Market Risk: Cycle Strategy & Preparedness

Chapter 17 Supplementary Information

By Charlie Hewlett, Managing Director

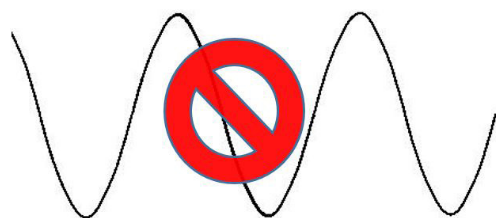
Chapter 17 Supplementary Information

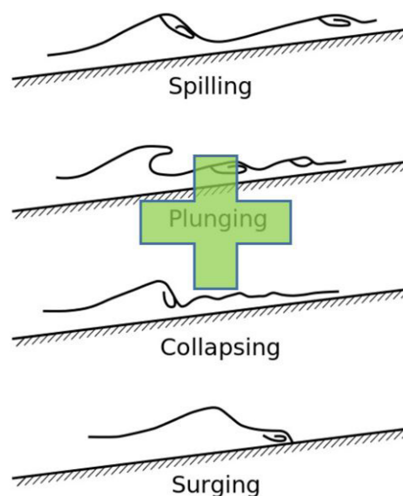
As discussed in Chapter 17 of *Strategy for Real Estate Companies*, risk management for real estate companies encompasses the identification, analysis, and response to various risk factors. Many of these are common factors facing any business, but there are several factors that are unique to real estate. Primary among these is "market risk" which includes monitoring and responding to changes in economic and real estate market cycles. As discussed in the opening chapter, real estate is one of the most cyclical businesses in the economy—more than tech, energy, or the stock market. Real estate experiences higher highs and lower lows than most other business sectors. The saying goes, when the economy catches a cold, real estate gets pneumonia. Therefore, planning for these extreme cycles should rank high on the list of risk management strategies for most real estate companies.

Market Risk

More than any other factor, the real estate cycle determines the appropriate strategy of a real estate company. When formulating a strategy and managing market risk, a company must start with an understanding of the effects these cycles have on the markets and their business. To ignore the extreme cyclical nature of the industry is to place a real estate company in peril, dooming it to continuous crisis mode during every real estate downturn. If companies do not plan adequately for downturns, they risk surviving to enjoy the inevitable upturns.

For the record, a perfect oscillating sine wave is a terrible analogy for changing economic and real estate market conditions. Far from being a perfect sine wave that repeats with rhythmic amplitude and duration, real estate "cycles" are more like ocean waves.





Sure, they generally look alike, but each one has its own unique characteristics, each one is precipitated by unseen forces lurking under the surface, and each one breaks a little differently with unpredictable results on the shoreline. Even though it is impossible to accurately predict the cause or triggering event(s), timing, magnitude, or impact of any one cycle (or wave), we should absolutely expect the U.S. economy and real estate markets will continue to experience periods of expansion followed by periods of contraction—the tide will eventually turn.

MARKET RISK

It is important that real estate companies have risk mitigation contingencies and strategies for each phase of the real estate market cycle. It is also important to remember that at a cyclical peak, real estate can turn from a sellers' market to a buyers' market in a a heartbeat. A real estate company that is slow to react in the depths of a downturn and misses the market upturn by a quarter or two may indeed leave some money on the table and miss some attractive opportunities. More significantly, a company that misses the call on a cyclical peak could find itself in a world of hurt; making investments or failing to divest itself of assets or shoring up its balance sheet could prove disastrous as the market enters a downturn.

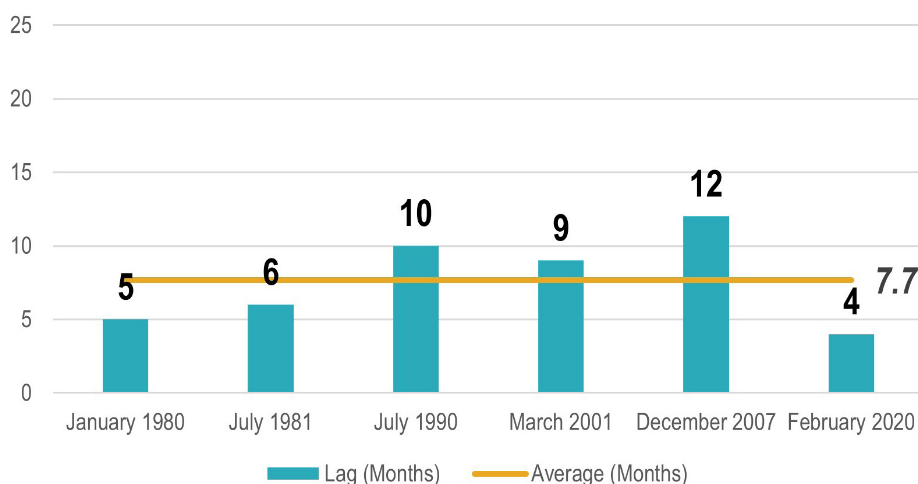
It is also important to acknowledge that you will never really "know" precisely where you are on the real estate cycle. What is perhaps more relevant than trying to determine a particular moment in time is talking in terms of probabilities. What is the probability that my market(s) will peak and enter a downturn sometime within the next 6, 12, or 24 months – which is probably the farthest out that anyone can see with any level of confidence?

For example, while there is nothing particularly scientific about the probabilities below, the following represent the RCLCO POV as of Q4 2022 with regard to the probabilities of various potential trajectories of the U.S. economy and real estate markets over the next 12 to 24 months:

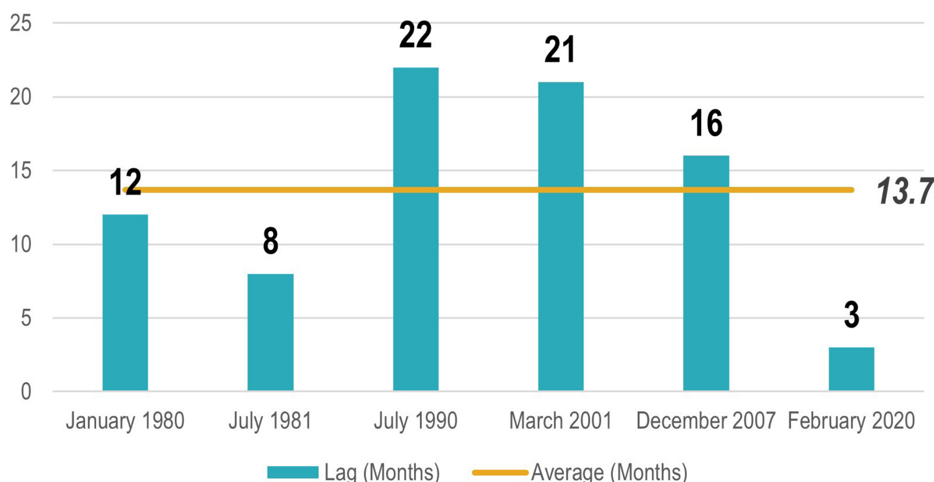
RCLCO POV – Q2 2023

PROBABILITY	SCENARIO	OUTCOME
20%	**Upside**	U.S. economy will avoid technical recession with GDP, job growth and real estate returning to trend in 2023.
60%	**Base Case**	U.S. economy will experience a mild recession in 2023 with negative a period of negative GDP growth, flat employment and declining real estate values returning to trend in 2025.
20%	**Downside**	U.S. will experience a more severe downturn with job losses, declining real estate fundamentals with growth resuming in late 2025 or early 2026.

