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Private island markdowns

Credit rolls in and rolls out like the fog, if you're from Kennebunkport, Maine. Or, it rolls in and rolls out like the tourists, if you happen to be from Miami. Either way, cycles in lending and borrowing constitute one of the main propulsion plants of the world's investment markets.

Real estate—illiquid, despised, discounted—is the subject at hand. It was subscriber Todd Tateo who observed last year that, for the precious right to convert an asset into cash at the twitch of a nerve, the world was prepared to pay exorbitantly. The price of liquidity has only gone up in the meantime.

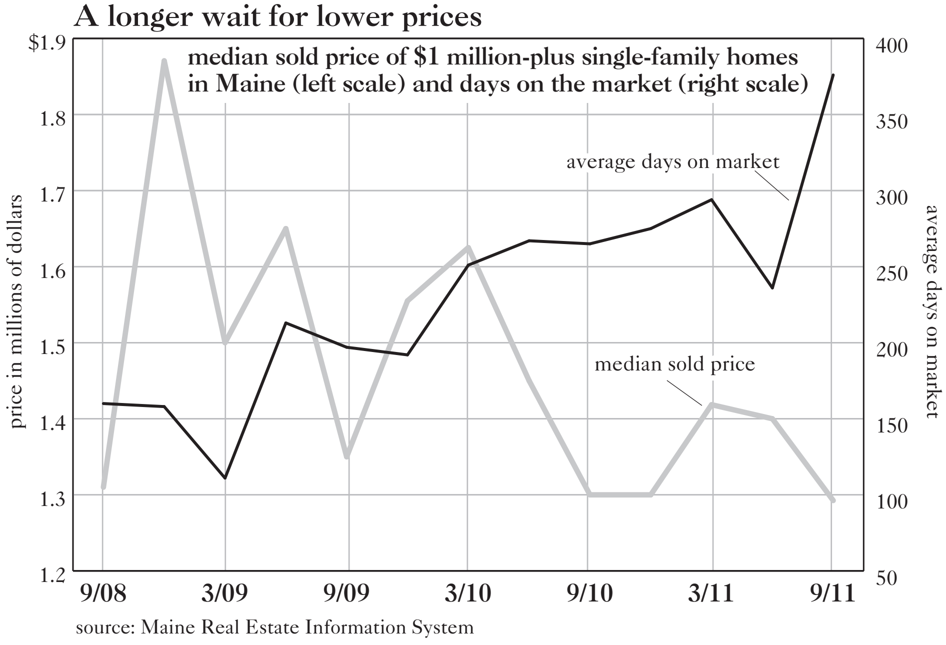
We turn, specifically, to the residential property markets at the north and south extremities of America's eastern seaboard. In preview, we are friendly toward high-end houses on the rocky Maine coast, a little less enamored of the luxury condominiums in greater downtown Miami. In the former, we see still-depressed value, in the latter, a vulnerable, China-derived, Brazilian-financed, exchange-rate-driven recovery.

In Wall Street argot, Maine would be considered a pink sheets market. Only about 1,000 houses change hands each month in the Pine Tree State, compared to approximately 20,000 per month in the Sunshine State. At the end of the third quarter, 7,800 Maine residences were trapped in the foreclosure pipeline, compared to 350,000 in Florida. Both markets are well off their boom-time highs, and both roll out the welcome mat for qualified buyers. But the reception awaiting the Portland shopper with, say, $3 million in check-writing capacity is likely to be especially ardent.

Scared of its own shadow, capital nowadays prefers cash to bonds, bonds to stocks and stocks to houses. Ever shrinking is the list of assets that the mainstream institutional investor deems "safe." And if German bunds have fallen out of consideration, as they seemed to do last week, it's a cinch that a 17-acre private island situated at the mouth of the St. George River along Old Hump Channel near Port Clyde, Maine—offered now at $800,000, including a "rustic" two-story structure, down from a 2008 asking price of $2.7 million—wouldn't pass muster, either. However, we think, there's something to be said for the island as well as for a roomy, 1992-vintage, not quite $2 million house in the coastal town of Harpswell, population 5,247. Hugely illiquid are these properties, yet each offers a hedge against the consequences of monetary "stimulus," as well as what Benjamin Graham described in another context as the "joy of possession."

"I am very concerned that safe-haven assets are fast becoming the riskiest assets with respect to long-term capital preservation and long-term returns," Chris Lynch, a former DLJ bond executive turned owner of the largest high-end real estate brokerage firm in Maine, Legacy Properties Sotheby's International Realty, wrote to his friends and clients last month.

