The Real Estate Investment Process:
A Practitioner's Perspective

Daniel B. Kohlhepp, Ph.D., MAI

Kohlhepp Realty Advisors, Inc.
2 West Park Avenue
P.O. Box 544
DuBois, Pennsylvania 15801-0258

Office (814) 375-2750
FAX (814) 375-2799
Email: kohlhepp@penn.com

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INTRODUCTION

The purpose of this paper is to describe the real estate investment process from a practitioner's point of view. First the nature of the real estate investment process is discussed and then each of the following steps is described:

- Step One: Establish investment objectives, policies, and guidelines;
- Step Two: Seek-out and screen investment opportunities;
- Step Three: Analyze and evaluate the investment opportunities;
- Step Four: Structure the investment;
- Step Five: Perform the real estate due diligence review;
- Step Six: Control, close, and fund the investment;
- Step Seven: Manage the investment; and
- Step Eight: Sell, refinance, or securitize the investment.

THE NATURE OF THE INVESTMENT PROCESS

Successful real estate investment decision-making is a labor-intensive, satisficing process in which reasonableness is the most important decision criteria in uncertain and dynamic environment. The process requires both a top-down and bottom-up analysis.

The Process

Successful real estate investments can only be achieved when the decisions involving that investment are made in the context of the entire real estate investment process. Real estate investing is not a single act or a single decision; rather it is a process, which has very specific steps, which every successful investor must take. Missing any steps in the process will lead to poor decisions and in the long run to poor real estate investments. Many real estate finance and real estate investment texts view the real estate investment decision as the end result of a process. However the real estate investment decision is really a series of decisions all of which impact the outcome of a successful investment.

Satisficing Not Optimizing

The objective in real estate investments is to satisfy a series of limiting constraints. The major problem is to identify the "feasible set" rather than to find the optimum solution for the feasible set. Optimizing a decision is a noble goal, but seriously attempting to optimize the real estate decision is not a fruitful activity. I recognize that a real estate investment can always be made a little better, the returns can always be a little higher, and the risks can always be a little less. However, for a successful real estate investment, we need to reduce the risks to an acceptable level and to increase returns to an acceptable level. There is always a better deal to be made, but a good deal for both parties is the best real estate investment. In other words, our objective is not to hit the bull's-eye on the target but simply to hit on the target. The reason for this goal is that the targets are moving, the targets are changing, and the targets are fuzzy. Consequently, an optimum solution today may be suboptimal tomorrow and infeasible the day after tomorrow. Our need is to find an area in the feasible set that allows a certain amount of movement in our environment and our limiting constraint without making the real estate investment unacceptable.

Uncertain and Dynamic Environment

Optimization models, which minimize, maximize or otherwise optimize some objective function work best in a very stable and well-defined decision environment. On the other hand, the real estate investment environment is characterized by much uncertainty regarding market conditions, financing terms, and buyers' and sellers' motivations. In fact, sometimes misinformation is added to the investment process by competing interest groups. Furthermore what is known today may be not known tomorrow, and what is a fixed variable today may be a highly uncertain variable tomorrow. Thus an investment decision which satisfies the buyers, the sellers, the financiers, the operators and the space users may be and probably is as good as it gets. More importantly, the investment will work.

Labor Intensive Activity

The real estate investment process is a very labor-intensive activity. Real estate appraisal texts emphasize that people determine the value of real estate. Similarly, people and more specifically their labor input determine the returns from and the success of a real estate investment. Trammel Crow, the legendary Texas real estate developer, once stated that "real estate is a body-contact sport." In every step of the real estate investment process there are myriads of human interactions, which must take place. Successfully managing the people and the human relationships in the real estate investment process is a necessary and almost sufficient condition for a successful real estate investment. There is no such thing as "passive real estate investment." The investor and its agents must be intimately involved with the practitioners, professionals, and craftsmen in the real estate market. The right people can make a marginal real estate structure into a successful investment. However, the wrong people can make the best-located land with the highest improvements into an unbelievable disaster. While real estate investments require lots of capital and of course lots of land and improvements, the most important ingredient in the real estate investment process is the human factor of production.