We should also admit openly that it is very challenging to predict exactly when the next downturn will be, or how deep, or how long-lasting it will be. Keep in mind that it won't be just like the last one, nor will it likely equal the average— it rarely does. The one thing that you can be certain of is that there will be another downturn. And, with the probability chart (above) in mind, it's important to think about how you are going to "know" when the next one comes, and what you are going to do differently leading up to the next cycle peak and through the inevitable downturn and then in the recovery.

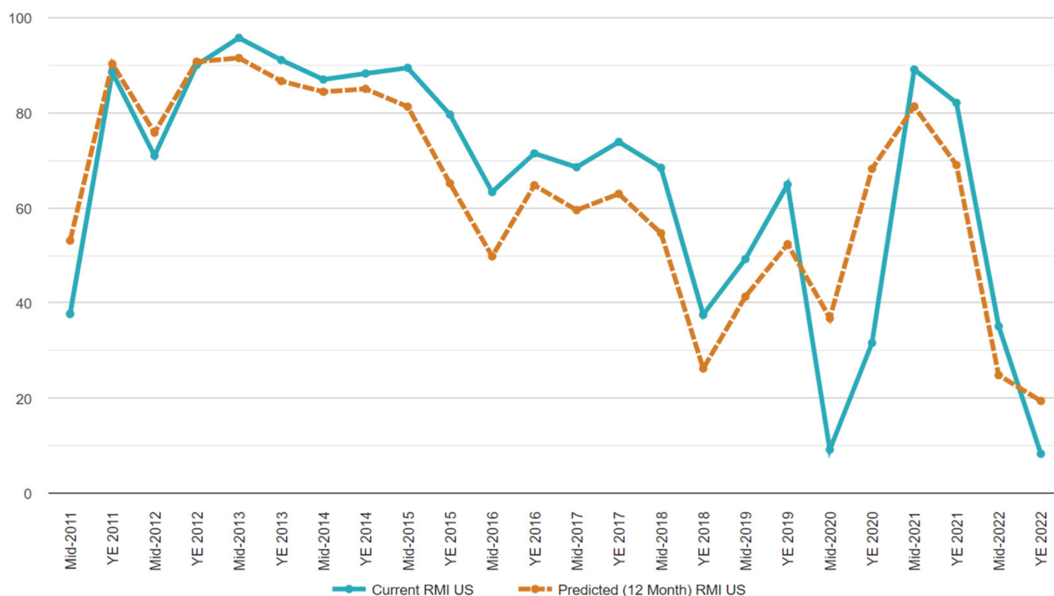


Source: NBER



Source: NBER

One of the most frustrating aspects of preparing for a downturn, or any change in the cycle, is the lag in data that helps you know when the market turns from expansion to contraction, or when the market hits bottom and begins to expand again. Very often, the confirming information arrives long after the event has occurred. If you waited for the National Bureau of Economic Research (NBER), the unofficial arbiter of recessions in the U.S., to tell you when the economy peaked, on average you will be informed approximately eight months after the fact, and you may have to wait nearly 14 months on average for the NBER to tell you when the downturn has ended.
The participants in RCLCO semi-annual Real Estate Market Sentiment Survey may be a better real time indicator than NBER - in Q4 2022, when the future index hit an all-time low below 20 and nearly 55% are predicting that the U.S. economy and real estate markets will be in a recession in the next six to 12 months, and a full 93% see a recession as inevitable within next 24 months – we'll see?



What is absolutely essential, particularly as a real estate company enters the "late innings" of the cyclical upturn and approaches a peak, is to analyze and interpret signs that indicate the probability that a peak is imminent. Then you must take graduated actions in advance of the peak to mitigate risk and protect the company from bad things happening to it in the downturn. Simultaneously, it's equally important, to position the company to take advantage of opportunities that will inevitably be available in the downturn.

Those who wait to prepare and deploy market risk mitigation strategies until it is clear that the current growth strategy is no longer applicable have probably waited too long. Being able to anticipate and plan for downturns, or other adverse conditions, is critical for success in real estate. It is well known that vast real estate fortunes are created during relatively brief periods of dislocation and inefficiency—which is typically in the real estate cycle trough.

Predicting the precise moment that the market will turn is a fool's errand, and it is inherently unknowable. So, what is a budding young real estate executive to do? To manage market risk, he or she should have a process in place for monitoring economic and real estate market indicators and an action plan for dealing with a number of possible outcomes and probabilities. Market monitoring and cycle planning should be a critical component of every real estate company's risk management strategy.

When things are going well, the savvy real estate company continues to ask; how well is the company prepared to deal with a slight hesitation or a mild economic slowdown sometime in the next one to three years? What about a more severe and (by its very nature) unanticipated downturn or another asset bubble or pandemic-induced deep recession? What economic and real estate market indicators should you be tracking to help gain perspective on where the market is and where it is heading? What market risk cycle strategies should I have in my hip pocket ready to deploy at the right moment?

Key questions that everyone in the real estate industry—developers, owners, operators, investors, lenders and service providers alike—should be asking themselves are:

- How well prepared am I for a slight hesitation or mild economic slowdown?
- What about a more severe and, by its very nature, unanticipated downturn?
- What economic and real estate market indicators should I be tracking to help gain perspective on where my market(s)/product(s)/segment(s) are heading?
- What predetermined cycle strategies should I have on my play sheet ready to deploy as conditions change?

Real Estate Cycle Stages and Preparedness Strategies

I know a number of very successful real estate CEOs over the years who have told me that it makes absolutely no sense to try to time the cycle. No one is smarter than the market, they would say, and no one can, or should even try, to pick the absolute top of the market – can't be done.

In general, I agree, but statements like this are missing the point of cycle planning as part of your strategic plan. Cycle planning is one important part of an holistic risk management strategy, and it should be designed not to pick a particular point in time when one phase of the cycle ends and another begins, but rather is intended to instill risk avoidance and mitigation discipline to a) prevent a real estate enterprise from exposing itself to unnecessary risk, and b) keep the company attuned to taking advantage of opportunities that will inevitably present themselves in these points of inflection.

