

CIRIOS TRENDS

SPECIAL EDITION: FOUR REAL ESTATE INVESTMENT THEMES FOR 2011



The State of the Markets: The Year Ahead

I settled into the rigid chair, personal space all but non-existent in the crowded ballroom. The speaker rose, lights dimmed and a hush fell over the several hundred commercial real estate professionals attending the 2011 State of Real Estate Forum. The first slide went up. The crowd released a nervous chuckle. I felt the hair on the back of my neck rise. My stomach churned and I flashed back to the weekly sales meetings in Manhattan circa 2007 where cocky mortgage traders tried to calm jittery bond salesman fielding calls from fearful clients. It's the nervous din of uncertainty: the sound of sweaty fingers crossing.

"Thank Heaven For 2011."

A clever tagline for a bunch of real estate stiffs, catchy and indicative of a group that's battered, but not quite defeated, hoping beyond hope that this year couldn't possibly be as bad as the last few. Slides slid by, compelling graphs and data explained that, after three years of dismal performance, the economy appeared to be back on track, jobs were slowly returning and maybe, just maybe, the worst of the real estate market's downward spiral was behind us.

I actually went into the conference with similar feelings, that risk-reward has flopped and despite persistent headwinds, opportunity outweighs risk if you focus on the right locations, the right properties and the right strategies. But this widespread opti-

mism spooked me. Here is a group with such extensive experience, insight and market knowledge that they were blindsided by the market's collapse. And now their breathing of a collective sigh of relief made me nervous.

The speaker droned on, slides blended together and the infectious optimism spread through the crowd like a slow, persistent wildfire. The Bay Area market was different, we were told. And perhaps it is. The economy is on the mend. And perhaps it is. Inflation looms. And perhaps it does. With prices down, there is nowhere to go but up. Perhaps. But perhaps not.

In this issue of Cirios Trends, we highlight four real estate investment themes for 2011. As you will see, these are not necessarily four strategies we endorse as the best buying opportunities out there, but rather four ways to frame the housing discussion this year in a more optimistic light. We are not without challenges ahead, massive macro-economic imbalances remain from historic intervention by both the federal government and the Federal Reserve.

But despite this, and despite the fact that a room full of suits are cheering for 2011, we at Cirios remain cautiously optimistic. Bullish may be too strong a word, but the time for bearishness on real estate, we believe, has passed. Perhaps.

Chart of the Month Homeownership Rate Falls to 1999 Levels



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Multi-Family Properties: Have We Come Too Far, Too Fast?

While most of the positive press in 2010 surrounded the single family home market, perhaps no segment fared as well last year as apartments. Investors piled into multi-family properties for a host of reasons, which leaves the sector at a critical crossroads for 2011.

First, a quick tour of last year's data. According to Integra Realty Resources 2011 IRR-Viewpoint, the multi-family sector is typically the first to turn around after a recession, and 2010 was no different. Integra saw 81% of US markets recover or begin an expansionary phase, compared to just 9% in 2009. Vacancy rates dropped dramatically, a finding echoed by REIS: Nationwide vacancies dropped to 7.1% in Q3 of last year.

A major factor pushing down vacancies was a snap back from the massive demographic upheaval of the Great Recession. According to Marcus and Millichap, between 2005-2009, the number of 18-34 year-olds living at home increased by 2.2 million, the highest level recorded in the past 25 years. Since this demographic is the highest population of renters, vacancies skyrocketed as the economy soured.

But vacancies started dwindling as the economy slowly got back on track. Call it pent-up demand to move out of mom's basement: As young adults began to find jobs (or became more hopeful they would do so soon), they moved into their own places in droves. Further, the housing market's dramatic collapse coupled with tightening mortgage guidelines is forcing many young people to delay the home buying decision for more clarity in the market's future.

Meanwhile, falling vacancies and an influx of investor cash pushed down capitalization rates to levels not seen since before the crash. During the early stages of the downturn, investors raised huge pools of cash to buy up distressed commercial properties as banks foreclosed on troubled borrowers and pushed the buildings out to market. But as Washington encouraged lenders to extend



loans and modify terms, the flood of distressed properties never came.

