

Real Estate: Time to Invest?

By Peter Benda

Can investors go bargain hunting in today's real estate market?

Nationally, housing markets are just edging "into the money" based on a comparison of long-term average rates of appreciation and recent adjustments in pricing. By "long term" we mean a full economic cycle for real estate, from low rates of growth, to highs, back to lows. The last real estate cycle lasted about 25 years, from the early '80s until now. During this time, real estate appreciated an average of 4% to 6% per year in most metropolitan areas. The average rate from 1980 to the beginning of 2008 was 4.9%. (These figures are not adjusted for inflation, and are weighted averages based on housing prices in 379 U.S. cities.)

The accompanying chart shows how the rate of housing price appreciation in the late '90s started to catch up with the long-term average. This long-term average is a theoretical index that shows what prices would have been if housing had risen consistently at 4.9% year after year. The "bubble" resulted from sustained above-average growth, which peaked around 2005. The dramatic correction over the last year has let the air out of that bubble.

Some degree of correction was expected. Unless a particular market experiences an economic transformation, such as a structural change in the local industrial base, it is unlikely that property values will all of a sudden sustain a higher rate of growth.

However, even though the national average is correcting, many markets are still inflated compared to long-term average rates. Another factor that we look at is affordability. We compare the price of entry-level investment property to the theoretical "most you can afford" price. This is the price at which the investor breaks even in the first year because rental income covers financing and operating costs. Our analysis indicates that as much as 70% of the top 379 U.S. cities are less affordable than they have been historically. Affordability will improve as housing prices fall, but rentals converted from excess housing inventory may also slow down rent growth.

So, is this a good time to look for

residential real estate opportunities, or isn't it? There are always opportunities. The question, more than ever, is "where" rather than "when."

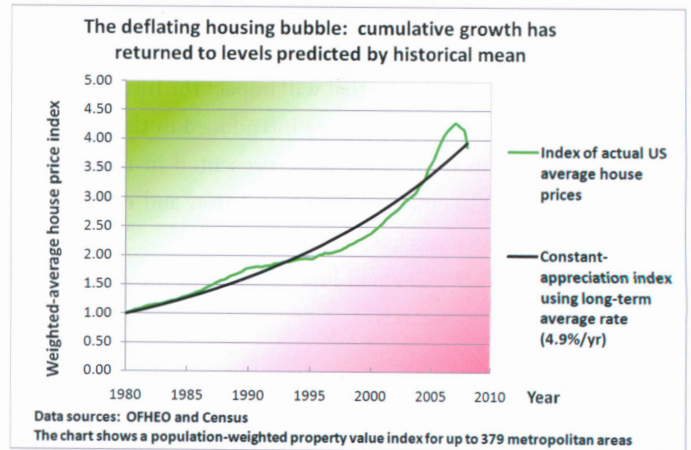
We stipulate that the serious investor should look for properties that (1) can be put into service without significant additional investment, (2) provide positive cash flow over the first year and (3) promise value growth to fuel investment returns over time.

Subject to these criteria, the Gulf Coast (cities like Jackson and Shreveport), Pennsylvania and Ohio (e.g., Pittsburgh and Cincinnati) look promising. Metrics such as affordability, employment trends, inventories and other factors suggest that these areas are relatively undervalued and should experience higher growth than most areas. Closer

to home — in Virginia and the Carolinas — there are opportunities but there's a great range of disparity from city to city.

Remember: With real estate, you have to do your own due diligence at a local level, run the numbers to make sure they work for you and be patient.

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