Zeppelin's

Real Estate Tech October 2003

A Newsletter by Zeppelin Real Estate Analysis Limited of the Zeppelin Group
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Have you made a booking, Sir / Madam? No? Please wait: This is what you may experience in a typical restaurant nowadays in Hong Kong as overall sentiment jumps back into positive territory, and the stock market has picked up in both dollar volume and index points. So have apparently real estate investment sales especially in the luxury residential and investment grade office / retail sectors. Coupling with these are decisions taken by the Beijing government to let more Mainland tourists into Hong Kong and to seal the CEPA (Closer Economic Partnership Agreement) deal, an arrangement between Mainland China and Hong Kong whereby the latter can enter the former markets more easily. Globally, market sentiment in the USA seems upbeat too as the latest employment figures show improvements.

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We are very honored to have Mr. Gary Carmell, President, CWS Capital Partners LLC, which focuses on luxury apartment and turnaround property investments, to share his views with us on the USA economy. We would also like to hear from prospective readers / writers who wish to share their real estate knowledge and experience with us.

This quarterly (January, April, July and October) newsletter is circulated freely via email to over thousands of readers including real estate developers, investors, owners, users, financiers, top executives, senior managers, prominent academics and related professionals from Hong Kong and abroad. Our content is / has also been published in newspapers and web portals such as **China Daily**, **Hong Kong Economic Journal** (a Chinese daily), **21st Century Business Herald** (China), **MITCRE Alumni Newsletter**, the **Surveying Newsletter** of the Hong Kong Institute of Surveyors, **Centanet.com, Netvigator.com, Hongkong.com, E-finet.com, Red-dots.com, Realtradex.com, FrogPondGroup.com, Icfox.com**, **PacificProperties.net**, **Soufun.com** and **House18.com**. We had also been quoted in the **Asian Wall Street Journal** and interviewed by **Radio Hong Kong**. We also publish monthly articles and analyses in the months between. This newsletter is now into its **7th year** and **28th** issue.

We also operate a website www.real-estate-tech.com through which we intend to share some of our real estate knowledge and ideas with interested parties. We also make available charts, tables, spreadsheets, reports, and the like for reference, the majority of it being free with some requiring a token fee.

Zeppelin Real Estate Analysis Limited is involved in real estate development, investment, and asset management with a focus on **independent analysis**, investment strategy, and portfolio management. It can also assist in setting up real estate analytical computer systems, software applications and content development. It is part of the Zeppelin Group of Companies which collectively also offers project management, facility management, marketing management, architecture, and capital management services.

What's Going On?

Real Estate Tech, October 2003

By Invited Guest Writer Mr. Gary Carmell, President, CWS Capital Partners LLC

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The stock market has rallied powerfully since October 2002, corporate borrowing costs have dropped significantly, federal tax relief is just beginning to kick in, global government bond yields have risen sharply (Japan 10-years have more than doubled from 0.45% to 1.06% in only a few weeks), corporate profitability is improving, investor "animal spirits" seems to be re-emerging, and even national apartment occupancies rose for the first time since the fourth quarter of 2000. Assuming these positives outweigh the cures being applied to the terrible fiscal situation of the states, particularly California, then an economic recovery would seem to be at hand. For three years economists have been forecasting an economic turnaround in the second half. 2003 might be the year it actually takes hold. One question lingers, however. Can we have economic growth without any jobs being created?

The fact that I'm writing about an employment situation that will be the most sluggish of all post-World War II economic recoveries probably means that we have hit bottom despite the unemployment rate continuing to go up and the average number of weeks people are unemployed being the highest since 1983. It's always darkest before the dawn. Two pieces of information may speak to this. The first is that the number of debt collection jobs is down and temporary labor may have hit bottom. The former may indicate less economic problems while the latter is considered a leading indicator of the employment market because companies tend to hire temporary workers before they do permanent ones. Chart A at the end of the article below shows the annual percentage change in temporary labor. While growth has not yet resumed on an annual basis, the bleeding has stopped, which is a very encouraging sign.

