Berkeley Investment Advisors

Real Estate Brokerage/Retirement Planning

Real Estate Investment Newsletter – October 2003

Residential Real Estate Market News

This month's newsletter provides a look at market conditions in 2003, trends in interest rates and Capitalization rates, and an analysis of several key markets.

Vacancy

Nationally vacancy has risen another 1% so far in 2003. Large class A and B buildings have aggregate vacancy of 6.4% according to Realty Rates' Market Survey. Census data indicate an overall vacancy of 9.9% for all rental housing units. Thanks to the jobless recovery, net household formation is stagnant. Low interest rates and rising investment property prices (see below) make development of new units profitable - even as fundamentals deteriorate. At the regional level, the Western U.S. actually had a slight increase in occupancy in the third quarter. Of 25 major Western markets, 22 showed increases in occupancy. Southern California markets still have the highest occupancy – over 95% in Riverside, L.A., Orange County, and San Diego. The recent fires will further tighten the rental market and will probably boost housing prices in the short term as insurance money pours into the resale market.

Employment and Rent Growth

In September total jobs in the U.S. were down .4% from the prior year. Despite this poor performance, some cities continue to generate job growth. Florida is doing well – Sarasota and West Palm Beach lead the nation in job growth (as a percent of existing jobs) and 5 other Florida cities are in the top 25. My top choice market, Las Vegas, grew jobs by 2.4% - placing it 5th overall and 1st among large cities. Honolulu (2%), Fresno CA (2%), Reno NV (1.8%) and Riverside CA (1.4%) were all in the top 25. San Jose CA experienced the biggest job losses (-4.6%) in the country; San Francisco was also among the worst performing cites (-1.8%). Despite San Francisco's job losses the drop in rents seems to be over; rents actually increased .5% last quarter. Southern California markets (in line with their low vacancy) registered rent increases ranging from 3% to 5% over last year. Nationwide, effective rents were down .9% last quarter and 2% for the year. Phoenix rents fell 2% while Las Vegas rents rose 1%.

Expenses

As noted in my April newsletter, insurance has driven up expenses significantly. Nationwide expenses are up roughly 7% year over year. Expenses are also impacted by rising sales prices since property tax is based on market value when a property changes hands.

Valuation

The story remains the same. It is a sellers' market out there. There are many more buyers than sellers and problem free properties, that are priced right, move very quickly. Even the problem properties will move quickly if the seller allows the buyer some compensation for fixing the problems. For the most part prices are high on a historical basis relative to net operating income (NOI). I.e. capitalization (Cap) rates are low and continue to decline (Cap = NOI/price). Sacramento, thanks to its proximity to the large pool of investors in the Bay Area, continues to appreciate rapidly: the median price per unit rose 11.4% in the first half of 2003. This is driven by the poor returns available on properties in the Bay Area rather than fundamentals.

Interest Rates and Capitalization Rates

I attribute the big run up in valuations (decline in Cap rates) to two factors. As mentioned previously, I believe there are large shifts of capital into real estate that are driving down expected rates of return. I have no way to quantify this aspect: it is mere hypothesis at this point. The second factor is easily observable – the decline in financing costs. For a given level of property cash flow (gross yield), any decline in the mortgage interest rate will reduce loan payments and allow an investor to bid a higher purchase price without reducing his own return on capital. This is the same phenomenon that is driving house prices higher (June 2003 Newsletter). As long as investors lock in their financing cost for their desired holding period, the decline in Cap rates should not affect their returns adversely – assuming you buy well! But - can one buy well?

Las Vegas

Developers are producing new apartments at a rate of about 6,300 units per year. Comparing this to the forecast for 26,000 new jobs, we can expect further declines in vacancy. Much of the new jobs are coming from the Casino's as 4,100 rooms are added. As predicted back in April, Las Vegas vacancy seems to have peaked at 7.8% in the fourth quarter of 2002. It should drop to 7.3% in 2004. As I've pointed out previously, long run prospects are bright: the supply of developable land stands at just 12 years at current development rates. As this limit gets closer, land prices will accelerate, taking housing along. In the short to intermediate term, appreciation will be driven by an influx of capital from California. The median price per unit for Class B properties in Las Vegas is $41,301. Comparing this to the western region median of $87,142 explains this shift of capital: smart investors are selling high and buying low to maintain their returns on capital in the double digits.

Phoenix

New development will add 4,700 units in 2003 while the local economy is expected to produce 26,500 new jobs. Despite the competition from starter home developments priced at $90,000 (area median = $149,000) on the fringes of the valley, job growth should bring in enough new residents to push vacancy down to 9.5% by year end. This is still too high for rent growth. Concessions are rampant in this market and rents should continue to fall at a 2% annual rate - at least until vacancy drops below 8%. I recently made a trip to Phoenix where I looked at a dozen apartment buildings (and a couple of commercial properties). Pro-forma Cap rates were clustered between 6.3% and 7.3% with a couple of outliers. In my view, the long run prospects for this market are very good and the current weakness presents an opportunity to pick up properties with good appreciation potential while still achieving maximum leverage (i.e. cash flows will be positive even at a 75% loan to value ratio). See the investment opportunity at the end of the newsletter for an example.

California

The state's fiscal problems and job losses in the technology sector will continue to put downward pressure on rents, particularly in Sacramento and San Jose. Prices seem to be out of line almost everywhere with future rent growth as investors bid up prices based on historical growth rates (rather than economics driven forecasts for the future). Riverside is probably the only place where fundamentals justify violation of my rule of thumb (December 2002 Newsletter) for avoiding bubble valuations. Even there, investors must work hard to uncover properties that can be leveraged enough to minimize reliance on rapid appreciation in meeting return goals.

Other Markets
Some markets in the South, isolated from the wealth on the coasts, are priced at very attractive valuations relative to local economic prospects. As a result properties here can yield great cash on cash yields – sometimes in the double digits. Biloxi Mississippi is an example. This is a growing gambling Mecca on the gulf coast that should attract increasing attention going forward. Investors interested in high cash flow should ask for details.

Featured Investment Opportunity

Larwood apartments is priced at $625,000. It has 12 two-bedroom units rented at slightly below market rates. This is located in a good neighborhood in north Phoenix with easy freeway access. Assuming a loan for 75% of the purchase price, the required investment is $182,000 - including closing costs and working capital. I estimate NOI at $39,800 after deducting $4,400 in reserves for capital expenditures. This should produce cash on cash of only 1% ($2,300) but long run returns in the neighborhood of 15% (1st year projected return is 18%).

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