Real Estate Investment Newsletter – February 2004

Primer on Real Estate Risk

Last month we looked at real estate returns. Of course looking at returns without considering the risks of the real estate doesn't give you enough information to make an intelligent decision – so this month we look at the other half of the equation: risk. Although most investors are "aware" that they are taking risks, few take the time to really analyze risk. In my observation most investors neither project returns nor measure realized returns. Instead they rely on gut instincts. Hence they are oblivious to risk as I define it. In this month's newsletter, I will give you a framework for thinking about and analyzing real estate risk. By defining precisely what risk is in the context of real estate investment, and its sources, we can manage it, mitigate it, and make informed decisions about which risks are acceptable or unacceptable.

Definitions of Real Estate Risk

In the most general sense risk is the possibility that actual returns will fall short of expectations (projections). In this context, risk is measured in terms of the size of the possible deviations from expectations and the probability of those deviations. Under this broad definition, you look at the continuum of possible outcomes for a particular piece of real estate and the likelihood of the bad outcomes to determine whether the risk is acceptable given the probabilities (and given the overall return expectations).

As I alluded earlier – if you haven't explicitly formed any expectations about returns you are unlikely to be disappointed. I believe that people implicitly have an expectation that their returns will be at least 0. Thus they simplify my broad definition of risk to: the likelihood of actually losing money. If they break-even, or better, they're reasonably satisfied. A related "short hand" definition of risk is the probability of catastrophic loss. By this I mean you consider the worst case loss that would devastate your principal and define your risk as the probability of this loss occurring. You invest in the real estate if the chance of that one event is sufficiently remote.

Another way of looking at real estate risk is to estimate the probability that returns fall short of your projections. If this risk is low enough given the returns you are projecting, the investment is acceptable. This definition of risk is simple and focuses attention on what is most important to real estate investors: how likely is it that they will achieve their return goals. Once you are thinking clearly about how you define risk, you must look at the various sources and types of risk in your real estate deal.

Sources and Types of Risk

The most important risk in real estate investing is **Cash Flow Risk -** an unexpected drop in cash flow that reduces cash returns. Management is a primary source of cash flow risk. A bad manager can cause a property to drastically under-perform. Among the sins of poor managers are:

- Not filling vacancies promptly
- Accepting tenants who won't pay rent or who damage the property
- Not maintaining the property – thus driving tenants away
- Overpaying for services
- Stealing

Economic factors both local and national pose risks to real estate cash flows. Unemployment reduces demand for rentals and low interest rates lead to both increased supply of apartments (competing for renters) and fewer renters because low mortgage rates allow more people to buy instead of renting.

Interest rates also pose a direct risk for those who have financed their real estate with floating rate debt. When rates go up, loan payments on adjustable rate mortgages will increase much faster than property income can increase. This may lead to default in cases where leverage is high and rental fundamentals are weak. *People taking floating loans in the current environment are putting themselves in a no win situation: if rates go up, cash flow will drop due to higher loan payments while a drop in rates will lead to increased vacancy as more renters move to home ownership.*

Finally, there is the self inflicted risk of cash flow not meeting expectations because projections were unrealistic in the first place. This should not be ignored; it is all too common. Listing brokers often present "pro-forma" operating statements that show what *could* happen if everything went great rather than what is most likely to happen. Sometimes they outright lie about a property's rents and expenses. As Ronald Reagan famously said "Trust but Verify."

Where there is cash flow risk there is **Liquidity Risk**: the risk of severe financial distress due to a lack of cash reserves[1]. While a temporary decline in cash flow can hurt your returns for that year, a lack of liquidity when cash flow turns negative can cause the loss of your *entire* investment. Even though an investment may be sound in the long run it will be meaningless if you don't have the cash to make it through the short run. Liquidity risk comes from the possibility of a temporary drop in cash flow. Alternatively the sudden elimination of credit lines or a failure to hold cash in reserve may lead to a liquidity crisis. For example: you invest all your cash in a fully leveraged real estate deal and experience temporarily high vacancy and can't make the payments. The bank forecloses, wiping out hundreds of thousands in equity or you are forced to sell at a loss. Thus the risk of a small drop in returns can be exacerbated into large losses.

Less recognized but very real is **Appreciation Risk**: the possibility that expected increases in value don't materialize. Appreciation is tied to growth in cash flows so that any source of cash flow risk is also a source of appreciation risk over the long run. Demand and supply of housing, as well as uncertainty about money supply growth and inflation all contribute to appreciation risk.

The physical characteristics of the building itself are another potential source of risk to expected appreciation. For example the age of the building, its functionality, and the quality of the construction all matter. As tenant tastes change a building may become functionally obsolescent which limits its appreciation even when it's well located.

