Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

Real Estate Investment Newsletter – December 2003

Focus on Phoenix

This month we will take a break from the mathematics of investing to show you the economics of a particular market. The focus is Phoenix Arizona because it combines sound long-run fundamentals with reasonable valuations that are necessary to provide good returns to investors. I have spent quite a bit of time on this market over the last few months. In this newsletter I will share with you what I know about its Rental Market and Investment Market conditions. I'll finish up with my conclusions about its potential for returns going forward.

Rental Market Conditions

Vacancy in Phoenix depends on the location and class of property. Overall vacancy is about 10% but this seems to fall disproportionately on Class A properties. Class C properties, which do not face as much competition from new single family homes, have roughly 9% vacancy according to my sample. The following table is based on a sample of 22 (Class C) properties:

	Median Asking Rent	Median Size (Sq. Feet)	Median Ask Rent/S.F.
1 Bedroom	460	600	$.78
2 Bedroom	575	800	$.71

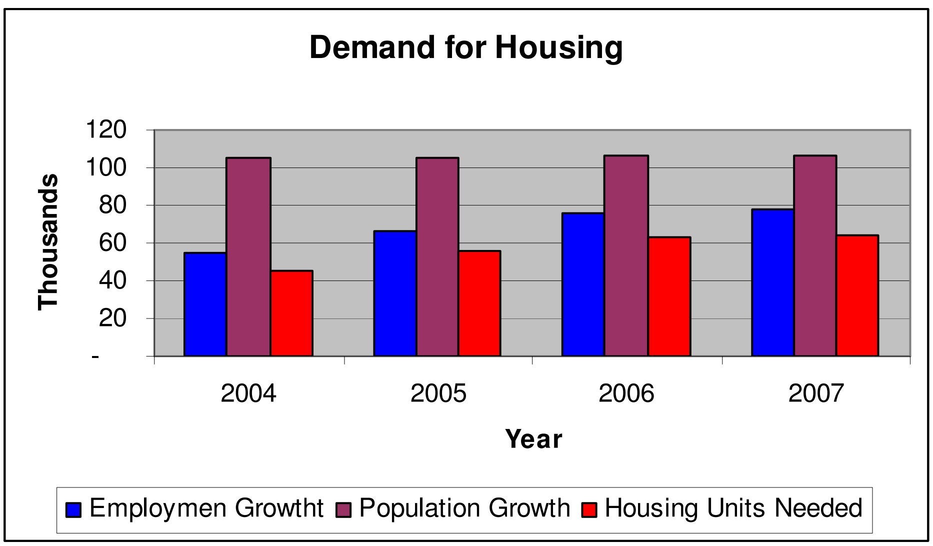
These asking rents do not take into account concessions. Because of the relatively high vacancy and the number of new properties built in the last 2 years, free rent for signing a lease has become the norm in this market. A year ago renters could find deals with 3 months free rent. Currently renters can expect one month free rent when signing a one year lease.

As of July 2003 there were 1,383,276 housing units in the Metro area according to the Maricopa (county) Association of Governments. Two thirds of these units (923,093) are single family homes. Apartment units represent 26% (361,632 units) of the housing stock. The remainder are mobile homes and "other" housing units. Of this supply, about 101,895 new single family units and 29,671 new multi-family units were built between 2000 and the end of 2002. Despite high vacancy and declining rents, it has taken some time for construction activity to slow down. New multi-family unit deliveries are expected to decline to 3,500 in 2004 compared to about 4,700 in 2003. Looking at building permits, which foreshadow completions, we see that multifamily permits have declined sharply while single family homes have accelerated.

	1999	2000	2001	2002	2003 est.
Single Family	35,430	33,107	33,428	35,360	41,000
Multifamily	9,093	8,691	8,656	6,957	3,500

This year was estimated based on totals through 9/30/03. This slow down will help stabilize vacancy, and, with the help of job and population growth, eliminate concessions over time. Mortgage rates have stopped falling and I expect them to move up over the next few years. This will increase the cost of single family homes relative to apartments and thus reduce incentives to produce more houses. I will discuss this in detail a bit later in the article.

