Berkeley Investment Advisors
Real Estate Brokerage/Retirement Planning

Real Estate Investment Newsletter – October 2004

Real Estate Market News

This month we'll look at market conditions in 2004, trends in interest rates and Capitalization rates, and an analysis of several key markets.

Vacancy

Nationally vacancy has risen another .3% in the last 12 months. Large class A and B buildings have aggregate vacancy of 6.7% according to Realty Rates' Market Survey. Overall vacancy according to the census bureau was 10.1%. Home builders continue to deliver new housing at a record pace. As renters continue to move to home ownership at a rapid rate and new apartment developments add even more supply, vacancy will continue to rise nationally in the short run. The National Association of Realtors forecasts a .7% rise in national vacancy in the 4^{th} quarter.

At the local level vacancies are very uneven across the country. Except for Sacramento, most of California has low vacancy: some markets are down around 3%. Class B and C properties in the Riverside California metropolitan statistical area (MSA), (also known as the Inland Empire) are at 3.4% vacancy and should drop to 3% by year end. Meanwhile significant new construction in Texas is driving vacancy ever higher there. Houston is nearing 15% with some submarkets at 20% vacancy!

Employment and Rent Growth

Political rhetoric aside, the economy has performed well over the last year. Since September 2003, 1.5 million jobs have been created – dropping the unemployment rate from 6.1% to 5.4%. Job gains have been concentrated in the South (46% of the total) and the West (26% of the total). The National Association of Realtors forecasts that the economy will produce 200,000 jobs per month over the next 12 months – driving the unemployment rate below 5%.

According to the Bureau of Labor Statistics, Las Vegas and Reno NV led the nation in job growth as a percentage of existing jobs at 4.7% and

4.0% respectively. Phoenix was 10th at 2.7%. Eight Florida cities were in the top 25. In California, only Riverside MSA, at 2% job growth, made the top 25. Over the next year Las Vegas should again lead the nation with a 4.2% gain. Phoenix should see jobs increase by 3.2%. Riverside should hit 2.9%. Five cities in Florida will be in the top 10: Daytona Beach, Orlando, Tampa, Fort Lauderdale, and West Palm Beach.

Overall rents have gone up .7% according to REIS, a real estate research firm. Thanks to low vacancy, rents in Riverside are rising 6.5% this year. Orange county and L.A. also will benefit from above average rent growth rates on non-rent-control units – 4% and 5% respectively. Most other markets in California and the Southwest will be in the 2-2.5% range except Phoenix which has high vacancy and will lag the high growth areas at 1.2%.

Expenses

Insurance costs have stopped rising for the time being. Property tax continues to rise as property values rise. Thanks to the run up in the price of oil, utility costs should rise significantly this winter – especially for master metered properties. This should result in even bigger discounts for properties that are inefficient energy users.

Valuation

The multifamily market can be divided into at least 3 distinct segments – delineated by the bank financing terms. A property with 4 apartments or less is easiest to finance and therefore most expensive (on a Cap rate basis). The other two segments, 5 or more apartments and mobile home parks, are progressively harder and more expensive to finance. Consequently, valuations are very different across these segments. Unless otherwise noted, the following price increases relate to the 5 or more apartments segment.[1]

It remains a seller's market. Although there are exceptions, nationally, valuations rose over the last year. Prices are setting record highs relative to net operating income (NOI). I.e. Capitalization (Cap) rates are low and continue to decline (Cap = NOI/price).

In the L.A. area per unit prices are up 10% from 2003. The fastest growing region of CA, the Inland Empire (Riverside), saw unit prices rise 34% over 2003! In the north, Sacramento unit prices are up another 11% since 2003; Bay Area prices showed more muted increases in the 2-4% range. Phoenix, Tucson and Las Vegas are also up marginally.

[1] I am writing about properties priced under $2 million. Larger institutional grade properties sell at higher cap rates as there are less buyers competing in this part of the market.

The buying binge is even more extreme in the 4 and under market. In the overheated markets of California and Las Vegas, a property in a desirable area will attract multiple offers the first day it's listed. In Oakland and Berkeley 4-plexes in nice areas trade at Capitalization rates of 3%[2] or less. In Las Vegas unit prices have risen 18%; Cap rates have fallen to 3.6%.

In the 5-unit and over apartment market, things are a little better (meaning Cap rates are higher) thanks to more stringent bank lending rules. Still, properties in nice parts of Oakland or Berkeley go for Cap rates in the low 4's (i.e. 4.2%). In Las Vegas and Phoenix, with a lot of diligent hunting, you can find properties in the high 5's (i.e. 5.8%).

