START WITH RISK
ABOUT REALCROWD

RealCrowd is a private, secure and simple-to-use online platform for accredited investors to access, review and invest in commercial real estate opportunities across the nation.

Using the platform, investors can inspect investment offerings and materials, such as legal documents and due diligence items, allowing them to make informed investment decisions in what is widely considered one of the greatest wealth creation tools on the planet.

WWW.REALCROWD.COM

THE VALUATION SERIES

RealCrowd’s Valuation Series is a set of informative ebooks to enhance investors’ knowledge of commercial real estate investing, from the fundamentals of valuing commercial real estate to more advanced analysis techniques.

After completion of the Valuation Series you will know how to:

- Understand different investment styles
- Analyze market conditions
- Evaluate risk profiles
- Carry out cashflow analysis
- Read financial models
- Apply a quicksnap analysis

SIGN UP TODAY
INTRODUCTION TO CRE201

START WITH RISK

Now that the preliminary “hows, whats and whys” have been answered in CRE101, you have the groundwork necessary for moving into more practical territory—developing and applying an understanding of risk and return.

The analysis of every real estate opportunity begins with this pair of concepts. Risk and return make up the basis for judging the quality of any commercial real estate investment, and accordingly, whether it’s appropriate for a given portfolio.

CRE201: Start With Risk will hone your ability to analyze the aspects of commercial real estate opportunities as they relate to risk and return, make comparisons between multiple properties, and ultimately, make informed decisions on the basis of that analysis.
Any investment that doesn’t start with understanding risk is a bad investment whether it turns a profit or not.

START WITH RISK

Far too often investors make decisions based on the big numbers on the side of returns, while ignoring the big factors on the side of risk.

This tendency is dangerous. If left unchecked, it can lead to unsustainable losses. The single best way to guard against it is to objectively determine the investment style best for you and then to invest accordingly. This means starting with risk — how much of it is appropriate for your portfolio, and how much is inherent in a given opportunity.

An investment that doesn’t start with understanding risk is a bad investment whether it turns a profit or not. Decisions should never be based on profit potential alone, but always include the potential for loss. While the pressures to do otherwise might be numerous, in the long run it pays to take a measured view of the consequences of all possible outcomes.

Every investment will have a different risk and return profile. Whether bond, stock or real estate property, each should be analyzed on an individual basis. Likewise, every investor will have his or her own individual risk tolerance and portfolio requirements. Matching portfolio needs to appropriate opportunities is the basis of all good investment decisions.

The following pages will lay out the styles of investments found in commercial real estate. Understanding their various risk and return characteristics will help you identify opportunities that pair well with your financial requirements.
Core Investments

Core Investments are characterized by lower risk and lower return opportunities. These properties don't require any value add and have stable tenants. As such, they provide steady streams of income from the cash flow derived from rental payments. Of primary benefit is their high degree of predictability and lack of correlation with the stock market. Core Investments can both be a foundational strategy and a method for balancing out a portfolio that has a high-risk lean.

IDENTIFIERS

- Located in primary markets
- Low vacancy rates
- Stable tenants
- Staggered lease expirations
- Low use of leverage
- Annual cash returns: 5-7%
- Lower IRR: 8-10%
- Low risk of loss

EXAMPLE

A building that houses a stable tenant, like Starbucks. The tenant runs a solid business and will lease the space contractually for an extended and predetermined period of time with virtually no need for building improvements.

Probability of:

- Risk of Loss
- Annual Cash Return
- Annual IRR

IRR

The IRR is the total return of the asset which includes annual cash flow and appreciation upon sale of the property.
Core Plus Investments

Core Plus has a moderate risk profile attached to it. The difference between a core and core plus strategy is the ability to enhance the value to an otherwise already stable asset. Adding value increases risk because it often requires capital to enhance a building. There will always be a risk that the added value doesn't correlate to an increase in rent or a higher sale price.

IDENTIFIERS

- Located in primary or secondary markets
- Low vacancy rates
- High employment
- Stable tenants with some rollover or lease-up
- Spread out leases
- Income derived from ability to raise rent through Value Add
- Moderate annual cash return: 7-12%
- Moderate IRR: 10-14%
- Moderate risk of loss

EXAMPLE

Very similar to core but let's say that this time Starbucks wants new carpeting and counters or else they will let the lease expire in 4 years. The value add slightly increases risk but also increases reward potential.

