In consulting on development risk, it's nose in, fingers out

By Francois Schoeman

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Nose in, fingers out! This is what I was taught on how best to approach the subject of risk detection in property development. As a company, we are very careful to not interfere with the work of the executives, whether on our staff or that of clients, but sometimes it's hard when seeing the results of a recent study conducted by the Internal Audit Authority.

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78% of respondents to the IAA said they turn to management to identify risk. Strangely, management noted they are surprised by risk more than 60% of the time - how then can they be the source of your mitigation?

In property development the risks are omnipresent. They all go back to the fact that property development is in essence caught in a triangle of space, money and time when looking at the associated risks.

Balancing costs and value

Real estate development is considered to be one of the riskiest corporate activities there is. As the creation of real estate products is in many cases speculative and therefore in anticipation of an unknown future demand, risk and uncertainty are key elements of real estate development. Successful development, inter alia, depends on bringing the adequate real estate product to the market at the right time at the right price. The development profit depends on achieving all that while balancing costs and value.

Development is fixed both in time and space and involves relatively large amounts of capital. Furthermore, real estate development is a very complex and cross-disciplinary task as it typically demands a dedicated team including people with different skill sets and expertise and the coordination of a wide range of interrelated activities.

Local authorities, legal requirements, residents and neighbours are to be satisfied, design teams and contractors to be managed, time scales, costs and contingencies to be monitored and lenders and other stakeholders – especially prospective tenants and investors – to be satisfied. In addition, real estate developers are often faced with considerable changes in their environment and new challenges driven by economic, social, urban planning, political, legal, environmental and technological conditions.

The real estate development industry assembles and applies the financial and physical resources to construct new built space in its role as a converter of financial capital into physical capital. In meeting these objectives, a developer has to focus on the satisfaction of the needs of both target and client groups, e.g. the users of the property and the investors.

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Most prominent risks

The most prominent risks associated with real estate is that it is tied to its location, it is heterogeneous, it is scarce and it has limited substitutability. This has far-reaching economic, legal and factual implications. The geographic location alone frequently determines the most likely use, as well as the physical and / or structural possibilities, and the value of real estate is largely determined by external factors such as the condition and the possible uses of adjacent properties, as well as the infrastructural facilities provided by the public sector.

Real estate development is a highly complex, dynamic and multidisciplinary challenge. The duration and complexity of the development process involves a considerable amount of time and, as a consequence, real estate developers lack the relative flexibility to respond and adjust quickly to any fluctuations in tenant and investment markets. This results in increased economic risk.

Real estate is also characterised by its long life cycle and useful life. Depending on the purpose of real estate, its capability of being used by third parties and its usage concept, the economic life of real estate ranges between 20 and 100+ years. During this long period of time properties have to be maintained, refurbished or repositioned.

How to avoid surprises?

Emerging risks create the biggest surprises. Thus, managing emerging risks is the single most important function of risk management. It should be risk anticipation and not managing it once it arrives.

Firstly, one must acknowledge the increase in change velocity, this is a great compounder of risk and associated costs. The speed of risk has increased tenfold - gone are the days when we could be weather forecasters, standing on a hill to see a storm coming from afar. They now arrive a lot quicker, and in some instances hide themselves from view until it's too late.

The industry is also captive, through subjectivity, to its own limitations. Hard controls are easy to check the boxes of legal compliance, but they tell you absolutely nothing. The soft issues are the dangerous ones. The single biggest contributor to risk mitigation is seeking external views and professional opinions to evaluate the process and identify the exit periods for the developer. Objectivity is lost as the emotional attachment to the development and the invested capital increases. Be sure to seek an objective opinion you can trust. Knowing what risks lay in each period of development enables a developer to gauge their expected returns on when they wish to exit the development.

Risk management is not only at the start of a project. Understand that your risk in property is tied to movability. Just as the development is immovable in terms of its location, the movability of a developer during the project timeframes is directly related to their risk. The less options you have, the higher the risk, as there is a higher probability of being impacted by any factors out of your control.

Evolving risks

As a project progresses, types and extent of risks may change; new risks may emerge and existing risks may change in their importance. Of particular importance is the relationship between time and flexibility. Risk management should be a continuous activity throughout the duration of a project. The complexity of the project decreases during the various stages of the development process, as does the ability to influence the project – especially with respect to the commitment of capital or tied-up costs. These are declines that lead to increased risk.

Good developers understand the phases of development, where the pitfalls in each phase lies and how to free yourself from the project at the right time is the most important tool in a successful developer's arsenal. As an industry we must be guided in our reflections on failed or struggling developments, to better guide the industry in future. As mentioned earlier, the industry and individual developers are often captive to their own limitations and the guidance of experts must be sought to best mitigate the unforeseen and learn from the past mistakes of others.

ABOUT FRANCOIS SCHOEMAN

Francois Schoeman's professional experience lies in driving business growth through strategic marketing and business company initiatives, including core competencies in governance, management, planning and directing launches for diverse sectors, and is known as a turnaround strategist. Currently, he is the COO of GEMS Property, consulting to more than 65 companies in diverse sectors.

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