A longer wait for lower prices



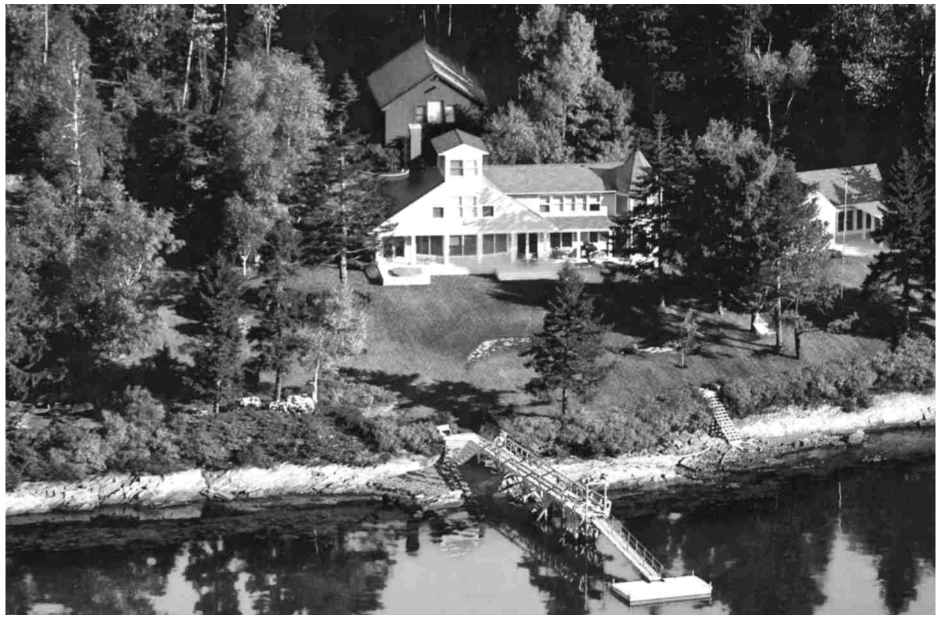
source: Maine Real Estate Information System

"The pervading fear in the marketplace has created a new bubble which may burst like any other when signs of recovery or stability creep back into the financial system. We are thinking real estate shares qualities with bonds and gold, yet real estate is at the bottom of its price cycle while the others are at or near all-time highs."

Once upon a time, the sky seemed to be the limit Down East. MBNA, the big credit-card purveyor, moved a part of its operations to Camden, Maine, in 1997, and proceeded to teach the Yankees about the alternatives to thrift. Camdenites rubbed their eyes as the newcomers bought seven-figure houses, built their own yacht club to house their corporate watercraft (including the MBNA flagship, Affinity) and their own hangar at the Knox County airport in which to house their corporate aircraft. And to facilitate the comings and goings of the MBNA Lear jets and Gulfstreams, they presented the airport with $70,000 worth of landing lights.

MBNA, which in 2005 became a wholly owned subsidiary of Bank of America, literally rolled into Maine on a wave of credit. The wave crested in 2006-07—in 2006, BofA announced the closure of four Maine call centers—and house prices, in and out of Maine, have been falling ever since. High-end houses on the beautiful Maine coast never reached the valuation altitudes of comparable properties in Martha's Vineyard, Nantucket, Greenwich or Vail, but the bear market has not spared Maine on that account. By Lynch's estimate, houses in Maine's waterfront communities have fallen in quoted value by 15% to 20% from their highs, inland properties by as much as 25%.

With respect to top-end prices in Maine, the bottom may or may not be in; this publication is agnostic on the question. October brought a new lurch up in inventory and a step down in houses under contract for sale. Supply of houses priced at more than $1 million, expressed in months of average inventory totaled 141, the highest in at least the past two years (runner-up was November 2010, when supply came in at 105 months). As for houses under contract, the grand total was four, one fewer than recorded in the cheerless month of April and the fewest in at least the past two years.



"Sora," of Harpswell, Maine

Granted, Maine's weather is a taste that some will never acquire, but the winters are cold in Vail, Colo., too, and there's no more to recommend Rehoboth Beach, Del., on a rainy afternoon in March than there is Cape Elizabeth, Maine. As for the storied beauty of the Pine Tree State, we are prepared to say that the artists and writers don't exaggerate. Then, too, there's value.

