

# CIRIOS TRENDS

FINDING REAL ESTATE OPPORTUNITIES.



## The State of the Markets

There is no ambiguity about the goal of current US government policy when it comes to housing: Prevent home price depreciation at all cost.

As such, this month's State of the Markets was going to discuss shadow inventory, diving into the numbers to see just how long we'll have to live with looming supply of bank owned homes. At current repossession rates (around one million per year according to Lender Processing Services), it will take around four years to work through all loans that are more than 90 days delinquent. Morgan Stanley agrees, pegging 47 months as the time required to work through the backlog of distressed loans. And those figures assumes no additional loans get added to that severely delinquent bucket.

Sobering stuff, and evidence that foreclosures are going to be a dominant market force for the foreseeable future.

But as we dug through the data, something wasn't adding up. Many are fearful that supply will flood the market as banks push through foreclosures. Housing bears often cite this inevitable inventory spike as evidence housing is in for a second leg down.

This is a very valid concern, and in order to remain ahead of the curve, Cirios closely monitors real time foreclosure and new listing data, watching out for early signs of a supply shock.

Our antennae were tripped in April as Trustee Sale activity began to ramp up and repossession levels began rising. Nervously, we waited for the natural increase in listings that were sure to follow. It never came. It still hasn't come. Something isn't adding up.

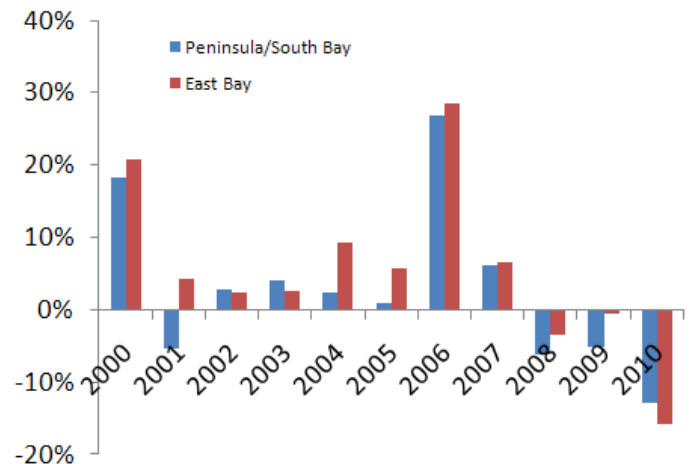
When banks take back homes, the next step in the process is to list those homes for sale. But that wasn't happening. Banks were foreclosing on more homes but the trail stopped there.

So we went to the tape. Since 2000, the average increase in new listing activity from April to May was 2.9% on the Peninsula and in the South Bay, while over in the East Bay, new listings rose almost 5.5%. During good times, the typical increase is a bit higher, while during bad times new listings in May can actually decline. In fact, they have declined in each of the past three years.

But this year, throughout the Bay Area, new listing activity in May plummeted relative to historic norms. East Bay new listing activity fell 15.8% while Peninsula and South Bay activity dropped 12.8% - both the highest on record. So what gives?

Without sounding like conspiracy theorists, we'd like to put forward the following, very logical thesis: Imagine you are the government. The tax credit expires, the economy starts to sputter, Europe begins to melt down, the Gulf is literally full of oil and the job market turns out not to be on the mend after all, and you have a stated policy of propping up home prices, what would you do?

Chart of the Month:  
Change in New Listing Activity, April to May



Source: Cirios Real Estate, MLS Data

“Something isn't adding up.”

### Housing Data Looks Good ... Compared to Last Year

- MAR. CASE-SHILLER HOME PRICE INDEX: +2.3% Y/Y | +0.0% M/M
- APRIL EXISTING HOME SALES: +22.8% Y/Y | +7.6% M/M
- APRIL NEW HOME SALES: +47.8% Y/Y | +15.0% M/M
- MAY HOMEBUILDER SENTIMENT INDEX: 22 (UP FROM 19, HIGHEST SINCE AUG '07)

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**“Each investor has different profit targets and time horizons.”**

## Feature: How Much Should I Pay?

“How much should I pay?” is about the most common question we get here at Cirios. Unfortunately (or fortunately), the answer to this question is never black and white. Depending on a buyer’s desired use for a property, there are many ways to determine value and what the right price to pay is.

An investor looking to rehab and sell a home quickly may put a different value on it than an investor looking to buy and rent for several years. Since each investor has different profit targets and time horizons, formulas that determine what price the investor would pay nearly always differ.

Still different is the price a regular home buyer would be willing to pay after accounting for mortgage payments, tax breaks, upkeep expenses, etc.