Marcus and Millichap noted that the pendulum has swung full circle, and that 2010 exhibited a flight to quality trend, as investors focused on geographic markets with strong liquidity characteristics and resilient economies. New York City, Washington DC and San Francisco have been the beneficiaries of investor money seeking high quality, cash flowing assets. Cap rates, as a result, have compressed, leading some observers to wonder if the apartment market has gotten ahead of itself.

Rental Vacancy Rate



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Multi-Family Properties: Have We Come Too Far, Too Fast? (cont.)

Here in San Francisco, there has been a marked change in the rental market just in the past six months. Gone are the days where tenants could negotiate a lower rent or get a couple months free. Back are the days where multiple applicants are common and the most pro-active prospects show up with deposit checks and completed applications in hand. Rents have risen in kind, as employers like Twitter, Salesforce.com, Zynga, Trulia and others are doing their part to repair the battered Bay Area employment market.

A second trend, which has been noted both nationwide and locally, is the divergence between high end and mid-low end buildings. Just last week, the popular economic blog Calculated Risk noted "the apartment market has bifurcated. Upper half of apartments are improving, regardless of geography. Lower half are struggling." This echoes Marcus and Millichap's view that there is a flight to quality ongoing.

So where are the opportunities, if big players are snatching up all the "high quality" properties and banks are delaying the flushing of distressed assets onto the market? The answer, in our view, lies somewhere in between.

As anyone who has spent considerable time as a renter can tell you, landlord quality varies widely, if not wildly. Often, owners of small buildings (duplexes, triplexes, etc) can offer high touch, personal service, resulting in a good tenant experience. On the other end of the spectrum, large institutional landlords may be impersonal, but generally their service adheres to a reasonably acceptable

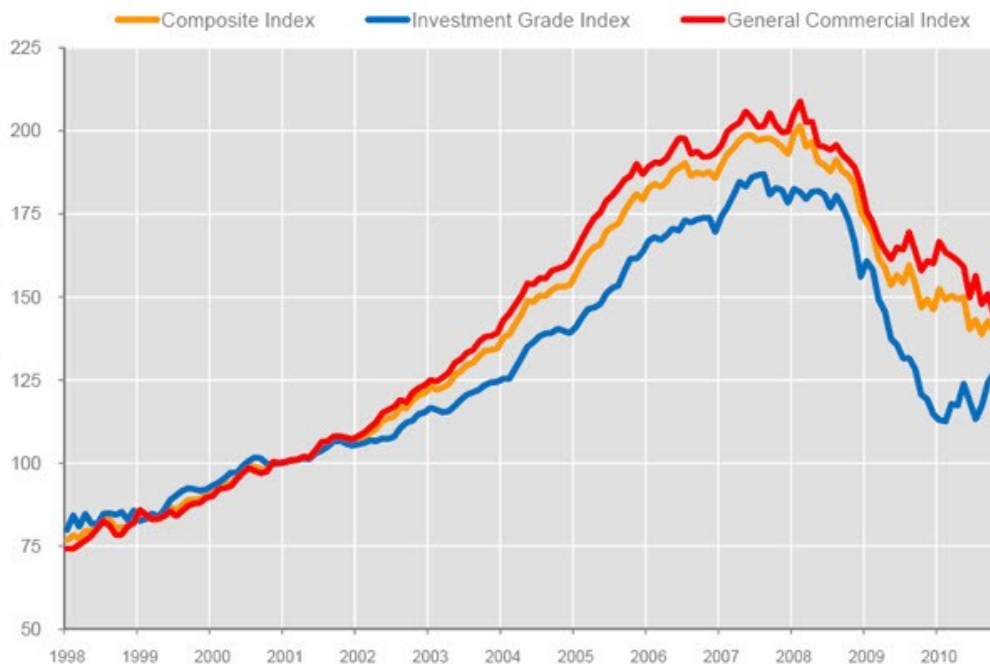
level of quality. Meanwhile, there is a middle band of properties that lie somewhere beyond the scope of the small-time landlord but below the radar of the institutional owner. Typically in the 5-30 unit range, these buildings are often older, landlords less pro-active and amenities lacking. Low rents can be found, but tenants likely have to settle for outdated kitchens, old appliances and fairly mediocre living conditions.

This is particularly true here in the Bay Area, where large numbers of such buildings were constructed during the 1950s and '60s. Many of these properties have been owned by the same individual, family or small investment collective for decades and haven't been updated since Reagan was President, or before.

