Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

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Investment Newsletter – August 2006

Thai Development Fund Offering

In five previous newsletters, I have laid out my research on Thailand and its implications for investors. In this newsletter, we are announcing the launch of an investment fund called the Thai Development Fund that will provide clients a way to participate in my top choice property in Thailand. We anticipate investors will own total returns of 100-150% over 2 to 3 years which translates into annual compounded returns exceeding 40%. Thai Development Fund (TDF) will be organized as a U.S. limited liability company (LLC)

The information in the prior newsletters, along with additional research and analysis, is incorporated in a business plan the maps a strategy for investing in land in Thailand. The Thai Development Fund will follow this strategy but only purchase a single property. This Fund will purchase a showcase investment property which will then be used to promote a larger Fund called the Thai Land Fund. This larger fund will be offered through an investment bank later this year to the bank's client base and because it will be an underwritten offering such investors will incur fees on the order of 6% up front when they invest. The current offering is for our existing clients only and thus there are no upfront fees for clients investing directly.

The Development Fund will either develop the property or merge into the larger fund on favorable terms at a later date. This newsletter announcement will include only a brief summary of the business plan for the fund. Interested investors must contact us to request the full set of offering documents. The current intention is to close the fund in mid September.

Target Property

Thai Development Fund seeks to raise $2 million to $3 million to purchase and develop the first property in Thailand. The target property is a 1.4 acre parcel in the Naklua area of Pattaya. The property is not listed for sale but we expect to be able to purchase it for $2.4 million. This property has roughly 150 meters of beach frontage between the largest convention center in Thailand and a luxury hotel. We estimate that this property could be developed as a Condotel with approximately 77,000 square feet and 68 units. Development would generate estimated profit of $3.8 million based on construction costs of $4.9 million. Pictures of the target property are at Exhibit A at the end of the newsletter.

In the event that Thai Development Fund is unable to purchase the target property, the Fund will seek to purchase a similarly attractive parcel in the Pattaya area or on Koh Samui. The Fund intends to develop the property as a Condotel and sell the units or merge the Fund into a larger Thai Land investment fund if the investors of Thai Development fund vote to merge the fund. Either development or a merger with the Land Fund would provide liquidity to investors. The goal is to create a showcase deal with very high returns as a demonstration to use in raising money for later Funds.

Investment Thesis

Better transportation links, demographics, supporting development, and a critical mass of foreign (European and Asian) buyers are driving a boom in demand for property in the beach resorts of Thailand. This demand, combined with a limited supply of Class A properties, has driven prices upward significantly over the last two years and this should continue for at least several more years. Because most of the Thai luxury Condo demand is not linked to the U.S. economy, returns should be uncorrelated to the U.S. market. This also implies there is limited exposure to a U.S. recession.

Land prices have already doubled in some locations but are still following building prices upward as development margins have widened to over 100% in some cases. While developers' capital is committed to one or two projects at a time, investors with capital can bank land to feed future developments and earn very high returns in the process. As developers and investors recognize that land prices must rise substantially to re-establish equilibrium, more money will come in to bid up land prices.

If land prices do not rise, owners have the option of developing their own land to capture the development margins that are driving land prices up. At current land prices and construction costs, development profit margins are over 70% in both Koh Samui and Pattaya. With leverage, returns on equity for developers are well over 100%. Returns of this magnitude are excessive for the risks of these ventures and therefore increasing amounts of capital is being attracted to these opportunities.

The Value Proposition: Identifying Undervalued Land

Based on our market research, we developed a financial model to predict equilibrium land prices. We can derive an analytical formula for equilibrium land prices based on a financial model of the economics of a development company. Any variable that would affect a developer's annualized return on equity from developing a particular piece of land impacts the value of the land to the developer. Likewise, a developer's minimum required return on equity determines the maximum price a developer can pay for land.

Given selling prices of condos to be built, the developer's costs of building and marketing the units, the price of land and potential building density for the land, we can calculate a developer's return on costs. Assumptions about leverage and project completion time, allow us to calculate the developer's return on equity (ROE). If we then estimate a minimum required return on equity for developers, we can use the calculation of ROE from land price to instead calculate the maximum land price that enables a developer to just meet their minimum ROE goal. This framework provides a method to infer the magnitude by which we can expect developers to bid up land prices when development margins (and therefore ROE) are extraordinarily high.

Specifically, we show in the business plan that equilibrium land prices can be calculated using the following equation.

Land price per square meter = L = $FAR * \dfrac{P}{1 + RR * E * T + LTC * I * T} - FAR * C$, where

FAR = Floor to Area Ratio
P = is net sales price per built square meter after sales and marketing costs.
RR = minimum pretax required return on developer equity
LTC = loan to cost ratio on development
E = developer equity = (1-LTC)
I = interest rate on developer leverage
T = project duration in years
C = construction cost per square meter
Using this tool we can plug in variable estimates from our research to identify the most undervalued parcel relative to development value.

Development Economics: Variable Estimates and Implied Equilibrium

Gross selling prices, costs, and floor to area ratios are specific to each market and have been estimated separately (though construction costs are roughly equal). In order to go from gross selling prices per square meter to net selling prices, we need to estimate selling costs and the ratio of saleable area to constructed area: (constructed s.m. – common area s.m.)/constructed area. In formula form, the net sales price is given by P = GP*SP*(1-Com-M) where GP is gross sales price per square meter, SP is the ratio of saleable area to constructed area, Com is the sales commission percentage and M is marketing costs as a percent of GP. We estimate selling commissions and marketing costs will total 8% of gross sales prices and the saleable area as 90% of the total built square meters.