Reasonableness

In 1972 Stephen A. Phyrr suggested that historically "most of the mathematics of risk are left to the four horsemen of the implicit decision-making apparatus: judgment, hunch, instinct and intuition. He contrasts this old fashion approach with modern financial theory which attempts to make risk analysis more explicit with procedures that are improvements over the old ones. In particular Dr. Phyrr presented a probabilistic rate of return model for evaluating real estate risks. I promptly included Monte Carlo simulation in my own discounted cash flow models and went on to develop additional models using linear programming and dynamic programming. These explicit decision models which were highly quantitative and mathematically rigorous enabled us to communicate many of the variables included in real estate investment decisions. However over the past 25 years I have come to appreciate that the "four horsemen of implicit decision making: judgment, hunch, instinct and intuition" are as valuable today as they were 25 years ago and 100 years ago. As our decision models have become technically more rigorous, many times their complexity obscures the essential problems and most significant risks of the real estate investment. Consequently rational decision-making based on flawed assumptions have lead us to very illogical conclusions. The critical criterion for using decision models of any kind is to ask the question "are our expectations reasonable?" That is to say, is it reasonable to expect these kinds of returns, is it reasonable to accept these kinds of risks, and basically does this investment make sense. Would a prudent man or a prudent woman make this decision? By using reasonableness as a decision criterion, my intention is to use the intuitive decision calculus (which is based on experiential data and learning) to balance and enhance the explicit and technical decision process, which is based on mathematical formulas and relationships. Maintaining a healthy cynicism towards our assumptions is a valuable if unflattering characteristic. Simplified assumptions help us to better understand our decision environment and clear away much of the overburden surrounding real estate investments. However as these assumptions clear away the overburden they may also clear away the very ingredients which provide the spice to our real estate investments, that is to say the up side and the downside risks.

When reasonableness becomes the ultimate test for our real estate decisions, the investment questions become:

- Can we reasonably expect to achieve these real estate returns from these investments?
- Can we reasonably expect to have these relationships hold for the foreseeable future?
- Can we reasonably accept these risks in exchange for the expected returns?
- Most important of all, is it reasonable to expect that this real estate investment with all of its complexities, nuances, risks and uncertain returns will help us achieve our long-term investment objectives.

Top-Down and Bottom-Up Approach

Many real estate strategists argue whether a top-down approach or a bottom-up approach is better. For the real estate investor, the top-down approach begins with a grand investment strategy and systematically reduces it down to the property level. On the other hand, the bottom-up approach requires the investor to find an attractive piece of real estate and then place it into a suitable real estate investment portfolio. My point of view is that real estate requires both a top-down and bottom-up approach. Without a grand investment strategy, which is reducible to operational investment objectives, we do not know what a "good investment" looks like. Without the clearly specified investment objectives, the real estate is "mush without a bowl". However the bottom-up approach is absolutely essential to maintain the integrity of the real estate investment process. For the best real estate investment won't be successful if the toilets don't flush.

In reality the real estate investment process is neither top-down nor bottom-up but a circular process so that one step flows into the other. It is the constant interaction and tension between the investment strategy and the real properties and the resolution of those interaction and tensions, which define a successful real estate investment.

STEP ONE: ESTABLISH INVESTMENT OBJECTIVES, POLICIES, AND GUIDELINES

Defining Investment Objectives

The first step in the real estate investment process is to define the investment objectives of the person, institution, enterprise or organization as they relate to real estate investments. The investment objectives must be compatible with the mission or vision of the organization, institution or enterprise. The mission or vision will suggest certain investment objectives, and the achievement of these investment objectives will require an appropriate investment strategy. The investment objectives will suggest a model portfolio, which accomplishes that objective, and it is in the context of this model portfolio in which the requirements of the real estate investments are defined. That is to say, what is the role of real estate investment in the overall investment portfolio? What is the purpose of the real estate investment and what is the closest substitute for real estate in this portfolio?

Diversification and Required Rates of Return

The model real estate portfolio (in context of a model investment portfolio) will suggest a diversification strategy. Ideally, the real estate invest diversification strategy will be defined in terms of geographic location, property types, as well as developmental and financial risks. Target rates of return should be assigned for each level of risk as well as each geographical location and property type if appropriate. The required rate of return or the minimum rate of return is most easily defined using a benchmark of a similar investment class, which is readily observable in the daily financial markets. Such financial benchmark rates may include long term US Treasury bonds, GNMA certificates, or high yield or junk bonds. To these benchmark rates an appropriate risk premium is added. For example, a fully leased office building may have a required rate of return equal to 10 year GNMA's plus 200 basis points.