This piece covers a couple different methods for valuing a property, and is at best a cursory examination of these topics. Each one contains many further levels of complexities and nuance.

Many investors that purchase and hold income generating properties use the Income Method of valuation to determine an attractive purchase price. If an investor wants to earn, say 6% on his money, he would use the annual operating cash flow generated by the property to calculate what purchase price would achieve that level of return.

This type of investor often uses the concept of a “Cap Rate” to figure out how much properties are worth. A Cap Rate (short for Capitalization Rate) is the rate of return generated by net cash flows - that is, rental income minus all operating expenses associated with owning the property. For example, if a 6-unit apartment building bought for \$400,000 generated \$30,000 in net operating income, the Cap Rate would be 7.5% ( $\$30,000 / \$400,000$ ).

If a nearby 6-unit building generated \$45,000 of income, applying the same Cap Rate you would arrive at a value of \$600,000 ( $\$45,000 / .075$ ). In general, as markets improve and property values go up, Cap Rates go down. This makes sense: When times are good, there are usually more buyers than sellers, so sellers can demand high prices which push down rates of return.

The reverse is true when prices fall and markets tighten up. Investors demand a higher rate of return for taking the risk of buying a property in a hard environment, which drives down the prices they are willing to pay and thus pushes the Cap Rate up.



For home buyers, the decision of what price to pay is determined by two primary factors. First, the buyer’s ability and willingness to pay. Monthly income and savings will often dictate how much a buyer can pay, then more emotional factors kick in to determine how much he or she is willing to pay. The confluence of hard numbers and soft feelings creates a price range where the buyer can be satisfied both economically and emotionally.

Second, recent sales, other listings and general market conditions will determine what a fair price for a given home is. Subjectivity plays a huge factor in comparing like properties, so valuing single family homes is much more an art than a science.

Often, relative affordability between different cities is evaluated using a “Rent Ratio.” A Rent Ratio is exactly what it sounds like, a ratio between the cost to buy and the cost to rent. If a \$200,000 home would cost around \$16,000 per year to rent, the Rent Ratio is 12.5 ( $\$200,000 / \$16,000$ ). According to Rent.com, which compiles rental data nationwide, a Rent Ratio around 15 means the buying and renting are roughly equivalent options. Below 15 and buying may be the best route, while above 15 and it may be best to hold off.

According to the most recent data, San Francisco is actually ranked as the best city to rent, with a whopping Rent Ratio of 37. That’s higher than New York at 21 and Honolulu at 24.

So, does that mean it’s a terrible idea to buy a home in San Francisco? Far from it. There may be plenty of valid reasons *not* to buy in San Francisco, but a broad metric like this doesn’t tell the story of individual neighborhoods.

What this high ratio does tell you, is that if you are lucky enough to find a property in San Francisco where buying and renting cost roughly the same, you are probably getting a pretty good deal.

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## Around the Bay: Local News Bites

### Toyota Gets Long Electric Cars (San Francisco Chronicle)

Toyota Corp. is plunking down \$50 million to help Tesla Motors restart the recently shuttered Nummi auto plant in Fremont. Tesla is hiring 50 staff per month to get the plant churning out its electric cars and expects to manufacture 20,000 vehicles per year. Nummi has a storied past, having been closed and reopened two times prior to its most recent resuscitation. For Toyota, while the strategic investment could end up paying off, the company is also working to repair its tattered image. In a separate release, the company issued its profuse thanks to British Petroleum, which, in a most benevolent display of corporate camaraderie, supplanted Toyota as the most hated foreign company in America.

(Read more here: <http://tinyurl.com/cirioستrendsune1>)



### Wells Unloading Commercial Loans (Bloomberg Business Week)

Wells Fargo, the biggest commercial real estate lender in the US, is looking to sell around \$1 billion in distressed commercial real estate loans and assets. The majority of the loans Wells has on the block were inherited from Wachovia, the Charlotte-based bank Wells swallowed up in October 2008. Buyers of such things are getting more aggressive on pricing, as a consensus is building that while not out of the woods by any stretch, downside risk for commercial real estate is limited. That, or investors are feeling the pressure to put money to work and rationalizing away the latent risks which remain in a market that is anything but healed: Foresight Analytics estimates that US financial firms hold \$185 billion in distressed loans.

