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Risk/reward ratio: How much can you stand, and how much do you need?

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What is your appetite for risk? How much reward do you think you need? What chances are you willing to take? These are the kinds of questions that real estate investors and developers routinely ponder. Some do it intuitively, and others use quantitative models. But all investors consider this issue to varying degrees.

I was discussing "return requirements" for land development with another real estate professional, and quickly realized how much he and I disagreed. He stated that his rule was a minimum of return was "50%" to undertake a project as risky as land development. I asked him what was the 50% of. He fired back quickly "gross sales". I thought, why would any developer measure his profit requirement in relation to gross sales. It ignores costs, nets, timing, etc. Certainly, there were better parameters. I responded back that the internal rate of return was a more likely measure for developers, and that the return should probably be based on equity in the deal. He came back with another rule of thumb, and I realized that we were not going to see eye-to-eye.

It got me thinking. Some developers do projects only for fees, with no equity invested, and they essentially are not willing to take equity and debt risks. Others participate at a small level alongside other equity partners. And others are big risk-takers, taking on the whole project. In trying to model developer behavior, we need to recognize there are all types.

There are many components to a person's perceived need for return, as well as on the risk. First of all, the perception of risk is always very different among investors. Those who are working in their area of expertise, may perceive little or no risk. Others who are outside of their comfort zone, may see greater risk. In my view, you can only generalize about this, since it is such an individual issue.

In development, I think everyone would agree that there is always some risk: permit risk, construction risk, financial risk, and marketing risk. These four combined, particularly with time delays, can create real problems. Any time any one of them is mitigated, however, the risk could be significantly reduced.

Now let's consider the required return for risk taken. Real estate investments are typically comprised of equity and debt. Since debt almost always is backed by a first mortgage on the property, in the event of a problem, the equity is most at risk as it will last to be paid. Thus, real estate counselors typically place a higher rate of required return requirement on the equity. However, should the rate of return on the debt side only be measured as the interest rate cost of the debt? If the debt is recourse, its risk can reach far beyond property value. In the event of a serious real estate problem, recourse debt reaches into the developer's or investor's pocket. The issue of recourse or non-recourse therefore plays a critical role in risk/return assessment in real estate development.

The required return on real estate is inevitably compared to other investments. At the end of the analysis, we look back with a broad perspective and say to ourselves "what else could we do with our money". If the development we are looking at shows, say, a 15% internal rate of return, but it takes 5 years to secure, and there will typically be a real estate cycle during that period, we would ask ourselves why don't we just invest in a B-rated corporate bond that is more liquid. Assuming there would be similar risks, and these bonds have been as high as 15%, we might conclude we could achieve the same outcome without making any effort or spending any time. Therefore, time plays a part in our decision. Developers have a tendency not to value their time, as they are looking for the big return at the end of the project. When the end-of-the-day return is less than anticipated, it would be prudent to look back at the years of work, meetings and management effort to gauge whether it was worth the effort.

Development is a risky business. It is important to set high goals for rates of return on investment, however you define them to account for the risk. But the goals need to be realistic, and account for different situations. There is no one magic formula or rule of thumb. In counseling others, it is important to consider all these questions.

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