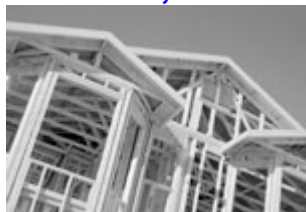


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**PortReal's Residential Market Update // 2nd Quarter, 2009**  
**Proprietary research and analysis.**

### **Housing prices are bottoming out, recovery expected within 1-2 quarters**

Nationally, the decline in residential housing prices has slowed, and about half of all markets are now experiencing a rise in "for sale" list prices. This trend change is occurring earlier than our previous forecast, and we expect the number of markets with rebounding prices to increase as the year continues.

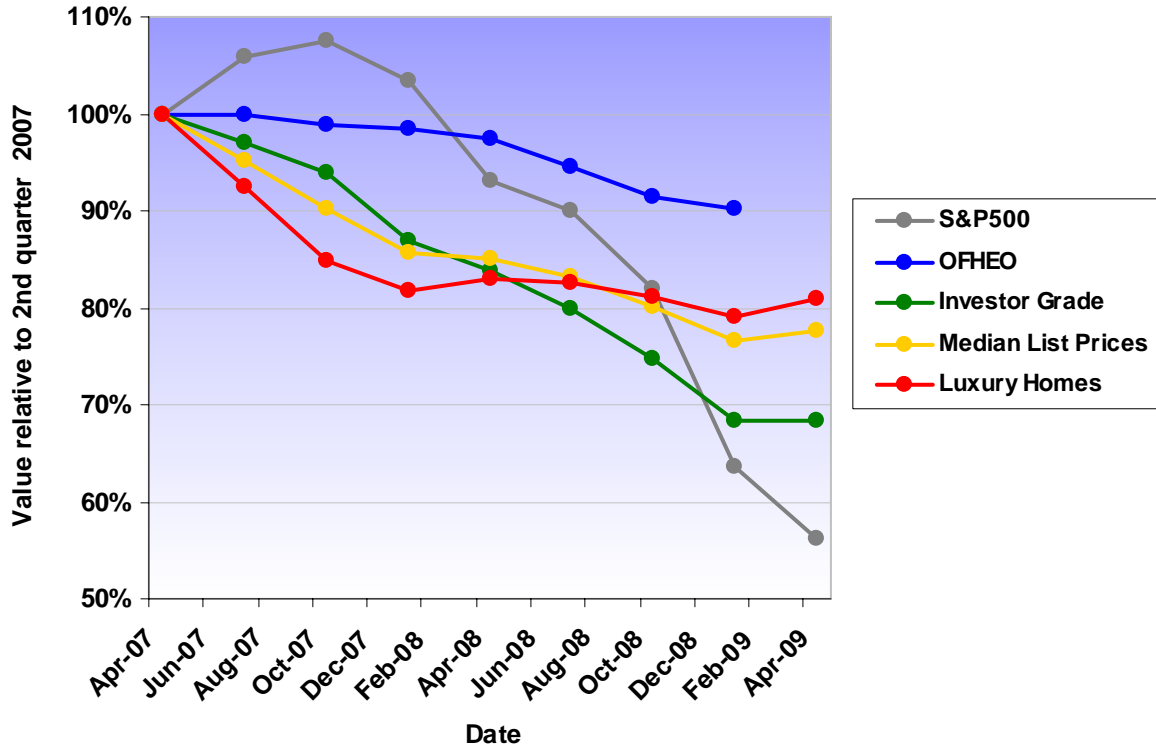
- People are pricing new listings higher than last quarter. The nationally weighted-average asking price for homes has risen between 0.1% to 2.5% over the last quarter, depending on price level. This is a significant change from the downward trend of the last 2 years.
- The largest rebound (2.5%) has occurred among luxury homes, which had already experienced a stabilization of pricing beginning a year ago.
- Generally, more expensive markets (higher median home price) are rising faster.
- Distressed and FSBO inventories have remained flat over the last quarter, a welcome change from previous growth.
- "For sale" inventories have also been flat, suggesting that demand and supply may be in equilibrium.
- We rate most markets as "affordable": investors should be able to cover ownership/operating costs and financing at current rents.
- However, shrinking employment in virtually every market will continue to undermine demand.
- Many cities in California and Florida continue to have exceptionally high level of inventories, but inventories are stable or declining slightly.
- Detroit maintains its distinction of having the lowest prices for investor grade (entry-level) houses. Inventories are dropping and approaching national standards, but the future of the automotive centers depends on the restructuring of the industry.
- 47% of US housing inventory is distressed (foreclosures, bankruptcies, etc.) or FSBO; this percentage has grown substantially since 4<sup>th</sup> quarter 2008 as FSBO sales have grown.

