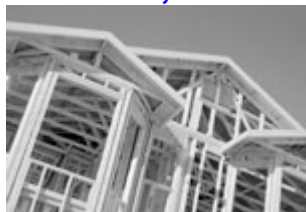


## PortReal, LLC // serving institutions & investors



[www.portreal.com](http://www.portreal.com)

## PortReal's Residential Investment Market Update // 4<sup>th</sup> Quarter, 2009 Proprietary research and analysis.

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### Growth is returning in some markets offsetting declines elsewhere

National average prices have stabilized: the decline in investor grade housing prices have been essentially flat for 3 quarters. This average masks some fundamental and seasonal effects. There was shrinkage in the number of markets (21%) that experienced price rises for investor grade properties. But those cities that did increase prices offset the declines in other markets. This is the first time in three years that we see substantial rises in prices at least in some markets even while the majority of markets experienced some decline. Notably California is experiencing a rebound as inventories shrink and prices rise. However, other distressed regions, such as Florida, continue to carry tremendous inventories with prices still in freefall.

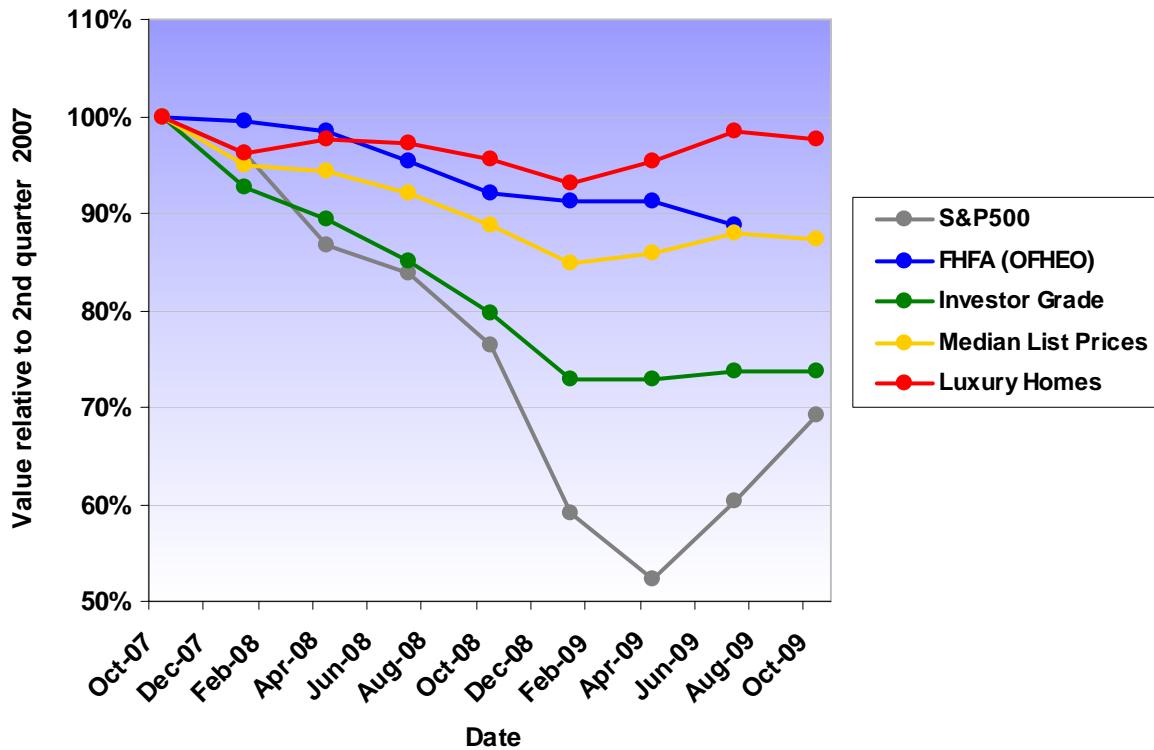
- After two quarters of slight increases, US average asking prices are flat.
- Luxury, median, and investor-grade homes are undifferentiated nationally: on average, prices are flat in each category. By contrast, luxury housing was recovering faster earlier in the year.
- Some regions are rebounding: California has had 3 quarters of growth in investor-grade houses.
- Anecdotally, investors are busy with bidding wars in California..
- Nationally, distressed and FSBO inventories are rising and now exceed for sale listings.
- California, however, has experienced declines in both for sale and distressed/FSBO inventory.
- Nearly all markets are "affordable" for investors: net operating income covers mortgage costs, when financing is available to begin with.
- Mortgage rates are the lowest in 45 years, and cap rates are over 10%; but a weak economy, low confidence, and restricted credit are hampering a widespread recovery.



## Luxury and median stable, investor grade poised for growth

Nationally, house prices have stabilized in each of three housing sectors: luxury, median, and investor grade (entry-level). Luxury housing has held its value relatively well, but experienced a slight dip in the last quarter. Investor grade/entry-level housing just began to stabilize earlier this year and may have nowhere to go but up. Compared to rents, income levels (consumer affordability), and other factors, investor grade housing is undervalued nationally.