No, you can't pinpoint the absolute peak, and don't try to, but do read the proverbial tea leaves, have a POV about where your company is on the cycle now and where it is likely headed over the next six to 12 months, and take some chips off the table in the latter stages of the expansionary phase of the cycle if you are able and feel overexposed. My father, who spent his career in the stock market, and not real estate, would always remind me that there is no shame in taking profits, and you will usually only pay taxes if you are making money. It's equally hard to make the gutsy call to go back into growth mode in the depths of a downturn – but just as sure markets will fall, so will they recover, and the rewards can be many for the bold and the early. Also, take some time when the sun is shining to create space and capital to consider opportunities that be available only in a down market. Many a real estate fortune had its seeds in the misfortune of others who did not prepare as diligently.

Those who will be better positioned to thrive from—and not merely survive—a downturn, particularly as a real estate market enters the latter stages of the cyclical upturn and approaches a peak, are those who learn to (a) analyze and interpret signs that indicate the probability that a peak is imminent; and (b) take graduated actions in advance of the peak to mitigate risk, including, but not limited to, bolstering the balance sheet, enhancing liquidity to protect the enterprise during the downturn, and make accretive acquisitions, whether that's assets, land, talent, etc.

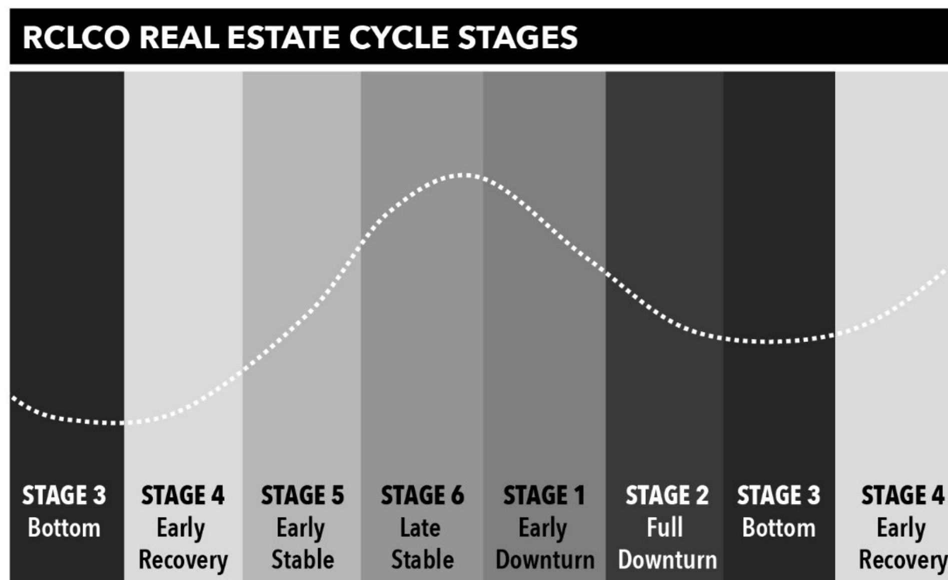
Early planning and ongoing monitoring will help provide real estate executives with the tools necessary to navigate changing market conditions. First, the enterprise needs to have a comprehensive strategy developed for all stages of the real estate cycle. It then needs to

be nimble as activities shift from one strategic initiative to the next—from growth to hesitation to rationalization strategies. Finally, the enterprise must be able to anticipate and monitor the economy and the marketplace to be among the first to realize what is going on and prepared to act on it before it's too late.

I find a useful analogy for a comprehensive cycle strategy is like having one of those laminated play sheets that NFL coaches always seem to be carrying around. As the coach of your real estate enterprise, you need to have a series of plays spelled out before the game that you can call upon in the right situation. There are probably 200 plays on that sheet, but fewer than a third ever get called during a game—and you can bet the coach and his/her staff have figured out at least one play for any given situation. Likewise, the leadership team of every real estate organization should have a play sheet. Maybe getting it laminated is a little over the top—but hey, you never know…

Some companies are also fond of using the baseball analogy of innings to describe the condition of their markets and segments on the real estate cycle – early, middle, and late innings. Others use a clock face, sine wave graphic, or expansion/contraction quadrants, any of which are fine, and certainly better than not doing anything at all. Only problem I have with innings is knowing if the game is going to end in nine, or if it will be a marathon 15-inning affair – but I digress. Using whatever method you choose, you need to "determine" where your company, your markets, and your real estate segments are on the cycle. You then need to have a point of view, and plans for, the near- and mid-term consequences for your business.

While there is no magic to it, at RCLCO we identify six real estate cycle "stages" to describe where the economy and real estate market in general, and specific real estate sectors and segments are on the cycle. We have also developed a playbook to describe what companies in the real estate industry should be doing in response to changing economic and real estate market conditions in each of these stages. For most real estate asset classes, determining the cycle stage is fairly simple - it boils down to income trends and the relationship between price and asset value and/or replacement cost. If you can define the relationship between these few variables, you will have a better than average view of the real estate cycle. Trouble is, of course, clear patterns in these variables are not always easy to identify.



Stage 1 – Early Downturn

This stage is the initial period following a cyclical peak, when the economy and real estate markets enter a period of contraction or downturn when real estate asset income, prices, and values are all falling. Credit is typically harder to come by on attractive terms, if at all, and most market participants try to delay and defer commitments they may have made just recently now that it has become clear that the market is post peak. Developers curtail starts and mothball deals where possible. Acquirers try to defer, retread, and in many cases walk on deposits for deals negotiated before the peak. This is also the time when savvy real estate players begin to focus their teams and confirm capital commitments to look for opportunistic buys that are likely to present themselves in the downturn. In addition, this is a time when real estate companies begin to pare down their overhead, ideally with flexible staff added in the latter part of the Late Stable growth phase, and work hard to maintain their "keepers."

Companies that reach this stage without having deployed intermediary cycle strategies will be ill prepared. They should have positioned themselves to take advantage of adverse conditions leading into the downturn. Instead, they may become those who create opportunities for others. At this stage, the company's strategic growth activities must be reevaluated and possibly shelved. Investments and activities that made sense in a growing economy, and still worked in a slowing economy, may make little sense in a downturn. This is the stage at which the company is focused on preparing for and weathering the downturn.

Stage 2 – Full Downturn

This is about as bad as it gets, and not every cycle enters the severe Full Downturn mode. In some cases, the market hesitates slightly or experiences a mild contraction in the Early Downturn phase, but can return to Early Recovery in relatively short order – but this is not always so. As Early Downturn Phase wears on, and the risk of a Full Downturn takes hold, companies should continue monitoring the economic and real estate market "trip wires" events they have put in place, including both internal company and external market indicators, and determine if they should deploy the next level of risk mitigation action items. Your trip wires could indicate, as they surely should have most recently in Q2 2008, and Q1 2020, that it may be necessary to move your company into full-blown survival mode. For a company to resort to survival mode, the market will have turned so severely that management/ownership must seriously evaluate the company's future as a going concern. At this stage new development activities are abandoned, and further cuts in G&A are made to

right size operating costs to the volume of activity/revenues. Rarely do companies emerge from survival mode without some meaningful changes, and some companies simply don't make it, or don't continue on in the same mode of operation and/or ownership as they had before the downturn,

The object, of course, is to avoid the need to go into survival mode, if possible. Indeed, successfully mitigating this stage derives from having capital and the capacity to capitalize on the opportunities created by the failure of those who were caught ill-prepared. In this stage, most developers refrain from starting any new projects and try to renegotiate contracts and re-trade deals wherever possible. Real estate companies that have developed a war chest in the waning stages of the expansion begin to deploy opportunistic capital to take advantage of distress and attractive pricing that is offered by those that did not plan well. As prices are typically below replacement cost, this is the time to buy assets, first, and then land, ideally at bargain prices. Companies with strong balance sheets and relatively low levels of leverage are able to withstand this phase of the cycle much better than companies that have overleveraged their assets or company and need to recapitalize projects and/or enterprises when that necessary capital is typically most expensive, if available at all.