### **Higher priced sectors and markets are rising faster**

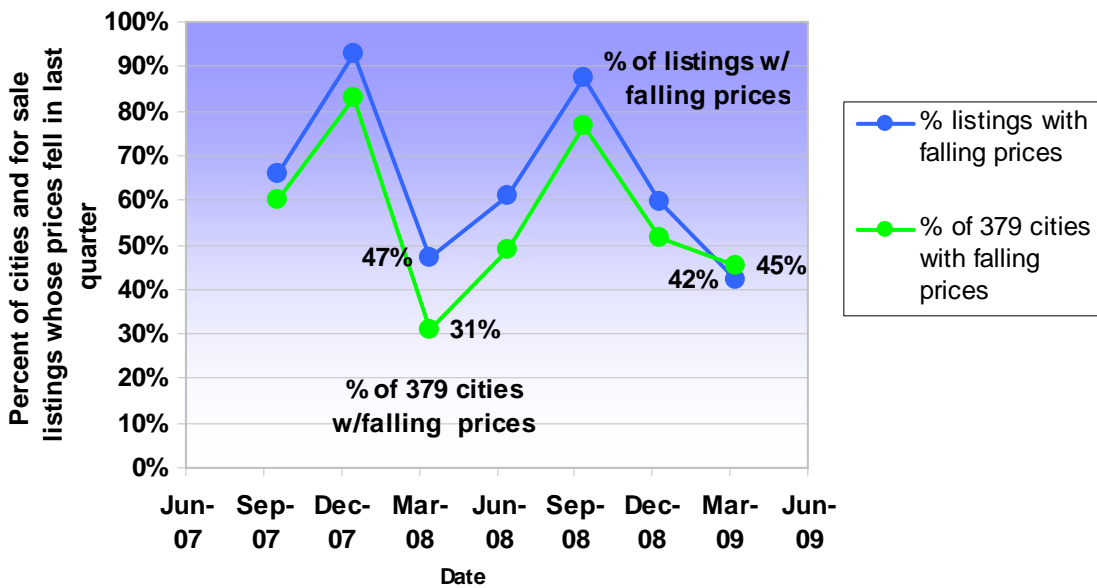
The decline in US real estate prices appears to be halting, and even reversing in some sectors. In January, 2008, (one year ago), price of luxury homes began to stabilize as the other categories (median and investor grade/entry level) continued to fall. Median homes continued declining, but less aggressively. Prices for median and investor grade homes began stabilizing last quarter (January 2009).

By contrast, the stock market has fared considerably worse than the real estate markets, supporting our argument that real estate generally experiences much less volatility than equities. The chart below shows pricing trends on a weighted-average basis across 379 US cities.

### US real estate prices seem to have hit bottom



Quarterly decline in median prices:  
fewer listings (42% now vs. 47% last year) experienced a decline  
and <50% of cities experienced a decline

