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The Coming Bottom in Real Estate. *by John Dumke*

In 1996, Penny and I had dinner at the “upper crusty” Canyon Club in Newport Beach with her great Uncle Bill. The conversation flowed to real estate and at some point great Uncle Bill emphatically stated that “It’s time to buy”. Not only was he right, he nailed it. You see, uncle Bill had been in real estate his whole life. He helped sell many of the real estate developments in Palos Verdes, Yorba Linda and Palmdale from the 1950’s - 80’s, and was proud of stating that his entire social security check paid for his Canyon Club dues. While not super wealthy, he had done well.

His observation was that real estate always went up. I argued “not for the last 5 years”. After all this was 1996; we had just experienced a long 5 years of continual decline. Was he just an old feeble man? No, he explained, in his own rational, “prices in 1989-1990 weren’t real”. But somehow the \$200,000+ in my personal lost equity felt real. I still questioned his sanity. But after he explained his rational, that home prices in the 1989 - 1990 weren’t real, I began to see his long term view. There was wisdom to his statement and long term perspective. A crystal clarity, separating the overall trend from the booms and busts, and an awareness of value. He instinctively knew when the market made sense and when there was “Madness of the Crowd”.

Despite taking a personal shellacking on my personal real estate assets, I heeded the words of my elder, and reluctantly got back on the untamed bucking bronco that is California real estate. That month Penny & I made an offer on a home, taking a leap of faith that we were not throwing good money after bad.

Now I can’t say that I am as prescient as my wise old Uncle Bill, nor do I think that this will be the exact year that real estate bottoms, but it’s close, or may just bump along sideways for a couple of years. I do feel that most of the risk is out of the market, and it is a good time to consider expand-

ing real estate holdings.

How is it that I think I can deliver this good news, albeit, possibly prematurely? Four sign posts that a bottom is near are: recent significant price drops in previously stable neighborhoods, valuations relative to rents are favorable, market sentiment is dire, and finally cash sales are prevalent.

Prices Drop

The first reason that good news may be on the horizon, is due precisely to bad news. Real Estate prices have taken a pretty big beating over the last year.

The first two thirds of 2010 were relatively stable. The \$8,000 tax credit was in place. This was a big benefit for buyers looking to purchase a \$350,000 home with 3.5% down using an FHA loan. \$8,000 represented half of the

\$15,000 total required to close escrow. This turned many “maybe” buyers into “can do” buyers. The trickle up effect also helped. The homeowner selling their \$350,000 home would need to buy a replacement.

But with any well meaning government program there are unintended consequences. It is my contention that this \$8,000 credit did not in aggregate increase demand, it only shifted demand from the future into the present. So the unintended consequence is that post stimulus, the market got “quiet”. Quiet isn’t good, if demand drops, and supply doesn’t, then prices yield. It is one of those important economic rules “supply and demand”.

So the bad news is that prices have declined significantly since last year. My seat of the pants gauge says between 5-10%. Further investigation shows that prices in the East Long Beach tract areas dropped 9.6% while prices in the trade up areas of Belmont Heights, Belmont Shore, Park Estate etc. dropped 11.6%



East Long Beach tract areas 9.6% drop

Jan-Aug 2010			Nov 10 - Mar 11		
# Sales	Ave SqFt	Ave SP	# Sales	Ave SqFt	Ave SP
307	1,464	\$475,600	129	1,388	\$429,800

Trade up markets 11.6% drop

Jan-Aug 2010			Nov 10 - Mar 11		
# Sales	Ave SqFt	Ave SP	# Sales	Ave SqFt	Ave SP
178	2,059	\$881,700	56	1,956	\$779,300

North Long Beach 3.3% drop

Jan-Aug 2010			Nov 10 - Mar 11		
# Sales	Ave SqFt	Ave SP	# Sales	Ave SqFt	Ave SP
410	1,146	\$242,400	116	1,102	\$234,800

These are BIG drops. During the 4th quarter of 2007, prices dropped about 10% in only 4 months which was the tip of the iceberg. This last drop will be the drop that formalizes the bottom.