Despite the seemingly improving situation, I find the weak labor market so interesting that it begs the question, "what's going on?" This economic downturn has been very unusual in that it hasn't been very deep but it's been quite long, yet still incredibly painful from a wealth destruction standpoint. In fact, the stock market decline associated with this recession was the most severe since the Great Depression.

I often find that using metaphors can be helpful in framing and understanding an issue. So what would I apply to the U.S. economy? I would analogize it to an aging individual that still has vitality but finds it much more difficult, painful, and time consuming to bounce back from injuries and illnesses. I played tennis the other day for the first time in a long time. It was fun, competitive, exhilarating, and strenuous. It felt great to go out and play. Unfortunately, one hour of hard work took about 72 hours to recover. When I was younger I could have bounced back immediately. Given that I'm a little under 40, my issue is probably one of being out of shape versus my body wearing down. Nevertheless, this is still detrimental to my ability to recover.

We know that not only is our society aging and growing more slowly but so is Western Europe and Japan (its population is projected to drop from 127 million today to 100 million in 2050). Our ability to recover is also burdened by our being out of shape and feeding on a terrible diet of too much wasteful consumption and debt accumulation to stimulate economic growth. This has resulted in a dramatic deterioration in net national savings as it has become negative for the first time since the Great Depression as Chart B at the end of the article below shows.

It is from net savings (after depreciation) that a nation's productive capacity can grow. Our tremendous consumption is resulting in our country heating our homes by burning our furniture. We get the result we're looking for (heat) but at the expense of our ability to generate it in the future. Currently, the countries selling us their exports are providing the logs. They are recycling the dollars they receive from us and purchasing our corporate bonds, Treasury securities, and most importantly, the securities of Fannie Mae and Freddie Mac, who are using these funds to propel our extraordinary housing boom. In other words, they are continuing to fuel our consumption by providing us with cheap capital. It's analogous to a huge amount of vendor financing. The American homeowner is carrying the weight of the global economy on his shoulders. Our savings deficiency is a very serious issue and needs to be addressed if we are to remain an economic power for the next generation.

In addition to our heavy consumption, our reliance on fiscal and monetary stimulus is akin to an old gentleman who continues to need increasing doses of viagra to maintain performance and output. Eventually there is either too much stimulus or a resistance is built up and each dose becomes less effective. The eventual outcomes become either a heart attack or more impotence. Rather than me pontificate about tennis and viagra, however, let's have the numbers tell the story.

Table 1 at the end of the article below shows the length of all major post-World War II recessions as measured by the peak in the industrial production index to its trough. I have not included a very short recession in 1980 because of how brief it was.

Two observations. For those of us who thought the recession was still going on, it actually ended by this measurement over 18 months ago. It sure doesn't feel like it's the case if you're an office building or apartment owner or manufacturer. If you're a homebuilder or real estate/mortgage broker, however, you were never in a recession. The second observation is that our recent recession was tied for the longest with 1973-75 which endured Watergate, the resignation of a President, an oil embargo and price spike, inflation exceeding 12%, wage and price controls, the Cold War, and a vicious bear market. While terrorism wasn't a U.S. problem then it was a powerful global force with the Red Brigades in Italy, the PLO in the Middle East, Lebanon beginning its disintegration, and international hijackings taking place with alarming regularity. It makes us wonder why today's recession has lasted so long when the problems we're facing don't seem nearly as daunting given our overwhelming military and economic strength. That's exactly my point.

Table 2 below shows the severity of the drop in industrial production, the number of months to reach the former peak, the average monthly growth rate from trough to the former peak, and how each recovery progressed 17 months after reaching bottom (length of current recovery with May 2003 data being the last available).