Clarification, Articulation, and Communication

The more information that can be established regarding the risks and returns expected from the real estate investment, the better the real estate investment process can operate. For example, it is important to differentiate between the annual taxable returns, the cash returns, and the expected internal rate of return. Also certain risks simply may not be acceptable to the investor. The investor may not want to accept any properties that contain asbestos or have under ground storage tanks. Another categorical risk factor may be that no property will be considered in the portfolio, which is not appropriately zoned at the time of acquisition. Another risk that may be avoided may be certain property types. For example, the Sears pension fund may choose not to have any funds invested in retail shopping centers. Again the more detail, the more clarification, the more specificity which can articulated in terms of the investment objectives (and specifically the rates of return and the acceptable risk levels), the better the real estate investment process will function.

Objectives must be reduced to policies and policies must be reduced to guidelines and all of these must be communicated to all of the other players in the real estate investment process.

STEP TWO: SEEK OUT AND SCREEN INVESTMENT OPPORTUNITIES

What We Have Versus What We Want

Initially the investor must determine the current status of its real estate investment portfolio and how the existing portfolio compares to the model portfolio specified in Step One. This exercise will indicate what kind of properties and investments need be added and/or deleted from the portfolio. This information provides a road map for the investor, directing where he can find and seek those kinds of investments. The human element is particularly critical in this step because the critical question is <u>who</u> can provide those kinds of investments. Which brokers, which mortgage bankers, which developers, which real estate companies control or have access to the kinds of investments that should be acquired or conversely are able to aid in the disposition of the properties or investments of that nature.

Investment Screens

Once the kind of properties and investments which are being sought have been determined, a series of screens or preliminary investment criteria are established to sort through the opportunities and find ones that have the highest likelihood of satisfying the portfolio objectives. Appropriate screens would be the size of the property, the location of the property and the type of property as well as the price per square foot, the overall cap rate, or the first year cash on cash returns. There also may be some criteria such as the number years of operating history or the amount of experience a potential development partner may have. These screens may also deal with the location characteristics of the property as well as its environmental risk exposures. These screens are critical because the amount of investments available will always greatly exceed the amount of capital. Consequently an efficient screening process is critical.

Networking

At this stage of the investment process it is important to develop and maintain an extensive network of contacts to provide the exposure to the type of investments that are desired. However having clear screens will greatly improve the chances of seeing the kind of investments, which are deemed appropriate for the investment portfolio.

STEP THREE: ANALYZE AND EVALUATE THE REAL ESTATE INVESTMENT OPPORTUNITIES

Property Analysis
Once the opportunities have met the initial screens, the next step is to analyze the real estate and to ask the question - "Is this property acceptable for the real estate investment portfolio?" While each kind of property requires its own particular analysis and contains its own specific nuances, a general outline of the analysis should first consider the property in terms of its location, the site, the improvements, the existing tenants and the projected budget.

Market Analysis
Secondly the market must be evaluated in terms of the general real estate market and the appropriate submarket. It is also important to determine which properties are directly competitive with the subject property and what the competitive advantages and disadvantages of the subject property are. Quite simply the question must be answered - "how will this property compete in this market?" What will be the most likely rental rates and occupancy levels both today and into the foreseeable future?

People Analysis
The third stage of the analysis should clearly and sharply focus on the people involved with the property in the deal. The question must be answered - "are the people risks acceptable in this investment?" If outside investors are involved, the background of the partners should be evaluated in terms of financial capacity, experience and expertise, and compatible investment objectives. If the property is to be developed, it is critical that the development team (which includes not only the real estate developer but also the architect, contractor, leasing agent, property manager and engineers) are all capable and qualified. Finally it is important to determine who will manage the property and who will manage the real estate investment. It is critical to realize that the real estate property must be managed and the management function of the property is different from the management function of the real estate investment.

Risk and Return Analysis
The fourth stage of the analysis should focus on the financial returns of the property and how these returns are affected by the most critical risks of the property. The question, which must be answered: "do the expected returns justify the risks associated with the investment?" First of all the property should be preliminarily valued in terms of the general market place and in terms of the investors' required rate of return. The annual returns should be calculated. These should include the return on the equity (cash on cash return) and the return on the total capital as well as a break down of those returns to debt capital, equity capital and contingent returns such as additional interest in participating

mortgages. The reversionary returns should also be estimated at both the property residual level and equity residual level and must recognize the capital distribution conventions of the partnership and the investment structure.

Sensitivity Analysis

Finally sensitivity of the returns to changes in the environment should be evaluated. At this point in the analysis the most significant risks should have been identified and the performance of the investment should be evaluated at various levels of the uncertainty. For example if the rental rates are not known because of major rent concessions or a new market, the yield should be determined at a low level, a medium level and high level. If the interest rates or financing terms are not known, the yields should be evaluated using low, medium and high financing interest rates. One of the most common risks is not the level of the variable but the amount of time, which it takes to achieve certain occupancy, a certain rent level, or a certain releasing level. These timing risks must be evaluated for their impact on overall yields as well as annual returns.