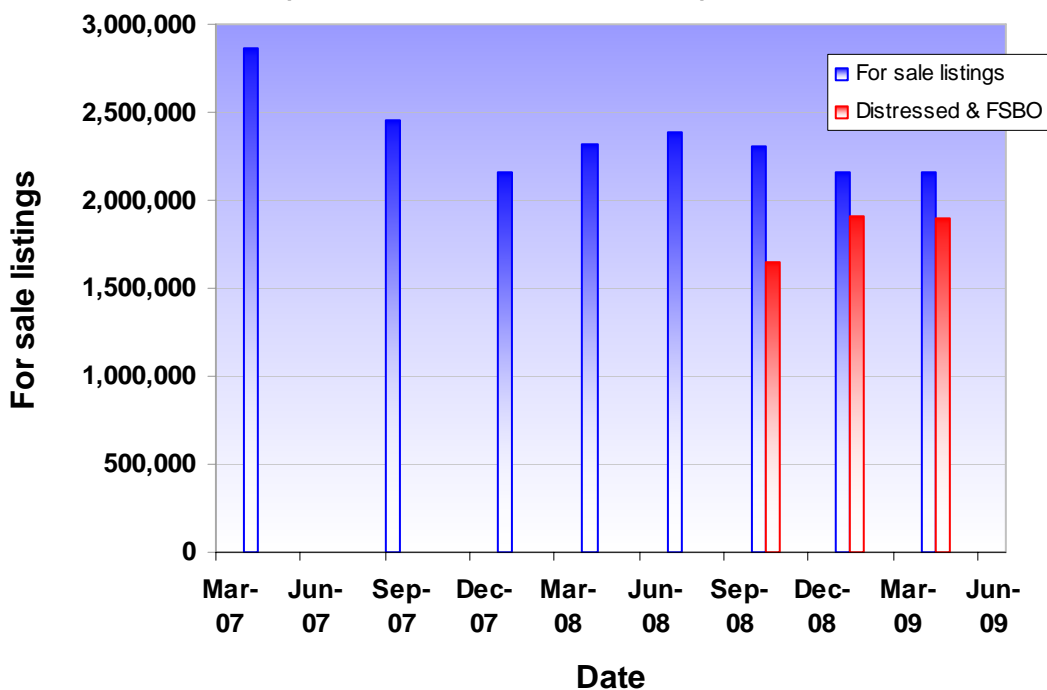


The percentage of cities and listings nationwide that have experienced price declines over the last quarter is declining. In other words, more markets are recovering value, which is a good thing. Some of this rebound may be seasonal, but even so, listings with declining prices (blue line) are down to 42% compared to 47% last year.

### Inventories flat or declining

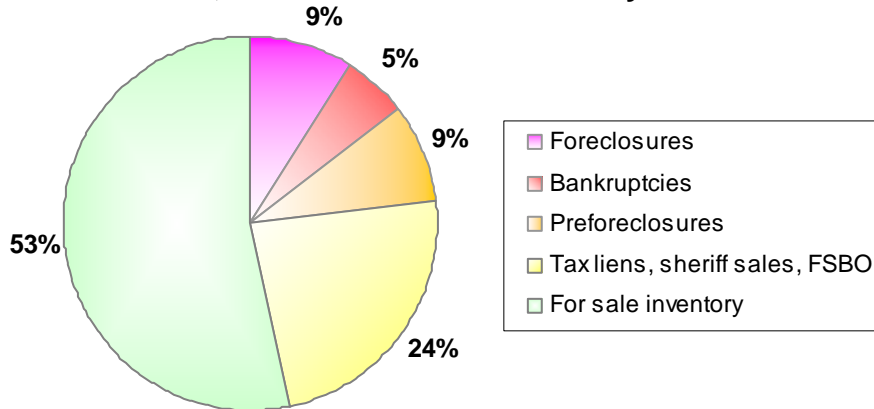
Inventories appear to be stabilizing nationally. Both the numbers of “for sale” listings and the inventory of distressed and FSBO properties appear to have settled out. The good news is that there is no new net inventory flooding the markets.

**Inventories of "For Sale" and distressed/FSBO listings have  
have been flat in the last quarter  
(totals for 379 US metro areas)**



Distressed and FSBO inventory comprise a whopping 47% of total inventory on the market, but a large part of this is FSBO inventory, which appears to be on the rise since last year. We surmise that sellers are cutting out intermediation costs (i.e., realtor fees) in order to recover as much equity as possible.

### US foreclosures, bankruptcies, other distressed sales, & FSBO = 47% of inventory



### Inflection in price trends coincides with good investor economics and realignment with historical trends

There has been an inflection in price trends: as noted elsewhere, asking prices have trended down for median and investor grade/entry level homes for the last two years, and luxury homes began stabilizing about a year ago. This quarter, we see that the national downward trend has changed direction: upwards.

We analyze two fundamentals to understand why this inflection may be genuine, and not just a fluke.