Comparative Industrial Production Statistics				
	% Drop	Peak to Peak - # Months	Avg. Monthly Recovery*	% Change +17 mos. From Bottom
February 1957 – April 1958	-13.6%	24	1.68%	15.9%
November 1973 – May 1975	-13.1%	39	0.79%	11.2%
July 1981 – December 1982	-9.6%	28	1.00%	15.7%
January 1960 – February 1961	-8.6%	21	1.23%	15.0%
October 1969 – November 1970	-7.0%	25	0.63%	13.1%
June 2000 – December 2001	**-6.8%**	**35+**	**0.07%**	**1.2%**
September 1990 – March 1991	-4.1%	19	0.34%	4.9%

While the most recent recession was the second mildest, it is virtually assured to be the longest to recover fully and the weakest 17 months into recovery. Its average monthly recovery growth rate is by far the lowest, with only the 1990-1 recession coming close. I find it interesting that our most recent recessions have the slowest recoveries. This seems consistent with getting older. Those injuries and illnesses become harder to shake off.

Since the focus of this article is on employment, how do the various recessions compare when looking at this indicator? Table 3 below uses the same comparisons as the previous one but for employment rather than industrial production. The dates may be different because they are based on peak to trough employment.

The employment situation in this "recovery" is nothing short of alarming. There is no post-war precedent of employment continuing to drop 18 months after the trough in industrial production. The longest delay for the two indices to reach bottom is three months, which took place in 1970. The slow recovery may have something to do with the delayed deceleration in job growth as employment peaked eight months after industrial production did, the longest delay in post-war history. After 18 months, however, one would expect employment to have already recovered despite the lagging downturn at the beginning.

Comparative Employment Statistics				
	% Drop	Peak to Peak - # Months	Avg. Monthly Recovery	% Change +17 mos. From Bottom
April 1957 – June 1958	-4.35%	24	0.47%	4.70%
July 1981 – December 1982	-3.10%	28	0.32%	6.00%
July 1974 – April 1975	-2.76%	19	0.31%	4.28%
February 2001 – ?	**-1.96%**	**28+**	**-0.07%**	**-0.51%**
February 1960 – February 1961	-1.75%	20	0.23%	4.10%
June 1990 – May 1991	-1.47%	32	0.08%	0.28%
March 1970 – February 1971	-0.91%	18	0.16%	3.35%

Recessions are about ridding excess from the system and lowering break-even points for businesses. The factors that help stimulate the boom also sow the seeds of its destruction. For example, 1981 tax law changes were designed to stimulate economic activity, particularly in real estate with very liberal tax shelters. A boom ensued, development was stimulated based on tax incentives versus underlying economic demand, the tax laws were changed again in 1986, real estate contracted, loans went bad, and the S&L crisis ensued (real estate wasn't the only reason for this). A similar cycle ensued with dot-coms, telecom firms, and venture capital in the late 1990s. Extraordinary innovation and risk taking took place that led to tremendous economic growth. Eventually this too went to excess as people were investing to flip securities for quick profits versus building sustainable businesses. The party came to an end and, like most great parties, many of the participants left having imbibed far too much alcohol. It was great until the next morning. How do you a cure a hangover? You don't. It takes time and healthy living for it to go away. It's no different for an economy that allocates precious resources in a wasteful manner during a boom. To resume growth, time and discipline are needed for the system to clean out the dead weight and begin re-allocating resources in a much more efficient manner and to push corporate break-even points to a lower level. This enables businesses to reach profitability with a reduced level of sales due to a more efficient cost structure. Only when this takes place can hiring and investment resume and the cycle can begin to reverse.

What makes these last two recessions so different in their recovery patterns? The bursting of bubbles: commercial real estate and the stock market/venture capital/telecom mania. The banking system was brought to its knees in the early 1990s with the collapse of real estate. Lending dried up as asset values collapsed. This severely curtailed economic growth until the banking system could be recapitalized. It did this by purchasing risk-free Treasury securities at a spread compared to its cost of deposits at the expense of lending to the private sector. Today, the flimsy and unprofitable businesses that got funded in the go-go days of the late 1990s are being washed out of the system and high tech is dramatically downsized.

A new variable added to the equation is the emergence of China as a manufacturing power. This has put huge pressure on our manufacturing base and when this is combined with the internet, technology and globalization businesses are much more productive and now able to access a more affordable global labor force. The economy has been able to grow by the Federal Reserve dramatically cutting interest rates that stimulated extraordinary housing activity and consumer spending despite trillions of dollars of wealth destroyed and the September 11 terrorist attacks. Nevertheless, stimulation of interest rate-sensitive industries during a period of slow economic growth is going to borrow from growth in the future. Although it appears that an employment recovery should take hold in 2004, it does not look like the snap-back, high growth recoveries when we had presidential resignations, oil embargoes, wars, and excessive regulation. Who says things weren't better in the good old days?

