LESSON 3 - INVESTOR TRANSACTION SELECTION CRITERIA

FOLLOW THE NUMBERS

Just because a property looks nice does not mean that it will be a good investment! The asset needs to have positive qualities, such as physical location and upside potential, and the market must be equally positive in terms of growth. Always remember that all markets are local. Regardless of what is going on in the larger economy, real estate is a local business.

Remember…In any given transaction, you must be dispassionate about the property and focus on the numbers. This is not the time to be emotional about the property. It is necessary to be dispassionate about the property and focus on the numbers…no emotion! Let the metrics (the numbers) lead your decision-making process.

SELECTING THE RIGHT INVESTOR

The sponsor (as we discussed earlier), or owner/operator, in a commercial real estate transaction needs to be suitably qualified in the following areas:

CAPITAL: Have sufficient capital to co-invest in the transaction

INFRASTRUCTURE: Have the appropriate organization to take on the project

CONSTRUCTION: Be qualified to manage the construction needed to rehabilitate the property

MANAGEMENT: Be qualified to manage or oversee the day-to-day operations of the property

LEASING: Be qualified to oversee the leasing effort

STAYING POWER: Have sufficient net worth to support the property if unexpected costs overrun the budget or delays occur.

SELECTING THE RIGHT INVESTOR

ALIGNMENT OF INTERESTS

When finding the right partner, the risks and rewards should be equally disbursed among all of those involved in the transaction. This typically means that the sponsor's equity is at risk as the first loss money. If the project does well, everyone should do well.

The overall debt should have a fixed return and equity has an unlimited return. Remember with value added projects that the key is to increase NOI, so the potential profit could be limitless if the project becomes a success. So, understanding where the debt portion of a project stops and where the equity begins is a key to making smart investment decisions.

SELECTING THE RIGHT INVESTOR

KEY EVENTS

Every value added transaction has one or two key events that must occur for the project to be successful. A good investor identifies those events early and creates a "performance structure" to minimize risk to the investor. Key events include the following:

- A major tenant that must renew.
- A certain percentage of the building that must be re-leased.
- Month-to-month tenants that are converted into long-term tenants.
- A pad sale that needs to occur to lower the cost basis.

SELECTING THE RIGHT INVESTOR

THE BACK-UP PLAN

A good investor will have a contingency plan if the key event fails to occur. If the failure of one key event means that the project fails, there might be too much risk for the investor. In these situations, the investor should seek other ways to mitigate risks.

Good investors look beyond the key event and understand what the economic outcome is, should the key event not happen. In the best deals, the back-up plan has a higher probability than the key event, and if the back-up plan is implemented it means that the project makes a little money or breaks even.