### Investor grade prices took the biggest hit but appear to have stabilized

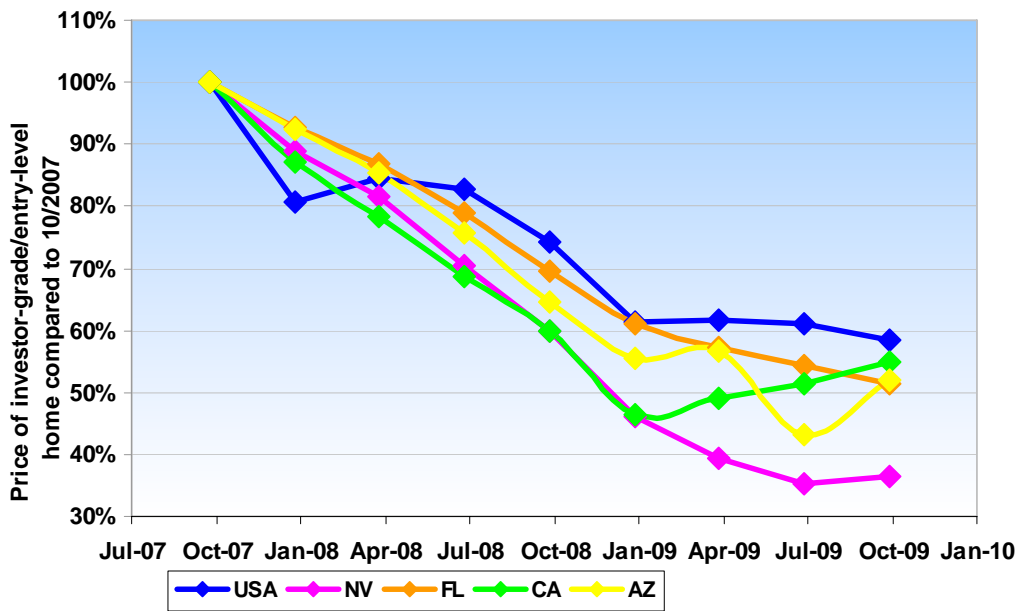


## While most markets still weak or flat, some markets are rebounding

Stabilizing housing prices on the basis of national averages mask regional differences. Most markets have declined slightly, and the remaining markets are flat or rising significantly. An optimistic assessment is that recovery in these markets is the early sign of a broader recovery soon to come.

The chart below focuses on four states that have been among the hardest-hit in the nation. It shows trends for investor grade property values. These trends are examples of what's going on elsewhere in the US: declining markets are not declining as fast, while some rebounding markets are rebounding rather quickly. California investor grade property prices have risen 20% since the beginning of the year, while Florida, Nevada and Arizona are either slowing down or flattening. There are anecdotes of bidding wars for properties in San Diego, and a significant jump in investor participation in the Bay area.