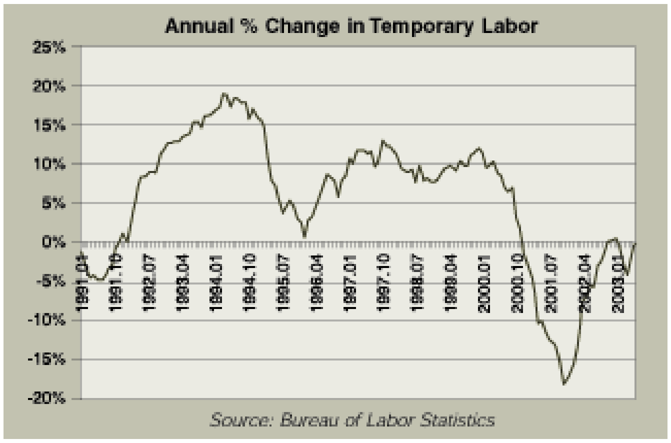

Chart A

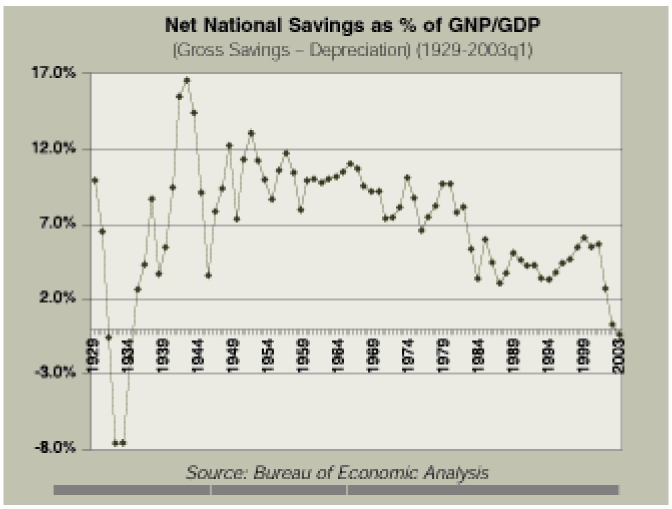

Chart B

Recession Length - # Months (Measured by Industrial Production)	
June 2000 – December 2001	**18**
November 1973 – May 1975	18
July 1981 – December 1982	17
February 1957 – April 1958	14
January 1960 – February 1961	13
October 1969 – November 1970	13
September 1990 – March 1991	6

Table 1

Premium For Good Joint Venture Partners

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Real estate investments often involve joining up with one or more investment / equity partner(s) to pursue some common investment projects. While there are plenty of published information and literature on macro and micro real estate investment analyses, there are comparatively fewer reports on analyzing a joint venture partnership. Here we attempt to outline the very basics:

A) **Competition** = irrespective of how friendly and courteous the joint venture relationship between partners is, there will be aspects of competition. This is only natural, and basically each partner will attempt to shift as much risk as he / she can to the other(s) and obtain as much return / benefits as he / she can from the venture. And most of these will be reflected in some form of joint venture agreement stating the responsibilities and privileges of each party involved.

B) **Cooperation** = there has to be a spirit of cooperation too, even if the relationship is not overly courteous, else things may simply fall apart benefiting no one. While there are joint venture matters in which the need to compete or cooperate are mutually exclusive and clear (thus at least the stance of each joint venture partner will be easy to comprehend), there will also be matters in which the need to compete and cooperate exist at the same time, and choosing to either compete more (risk of a stalemate) or cooperate more (risk of losing too much benefit) becomes a difficult decision. Careful weighing and delicate handling of the situation are required.