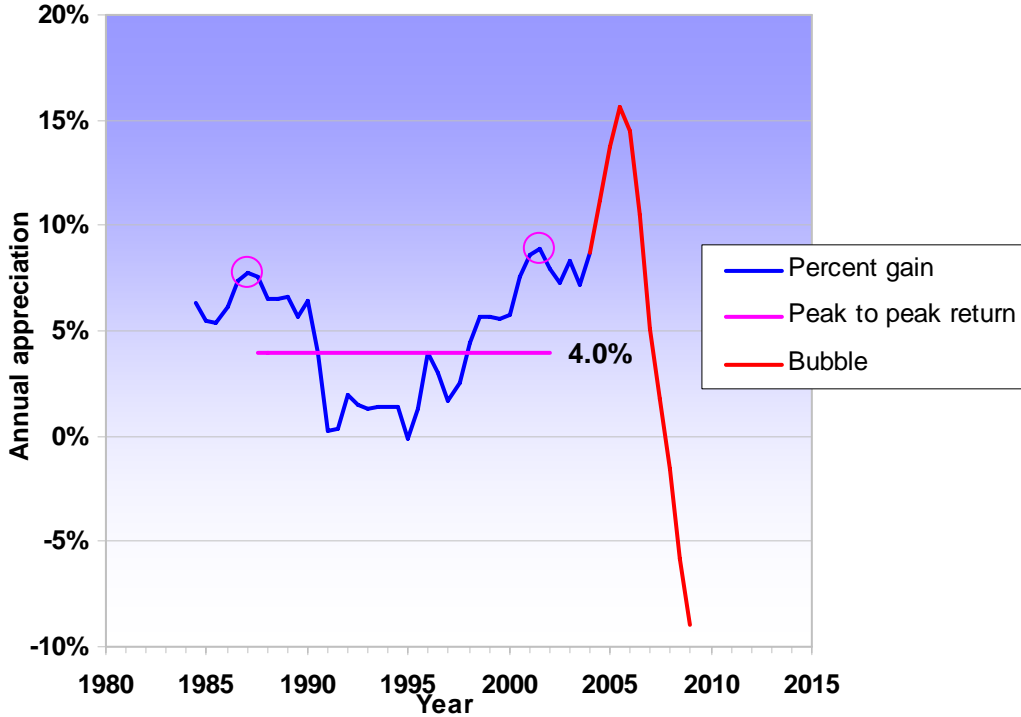
(1) Investment affordability: We evaluate the cost to buy, own, and operate a rental property vs. expected rental income. This is similar to a cap rate analysis, but we also include an estimate for ongoing capital investments. We estimate cash flow from the investment as: the net operating income less capital investments (amortized roof replacement, for example), less estimated financing costs. Nearly 100% of US markets are affordable (break-even cash flow or better) to the investor under this analysis. This means that pricing has dropped enough to produce attractive economics for investors.

(2) Recent price adjustments compared to historical trends:

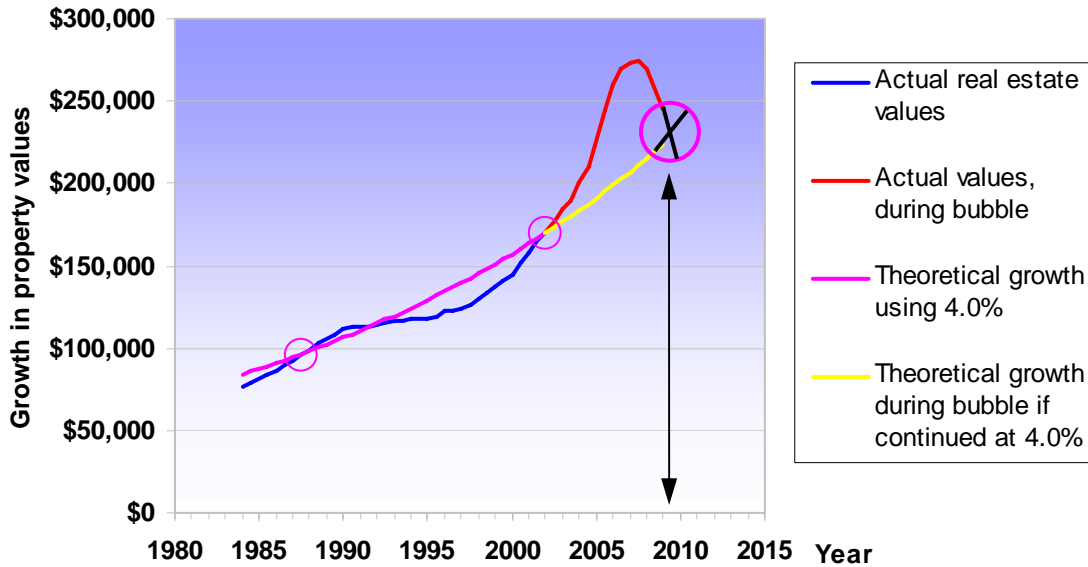
Next, we compare recent pricing trends to historical norms. This gives us an indication of whether the market is inflated compared to averages over an economic cycle. The bubble of the last 7 years inflated prices above historical norms, and that bubble has been deflating since 2007 (earlier in some markets). First we estimate an "historically normal" rate of property value appreciation. The following chart identifies a real estate price cycle that begins in 1987 and ends in 2001, based on peak-to-peak returns. The nominal rate of increase in national property prices during this cycle is 4.0% annually. For simplicity we do not account for inflation and other factors.