**California picking up steam as investors enter the market;  
Florida continues downhill; other markets in transition**

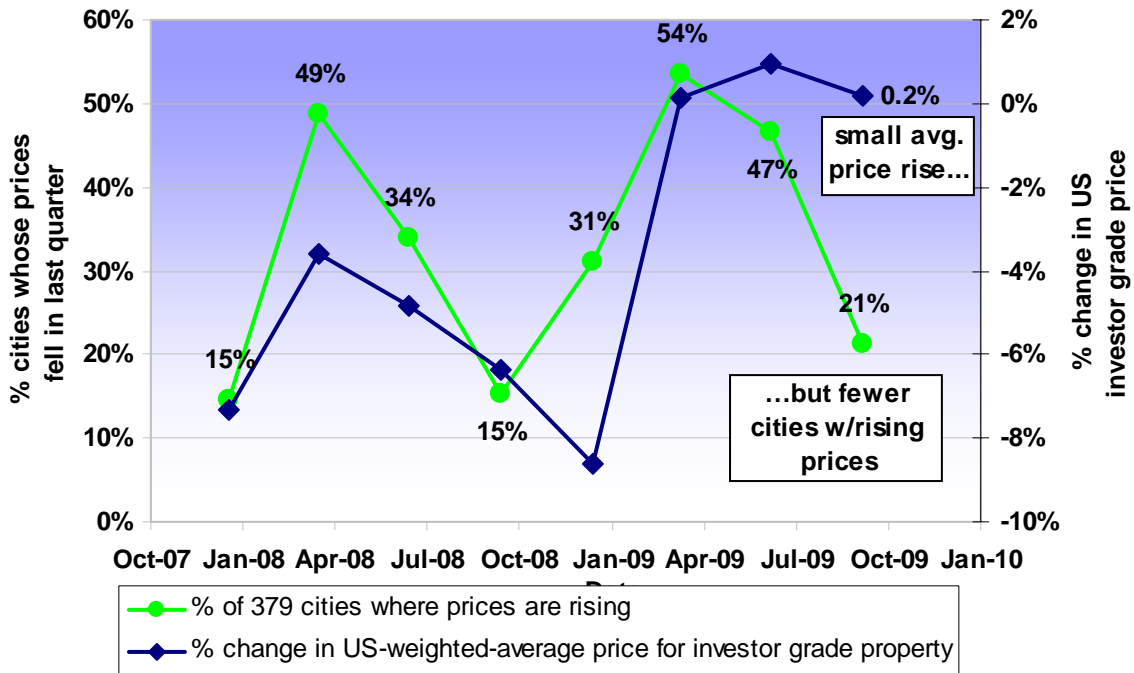


The next chart tells the same story for all 379 US markets that we cover: while most markets are declining in value, those that are rising (21% of cities) are rising faster, thereby neutralizing average US losses (bringing total weighted average price increase to 0.2%). Stated differently, nearly three-fourths of cities experienced price declines, at an average of 5% per quarter. But 21% of markets climbed by 10%, so few markets climbing at higher rates caused the US average change slightly positive (+0.2%).

Some of the larger gains may be a short-term bounce, but we believe a gradual return to widespread sustainable growth is imminent in the coming quarters. We are not predicting, however, that prices will return to the earlier highs of the bubble, as the high point was the result of a market fever that drove prices up to irrational levels.



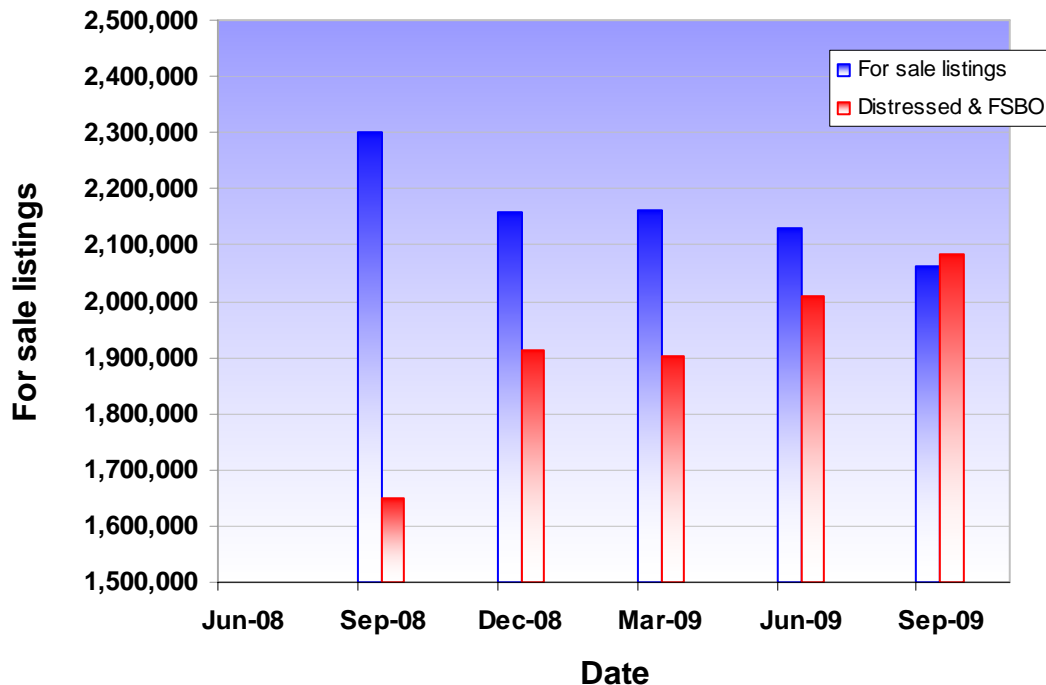
In last quarter, 21% of markets experienced growth in investor grade prices, but recovery in those markets offset declines elsewhere, keeping national average flat



## Inventories flat = “for sale” is down + distressed is up

Total US inventories have been flat for the last quarter. While “for sale” listings are declining, distressed and FSBO inventories are still on the rise. In fact, distressed and FSBO inventory exceeds the number of for sale listings nationally for the first time. This reflects declining “for sale” inventories as well as a continued rise in distressed inventories.

