SOUTHERN CALIFORNIA APARTMENT OUTLOOK
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These last five years has been the “perfect storm” for apartments. Rental rates have increased, vacancy has dropped, interest rates have dropped, CAP rates have dropped**,** and price per units have almost doubled. Property owners have prospered in Southern California.

What is the outlook for the future of the apartment market in Southern California? In order to answer this question we will examine supply and demand, prices, rental and interest rates, financing plus equity participation of overseas funds, government**,** and politics to determine the apartment market outlook.

Real Estate is a local and regional market phenomenon. Nationwide statistics on sales, rents**,** and vacancy rates do not necessarily apply to local real estate markets. The real estate market in Syracuse, New York has suffered from a declining population and job losses. Increasing real estate taxes in New York have not enjoyed the enhanced rents and values that Southern California has experienced in the last five years.

SUPPLY
In coastal areas of Southern California, the supply of housing and development, especially apartments, has been restricted due to high land costs, zoning, environmentalists**,** and cities that get a better tax base from retail than housing. Cities get to keep 1% of the sales tax revenues, which is why companies like Costco Wholesale and certain auto dealerships get special tax breaks and other concessions. Apartments require more aid from their local police and fire departments, social services, health care, and schools than retail. Therefore, cities are not inclined to help apartment developers with density, parking or zoning variances. Most apartments being built today are Class-A, senior citizen or tax credit units.

The supply of housing, especially apartments, is increasing slowly and most of the new housing falls below the affordability levels of most Californians, especially those that live near the coast where land is more expensive. Many of the developers are combining apartments on the top floors of retail properties, which allow the areas that were not previously zoned for apartments an introduction of mixed-use developments that will increase the supply of new apartment development.

DEMAND
In California the demand continues to grow although not as fast in the past few years. This is especially true for areas of Southern California. Population continues to grow both with legal and illegal immigration. Chapman University predicts a 1.5% job growth for California in 2006 and 1% in 2007. The predicted job growth for Orange County is 1.7% (26,000) in 2006 but drops to 1.4% (21,000) in 2007. My rule of thumb is that each new job creates demand for a ½ a housing unit.

Unemployment in Southern California by Counties:

Orange County	3.2%
Los Angeles County	4.9%
Inland Empire	4.3%
San Diego	3.7%

The recent job growth and low unemployment rate will continue to create more pressure on housing availability and rent levels.

HOME PRICES

The median home price in Southern California has continued to increase to record levels (what bubble?). For example:

		Increase over past year
Los Angeles County	$512,500	+16.5%
Riverside County	$415,000	+12.2%
Orange County	$635,000	+13%
San Diego County	$520,000	+6.1%
San Bernardino	$365,000	+22.1%
Ventura County	$608,500	+12.9%

The median home price in California is $562,000 (California Association of REALTORS®). Again, we observe coastal counties with higher values. In Los Angeles County, a buyer making a 10% down payment on $512,500 median price home would have a $462,000 mortgage at 6.5% first loan. A 30-year amortization fixed loan would equal to a $2,920 monthly mortgage payment plus $650 per month for taxes, maintenance and insurance plus possible condominium or PUD dues of several hundred dollars per month or more. Assuming the total cost is $3,600 per month and the housing cost to be 30% of a gross household income, the amount a buyer needs to earn each month is $11,917 or $143,000 per year. Not many buyers can afford these payments and will have to move to an inland area or continue as a renter. The affordability index for Los Angeles County is 12%.

RENTAL RATES VS. APARTMENT PRICES

The apartment rental rate has been increasing about 5-6% and even less in rent controlled areas in Southern California. Vacancy rates remain low at 3-4%. Some examples of median rent levels include:

Irvine	$1,660
Inland Empire	$1,012
Los Angeles County	$1,754
Orange County	$1,754
San Diego County	$1,112

In California, the percentage of monthly income that renters paid to property owners is down to 27.7%. The rental rate increases are slow due to affordability and over-crowding by tenants. So many units have two or three families cohabitating to achieve affordability. If a tenant is making $10.00 per hour (minimum wage is $6.75), they are grossing $1,732 per month and 30% of this amount would only allow $520 per month for housing.

