

Rodino Associates

Economic Development & Real Estate Services

Information Series Article No. 102

Published by Rodino Associates - July 11, 2011



Risk – Reward Management Strategies in Real Estate Investment and Development

Risk - reward trade-offs are fundamental decisions made in any investment process. While risk and reward often rise and fall together, there are intelligent investment strategies that can reduce risk while maintaining a desired yield, or putting it another way, that can increase the potential for reward while maintaining risk at an acceptable level. These trade-offs are particularly important considerations for real estate investment and development, normally considered high-risk/high-reward investments. In this paper I will attempt to dissect the components of risk and reward in real estate investment and development, and suggest strategies that encourage their rational management.

Risk is considered to be the probability or likelihood that one will NOT receive the rewards anticipated in either quantity of money (or other non-monetary rewards), in the timing of the receipt of rewards, or in relation to the amount of effort and money invested – usually referred to as return on investment. Reward (or return) is simply the monetary and non-monetary gains received as a result of investing money, time and effort in a project. The ideal investment vehicle is one that provides a high reward with low risk. Strategies that can move an investment toward that ideal are obviously valuable.

Risk management came to the real estate investment business largely from stocks and bonds investment analysts, and has its roots in modern portfolio theory. This school of thought has analyzed investment risk as composed of two elements, sensitivity and uncertainty. Sensitivity is the degree to which the expected results or outcomes of an investment vary with changes in the investment's variables, inputs, or assumptions. If the calculated internal rate of return (IRR) of a multi-family property acquisition is highly sensitive to changes in rent increases then that acquisition could be considered to have a high level of risk.

Uncertainty involves the degree to which changes in key investment variables are predictable with confidence. If an investment involves outcomes which are highly sensitive to changes in investment

Rodino Associates

Economic Development & Real Estate Services

variables, and those variables, rent escalation in the above example, are not easily predictable, say based on property past history or comprehensive market data, then the investment in question could be considered to have a high degree of risk. This is not to suggest that our hypothetical high risk investment is to be avoided, since we have said nothing yet about reward. Further, investments are usually judged in a comparative manner in which the risks and rewards of various investments and investment types are compared to each other.

Let's consider risk/reward management concepts for real estate investment in general, first on a relatively simple basis, then on a more sophisticated level involving transfer of risk. In a companion follow-up paper I will cover risk management concepts involving portfolio diversification for the four major property types, multi-family housing, retail, office and light industrial, under varying economic conditions.

- **Simple Risk Management Techniques:**

There are several somewhat obvious strategies that should be mentioned to minimize risk and maximize rewards, but that are often ignored, even by experienced investors and developers, so we will run through them briefly.

Stick to what you know, or learn before you invest. This seems obvious. If you are a multi-family developer expanding into senior housing might work, but first learn about what kind of senior housing you will build and what services that are different from traditional multi-family housing must be included in your project.

Assemble a knowledgeable team. Another obvious strategy, but one that will save time, money and heartache. Probably the key players are your architect, general contractor, property management, and sales/leasing team.

Don't over leverage. This is difficult to do in today's financial environment. In the event cash flow takes an unexpected dip overleveraging will likely result in needing to make a capital call on investors – never a happy event.

Rodino Associates

Economic Development & Real Estate Services

Carefully assess market comps and the property's operational history when projecting rents, occupancies, turn-over and operating expenses. This is easier to do with an existing property than with a development project where there is no operating history. A balance is needed between overly optimistic projections and doomsday pessimism. Three-tier projections are useful, optimistic, middle-of-the road and pessimistic to give a reasonable picture of the range of future rewards.

Pre-leasing and pre-sales. In a development or expansion project, or one with high vacancies that is to be repositioned, pre-leasing or pre-sales to some level is pretty much a requirement for financing and for risk reduction. The exact level of pre-leasing or pre-sales is usually related to the level of income needed for debt servicing.

Let's examine three more advanced techniques for minimizing risk and maximizing rewards in real estate investments, which are applicable to investing in existing properties as well as in development projects involving transfer of risk. In a future I will discuss portfolio diversification, and developing investment criteria that connect property investment variables to larger economic and market conditions.