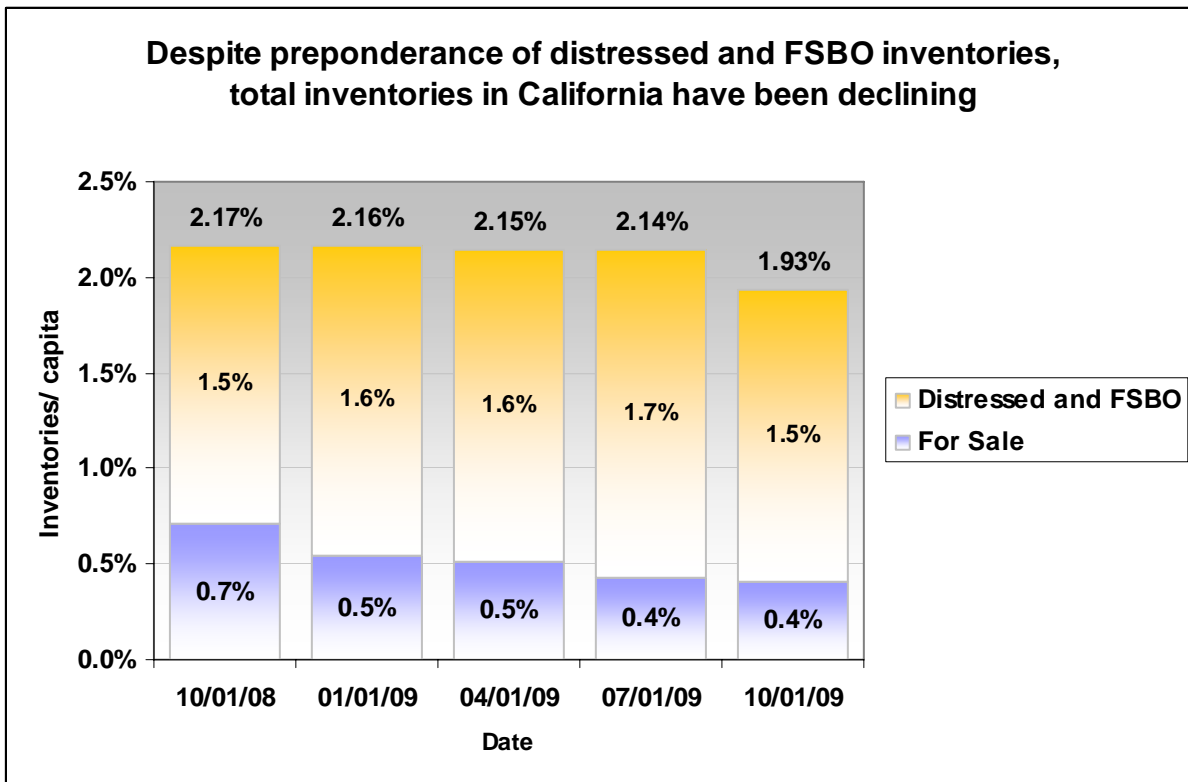
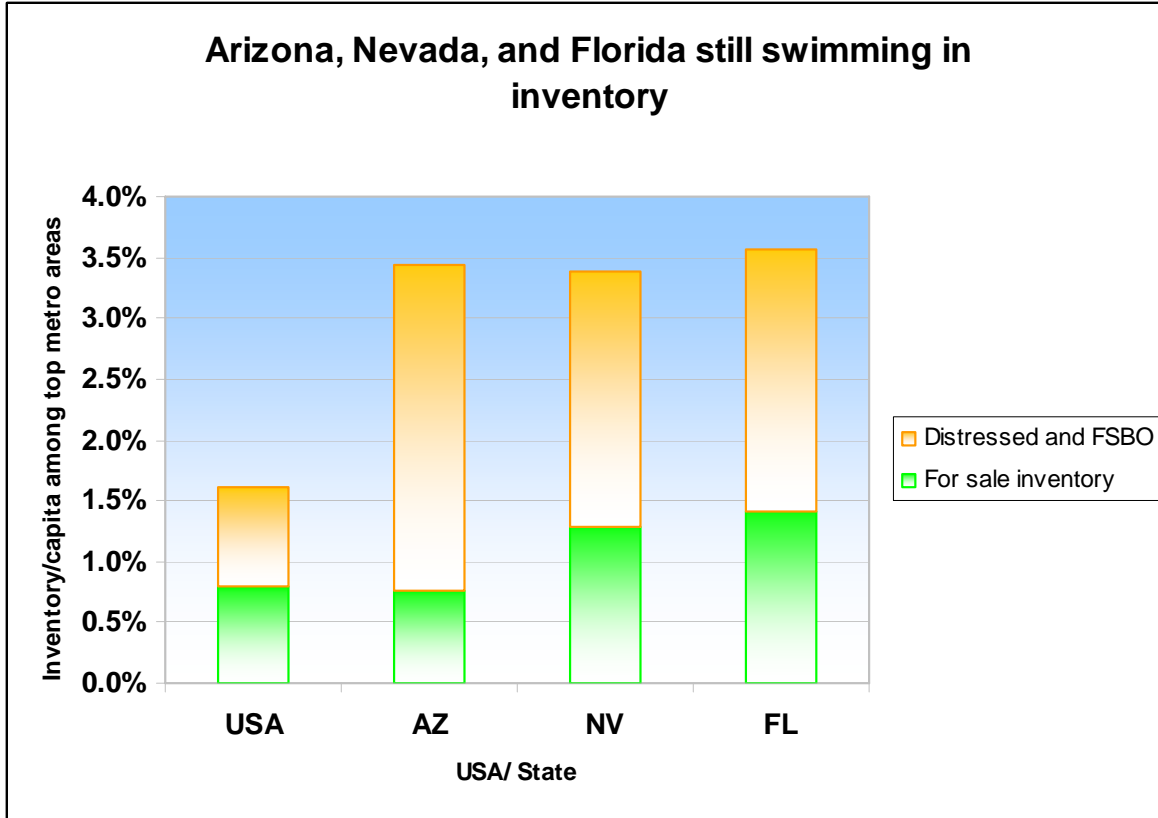
**“For sale” inventories are shrinking (that's good)  
but distressed and FSBO inventories are on the rise  
(totals for 379 US metro areas)**



As with pricing trends, the inventory situation is significantly different by market. As seen below, Florida, Nevada and Arizona still have tremendous inventories compared to national averages. California, on the other hand, is shedding “for sale” inventory and distressed and FSBO inventory.