Probability of:

- Risk of Loss
- Annual Cash Return
- Annual IRR
Value Add Investments

Value Add properties are higher risk and higher reward investments. Value Add are commercial real estate properties where the strategy for turning a profit is improving the building and then selling it when the time is right. This is an appreciation play. Value Add investments generally have lower annual cash returns, a high expected IRR and a higher level of risk.

IDENTIFIERS

- A rundown building in a major market with rising market rents
- Undervalued market or undervalued asset within the market
- Lease Up
- Required Physical Enhancements
- Higher Use of Leverage
- Profit dependent upon response to enhancements
- Annual cash return: 0-5%
- High IRR: 15-20%
- High level risk of loss

EXAMPLE

Converting a vacant rundown restaurant into a modern open floor space that attracts a higher paying tenants and increases the sale value of the property.

Probability of:
- Risk of Loss
- Annual Cash Return
- Annual IRR
Opportunistic Investments are the highest risk and reward investment style. These are opportunities that either require major enhancements, development or land prospecting. Finding these “diamond in the rough” opportunities takes skill and an understanding of the surrounding market. Correctly projecting the costs of the major enhancements and the markets response to the enhancements is vital. These opportunities often have low or no cash flow during the term of investment.

**IDENTIFIERS**
- Major enhancements or development needed
- Higher use of leverage
- Often relies on appreciation for returns
- Potential for capital calls may be higher
- Annual cash return is often 0%
- Annual IRR: over 20%
- Carries the highest level of risk of loss

**EXAMPLE**
Converting a vacant building into a movie theater. The extreme cost could reap major rewards but also has a higher probability of a loss.

**Probability of:**
- Risk of Loss
- Annual Cash Return
- Annual IRR
# Asset Profile Comparison

<table>
<thead>
<tr>
<th>Investment Type</th>
<th>Core Investments</th>
<th>Core Plus Investments</th>
<th>Value Add Investments</th>
<th>Opportunistic Investments</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Probability of:</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Risk of Loss</td>
<td>Very Low</td>
<td>Low</td>
<td>Medium</td>
<td>High</td>
</tr>
<tr>
<td>Annual Cash Return</td>
<td>$$$$ Low</td>
<td>$$$$ High</td>
<td>$$$$ Low</td>
<td>$$$$ None</td>
</tr>
<tr>
<td>Annual IRR</td>
<td>$$$$ Low</td>
<td>$$$$ Low</td>
<td>$$$$ Medium</td>
<td>$$$$ High</td>
</tr>
<tr>
<td>Leverage</td>
<td>Less than 50%</td>
<td>50%-65%</td>
<td>60%-75%</td>
<td>Over 70%</td>
</tr>
<tr>
<td>Occupancy Rate</td>
<td>90-100%</td>
<td>80-95%</td>
<td>Less than 80%</td>
<td>0-50%</td>
</tr>
<tr>
<td>Asset Strategy</td>
<td>Buy &amp; Hold</td>
<td>Light Renovations</td>
<td>Heavy Renovations</td>
<td>Ground Up Development</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Re-Lease Strategy</td>
<td>Major Retenanting</td>
<td>Major Rehab</td>
</tr>
<tr>
<td>Stable Tenants</td>
<td>Bulk of rent roll</td>
<td>Partial</td>
<td>Few / None</td>
<td>None</td>
</tr>
<tr>
<td>Hold Period</td>
<td>Long Term</td>
<td>3-7 Years</td>
<td>2-6 Years</td>
<td>1-3 Years</td>
</tr>
</tbody>
</table>
RISK FACTORS

Understanding the risks you will be exposed to as a commercial real estate investor is vital to the investment selection process. Once you know the risks, you can compare opportunities and determine varying levels of exposure. As we continue with The Valuation Series, you will learn through analysis how to limit your exposure to the following risks.

**Tenants**

Commercial Real Estate is an industry that relies on revenue from tenants. At the end of the year, the income sheet is going to show either a profit or loss. The difference will be determined by how much tenants are paying in relation to operating expenses. If tenants are paying more than the operating costs, the property is profitable. If tenants are paying less than the operating expenses, the property is losing money.

The less stable a tenant’s business, the more risk there is associated with that income. A tenant in an office building could have a failing business and file for bankruptcy, thereby not having the ability to pay the rest of the lease. If the property is an area with a high vacancy rate, the space may have trouble leasing up.

**Market Illiquidity**

Commercial Real Estate is a buy and hold proposition where the liquidity is tied to the sale of an asset. If an investment is losing money and the market dries up, it may prove tough to exit and the sale price may be significantly lower than the purchase price.