Turning to the demand side – according to Newsweek Magazine - Phoenix is projected to be the 2nd largest "job engine" in the U.S. through 2025. Employment is forecast to grow by 54,700 jobs in 2004 and 66,800 jobs in 2005; population is expected to grow by 105,000 each year. This should translate into demand for about 45,600 units in 2004 and 55,700 units in 2005.[1] Over the next four years employment is forecast to grow by 3.9%



annually.[2] Meanwhile population should grow 3% annually.[3]

[1] Based on a ratio of 1.2 jobs per housing unit.

[2] Source: University of Arizona Economic and Business Research, October 2002.

Based on these forecasts, new demand and new supply will be roughly in balance in the aggregate for 2004 and demand should exceed supply in 2005. This implies vacancy will decline after 2004.

So far we've looked at housing units demanded in total, but what matters for apartment owners is the number of apartments needed. While single family homes are a substitute for apartments for families that can afford to buy, certain parts of the population cannot or will not cross over to home ownership. As I mentioned earlier, I expect mortgage rates to move upward as the economy strengthens and this should reduce the number of renters converting to home ownership by raising the price of houses relative to apartments. This too, will contribute to stabilization in apartment occupancy and, over time, should allow vacancy to come down. The table below illustrates the effects of mortgage rate increases on affordability for the listed income groups.

Maximum House Affordable by income by mortgage rate

	Annual Income:	25,000	30,000	35,000	40,000	45,000	50,000
Mortgage Rate	6.00%	75,189	**90,227**	105,265	120,302	135,340	150,378
	7.00%	69,586	83,504	97,421	111,338	125,255	139,173
	8.00%	64,576	77,491	**90,407**	103,322	116,237	129,152
Drop in Buying Power in $		10,613	12,735	14,858	16,981	19,103	21,226
Drop in Buying Power as %		14%	14%	14%	14%	14%	14%

Renters are typically in the lower income range in the table - $35,000 annual income and below. Although the median house price in Phoenix is $149,000, new "starter" houses are being developed on the fringes of the valley that sell for $90,000. The table shows that at the current mortgage rate, 6%, a household with income of $30,000 would just be able to afford the starter house. A rise in rates puts it out of reach to this income group. If rates rise to 8% (which is very possible over the next 2-3 years), these starter homes would be affordable only by households with $35,000 or more in annual income. Since 37% of households in Phoenix have income below $35,000, this decrease in single family home affordability would eliminate the possibility of home ownership for a significant portion of the renter population[4] and divert housing demand to apartments. This could easily increase apartment absorption by 3-4,000 units per year. Current fiscal, monetary, and exchange rate policies are stimulating faster economic growth and will eventually push up inflation and interest rates. It would be surprising if we did not see higher mortgage rates 2 years from now. This is bullish for apartment owners everywhere.

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[3] Source: ASU Seidman Research Institute, July 2002

[4] I estimate that an increase in mortgage rates of 2% would reduce the potential demand for new "starter" single family houses by 10-15%.

Investment Market Conditions

There were 125 apartment building sales in the first 9 months of 2003 and the full year will likely be a record for sales activity. The majority of buyers are from out of state. Californians accounted for 30% of the dollar volume as they shifted money from their over-priced home market to Phoenix in search of higher returns going forward. There is significant competition for properties priced well. By that I mean properties without serious problems with projected capitalization rates above 6.8%. Exhibit A provides data on 18 sales in 2003 and 3 from 2002. The 2003 median unit price for this sample is $42,670 which comes to $61.53 per square foot. Gross rent multipliers ranged from 5.7 to 6.9 but data was not available for all properties. Cap rates are not available at all. If consistently estimated, I expect they would fall in a range of 6% to 7.5% depending on perceived desirability of the property and its location.

Most of the properties trading hands are in North central Phoenix above interstate 10 and within 2 miles of highways 17 and 51. Properties near the "Camelback Corridor" are highly sought after as this area has a lot of commercial activity and many jobs. The neighborhoods in this area range in quality but are usually middle class, to lower middle class. Further north are more upscale areas with some nicer properties. Scottsdale Airpark is a business park that houses 2,200 businesses with 42,000 employees. Apartment buildings near this development have strong appreciation potential but are rarely listed for sale.

