

## Bad News. Good News. *What goes down, usually comes up.*

*June 2009* - Nearly two years have passed since the beginning of the end for Bear Stearns, triggering a financial crisis many economists liken to the Great Depression. Industrial production, exports and equity valuations continue to descend. As banks fail and lending standards tighten, the real estate market also continues its downward spiral.

Overspeculation and inflated consumer confidence have spawned illiquidity, deflation and investor paralysis. That's the bad news. The good news: crisis often creates opportunity. With exponential bank failures this year, real estate is being transferred from banks to the federal government at an alarming rate. While the potential opportunity for real estate investors in this downturn is significant, patience may be best, until the current Administration has revealed the process of how and when these assets will be released.

### **Public-Private Investment Program**

The Treasury Department's Public-Private Investment Program (PPIP) is attracting a lot of press these days. Announced in February, the PPIP will offer favorable financing to public-private partnerships that are qualified to purchase distressed mortgage loans through the Legacy Loans Program (LLP) and mortgage-backed securities through the Legacy Securities Program (LSP).

In a press release issued March 29, 2009, the FDIC described the LLP as a program, "intended to boost private demand for distressed assets that are currently held by banks and facilitate market-priced sales of troubled assets. It is necessary because uncertainty about the value of these assets makes it difficult for banks to raise capital and secure stable funding to support lending to households and businesses."

We believe that the LLP may enable investors to take advantage of deals with enormous profit potential, but it's too early to be certain. Concerns about the Treasury Department's \$700 billion Troubled Asset Relief Program (TARP) are fresh, which is forcing tighter scrutiny of the LLP—a program predicted to cost \$2 trillion.

According to a recent report by the rescue program's special inspector general, "The sheer size of the program ... is so large and the leverage being provided to the private equity participants so beneficial, that the taxpayer risk is many times that of the private parties, thereby potentially skewing the economic incentives."

Moreover, it is not clear that sufficient market forces exist to prompt banks to release assets or to price them for market absorption. Once the fog clears, investors will have a better understanding of the real deals to be had.

### **Green Policies May Increase Land Values**

The Obama Administration has already shown a strong commitment to the environment, directing nearly \$80 billion to clean energy, the environment and science. In some cases, this has come at the expense of the current economy—a choice most Americans take issue with. According to a Gallup poll in March this year, "more Americans say that economic growth should be given priority even if the environment suffers to some extent (51%) than say protection of the environment should be given priority even at the risk of curbing economic growth (42%)."

Despite public opinion, the Administration continues to make decisions contrary to market demands. Case in point: their dealings with Detroit auto makers. By forcing auto makers to build fleets of vehicles that are as efficient as today's European automobiles, they continue to ignore consumer preference. As a recent Wall Street Journal article suggests, "Mr. Obama and congressional leaders have refused to endorse higher fuel taxes, causing industry executives to fret that they will build the modern, fuel-efficient cars Washington wants, only to have consumers turn up their noses and buy used Chevy Suburbans."<sup>1</sup>

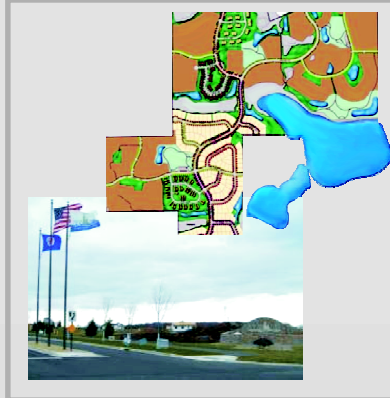
What does this all mean for real estate and development? In a town hall forum earlier this year, the President commented that, "The days where we're just building sprawl forever, those days are over." No doubt, the Administration's green policies will affect land use decisions and impede development beyond urban growth boundaries. However, that won't change consumer preference. Americans are used to getting what they want, and studies show that most prefer to live in single-family homes in the suburbs. In fact, in a nationwide survey, only 17 percent of Americans prefer a townhouse in an urban setting close to public transportation, shopping, and work, while 83 percent choose a single-family detached home in an outlying suburb.<sup>2</sup>

The silver lining? Investors sitting on improved properties in these restricted, high-demand areas may be able to sell at a premium when the time is right.

## Practicing Patience in a Down Market

At Miller & Zimmerly Real Estate Investment Group, our focus has always been on investing in property where we have a competitive advantage over the market. It is a strategy that demands patience and discipline, and it's one that has paid off for our investors. Since inception, our firm has outperformed the market, recording a 61% nominal annual rate of return on equity placed in disposed assets without taking the risk of leverage.<sup>3</sup> We sold off most of our assets at the top of the market between 2005 and 2007. A decision which helped protect our investors from the market freefall.

Earlier this year, we made another decision rooted in patience and discipline. We decided to cancel our Advantage Fund. Focused on distressed real estate assets, the fund targeted opportunities arising from declining market conditions, foreclosures and the sale of bank-owned assets.



## Strategy In Action

We acquired 177 subdivided lots in Minnesota, from a bank in a deed in lieu of foreclosure for approximately \$16,950 per lot (\$3,000,000). All improvements on the property had been made, including streets, lighting, and parks.

Even if the land had been free, we could not have made all the improvements on the property for the purchase price. The tax assessed value in 2008 was in excess of \$8,600,000.

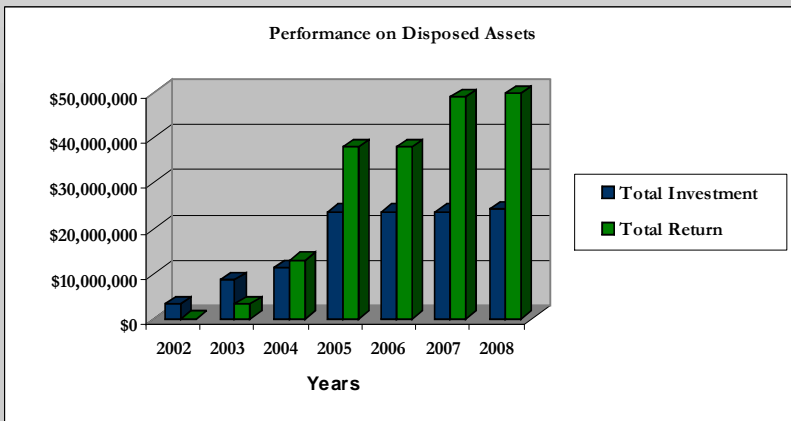
While we were successful in raising capital, we felt it was premature to move forward amid uncertainty about when and where the market would hit bottom.

### Our strategy today

Today, our fundamental strategy remains unchanged. We continue to seek equity investments that yield significant, long-term gains with manageable risk. That means evaluating each market opportunity to assess its potential for growth and absorption, focusing on those with limited competition and minimal risk of further deflation.

While the federal government works through its plan to liquidate distressed assets, we will continue to analyze select markets for ripe opportunities.

In many ways, the financial turmoil is creating auspicious circumstances for future real estate investment. Illiquidity, waning competition and devalued assets may offer the potential for long-term investments with lucrative returns - when the timing is right.



1) White, Joseph B., "New Car Order: The U.S. Auto Industry's Road to Recovery Won't Be Easy," *The Wall Street Journal*, (May 1, 2009.)

2) National Association of Home Builders, *Consumer Survey on Growth Issues*, (Washington, D.C., April 1999.)

3) Indicates total returns '02-'08, does not reflect the net percentage returned to investors. Past performance is not necessarily a guarantee or indicator of future results.

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