Rents are low, systems are out of date and the properties in general are in need of some love. The opportunity exists for savvy buyers to come in, make smart improvements, raise rents, lower operating costs and dramatically increase the value of the property. Couple this straightforward, time-tested investment strategy with downtown redevelopments ongoing in cities like San Mateo, San Carlos, Redwood City and Sunnyvale and you have a recipe for opportunity.

Of course, such properties are scarce and sellers often unwilling to bring prices down to where it makes sense for an investor. Which begs the question, where are the real sellers and will they finally come out of the woodwork in 2011?

National Composite Resale Price Index



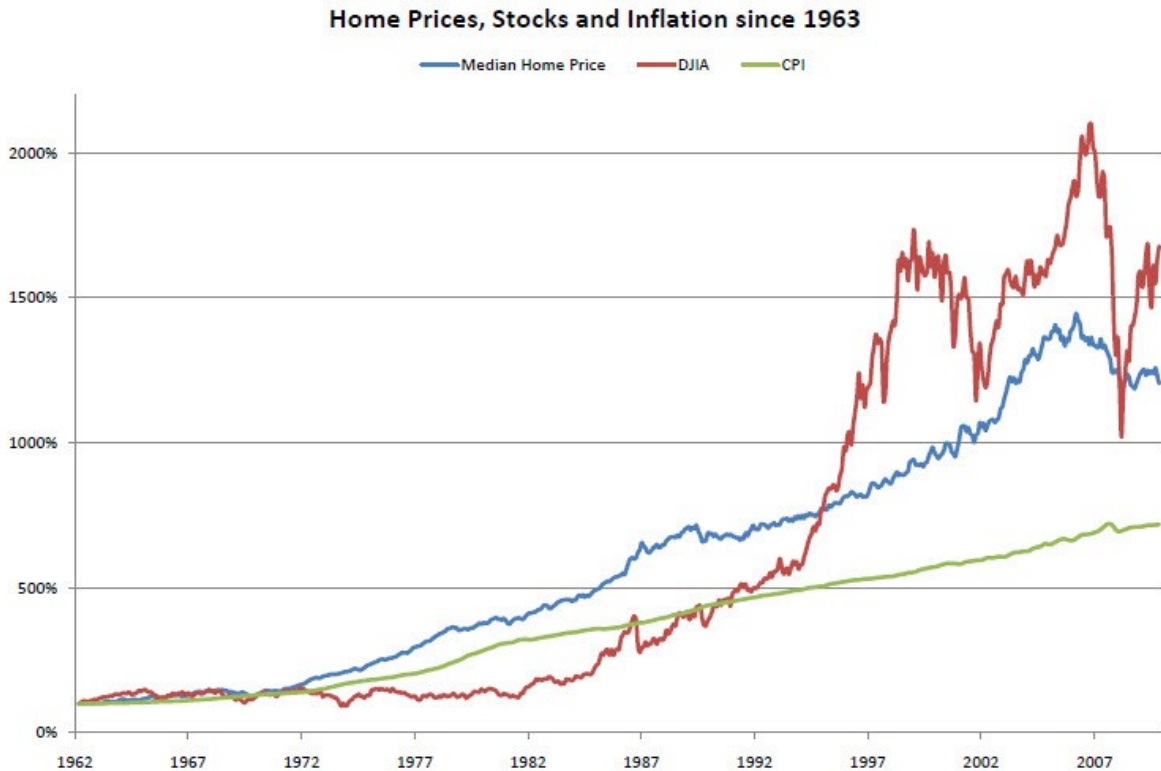
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If You Fear Inflation, Should You Buy Real Estate?

It often gets thrown around that owning real estate is a good “hedge” against inflation. That is, real estate prices will inherently rise under inflationary pressures. As far as conventional wisdom goes, this seems to be the case. But does this rising inflation = rising real estate prices relationship actually hold true? To investigate this idea further, we looked at three separate data time series: National Median Home Price, Dow Jones Industrial Average (DJIA) and Consumer Price Index (CPI, a measure of inflation).