Many new single family homes are being built in the Southern part of the metro area (Phoenix, Chandler, Gilbert, Mesa) and there are also significant single family developments in the West and Northwest areas of the valley (Surprise, Avondale, El Mirage, Peoria). Developments in the West are commuter towns where residents must drive to more central areas for their jobs.

Exhibit B shows recent property listings along with valuation metrics and estimated returns. The stabilized return estimates shown here are fully leveraged (i.e. as if first year of ownership) assuming market vacancy and market rents with no rent concessions. Note that estimated returns are dependent upon financing. Therefore, because returns have not been estimated with consistent financing assumptions, some properties with lower capitalization rates may show higher forecast returns.

Conclusions

Based on the estimated returns shown in Exhibit B, there are clearly a lot of opportunities in this market for investors who are willing to buy in anticipation of firming market fundamentals over the next several years. Even considering the poor current rental environment, investors can expect healthy double digit annual compounded returns over a 5 to 10 year holding period.

Featured Investment Opportunity

Any of the properties with forecast returns above 12% on Exhibit B would make an excellent investment. Note that many of these may already be sold.

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Exhibit A

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Apartment Building Sales in Phoenix

Name	Address	Price in $1,000's	Sale Date	Built	Units	Square Feet	Gross Rent Multiplier	Price Per Unit in $1,000's	Price per Square Foot	Avg S.F. per unit
Westwinds	4635 N. 27th Ave	860	10/16/2003		24	17,758	6.4	35.83	48.43	740
Central Palms	1422 N 5th Street	1,650	9/17/2003	1967	36	20,520		45.83	80.41	570
Palm Vista	4138 N Longview Ave	1,825	8/29/2003		40	27,198		45.63	67.10	680
Biltmore 24	4221 N 24th St	1,220	8/14/2003	1966	31	18,426		39.35	66.21	594
Missouri Crest	1623 W Missouri Ave	1,105	8/4/2003		29	21,999	6.7	38.10	50.23	759
Maryland Palms	2507 W Maryland Ave	885	7/9/2003		22	14,839		40.23	59.64	675
Casa West	4029 W McDowell Rd	1,225	6/20/2003		32	22,277	6.1	38.28	54.99	696
Williams Crossing	2510 W Highland Ave	1,373	5/20/2003	1964	34	26,506	6.9	40.37	51.78	780
Imperial Arms	3738 E McDowell Rd	1,250	5/19/2003	1980	32	19,500		39.35	64.10	614
Sandpainter	2225 W Indian School Rd	4,000	4/18/2003	1979	116	67,103	6.1	34.48	59.61	578
Silver Tree	4336 N 35th Ave	3,410	4/3/2003	1986	98	59,150	6.1	34.80	57.65	604
Willow Glenn	2333 W. Glenrosa Ave	1,200	2/10/2003		26	25,845	6.3	46.15	46.43	994
Brentwood II	6805 N 27th Ave	2,645	1/29/2003	1985	71	44,943	5.7	37.25	58.85	633
	716 E Turney	449	8/15/2003	1948	16	5,613		28.12	80.00	351
Hermosa	3132 N 32nd Street	1,900	3/31/2003	1980	50	24,257		38.00	78.33	485
Central Mountain V	9836 N. Central Ave	1,800	7/25/2003		32	32,603		56.25	55.21	1,019
Garden View Villas	3120 E Paradise Ln	995	1/22/2003		15	17,161		66.33	57.98	1,144
Mountain Manor	4902 E. Willetta St.	1,828	6/13/2003		40	25,900		45.69	70.56	647
Vista Village	1805 W. Cortez St.	2,585	9/12/2002		60	45,898		43.08	56.32	765
Silver Oak	5510 N 35th Ave	1,540	6/24/2002	1959	36	30,757	5.7	42.78	50.07	854
Suntree	2740 W Medlock Dr	1,510	3/5/2002	1982	40	29,337	6.5	37.75	51.47	733
Average for 2003			6/7/03					41.67	61.53	698
Median for 2003			6/16/03				6.2	39.35	59.23	661

