



Real Estate Investment Newsletter – April 2003

Residential Real Estate Market News

This month's newsletter provides a glimpse of market conditions as they existed in 2002, an analysis of the risks of a real estate price "bubble", some predictions and recommendations for 2003.

Vacancy

The National apartment vacancy rate rose 1% in 2002 to 6.5%. The high end of the market suffered most as affluent renters took advantage of low interest rates to purchase houses. Job losses also contributed as the unemployed cut costs by doubling up, moving down in quality, or moving back in with parents. Atlanta (10.3%), Austin (14.0%), Charlotte (10.4%), Denver (11.1%), and Orlando (10.8%) all reached double-digit vacancy rates. Meanwhile, with the exception of Silicon Valley, California vacancy rates remained at or below 5.6%. San Diego is at a 3% rate. Los Angeles and Riverside-San Bernardino are at 3.3%.

Employment and Rent Growth

Las Vegas and Riverside-San Bernardino generated the most job growth in 2002 at 3.9% and 2.5% respectively. In 2003 Las Vegas is expected to lead the country again with a 5.5% gain. Riverside-San Bernardino will place in the top 5 with 1.9% growth. Rent rises in Las Vegas will be held to 2% by a relatively high vacancy rate (7.8%) while Riverside should see rents rise about 4.5%. Among other markets expecting significant job growth, Houston and Dallas should see rent gains on the order of 1%. On average rents nationwide should advance by only 2% in 2003.

Expenses

Booming insurance costs are the wildcard for purchasers. Newly underwritten policies can be more than 100% higher than those carried by

the seller. The explosion in mold related claims along with the big drop in insurance industry capacity make obtaining reasonably priced coverage a challenge.

Valuation

Investment property prices have risen everywhere as dropping interest rates and a sagging stock market push required yields on property lower. In particular, price rises reflected the strength of the California market as well as the wealth pouring into hard assets. Sacramento led the way with per unit prices rising more than 20% during 2002. While prices skyrocketed, rents rose by a more modest 3.8% in this market.

The B Word?

Rising prices combined with higher vacancy and weak rent growth have led some investors to question whether there is a bubble forming in investment property prices. One can make the argument that capitalization rates (required yields) will inevitably rise, driving down prices, as money flows back to other investments in an economic recovery. Today's buyers, however, can take heart from the fact that long run demographics (the echo boomers), combined with less affordable houses and a stronger economy, will drive up demand for rentals. Besides, the smart buyers are not counting on short run price gains or the high appreciation of the past in order to reach their return goals.

Even investors in relatively overpriced markets such as San Francisco are unlikely to see outright losses. These markets often have virtually no new supply coming in and eventually there will be new residents demanding space (and investments). A small amount of incremental demand for rental units or rental investments can drive prices higher. Prices may well stay flat for some time, leaving investors in pricey markets with puny returns in the 3-5% ranges, but price drops big enough to cancel out rental income entirely are a long shot.

Investors choosing to pursue properties with good cash flow returns can do much better. Even with no price appreciation, an investor can make **10%** after-tax return if he buys at a reasonable valuation. (For an example, see the investment opportunity at the end of this newsletter).

Las Vegas

The 7.8% vacancy rate at the end of 2002 was probably the peak for this market. Las Vegas was hit hard by the downturn in travel after 9/11 but now is benefiting from the increase in domestic vacations. I like this market right now and I urge my clients to consider investing here. The long run fundamentals are outstanding. Employment growth is robust and supply constraints loom in the not too distant future. A recent article in the Wall Street Journal pointed out that although Las Vegas is surrounded by a vast quantity of empty land, this land is owned by the federal government and for various reasons will not be sold at a fast enough pace to meet demand.

Eventually, developers will look to in-fill and teardown properties. Thus I expect significant new demand for class C properties downtown to eventually materialize. In the meantime, these properties can be had at valuations that allow the investor to earn 8-11% cash return on cash invested. This return is supplemented by equity buildup from loan repayment and property appreciation so that overall returns can be very satisfying. This market is already seeing compression in capitalization rates and this will continue for some time until these are more in line with those in neighboring California. At that point it will be too late, so jump in now if you can – this is looking like the next Sacramento in terms of price run-up.

Houston and Dallas

While fundamentals aren't quite as strong in Texas, as in Nevada, there are some positive signs. The 8.5% vacancy rate in Houston and Dallas is 2% above the national average and it may go higher in 2003 thanks to significant new supply coming into these markets. On the positive side, job growth will drive absorption of units and future deliveries of new units will drop once the construction pipeline has emptied. Houston should be in the top 5 cities for job growth in 2003 and Dallas will show a respectable job gain of 1.5%. Even in these slack markets, vacancies can be filled with the appropriate strategies in place. The key for these investment markets is that valuations are at levels such that very modest rent growth is needed to achieve good returns.

California and the Rest

As always there are good investments to be had almost everywhere if you are willing to turn over every stone. Even in the low risk, low return,

California market, great deals sometimes show up. Berkeley Investment Advisors can help you spot the opportunities and know when a fast offer is warranted to lock up a good deal.

Featured Investment Opportunity

Northwinds is a 24-unit property right on the strip in Las Vegas, priced at \$895,000. The investment required would be approximately \$259,000 if a loan for 75% of value can be obtained. There are 20 studios and 4 one-bedroom units. It is currently 100% occupied. I estimate net operating income at \$76,700 after deducting \$8,500 from cash flow as a reserve for replacements. After loan service, the free cash flow would be about \$25,800 – 10% cash on cash return ignoring reserves. Including cash set aside for reserves, cash flow would be \$34,3000. If this property appreciates at just 2% in its first year, the after-tax return on equity would be 15%.

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