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Money for real estate: A tale of two cities

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In the past, I have written about how risk adjusted return requirements for real estate can vary. It was not a simple story, since one person's required return was so different from another's. I realized that it was often the perception of risk, and that some personalities are simply bigger risk takers, and some are not. Often these personalities were defined by the amount they could afford to risk, their most recent experience, their age, and their need v. greed quotient.

In today's marketplace, the divergence of investor appetite for risk is in the extreme. It is essentially a tale of two cities out there: with an increase in the wealth of the wealthy class, and a decrease in wealth of the middle class, there is a growing schism between those who can take risks and those who can't.

If you are currently in the stock market, you were fortunate that you were able to take the risk to either stay in or get back in after the meltdown in 2008-9. Year-to-date, since March 2009, the market has increased by approximately 70%, an unprecedented rate of return for most equities. The risk takers who stayed or went in are in a very small minority of the country. The market is very thinly traded by those with wealth, knowledge, and the appetite for risk. As many articles suggest, those in the market, and in the know, have done very well since the meltdown. Others have not. During the meltdown, the conservative players typically lost their nerve at some point, took their losses, and vowed to never to go back in. Many or most of those stayed out during the upturn because of their most recent past experience, projected into an uncertain future.

There are parallels in real estate. I have read many accounts of how it is easy to get money for real estate ventures, with many institutions or high net worth individuals looking to get returns better than treasuries. I have also read many accounts that say that funds are impossible to get, that loan to value ratios have decreased, that underwriting is far more conservative.

In casting about for funds for several recent real estate deals, both debt and equity, I have found that debt is readily available, although a little to land. For strong core investment grade commercial real estate, debt is available between 6Â½ and 7Â½%, with 60 to 70% loan to values.
Equity, on the other hand, is not so predictable in such a narrow range and appears more to behave like the stock market. It runs a little hot and cold. There are some conservative investors who are happy with 6 and 7% returns on their investment, if the net operating income appears to be solid. Other investors, often those who are well versed in equities, venture capital, sophisticated financial instruments, have no interest whatsoever in 7% returns. They are out for the "pop". They are willing to take risks, willing to lose money in exchange for a bigger return. They typically look for 20% to

25% internal rate of returns, or even higher.

While it is perhaps a generalization, there does not appear that there is much money in between. There are those who simply won't invest; those who will only invest in the most secure properties and are happy with low returns; and those who seek the other extreme of the big win.

It may be no different than other markets in the past, but it seems so. These extremes seem to be more polarized because of the financial extremes in the economy of the recent past. There are those who know to maneuver in these markets, how to take advantage of the catastrophe. Those continue to be the risk takers. And there are those who have been burned and have no wherewithal or desire to experience it again in the near future. The extremes of financing make for a more volatile and unpredictable future in an old "bricks and mortar" business.

Daniel Calano, CRE, is the managing partner and principal of Prospectus, LLC, Cambridge, Mass.