Stage 3 – Bottom

This is the trough, and conversations at this stage in the cycle typically revolve around how long before the economy and real estate markets recover and return to growth mode. Will be bump along the bottom for some time, will we see a "hockey stick" or sharp "V" curve recovery with a robust snap back to growth, or, as was widely discussed at the bottom of the 2020 pandemic-induced downturn, will we have a "Swoosh"-shaped recovery, mimicking the iconic Nike sneaker brand with an initial rapid recovery and a slower, longer tail before the markets get back on trend?

Remember, it typically takes more than a year for the NBER folks to tell us the recession has officially ended. For us mere mortals in the real estate industry, it is usually three to six months before most market participants "know," or at least feel, that the bottom of the cycle has been reached. As your strategy team begins to think about when it is appropriate to go "risk on" for renewed growth and new investments, it's probably okay to be cautious and possibly miss the bottom by a quarter or two, but, as discussed above, missing the peak can cause much more damage. While it's a gutsy call to make, and you have to have the capital, this is absolutely the best time to begin development projects make acquisitions. Prices are still likely well below replacement costs; construction labor and material costs have either stalled or, in some cases, have come down, at least on an inflation-adjusted basis; and the pipeline of competitive project starts has been held largely in check during the downturn. Real estate companies should aggressively pursue asset and land purchases in an effort to secure a pipeline of projects that will sustain the organization for the next three to five years in the coming expansion. With perfect hindsight, real estate market participants are often fond of saying after this stage has well passed, "if I only knew then what I know today, wow!"

Very often, the best time to be in the land acquisition business for vertical building is during the downturn and bottom stages of the cycle. This is when land sellers are eager to unload excess inventory, and it is typically when developers and builders who are able to finance their activities can secure the cheapest costs, the best sites, and so forth. I can distinctly remember back in 2010, when most real estate market participants were hunkered down in the wake of the GFC, AvalonBay had cranes in the air next to Natick mall in suburban Boston building a new apartment community when almost no other construction was taking place. They had the foresight and discretionary capital to proceed when others could not, or would not. As a consequence they had the market largely to themselves when this new community came to the market two years later. Similarly, I can recall the advice my colleague Gadi Kaufmann gave to the Bozzuto Group in the depths of the same downturn. He told them to go buy every piece of land they could find, which then set the company up very nicely to execute new development projects on this land for the next three or four years into the recovery as others were still emerging from their proverbial burrows.

Stage 4 – Early Recovery

This is the stage in the cycle when the markets actually return to expansion. By the time the market has moved into this stage, everyone generally knows, or acknowledges, that the market has begun to rise from the bottom. And while there is still some nervousness regarding the robustness of the recovery, market participants and capital are again entering an increasingly competitive marketplace. Prices are still somewhat below replacement costs, and development and acquisitions should be made according to the company's investment/yield matrix. This is the time when real estate companies will want to identify and deploy less expensive debt capital to fund growth and leverage expensive equity capital. With regard to overhead, this is the time to begin to add staff to bolster the core group of "keepers" that you were able to hold onto during the downturn.

Stage 5 – Early Stable

This is the stage that comes closest to representing equilibrium in the real estate markets and is time to blow and go, put away the sharpening tools and swing your axe. Because it takes time for real estate companies to gear up and deliver new projects to the market, there remains some pent-up demand and forward momentum in the marketplace. Prices for existing assets are increasing and are close to matching or exceeding replacement costs and development yields are looking increasingly attractive. Most real estate companies are squarely focused on deploying growth strategies in this stage. Developers continue to start new projects per their investment/yield matrix, companies typically expand into new sectors, customer segments, and geographic markets. This is the time that many companies look for M&A opportunities to achieve grow. Talent is challenging to acquire, and this is the time to focus on rewarding your valued keepers and expanding your recruiting network to be able to execute on the business that just seems to keep coming. These are indeed the salad days.

Stage 6 —Late Stable

Before long, the early stages of the nirvana Early Stable stage gives way to the more challenging Late Stable stage in the expansionary phase of the cycle. In the late stable portion of the cycle leading up to the peak, prices that market participants and investors seem to be willing to pay for assets (such as finished lots, raw land, stabilized income-producing assets, or multiples on service business acquisitions, etc.) exceed asset values—not the inflated sugar-plumbs-dancing-in-your-head values, but the real, or, even, reasonable values of the asset. If you are anything other than long-term (and in real estate, seven to ten 10 years is now considered "long-term") owner of real estate, this is the time to sell. This is also the time to raise hurdle rates even further, dispose of any marginal assets, or assets that are not wanted after the peak.

This is also the time to refinance your portfolio with flexible, low-cost debt, secure a corporate line of credit at favorable terms, and create a war chest for the next downturn to take advantage of dislocations in the market. One of the hardest decisions real estate executives have to make is to sell into what may feel like a continuing expansionary market. However, you must have courage to make decisions in the latter stages of the expansion to mitigate potential risk that could arise quickly in a contracting marketplace. The downside is that you may leave some money on the table between the time you sell and the actual peak. But by pulling the trigger sooner on assets you want to sell, or not doing that last deal before the markets turned, you avoid not being able to dispose of them after the peak. Keep in mind that at the peak, the market turns in an instant from a sellers' market to a buyers' market, and it may become very challenging to sell any asset you wanted to, at least at the price you had hoped for.

Jeff Blau of Related recalls how quickly things changed in the first quarter of 2020 as the COVID-19 pandemic began to grip the U.S. economy and real estate markets. In May 2020, he told RCLCO "In terms of asset sales, it's all timing. No-one knew was going happen. So, we had two big trades that were about to happen, one apartment building, and one hotel. And now, it looks like one of them is going to go forward and one is not. So it's just all timing. The apartment deal is going to go through, effectively at full price. And the hotel is on hold for now."

There are, of course, some key differences between real estate companies with long-term hold and merchant building strategies. Build-and-hold companies need to determine whether they can withstand the approaching storm, or whether they will need to sell assets to improve liquidity, lower debt to manageable levels, or create the necessary war chest for attractive opportunistic purchases in the downturn. Land development and homebuilding companies should adjust growth strategies that are central to the proceeding stage, and focus on market penetration over market/product expansion, as gaining market share and expanding market segmentation has a much lower risk profile at this stage in the cycle.