When we extrapolate this rate of value growth (4.0%) into the period of the bubble (2003-2005) we find that the bubble over-inflated prices vs. the "normal" rate, creating a gap of 9% as of 2<sup>nd</sup> quarter, 2009. Extrapolating the current decline of 10%/year versus a normal growth of 4.0%/year shows that the gap should close by the end of this year (December, 2009).

**Prior to bubble, annual average appreciation of residential housing was 4.0% (peak-to-peak cycle)**



**Real estate prices will have corrected back to historical averages around 3rd quarter of 2009**



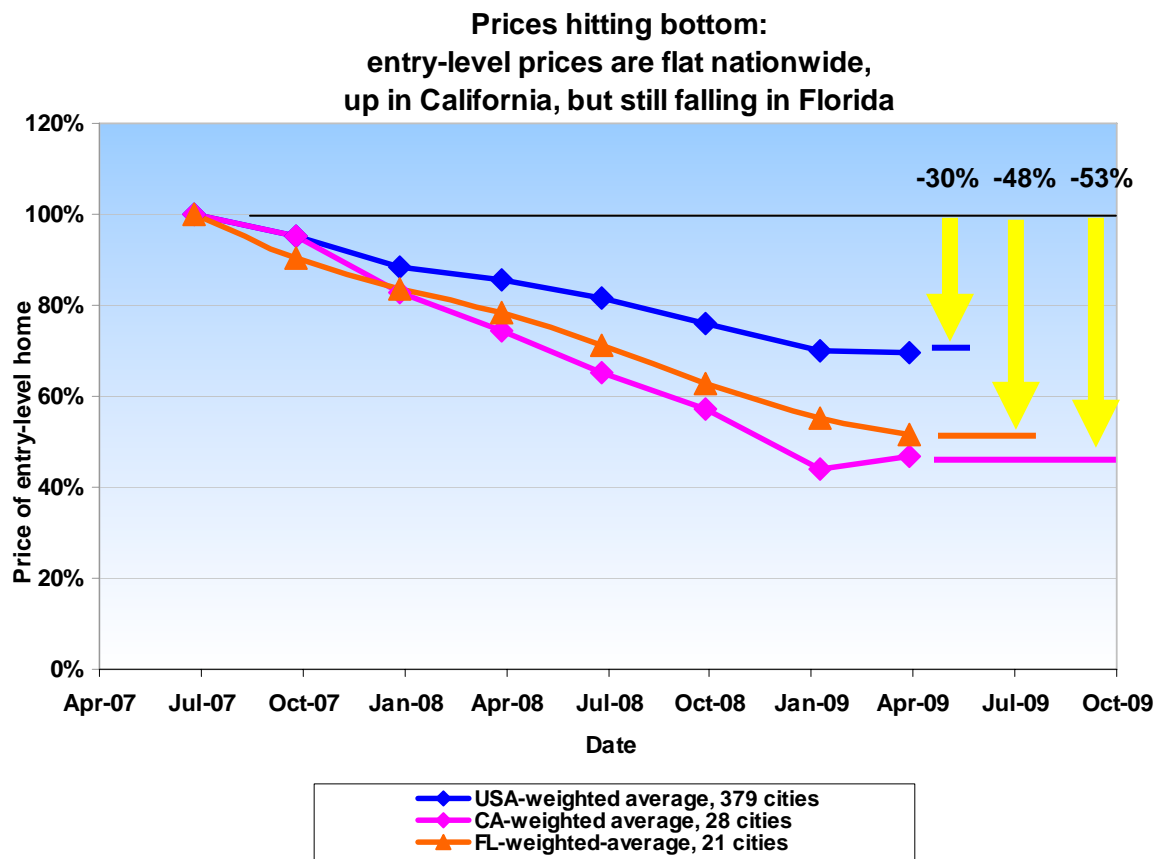
This analysis is based on OFHEO data, which lags actual market data by one quarter, and understates the volatility of market prices. “For sale” list price data (asking prices) have dropped faster and lower than the OFHEO data, which is based on closing prices of sold homes. Whether “for sale” is a real-time measure or just a predictor of a turn-around is not clear, but we are confident that the turn-around has begun and will be trending upward as the year progresses.