At this point if the property appears that it is appropriate and the expected risks would justify the expected returns, the next step in the investment process is taken.

STEP FOUR: STRUCTURE THE REAL ESTATE INVESTMENT

Clean, Simple, and Fair

The structure of a successful real estate investment must be clean, simple and fair. Real estate investments with lots of whistles and bells, highly complex financial arrangements, and lopsided risk allocations are doomed for failure.

Match the Structure to the Enterprise and the Market

The structure of a successful real estate investment must be compatible with the real estate enterprise and with the market environment. For example a retail shopping center which is leased with base rents and percentage rent provisions should not be financed with a mortgage which has regular fixed increasing debt payments. The cyclical nature of sales means that sooner or later the sales will drop and the corresponding rents will drop while the fixed debt payments will increase and defaults will incur. This was my experience with a $154,000,000 portfolio of WAL-MART stores. Also for example, highly levered participating mortgages are not appropriate in a market with decreasing rents, increasing vacancies, and declining property values. Again, this was my experience in the early 1990's. A well-structured real estate investment must provide for a minimal acceptable return while reducing the most significant risks to acceptable levels.

Risk Avoidance and Allocation

Also any unacceptable risks should be avoided in the deal structure. However this begs the question: " can the parties who are assigned the risk bear the risks?" It is imperative in the allocation of risk that the parties who control the risks are assigned responsibilities for the risk. Also it is imperative that the parties accepting the risk have the financial where-with-all to do so. Personal guarantees or master leases from shell entities or persons of limited financial capacities are truly worthless. In structuring a real estate investment it is important that all of the parties are treated fairly. That is to say, are the parties rewarded for the risks they bear and can the parties control these risks? The use of representations and warranties is a legal approach to assigning risks. However on an economic level, letters of credit, additional collateral, escrow accounts, or deferred payments should back risks.

Distribution of Cash Flows, Tax Flows, and Capital Proceed

Every real estate investment should provide for a clear distribution of cash flows and clear distribution of capital proceeds. The allocation of taxable income and taxable losses should be understandable to the participants and not only to the tax accountants.

Capital When You Need It Most

Another provision in the deal structure should be for the addition of new capital to the real estate investment. Most often, new capital is required when the real estate investment does not perform as expected. This means that the newest capital require the highest rate of return and the highest priority for repayment. This capital may be in the form of additional partnership loans or secondary financing. It also could be in the form of new partners or equity stockholders with preferential returns.

Dispute Resolution

A well thought-out investment structure should also provide for the resolution of investment disputes and partnership disagreements. Investment disputes can occur between the buyers and lenders wherein appropriate default and cure provisions are required. In the partnership disputes a systematic resolution of the disagreement should be provided for and in the end a fair method of dilution or liquidation should be articulated.

STEP FIVE: COMPLETE THE DUE DILIGENCE REVIEW

Integrity

The due diligence review provides the integrity in the real estate investment process. The due diligence review is by necessity a bottom-up approach. It starts with the property and the property characteristics and moves to the market and on to the particular investment and then to the portfolio objectives. The due diligence review is so important that some financial institutions now require a third-party due diligence study as a requisite precondition for committing capital to real estate.

Due Diligence Or Else....

It is critical that the due diligence study be completed prior to the acquisition of a real estate investment and property. If the due diligence study is delayed until after funding, investors may be faced with "overdue diligence". Overdue diligence occurs when the investors discover what they wish they had known prior to the investment funding. Needless to say overdue diligence causes a loss of faith, second-guessing, and chagrined investors. When the due diligence review is ignored completely, the result is "do-do diligence". Do-do diligence occurs after the investment has become insolvent, the loan has been foreclosed, or the real estate enterprise has been abandoned. At this times capital lenders and /or their agents attempt to clean up the mess or "do-do" that has been left behind. Of course, a timely and thorough due diligence review will avoid both "overdue diligence" and "do-do diligence."

Due Diligence Defined

The definition of real estate due diligence which I prefer is as follows:

> Real estate due diligence is a multi- disciplinary process to evaluate the real estate investment (whether it is proposed, contemplated or existing) in the context of the investor's policies and guidelines, investment objectives, regulatory constraints, performance expectations, and overall portfolio strategy. The real estate due diligence process incorporates all known material facts, contractual obligations, financial assumptions, market trends, and risk factors in evaluating the reasonableness of the investments expected performance. Results of the due diligence process should be decision impelling.