So if you have not done so already, this is the time when acquirers should become more selective on land acquisitions that will take time to bring to market, and asset acquisitions should be subjected to higher scrutiny by virtue of increasing hurdle rates to eliminate marginal deals. Real estate companies need to continue to manufacture and deploy both debt and equity capital to execute the development pipeline. Organizations should look for opportunities to outsource with flexible staff, or partner to manage growth and avoid the age-old problem of expanding and contracting overhead like a well-worn accordion.

While each real estate company will have its own unique playbook to leverage its experience, its tolerance for risk/reward, and that is consistent with the talent on its roster, some common themes that most real estate companies should consider in the various cycle stages are as follows:

RCLCO CYCLE STRATEGY PLAYBOOK

	STAGE 1 EARLY DOWNTURN	STAGE 2 FULL DOWNTURN	STAGE 3 BOTTOM	STAGE 4 EARLY RECOVERY	STAGE 5 EARLY STABLE	STAGE 6 LATE STABLE
Development	Mothball, delay, no new starts	Retrade, walk, no new deals	Begin opportunistic starts	Starts per investment matrix	Starts per investment matrix	Raise hurdles, dispose of marginal deals
Acquisitions	Walk, defer deposits	First acquire discounted assets, then land	Aggressively secure pipeline for recovery	Acquire to yield expectations	Acquire to yield expectations	Become selective dispose of marginal assets
Capital	Confirm capital for opportunistic buys	Selectively deploy opportunistic capital for distress/ bargains	Aggressively deploy opportunistic capital for distress/ bargains	Recap expensive debt, manufacture capital to fund growth	Deploy capital to execute development pipeline	Refinance portfolio with flexible, low cost debt, create war chest
Team	Pare flexible staff added in previous growth phase	Maintain core '"keepers" throughout the downturn	Maintain core "keepers" throughout the downturn	Aggressively hire new staff to accommodate growth	Reward keepers and expand recruiting network	Supplement "keepers" with flexible staff to avoid bulking up

Market Monitoring & Cycle Stage Declaration

A critical component of a well-executed cycle risk mitigation strategy is creating a mechanism to declare which stage your real estate enterprise is facing, and likely will be entering over the next six to 12 months. Repeat—you may never really know for sure—but you should have a point of view so you can develop a consensus among those charged with executing the company's strategy. This strategy is key in order to avoid the natural human tendency to avoid making big decisions until everything is "perfectly clear," since you will never have such perfect clarity.

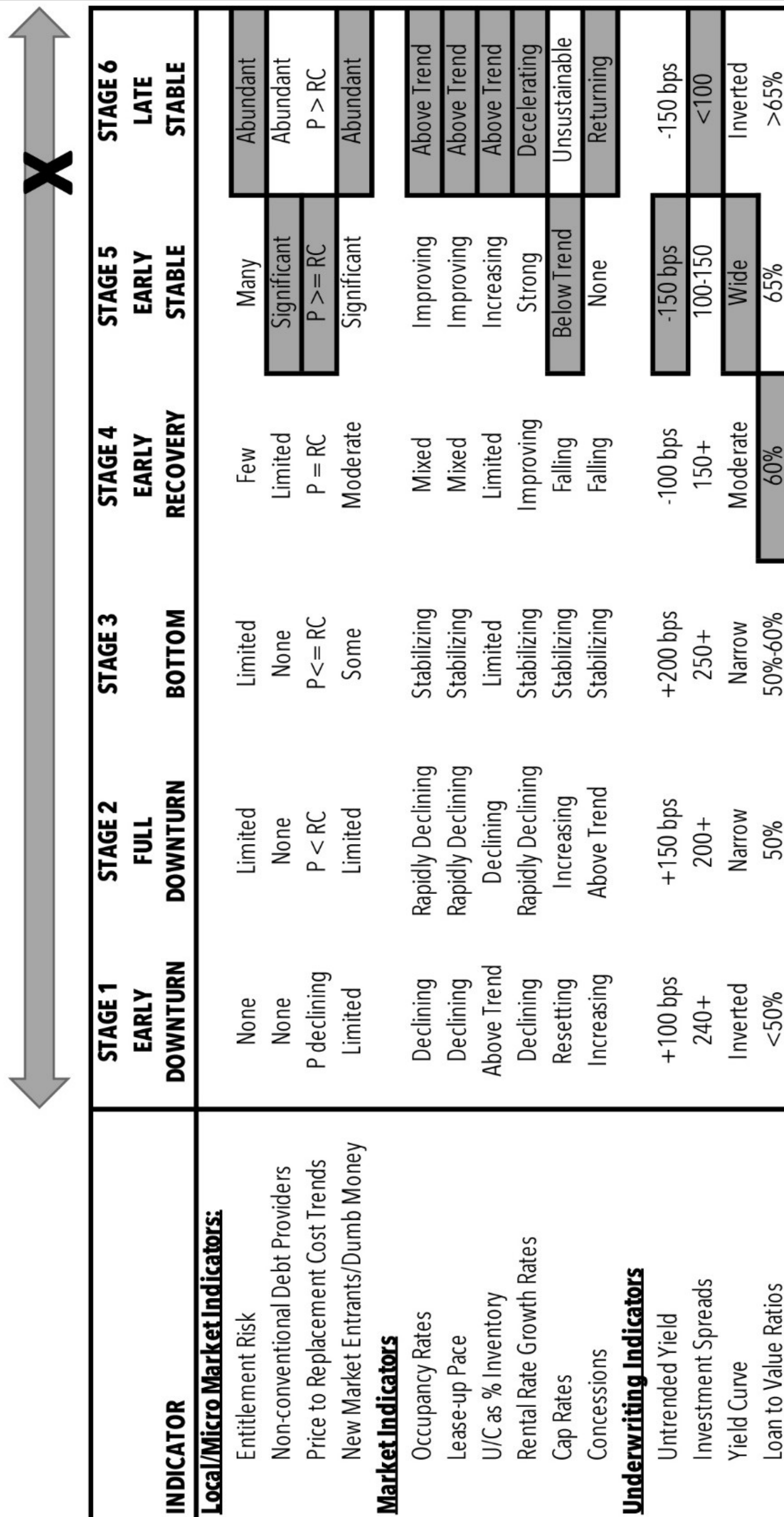
Over the years, I have searched for the Holy Grail, the perfect set of a market monitoring system and trip wires; the sublime algorithm that would tell me to the fifth decimal point exactly where the economy and real estate market are at any given moment and where they will be six months from now. And I have found it, in fact, two times! Twice I have constructed a set of indicators that did a perfect job of describing the past 11 cycles. In fact, one of these algorithms would have produced very accurate early warning "trip wire" indicators three to six months before a change from one stage of the cycle to the next. If I had had this in place in 2007, I would have seen the GFC coming at us with perfect clarity. The problem is that my most recent algorithm only worked perfectly looking backwards, and it was not particularly effective at predicting the 2020 global pandemic, as the factors that precipitated this recession were completely different than those that presaged the Great Recession. Back to watching the waves hit the beach…

