprove or approve with conditions. You need a site plan and specifications for the structure.

Conclusion

Hawaii continues to be a very hot market and prices are high relative to rents. Oahu is in the midst of a speculative frenzy, particularly in hotel condos; this increases the risks of overpaying. Infrastructure constraints on the Big Island will limit new development for a long time. This fact, combined with increasing demand from retiree and vacationers should continue to drive prices higher over the long run. Existing vacation rental properties may make sense if occupancies and rents grow sufficiently in the short run. The best bet, however, is to take advantage of the run up in prices by developing in-fill projects[1] on vacant land. High density condos along Alii Drive in Kona would generate the most profit, but two houses on one lot could also be quite profitable if the location were right. See Exhibit A for a summary of my analyses of the opportunities. I'm looking forward to helping my clients make profitable investments in Hawaii!

Stock Market Notes

This month we had one of our first big gainers in the special situations portfolio. We bought Petrokazakstan on August 2nd for $43.25 based on my projection that it would be bought out at least 10% higher before year end. August 22nd the company announced a takeover by one of the Chinese State Oil companies at $55 per share. We're holding to see if a rival bidder tops the offer. Since Special Situations is a relatively small piece of client investment portfolios, in the future I will invest up to 25% of the portfolio in a single stock when I have high confidence in a big win (as I did in this case).

