CRE INVESTMENT STRATEGIES

Top 10 Sources of Risk in Real Estate Investment Deals

Posted by Ian Formigle on 16 May 2016

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Risk is the elephant in the room when it comes to private real estate offerings. It's open discussion is often skirted at the outset of a **proposed investment opportunity** and, in some instances, vastly underestimated. While avoiding investment risk is ideal, unless investors want to simply hold treasuries (which is generally referred to as the "risk free rate of return"), the reality is that risk is a natural part of any investment and commercial real estate is no exception.

So, rather than pretend that every investment will experience the "good deal" exemption, it is wiser to confront the issue head-on by recognizing where risks exist, estimating how big those risks are and determining whether or not you, as an investor, are getting sufficiently compensated for assuming that level of risk. The first step is understanding the different types of risks that can pop-up to negatively affect a real estate investment. At a macro level, there are a number of broad geopolitical and economic events that can derail a potential investment. Since investors have no control over such events and they are nearly impossible to predict, this article will, instead, focus on the top ten micro or "deal" level risks that are more easily compared and contrasted across competing investments choices.

When evaluating a **real estate investment**, it is important to consider the following ten elements of risk:

1. **Sponsor risk:** The experience and ability of the developer, operator or lender can have a substantive impact on whether that sponsor can execute on a

business plan and deliver targeted results to stakeholders. Within sponsor risk, there are two primary subsets:

1. Asset management risk: The asset manager is charged with executing the business plan at a strategic level. The asset manager's expertise and attentiveness to the asset is paramount in translating a business plan into a successful outcome.

2. Property management risk: Assets that require individual customer service as an important part of executing a business plan (e.g. multifamily, senior housing, hospitality and storage) are highly dependent upon property management. In these scenarios, outstanding property management is critical as the day-to-day onsite operations of the asset will have a direct effect on its performance.

2. **Debt risks:** Placing debt on a project is a common practice but placing too much debt on it or having it mature at an inopportune time can imperil it, particularly in the event of a market downturn (see market risk below). Debt risks can lead to foreclosure. Foreclosure isn't as much of a risk itself but the unfortunate outcome of the incurred risks of over leverage, debt maturity or a combination of both.

1. Over leverage: If a property loses too many tenants its net operating income can drop to the point that its debt coverage service ratio can fall below 1.0, which now places the asset into risk of defaulting on its mortgage. Prudent leverage on an asset can range anywhere from 0% to 80% depending on the asset strategy (see: **Real**

Estate Investment Strategy: Four Categories of Risk & Reward). If an asset is leveraged in excess of 80% of value then it should have a compelling justification for the use of that much leverage. Otherwise, it may be overleveraged.

2. Debt maturity risk: If a property's debt matures in a down market (see market risk below) or at point when its net operating income is compromised, as noted above, then the project may be unable to obtain a new loan in the same amount of the outstanding debt. If investors are unable to infuse the additional capital necessary to refinance the project then the asset is now in risk of mortgage default. Debt maturity was one of the major culprits of why projects were lost during the financial crisis.

3. **Cap rate risk:** Of all the financial assumptions in a pro forma, cap rate risk is the most extreme since it has a dramatic effect on an asset's exit value, and that is why it is included in this list. As I illustrated in my article, What is a Cap Rate?, prevailing cap rates for different asset classes move in ranges and are subject to supply and demand for that particular asset class. A small movement in a cap rate percentage can have a substantial effect on the residual value of an asset and, in turn, the profitability (or loss) on a particular transaction. When analyzing an investment opportunity, pay attention to the entry and exit cap rates and ask yourself 1) is the entry cap rate attractive for this asset when compared to its competitive set and 2) is the assumed exit cap rate is defensible over the prescribed holding period?

4. **Tenant risk:** There are two primary subsets of tenant risk a) rent roll quality and b) rollover risk:

1. Rent roll quality – this usually refers to credit worthiness, stability and number of tenants. Do the tenants of a particular property have staying power, or could the tenant(s) go out of business, file bankruptcy or default on its lease? Generally, large national tenants such as Google or Amazon are viewed as highly desirable and less risky compared to a mom-and-pop start-ups. Another element of tenant risk is single tenant vs. multi-tenant scenarios. Single tenants can be great during a lease term since your property, by definition is 100% leased but if they default or vacate at expiration, your property is now 100% vacant. In contrast, multi-tenant buildings are rarely 100% leased or 100% vacant. By creating a diverse tenant mix where no single tenant occupies more than 20% of the total leasable area of a building and staggering lease expirations, you can mitigate occupancy risk and help to ensure your building remains mostly occupied at all times regardless of what happens with any single tenant.