Multi-Disciplinary Process

The multi-disciplinary nature of the real estate due diligence process is fundamental and can not be ignored or compromised by the professional arrogance of certain service providers. For example many investors have the due diligence process performed by their legal department. While lawyers can evaluate the contractual obligations, they are usually poorly equipped to handle the market evaluation. Other times, the due diligence process is delegated to the acquisitions department or brokerage personnel who may understand the real estate markets and competitive conditions but have little ability to evaluate the regulatory concerns, environmental concerns or financial risks of the investment. Needless to say there is a conflict of interest when the acquisition department or the brokerage department conduct a due diligence process and are paid only when the transaction takes place. The due diligence process must include professionals in the legal, accounting, marketing, financial, engineering, and environmental areas. Only when the multiple disciplines are integrated into the review process with the acquisition decision clearly in focus, will the risking of the acquisition be appreciated.

Articulation and Communication

The success of the due diligence process will be largely dependent on how well the investor's portfolio strategy, investment objectives, policy guidelines, are articulated and clarified. When broad policies or guidelines are established and never reduced to operative measures of performance, the effectiveness of the due diligence review is compromised. In performing the due diligence process the policies and guidelines need to be clarified whenever ambiguous or contradictory expectations or objectives exist.

The Reasonableness Criteria

The due diligence process must ask the following series of questions:

- Is the information accurate?
- Are the expectations reasonable? and
- What does this information mean in terms of the real estate investment?

The due diligence process can follow the same topical outline, as the analysis of the real estate but a different party than the one that made the investment analysis should do it. There is an important and critical need for a "second set of eyes" to see clearly the information hidden by the data and the risks obscured by the analytical techniques.

Property Due Diligence

The due diligence review of the property should include the title search, the title abstract, title insurance, the accurate as built survey of the property, appropriate environmental studies, soil tests, engineering studies, existing leases, and as well as the properties compliance with zoning codes, zoning regulations, zoning and subdivision regulations, building codes and ADA regulations.

Market Due Diligence
The due diligence review is a market should include a review of existing market studies and attempt to reconcile third party studies with the rental assumptions and absorption rates of the original analysts. It is appropriate at this point also to confirm with skeptical eye whether the property characteristics are in fact competitive advantages or disadvantages. The evaluation of the market value appraisal is appropriate in the market section of the due diligence review.

People Due Diligence
One of the most difficult parts of the due diligence process is to evaluate objectively and critically the people involved in the investment. Due diligence analysts must confirm that the people are qualified, competent, experienced and capable of performing their roles and functions in the real estate investment process. A thorough review of their track records is appropriate and calls to former customers, business partners, and former clients are imperative.

Beware of Related-Party Agreements
Probably the most important item to ferret out is the existence of and potential for related-party transactions. Related-party transactions are the Achilles Heel of real estate investments. "Good friends making good deals with each other" will compromise an otherwise viable real estate investment. Related-party transactions can occur everywhere in a real estate investment process, and the due diligence analysts must examine every relationship and arrangement for related parties. Related-party arrangements are not necessarily bad, however many of these arrangements do not stand up to the glare of the spotlight and the objective eye of the due diligence analyst.

What's The Deal?
The "risk and return" part of the real estate due diligence process must focus on what the actual investment deal is and in what kind of property rights are being invested. The due diligence analyst must find out what real estate interests are being purchased. The analyst must measure the returns on the investment and must evaluate the robustness of the expected returns given the significant risks of the investment. The analyst should begin with a thorough review of the sales or purchase contracts to determine what interests in the real estate are being purchased and under what terms and conditions the purchases are being made. After understanding what real estate interests are being acquired the due diligence analyst must determine what benefits the investor will receive. A thorough review of the mortgage commitments and mortgage documents along with a critical reading of the partnership agreements should provide a clear explanation of the expected benefits from the real estate investment. Once these benefits are understood, the measures of return should be verified.

Verify Rates of Return
The "rates of return," "cash-on-cash returns," and "yields" are the most commonly used and most commonly misunderstood and most commonly misleading profitability measures. The due diligence analyst must confirm the definition and specification of these measures along with the accuracy of the calculations. I performed a due diligence review for a client who used a discounted cash flow model as the basis for its investment decisions. When the discounted cash flow model was analyzed, I discovered the

mathematics of the model were incorrect and systematically produced returns which were over 500 base points too high even with reasonable assumptions. However more often than not the assumptions about expected benefits are often inflated or too aggressive for the market conditions.

