Privcap/ Report

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Thought-Leadership Series:

Emerging Risks in Real Estate Investing and Management

How to invest in a market that grows more uncertain by the day

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Emerging Risks in Real Estate Investing and Management

Key Takeaways

1. A firm with a disciplined, repeatable approach to underwriting is less exposed to risk

2. Late in the cycle, development deals have many risks to manage

3. An institutional-quality back-office demonstrates a broad commitment to risk management

4. Cybersecurity needs to be pushed down to the asset level

The Experts

Jay Morgan
Partner,
StepStone Group

Russell Appel
Founder,
The Praedium Group

Nate Ruey
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1. A firm with a disciplined, repeatable approach to underwriting is less exposed to risk

Real estate investment firms that thrive through multiple market cycles seldom adhere to the "trust your gut" approach to investing. A winner at one end of the cycle may make a losing bet at the other end, losing LP confidence in the process. The best firms trust a repeatable process that involves a painstaking assessment of all forms of risk.

StepStone's Jay Morgan, who annually vets hundreds of real estate GPs on behalf of institutional clients, says: "The repeatable process is important when we're doing the underwriting on a real-estate investment manager because we expect them to carry out their strategy through a changing market environment, through a changing capital-market environment where fundamentals may be changing. Gut feel can lead to incredible returns sometimes, but when you think about what's prudent for long-term liabilities, we think you really want to identify a team that has identified a process."

Adds Russ Appel of The Praedium Group: "A lot of risk is preparing for the unexpected. When a real estate investor comes up with pro-formas, everything looks great. But reality never unfolds as you projected it. You need to put a plan in place so that when the unexpected happens, you're prepared. The hard thing for us to teach our young people isn't so much what goes behind the projections, but to really understand how one asset is going to perform differently than the next asset."

Real estate investors must take a systematic approach to assessing risks at the macro and enterprise level, says Nate Ruey of RSM. For example, an investor focused only on cap rates and deal-level uncertainties around interest rates as well as geographic risk might ultimately fail by overlooking weaknesses in the finance function, information technology and cybersecurity at the firm level. "It's important to have checks and balances not only with back-office operations, but also through the management of the underlying assets and properties," he says.

Employee Theft | Nate Ruey, *RSM US LLP*

RSM's Nate Ruey shares an example of what can happen at a firm with weak financial controls in the back office, in which a modest hit to the bank account nevertheless spelled a big hit to the firm's reputation: "The bookkeeper for one real estate client had access to the firm's checks and vendor master file. The employee was altering the file and cutting checks in their own name. The oversight and controls just weren't there—the fraud went undetected for months."

2. Late in the cycle, development deals have many risks to manage

Investing in real estate developments has always carried additional, unique risks compared to investing in existing real estate. But as a cycle matures, development deals carry greater risk, not only in the market but in the willingness of some investors to "swing for the fences."

Appel and Morgan both point to the tight labor market and how the added expense of labor can add risk to a project. "Clearly, construction costs are going up," says Appel. "Part of that is hard costs, part of that is labor costs."

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"Employment is tight," says Morgan. "The other aspect of labor risk is the union side of it. When you go through a repositioning of an asset without union labor, you may have a strike in front of your building for an indefinite period of time, which blows the economics of the deal entirely."

Given the labor shortage, it is important to procure contractors and subs in a timely manner. The longer the duration between when the development's financial models and contracts are put in place and when ground breaking actually occurs can significantly increase the risk for higher labor costs and misaligned cost expectations.

In an environment where investors are trying to squeeze out every basis point of return, Ruey warns that noncompliance with a contract is a major risk. "If you're working with a developer, you really need to make sure you are monitoring their compliance with the terms and conditions of the deal," he says. "You need to monitor things like the procurement process for contractors and subcontractors, as well as the reasonableness of reimbursable and pass-through costs to really make sure you are on top of the books and records. One of our clients was recently doing construction of high-end university housing. It was supposed to be a $35 million project, but it had $3 million in cost overruns because there was poor oversight."

The '90s Are Over

Russell Appel
The Praedium Group

The bootstrapping, wildcatting roots of the private equity real estate industry have necessarily morphed into an institutional asset class, says Praedium's Appel. "In the 1990s you had a bunch of deal junkies—a bunch of people who were running around, doing deals. They were highly entrepreneurial. But the industry has evolved, because things happen that you don't expect. No projection comes out exactly as you projected it, and so the focus on being a fiduciary and planning for the unexpected has just become more important. What investors want is durability of returns, and to do that you have to plan for the unexpected."

Another late-cycle risk lies in the mindset of the investor. With high valuations threatening to deliver weak long-term returns, an appetite to look for riskier projects increases. While prudent risk is appropriate in a competitive market, not every manager has the discipline or skill to execute on projects with greater development risks.

"Some people will be reaching for return," says Morgan. "There are a number of managers and investors who will come in behind those managers who are looking at 7.5 percent expected return, and they need to go find somebody who's going to deliver that for them. And they will look at the fundamentals where they see tight vacancy markets, and they'll go out there and underwrite to development yields, only to have those deals turn against them as the market goes through another cycle."

3. An institutional-quality back-office demonstrates a broad commitment to risk management

A strong investor with a weak back-office will eventually embarrass its LPs or, even worse, impair their capital accounts.