2. Rollover risk – this refers to the remaining term left on leases at a property and it affects both single tenant and multi-tenant properties. Logically speaking, more term is better but that aspect of leases is often priced into assets, so it's not as easy as simply looking for longest term leases you can find. In addition, acquiring a property with a tenant on a long-term lease that then defaults is the worst case scenario. You likely paid a premium for the value of that lease, which is now diminishing the asset's value. As part of an acquisition, a reputable sponsor will interview tenants in an effort to handicap

the likelihood that each tenant will perform on its existing lease and renew upon expiration.

Operators who are adept at analyzing the quality of a tenant rent roll and assessing rollover risk can create asset value.

5. **Leasing risk:** In an asset where current vacancy exists that the sponsor expects to lease up over time, there is risk that the lease up may not occur or may occur at a slower rate than the sponsor anticipates. Good sponsors mitigate lease up risk by budgeting appropriate amounts of time and resources (monetary and human) in a pro forma when contemplating lease up scenarios.

6. **Physical asset risk:** There is the potential that unexpected costs may arise due to the condition of the property itself. Aging assets tend to have more risk for unforeseen problems to surface, such as costly roof replacements or equipment failure. Sponsors can mitigate physical asset risk through professional third party reports that examine the physical aspects of an asset and highlight abnormal costs. Good sponsors then utilize these reports to further mitigate risk through renegotiation of price or terms with sellers.

7. **Entitlement risk (new development only):** New developments must navigate a lengthy and often complex process in order to obtain municipal approval to construct the project. This is referred to as the entitlement process and, prior to receipt of construction permits, all new development possess entitlement risk. Since this process is detailed and contains many unique

features, we have dedicated an article to its discussion: "**The Real Estate Development Process: Understanding the Risks and Milestones**".

8. **Construction risk:** Any time a project entails significant construction (new development or redevelopment of an existing asset) there are risks that the construction project may incur cost overruns, take longer than anticipated to complete (creating leasing risk as noted above) or expose previously unknown defects in the physical asset (see physical asset risk above). When looking to invest in a project with significant construction, it's critical that the sponsor have experience in managing construction projects.

9. **Market risk:** Real estate as a whole is known for its up and down market cycles. Good markets are characterized by strong occupancies and steady rent growth while downturns often result in lower occupancies and flat or even discounted rents. There are myriad market risk factors that can trigger an imbalance in the supply and demand for space, such as a surge in new development or a dip in demand from a slowing economy.

10. **Geographic risk:** Properties are heavily influenced by their location based on the regional, state, city or even a specific neighborhood.Job growth, population and demographics are some of the key ingredients to that equation.Primary markets such as New York, San Francisco, L.A. or Chicago have larger, more diverse economies and a bigger population base to insulate it from market downturns. In contrast, secondary markets are viewed as riskier and tertiary markets as riskier still because they are more susceptible to dips in the economy and have shallower pools of buyers. While primary markets to enjoy the greatest amount of

transaction activity, it is also imperative to remain cognizant of this factor becoming overpriced into assets. For example, after an amazing run over the previous five years, core located assets in San Francisco are currently of topic when it comes to the conversation of location overpricing.

Given the discussion of the risks summarized above, it becomes easier to now understand how two real estate investments that both offer the same targeted return may have dramatically different risk profiles. In that regard, it is important for the investor to peel back the different layers of risk to determine the superior risk-adjusted return, which is another way of asking which deal poses the opportunity to earn the most return for the least amount of incurred risk.

One final point is that risk is subjective. Two different investors may have entirely different views of the risks that can translate into different perceived risk-adjusted returns. For example, in the category of tenant risk, one investor may argue in favor of the certainty associated with a single tenant while another investor may argue in favor of a multi-tenant property, citing the huge risk of absolute vacancy if the single tenant vacates – they are both correct.

Investors must make their own judgement calls on risk based upon what feels acceptable in the eye of the beholder. Once a determination of risk level is identified in an investment opportunity, the investor may now proceed with a rational assessment of the deal, which will serve both investor and sponsor well in the event that those risks avail themselves during the holding period.

CrowdStreet is simply educating investors on where to look for potential risks as they conduct their own due diligence. To learn more about online real estate investing and to register for a free commercial investing account, please JOIN NOW.

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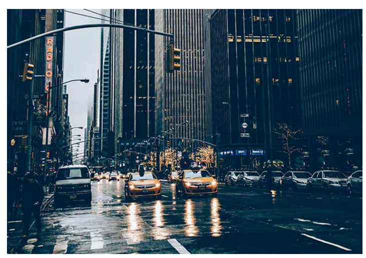

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