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EXCLUSIVE

A Risk Assessment Program for CRE

By **Joseph Ori**, Executive Managing Director, Paramount Capital Corp. | Commentary



WALNUT CREEK, CA-Investing and developing commercial real estate has many risks. The below list is not all-inclusive but represents key risk areas for any CRE owner.

The list does not include geographic, property type and industry concentration risks which should be considered at the asset allocation level in the CRE investment process.

Some CRE owners may delete or add other risk factors that are specific to their property or portfolio. For example, entitlement risk applies only to land and development projects and would not be applicable for completed properties.

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Every CRE owner should be cognizant of the risks of owning CRE and the potential affects these risks have on the performance and value of the real estate assets. However, most investors are not aware of or do not have a program to review, analyzes and mitigate these risks.

These risks can be summarized as follows:

1. Cash Flow Risk (volatility in the property's NOI or cash flow)
2. Property Value Risk (reduction in a property's value)
3. Tenant Risk (loss or bankruptcy of a major tenant)
4. Market Risk (negative changes in the local real estate market)
5. Economic Risk (negative changes in the macro economy)
6. Interest Rate Risk (an increase in interest rates)
7. Inflation Risk (an increase in inflation)
8. Leasing Risk (inability to lease vacant space or a drop in lease rates)
9. Management Risk (poor management)
10. Ownership Risk (loss of critical personnel)
11. Legal and Title Risk (adverse legal issues and claims on title)
12. Construction Risk (development delays or cessation and payment defaults)
13. Entitlement Risk (inability or delay in obtaining project entitlements)
14. Liquidity Risk (inability to sell property or convert equity value into cash)
15. Refinancing Risk (inability to refinance property)

A CRE owner should perform at least annually, a risk assessment of its portfolio or property. In practice, this is rarely done and one of the main reasons for sub-par investment performance and returns. Implementing this analytical framework to access risks inherent in CRE and then taking steps to minimize or eliminate these risks is a proactive approach to increased cash flow, value creation and beneficial to real estate owners and investors. This risk assessment process outlined below is a quantitative analysis of a property or portfolio using a simple numerical grading system of 0, 1, 2 or 3 points. The general steps in performing a risk assessment are as follows:

- Define assets in fund, portfolio or entity to be assessed.
- Segregate assets by property type or location.
- For each asset and then each risk factor assign a risk assessment score of 0, 1, 2 or 3 points. 0 points are assigned to a risk factor, if there is no risk. 1 point is assigned if there is low risk. 2 points are assigned if there is moderate risk and 3 points for high risk. The assignment of the risk assessment score should be reviewed and approved by senior management of the real estate owner/manager to make sure the assessment is accurate and reliable.
- Once all the properties are assessed, all the points for each property should be totaled. Since there are 15 risk factors, the range of risk points are from 0 to 45. A property with a risk assessment of 0-15 points would have no or low risk, a property with 16-30 points would indicate medium risk and one with 31-45 points is considered high risk.

A property with a high risk assessment is an early warning indicator to ownership that steps need to be taken to reduce or eliminate the various risks. For example, if a risk assessment score is 39 points with high scores for Cash Flow, Property Value and Refinancing Risks, ownership must, at a minimum, seek to stabilize the property cash flow, reinvest capital to attract new tenants or renegotiate the loan terms with the lender. It may also be necessary for management to replace the property manager and reduce operating expenses in an attempt to increase cash flow.

Using this simple risk assessment analysis, any property owner can better understand the risk and volatility of their assets and attempt to reduce or eliminate the risk exposure. The 15 risk factors can be altered and tailored to the specific company and portfolio. Although the assignment of risk points is somewhat subjective, it is easy to use and provides a simple grading system for ownership.

Joseph Ori is executive managing director at Paramount Capital Corp. The views expressed in this column are the author's own.

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