While pricing may be re-bounding, the question is whether investors are ready to enter the market. Much will depend on a variety of factors, including: whether they have cash or credit available, whether they have confidence that the price growth is sustainable, and whether there is demand for rentals in their marketplace. After two-plus years of wait-and-see, there is pent up demand for housing, while new construction has been low or halted, so we expect demand to increase sharply as confidence grows.

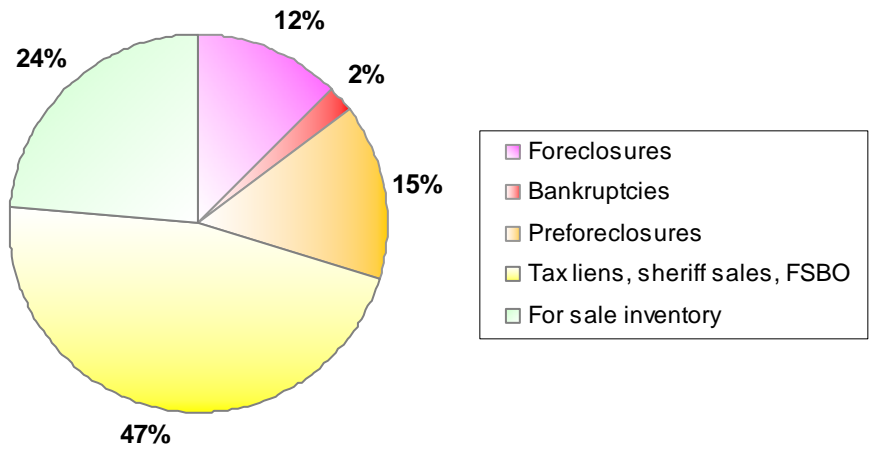
### Previously overheated markets still in trouble

Florida continues to carry huge inventories, despite a slight decline. Until this inventory has been absorbed, investors should be wary of investing in most markets in Florida. Cape Coral, Lakeland, and Punta Gorda have especially high inventories, but even the Fort Lauderdale and Miami areas (and others) have exceptional levels of inventory compared to national benchmarks. Gainesville has more potential for investors with lower inventories and less dramatic jobs shrinkage.

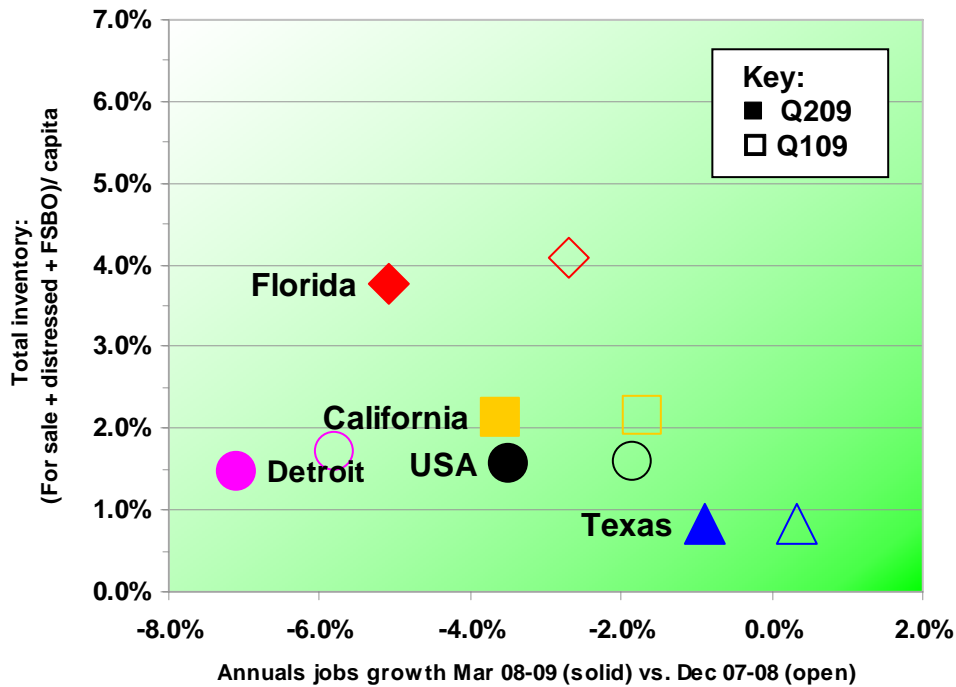
As Florida markets continue their free-fall, many cities in California are experiencing a slow-down in price declines. While total inventories are stable, they are high and California distressed and FSBO inventories now make up 76% of total inventory on the market.



