JAMES A. GRAASKAMP COLLECTION OF TEACHING MATERIALS

V. INDUSTRY SEMINARS AND SPEECHES - SHORT TERM

I. Other Presentations In Which Either The Date And / Or Sponsoring Organization Is Missing

1. Risk Management/Investment Related Topics

c. "Real Estate Risks Can be Controlled", no date

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REAL ESTATE RISKS CAN BE CONTROLLED

The investor in real estate has in fact accepted a set of assumptions about the construction costs, the revenues, the operating expenses, financing terms and tax laws which relate to the business of marketing the space-time product loosely referred to as real estate. Modern money management defines risk as the variance between these assumptions before the fact and the financial realization which are reported after the fact. Moreover, modern money management views this risk as measurable, at least to a degree, and controllable through a thorough and explicit program of risk. The objectives of risk management are first to conserve the original equity capital and secondly to realize the income anticipation of the financial assumptions despite the surprises of potential alternative outcomes. The best way to protect the original investor equity is either to reduce the equity cash required to a minimum or to achieve payback of capital vulnerable to loss as quickly as possible. Thus, one measure of risk in real estate is the maximum loss represented by unrecovered cash investment plus contingent liability for notes, mortgages or the unknown liabilities of apartments. Corporate shells, limited partnerships, and exculpatory clauses on mortgages are well-known methods of limiting the maximum loss for the equity investor. Risk management can be more positive in its approach than these techniques would imply, however, particularly in the realization of income expectations.

The first step is to identify the most significant elements of variance in the financial plan and typically a deal is most sensitive to assumptions in the following areas ranked in importance to yield:

A. Cost to construct and indirect costs of rent-up
B. Prices and absorption periods or rents and vacancy rates
C. Operating expenses
D. Status of the tax law

Some of these risks can be shifted to others for a price while others can be controlled by structuring management incentives correctly. For example, construction costs can be controlled by careful design, precise bidding, and careful drafting of construction documents of all kinds so that mistakes, surprises about soil or labor conditions, consumer needs, or efficient expediting can be the responsibility of others. Financial plans should include some capacity to absorb an over-run--a legitimate variance between assumptions and realizations as distinct from variance due to careless contracting. Variance in absorption rate and rental price can be controlled by pre-leasing, or staging the project, or careful selection of a rental agent. Provision for his commission should withhold any of his profits until he achieves realistic goals set by contract. The key to profitable rental properties is a low vacancy rate and it may be necessary to give a property manager 25% of all the rents collected above 95% occupancy so that his incentives parallel the interest of the long term investor. By using a penal clause the property manager may be required to hold expenses to a rate of increase equal to that of the increase in rents.

In the same fashion the limited partner should never agree to fund the unknown difference between available mortgage financing and the cost of a project--as all the variance (risk) for whatever cause is then shifted to the limited partner. Instead the general partner should be required to produce operating results equal to the assumptions made about the project or the developer forfeits a progressive amount of his profit, management fees, and income participation proportionate to his failure to meet certain levels of performance. Despite all that management can do some variance in results can be anticipated and a promoter of a project should present not one set of assumptions but several sets, one representing a reasonable but pessimistic set of assumptions, another representing the central tendency of expectations, and perhaps a third showing a sensitivity of yield to unexpectedly favorable results.

Computer models already exist which permit the analyst to determine the range of revenues and costs that could reasonably result in a given project and show a probability distribution as to investment yield, breakeven operation, and the possibility of additional capital required on mortgage foreclosure, etc. These are called density models and are being used only by the most sophisticated investors in financial institutions but they indicate that real estate financial analysis is primarily concerned with the reliability of assumptions or degree of variance involved. The errors in these estimates or assumptions can be controlled by shifitng responsibility by contract, by avoiding unpredictable problems such as rezoning, by providing dynamic incentives for management which parallel those of investors, and by always recalling that almost every outlay made by the partnership is revenue to another enterprise. Is such an outlay an arms length agreement or does it represent a profit center to be retained to the interest of the investor, at least in part? The best control on risk is adequate information about the site, the market, and the other details that create flexibility and tolerance for financial surprise in the project. Good real estate investment should not rely on the luck of the "wildcatter", the implicit assumptions of a promoter, or the fatalism of those who see inflation and tax law as the guarantors of any investment. High yields do not compensate for high risk as risk is not necessarily related. The investor with no capital invested has no risk and on original cost his yield is infinite! Some variance cannot be predicted or controlled, but many financial assumptions in real estate can be held to an acceptable range of alternative outcomes.