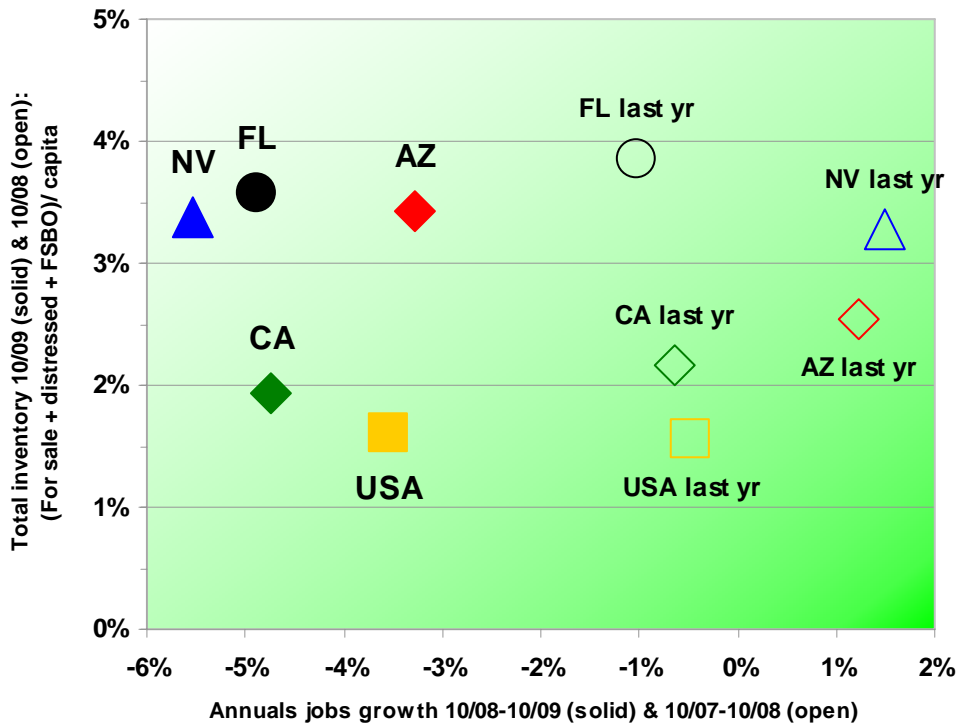
A potential shortage of housing inventory looms ahead. Speculative construction during the housing boom resulted in significant excess inventory. When the real estate market crashed, new construction slowed dramatically, and to levels well below sustainable requirements. Current and planned new construction levels are insufficient to meet demands of net population growth and to replenish houses taken out of service (demolished). Once the excess capacity has been absorbed by population growth, it is possible that housing demand will exceed inventory before. This shortage, if it occurs, could manifest itself as early as 2010.





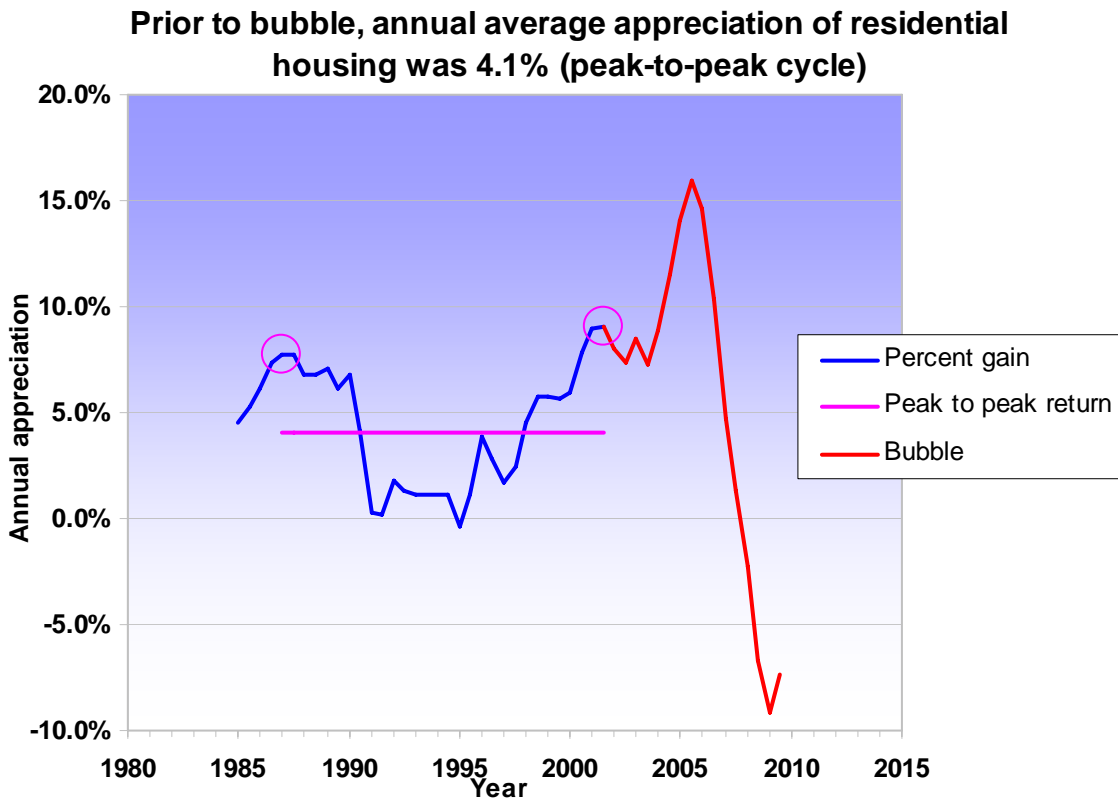
Unemployment is one factor in home owner defaults. Defaulting loans result in new inventories. However, unemployment has risen much faster than inventory growth. To some extent, unemployment is has not been the primary driver of the current foreclosure crisis. The foreclosure problem is related to homeowners buying more than they could afford even when they are employed, and to the prevalence of teaser-rate mortgages which proved unaffordable when rates were re-set after the grace period. However, as unemployment rises, additional foreclosures will follow.

