2007 MARKET FORECAST ISSUE • BROCKTON BRIGHTFIELD

BrownfieldNews

VOL.11, ISSUE 1 **FEBRUARY 2007**

www.brownfieldnews.com

BFN Goes the Distance: Celebrates 10 YEAR Anniversary

Our editors give a blow-by-blow account of where the industry's been and where it's headed.

Brownfield Risk and Return

By B. Robert Amjad

Would you parachute from an airplane for fun? If not for fun, would you jump for money?

Your answer to these questions is based on an unconscious balancing of risk and reward. Some people would jump just for the thrill. Others wouldn't do it for any amount of money. That is the nature of evaluating fair returns for risks taken—it is very personal by nature and the balance point can vary dramatically by individual.

Equitable risk/reward trade offs also vary over time for individuals. Simply put, the risk taken for any endeavor must be worth the reward gained. Otherwise, rational people will not pursue the endeavor.

This same analysis is conducted every day, either consciously or unconsciously, by business and municipal entities forging public/private partnerships on brownfield projects. By their nature, these partnerships are necessary on many brownfield redevelopments because neither partner, public nor private, is willing to shoulder the risk alone. In other words, risk to either partner far exceeds the return required (financial or otherwise) to invest in the redevelopment. This public/private relationship is necessary, even if it means teaming with partners you don't understand or may not even like. The end result is the overall project risk can be reduced for everyone and the required return to enter into the transaction is reduced.

What Is Risk?

Fundamentally, investment risk is about liquidity, uncertainty and volatility.

- Liquidity: How easy is it to get my money out of the investment?
- Uncertainty: Do I understand and can I reasonably estimate the risks associated with the investment?
- Volatility (related to uncertainty): What is the magnitude of expected change to my risk estimates?

Public and private partners alike would be wise to view any investment from these perspectives. For private parties, the primary investment risk factors for which the above questions must be answered include:

- Time: How long will it take for me to get my money back? How reliable is that timeframe?
- Cost: How reliable are the cost estimates? By what magnitude may they change?
- Revenue: Can I actually sell the product, in this case land, at the value I predicted? Will it happen in the time I estimated?
- Market: What macro market factors out of my control will impact the project? How does time impact these forces?

Complicating matters, private and public parties often value risks very differently. So the primary challenge is to bridge the dramatically different cultures between developers, consultants and municipalities.

Cost

If you were asked to invest $1,000 into a project with the hope of a $10,000 return, would you do it? Initially, it might seem a risk-free profit, but what if you were told that there was a 33 percent chance of incurring a 10-fold cost overrun from which you could not walk away? Would you now put your hard earned money in the deal? Insurance may limit the cost risk, but it will cost you another $1,000 up front. Is it worth it to you? And while this example only deals with cost risk, it ignores time, revenue and market risk.

Time

If reliable time estimates could be made, time risk could be priced relatively easily. The chart below highlights the impact of time delays on project returns. Holding other parameters constant:

Doubling the timeframe cuts the return by two-thirds and the actual cash value by $200,000. This decrease in project value is due solely to the delayed timeframe associated with project completion—the time value of money.

And this simplistic example highlights why long and/or uncertain timeframes chill enthusiasm for investing in brownfields or increase the cost of brownfield deals. If you can cut a timeframe in half, guarantee delivery on schedule and do it with credibility, that is as good as putting cash into the deal.

Revenue

Commercial development is not like selling your house—put it on the market, and unless you're being greedy, you can sell your house in six months or less. Traditional commercial real estate deals are about

	Scenario	
	1	2
Total Investment	($1,000,000)	($1,000,000)
Project Revenue	$2,000,000	$2,000,000
Years to Completion	2	4
Present Value of the Project	$743,802	$537,07
Return on the Investment	100.0%	38.9%

timing—the right buyer having a need in your market; however, the pool of buyers is dramatically smaller in the commercial market, particularly in slow economies. Pro formas are, hopefully, directionally correct, but by nature never set in stone, and typically, wrong as soon as they are printed. Flexibility is critical. Revenue risk is real unless you've got a monopoly and people need your product.

Market

Unpredictable, uncontrollable risks are substantially difficult to estimate. These factors change daily according to market forces. These "market risks" are completely out of everyone's control and the passage of time increases the cost of these risks because, as time passes, these factors will change. No one knows if the change will be negative or positive, but investors and developers price any unknowable, uncontrollable change as a cost.

The better a business can quantify and estimate risk, the less impact the risk has on project costs.

Insurance products can prove useful tools to help mitigate some forms of brownfield project risk, primarily environmental cost overruns and contingent liabilities, but even environmental insurance providers will not guarantee project returns.

As regards brownfields, a developer typically must invest substantial amounts of time and money to understand the risks before the business deal or even the insurance costs are understood. And there is a great risk of losing this investment without any hope of return. The result is that just the cost of performing due diligence (the riskiest funds invested in a deal) is a significant barrier to brownfield investment.

What Does Risk Cost?

Generally speaking, private capital flows to markets where risk is appropriately compensated with reward. It also flows like water, taking the easiest path to investment, typically accepting lower returns for easier investment processes.

Like risk, return is also defined differently by public and private partners. Public partners may define appropriate return solely by the public benefit generated by remediating a site (including improved public health and environmental conditions), by job retention/creation, or by other more esoteric measures. Private partners—oft regarded as "those greedy bastards"—measure return by cash, as well as by time- and risk-adjusted rate of return.

The private market is adept at pricing return. For instance, bank savings accounts, where you can get your money instantly (liquidity), where risk of losing your money is negligible and your return is guaranteed (certainty and volatility), currently pay 1 to 2 percent interest per year. On the other end of the scale, stock market returns (S&P 500) between 1981 and 2005, have delivered an average return of around 12.5 percent per year, justified in a market where you may lose your entire investment (no certainty), individual stock returns may vary dramatically up or down (volatility), but you can get the current market value of your investment back relatively instantly (liquidity).

If private capital is not flowing to an opportunity, it is a strong sign that the private sector does not view the reward, or return, as being adequate for the risk taken. Conversely, if capital is beating down a path to your door, you have offered too much return. Likewise, if public resources are not flowing to a specific area of a city, the public sector has implicitly decided there is not enough return—however the sector defines return—to justify taking an investment risk.

But what the public and private sector seem to have in common is that neither sees enough return for the risks required to redevelop a great number of brownfield sites in this country. So it becomes essential that they forge partnerships to produce successful projects that neither could do on its own. And to do so successfully, both sides must truly—not just conceptually or academically—understand what drives the other's decision and be willing to accept those perspectives, no matter how unpopular.

So, how much reward does it take? There is no static formula or ratio. Every deal is different, but understanding your partner's views of risk and reward can lead you to the right answer. At the end of the day, everyone should feel like he or she won a little and lost a little, or as the Wall Street saying goes, "Pigs get fat and hogs get slaughtered." So, be a pig, not a hog. Make the best deal you can and then look forward. **BFN**

B. Robert Amjad is a managing director of Hemisphere Development LLC, based in Cleveland, Ohio.