Based on this experience, and knowing that professional economists are terrible at calling out inflection points in the economy, I believe the better course of action is to identify a series of concurrent and, possibly, predictive indicators that are specific to a certain real estate business, sector, and/or market, and use these indicators to inform a judgment about the real estate cycle stage, and suspend the search for the Holy Grail. Some indicators may be quantitative, while others may be purely qualitative, but still no less valuable in determining your particular cycle stage. Many real estate companies have a wealth of internally-generated company information about their business or portfolio that is often more current and timelier than secondary source data available about the market, which may have a lag time of weeks or even months. For example, master-planned community developers and homebuilders typically have access to real time, or very near-time, data regarding customer traffic, conversion rates, pricing and option trends. Such data can provide valuable insights into what is happening in the markets. But if you wait for the Census bureau to report building permits or starts, you will be woefully behind the curve. Similarly, most rental apartment owners and operators are able to know with a high degree of accuracy what the occupancy is in their portfolio at least 30 days ahead of any published market reports; and they know how many of their residents have renewed, how many new leases have been signed, at what price and with or without concessions. From their own data they are able to begin forecasting where the market is headed over the next several months into the future. In addition, real estate companies and executives have vast networks of suppliers, vendors, partners, and customers, who can provide equally valuable insights into current market conditions, whether it's sharing hard data or qualitative information about trends.

That is not to say you should ignore national economic data about job growth, GDP, permits, etc., but recognize that there is typically a lag time in the reporting, and supplement this information with relevant hard and soft data from your internal company operations and your network of contacts. Some of the key real estate cycle stage data that real estate companies track include the following:

CYCLE STRATEGY INDICATORS	EXAMPLES
National Economic Indicators	Job growth, GDP, inflation, sales, production, etc.
National Real Estate Market Indicators	Absorption, building permits/starts, occupancy rates, rent and appreciation growth, etc.
Capital Market Indicators	Interest rates, cap rates, investment sales, etc.
Metro/Submarket Economic Indicators	Job growth, migration patterns, regional product, export industries, etc.
Metro/Submarket Real Estate Indicators	Absorption, building permits/starts, occupancy rates, rent and appreciation growth, etc.
Internal Company Metrics	Traffic, sales, conversion ratios, occupancy, rental rate escalations, volume, profitability, etc.
Soft/Qualitative Network Market Intel	Competitor wherewithal, transaction trends, employee retention, etc.
Sentiment Survey Results and Trends	Consumer, business, homebuilder confidence, etc.

Using these, and other, indicators, I have worked with dozens of real estate companies to come up with their own set of unique indicators and set up a process to generate an internal consensus regarding the likely durability and duration of the current stage of the cycle and predict the next, and then make proactive decisions about how to mitigate the risk and/or prepare the company to take advantage of opportunities depending upon what the predetermined action matrix calls for at that time. The following is an example of the type of game plan that can be developed with this construct in mind – and it's fine if you want to get it laminated…



MARKET MONITORING: EXAMPLE

INDICATOR	STAGE 1 EARLY DOWNTURN	STAGE 2 FULL DOWNTURN	STAGE 3 BOTTOM	STAGE 4 EARLY RECOVERY	STAGE 5 EARLY STABLE	STAGE 6 LATE STABLE
Local/Micro Market Indicators:						
Entitlement Risk	None	Limited	Limited	Few	Many	Abundant
Non-conventional Debt Providers	None	None	None	Limited	Significant	Abundant
Price to Replacement Cost Trends	P declining	P < RC	P<= RC	P = RC	P >= RC	P > RC
New Market Entrants/Dumb Money	Limited	Limited	Some	Moderate	Significant	Abundant
Market Indicators						
Occupancy Rates	Declining	Rapidly Declining	Stabilizing	Mixed	Improving	Above Trend
Lease-up Pace	Declining	Rapidly Declining	Stabilizing	Mixed	Improving	Above Trend
U/C as % Inventory	Above Trend	Declining	Limited	Limited	Increasing	Above Trend
Rental Rate Growth Rates	Declining	Rapidly Declining	Stabilizing	Improving	Strong	Decelerating
Cap Rates	Resetting	Increasing	Stabilizing	Falling	Below Trend	Unsustainable
Concessions	Increasing	Above Trend	Stabilizing	Falling	None	Returning
Underwriting Indicators						
Untrended Yield	+100 bps	+150 bps	+200 bps	-100 bps	-150 bps	-150 bps
Investment Spreads	240+	200+	250+	150+	100-150	<100
Yield Curve	Inverted	Narrow	Narrow	Moderate	Wide	Inverted
Loan to Value Ratios	<50%	50%	50%-60%	60%	65%	>65%

Internal Cycle Strategy Committee

Using your own proprietary mix of market indicators, your company's "Cycle Strategy Committee"—whether that is a committee of one, or the entire leadership team—should convene on a regular basis, perhaps quarterly, semi-annually, or more frequently as rapidly changing market conditions may dictate. They should review, discuss, and debate the various factors that feed into your company's trip wire model. If this committee meets quarterly, it should declare a cycle stage for the current quarter, compare that with the stage from the previous quarter, and predict the expected stage for the next quarter and the expected velocity with which the market is expected to change. The committee should then consider which, if any, of the predetermined cycle strategies to deploy in the face of this consensus view of the world in which the company operates. Above all, resist the temptation to rationalize away the information that is staring you in the face. A company that waits until the market has clearly shifted from one phase of the cycle to the next to begin thinking about preparedness strategies has probably waited too long and could either miss some attractive opportunities, or conversely be in for a rough ride. A company with a well thought out and executed preparedness strategy can benefit greatly from the dislocations and inefficiencies that inevitably accompany periods of uncertainly and instability in the market.

Again, it sounds simple, right? No, in fact it is very difficult, and very often unclear what the right call is to make – and this is why far too many real estate companies fail to even make an organized attempt at it. Real estate companies that do have the discipline to develop a preparedness strategy protocol find that the early planning and ongoing monitoring gives real estate executives the tools necessary to avoid getting into trouble. They make smart, and ideally, graduated decisions in advance of changing market conditions. This helps them identify, and take advantage of, opportunities that present themselves in the downturn. First, you need to have a comprehensive strategy for all portions of the real estate cycle. Then, you need to be nimble as you shift your activities from one strategic initiative to the next—from growth to hesitation to rationalization strategies.

Lastly, you need to be able to anticipate so you can be among the first, not last, to realize what is going on and do something about it before it is too late. As you plan for, and ultimately, implement, your preparedness strategy, you must be prepared to act decisively, as history has shown how companies that hesitated for too long have often failed.