### Inventories are stable despite falling employment



## Pricing back on track

The bubble has deflated. We believe housing prices are at or below historical trends. Prices are low relative to consumer income, relative to rents, and relative to long-term historical norms. Below, we look at historical norms: long-term price trends. The chart shows that peak-to-peak price appreciation in the previous real estate cycle was 4.1%.



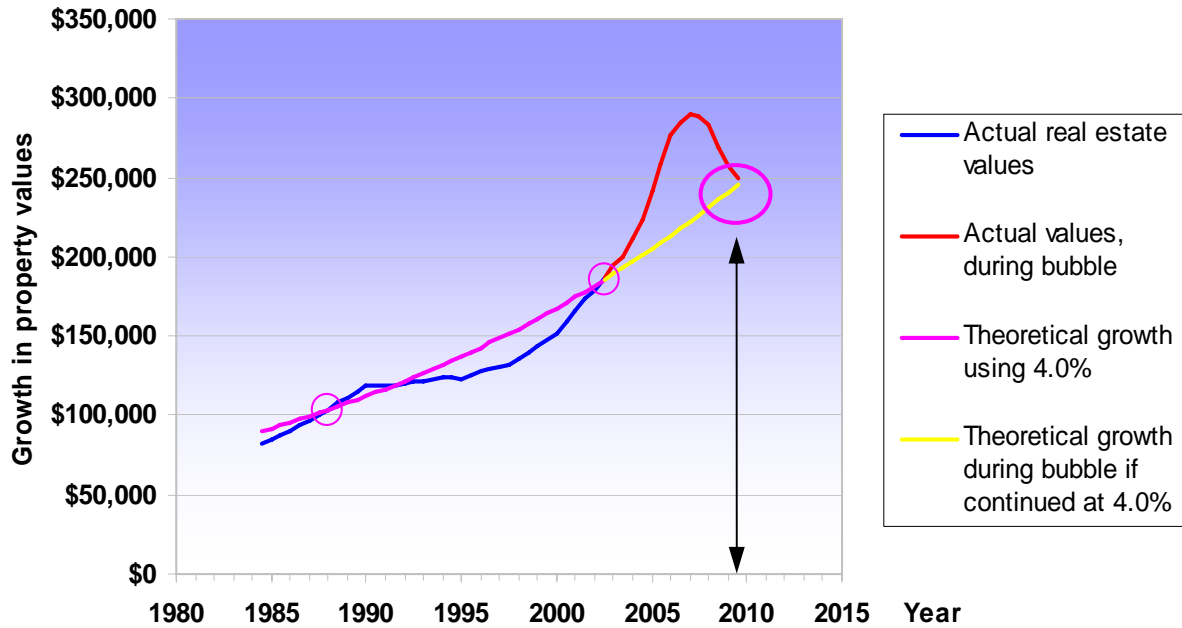
In the following chart, we project this growth rate forward from the last peak (yellow line) to show how far actual prices varied from the norm during the “bubble”. Recent declines in prices have deflated the bubble so that prices are now in line with an estimated normal 4.1% rate of appreciation. Assuming some more decline, prices will be below historical norms by the end of this year.

This analysis is based on FHFA/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 FHFA/OFHEO data, which is based on closing prices of sold homes. “For sale” prices are already showing stabilization—as noted elsewhere—and a strong bounce in some markets.

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. Access to the federal first-time homeowner tax credit is also a factor, and extension of hits program will affect the nature of the recovery.