“Let Them Eat Cake” - Now the Cake is gone

When the credit crunch hit in 2007, it most widely affected entry level markets. Prices in North Long Beach corrected the most, along with the inland empire. Yet prices in East Long Beach, during this initial correction, avoided the brunt of the storm.

In my 4th Quarter 2008 article “Tale of Two Cities” available online at www.LBRE.com, I noted that the prices in the East Long Beach areas had only fallen 15% from peak, while Lakewood corrected 24%, North Long Beach corrected 35% and the inland empire corrected as much as 49%. I called these initial two years of the correction a “Marie Antoinette” correction, where the wealthier neighborhoods remained less affected.

This is no longer the case, because during this last year the wealthier areas bore the brunt of the damage. In fact the entry level market of North Long Beach remained relatively stable, with only a 3.3% drop over last year. The entry level markets had already been devastated and their valuations area being supported.

I believe that this last significant correction in the wealthier areas is a final piece to the puzzle, making valuations attractive across the board, and North Long Beach's stability is confirmation of this theory.

Sentiment - A Contrary Indicator

There are two extremes in the perceived value of home ownership and often times they are counter to what the future holds in real estate because they are based upon recent past. When homes have gone up wildly for years

owners feel their homes are made of gold. In a way, this is the case because home ownership IS better than owning a gold mine when homes go up 20 - 30% per year. But when prices have declined for years like 1990 to 1995 or 2006 to 2011, homeowners aren't feeling too hopeful.

This is strictly anecdotal information, but how homeowners as a group respond to the following question “What do you think your home is worth?”, offers some telling insight. When prices have just peaked and are no longer going up, homeowners will still believe that last years price plus \$50,000 is a realistic possibility. “You mean homes don't automatically go up \$50,000 every year?”. What I noticed during the previous bottom of 1995 was that when asked this question, it was not atypical of a homeowner to respond “I don't know how much my home is worth, I just hope I can sell it.”

This was true capitulation. No longer did homeowners consider price the objective, just getting a home sold would be considered victory. Now I don't see this type of sentiment in the marketplace, but with this latest year over year price drop of an additional 10%, it would not surprise me if I hear this phrase repeated once or twice over the next couple of years. When I hear an owner respond with this answer, I will know that prices are about to rise.

Valuations

One of my quick gauges of value is to compare a homes mortgage payment versus the rent. In the 4th Quarter of 2005, I wrote about homes being 40% overpriced relative to rent. You can read this 2005 article on our website at www.LBRE.com. Look for newsletter archives. The exact details can be read in this 2005 article, but here is a summary. Calculate the total payment with 10% down and multiply this total payment times 75% which takes into consideration the tax advantages of home ownership and compare this number with fair market rent.

A brief history of this valuation metric at previous market peaks and bottoms is as follows:

1990 Market Peak - 28% Overvalued

1996 Market Bottom - 13% Undervalued

2005 Market Peak - 40% Overvalued

Let's run today's number on an average East Long Beach home. The average 3/2 in East Long Beach is now selling for about \$430,000. The total payment at 5% interest with 10% down would be \$2590, then times 75% eliminates the tax advantages which equals \$1,942, a rent relative cost. This three bedroom, 2 bath home would probably rent for around \$2,200. This exercise shows that homes are 13% undervalued. Surprisingly, this was the exact number, 13% undervalued, that my 2005 article showed for the previous bottom in 1996.

During 2009 and 2010 this valuation metric showed homes at fair market value. But markets always go to extremes. Certainly, being able to purchase a home and have it cost



less than renting the home is a big incentive to buying. Then just on a simple cash flow basis it makes sense to buy. It no longer matters whether home prices go up or down. This undervaluation will help support prices during this coming year.

Cash Sales Play a Big Role

Anecdotally, I can say that just last month Penny and I sold two homes in Alhambra Heights, where the buyers purchased homes in the mid/upper 600's all cash. All cash transactions area really pretty rare.

Not anymore. The LA Times reports all cash purchases in January 2011 represented 30.9% of all condo and home purchases throughout the state. The March 1st article further stated:

Overall, cash deals constituted 27.8% of Southern California home sales in 2010, the most since DataQuick began tracking the market in 1988. It's also more than double the 13% average for cash sales over the last decade.