Mobile Home parks typically trade at Cap rates that are 1%-2% above local apartments. This varies widely and is also influenced by the number of park owned mobile homes. The higher the number of park owned homes, the harder the financing will be and the higher the Cap rate. For obvious reasons, Mobile Home Parks in Florida trade at significantly higher Cap rates. In my view, return premiums there are well worth the hurricane risk.

Interest Rates and Capitalization Rates

Although long-term interest rates ran up significantly in the spring, they came back down in the summer. The long anticipated increases in short-term rates by the Federal Reserve have not affected long-term rates at all – the yield curve is flattening. The Fed will probably need to raise short-term rates until they exceed inflation by at least 1%. Thus I anticipate a short-term rate of 2% by the end of 2004 and at least 3.5% sometime in early 2006. Except in times of recession and dropping inflation, the yield curve is usually upward sloping. Thus I expect long-term rates will eventually have to rise in response to the Fed's tightening monetary policy. My guess is the 10-year treasury yield will need to rise at least 1% from current levels. This in turn will raise financing costs. All else being equal, this should trigger a rise in Cap rates from current levels, though it is unlikely to be as large an increase as the rise in interest rates. Note that investors in markets with significant NOI growth potential (Las Vegas, Phoenix, Riverside) will find themselves in the pleasant position of owning a natural hedge against rising Cap rates.

Las Vegas

My predictions for the single family home market in the April newsletter are starting to show up in statistics. At that time the number of

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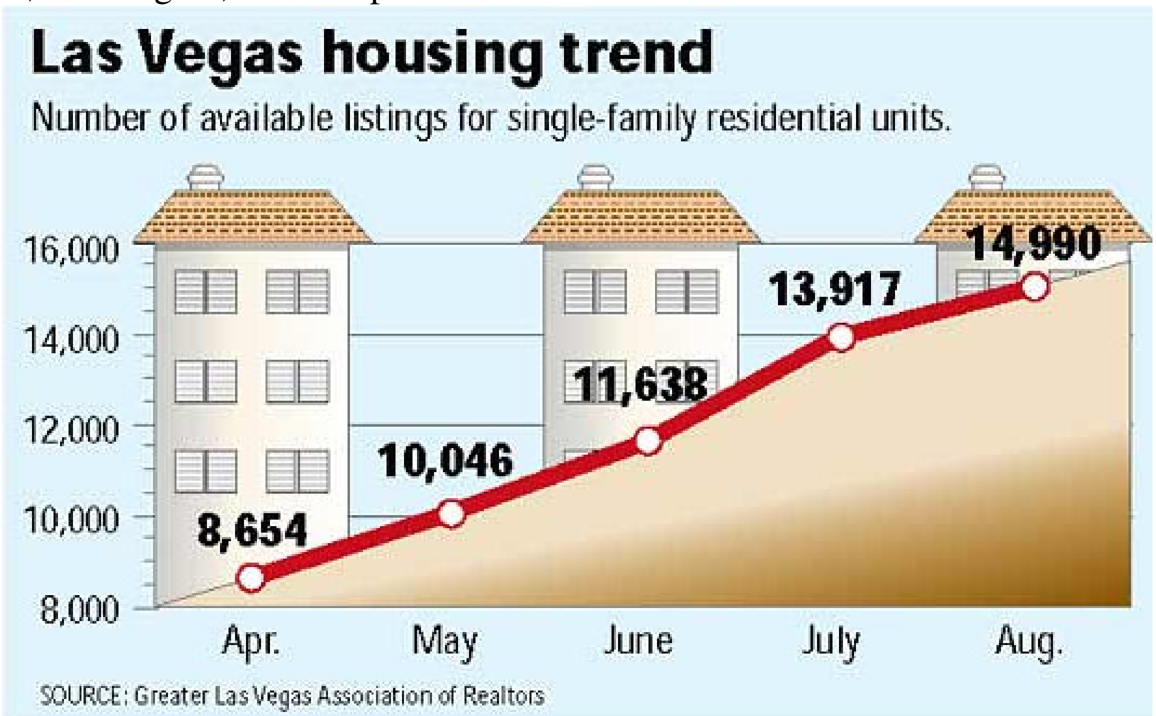
[2] This takes into account management costs. If we assume management costs 0 as most local buyers do then Cap rates are .3% higher.

house listings in the local MLS was 8,654. Available listings have steadily climbed, reaching 15,758 in September.



When we visited Pulte homes development in North Las Vegas back in April we saw that a substantial portion of their delivered houses were for sale or rent – indicating speculative demand. This situation was not sustainable and Pulte recently cut prices between 5% and 25%. Up until now other builders have not been affected because they are selling at lower prices, but I expect similar pullbacks from them in the future. Single family home permits increased even further in the second quarter from an already overheated pace. In the first half of 2004 permits exceeded 20,000 – up 40% from 2003. Through September permits are up 47.4% over 2003. This is at least double the expected absorption rate. **Do not buy single family homes in this market!** Wait till 2006 and look for foreclosures at discounted prices.

