



E-llumination

Is this a good time to buy real estate?

August 15, 2006

We have been getting an increasing number of questions lately about whether or not this is a good time to buy real estate. We assume that we are getting the question because people know anecdotally that there is a slow down in real estate, or that one is anticipated.

Real estate cycles are usually very long term and take a long time to play out. Therefore it is difficult to accurately estimate the magnitude and duration of a downturn when we are probably only a few months into the cycle. In general we are advising caution right now when it comes to new acquisitions of real property.

Does that mean that we would unequivocally ignore opportunities in real estate? The answer is no. For example, Meghan and I purchased a new home only four months ago. For all we know that purchase may have been made at the peak of the last bull market cycle. Bear in mind that we also sold a home at what might have been near the peak of the same bull market cycle. So we would consider those events a wash and we love our new home. We consider the “love our new home” part to have been the key consideration in buying and selling. We were not motivated by investment considerations.

Therefore at K&A we have found ourselves answering the question of “whether or not this is a good time to buy real estate” in the following way:

- 1) If you are considering buying a home and your motivation is related to enhancing your lifestyle, and if you intend to stay in the home for five years or more, then go ahead. On the other hand if your motivation is a quick profit we would urge caution. We think the days of quick profits are past for the most part.
- 2) If you have sold rental property and are seeking a tax free exchange then go ahead and complete a purchase to complete the “tax free exchange”. Otherwise we would urge caution.
- 3) If you are buying real estate because you need the property or facility to house or enhance your business in some way, then go ahead. Otherwise we would urge caution.
- 4) If you find an opportunity in the Napa Valley to purchase an older residential or commercial property that you can renovate and “add value to” the odds still favor that you could sell that property for a significant profit. But even those opportunities look tougher to us today than they did a year ago.

We are also asked frequently if we think the Napa Valley is immune to a downturn in real estate prices. The answer is no; it is not immune. Does that mean that prices will drop

here? Frankly, we don't know. But if there is a big downturn nationally we are certainly not immune to participating in that downturn.

We are also asked if the national real estate market is slowing down. If you own shares of REITS you probably wouldn't recognize a slowdown. Most REIT share prices have held up much better than we expected.

On the other hand if you own either residential or commercial rental property outside the Napa Valley you may have experienced symptoms of a slowdown. We know of several owners of rental property who have experienced downturns in one form or another and that leads us to continue questioning the sky high value of some REIT shares.

The publicly traded home building stocks have all collapsed. They are down 40 to 50 percent from their highs. Several of these companies have significantly slowed commitments to new projects. That is actually a good sign that they have learned some significant lessons about managing their businesses since the last time that they went through a downturn in the real estate cycle.

In recent earnings reports Centex, Lennar, D.R. Horton, and Pulte homes ALL reported that they have taken significant write downs related to forfeiting deposits that they had made on the purchases of new land to be used for development projects. In other words, they had all signed agreements of some kind to buy land, and made cash deposits on that land, and then walked away before closing escrow. The amounts that they forfeited were not insignificant, including \$36 million for Centex; \$22 million for Lennar; \$57 million for D.R. Horton; and \$62 million for Pulte.

If you are willing to leave a cumulative \$177 million on the table and walk away, you are anticipating a significant slowdown. We will let those numbers speak for themselves.

Last month Angelo R. Mozilo, chief executive of [Countrywide Financial](#) Corp., the U.S.'s biggest home-mortgage lender, shook up the markets a bit. He told analysts on an earnings conference call that "I've never seen a soft landing in 53 years," He has been in the business for more than 50 years. "House prices are leveling off in many areas and edging down in some." "How low are they going to go?" Mr. Mozilo asked during the conference call. "It's hard to tell. But the trend is down."

MarketWatch.com reported the following story today, "The confidence of U.S. home builders collapsed in August, falling to the lowest level since February 1991, the National Association of Home Builders said Tuesday. The NAHB/Wells Fargo housing market index dropped by seven points to 32 in August, indicating that most builders think the housing market is poor.

A year ago, the index was at 67. A reading of 50 would indicate builder sentiment was balanced between good and poor.

The index peaked at 72 in June 2005 and has fallen in the 12 months since then. It's the fastest decline in the 21-year history of the index, which has had a fairly good record of predicting the number of new homes started. Builders in all four regions of the country are pessimistic about the market.



"Two factors are coloring builders' perceptions of the market right now -- rising sales cancellations and substantial growth in inventories of both new and existing homes," said David Seiders, chief economist for the home builders' industry group. "These factors are largely the result of an increasing number of potential buyers adopting a 'wait and see' attitude because of uncertainty about where the housing market is headed.

Speculators are fleeing the market, he said.

High energy costs are also weighing on buyers' minds, Seiders said.

In August, all three components of the home-builders' index fell. Current sales index fell to 36 from 43, the expected sales index dropped to 40 from 46 and the traffic of potential buyers' index fell to 21 from 27."

So there you have it. Is this a good time to buy real estate? If you meet one of our four criteria then we would say the answer is yes. If you don't, then we would exercise caution. This coming winter could easily turn out to be a better time to be a buyer of most types of real property.

Paul Krsek
For K&A Asset Management, LLC