As you can see in the graph below (all lines are expressed as the percent change starting from January 1963), home prices have consistently outpaced inflation by a wide margin. Even the recent real estate market meltdown hasn't brought prices back down to inflationary levels. By contrast, the stock market had been growing at below inflation levels until the early 90's when it exploded, even surpassing home price growth.



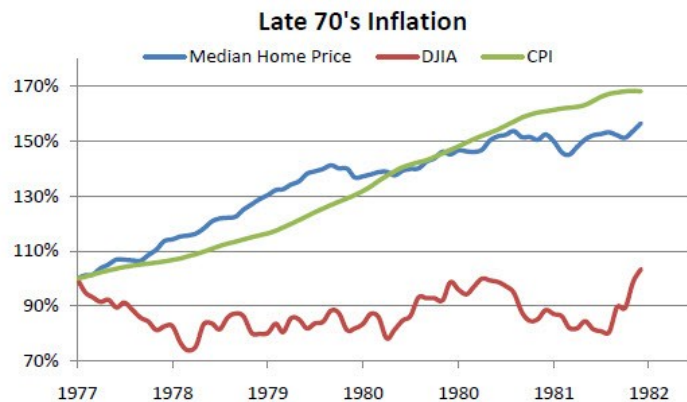
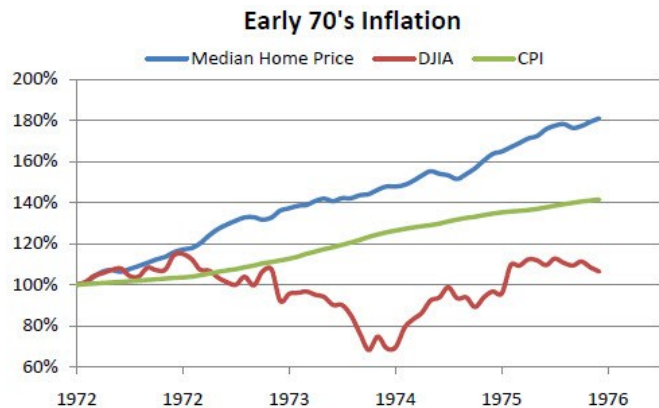
This type of broad, long term analysis can be a bit misleading, however, as most of us did not buy a house in 1963. By looking at the same percent change analysis for smaller time periods we can get a better feel for how a real estate investment might fare versus inflation over a more reasonable time scale. We looked at three historical periods of high inflation to ascertain how home prices fared during those times.

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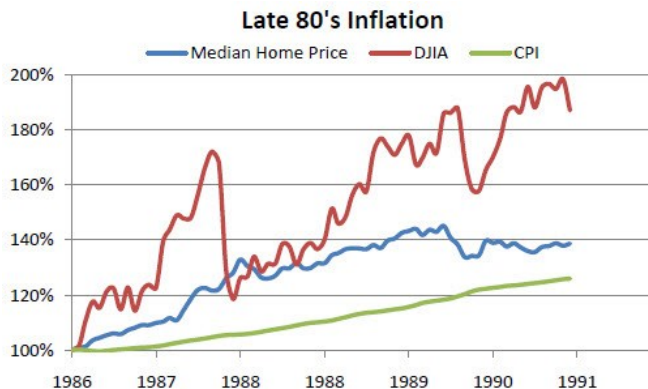
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If You Fear Inflation, Should You Buy Real Estate?

As you can see, during the heavy inflationary periods of the early and late 70's, real estate did indeed provide an excellent hedge against inflation. Home prices essentially kept pace or outpaced CPI growth during these periods while the stock market stagnated. From a basic perspective, therefore, a dollar would have been smartly invested in real estate during this time.



Interestingly, looking at a more recent time period, the late 80's, real estate again outpaced inflation (much more modest inflation this time than the 70's). However, over the time period shown here (1986-91), the stock market more than outpaced home price growth at almost all times (the exception being the '87 market crash). So in this case, in hindsight, a dollar would have been more smartly invested in the stock market than in real estate.



To conclude, historically speaking, real estate investment has been a good inflation hedge, particularly during periods of high inflation when other market growth stagnates. Of course, this is a vast over-simplification of the picture, as evidenced by the stock market growth of the late 1980's. Furthermore, individual real estate markets can behave wildly different from national trends. It is also important to note that on smaller time scales, fluctuations in both inflation and home price trends do not correlate exactly, meaning that inflation is not as significant a price driver for real estate than some might have you believe.