It reflects speculation by wealthy investors who believe home prices are at or near a bottom.

My thoughts exactly. Never in 22 years of real estate have I seen such high levels of cash purchases. Stable and capable buyers stepping in are certainly an indication of a coming bottom.

Outlook & Summary

My great Uncle Bill has since passed away at the ripe old age of 86, so I do not have him to consult. However I do believe that he would agree that the previous indicators discussed are the precursor to a new market bottom.

However, a bottom doesn't mean prices will now take off. Quite the contrary, it will take awhile for this bottom to play out. My guess is that this will be a multi year process with 2011 as the start. Most economic news reports on what they see in the rear view mirror. So it is likely you will hear bad news when comparing 2011 to last year. 2012 will be the first year with no further price drops.

Moving forward it helps to look at previous market bottoms. Even though 1995 was the first year with flat year over year prices, we really didn't see any significant price increases for another 2-3 years. We also had the benefit of tail winds in the form of a decreasing interest rate environment. However, today's interest rate environment is the opposite. I think the current interest rate environment is artificially low and once the economy picks up we will see higher interest rates. So rather than home prices rising first, we will see higher interest rates be the first to soak up any additional purchasing capacity on the part of buyers. This may put off price increases for another year or two, depending upon how much rates may rise.

Conclusion

The bottom line is that I am trying to give you some insight into what I think will now be a very good buying opportunity. For the next two years it will be time to keep your eyes open and consider whether or not purchasing an investment property will make sense. A famous statement about investing, is that "You make your money on the purchase". Many might think that you make your money when you sell, but it is by buying "value" at the right time, that drives your eventual profit. We are embarking on that right time.

Syndication

Seeing opportunity in the real estate market as early as two years ago, Penny and I purchased an apartment building in San Pedro with a long time friend who is also now happily our business partner. Over the next several years I will be evaluating the structuring of additional real estate syndications (the pooling of several buyers resources) to purchase apartments that cash flow. The basis for any purchase will be strict valuation based upon positive cash flow.

The overall goal will be to find residential income property that generates a 7% yield after all expenses, not including debt service. This 7% yield will be based upon the cash flow of the property solely, any appreciation down the road will be icing on the cake.

If you are somebody that would like to benefit from the income property ownership, but don't really want to be actively searching for the right property or managing property, then this type of partnership might work for you.

As this market unfolds, I hope to see some excellent values and would like to have partners already in place ready to capitalize on these opportunities. If you would like to be kept abreast, you can either call me or e-mail me at John@LBRE.com.

REAL ESTATE NEWS

Inside.....

The Coming Bottom in Real Estate.

Four Sign Posts:

- Entry level markets stable
- Sentiment
- Valuations
- Cash sales



La Marina Estates - 6540 DeLeon

3 bedroom, 3.5 bath, 2,240sf., custom pool home with many upgrades.
\$725,000 [More photos online](#)



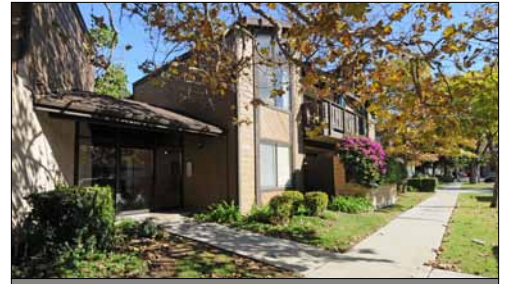
Top of Signal Hill - 2600 Panorama

2 bedroom, 1.75 bath, 1,221sf, panoramic views, top floor, 2 car gar & inside laundry.
\$325,000 [More photos online](#)



Plaza - 3511 Faust

2 bedroom, 1 bath, 1,275sf, great condition, large family room w/ vaulted ceiling!
\$419,000 [More photos online](#)



Los Altos - 1630 Park #3

2 bedroom, 1.75, 2 car garage, inside laundry, patio, feels more like a home!
\$275,000 [More photos online](#)

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