BusinessWeek online

Close Window

MAY 22, 2006

INVESTING IN REAL ESTATE
By Christopher Palmeri

Real Estate: The Going Gets Tougher

Interest rates are rising and markets across the U.S. that have seen phenomonal growth are slowing or declining. What's an investor to do?

SLIDE SHOW >>

The theme music from *Star Wars* played as Bill Rancic, the first winner of TV's *The Apprentice*, bounded onto the stage. Rancic told his life's story. How he made money selling pancakes to his grandmother's friends as a 10-year-old. How he quit his dead end job selling commodities and built a successful cigar-of-the-month club, despite snickers from his old bosses. Then, facing off against Ivy Leaguers and MBAs, he came out on top of one of the most popular reality shows in the country, winning the right to supervise the construction of a 90-story condo building in Chicago for none other than Donald Trump.

"The bumble-bee wasn't meant to fly," Rancic told the enthralled audience. "The wing to weight ratio is all wrong. But nobody told him that. He just went out and did it."

GLOOMY PERSPECTIVES. Judging by the crowd of several hundred attending the recent Celebrity Conference seminar in Beverly Hills, there are a lot of people who want to fly like the bumble bee -- or at least make money in real estate like The Donald. Rancic's appearance was sandwiched between that of Wayne Gray, who was selling a $4,000 DVD and software package to help folks get rich in tax liens, and James "Mr. Real Estate" Smith, whose pearls of investment wisdom included this observation: "What do you think Jesus did for a living? He was a carpenter -- directly related to real estate."

Out in the real world, storm clouds are gathering on real estate's horizon. On May 10, the Federal Reserve raised its key lending rate to 5%, the highest level in five years and the sixteenth consecutive hike since June, 2004 (see BW Online, 5/18/06, **"Will the Fed Go Too Far?"**). The cost of a 30-year mortgage now tops 6.6%, the highest in nearly four years. Fears of continued inflation and rate increases have sent the stock market tumbling. Meanwhile, a closely-watched survey of builder attitudes conducted by the National Association of Home Builders recorded its lowest level since 1995.

The higher rates are beginning to impact home values. The median price of a house in the U.S. peaked at $227,000 in the third quarter of 2005, according to the National Association of Realtors. In this year's first quarter the median price was $218,000. "The boom is over," former Fed chief Alan Greenspan declared in a speech to bond firms in New York on May 18. "I think we can safely say that with a strong degree of confidence."

"CAUTIOUS INVESTORS." Some smart investors are starting to cash out. Houston entrepreneur Andrew Segal made a killing buying up second- and third-tier office buildings in the oil patch in the early 1990s, paying an average of $20 a square foot. He's been selling his properties recently at around $70 a square foot, mostly to out-of-state investors. Who could blame him? A lot of money has been flowing into the sector. According to the Mortgage Bankers Assn., commercial mortgage originations totaled $202 billion last year, a 48% increase over 2004.

Brock Harris, a Realtor in Los Angeles, sees changes afoot in his once-hot housing market. Gone are the days of multiple offers over the asking price and buyers agreeing to waive inspections. "What we're seeing right now is a lot of overoptimistic sellers coupled with increasingly cautious buyers," he says. "That's keeping a lot of inventory on the market." Home sales in Southern California fell 16% in April. "The pieces are in place for price reductions to begin soon." Harris says.

Some categories of real estate may fall farther than others. Take second homes and investment properties, for example. The National Association of Realtors reports that a record 40% of all homes bought last year were not a primary residence for the buyer. The trend is particularly strong among Baby Boomers -- more than a quarter of them own at least two homes. "We've seen a lot of entrepreneurs, a lot of customers trek to that market," says Kevin Kane, a senior vice-president at Fox Chase Bank in suburban Philadelphia. On the New Jersey Shore, Kane had been seeing customers buying $750,000 beachfront homes, tearing them down and building two homes on the lot. "They'd flip one and live in the other mortgage free," he says.

"MAKING A BUNDLE." That game is almost over, Kane says. For one thing, his bank has tightened lending standards, requiring at least 30% down in equity, up from just 10% a couple of years ago. Those buyers now have to come up with a larger percentage of cash for a more expensive home. Kane is predicting a decline of as much as 50% in sales of second homes. "The large scale appreciation, I don't think we're going to see it," he says.

Those still interested in investing are looking in more out-of-the-way markets. San Francisco interior decorator Marjory Graue has bought or sold six properties in the past six years, including two homes in Los Angeles and a duplex in Austin, Tex. She is still sitting on a lot in Los Angeles, even though she's already had plans drawn up for a new home. She waiting until the market cools. "Those contractors are just making a bundle," she says.

Instead Graue recently paid well under six figures for a three-bedroom, two-bath house in Marfa, Tex., an artists' community near the Mexican border. Graue figures she'll spend another $30,000 remodeling the place and then either rent it out or flip it. Her purchase price was so low, she doesn't have a mortgage. "My Dad said Rockefeller bought at 10 cents on the dollars and sold at 70 cents," she says. "I see these people keeping loans on top of loans. I'd rather buy really cheap and sell it to somebody else who'll make some money, too."

DEFY GRAVITY. We all can't be Rockefellers, or even Donald Trumps. But BusinessWeek Online will try to help you hang on to the money you've got -- and maybe even make a little more. In our online special report you can find how wealthy investors play the limited partnership game -- (see **"Buying Property, Minus the Hassle"**) -- and read about five real estate stocks to avoid (see **"Knowing REIT From Wrong"**). We also feature conversations with David Lereah, chief economist for the National Association of Realtors, about his take on the current market (see **"Housing Takes a Deep Breath"**), and author John Talbott (see **"The Growl of a Housing Bear"**), whose book *Sell Now* tells why property owners may wish to head for the exits. And check out our slide show, **"Savvy Steps to Enrich Your Home"**.

Bricks and mortar have been just about the best place you could have put your money over the past five years. What might the next five years hold? You don't have to fly like the bumble bee, you just have to keep your head above the ground.

Palmeri is a senior correspondent in *BusinessWeek*'s Los Angeles bureau