With this in mind, LPs are increasingly conducting on-site due diligence of their managers' back offices to ensure that an infrastructure of institutional quality is going to support the investment process.

"We've gotten to the point of having an ODD [operational due diligence] team go on site," says Morgan. "They're looking at the regulatory environment that the manager operates in and making sure that everything is consistent with the statutory requirements. They're looking at the cash controls. They're looking at the IT security. They're looking at stuff like compliance manuals, making sure that they exist and making sure that they're adhered to.

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They look at code of ethics to make sure that that exists and is demonstrable within the investment process within the firm."

Morgan adds that StepStone's assessment of the back office is independent of the assessment of the investment track record, and both need to be in place before a fund commitment can be approved.

Based on his own firm's experience on the receiving end of ODD, Appel confirms that "it's not only having the check list of the processes, but it's actually making sure we're following them."

According to Ruey, operational due diligence can focus on governance, IT, the confidentiality of data, cybersecurity, cash controls, and fraud risk, among others. Investors are not only worried about losing money but also "if something went wrong in the back office, what would the impact be from a perception and reputation standpoint."

4. Cybersecurity needs to be pushed down to the asset level

Breaches of a company's IT security have become more common and more serious as bad actors have proliferated. In the real estate world, most professionals are focused on the security of electronic communications at the firm and between manager and investor.

Real estate firms are besieged by sophisticated hackers who know that the firms control the flow of large sums of money. "We see people who are constantly getting phishing emails sent to them," says Morgan. " We've actually seen rewritten wiring instructions come in. The controller sees what looks like a completely legitimate set of wiring instructions, and all of a sudden cash is moving in a way that you wouldn't expect. it can easily happen, and has happened in some of the smaller firms, or in firms with inexperienced controllers."

Ruey states: "It's becoming more and more sophisticated how hackers use social engineering with phishing emails, by creating messages which appear to come from a legitimate internal or external source, while knowing who the key stakeholders are, and coming up with scenarios to transfer money."

Question Assumptions

Jay Morgan
StepStone Group

As LPs seek to understand whether a GP has a repeatable approach to investing, they would be wise to understand how return projections are created, says StepStone's Jay Morgan: "Too often firms will just implement a model to solve for whatever their return target is. They may not really have a good understanding of what the rental expectations are, what the exit cap rate projections are, what the expected capital market environment may be at exit. They've come up with a number out of the air and don't have a foundation for it."

But Ruey adds that managers need to know that hackers are also targeting their underlying buildings and assets: "Let's take building management systems, for example. Oversight of the systems, if it exists, would be at the GP's back office. However, if a building management system is hacked, the hacker could get into the tenant network. They could be able to take down the servers for the buildings, take down the fire suppressor systems, as well as have ability to take control of PA systems or elevators. You could really do some very malicious things."

"We want to protect our investors," says Appel. "But we also own all this real estate. We have responsibilities to our tenants, and we need to make sure they're safe. And, of course, we have employees that work for us, and make sure that we do the right thing by them, too. Part of what we're talking about is making sure that firms have processes in place to be prepared." ■

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Expert Q&A

Managing Risks Unique to RE Investing

How does RSM help real estate investors assess and manage risk?

Nate Ruey, RSM: We advise our clients on risk management and help them to identify the key business processes and technology that they may be facing. We work with real estate LPs and GPs to determine whether they have sufficient controls in place. This includes adding value to operating and compliance processes while at the same time anticipating evolving risk and regulatory compliance requirements.

Our team provides sound recommendations and best practices based on our experience working with clients throughout the real estate industry. We help establish a strong foundation to ensure that the right governance and control structure is put in place to support their investor's strategic goals.

How do you work with managers to manage third-party risk?

Ruey: Our clients often outsource important processes to third parties. They sometimes think that when they do this, they outsource the risk as well. However, they still need to be able to monitor those third parties to make sure they are delivering what they agreed to deliver in the terms and conditions of the agreement. We can help with this important verification and monitoring process.

You also help institutional investors monitor the risks of separate accounts. What is behind the rise of separate accounts, and what risks are unique to them?

There is a greater interest among institutional investors in separate accounts, as these hold the potential for greater returns, thanks to lower management fees. Separate accounts are different because the institutional investor directly owns the underlying assets or entities. Separate accounts are also unique in that each of the entities may have different businesses, asset classes, operations, and advisors/management teams.

The separate accounts we tend to work with are advised by very recognized real estate advisory firms that have robust processes and controls in place to assist institutional and pension fund investors in managing risk. However, even the best control environments are susceptible to the complexity and interpretation of documents and third party influences such as outside property managers.

Nate Ruey
Partner, Risk Advisory Services, RSM US LLP

Institutional investors want the entity's advisors and management team to focus on executing strategy while ensuring the oversight and checks and balances are in place. Because of that, investors need to make sure that each of the entity's infrastructure is set up properly, with correct oversight, accountability, and appropriate controls and policies and procedures in place.

In order to achieve this, institutional investors are establishing specific control guidelines to make sure these investments are protected from a governance, financial, fraud, information technology, reputation, and security perspective. The separate accounts are then periodically monitored to assess whether they are in compliance with the control guidelines. In establishing this programmatic oversight, it has provided investors with more comfort that the separate accounts are operating under a sound control environment. ■

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