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# How to live with real estate risk

*One in a Series*

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The intermittent terrorist alarms raised by our National Security Agencies, the Middle East battlefront, the Washington sniper attacks, as well as unintended mayhem such as the Staten Island Mobile Oil terminal fire of February 22, 2003, forces us to be constantly aware of the ever present risk of terrorist-created calamities. How is the New York City real estate market being affected by this risk factor? All market activity can be analyzed on the simple principle of supply and demand. However, many an analyst has stumbled in trying to gauge the future strength of either.

Shortly after the events of 9/11, many analysts affirmed that real estate values in the New York City Metropolitan area would rapidly fall. While correct on a micro-economic basis for the downtown office market, demand actually outstripped supply in most other property categories throughout the metro area as funds previously targeted for the stock market flooded the real estate investment market. It is the nature of real estate markets to adjust slowly to specific risks, due to their illiquidity (properties can't be sold or bought like a stock with instantaneous transactions), and generally react in unpredictable ways after a terrorist event (or other broad-reaching economic event) has taken place.

There is an underlying level of risk in the ownership and operation of real estate which, as an investment class, is greater then stocks, bonds, and annuities. However, those risks have generally been in the past predictable if not, wholly avoidable. Terrorism adds a wild card which can, like any other potential event, be planned for so as to mitigate financial loss. There is no reason why the real estate market cannot continue functioning in a normal manner while operating under what may become a perpetual cloud of threat.

*The recommendations many of my clients are following are as follows:*

**1. DIVERSIFY.** The diversification should be both geographic and property type. For example we recently sold 20% of a local business' industrial land holdings which were then reinvested via a 1031 tax-free exchange method into net leased retail, and office properties in Memphis and Minneapolis.

**2. OBTAIN NON-RECOURSE FINANCING LEVERAGE.** Offset a portion of your equity risk by taking out non-recourse financing. While many prudent property owners operate with little financing on their property (low leverage) this is the recommended time to take out a low loan to value mortgage with a financial institution which will not hold you personally liable. In effect, shift risk to the banks.

**3. OBTAIN TERRORISM INSURANCE.** The terrorism risk protection act of November 2002 eliminated the "terrorist exclusion" which many insurance companies began to add to their policies after 9/11. However, the insurers are free to set premiums for such coverage. Expect premiums to rise due to the Federal exclusion of the first $5,000,000.00 of loss under property and casualty coverage: such loss is only from foreign acts of terrorism with no coverage for liability. Predicated on the extent of the event, this insurance may provide adequate protection to ownership's equity.

**4. ON-SITE PRECAUTIONS.** These would include capital improvements such as: physical barriers, security measures to screen personnel access, installation of surveillance systems.

The next article will provide specifics on methods to implement our recommendations.

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