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Exhibit B

Phoenix Apartments Recently Listed for Sale

Price	Address	Total # of Units	Annual Gross Rents	Year Built	Unit Price	Current Gross Rent Multilpe	Proforma Cap Rate	Vacancy	Estimated Stablized return	Cash on Cash
$ 1,370,000	3002 W. Camelback	34	210,960	1960	40,294	6.5	7.0%	9%	24%	2.8%
$ 1,375,000	4615 N. 39th Avenue	28	212,400	1975	49,107	6.5	6.9%	7%	20%	3.3%
$ 720,000	1724 E. Cambridge	16	95,040	1986	45,000	7.3	7.4%	0%	18%	5.0%
$ 2,900,000	6805 North 27th Avenue	71	489,900	1985	40,845	5.9	6.0%	40%	18%	1.8%
$ 3,375,000	4333 N 27th Ave	96	558,770	1985	36,198	6.0	6.5%	13%	15%	0.4%
$ 1,000,000	2417 W. Campbell Ave.	24	144,000	1983	41,667	6.9	6.4%	10%	15%	1.6%
$ 1,470,000	1641 E Grovers Ave	30	173,100	1986	49,000	8.5	6.3%	6%	18%	1.3%
$ 750,000	3406 N 38th Street	15	92,760	1973	50,000	8.1	7.3%	40%	17%	5.2%
$ 1,090,000	2432 West Turney Ave.	30	222,840	1974	36,333	4.9	7.1%	10%	17%	4.0%
$ 720,000	426 W 9th St., Mesa	27	141,344	1964	26,667	5.1	7.1%	15%	17%	3.9%
$ 900,000	1827 E Lemon St, Tempe	24	149,520	1961	37,500	6.0	7.2%	8%	17%	4.2%
$ 999,000	546 W Glenrosa Ave	33	185,000	1956	30,273	6.3	7.6%	5%	16%	9.4%
$ 589,000	1833 N. 1st Place	14	87,000	1958	42,071	6.8	6.2%	10%	15%	-1.6%
$ 715,000	301 East Townley Ave	23	110,220	1980	31,087	8.1	6.6%	35%	15%	2.0%
$ 835,000	4424 12th Street	20	118,500	1956	41,750	7.0	6.3%	8%	14%	1.2%
$ 925,000	1545 W Denton, Phoenix	22	131,400	1984	42,045	7.0	5.9%	24%	12%	1.0%
$ 1,270,000	2101-2221 W. Heatherbrae	31	204,300	1962	40,968	6.2	5.9%	16%	13%	1.0%
$ 590,000	2947 N 39th St.	11	74,880	1960	53,636	7.9	5.6%	0%	11%	0.3%
$ 629,000	1514 E. Monroe	16	85,800	1961	39,313	7.3	5.5%	8%	10%	1.0%
$ 1,175,000	4020 Parkway Ave.	24	143,880	1960	48,958	8.2	5.3%	20%	10%	1.0%
$ 1,399,000	1914 W. Hayward	26	190,008	1962	53,808	7.4	5.2%	12%	9%	1.0%
$ 1,550,000	6101 N. 60th Avenue	38	244,440	1984	40,789	6.3	4.5%	7%	7%	0.7%
$ 1,380,000	365 W Pierson St.	28	208,800	1960	49,286	6.6	6.8%	5%	20%	9.2%
$ 776,000	1744 Glendale Ave.	16	101,220	1956	48,500	7.4	6.6%	5%	19%	2.2%
$ 1,265,000	4401 N 12th St.	40	198,900	1966	31,625	6.3	7.0%	10%	18%	3.5%
$ 625,000	13235 N 21st Place	12	79,200	1985	52,083	7.9	6.3%	8%	18%	1.3%
$ 885,000	1908 North 32nd St	26	140,400	1983	34,038	6.3	7.1%	10%	17%	3.8%
$ 1,245,000	322 N. 14th Avenue	31	193,368	1976	40,161	6.4	6.7%	7%	14%	2.6%
$ 960,000	2501 W Elm Street	20	124,800	1964	48,000	7.5	5.9%	6%	12%	0.8%
$ 1,350,000	510 West Highland.	40	202,000	1950	33,750	6.6	2.7%	5%	5%	0.0%
$ 585,000	10034 N 18th Ave	16	93,600	1961	36,563	6.1	5.4%	15%	11%	-2.1%