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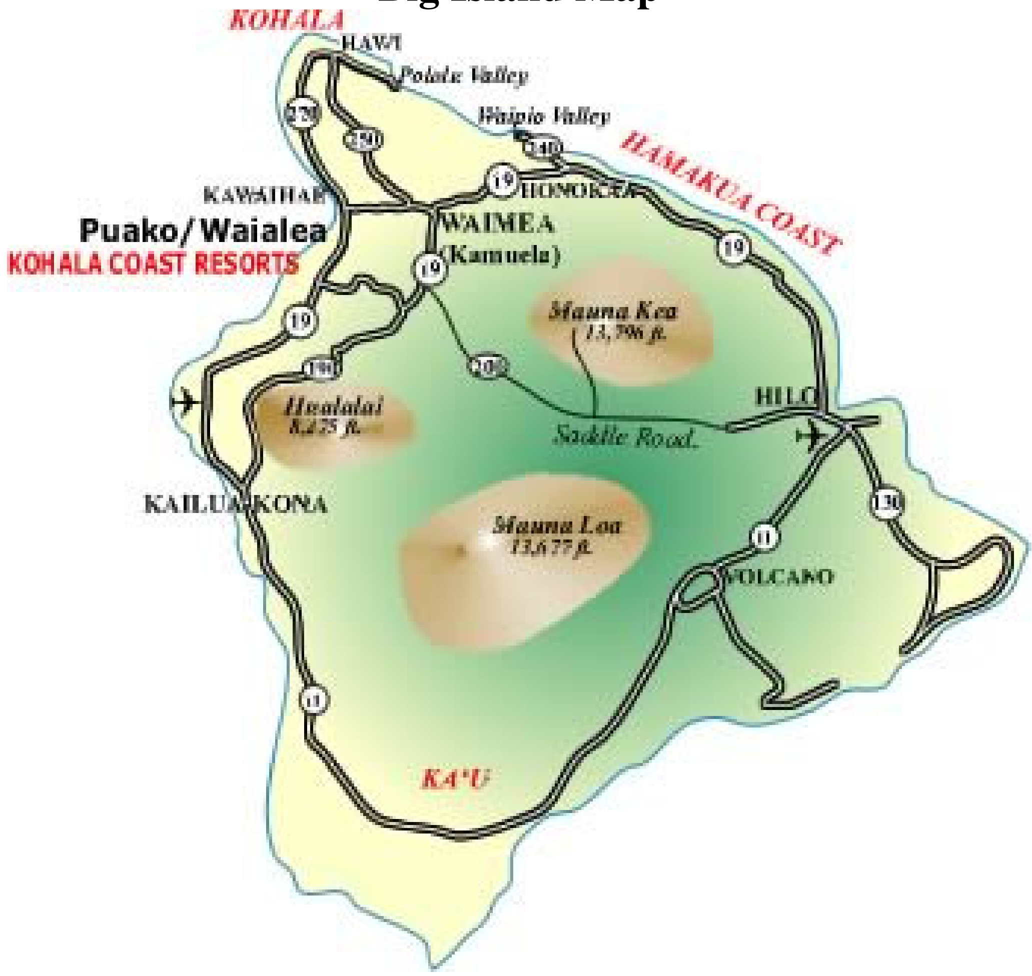
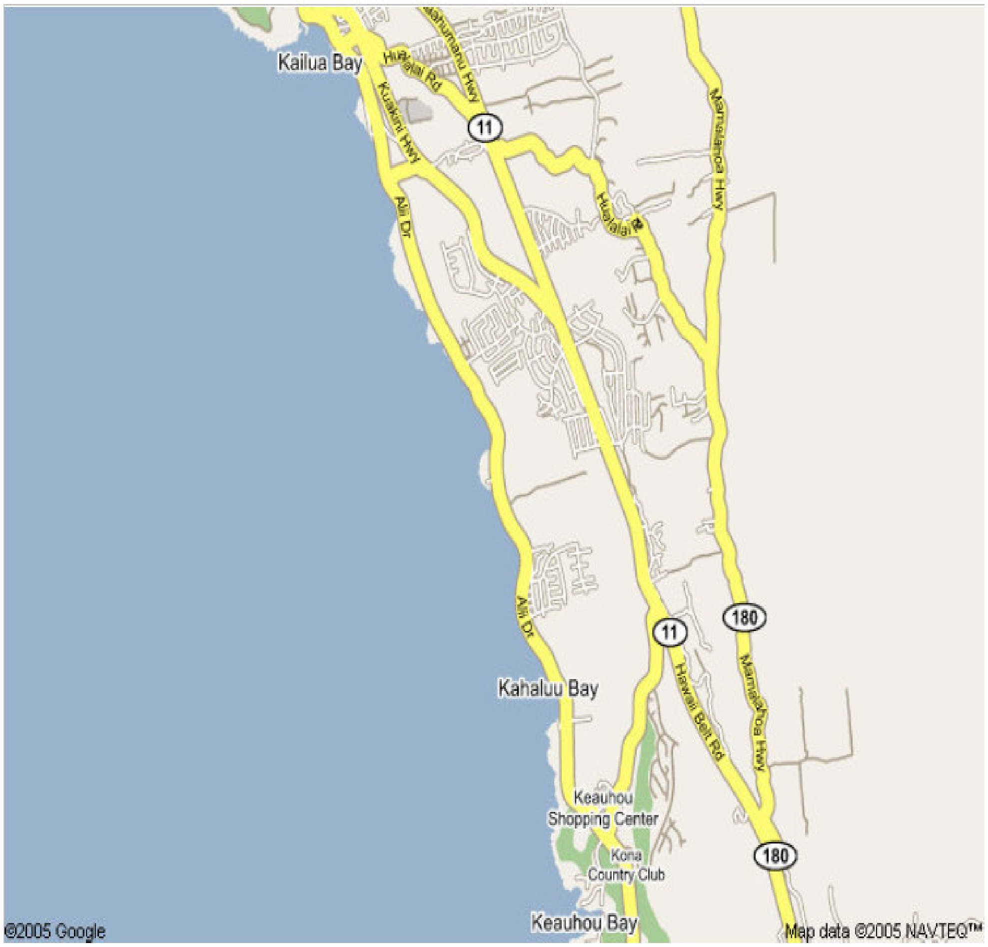
[1] By in-fill, I mean developing land within the currently developed zones rather than developments in new areas.