Sensitivity Analysis
The riskiness of the investment should be measured by the amount of variation and the returns given the changes in the most uncertain or volatile conditions in the investments. The analyst should have performed this exercise however the due diligence review helps to clarify and confirm the risks in the investment.

Compliance
Finally due diligence reviewers must evaluate the real estate investment and the expected benefits and risks for compliance with the policy, strategy, and guidelines of the overall real estate portfolio. This would include compliance with financial and security regulations.

Decision-Impelling
As mentioned in the definition, the results of the due diligence process should be decision impelling. Many times due diligence reports simply confirm that certain documents do exist. However, the due diligence review should directly answer the question: "Is this investment appropriate for this investor and these investment objectives?" Otherwise, the due diligence review is just another check mark on the closing checklist, and it will not maintain the integrity of the investment process.

Limiting Assumptions Are Stupid Assumptions
A valuable guideline for a due diligence review is the list of "limiting assumptions" contained in the appraisal report. Only a fool would make those assumptions! The due diligence analyst should confirm the reality of each assumption because the real estate investor cannot afford to make the assumptions.

STEP SIX: CONTROLLING, CLOSING, AND FUNDING THE INVESTMENT

It's Not Over 'Till It's Over

The time between the commitment of capital to a real estate investment and the eventual closing and funding of the investment may be 6 months, 12 months or several years. The closing does not occur until certain conditions are met or certain time periods expire. Funding obligations are contingent on certain precedent conditions, and funding obligations may occur throughout the lifetime of the investment.

Document Management

Commitment letters, letters of intent, purchase contracts, and partnership agreements all commit capital to the real estate investment. These documents should clearly articulate when title passes and when certain fundings are made. These documents control the investments and these documents must be managed and communicated to all parties involved. The accurate and responsible management of these documents is critical to controlling the real estate investment. Deadlines and extensions, defaults and cure periods, notification and response times are vitally important in agreements where "time is of the essence". Also during this period, documents are being drafted and circulated to parties involved. There are usually very specific time periods for review, response, and approval of these documents. Failure to manage accurately these documents will lead to defaulted agreements and a failed real estate investment, or worse yet, real estate investments which never should have been made.

The Natural Tension of Closing

The closing of a real estate investment is usually a time when title to the property passes, investment interests are vested, and initial fundings are made. The natural tension caused by the closing process should be constructively used and exploited to resolve the outstanding issues related to the investment. There are numerous legal and financial documents are drafted in preparation for the closing. Each document can change the investor's benefits. The real estate investment can be compromised or enhanced by redefining the benefits or shifting the risks. It is critical that as the pressure to close increases, the investor's critical evaluation review of each document is complete.

Clearly Worded Documents

Fundamental to this process is the use of complete and clearly worded legal documents. If these documents are not understandable to the investors, they most certainly will not be understandable to the lawyers when the investors have disagreements in the future. I recommend the using narrative and mathematical examples throughout the documents. Documents, which clearly convey and articulate the intent of the investors dramatically, increase the chance of the parties productively working together.

Problem Resolution Time

It is imperative that all problems associated with the investment be resolved prior to the closing of the investment. It is almost impossible to resolve environmental problems, title problems, tenant problems after the closing. The closing date provides the precipitating event for the resolution of the myriad of problems related to the property and the investments. Consequently the tension caused by closing should be viewed as a very beneficial and productive time rather than an onerous and vexing situation.

Closing Costs

In preparation for closing, all contracts are should be accurately drafted, and the accounting for closing is understood by all. The allocation of closing costs, legal closing costs such as legal fees, transfer taxes and brokerage commissions and financing points should be documented and approved by all parties prior to closing.

Management Teams, Budgets, and Reports

Prior to closing the management teams should be prepared to assume control of both the property and the investment at closing. This means that property budgets should be drafted and the property accounting system should be in place along with the property management personnel. Management of the investment should be defined in terms of the managing officers, the administration policies, and the investment accounting. Also the standard and necessary reports to lenders, investors, and related parties should be prepared.

Funding Is Dicey

The actual funding of the real estate investment can be a very dicey situation. It is important that the documents reflect and clearly explain under what conditions how much money is paid to whom by whom. Documents should also articulate the proper accounting of the funding. For example, a $100,000 partnership contribution is very different from a $100,000 partnership loan, which is very different from a $100,000 masterlease payment.