## Real estate prices have nearly corrected to historical averages



The fact that pricing is at or below historical trend levels does not mean it can't drop further. But it allows normal growth without downward pressure due to overpricing. Any volatility from this point forward is more likely tied to market supply and demand rather than momentum associated with too-easy credit and speculative frenzy.



## Key challenge for investors: financing

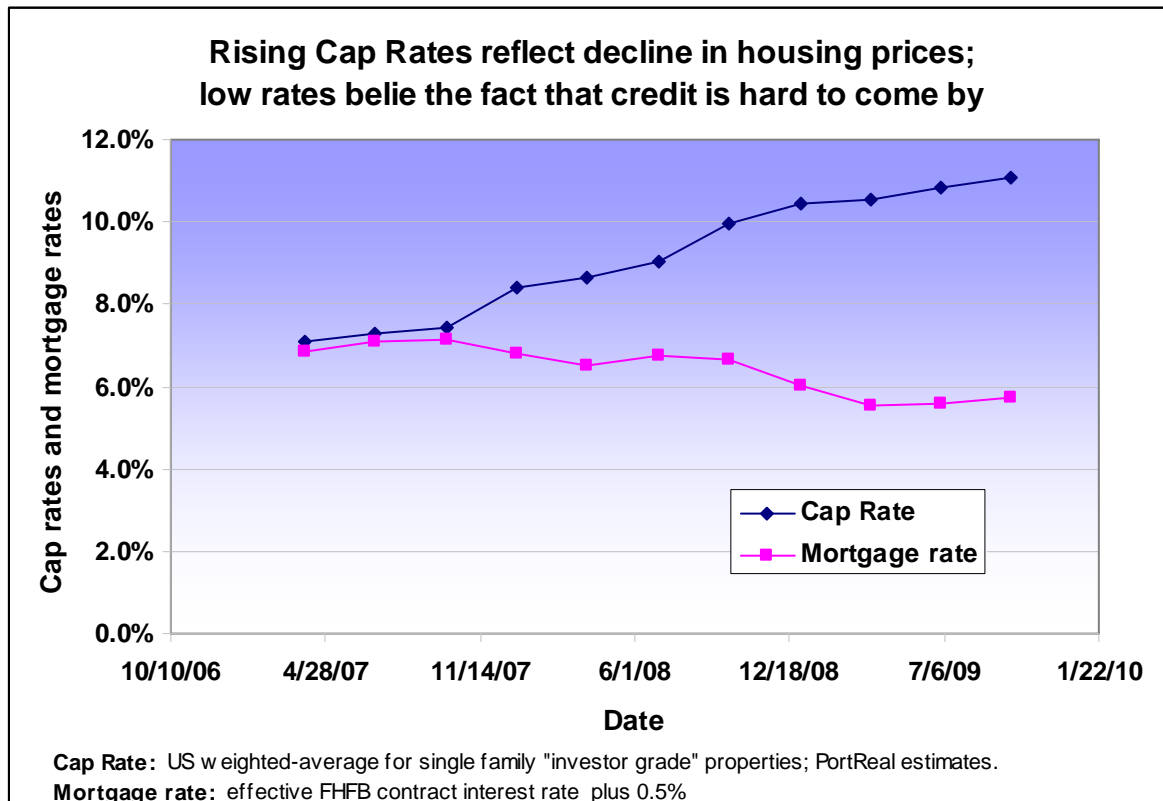
There are various challenges facing real estate investors. These include general risks such as continued economic weakness (jobs, inflation, energy), national issues (nation at war, consumer uncertainty), and the risk of natural disaster. Other risks are more specific to residential housing:

- Lack of access to mortgages due to higher credit standards.
- Lack of access to all kinds of funding due to general illiquidity and low investor confidence.
- Barriers to transaction flow, specifically the HVCC appraisal process, which is widely viewed as a frequent deal-killer for legitimate purchase offers.
- Restrictions or phase-out of government-backed stimulus programs such as the Federal Housing Tax Credit for First-Time Home Buyers and credit flow derived from TARP investments.
- Failure of local markets to recover due to regional economic factors.

Despite the gloomy news, investors should note that there is good news:

- Some markets are clearly transitioning, with shrinking inventories and rising prices
- Interest rates, when loans are available, are at or near 45 year lows
- Cap rates are rising. Investor grade properties are relatively inexpensive, inflation is expected to be low through 2010, and rents are generally rising.

The challenge for investors who wish to take advantage of the growing gap between cap rates and lending rates is actually securing credit or finding equity for investments.