Only 4,800 new apartments will be added in 2004 and this is largely, if not completely, offset by conversion of existing apartments into condominiums. Home prices have risen so much that all available land has been bought up by home builders. At the current rents and land cost, it does not make economic sense to build apartments. Meanwhile, Las Vegas is on track to add 61,000 residents and 33,000 new jobs in 2004. As predicted in my April newsletter, the huge increase in home prices is discouraging potential home buyers and diverting demand to apartments – thus driving absorption of vacant units. Thanks to unexpectedly strong job growth, vacancy has been declining in Las Vegas even faster than I expected. Region wide it now stands at 6.5% and it should drop further by year end. Rent increases will accelerate as vacancy drops below 6%. In contrast to single family homes, now is a great time to buy apartment buildings in Las Vegas.

Phoenix

The city has just unveiled its long-term plans for redeveloping downtown. These projects will open up the possibility of significant upside potential for investors brave enough to buy early in the affected areas.

The city is now attracting condominium developers to the key employment centers. Apartment completions are expected to drop to 3,900 units in 2004, down from 4,800 in 2003.

Payrolls should increase by 52,000 in 2004 as relatively low costs continue to draw companies away from high cost California. Job growth combined with population growth and rising home prices is leading to increasing numbers of renters. Vacancy should drop to 9.2% by year end. While rent concessions are still the norm, they are decreasing and if trends continue they could be a thing of the past by 2006. Elimination of rent concessions will result in double digit growth in net operating income for many properties, and thus provide significant upside for investors buying now. This should mitigate the impact on valuations of interest rate and capitalization rate increases expected over the next 2 years.

California

Inland areas are booming and I expect continuing opportunities for significant appreciation in retirement oriented communities. The cities in Coachella valley (Palm Springs area) look particularly attractive.

San Francisco Bay Area

As I mentioned earlier, Cap rates on well located 4-plexes in Oakland and Berkeley are selling at Cap rates as low as 3 %. This means that the property generates Net Operating Income (NOI) equal to 3% of its value. Both of these are rent control markets and owners can expect no more than 3.8% growth in NOI. Over time we can expect market Cap rates to slowly rise from their historic lows. Even if this were not the case, a specific property should see increasing required yield (Cap rate) as it ages.[3]

Combining the low initial Cap rate, limited growth in NOI, and .1% annual increases in Cap rates we can calculate appreciation rates. Using an

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[3] As buildings age they deteriorate physically. At the same time newer buildings are built with more modern features. Therefore buildings lose their appeal and become more management intensive over time. A seller must therefore price the property to yield a higher return than a newer property to induce buyers to accept the effects of aging. Therefore, even if overall market Cap rates are stable, individual property Cap rates should increase through time.

example property I calculated .5% appreciation. Thus overall un-leveraged return on such a 4-plex in Oakland would be 3% + .5% = 3.5%. Unless you take a loan with an adjustable interest rate (and therefore huge interest rate risk), the mortgage rate will exceed 3.5% and leverage will reduce returns on a pre-tax basis. Ignoring tax benefits, the property will breakeven (i.e. your return is 0) at a mortgage rate of 4.5%; your pre-tax return on investment would be negative at higher (more realistic) rates. Such a purchase would only make sense if you are in a position to realize significant value from the tax losses that the property will generate. Even so, at a realistic mortgage rate you would probably come out ahead investing in a bank CD.

Other Markets

Florida is a very attractive market right now. It has strong population and job growth. Recent hurricanes wiped out many mobile home units which should reduce vacancy. Clean-up workers drawn from out of state will boost the number of renters in the near term. Prices are rising but still reasonable in some markets.

Tucson and other secondary Sunbelt markets are still good long-term bets for investors as their valuation versus growth trade-off is more reasonable in these markets than the bigger markets.

Featured Investment Opportunity

This Tampa Mobile Home Park sits on 4.5 acres of waterfront land in the middle of a fast growing area – just 10 minutes from downtown. This looks good as a redevelopment play that pays its own holding costs. The purchase price is $650,000 for a 2-bedroom house and 18 park-owned homes. Assuming a loan for 75% of the purchase price, the required investment is $180,000 - including closing costs and working capital. I estimate NOI at $45,600 after deducting $5,300 in reserves for capital expenditures. This should produce cash on cash of 4.3% ($7,700) and long-run returns in the neighborhood of 12% (1st year projected return is 14%).

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