Funding Holdbacks

Mortgage loans and partnership agreements usually provide for a series of fundings over the lifetime of the loan. Funding usually begins with an initial funding or floor funding, which usually occurs at closing. However the complete real estate investment is usually not funded at that time for there are usually holdbacks for subsequent funding which would include physical improvement holdbacks, leasing commission and tenant improvement holdbacks, and economic holdbacks. Often the timely funding of these holdbacks is critical to the viability of the investment. Ambiguity in the documents can lead to disagreement among the parties, which in turn leads to a poor real estate investment.

Subsequent Funding

Throughout the lifetime of an investment there are also required subsequent capital contributions, which may arise because of masterlease agreements, cash flow guarantees, partnership loan provisions, and second mortgage arrangements. In partnerships, subsequent capital contributions are usually referred to as capital calls, and there are notification procedures, response times, and dilution provisions for non-contributing partners. In summary, determining how much and when money goes into a real estate investment is every bit as important as determining how much and when money is taken out!

STEP SEVEN: MANAGING THE REAL ESTATE INVESTMENT

Budgets
The real estate investment must be managed at three levels. First it must be managed at the property level; second it must be managed at the investment level; and thirdly it must be managed at the portfolio level. However regardless of the level of which it is being managed, the most important ingredient to successful management is the budget. The property must be managed against the property budget; the investment must be managed against the investment budget; and the portfolio must be managed against the portfolio budget. That is, the budget represents our expectations and our expectations must be compared against the actual experience of the property, the investment, and the portfolio.

Reports
The effective management of the real estate investment requires not only budgets but also an effective reporting of the actual performance against the operating budgets. These reports must be provided on a timely basis; they must be accurate; and they must be readily understood and communicated. Thus the budgets and the reports are the critical ingredients for the management of the real estate investment.

Property Manager
However once again the most significant risk of the management of the real estate investment is the people involved in operating the property, preparing the budgets, and reporting the results. At the property level, the property management manager must anticipate preventative maintenance and schedule required capital improvements. The property manager also must control regular operating expenses as well as capital expenditures. The property manager must be astute at tenant management and non-violent conflict resolution.

Leasing Agent
The other person critical at the property level is the leasing agent who must always be searching for new tenants, evaluating the expansion and renewal needs of existing tenants and discovering new market opportunities.

Property Management Report
The property management report should include the property's physical operation, the financial reporting of the income and expenses, and a summary of the market conditions.

Investment Management
At the investment level, the managing partner or the asset manager manages the property. The management of the real estate investment requires not only the accurate reporting of the results of individual property performance, but also converting those performance numbers to the benefits of the individual investor. This conversion is not always obvious.

Investor Benefits
Various classes of investors may receive different benefits, while partnership arrangements may require for the differential allocation of cash flows, tax flows and sale proceeds to the investors. It is critical that the investment management accurately accounts for the funding of the investor's capital as well as the accrued returns and priorities which that capital deserves. Equity capital often receives cumulative preferred returns while debt capital often earns additional interest or accrued interest. It is also quite possible that there are partnership loans, which accrue and require repayment at sometime as well as secondary mezzanine mortgages, which require tracking. Reporting these investment benefits on a quarterly basis is critical to keeping the investors well informed and the investment well managed. The old adage "we can take good news, and we can take bad news, but we can't take no news," is very appropriate for the investment manager.

Portfolio Management
The portfolio manager has a responsibility of aggregating reports of numerous investment managers into a cogent and comprehensive portfolio report to the client, which may be a financial institution, a business enterprise or a non-profit organization. The portfolio manager must also compare the actual results to the projected or budgeted results of the portfolio. The explanations of the variances from the budgets are as important at the portfolio level as it is at the property level. Again regular reporting is critical to a well-managed portfolio. The portfolio manager must also evaluate the portfolio risks in terms of the actual portfolio allocation to the model portfolio. At different times the portfolio may be over funded or under funded in certain areas, different property types or at certain risk levels. This information must be shared with the investment manager and also with the property manager. In summary, the effective management of the real estate investment must be both a bottom-up and a top-down system.

STEP EIGHT: SELLING, REFINANCING AND/OR SECURITIZING THE INVESTMENT

Future-Oriented Decisions
The decision to sell, refinance or securitize the real estate investment is based on the future expectations of the property's performance, the investment's performance, and the overall portfolio performance compared to the expectations of alternative investments. Clearly, this future-based decision contrasts "what we have" with "what we think we can get elsewhere".