- **Transfer of Risk**

As the term implies, "transfer of risk" means utilizing strategies that result in someone else bearing a larger share of risk. Lenders use recourse loans to transfer more risk to borrowers by gaining access to personal assets if a loan goes sour. There are numerous risk transfer strategies and I shall briefly list the more prominent ones for the readers' consideration.

Transfer of Risk between Buyer and Seller: Several strategies can be employed between a buyer and a seller that can transfer the burden of risk from one to the other. A seller may guarantee the leases of weaker tenants (not applicable to multi-family residential) thereby transferring some risk to the seller in the event tenants default. A seller may offer this to induce a buyer to buy a property that may have weak tenants, or a buyer may require lease guarantees to provide lower risk to its investment.

A buyer may project higher vacancies in weaker markets and buy, or offer to buy, based on the adjusted income and NOI – possibly with an earn-out to seller if vacancies are lower after some time period. This

Rodino Associates

Economic Development & Real Estate Services

strategy can benefit both buyer and seller. It benefits the seller by inducing a buyer to buy in a weak market, while at the same time providing the buyer with some protection if the market remains weak. If the market recovers everyone can gain.

Sometimes owners provide free rent to tenants in exchange for higher face rent rates and a correspondingly inflated property value. This transfers risk of future value to a future buyer unless buyer discounts rents accordingly. So if you are a buyer discount free rents in the past to adjust rates to “real rent” and value property accordingly. In a complicated transaction or complex market conditions, a buyer can negotiate a longer due diligence time reduces the uncertainty aspect of risk and in effect transfers some risk to the seller. Rigorous due diligence reduces the uncertainty component of risk.

Finally, when a developer enters into a J/V with a land owner, setting land value as part of the land owner’s equity can be tricky and risky, since the land value really depends on the ultimate future value and cost of what can be built on it. Setting a sliding land value, with a maximum and minimum as function of development performance at some stabilized period of time, can protect both sides from the risk of uncertainty.

Transfer of Risk between Owners and Tenants: A variety of risk management strategies can be employed to reduce a property owner’s risk. Personal lease guarantees provide owners with access to personal assets if tenants default. Rent escalation clauses tied to CPI increases transfers risk of inflation to tenant. In periods of low market rent increases longer term leases transfer risk of rent loss due to vacancy to the tenant, short term leases transfers same risk to the owner.

The reverse is true in periods and markets of high rent increases – long term leases transfer risk of increased rental cost from tenant to landlord, since there is a loss of opportunity to increase rents. Short term leases place increased risk of rent escalation on the tenant.

Transfer of Risk between Lender and Borrower: We’re mostly familiar with risk transfer strategies of lenders, particularly in the current lending environment. Personal guarantees of loans by borrowers transfers risk from lender to borrower by granting access to the borrower’s personal assets in the event of default. Higher debt coverage ratios and lower loan-to-value ratios transfers risk from lender

Rodino Associates

Economic Development & Real Estate Services

to borrower. Under these criteria more equity is needed to purchase or develop with the reduced chance of negative cash flow due to lower debt service payments.

The opposite happened in the recent financial crisis. Lenders often provided loans with 100% loan-to-value ratios resulting in what appeared to be no risk taking by borrowers. Both sides fooled themselves however, as the overall risky financial structure came tumbling down on everyone. This financial crisis could be understood as a crisis in risk management. Rigorous due diligence was often absent. Overleveraging was rampant and compensation was tied to deal volume rather than deal performance.

Risk – reward management is a critically important perspective from which to view any investment, especially in real estate. By understanding the dynamics of risk and reward you can manage your investments for greater profit.

I hope you found this paper useful in your work. If you would like to discuss any aspect of work, or if I can be of help to you or your clients in this area, please feel free to call or e-mail me at bobrodino@aol.com.

*Best regards,
Bob Rodino, Ph.D.*

Development - Real Estate Investment Services - Downtown Revitalization – Expert Witness