(Read more here: <http://tinyurl.com/cirioستrendsune2>)



### San Francisco Courts Builders (San Francisco Business Times)

In a move aimed at jumpstarting new construction in San Francisco, Mayor Gavin Newsom is allowing developers to defer impact fees regularly paid when construction begins. Under the new legislation, up to 80% of the impact fees can be paid just prior to completion, which the city hopes will encourage builders to start projects otherwise tabled or delayed. Newsom estimates that the change could generate 4,800 construction-related jobs and spur almost \$900 million in spending.

(Read more here: <http://tinyurl.com/cirioستrendsune3>)



### Brisbane Boomtown? Bullocks. (San Francisco Business Times)

The sleepy town of Brisbane, best known for being the most enigmatic city in the Bay Area, could soon become a hotbed of development. The city wants to redevelop a 660-acre swath of capped landfill and rotting train yards, known as the Baylands. Universal Paragon, a San Francisco-based developer, is proposing a project consisting of 4,500 homes, 6 million square feet of office space and 25 acres of solar arrays. If approved, the plan would triple Brisbane's population over the next 30 years and transform the town into, well, something.

(Read more here: <http://tinyurl.com/cirioستrendsune4> )



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## Zip Code Spotlight - East Palo Alto - 94303

**“Entire neighborhoods were bought up, torn down and redeveloped.”**

This month's spotlight falls on East Palo Alto, CA, perhaps one of the Bay Area's most interesting pockets of real estate and an excellent illustration of the effect of housing boom and bust on marginal areas. Surrounded by islands of almost inconceivable wealth, East Palo Alto (or "EPA"), for many years remained a low-price, crime-ridden enclave that more wealthy residents in the area wouldn't dare set foot in.

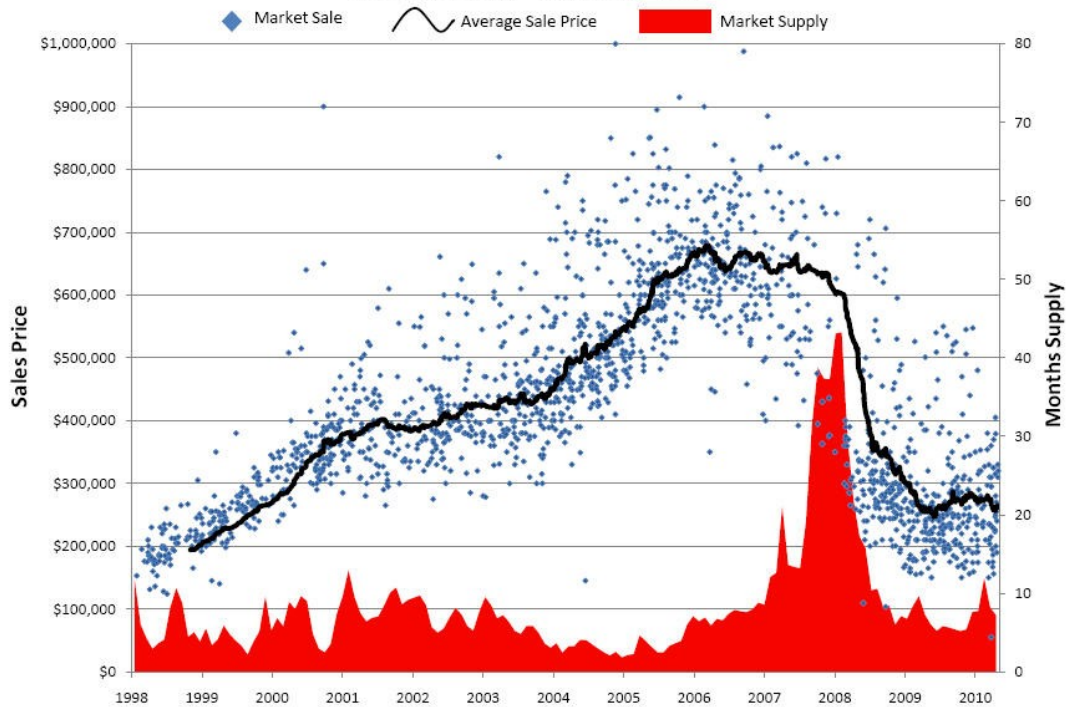
Towards the peak of the boom, the forces of real estate pricing began to bring change to EPA. Entire neighborhoods were bought up, torn down and redeveloped into either



commercial space or new residential housing. Gentrification began happening at an accelerated pace, during which time prices rose almost 70% in just four years. When the bust hit, the market tumbled even more quickly than it rose. Prices fell 60% in a single 12-month period. On the graph below, witness the massive supply spike that coincided with prices falling off a cliff (note also the scarcity of blue data points during this time, indicating an extremely illiquid market). Since that time prices appear to have stabilized at around year 2000 price levels and supply has returned to more normal levels.