Big Island Map



Kailua-Kona Core Area



South Kohala Area

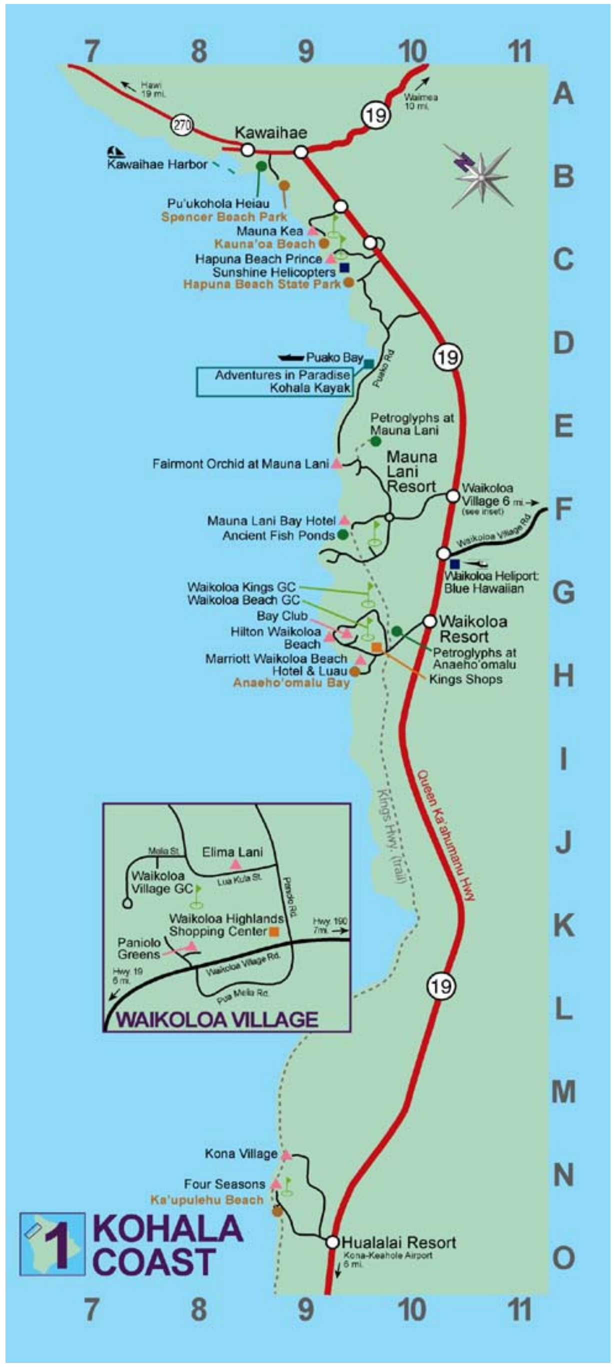


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EXHIBIT A

Big Island Development Opportunities

Location	**Alii Drive**	**Alii Drive**	**Alii Drive**	**Hoomalu**
Lot size	15,739	33,979	14,897	5 acres
zoning	V-1.25	V-1.25	V-1.25	Ag
units	12	27	11	2
s.f. per unit	1,500	1,500	1,500	3,000
Hard Costs per s.f.	$ 150	$ 150	$ 150	$ 150
Land Costs per s.f.	$ 100	$ 121	$ 91	$ 121
Design Costs	$ 100,000	$ 100,000	$ 100,000	$ 60,000
Management Costs	240,000	240,000	270,000	240,000
Common Area Costs	120,000	270,000	200,000	50,000
Hard Costs for units	2,700,000	6,075,000	2,475,000	900,000
Holding Costs (interest)	420,000	987,000	396,000	174,000
Total Development Costs	3,580,000	7,672,000	3,441,000	1,424,000
Land Price	1,800,000	4,900,000	1,500,000	725,000
Total Costs	$ 5,380,000	$ 12,572,000	$ 4,941,000	$ 2,149,000
value per s.f.	$ 400	$ 400	$ 400	$ 500
price per unit	$ 600,000	$ 600,000	$ 600,000	$ 1,500,000
Sales Cost %	6%	6%	6%	6%
Net Sales Value Total	$ 6,768,000	$ 15,228,000	$ 6,204,000	$ 2,820,000
Profit in Dollars	**$ 1,388,000**	**$ 2,656,000**	**$ 1,263,000**	**$ 671,000**
Profit as % of Costs	26%	21%	26%	31%
LTV on Value	70%	70%	70%	70%
Acquisition Loan	$ 1,260,000	$ 3,430,000	$ 1,050,000	$ 507,500
Construction Loan	$ 3,477,600	$ 7,229,600	$ 3,292,800	$ 1,466,500
Equity Required	**$ 642,400**	**$ 1,912,400**	**$ 598,200**	**$ 217,500**
Profit as % of Equity	216%	139%	211%	309%
Estimated Income if held				160,000
Cap Rate				5.3%