In general however, it is safe to say that real estate values are not likely to be pushed down in any material way by inflationary pressures. As diversity is the key to any long term success in investment, real estate has to be included in any portfolio.

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Is Equity Sharing the New Way Forward in Housing Finance?

Since mortgage giants Fannie Mae and Freddie Mac collapsed in September 2008, housing experts and policy wonks alike have searched for a way forward with these two crucial pillars of the housing market. But each proposed solution, whether it includes a break up, wind down, privatization, or some combination of all three, fails to address the root of the problem: Too much debt.

We don't need just need to figure out what to do with Fannie and Freddie. Rather, we need a sustainable system for financing residential real estate that is not so heavily reliant on debt. Equity sharing, the process by which a third party investor injects risk capital to the housing transaction in exchange for a partial equity stake in the property, is one such possible solution.

Fannie and Freddie, with their implicit (turned explicit) government backing, drove down the cost of mortgage debt, expanded the availability of credit and helped fuel home price appreciation. This worked great, until it didn't. The system became highly unstable and ultimately crashed, largely due to the excessively high levels of debt Americans had used to purchase homes.

As any seasoned investor will tell you, asset depreciation can be tolerated and absorbed if risk is managed correctly. A key component of that risk management is smart use of leverage. Without leverage, losses take on a 1-1 ratio with the investment. That is, bet \$100 to lose \$100. But with leverage, the scales tip, and can do so dramatically if investors (or borrowers) are only required to post a fraction of the purchase price in equity. Even a "safe" mortgage where a borrower puts down 20%, is akin to betting \$20 to lose \$100. Add some zeroes and potential losses pile up quickly.

According to Freddie Mac, as of December 2010, the total value of US housing stock was \$16.5 trillion, down a cool \$7 trillion from the peak in 2006. Underpinning this dizzying large number is \$10.1 trillion in debt, for a total current loan to value (or "LTV") of 61.2%. Taken at face value, that actually doesn't sound too bad. But dig into the data and its easy to see why most experts agree the housing market in this country cannot truly heal without some sort of material change to the way homes are financed.

At last tally, around 11 million US homeowners are underwater on their mortgage, meaning they owe more than their home is worth. With the median home price hovering around \$180,000, that means about \$2 trillion in housing stock is stuck, trapped in a negative equity situation that will either be resolved by default and eventually foreclosure, a modification or workout scenario, or simply through waiting and hoping appreciation comes back. Put another way, a full 1/3 of our excess housing value is immobile, paralyzed.

What the system needs is a structural process for injecting equity and paying back debt. Homeowners need to recapitalize their balance sheets at more sustainable levels, which would not only allow underwater borrowers to sell, but greatly reduce the portion of individual discretionary income that goes towards debt service. Pay less interest, buy more stuff, stimulate the economy, create jobs.



Wash, rinse, repeat.

The challenge of course is where to find this admittedly sizable chunk of cash. Why, the free market, of course.

In a rare show of legislative foresight, Congressman Gary Miller (R-CA), introduced a bill last September that would launch a pilot program through the Federal Housing Administration for "equity sharing" as a way to reduce our dependence on debt to finance the purchase of homes.

Equity Sharing, while containing certain complexities, is relatively straightforward. A homeowner finds an equity partner to help pony up cash for a down payment. The homeowner retains the obligation to make the monthly mortgage payments, but in exchange for the down payment assistance gives up a chunk of home's equity. The equity partner is silent(ish) in that he or she doesn't get to pick carpet or paint colors, but the homeowner is obligated to maintain certain levels of responsible home maintenance.

Far from just another way to make it easier for individuals without much money to buy houses, equity sharing programs inject risk capital into the housing finance system rather than debt. That is, equity investors stand side by side with homeowners and take the first loss if housing prices fall, providing lenders more cushion and ultimately less risk on their loans. More equity (and consequently less debt) creates a more stable, less risky housing market.

Equity Sharing has applications in distressed housing situations as well. Third party equity investors can inject capital into underwater mortgages, enabling borrowers to lower LTVs to acceptable levels for a refinance.

