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Investment Newsletter – June 2005

Investing in New Construction in New Mexico

This month we move back to the real estate world to highlight the opportunities we see in Albuquerque and Rio Rancho New Mexico. We'll lay out the economic and demographic trends that we see driving this market. Then we'll provide some background on the region's development and explain some specific catalysts for real estate price appreciation. Finally, we'll provide the financial details of some specific opportunities available to our investors. Before we get into the specifics of New Mexico, however, I want to give you my thoughts about the risks of following a momentum investing strategy.

Momentum Investing

When you invest in something because it has appreciated rapidly in the past, without regard for the true economic value going forward, you are a "momentum investor". Timing is everything – in real estate as in the rest of life. With talk of residential real estate bubbles cascading through the media and cocktail party circuit, investors must be careful they are not buying at a market peak. Many people use the past to guide their investment strategy. As we saw in the 2000 stock market, this can lead to LARGE losses.

In order to be successful investors, we must predict where returns will be highest going *forward*. To do so we must understand the underlying economic factors that drive prices; observing the resulting price appreciation is not enough to predict the future. For example, in Japan interest rates have fallen to virtually zero. Consequently the value of a government bond should approach the total of the promised cash flows. While rates were dropping the price of bonds rose as future cash flows became worth more in today's dollars. If rates actually go to 0 all future cash flows are worth the same as if paid today and the bond cannot rise further. A naïve investor looking at the price trend rather than the underlying economics would bid up this bond beyond its total cash flows. This is a losing investment and a stupid mistake.

While momentum can carry a real estate market up for years, the risk of a downturn increases as prices rise further and further above true economic value. When a downturn may occur is very difficult to call since it depends greatly on the psychology of crowds. Knowing what you don't know is, in this case, useful. If you are depending upon your intuition to predict others' behavior, you are taking a lot of risk. You may make money but you are taking big risks to do it. I don't recommend it. A better strategy is to find a real estate market where prices are more in line with the true underlying economic demand. These markets may also be driven up by speculative buying but at least you are getting in at a price that limits your downside risk. I.e. if you buy at more reasonable valuations relative to rents and incomes, you get the same or greater potential for future gain without the huge downside risk of a market driven purely by speculative momentum. This is why we're talking about New Mexico this month: big upside + less risk.

The Big Picture

Cheap real estate, a low cost of living, and good weather, make New Mexico very attractive to both retirees and employers. This is a place that we expect to benefit from demographic and economic trends. The growth that we have seen in Phoenix is also happening here but on a smaller scale.

New Mexico has a very stable economy due to federal funds that flow into the state. As more baby boomers buy vacation or retirement homes here, the local economy will grow further and new housing development will move to less desirable land. Correspondingly, well located new homes will increase in value.

Sante Fe has already seen a huge run up in real estate prices. The median price of houses in Sante Fe was \$365,000 in the first quarter of this year up more than 100% over the last 7 years¹ (36% of that came in the last 3 years). Middle income workers have been forced to live as far away as Rio Rancho and commute 60 miles to Sante Fe.² Commute time is roughly equivalent to a 25 mile commute in the Bay Area or Los Angeles.

Albuquerque is home to Kirkland Air Force base, which houses a substantial arsenal of nuclear weapons. Because of this, it is unlikely that this base will ever close. The Sandia and Los Alamos Labs conduct research and build new weapons. This is a huge economic force for the north east section of Albuquerque. There is also significant manufacturing and retail activity there. Intel has facilities in Rio Rancho and is also a major employer in the area. The Bureaus of Business and Economic Research at the University of New Mexico

¹ In April 1998 the median price in Sante Fe was \$180,500.

² Sante Fe has authorized its police officers to drive their cars home at night - as far as Rio Rancho.

(UM) projects that the population of the Bernalillo County (where Albuquerque is located) will grow 1.2 % annually over the next 5 years. This 35,885 increase in the population, translates into demand for 14,354 new houses.

Impact of the Eclipse Jet



The Eclipse jet will be a new affordable 6 passenger executive jet that should be FAA certified no later than September 2006. The current schedule has it being certified by March of 2006. Rick Rife a pilot, and aviation expert, toured the Eclipse production and test facilities and concluded that this jet will be a huge success. He explained “It will satisfy a market niche that has never been tapped by providing convenient, fast transportation for mid to high level executives at little more than a first class ticket.”³ This jet will be flown by charter companies, cargo companies like UPS and FEDEX, and other owner operators. Developing countries will use it to serve cities that would not otherwise have air transportation. The principal investor is Bill Gates. Total cost of the project to get the jet certified is approximately \$400M.