### California foreclosures, bankruptcies, other distressed sales, & FSBO = 76% of inventory



### Inventories are stable despite falling employment



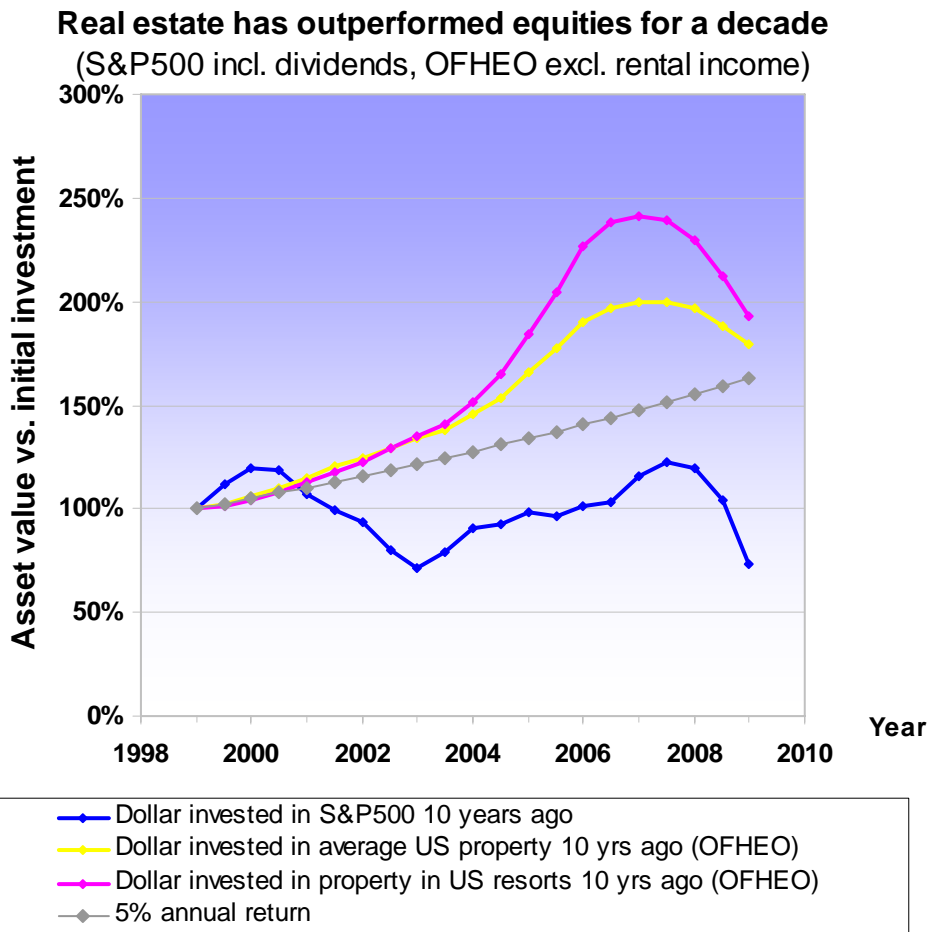
The Detroit market has consistently maintained the distinction of having the lowest investor grade prices (\$35,000) in the nation. (We define “investor grade” as the 15<sup>th</sup> percentile price point in the For Sale listings market). It has one of the highest unemployment rates of any major metropolitan area in the U.S., but also one of the fastest rates of inventory shrinkage, with inventory per capita approaching national averages. The low housing prices and shrinking inventories favors the investment outlook for Detroit. Much will depend on the restructuring of the automotive industry.

### Looking forward—top 20 investment picks

We believe property values are poised for recovery on a national basis. We also believe that real estate is a good investment over the long term due to low volatility and other factors. In recent years, real estate has outperformed equities, largely due to its relatively low volatility. Move-in quality “investment grade” properties at the low end of the price spectrum yield the highest cap rates. With today’s low mortgage costs rates, most markets in the US offer properties with break-even-or-better investment economics.