And while far from a silver bullet to solve our country's housing woes, equity sharing is a start. Already firms are popping up looking to set up equity sharing transactions. Steve Cinelli, CEO of Primarq, an equity sharing facilitator headquartered in the Silicon Valley, is optimistic about the industry's potential: "[Equity Sharing] sets forth a direction for more affordable and sustainable homeownership, more prudent lending practices and a reduction of the role of government in supporting a most critical element of the US economy."

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Location, Location, Location: Let The Data Be Your Friend

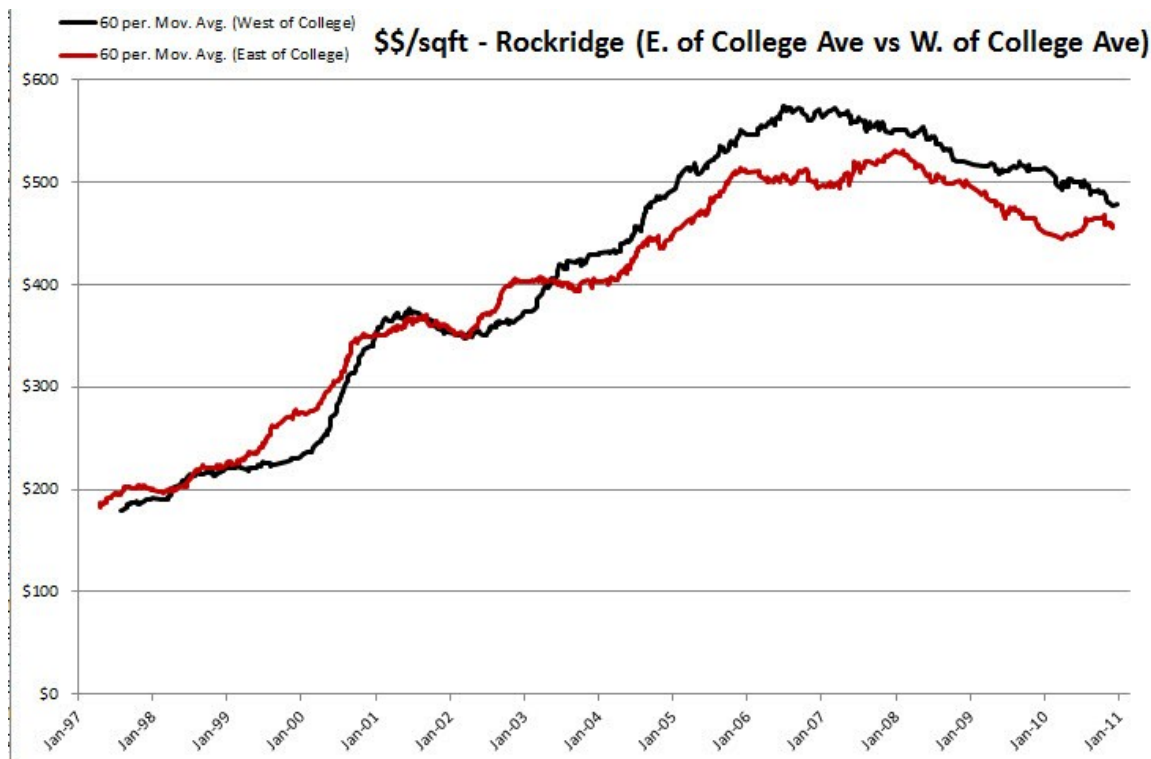
What could be the oldest adage in all of real estate has never been more true: Location, location, location. According to the Case-Shiller Home Price Index, a widely watched gauge of home prices in major metropolitan areas around the country, only four cities experienced net gains in home prices in 2010: San Francisco, Los Angeles, San Diego and Washington DC. Yet, it was widely reported throughout the year that the housing market was on the mend.

And now with nationwide home prices back down to where they were in 2003, many are wondering if now is the time to jump back into the market. The answer is, of course, complicated.

A great way to begin your assessment of how risky buying a home may be is digging into the data. But what data? Average sale price, Median sale price, price per square foot?

Using the Oakland neighborhood of Rockridge, one of the most popular places in the East Bay for young families to live, as a proxy, we drilled down into localized data to show how simple data analysis can help identify market trends on a truly street-level. Rockridge's main drag, College Avenue, is packed with bars and restaurants just a few short blocks from BART. Its logical that living close to College carries a premium, but let's examine whether there is a difference on the east of west side of the street.