"For instance," reports colleague Charley Grant, "a six-bedroom, six-bathroom, 8,900-square-foot house in Cape Elizabeth, a 15-minute drive from downtown Portland. Built in 2005 and listed on realtor.com for 381 days, the property features a pool and spa, central air conditioning, a mother-in-law house and grounds that, in the Realtor's estimation, are 'lush' (a grand total of 1.65 acres). Asking price: $1,695,000. No waterfront access, but saltwater in Cape Elizabeth is a five-minute drive, tops. I went online to comparison shop and found that you can, indeed, do worse.

"To wit: A six-bedroom, six-bathroom, 8,800-square-foot house in Lewes, Del., i.e., Rehoboth Beach, without beachfront access, lists for $2.25 million. A six-bedroom, four-bathroom house with no waterfront access and just 2,766 square feet of living space in Edgartown, Mass., i.e., Martha's Vineyard, was listed—the ad vanished last week—for $3.45 million. A six-bedroom, six-and-a-half-bathroom house in Vail, with 8,300 square feet of living space, lists for $16.5 million. While Maine might never have the cachet of Martha's Vineyard or Vail, you'd infer from the price that the Cape Elizabeth offering was plopped down between a sewage treatment plant and an international airport."

You can value residential real estate in relation to similar structures in comparable markets as we have just done. Or, you can value it in comparison to its cost of construction or by what it might yield in rental income, which we are about to do. By all methods, the upper-end portion of the Maine market we judge to be relatively attractively valued. Of course, if the macroeconomy were to go from bad to worse, that relatively attractively valued, picturesque, $3 million Maine house might well trade at $2 million or less. Then, again, if the world truly goes to hell in a hand basket, you may wish you were living on your own 17-acre island on the St. George River. Stone Island, as that romantic sanctuary is known, lacking fresh water, a septic tank and, within the "rustic" living quarters, heat, is not for the faint of heart.

For those seeking truly to distance themselves from leveraged finance, Birch Island, in Greenville, Maine, is another option. You land at Bangor Airport, drive 90 minutes to Moosehead Lake and hop on a boat. Thirty minutes later, you turn the key (a New Yorker always locks up) to your two-

Portland dowager—with a 6.1% yield

bedroom, one-bath summer cottage. A dock, boathouse, one-bedroom guest house, canoe and a pair of motorboats are included in the purchase price. You will have no company on Birch Island. Then, again, you have no electricity. Offered in August in *The Wall Street Journal* for $1.5 million, the property is currently listed at $650,000; it's been offered online for 526 days.

"What we have learned," Lynch advised his readers late last summer, "is that Maine is tied more closely to the global economic fabric than we may have believed. Today's prospective sellers need to reacquaint themselves with these new pricing levels as buyers have clearly made the adjustment."

In Harpswell, there's a 20-year-old house named "Sora." It and its private dock, barn and bunkhouse were recently listed for not quite $2 million, or $419 for each foot of its 4,713 square feet of living space. Lynch and his team reckon that the house would rent for $6,500 a week during the 12-week summer season (a total of $78,000) and for $2,500 a month during the nine-month off-season (i.e., $22,500), for a grand total of $100,500 before property taxes of $6,331 and maintenance costs of $10,000. At the listing price, Sora would yield 4.26% after tax and before the additional maintenance costs that somehow never fail to bite the homeowner in the ankle. Remote Harpswell has no school system—a plus in the tax department—but, then, it draws few visitors, a negative for rents.

"Or consider," our reporter goes on, "a five-bedroom, three-and-a half-bath waterfront house in Falmouth. Living space measures 3,926 square feet, with a truly spectacular kitchen; at the $2.2 million listing price, that's $560 per square foot. Right down the street is the Town Landing Market, which sells live lobsters for $4.99 a pound, a seemingly arbitragable difference with the $16.99-per-pound lobster sold at Eli's on East 91st Street between York and First Avenue in Manhattan. Built in 1925 and renovated in 2006, the house is set on grounds that 'are just as amazing as the home itself, boasting beautiful stone walls, perennial gardens, patios, in-ground pool and a gazebo overlooking the water and private boat dock,' according to the Realtor. This claim has been vetted by your correspondent and deemed to be accurate, perhaps even an understatement. Neighbors are few and far between, despite the central location. Projected rental income is $6,000 a week in season, $4,000 a month for the other nine months, for a total of $108,000. Property taxes come to $28,320, while annual maintenance (the owner swears to it) amounts to a mere $7,500. After taxes and before surprises, this property would fetch 3.3% a year at the asking price.

