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Preserving the deal: Protections for investments in real estate

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The real estate market is regaining its footing after a difficult five year span, and with that confidence comes a new wave of investors and developers eager to participate. As activity heats up, both parties should avoid rushing into agreements; laying out the necessary protections will help keep their relationships - and their projects - in good standing.

The discussion around careful deal-making is timely. Developers are in full stride launching or restarting projects, especially urban multi-family complexes of up to 75 units with a project price tag of $10-$50 million. Boston serves as a prime example. As noted in a recent Boston Globe article, "In just one year alone â€” 2010 â€” Boston's population grew by 7,500 people, and is now above 625,000, its highest level since the 1970s, according to city data. The population surge has thoroughly reversed the suburban migration that began in the 1950s." (Boston humming as appeal of life in the city booms, Casey Ross, The Boston Globe, March 2, 2013)

Whether in a residential or a commercial deal, here are four guidelines that should be considered:

Don't skimp on due diligence

Who are you dealing with? Both parties will want to work with partners who are reasonable and flexible when the situation demands it; the only way to find out in advance is to do the homework. Investors should also review the timing, market context, and location of the project as much as they review the track record of the developer and the contractors involved. A thorough due diligence process is not a guarantee of success, but it does lay the groundwork for a relationship built on trust.

Outline liquidity goals

Parties should determine the timeframe for liquidity events at the outset in order to protect the investment and determine the life cycle of the deal. Investors may be focused on an exit, for example, while developers may prefer to maximize fees by keeping the project in play over a longer time frame. These competing needs for cash should be addressed in a business plan drafted by the development team. The plan should lay out the complete sales strategy and expected cash flow fluctuations throughout the project.

Think ahead to cost overruns
and additional capital

As activity ramps up in the industry, guarding against cost overruns has become a hotly contested issue. Sophisticated investors often ask for a guarantee that the projected budgets are fixed, including estimated development costs and a built-in contingency.

Developers, of course, will likely resist giving investors the power to define these parameters. From their perspective, this is one advantage to bringing together a group of small investors instead of one or two partners with deep pockets. When participation is widely shared, no single investor has over-weighted bargaining power.

Balance the need for control
and compromise

Control over decision making is another sensitive issue that should be sorted out before a deal is sealed. As with other elements, there is a direct correlation between due diligence and control: the more investors know, the more control they have. A full understanding of the developer and the project will guide investors to the right questions, goals, and legal protections.

In terms of ongoing control, first-time investors may want to begin with projects close to home. They will know more about the local market and usually stay more involved if they witness the project coming together firsthand.

As the list of considerations grows, investors that are new to real estate deal-making should keep a fundamental phrase in mind: know what to ask for and who to ask. Investors and developers alike should do their homework, protect themselves, and have confidence in the structure of the deal.

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