The question, of course, is where will EPA go from here? With crime again on the rise and municipal budgets slashed by plummeting tax revenues, EPA could again be plagued by the troubles it has known for decades. But the fact remains that EPA has by far the most affordable housing on the Peninsula. Investors are finding value on these once dangerous streets, betting the disparity between EPA home prices and everywhere else will narrow in the years to come.

Sales Activity - East Palo Alto



**“Seller financing carries potential benefits for both buyers and sellers.”**

## Cirios Opportunities - Is Seller Financing Right for You?

As the aftershocks of the housing crash continue to rumble through the mortgage market, many home sellers, from investors to individuals, would be wise to look into the benefits of offering seller financing to sell their properties. Seller what?

Seller financing is precisely what the name implies: The seller of a property offers prospective buyers not just the house, but financing too. Rather than taking out a traditional mortgage, the seller would issue a note obligating the buyer to repay a certain amount at a certain interest rate, just like a regular mortgage. Terms, including down payment, interest rate and repayment period, are negotiated directly between buyer and seller.

This is by no means a simple transaction and should be entered into only with the guidance of an expert, but seller financing carries potential benefits for both buyers and sellers.

While some real estate markets are in full recovery mode, certain market segments remain slow and illiquid. There are many reasons a home will not sell, but one of the primary factors is a lack of qualified buyers. In today's market, a qualified buyer is defined as someone who can afford to make the monthly loan payments, can post a 20% down payment and has a high credit score.

Buyers not meeting these criteria are essentially locked out of the market, since private lenders are still charging outrageously high rates and fees.

A logical alternative for home buyers and sellers held hostage by the current lending market is for the two parties to negotiate directly and agree upon terms that work for both parties. Sellers can open the marketing of their property to a wider buying pool, potentially increasing the purchase price. Buyers with dinged credit or who otherwise don't fit inside the ever-narrow mortgage guidelines can still participate in the housing market by buying a house with seller financing.

For the seller, rather than rolling sale proceeds into the stock market or a low-yielding CD, he or she can create a financial instrument with a consistent rate of return commensurate with secure corporate bonds. And even though the value of the underlying security (the property) could fluctuate and even

go down, how good do you feel about the balance sheets of the companies whose stock you own? There are risks in issuing a mortgage to someone to buy your house, but the risks are tangible and often easier to wrap your head around than the volatile stock market.

Seller financing actually happens all the time when big banks and investment companies buy or sell assets. For example, when it was still an independent company trying to raise cash against the backdrop of a collapsing financial system, Merrill Lynch infamously sold various collateralized debt obligation investments for 17% of their face value. The move shocked markets, as all of a sudden the rest of Wall Street had to reprice their assets to this new, dramatically lower level.

Behind the scenes, however, the trade indicated that market conditions were far more dire than they seemed. Merrill offered cheap leverage to the buyer of the assets, enabling the buyer to put up almost no down payment yet still make the purchase.

Merrill, desperate to shore up its balance sheet, could book the sale and remove the assets from its books. In their place was a shiny new loan. However, since it would be forced to take back the assets if the buyer (now borrower) defaulted, Merrill really hadn't unloaded any of its risk.

The lesson here is that seller financing should only be undertaken by parties familiar with the risks and potential benefits of this sort of transaction. This knowledge can be learned though, so even if you didn't understand a thing you just read, don't be disheartened.

A good real estate or financial professional should be able to walk any buyer or seller through the logistics of seller financing. Sellers should know that they do retain the risk their property may depreciate, but can also earn a solid rate of return with the possibility of selling their home at a higher price.