"Perhaps the best value of the day," Grant winds up, "came from a four-bedroom, three-and-a-half-bath townhouse in downtown Portland, within an easy walk to both the city center and the waterfront. Built in 1890 and restored in 2007, the property is listed for $895,000, or $249 for each of its 3,589 habitable square feet. Estimated annual rental income of $70,200 compares with property taxes of $9,700 and—so they are represented—purely nominal maintenance fees; call them $6,000. On this basis, at the offered price the townhouse would yield 6.1%. Portland, let me add, is an extremely livable city. Driving throughout Cumberland County all day, including the morning and afternoon rush hours, we encountered no 'traffic,' as a New Yorker understands the meaning of that word. On Monday evening, the total elapsed time between arriving at Portland International Airport and checking into my downtown hotel was 40 minutes, including a stop at the rental car counter and some shoddy navigation. Portland is that urban rarity, a city both walkable and drivable."

Famously cosmopolitan Miami is flyable. Laid low by the real estate bust, the biggest city in the Sunshine State is host to a new wave of condominium-buying, South American immigrants. They come with cash, too. In Miami-Dade County, according to the Miami Association of Realtors, foreign buyers

Icon Brickell: "over the top"

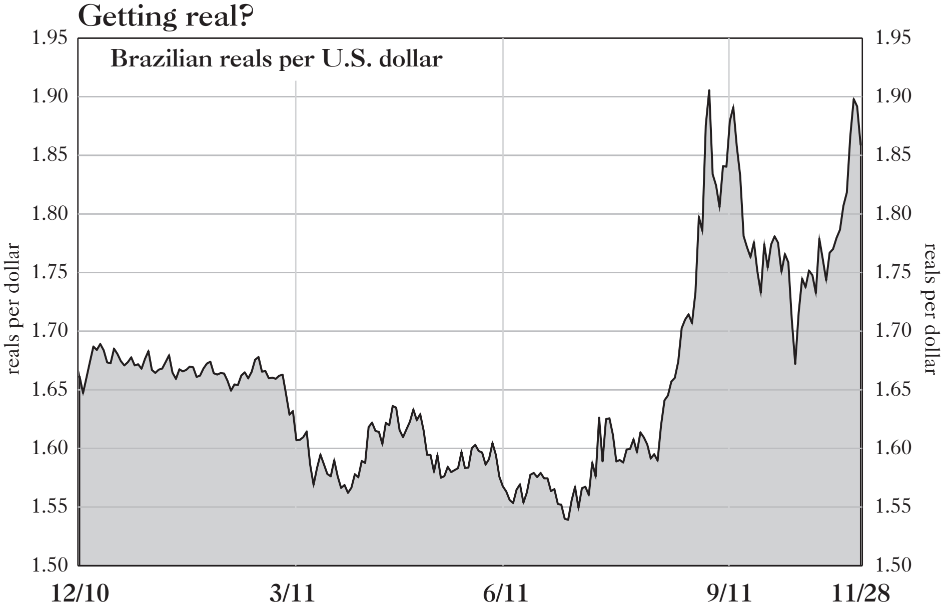
usually requiring no mortgage account for 60% of residential real estate sales. According to Peter Zalewski, principal of Condo Vultures LLC, a Bal Harbor, Fla., advisory firm, "When they're running their numbers," referring to the foreign apartment investors, "they're saying: 'We have a weak dollar. We have U.S. predictability, in terms of the legal system as well as title. And we have this safe haven that we can ultimately run to, if need be, if the economic and social conditions deteriorate in our home country. . . .' Basically, it's a re-colonization of Miami."

You'll hear no protests from the greater downtown Miami real estate community (the area consists of 60 blocks bounded on the north by the Julia Tuttle Causeway, on the south by the Rickenbacker Causeway, on the west by I-95 and on the east by Biscayne Bay). Of the 350,000 Florida homes in foreclosure, 100,000 are situated in the three most populous south Florida counties—Palm Beach, Broward and Miami-Dade. Like the infamous local humidity, this immense overhead supply hangs heavy. "We see considerable downside for home prices in the metro areas of Miami and Tampa," says a Nov. 16 report from Bank of America Merrill Lynch. "There is a judicial foreclosure process in Florida, which means that it takes considerably longer to clear the foreclosure overhang. This has left a considerable number of homes in the foreclosure pipeline, which will depress prices. In addition, the regional economy is weak, with unemployment above the national average."