The question is not so much “when” to invest, but “where” and in what kinds of properties. We believe that the traditional hot markets—resorts, Florida, California—are still risky due to high supply (inventories) and eroding demand (downward employment trends).

Real estate values have outperformed equities over recent years due to the collapse in the stock market. However, even as the stock market recovers, rent-generating investment properties can generate exceptional returns on investment.



We use 4 criteria to assess markets for investors and home-buyers: (1) housing supply vs. demand (essentially absorption), (2) pricing trends, (3) investment affordability (essentially a cap rate analysis), and (4) local economics. We use four proxies for these criteria: housing inventory/capita, statistical evaluation of appreciation rates, affordability of buying vs. renting, and jobs growth in the area. We use these criteria to pick cities that appear to be poised for growth in demand and pricing.

We still like some of the major metro areas (San Francisco, Washington/Bethesda, Philadelphia). We also like a number of cities in the Midwest, especially in Indiana, Illinois, Iowa and Wisconsin, primarily due to low inventories.

Below is our pick of cities for this quarter, in alphabetical order by state. This list is only a starting point based on high level factors. Investors must perform their own due diligence regarding local market conditions and the viability of any specific investment:

### **PortReal Investment Picks for 2<sup>nd</sup> quarter, 2009**

- CA: San Francisco-San Mateo-Redwood City
- DC: Washington-Arlington-Alexandria
- IA: Ames
- IA: Des Moines-West Des Moines
- IN: Anderson
- IN: Fort Wayne
- IN: Lafayette
- IN: Terre Haute
- MD: Bethesda-Gaithersburg-Frederick
- MO: Joplin
- MO: Kansas City
- NE: Lincoln
- NE: Omaha-Council Bluffs
- NY: Buffalo-Niagara Falls
- NY: Rochester
- PA: Erie
- PA: Philadelphia
- PA: Pittsburgh
- WI: Appleton
- WV: Weirton-Steubenville

A good strategy for investing in residential real estate is to ensure that the cap ratio is adequate to generate break-even cash flows (i.e., cover capital investments and financing). This produces high returns on equity over time as property values increase and mortgages reduced the amount of investment. We believe it is critical to buy move-in quality properties at the lowest possible cost in markets that have underlying fundamental economics that support both continued occupancy, rents, and appreciation.

Transitions in the economy frequently create opportunities, or at least require adapting one's investment strategy. Now may be a good time to re-enter the market to acquire investor grade properties at low prices in markets that will sustain housing demand as the economy recovers. This may also be a good time to reallocate one's investment portfolio to cash out relatively high-valued properties and reinvest in undervalued properties. For example, luxury properties have maintained their value in some markets, and are unlikely to see a significant rebound as the market recovers. In these same markets, investor grade properties have fallen drastically and are likely to rebound quickly for a variety of reasons (underpriced relative to rents, risk-averse home buyers will buy conservatively-priced homes). This suggests a strategy of selling out of luxury or median properties and buying into lower-cost properties.

## Definitions

**Investor Grade** is a starter-home property ready and suitable for renting or resale. We benchmark **Investor Grade** pricing using the 15th percentile price point in the market. **Investor Grade** housing shapes supply/demand for the overall housing market by defining a clearing price for investors. PortReal's Investor **Affordability** benchmark is the ratio of the **Investor Grade** price to a "most you can afford" price based on rental income. If rent cover ownership and financing costs, then the market is affordable (similar to cap rate analysis, but also accounts for capital investments). Our measure of **Affordability** can be a weathervane for imminent price trends. **Distressed properties** are those in foreclosure, pre-foreclosure, bankruptcy, and sheriff's sales. We associate **FSBO** (For Sale By Owner) with this category to distinguish from retail "**For Sale**" home prices.

## PortReal news

Our 2<sup>nd</sup> quarter Market Report has just been released, and is available from our website, or through EBSCO, Research and Markets, and Alacra.

**Disclaimer:** Investors should not rely on our data to make specific investment decisions. Economic and market conditions differ greatly by location and property. Our analysis ranks metro areas using standardized assumptions across geographies. Investors must perform their own analysis of vacancy, rents, operating costs, and other factors before making investments.

**Sources:** Census, OFHEO, Bureau of Labor Statistics, and online listings and foreclosure data (including Realtor.com and Foreclosure.com).

### **For more information, contact:**

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