This brings us to a very important source of appreciation risk: the physical attributes of the location. Areas subject to natural disasters or even just lousy weather can put appreciation at risk if it becomes undesirable to tenants.

Local land use politics can also be a source of risk. If an area is rezoned to an inferior or undesirable use it could depress property values. Or the local politicians may impact property appreciation through their decisions about where to encourage growth and where to make investments in transportation or other infrastructure.

Capital market conditions – increases in the cost of financing and capitalization rates (required rates of cash return) are also a major source of risk to real estate appreciation forecasts. Of course, unrealistic appreciation forecasts themselves are a source of risk. Beware; forecasting appreciation by extrapolating from past rates of appreciation is very risky: it's the investing equivalent of driving while looking in the rearview mirror. As explained last month, an appreciation forecast done correctly is the result of forecasting both net operating income

[1] Just to be clear: liquidity means immediate availability of cash to meet obligations. This can be in the form of money in the bank, marketable securities, or a committed credit line.

growth and changes in capitalization rates. In the end, all must be consistent with a view of how the national and local economies will evolve through time.

Risk Management and Mitigation

Fortunately in real estate there is much that can be done to manage or mitigate risks. First and foremost is doing the necessary research and due diligence up front to produce realistic forecasts and evaluate the sources of risks. Base your forecasts on conservative assumptions to keep the probability of missing forecasts to an acceptable level. Of course you don't want to purposely underestimate performance or you may pass up opportunities you should take. Shoot for an overall return forecast that you feel will fall within 3% of actual about 80% of the time.

Once you own the real estate, monitor its performance versus expectations and compare it to benchmarks so that you will know quickly if problems arise. If results deviate from expected - find out why. If it's due to economic conditions beyond your control, that is a risk you must bear, but if it's because of poor management you must correct the problem right away to keep returns on track.

Minimize financing risk by using fixed rate financing for at least 5 years unless you have a fix and flip strategy. Interest rate risk beyond 5 years is usually acceptable because cash flow should grow enough over 5 years to provide some cushion against rate rises; You will probably want to refinance anyway at that point to pull out equity. The switch to floating at the end of 5 years should eliminate any loan prepayment penalties that otherwise might impede a sale or refinancing.

Maintain adequate reserves and credit lines to withstand any reasonably possible adverse scenario. At a minimum be able to come up with property tax, insurance, and the monthly payment out of pocket all at once. Project out cash flows, including tax payments, to avoid surprises. It's worth it to take a bit more leverage than you need so as to hold higher liquidity reserves. If you hold the money in low risk high dividend stocks (e.g. REITs) the dividends may even cover the extra mortgage interest. Credit lines are also an efficient way of maintaining liquidity. Preferably you would do both: hold securities and have a back up credit line. This positioning will be very popular with lenders when it's time to apply for new loans on your next deal.

Avoid real estate deals that require future buyers to bail you out by bidding down capitalization rates. Appreciation from investor demand for assets that is unconnected to economic value is fragile – this is the source of bursting asset bubbles like the technology stock meltdown from 2000-2002.

Conclusions

Up front homework (research), contingency planning, and prudent management can significantly reduce the risk of surprising shortfalls in returns or outright losses. Berkeley Investment Advisors understands the risks as well as the returns and works with you to minimize and manage risk. After all, we want you to grow your capital so we can grow our business with you.

Announcement

As many of you know, Rick Rife has joined Berkeley Investment Advisors to cover the 1-4 unit investment market. In keeping with the firm's principles, Rick does not represent sellers; he helps investors find the best property possible, given their investment parameters. While his focus is on high growth markets outside of California, his attention to detail and rigorous research will ensure you have all the facts needed to make the best investment decisions wherever you choose to buy. Rick evaluates every property as if he was buying it and he only recommends deals he would do himself. If you're looking to take advantage of the hot 1-4 unit market and its great financing terms, please contact Rick for a consultation.

Featured Investment Opportunity

This 16 unit apartment building in Lubbock Texas can produce good returns for a relatively modest investment of $110,000. All units are 2 bedroom 1 bath and average rents are just $391 currently. The asking price, $375,000 is just 4.9 times current gross rents. Rents are below market. Assuming the units are moved up to market and insurance and management costs are brought down to more normal levels, the pro-forma cap rate is 8.1%. With a mortgage at 6% (fixed for 5) for 75% of price, the cash on cash would be 9.3%. While Lubbock is a regional center, it is not a fast growing city. Still even very modest appreciation of 2% would produce first year returns in the high teens. This property should return 11% even if appreciation is 0!

Contact Information

RayMeadows@BerkeleyInvestment.com San Francisco phone (510) 367-3280 Tokyo phone: (080) 3122-9601		RickRife@BerkeleyInvestment.com San Francisco phone (415) 425-3332