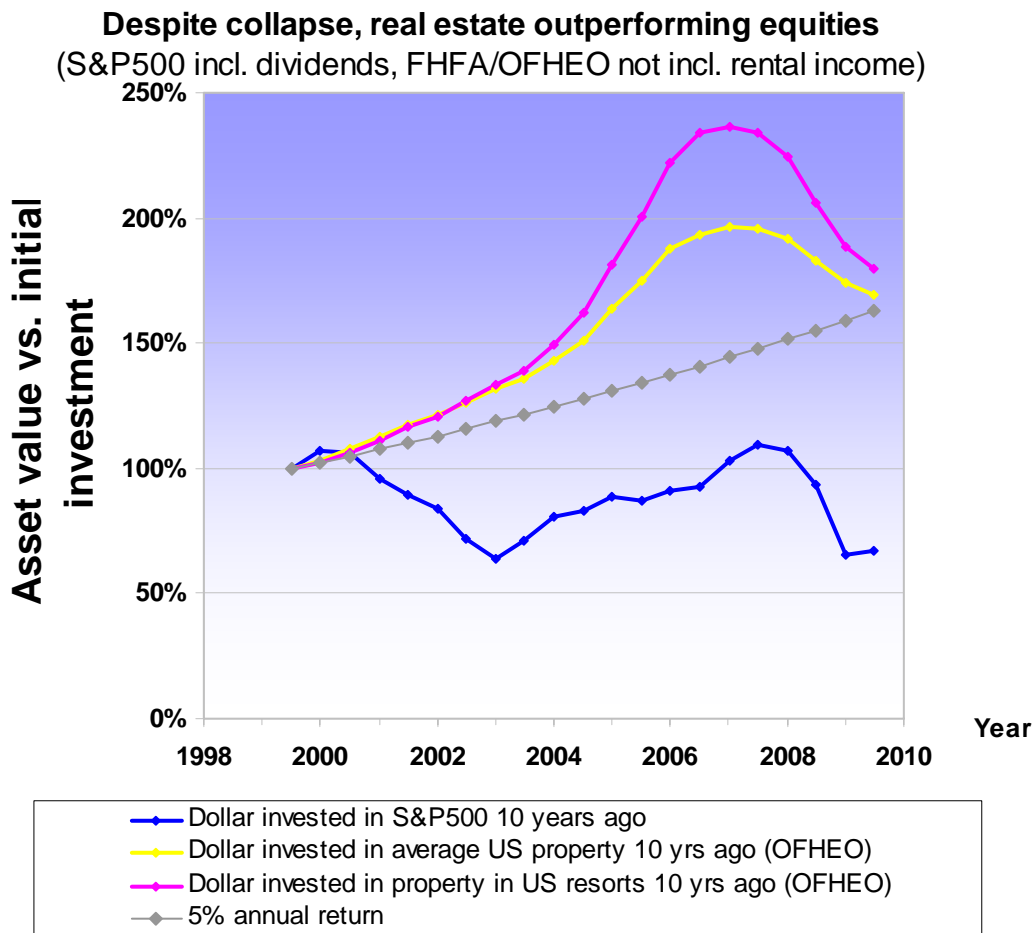


## Real estate still outperforming equities

Investors with new money to put into the market may weigh the potential opportunity to buy near the bottom against the risk that this isn't really bottom yet, or that the recovery will be more sluggish than expected, or that there are other markets—as yet unidentified—that have more potential. Timing is less important in the long run than selecting the right property in the right market, within a consistent investment strategy. Having said this, we believe some markets are looking favorable for new investment.

Property values are recovering regionally, and 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 mortgage rates as low as they have been in over 40 years, most markets in the US offer properties with break-even-or-better investment economics, assuming the investor can secure financing and establish reliable rental income.

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.



## Top 20 investment picks for Q4 2009

The question is not so much “when” to invest, but “where” and what types of properties. Anecdotal evidence, declining inventory, and rising prices indicate that California markets are heating up. Rising prices despite high inventories and discouraging unemployment suggest that the market is undervalued.

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.

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, and is intended for a buy-and-hold strategy with at least a 1-2 year outlook. Investors must perform their own due diligence regarding local market conditions and the viability of any specific investment. Further detailed market analysis for each city is available from PortReal’s web site.

### PortReal Investment Picks for 4<sup>th</sup> quarter, 2009

- Jonesboro, AR
- Washington-Arlington-Alexandria, DC
- Sioux City, IA
- Springfield, IL
- Owensboro, KY
- Boston-Quincy, MA
- Cambridge-Newton-Framingham, MA
- Peabody, MA
- Baltimore-Towson, MD
- Bethesda-Gaithersburg-Frederick, MD
- St. Cloud, MN
- Omaha-Council Bluffs, NE
- Buffalo-Niagara Falls, NY
- Nassau-Suffolk, NY
- New York-White Plains-Wayne, NY
- Utica-Rome, NY
- Lawton, OK
- Texarkana, TX
- Wichita Falls, TX
- Burlington-South Burlington, VT

Investments that break even in cash flow—with operating income covering finance costs—should produce high returns on investment as property values increase in the long term. We believe it is critical to buy in markets that have strong underlying economic fundamentals that support continued occupancy, rent levels, and value appreciation, to ensure consistent operating income and long-term growth.

Transitions in the economy typically create investment opportunities. Now may be a good time for new money 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 money invested in 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 significant increases as the market recovers. In these same markets, investor grade properties have fallen significantly and are more likely to benefit from a recovering economy. In some markets, then, it may make sense to sell off luxury properties and buy up investor grade 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 4<sup>th</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/FHFA, Bureau of Labor Statistics, and online listings and foreclosure data (including Realtor.com and Foreclosure.com).

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