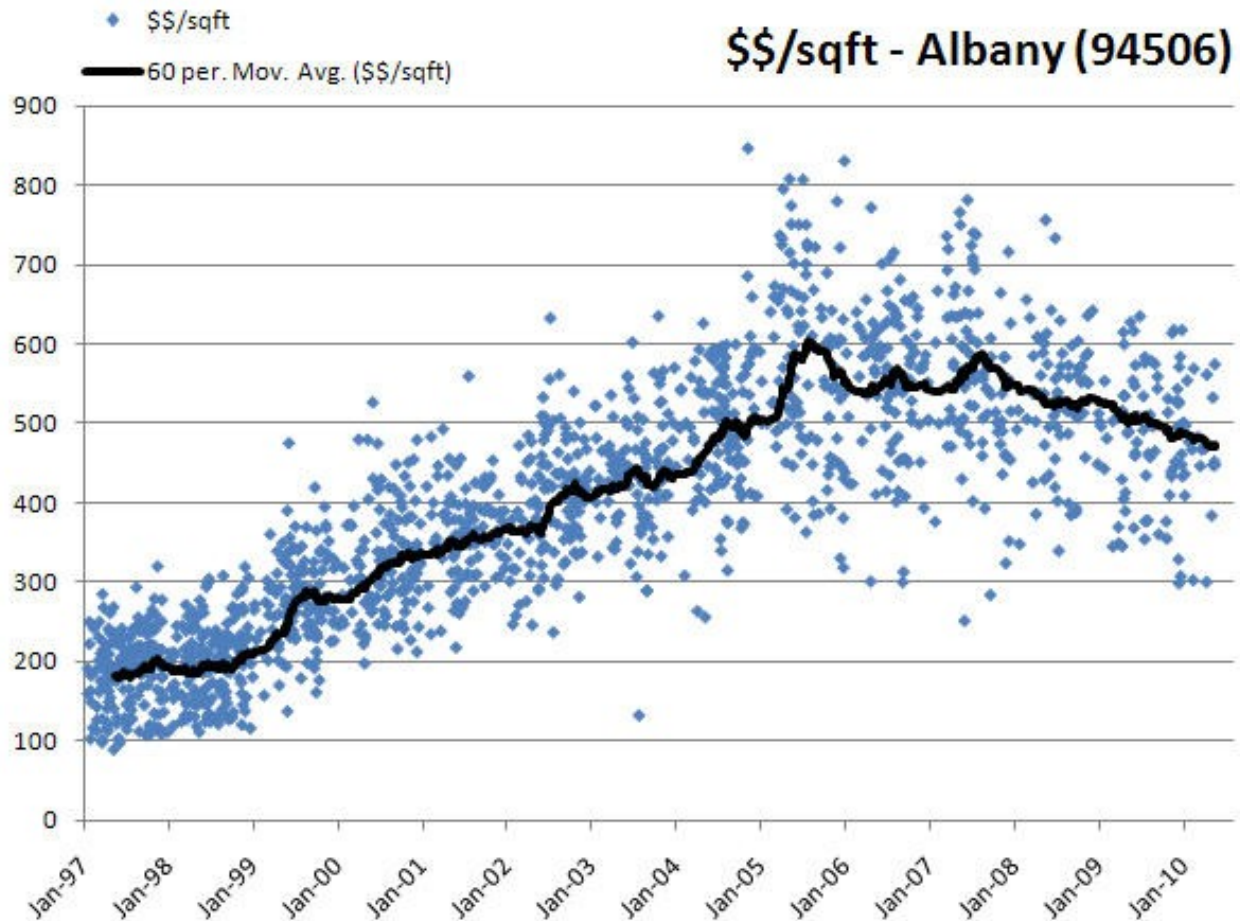
Buyers have another option if they get turned down by the bank, even though it is likely to be a more expensive one.

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## Talking Charts - Who's Back on Track? - Albany

If there is a theme we at Cirios harp on more than any other, it's that just because a particular city or neighborhood is considered "more desirable" than another, that does not mean by extension it's also a better place to buy real estate. The following slides compare four different markets, and we challenge readers to put their preconceived notions aside when evaluating the home price trends in each area. Making sound real estate decisions doesn't just depend on one's ability to identify where he or she would like to live (that's pretty easy), but rather where large groups of people are *going to want* to live. Demographics drive home price trends, and understanding demographics, population movements and macro culture shifts enables savvy investors to position themselves in front of, rather than behind, trend shifts and market movements.

