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Planning for a real estate downturn: Mitigating risk and finding value in today’s environment - by Mike Packman

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Those of us that have been in the industry a while, understand that markets are cyclical and eventually, history repeats. So how have the lessons we learned during past markets, translated into actions that mitigate risk when those cycles repeat?

I recently participated on a panel at the Alternative & Direct Investment Securities Association’s (ADISA) Annual Conference & Trade Show, held in Las Vegas. Some 1,000 real estate and financial services executives, financial advisors, family offices, and investment sponsors attended. The panel was aptly titled, “What to do when real estate goes wrong,” and we discussed where the industry is in the market cycle, lessons we have learned from the past, and how we are mitigating risk and finding value in today’s environment.

Don’t Chase Yield

Many investors follow yield, but yield is only one component of an investment. Higher cash flow does not mean lower risk. When the markets begin a downturn, you want to be invested in real estate that can weather that downturn and preserve your capital. The consensus of the panel was to acquire the highest quality real estate in the best markets you can find. This will most likely mean purchasing a property with a lower yield but owning a property in a market where people want to be, and that can potentially put you in a better position if the economy turns.

Invest in Good Real Estate

At KNPRE, our real estate motto is “location, location, location.” We believe that good real estate will be in demand regardless of the market cycle. I recommend searching for real estate:

In established or growing markets.
In high-traffic areas.
Within average to high income areas.
If investing in retail, look for tenants that have established brands that have weathered multiple market cycles.
Look to find properties across multiple geographic locations to help you create a diversified real

estate portfolio.

During market cycles like the one we are currently in, these higher quality real estate investments may come with a lower cap rate but may offer greater preservation of capital.

Underwrite for a Downturn and/or a Higher Interest Rate Environment

Today, we must underwrite for a possible economic downturn as well as anticipate the possibility of higher interest rates. Certain commercial real estate sectors may be more sensitive to changing interest rates than others, therefore the impact of a high inflationary period will not be felt equally. Location, demographics, and demand for products and services also impact real estate prices. Be open to exploring other asset classes and locations to find the best value. When negotiating your purchase, strategize ways to underwrite for a downturn and higher rates. For example, when purchasing commercial properties, finding those with long-term leases with multiple extensions can help mitigate the risk of a downturn, and one way to mitigate rising interest rate risk is to tie rent increases to a percentage of sales at those extension dates. Consider asset classes with the potential to weather the environment. As an example, multifamily properties are an asset class that may weather a high inflation environment as their shorter-term leases (one or two years) can be adjusted as a hedge against inflation when they renew. Of course, in a severe downturn or hyper-inflationary environment, the risks may outweigh any of the planning you may have done to prepare.

Consider Passive Real Estate Investments to Diversify

A final thought on a strategy that could potentially mitigate your risk, is to invest in real estate portfolios, like a Real Estate Investment Trust (REIT) or multiple Delaware Statutory Trusts (DSTs). You can invest all, or a portion of, your real estate portfolio in these products, and, with DST investments, can even defer your capital gains. These opportunities allow you to invest in multiple properties, diversify geographically and by asset class. You can also strategically invest in states with no income tax, reducing your overall ongoing expenses.

The search for the “right” commercial or investment property may take longer in the current environment, but it is still possible to find good properties at a fair value. Being patient and remembering the lessons of the past may help you plan for the uncertain future. Reset your expectations, reevaluate your investment criteria with the possibility of a downturn in mind, and keep a watchful eye on interest rates as you navigate the current real estate market.

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