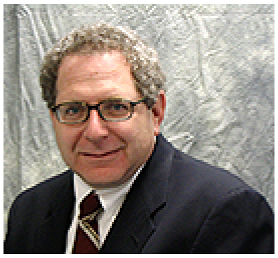

As the Pendulum Swings - Be Careful When Investing

by *Cliff Hockley*

As the stock market attempts to work its way out of its funk, and the national economy slows down, we are faced with decisions involving the transfer of investment dollars from the stock market into real estate.

This would seem like a logical decision to balance your portfolio. But, and there is a but, does it make sense? Many investors have made a nice return from their real estate investments, but they are practiced in their art.

- Last week I met with a client who invested in a TIC investment with a small sponsor and after two years there was no more cash flow. The client was upset by this change after receiving an 8% return on his investment for two years. The sponsor had not set aside re-leasing and tenant improvement reserves.
- In another TIC situation, a client invested in shopping centers that were shadow centers to anchored shopping centers. These shadow centers lost a few key tenants after closing and now they do not have expected cash flow. In this second example, the managing partner had put aside reserves to take this potential into consideration, but the re-leasing took longer than expected.
- The same applies for smaller investors who refinanced their homes to take advantage of the condo boom, and bought condos so they could flip them. Unfortunately, the condo market became overbuilt and they are now stuck with non performing assets. In Florida for example, there is a five year supply of unsold condominiums.

Still, there are many real estate investors in the market place. This spring we have been faced with an additional curveball, the sub-prime crisis. This crisis has placed banks on notice that they were too liberal with their underwriting policies. In response to this crisis many banks have pulled back the reins and tightened up their loan requirements significantly.

This has made it difficult for developers to continue developing and for buyers to continue buying. There are foreclosures in many states that will be leaving a significant impact on the market place. RealtyTrac CEO James Saccacio had this to say in a statement: *"The total number of U.S. properties with foreclosure activity in April was the highest monthly total ….. since … January 2005.... Areas of California, Florida, Nevada, and Arizona continue to be particularly hard-hit."*
Here are the states with the highest foreclosure rates:

	STATE	FORECLOSURE RATE
1.	**Nevada**	**1 filing per 146 households**
2.	**California**	**1 filing per 204 households**
3.	**Arizona**	**1 filing per 224 households**
4.	**Florida**	**1 filing per 242 households**
5.	**Colorado**	**1 filing per 349 households**
6.	**Maryland**	**1 filing per 380 households**
7.	**Georgia**	**1 filing per 422 households**
8.	**Ohio**	**1 filing per 432 households**
9.	**Michigan**	**1 filing per 440 households**
10.	**Massachusetts**	**1 filing per 539 households**

From and article in the US News and World Report, Dated May 14, 2008, By Luke Mullins called The Home Front: http://www.usnews.com/blogs/the-home-front/2008/5/14/10-worst-foreclosure-states.html

These home foreclosures will also affect the commercial marketplace. Office buildings in these states will have greater vacancies and retail stores will have trouble attracting customers if they can't even pay their house payments.

This also forces the banks to pick very carefully among the minefield of loans they have been asked to grant. Last year you could purchase a commercial investment property with 25% down; today a 35% or 40 % down-payment is not unheard of. Debt coverage ratios have been increasing from 1.15 to 1.25 this year. This also covers banks and reduces their risk in the market place if properties do not meet their cash flow goals.

Interest rates will be inching up by the end of the year, as the Federal Reserve tries to stabilize the Dollar and in that way try to control inflation and the stratospheric increase in the cost of oil/ gasoline.

This turmoil has created a yo-yo effect in the stock market, a feeling that is not for the faint of heart.

The real estate market is seeing significant interest from investors who want to diversify out of the stock market and from investors looking for opportunity. From my perspective, we will continue to see low CAP rates for "safe" properties and higher cap rates for properties that have some level of risk and increased borrowing costs.

As the pendulum swings, it pays to be very careful as you invest. Buyers have to put more money down to close deals and they will see more failed transactions, due to banking instability.

Of course this pattern does not hold true in all submarkets, but finding successful markets is a tough job for the investor. What motivates an investor, is knowing that our population will continue to grow over the next 50 years, so the demand is there, but squeezing profitability out of the sale of our real estate investments will be challenging, in the near term.

Real Estate should continue to be a good long-term investment. Now more than ever the use of a qualified team of professionals (real estate brokers, accountants, attorneys) is critical to selecting the right investment that meets your needs over your investment horizon.

Clifford A. Hockley, Certified Property Manager, is the President of Bluestone & Hockley Real Estate Services, which is one of the larger brokerage and property management companies in Portland.   Bluestone & Hockley is an Accredited Management Organization (AMO) by the Institute of Real Estate Management.