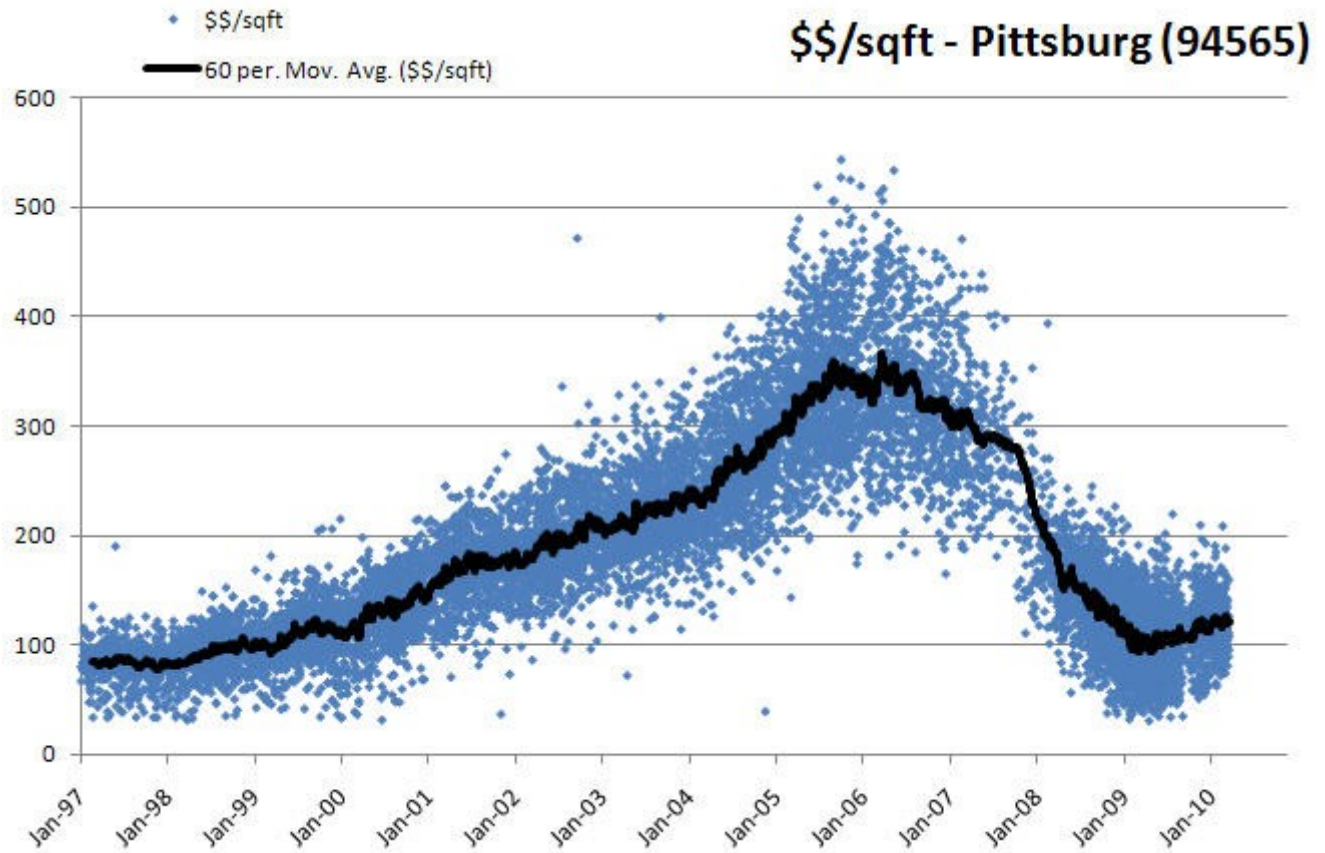


Albany, what's not to love? Great schools, good weather and even a decent selection of restaurants. BART makes for an easy commute into San Francisco and the city's quiet suburban streets attract families young and old. But what about home prices? Since the market peaked in 2005, which notably was well before most high end markets peaked in 2007, prices have been in a steady slide. Even over the past 12 months, a time period when many Bay Area housing markets were actually improving, Albany remained sluggish. And while there are many explanations for the continued declines, if the graph above tells you anything, it's that just because a town has great schools and a strong community, that doesn't mean its housing market is immune from factors affecting what most would consider a significantly less desirable area ... like, Pittsburg.

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## Talking Charts - Who's Back on Track? - Pittsburg