As our readers know, we often use price per square foot to examine value trends over time, so let's look at Rockridge.

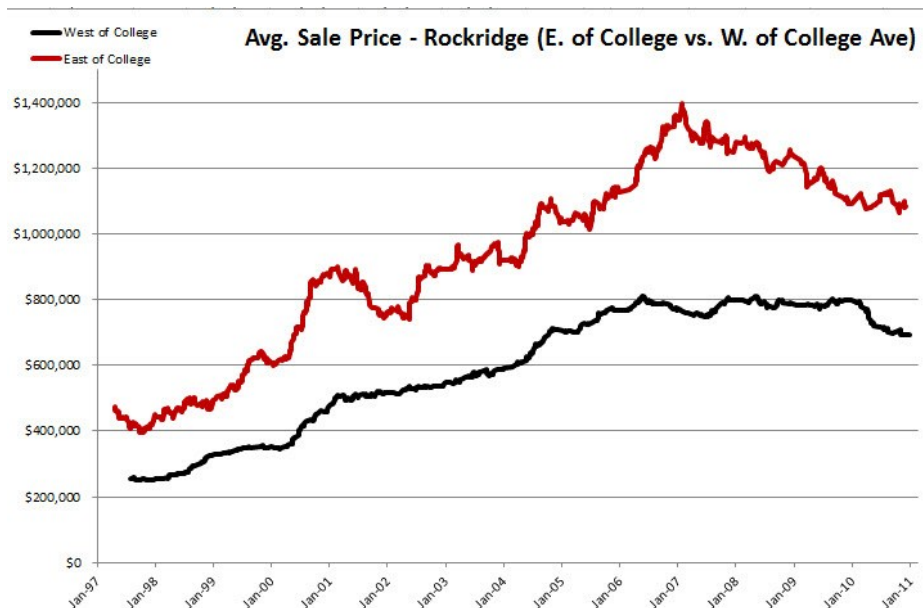


While values on each side of College have fluctuated a bit, by and large the value trends have tracked closely without much spread between the two areas. If the ended the analysis here, one might determine that it didn't really matter on which side of College you bought. But we know better, that price per square foot only tells part of the story. So we looked at a rolling average sale price for the previous 60 transactions to see if the two sides of College Avenue really were that similar. Looking at the graph below, its clear to see they are not.

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Location, Location, Location: Let The Data Be Your Friend (cont.)



It's pretty clear then that there is a marked difference between the east and west sides of the street. Armed with this knowledge, we can set to figuring out why. It turns out that College Avenue, in addition to being the main drag, is also a school district boundary. Elementary schools on the east side are some of the highest quality in the state, while those in the west are mediocre at best.

Why then did the price per square foot graph tell such a different story? The answer lies in home size. On the east side of College, where home prices are far higher, the average home size in this data set is around 2,400 square feet. Over in the west, it's just under 1,500 square feet. All things being equal, smaller homes will command a higher price per square foot, since as you add more house, the value of that incremental living area diminishes. It makes sense, adding 1,000 square feet to a 1,500 square foot home almost doubles the size, while tacking the same addition onto a 2,500 square foot home doesn't make nearly as big a difference.

This dynamic can be clearly seen on the previous graph, where the superior neighborhood (the red line), actually has a lower price per square foot than the one with the inferior schools. If we had stopped at price per square foot, we might have wrongly determined that

there really wasn't much of a difference between the two sides of College Ave.

This analysis then begs the question, what is the point of looking at data to figure out where school and other value boundaries, when local real estate experts should have the same information? A fair argument, and one we often hear when we venture outside our back yard and try to tell real estate agents what (they think) they already know. But what if a buyer wants to live within a 30-minute commute of San Francisco, send their kids to a public elementary school with an API score above 800 and be within walking distance to a downtown with shops and restaurants?

Rather than calling a dozen real estate agents and getting their biased view on why their local area is better than the rest, smart data analysis can help narrow down a search by using consistent metrics to get an untainted view of markets on a localized level. Only by combining data analysis, local market expertise and an understanding of macro trends affecting a region can one get a complete view of home price trends down to a street level. Armed with that knowledge buyers can set out to make smart buying decisions — even if that decision is to keep renting.



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