Bank lending for development projects in Thailand is likely to be pretty conservative. Developers have therefore turned to their customers to provide money for construction. Condos are sold prior to construction with large deposits due at contract signing and ongoing monthly payments during construction. Developers effectively pay for this leverage in the form of early buyer price breaks. While actual leverage varies by developer, we assume (for purposes of estimating land bidding) developers make land buying decisions based on minimum leverage of 50% of costs. Many developers will exceed this number and some will use less leverage, but this is likely to be close to the average; deviations would likely imply corresponding (and offsetting) changes in developers' required returns on equity.

Developers' required returns on equity for projects relate to the risk that their capital providers perceive. This is affected by the amount of leverage employed (leverage magnifies existing risks). Given investor attitudes towards real estate development in Thailand and our relatively conservative average leverage assumption, we will assume required returns on equity for developers are at 40% or less. This is probably high but is appropriate given that this level of return provides an incentive for the Fund to undertake development.

Based on our research we know the market specific cost, pricing, and density variables for Pattaya and Koh Samui. Putting it all together, our analysis implies that land prices must rise 120% to 150% to reach equilibrium given current market conditions. For this fund we will most likely develop the property and earn the development profit as well. Spreading out the total returns over 2-3 years implies compounded returns well in excess of 40% but of course there are no guarantees.

The Fund

The Fund will pay management fees of 2% annually plus incentive fees equal to 20% of returns in excess of 18% per year. Investors will own shares in a U.S. limited liability company (LLC) which will set up separate corporations in Thailand to own the land. The land acquisition team in Thailand will use local knowledge and contacts to purchase land with as few competing bidders as possible. The fund expects to develop a Condotel on the parcel and sell off the Condo's to provide cash back to investors. At the end of the development investors will be able to pull money out or vote to merge the fund into the Thai Land Fund.

Risks

Thailand is a stable democracy with a well established legal system. Many foreigners, including Americans, enjoy solid legal standing thanks to strong trading relationships. The U.S. and Thailand have had a friendship treaty in force since 1968. Thai laws generally do not allow direct ownership of land by foreigners. Thai lawyers have developed standard ownership vehicles that use Thai corporations to meet title holding requirements but there is some risk that changes in the laws could cause forced sales or restructuring by foreign controlled corporations. Similarly, a reduction in allowable density could also reduce land values. Because these events would severely disrupt an important part of Thailand's economy, they are very unlikely to happen. Compared to other foreign investment locations, such as Mexico and Costa Rica, Thailand is much more investor friendly.

Escrow services are new to the Thai real estate market and, as of yet, there are no sellers of title insurance. We will work closely with our lawyers in Thailand to minimize settlement and entitlement risks. We will do thorough background research on sellers and their title before committing significant funds.

In terms of comparable real estate market risks, Thailand is very cheap relative to similar caliber destinations and therefore low risk. Currency risk is not a factor because demand for our product is coming from hard currency investors outside the country.

There is some level of event risk in Thailand but this is not catastrophic risk. Koh Samui, on the eastern side of the Thai peninsula, is not subject to Tsunami risk coming from the Indian Ocean plate. The tsunami that hit Thailand's west coast actually diverted many tourists to Koh Samui and Pattaya. There is a small chance that terrorism or a flu epidemic could reduce demand for Thai property over some period of time. While these events would temporarily reduce demand for real estate and therefore prices, they are unlikely to cost us more than half of our expected returns.

The Team

Ray Meadows, CPA, CFA, MBA heads the Fund as the Chief Investment Officer. Ray earned his MBA at U.C. Berkeley specializing in Real Estate and Finance, and went on to earn a Master's in International Economics in Berkeley's real estate Ph.D. program. Ray is an expert at researching markets and analyzing real estate investments. He has an excellent investing track record. Ray is currently president of Berkeley Investment Advisors in San Francisco; previously he worked on Wall Street for Citigroup and before that, he was at Wells Fargo Bank.

Gerald Niesar, partner at Niesar, Curls, Bartling, will serve as the Fund's general counsel. In practice in San Francisco since 1969, Mr. Niesar was named a California Superlawyer (an outstanding lawyer who has attained a high degree of peer recognition and professional achievement) in 2004, 2005 and in 2006.

Jane Pitakkoshkorn MBA, a Thai citizen living in San Francisco, will serve as a managing director in the Fund's Thai business entities and ensure compliance with Thai legal requirements for holding land (in cooperation with the Fund's attorneys). Jane will provide research support for the Fund and participate in the acquisition process.

The Fund will utilize a network of associates in Thailand to identify opportunities. Jeff Hock and Dr. Iva Macakova have lived in Thailand for many years and know the local markets extremely well. They will help find unlisted properties that can be purchased without competition. We will also employ local brokers such as Mark Holt and Khun Ta, who know the real estate owners in Pattaya and Koh Samui.

Conclusion

Thai Development Fund provides a means for clients of Berkeley Investment Advisors to participate in the high returns available in the Thailand real estate market and diversify away from U.S. assets. Interested investors should contact us immediately for the offering documents since the fund is scheduled to close in September.

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280 Tokyo phone: (080) 3122-9601		Single Family Home Investment: RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332

Exhibit **A**

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