Borrowing liberally from the poet Emma Lazarus, the brokers and developers of greater downtown Miami may hopefully murmur, "Give me your Brazilians, your Venezuelans, your Argentines, your rich yearning to breathe free. . . ." The great American bear market is one side of the Miami real estate coin, colleague David Peligal observes. The view of that bear market from Sao Paulo is the other side. Those who gaze upon our sunken prices from South America or Mexico can hardly believe their eyes, says Harvey Hernandez, managing partner and chairman of Newgard Development Group, a Miami developer. "Their properties, wherever they're from . . . are worth double or three times as much as here in Miami," he says of the prospective buyers to the south. They say, 'This is impossible—it cannot be.' They see value."

Peligal, on a recent visit to Miami, also spied value, though not so much as to cause him to doubt his senses. The focus of his investigation was the Icon Brickell, a 1,793-unit, triple-tower, boom-time jewel in the southern section of greater downtown Miami. The project, which was unveiled at the peak in 2006 and completed at the bottom in 2008-09, bears no outward sign of the scars of the man who imagined it, developed it and subsequently lost it, Miami's own "condo king," Jorge Pérez, chairman of the Related Group. Peligal, echoing his tour guide, broker Felicia Doring of Fortune International Realty, pronounces the premises "unique," "ultra-contemporary" and "over the top." A series of immense sculpted faces, done in the style of the Easter Island monoliths at a cost of $15 million, would seal the over-the-top claim all by themselves. Furthermore—a notable change from the dark days of 2009—the apartments are selling, and at prices well in excess of the $300 per-square-foot cost of construction.

Getting real?



source: The Bloomberg

Consider, says Peligal, a 1,500-square-foot, Biscayne Bay-facing, two-bedroom apartment on the eighth floor of the Icon Brickell's south tower. It's listed at $640,000, or $427 a square foot. "By way of preface," Peligal relates, "the rental market in south Florida has tightened as the 'strategic' defaulter, the person who bought at the peak of the market, opts for a short sale and decides to rent. Second, whereas the average high-end condo might rent for $2 per square foot per month, condos at the Icon Brickell rent for a premium because of the location, amenities and clientele associated with the building. You can get $2.47 per square foot per month, or $44,400 a year.

"Now, then," Peligal continues, "property taxes are roughly 2% of the $640,000 purchase price, or $12,800 a year, while condo maintenance fees are on the order of 56 cents per square foot per month, or $10,000 a year. Subtracting taxes and maintenance costs from rental income leaves us $21,600, which, when divided by the $640,000 listing price, delivers a rental yield of 3.38%. Not fantastic but better than the 10-year Treasury."

"Renters today are enduring high rents in anticipation of being able to own in the future," the afore-quoted Zalewski sums up the situation. "Foreign buyers are acquiring today in anticipation of being able to unload their product in the future to domestic buyers who are going to be able to tap into leverage."

If the global financial gales reach even little Harpswell, Maine, they rock Miami, the New York City of Latin America. To simplify only slightly, Brazilians can afford apartments in the Icon Brickell because the Brazilian real is strong. The real is strong because commodity prices are high. Commodity prices are high because China was growing. If, as we believe, Chinese growth is braking, commodity prices would likely continue to fall and the real continue to weaken. Against the dollar in the past four months, the Brazilian unit has fallen by 16%. "Much of South America's prosperity over the past decade—and its sense of having arrived, including its significant contribution to global economic growth—has been due to the China-inspired commodity price boom," notes *Financial Times* columnist John-Paul Rathbone.

If the China-Brazil axis poses a distant and abstract threat to the recovery of Miami condo prices, the resumption of new residential construction on Brickell Avenue itself is a risk both local and immediate. An Oct. 17 press release from Harvey Hernandez's Newgard Development Group announces a notable milestone: "BrickellHouse, a 46-story luxury residential tower under development by Newgard Development Group, becomes the first newly conceived condominium project to launch since 2008, reflecting the rising demand for urban living in South Florida and fast-improving market dynamics in downtown Miami." A kind of budget Brickell project—"MyBrickell"—is also on tap, slated for completion by the end of 2013, with the prospective residents themselves expected to front most of the capital.

Taking one thing with another, subjective as well as objective—price, value, scenery, weather, proximity to the chain of causation running from China to the quoted value of a bushel of soybeans and to the real-dollar exchange rate—we'll opt for a house in Maine. Or a reasonably priced island. It could be just the place to wait out the coming rationalization of the world's monetary and banking arrangements.

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