New manufacturing techniques will enable Eclipse to produce 4 jets per day initially at their production facility at Sunport Airport in South Albuquerque. All scheduled production is already sold out through 2008. The company is expected to boost production to 6 aircraft per day in 2009. At that

³ Rick plans to buy one of these new jets in 2008 and will allow clients to participate under a shared equity arrangement. Using the plane to visit your property in New Mexico will be tax deductible of course.

point the city of Albuquerque has agreed to move them to Double Eagle Airport on the West side of the city. They have signed commitments to build the final assembly manufacturing plant there. The main assembly plant may have as many as 5,000 jobs. Many of the 100 companies that build the jet components are not currently located in the area. Contract agreements between Eclipse and many of its suppliers call for these companies to move production to Double Eagle. One particularly large vendor that will move here is a Japanese wing manufacturer. These vendors will generate a large amount of commercial development in the area and create thousands more jobs. For more information about the Eclipse, check their website at www.eclipseaviation.com.

Market Geography and New Development

To the north of Albuquerque is the Sandia Indian Reservation, and above that is Santa Ana Indian Reservation. Albuquerque is totally “built-out” to the Northeast to the boundary of the Sandia Mountains. The South and the South West are growth areas within Albuquerque. Those areas however have not attracted any significant commercial development and the city has done nothing to support business development in this area. The city lacks the funds needed to build the infrastructure that would be needed to support development of job centers here. Schools in this part of Albuquerque are not good. Consequently this area is less desirable and houses built in these areas are targeted at lower income buyers. Our conclusion is that investors should buy into new developments within easy commuting distance of the Eclipse facilities and the commercial developments in Rio Rancho.

Fastest Growing City in New Mexico: Rio Rancho

About 11 miles northwest of Albuquerque is the town of Rio Rancho. With a population of 65,000, it is the 4th largest city in New Mexico. Rio Rancho is elevated above Albuquerque, the infrastructure is new, and it has one of the lowest crime rates in the nation. The city has the fifth best high school in the nation based on test scores.

Intel’s facilities, located in the Southeast corner of Rio Rancho, employ over 5,000 people. The city is also a commuting suburb of both Albuquerque and Santa Fe (60 freeway miles to the north). The Double Eagle airport is about 15 minutes away. Rio Rancho is a very desirable place to live or retire and new housing remains affordable given the city’s median family income of \$50,000. Rio Rancho is surrounded by large Indian reservations which restricts land available for future development.

This is in Sandoval county where UM projects population growth of 3.1% annually over the next 5 years. This means demand for 7,100 new housing units. Developers are increasing housing production in response. I forecast that

developers will put up 2,140 units over the next 12 months. Given the desirability of the location and the demand for 2nd homes, we expect there will be sufficient demand to absorb the new housing units at current prices. The average monthly rent for a 2 bedroom apartment is \$750; we expect rental homes will go for \$1,000 per month. The property tax is .8% of the assessed value and increases in assessed value are limited to 3% per year.

The city is building a very nice city center, including a multipurpose stadium which will be home to the professional hockey team called the Scorpions, and a football team. The city center plan also calls for a new \$11 million city hall, retail shops, restaurants, parks, walking paths, lofts, Bars, underground parking, and wireless internet everywhere on 160 acres of land.

Conclusion

We see Albuquerque and Rio Rancho benefiting from the same characteristics that have drawn so much capital into Phoenix. Here things are at an earlier stage and investors can still get into new construction housing at prices that are in line with local fundamentals. This is exactly what we look for: limited downside risk with lots of upside potential if the predicted flow of capital into the region continues. As with Phoenix and Las Vegas before it, developers here are limiting investor access and we expect to be shut out completely in the near future from the opportunities we've identified so far. If you want to benefit from our research, now is the time.

New Construction Investment Opportunities

We are recommending purchase of townhouses in Northwest Albuquerque near the border with Rio Rancho. The model we like is priced at \$152,000 and should rent for \$925 per month. Assuming a 20% down payment this should have positive cash flow in year 1 on an after-tax basis. In year 2, property tax will rise to reflect the purchase price. We estimate the property would then have roughly breakeven cash flow after taking into account tax benefits.

Investors can also buy a top end house on an acre lot in Rio Rancho for \$210,000. These will rent for \$1,000 to \$1,200 but could go higher if positioned to tap the relocating executive market. Based on 20% down and rent of \$1,000, these houses will have slightly negative cash flow after-tax in the first year. When higher property taxes are due in the 2nd year, you'll have carry costs (negative cash flow) of about \$1,400 per year after-tax. Rent at \$1,200 per month would enable the property to breakeven in year 2 after taking into account tax benefits.

Increasing the leverage on these would cause the carrying costs to go higher but some of the extra borrowing can be set aside to cover the negative

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cash flow. Given the likely appreciation in this market, investors should see excellent returns. We are recommending a 5 year holding period to allow time for the economic effects of the Eclipse jet to boost values in the area. If you are interested in buying, contact Rick as soon as possible.

Stock Market Notes

As predicted, the energy market has realized that the spring buildup of inventories in the U.S. is immaterial to the overall demand versus supply balance. Consequently oil prices bounced back and the energy companies in our portfolios enjoyed a big rally. For those of you wondering if it's too late to get in, I think the answer is no. The market is still valuing many companies as if energy prices will decline substantially over the long run. Consequently I see plenty of upside left in my picks.

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