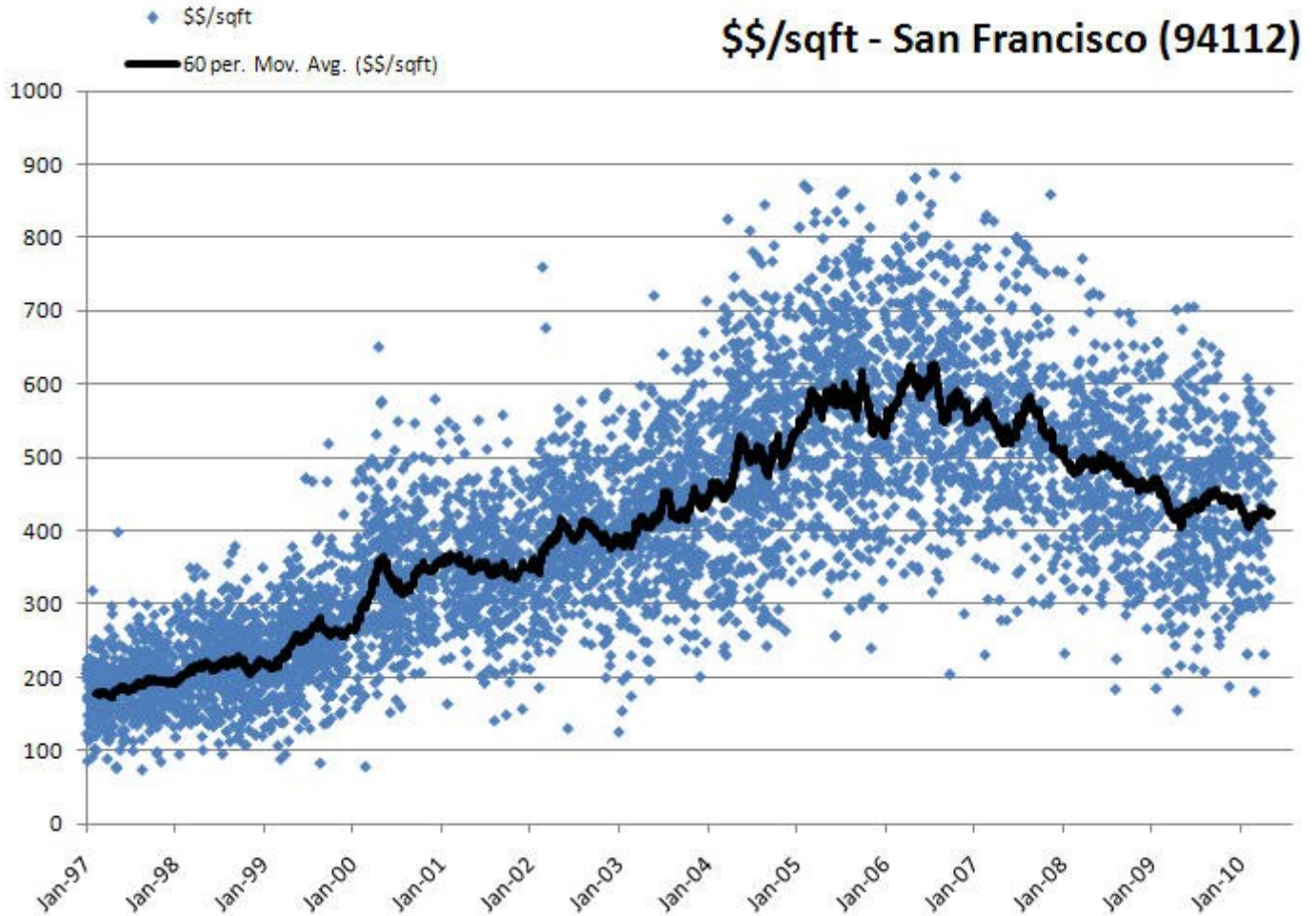


Pittsburg (California, not Pennsylvania) lies about 45 minutes east of San Francisco and is a fairly typical working class community. North of Highway 4, neighborhoods can get fairly rough, but south of the Highway you can find quiet streets and generally affordable homes. Pittsburg schools are not going to win any awards and they are certainly not on par with nearby Brentwood, but then again, home prices are lower too. The price trend here is pretty clear ... up up up DOWN DOWN DOWN flat flat up. The drop in late 2007/ early 2008 was dramatic, to be sure, but since early last year prices appear to have stabilized. And while much of the rebound can be attributed to government intervention into the market to prevent foreclosed homes from being sold, affordability also played a key role in the recovery. Not only is buying at times cheaper than renting, but investors can also earn solid rental yields. These two factors lead to a stronger housing market, government meddling notwithstanding.

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## Talking Charts - Who's Back on Track? - San Francisco