Balance Sheet and Other Risk Factors

For real estate companies, particularly those involved in taking on capital risk roles, creating strategies to deal with market risk is a high priority, but it should not be the only risk factor addressed. For most real estate organizations, it is also critical to develop other mission critical risk management strategies, including in the following areas:

- Financial and Balance Risk
- Concentration Risk
- Enterprise Risk
- Operating Risk

Financial and Balance Sheet Risk

These strategies often relate to balance sheet metrics that are designed to enable companies to take measured risk within their tolerance levels to avoid finding themselves in unnaceptable risk territory. The most common strategy is to determine and monitor specific relevant financial guardrails and metrics at the individual asset, overall portfolio, and enterprise levels.The most typical metrics that real estate development and investment companies set for themselves and monitor closely are:

Loan-to-Value (LTV) and/or Loan-to-Cost (LTC) Ratio – this is the amount of debt as a percentage of either the value or the cost of an individual asset, or for a portfolio of assets. In the public REIT world, investors have dictated that real estate companies and their portfolios must maintain a relatively low level of debt or leverage, typically in the 30 to 40 percent range. Public companies that exceed this amount are often punished with lower valuations, or multiples, to reflect the perceived higher risk associated with this level of debt to asset value or income. Private companies can, and often do, obtain the maximum amount of leverage possible, typically 65 percent loan-to-cost for development projects, and up to 70 percent of loan-to-value for stabilized income producing assets.

Of course, some private companies that want to operate conservatively may set up financial risk mitigation guardrails much lower. They may be comfortable using the maximum allowable leverage on development deals, but may want than, say, 50 percent leverage on the overall portfolio, meaning that the stabilized properties in the portfolio may only have 30 or 40 percent leverage. This enables these companies to operate with a high degree of certainty with regard to their stability of cash flow from the stabilized portfolio, and know that they won't risk losing an asset if the value or income drops in a period of slower growth/recession.

Debt Service Coverage Ratio (DSCR) – for an income producing real estate asset or portfolio this defines the amount of net operating income available to cover debt service obligations. Most hard money lenders and investors typically require a DSCR of 1.20 or greater, meaning that there is a 20 percent "cushion" of cash flow available to pay debt service on a given asset. Operating income would have to decline by more than 20 percent, which is a very big drop for a well-located and managed income producing asset, before the property was unable to service its debt and be at risk of default. Some companies operate with an abundance of caution, setting even higher DCSR financial risk metrics to their assets and portfolios to operate so they will never be in the position of losing a property. Closely held multi-generation real estate companies that have a number of family shareholders that may depend upon income produced by the legacy real estate portfolio use some type of "modified" debt coverage service ratio (MDSR) to reflect not only the need/desire to have a cushion to satisfy debt service, but also to cover some level of recurring dividends to its shareholders, which may be a MDSCR of 1.50 to 2.50+.

Recourse – another common financial risk management metric for a real estate company is to eliminate, or limit, the extent to which principles and owners in the business are liable for personal guarantees, or recourse, in the event that a real estate investment fails to perform as expected. Many private real estate companies and entrepreneurs work hard to evolve from recourse, cross-collateralization of debt and equity capitalizations to non-recourse, project-level financing where each asset stands on its own, and cannot negatively impact other assets in the company's portfolio. The way to get off recourse is either to have a relatively low level of leverage so as to provide the lender sufficient security at the property level, even in the case of a diminution of the valuation, or to enhance the borrower's credit. The borrower's credit and performance record also plays an important role in reducing the personal obligation and eliminating cross-collateralization requirements; the stronger the borrower is, in terms of having a long history of successful, profitable development with no defaults, the easier it is for that borrower to get requirements for personal guarantees and cross-collateralization waived. This makes it easier to obtain credit enhancement, if necessary.

Today's sophisticated highly specialized credit markets draw capital market players who will accept the liability for just about anything, for a price. Credit enhancement may help increase borrowing capacity at a relatively modest cost, particularly when compared with the cost of outside equity. To enhance credit, the borrower typically sets aside a pool of funds that serve as the first source of repayment in case of trouble. After that pool is exhausted, the credit enhancer steps in to accept the liabilities. The price of credit enhancement is set as a percentage of the contingent obligation. While not free, credit enhancement is an attractive way to reduce risk and gain peace of mind for those who cannot otherwise avoid providing personal guarantees and cross-collateralization provisions. In some instances, real

estate companies set up “guarantee corporations” which typically consist of a collection of no or low-leverage real estate assets that also serve as collateral designed to protect members from the liability of default on loans or other guarantees.

Line of Credit (LOC) – another financial risk mitigation strategy employed by many real estate companies is to maintain access line(s) of credit that can be drawn upon in times of slower growth or to otherwise bridge a period of low cash flow. This enables them to cover operating expenses or make investments and/or fund pursuit costs or tie up land/deals before more permanent sources of debt and equity can be secured. The portion of these LOCs that are drawn upon should indeed be counted in the company’s overall LTV risk mitigation measures and guardrails.

Investment/Return Hurdles – a very common risk mitigation strategy that covers both financial and market risks is ensuring that your real estate company has very clearly defined investment hurdle guidance for either undertaking a new, or maintaining an existing, real estate investment. For development companies, the most common metrics are typically going in yield, or return on cost calculation that determines the investment return in the first stabilized year of operations for an income producing property divided as a percentage of the cost to product said asset. Synonymous with a going in cap rate, this can and does change for most real estate companies based on the timing of the real estate cycle and conditions of capital markets, and is often pegged to a certain margin above the project’s (or in the case of public REITs, the company’s) cost of capital. Otherwise known as spread investing, real estate companies taking on capital risk typically require their development teams to meet or exceed a minimum spread (say 200 to 300 bps) above the weighted average cost of capital (WACC) in order to proceed with a deal and compensate for the relatively higher-risk associate with development projects above the so-call risk free rate (typically benchmarked against the U.S. 10-year treasury). Investment spreads in core stabilized income producing assets may have a lower threshold or hurdle to justify the lower risk profile of anywhere from 100 to 200 bps spread in the current market environment. [CHECK CURRENT SPREADS]. Real estate companies often look to various industry benchmarks to assess the performance of their real estate assets and portfolios, such as the NCREIF ODCE index which tracks private predominantly core income producing real estate assets, before they make, buy, hold, reposition and/or sell decisions based on this comparison. The old adage being, if you decided not to sell an asset today, then you just agreed to buy it at the current market price.

Maturities – in addition to the relative amount of the debt and the ability to cover the associate debt service, most sophisticated real estate companies look at the amount of debt that may be coming due in any given year, or over a short period of time, and make important decisions about their capital stack based on this schedule. It may be acceptable to have no more than 20 percent of the company’s total portfolio of debt coming due in any given year, or at an interval shown on some such metric.