C) **Don’t rely 100% on a piece of joint venture contract as “crooks will eventually be crooks”** = contracts, or joint venture agreements, are there to spell out as detail as possible the rights and responsibilities of each joint venture partner, so that misunderstanding or miscomprehension etc will be reduced as much as possible to ensure a smooth process. No matter how in depth, comprehensive, or technical the agreements are, there are likely to be some loopholes or matters that have not been envisaged at the time of writing up the agreements. Hence, rather than rely fully on a joint venture agreement to bind a partner to his / her word, choose a good trusted partner may be the better option. That is to say, should a prospective partner seem untrustworthy, better forfeit the deal than go ahead with drafting a more complex agreement. While one can always size up a prospective partner via company searches, business intelligence reports, business references, and the like, actual observations and contacts may also help provided one keeps one’s mind open and alert.

D) **A reputable joint venture partner reduces risks and ensures return more** = apart from having business shrewdness, professional management, technical skills, and so on, a reputable and trusted joint venture partner helps reduce part of the risk in the venture and vice versa. From a commercial angle, one should ask for a higher rate of return to compensate for less than competent and trustworthy partner, and in the extreme case, consider giving up the deal.

The foregoing is only a general outline and applies to situations where the joint venture partners are active and need to contribute certain resources to certain aspects of the joint venture and may not apply to situations where there is a passive partner. Also, the above also assumes a certain reasonable legal framework and adherence to the law by the general public in the economy where the joint investment is done.

Guns of America: Interesting Statistics

Real Estate Tech, October 2003

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The USA gives an impression in particular to Non-Americans that there are guns everywhere, and they are easily bought or obtained, legally or otherwise. Reportedly, there are around 200,000,000 private-owned firearms (including handguns, rifles, shotguns etc), some 50,000,000 firearms owners, and close to 40,000 fatal deaths and crimes related to the use of firearms. Despite the foregoing, it may not be as scary as it sounds, and here are some interesting figures:

A) **Data and information** = the bulk of these comes from the Department of Justice.

B) **More than half of the households do NOT have or own guns** = around 35% of households have one or more firearms, which is not a low figure in itself yet is lower than the 1950s when 50% of households had at least one. This differs from the common perception that guns are in almost each and every home.

C) **Those who have guns usually own more than 1** = based on the reported data, around 100,000,000 guns are owned by 10,000,000 people, i.e. an average of 10 guns per person, while another 87,000,000 guns are owned by some 34,000,000 people i.e. averaging a bit less than 3 guns per person. Collectively, there are around 50,000,000 gun owners, or roughly 17% of the total population. Given that there are around 100,000,000 households in the USA with 35% of them having guns, and that on average there are around 3 people per household, this means some gun-owning households have more than 1 person who own guns.

D) **Typical gun owner profile** = male mostly, educated, lives in smaller towns and less urbanized areas, with a gun-owning family history-influence. Half of these gun owners start using guns before 20, and most own guns for sports, hunting etc with self-defense being a second objective. This differs from the popular perception the gun owners are usually less educated and / or violence-inclined.

E) **The South seems most pro-gun** = it is noted that most Americans intend to keep the constitutional right to bear arms, even among those who do not own guns or even dislike them. Nonetheless, many Americans also favor having some control mechanisms including those who are pro-gun ownership. As a rough statement, the least pro-gun region is the East Coast.

F) **Putting real estate prices into the equation** = very vaguely it seems the less pro-gun the regions are, including cities such as New York City, Boston etc, the higher real estate prices there are, though it remains to be seen whether there is any significant correlation between the two. It would be an interesting challenge for the academically inclined.

Notwithstanding the above and the commonplace of guns in general, if one does a *not-so-scientific calculation, the chance of getting killed by guns, albeit sad and regretful = 40,000 gun deaths or crimes per year divided by 50,000,000 gun owners and 365 days = 2.192e-6 is not overly significant, i.e. overall America seems <u>relatively restrained</u> in terms of gun usage given its prevalence.

*The deaths may or may not have anything to do with (any of) the known 50,000,000 or so gun owners, or for that matter, with (any of) the guns they own, as there are users and guns that may fall outside the registered-recorded statistics. There is also no implication here that such gun owners and / or the guns they own are largely responsible for the 40,000 reported gun deaths.