The value of apartments per unit has increased from $80,000 to almost $150,000 in the past few years, almost 90% in many areas of California. Rent should have increased to the $2,300 per month range but have slightly increased 15-20%; a huge gap between value of apartments and the economic benefits (rent) is born. Thus, my prediction is that rent will not increase 60% to cover this gap and prices for apartments will not increase and may indeed fall in the near future as investors turn to retail, industrial**,** and out of state real estate properties.

INTEREST RATES AND FINANCING
Interest rates have gone up from 4.5% to 6.5% or 200 basis points in the last year. The Federal Reserve and its new Chairman, Ben Bernake, continues to raise the discount rate ¼ of a point (17 consecutive times since June 2004). Their reasoning is to keep inflation under control by raising the discount rate and borrowing costs to businesses before passing on these higher interest costs that increase inflationary pressures. The Federal Reserve, in my opinion, will raise the rate to 6% in 2006.

If the Cap Rate is 5% and the interest rate is 7.5% the investor will have a negative leverage. On a million dollar loan 2.5% with 30 year amortization amounts to $3,951 per month or $47,414 per annum. Operating costs such as utilities and maintenance are also increasing**,** so if apartment owners do no raise rent, they may have negative cash flows. These negative or reduced cash flows may lead to foreclosures and decrease in apartment values in the next few years.

GOVERNMENT & POLITICS
The Federal, State and Local Government policies and action have a significant impact on real estate and the economy.

Trade Deficit – United States Trade Deficit increased 19% from $665 billion in 2004 to $791.5 billion in 2005 and predicted to be even higher in 2006. China is the biggest culprit with over $200 billion more goods shipped to United States vs. purchased. Senator Byron Dorgan (D-N.D.) commented that the United States needs $2 billion dollars a day to finance the trade deficits.

Federal Budget Deficit – The Federal Government collected taxes of $2,221.9 trillion in 2005 vs. $1974.8 trillion in 2004, a 12.5% increase. The budget deficit was $326.6 billion in 2005 down from $406.5 billion in 2004 but still is a huge outlay.

If we add $791.5 billion trade deficit to the $326.6 billion budget deficit we have sucked $1.118 trillion out of the money supply, which increases the interest rate for real estate and other business borrowing thus causing inflation. The Federal Deficit is more than $8 trillion and the dollar falls in value vs. other currency. For example, five years ago the Euro cost $.90 and today it is $1.25 in U.S. Dollars. Foreign investors need a higher interest rate to compensate for the weakening dollar and inflation.

OVERSEAS FUNDS

In the past, foreign investors would buy U.S. Bonds if we bought their goods. With the threat of inflating interest, rates have raised but when you subtract inflation and the declining value of the dollar bonds are not attractive. Many foreign investors are now purchasing equity investments in America. For example, a United Arab Emirates Firm (Emaar Properties) purchased John Laing Homes for $1.1 billion in cash. Another United Arab Emirates company tried to buy several U.S. ports earlier this year. This trend may mean foreign investors could prop up prices on trophy-type real estate investments as they see a better return in equity vs. bond investments.

In summary, residential housing and apartments, especially in Southern California, has an imbalance of supply and demand. On the demand side, new jobs are being created, immigration remains strong, and desirability is especially high for coastal areas. Apartment rental rates, however, have not kept up with increases in value thus creating a huge gap. The gap equates to over $600 per month in higher apartment rents to justify new construction. Increased government spending, large Federal budget deficits, huge trade imbalance and the Federal Government raising discount rates resulting in even higher interest rates in the near future, increasing ownership costs, foreign investors are now looking at equity vs. just bonds and stock in the United States. In conclusion, apartment values have probably peaked and will remain flat or fall due to the gap between rent and value. One should anticipate that rent will have to increase 7-10% to cover costs in the near future.