Disposition Decision
The sale or disposition decision begins with the portfolio strategy and model portfolio allocation. The question that must be answered is: Does the investment comply with the portfolio strategy? If it does not comply, then the investment should be sold, provided however, that the released funds can be reinvested in a portfolio compatible real estate investment at an expected return that is equal to or greater than the existing investment.

Refinancing
The refinancing decision includes the securitization decision. However in this discussion we will address the securitization decision separately. The purpose of refinancing is to increase the expected rate of return on the investment which will more than justify the additional financial risk which is added to the investment due to the refinancing. Again this decision is based on the portfolio strategy and guidelines which relate to financial risk and leverage. These guidelines may be in the form of debt coverage ratios, loan to value ratios, or portfolio threshold amounts.

Securitizing Decision
The decision to securitize a real estate investment involves continuing to hold the investment while capturing the spread between the individual real estate investments return and the real estate securities return. The securitization decision is essentially a refinancing decision which again relates to the portfolio strategy and guidelines which address the amount of risk which can be added to the portfolio in exchange for higher expected returns.

Seller Resistance
Often times the sales decision is clouded by the investor's "pride of ownership" of a historically high performing property or of a beautiful trophy property. Other times the investor's decision to sell may be affected by the fear that the buyer of the property will get a good deal. That is to say the seller will forego some investment benefits. Ironically the investor can only sell the real estate investment if someone wants to buy it. If someone will buy the property or investment only if they fell there is an opportunity.

Along the same lines the refinancing or securitizing decision can be accomplished only when someone wants to lend money for the investment or buy the securities.

Seller's Due Diligence Package

After the decision has been made to sell, refinance or securitize a real estate investment the next step is to prepare a seller's due diligence package. The purpose of this due diligence package is to disclose exactly what rights, benefits, risks, and promises are being offered for sale and under what conditions. It is imperative that good historical data on the investment's performance and property's performance is available to the prospective buyer. A well-constructed seller's due diligence package will be particularly valuable to the buyer who needs to perform its own due diligence studies. In the securitization realm, the seller's due diligence package is effectively being a risk minimization program. In fact, the concept of "due diligence" began in securities market when it was used as a defense against irate investors who sued the issuers of the securities. In effect, the seller's defense was that used all due diligence in preparing the seller's information and disclosing the risks in the investments.

The Human Factor, Again

Ironically, the disposition, refinancing, or securitization decision requires a tremendous amount of personal involvement and human interaction as a new team is organized or perhaps a brokerage company is brought on board to sell the property and/or investment. The choice of the real estate brokerage firm, mortgage banking firm, or investment banking firm to handle the sale, refinancing or securitization of the investment is a critical decision. Again the people risk must be clearly and carefully evaluated. Market knowledge, track record, and personal contact must be objectively evaluated.

Marketing Strategy

The marketing strategy must be compatible with the investor. The strategy must address both the acceptable price and the terms and conditions of the sale. Such terms and conditions would include the timing of the purchase price payments or the acceptance of a purchase-money mortgage. Also the willingness to accept certain residual risks such as tenant move-outs, releasing performance, or environmental remediation costs. Again, it is important to clearly disclose what representations and warranties are given with the sale of the investment for these can continue the risks of the investment long past the disposition date.

SUMMARY AND CONCLUSIONS

The Four Horsemen Versus The Computer

The process outlined in this paper emphasizes the most important steps in the real estate investment process -- a labor-intensive, satisficing process in which reasonableness is the most important decision criteria. It is a process in which the "four horseman of implicit-decision making: judgment, hunch, instinct, and intuition" are used to balance and interpret the results enormous amounts of data analyzed with rigorous, quantitative, computer-based decision algorithms.

Eight Steps More Or Less

The eight steps could be regrouped and the number of steps could be expanded. Clearly, the steps overlap each other, and the some additional steps would emphasize particular types of developments, properties, and investment situations.

Everyone Needs Good Information

Throughout the decision process there is a continuous need for accurate, current, and usable information. Furthermore, information developed in one step will impact decisions made in another step. All of the participants in the real estate investment process need to understand the entire process and have available information developed in each step of the process.

Information Must Flow Up And Down

Participants in the real estate investment process will also need to have information at three level of aggregation:

1. unique, spatially dispersed properties;
2. individually negotiated, spatially disbursed investments; and
3. investment portfolios with differing investment objectives and strategies.

The ability to understand the investment process and to flow information throughout the process will determine the success of individuals at each step in the process. For it is the success of the individuals at each step that will determine the success of the properties, the investments, and the portfolios.

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