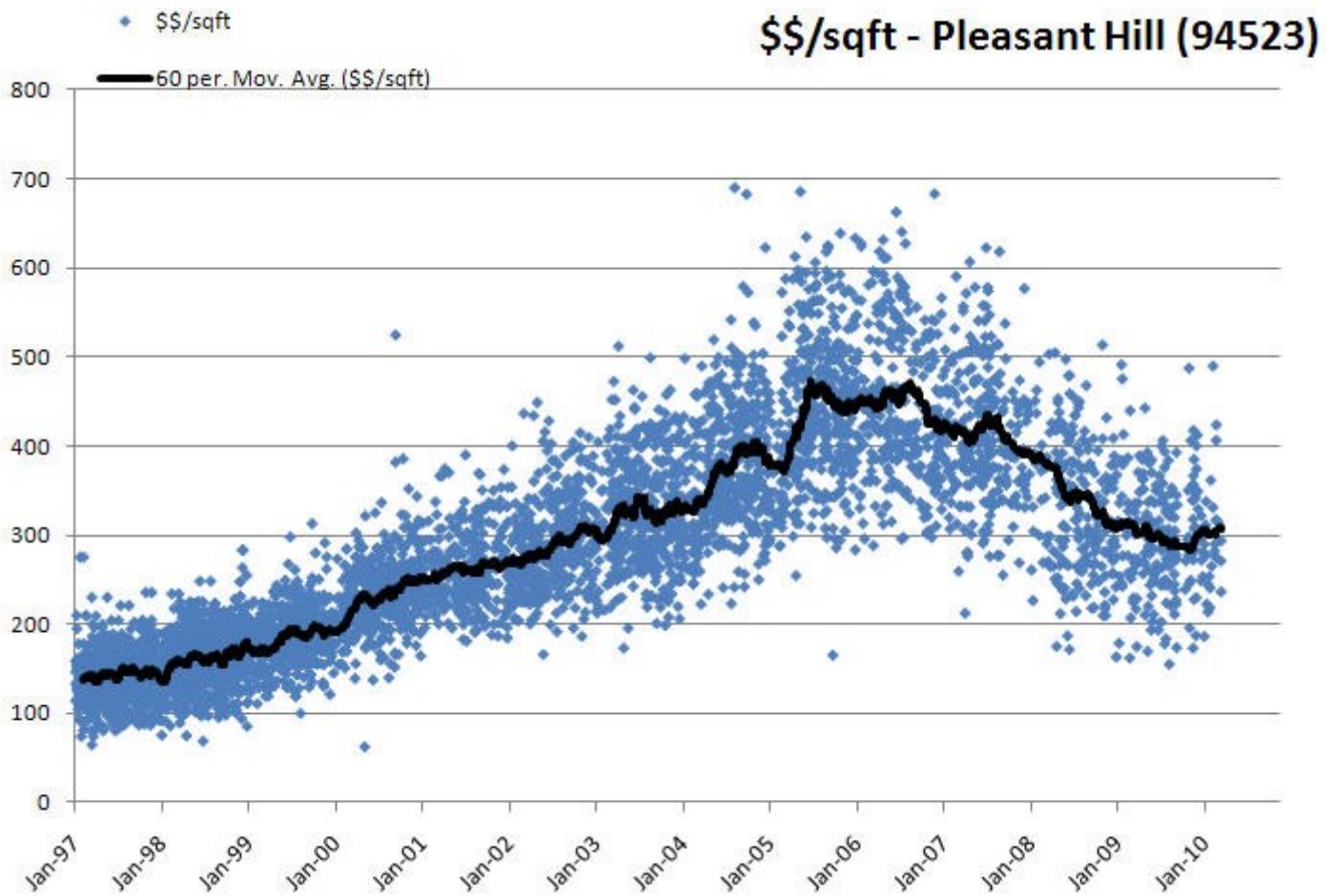


94112 is not the sexiest zip code in San Francisco. Encompassing such neighborhoods as the Excelsior and Ingleside, this suburban, gritty section of San Francisco is far from the city's most coveted spots. Prices are down to be sure, but demographics and affordability bode well for these fringy areas. Single Family homes remain one of San Francisco real estate's most prized possessions, and this zip code is chalked full of single family homes. As buyers are forced to move further and further from the city center to find affordable housing, this area should benefit from its relatively low prices. As for demographics, these ethnically mixed neighborhoods are home to populations where the middle class is growing, not shrinking. Think of it like comparing the developed world (Pacific Heights) to the developing world (Excelsior). Developed countries grow more slowly while developing countries expand at a sometimes blistering pace. True, less established areas are often more susceptible to economic headwinds, but remember the bit about wanting to be where the people are going, not where they already area.

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## Talking Charts - Who's Back on Track? - Pleasant Hill



Pleasant Hill is a quick 35 minute drive from San Francisco through the Caldecott Tunnel or one stop past Walnut Creek on BART. Not quite as nice as Walnut Creek but a touch better than Concord, Pleasant Hill is a, well, "pleasant", option for homeowners looking for a desirable area, quiet streets and big lots. Home prices were slow to stabilize last year, likely since Pleasant Hill had a fair number of aspirational homebuyers who moved up too far, too quickly during the boom. But since last summer, prices have popped as investors and regular home buyers have found value. Similar to 94112 in San Francisco, Pleasant Hill could be classified as a place where people are going, not necessarily where they already are.



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