**Taxes**

Federal and state income taxes vary according to each individual investor, leaving some investor’s with greater tax liability. Income taxes can change, increasing or decreasing tax liability. Additionally, different deal structures also have different tax consequences. It is always in the best interest of an investor to consult a tax advisor prior to investing in commercial real estate.

**Competition**

The property you own isn’t the only property trying to earn a profit. The competition of the market can drive rent prices down and even take away potential tenants.

**Operating Costs**

Operating costs can increase due to repairs, renovation, insurance and other costs associated with operations. It is not always possible to raise rent to cover extra costs.

**Market Rent**

The value of market rent can vary in the area of your property. If your property is reaching for above market rents expect to lose tenants or lower rent which will lower revenue.

**Leverage**

Leverage adds risk for the same reason it increases reward. The capital the investor puts down is amplified by the loan from the bank by as much as 10 to 1. This means that if property value increases the total investment is amplified by 10 times and if property value decreases its amplified by 10 times, potentially leading to a total loss.
Bad Business Partners
If you haven’t been burned by a bad business partner, you likely know someone who has. Commercial Real Estate is just as likely to have business partners who aren’t looking out for your interests as any other industry. This is a real risk.

Capital Calls
Over the term of an investment, it might happen that either (a) funds are needed to protect the investment or (b) an opportunity arises to add value to an asset. Such occurrences can lead an operator to conduct a “Capital Call”—i.e., to ask investors for additional funds.

For example, if an existing tenant went bankrupt and had to be replaced, new funds may be required to prepare the suite for a new tenant. To obtain these new funds, the operator would initiate a capital call.

In another case, an operator may determine that specific property upgrades, also requiring new funds, would add considerable value to an asset. This could also result in a capital call.

Capital calls can be very beneficial, because adding value to an investment can increase returns. In other cases, supplying additional funds might be found necessary by an investor simply to protect an equity position, lest they forfeit the property to the lender.

Generally, investors have the right and not the obligation to add additional funds. (However, every deal is structured differently, so it falls on the investor to understand the terms of each investment.)

Understanding the risks you will be exposed to as a commercial real estate investor is vital to the investment selection process. Once you know the risks, you can compare opportunities and determine varying levels of exposure.
Choosing Your Style

Now that you understand the investment styles in commercial real estate, the next step is choosing your “style lean.”

A style lean is simply how you build your portfolio. Will it have an aggressive lean that includes more risk intensive investments? Or will it have a conservative lean, yet also make room for one or two higher risk investments?

There are as many style leans as there are investors, because determining the appropriate portfolio allocation requires identifying your own personal risk tolerance.

An individual’s risk tolerance depends on multiple factors: How much capital is available, the investment time horizon, sources of cash flow, and the value of other assets, such as property, inheritance, or pension. But it fundamentally comes down to determining how much loss can be sustained.

This means, above all, looking at the worst-case scenario. Take a given investment or spread of investments. If you took a loss on the given positions, what kind of financial situation would you be in? Would recovery be difficult? How much capital would you have left? Would you have to sell off any assets? Would your quality of life be negatively affected?

Rational, sophisticated investment decisions are based on whether the outcomes of those investments, whether loss or gain, are sustainable. Understanding your financial life and individual risk tolerance, then investing accordingly, will ensure that losses will be limited, and in the long run, that your financial position will improve.

Analyzing Multiple Opportunities

Once you know the investment style lean most appropriate for your needs, how do you further filter the investments that are right for you? For instance, if you had 10 different Core Plus investments to pick from, how would you go about selecting the correct one?

This selection process begins with assessing risk and ends with the skill of analyzing property value. This analysis requires a host of sub-analyses: market analysis, cash flow analysis and projection analysis. In all, it’s a heavy topic, but don’t worry — the rest of The Valuation Series will break it down for you.
CONCLUSION TO CRE201

GETTING THE BIGGER PICTURE

You now have the basic toolset employed in the detailed analysis and comparison of CRE opportunities. But being an effective investor also requires an understanding how the real estate market functions on a larger scope.

Why do real estate markets trend up or down? When do new properties get built? How does the rental market relate to the asset market? Being able to answer such questions will strengthen your ability to think long term and become a “big-picture” commercial real estate investor.

CRE202: How it Works continues RealCrowd’s Valuation Series, and will provide you with a bird’s eye view of the real estate system, outlining its broad connections, relationship to the general economy, and factors governing its cycles.

Please email us at CRE202@realcrowd.com to obtain the CRE202 ebook and to continue becoming a more informed commercial real estate investor.