Diversity of Capital Sources – another risk mitigation tool is to make sure that your real estate company has multiple sources of capital and is not overly reliant upon a single source of capital. Having a significant relationship and favorable terms with one source of debt or equity capital can result in more favorable terms, but it also puts a company at risk if that single source of capital should have a change of heart and decide to pull back from the market. Working with one capital source can be much more efficient than managing relationships with several, and it can be time consuming for real estate executives to form relationships with multiple capital sources, especially since those sources often know the executives are talking to other sources as well. On the flip side, relying on a single capital source could be disastrous if that source suddenly decides it no longer wants to invest in a company or its projects, and the company has no other source lined up. This is the hard lesson that Crosland learned, as detailed in the next Chapter 18 below, during the GFC when their primary lender decided not to extend loans and forced the company into a very difficult situation.

Concentration Risk

A variant of market risk, but unrelated to the real estate cycle per se, is concentration risk management. Many real estate companies with multiple asset classes and/or geographic markets define their risk tolerance in term of an acceptable amount of exposure to any one real estate segment, asset class or strategy, and or geographic market so as not to suffer disproportionately if one sector, strategy or market experiences stress.

So, for example, a real estate organization may determine that it wants to have no more than 10 percent of its net asset value in any one given property, or it may say it does not want to have any more that one third of its balance sheet devoted to opportunistic development acitivies, or no more than X percent of its net operating income in any given geographic market. This is both to mitigate risk, and to ensure that the portfolio and company has the benefit of diversification. The same goes for office or retail owners and operators who may want to limit their turnover risk and exposure to any one tenant or company, or any one segment of the economy. And just as real estate companies may want to mitigate the risk of too many loans coming due at one time, commercial real estate investors may want to limit the number of leases that expire or come up for renewal in a condensed period of time, and may take proactive steps to stagger these renewals to comply with their risk tolerance.

Enterprise Risk

Beyond the critical market and financial risk mitigation strategies, there are a host of challenges that most real estate organization face that need to be identified and addressed. Beyond the typical "bad boy" provisions including fraud or other malfeasance, for most companies engaged as a sponsor in development and construction capital risk roles, capital partners (both debt and equity) typically require completion guarantees and may insist upon personal guarantees. Not sure it has to be written into your company's strategy, but the simple solution is to not commit any of these so-called bad boy acts – best to avoid this risk altogether. Many principles are keen to avoid, or significantly mitigate, personal guarantees where creditors could come after them personally if a real estate development or investment turns south. The most effective way to do this is to build up a sufficient "company balance sheet," create the aforementioned guarantee corporations, or otherwise invest in credit enhancements provided by others, to eliminate or limit this risk.

However, these strategies come at a cost, and many sponsors may be willing to accept these risks in exchange for more favorable terms, either in the form of more attractive borrowing interest rates, loan proceeds, or through a more favorable share of the promoted interest waterfall off the back end of a given deal. Others are able to mitigate risks like completion guarantees by pushing some of this risk off to third party construction providers or secure "gross max pricing" (GMP) from these providers to lock in costs and/or secure completion guarantees from third-party general contractors to mitigate this risk. For companies engaged in these types of capital risk roles, it is important to determine the tolerance for risk, and to develop strategies to deal with avoiding or mitigating same.

Most real estate companies recognize that people are one of the most important assets that the company possesses. Therefore, mitigating your company's human capital risk is essential. This exists on several levels. The most action you can take is determining strategies an actions to "keep your keepers." Obviously this dovetails closely with the company's organizational strategy, and includes strategies and tactics related to compensation, company culture, growth, training and professional/career development. Succession planning is an important human capital risk mitigation strategy to ensure that the company is resiliant and can prosper in the face of both unanticipated and expected turnover. Then there are a host of liability issues that every company should address including key man insurance, general corporate liability insurance, sexual harassment training and certification, etc.

This is certainly not an exhaustive list, but one more important bucket of risk that companies should address is disruption risk. This a may be a result of competitor wherewithal and the risk of competition, which can emanate from traditional "known" competitors as well as unique, new "unknown" or unanticipated sources of competition. Disruption in the form of technologhy and innovation is nothing new, but has absolutely accellerated in recent years and will continue to do so. Companies that don't acknowledge, embrace, and develop strategies to deal with the infiltration of technology in real estate are exposing themselves to enormous risk. Redfin and Zillow are two great examples of technology platforms that have disrupted the traditional residential brokerage business, and while the National Association of Realtors (NAR) has done a great job of promoting the value of Realtors to individual home buyers and sellers in the face of these disruptors so far, commissions have been significantly impacted. I for one can envision a day in the not too distant future when most, if not all, home sales are transactions driven by technology and not people. Fidelity and many others have bots that dispense portfolio composition advise to individual investors, and they are pretty good for most people, so why pay an expensive fee to a human to do the same job? Blockchain technology is not just driving the advent of crypto currencies, but has the real potential to replace a host of creitical real estte functions that are now handled by big companies, and people. But if securing title to a property can be handled by blockchain

technology in a secure manner, what is likely to happen to the big title search and insurance companies, as just one example. I think it was Larry Ellison founder of Oracle who said words to the effect of "stay paranoid." When it comes to technology disruption and potential disintermediation for real estate organizations, this is sage advice.

Operating Risk

Operating risks are aplenty, but often fall into the realm of tactics vs strategy, and include things such as slips and falls at the individual property level, workers compensation, cash management, etc. Not to be ignored, but this is the bucket that most companies have, or should have, robust policies and proceedures to address and mitigate such risks.

REAL ESTATE CONSULTING

56
Years in Business

400+
Annual Projects

>100
Employees Globally

"I have engaged RCLCO many times over the past 20 years. Each assignment resulted in community lot sales pace and lot prices above my pro forma values. RCLCO is the GOLD standard for real estate consulting."

Jimmie Jenkins, Vice President | Toll Brothers, Inc.

Since 1967, RCLCO has been the "first call" for real estate developers, investors, the public sector, and non-real estate companies and organizations seeking strategic and tactical advice regarding property investment, planning, and development.

RCLCO leverages quantitative analytics and a strategic planning framework to provide end-to-end business planning and implementation solutions at an entity, portfolio, or project level. With the insights and experience gained over 50 years and thousands of projects–touching over $5B of real estate activity each year–RCLCO brings success to all product types across the United States and around the world.

RCLCO has expertise in three major areas: real estate analytics, investment advisory, and enterprise strategy. Our multidisciplinary team combines real-world experience with the analytical underpinnings of thousands of consulting engagements.We develop and implement strategic plans that strengthen our clients' positions in a market or sector, add value to a property or portfolio, and mitigate price erosion.

Since we first opened our doors, RCLCO has been governed by our core values. We believe that excellence, integrity, honesty, respect, exceeding expectations, and quality are great goals that all firms must possess. These goals and values shape the culture and define the character of our firm. They guide how we behave and make decisions. Our extensive network provides us with a unique and comprehensive outlook on the industry, not to mention unmatched access to the best minds in real estate.

Contact Us Today!

Charlie Hewlett | Managing Director
P: (240) 644-1006 | E: chewlett@rclco.com

RCLCO.COM

AUSTIN | DENVER | LOS ANGELES
NEW YORK | ORLANDO | WASHINGTON, DC

RCLCO
REAL ESTATE CONSULTING