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CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND TO THE STUDY

Real estate investing involvesthe purchase, ownership, management, rental and/or sale of real estate forprofit. Improvement of realty property as part of a real estate investmentstrategy is generally considered to be a sub-specialty of real estate investingcalled real estate development. Real estate is an asset form with limitedliquidity relative to other investments, it is also capital intensive (althoughcapital may be gained through mortgage leverage) and is highly cash flowdependent (Syz, 2008). If these factors are not well understood and managed bythe investor, real estate becomes a risky investment. The primary cause ofinvestment failure for real estate is that the investor goes into negative cashflow for a period of time that is not sustainable, often forcing them to resellthe property at a loss or go into insolvency. A similar practice known asflipping is another reason for failure as the nature of the investment is oftenassociated with short term profit with less effort (Clayton, 2007).

Management and evaluation of risk is a major partof any successful real estate investment strategy. Risks occur in manydifferent ways at every stage of the investment process. For instancemitigation strategy for fraudulent sale is to verify ownership and purchasetitle insurance. Real estate owners often assume risk on theirproperty exposure in response to unavailability of coverage. While riskretention by financially sound companies may help to reduce their cost ofrisk, absence of insurance is not always desirable. In many cases, propertyowners are required under the terms of their loan covenants to maintain fullinsurance to value, with restrictions placed upon the amount of deductiblesthey may carry (Fisher, 2005). Additionally, under high-deductible orself-insurance programs, operating companies no longer have a budgeted premium,and payment of unexpected retained losses creates potential cash flow problems. Finally, property owners ormanagement of companies have no ability to charge the full cost of retainingproperty risk to their clients. Although real estatemarkets represent a large proportion of total wealth in both developing and developedcountries, the real-estate derivatives markets are still lagging behind involume of trading and liquidity with has greatly influenced project viability (Black,1986). Over the last few years there has been increased activity in developingderivative instruments that can be utilized by asset managers to reduce realestate risk. The possibility of financial loss occurring as the result of owinga real estate investment and its implication on project viability will befocused on in this study. Real estate risk might arise from such things asliability, legal issues, partner problems that can force a sale, fire or theft,loss of rental income and purchasing property with an imperfect title.

1.2 STATEMENT OF THE PROBLEM

Real estate management is a particularly difficultchallenge because of its tendency towards liquidity. Typically, even publishedindices in real estate are based on annual appraisals of large properties, notactual transactions. The recent unprecedented recession has resulted in major long termdistress across the real estate industry, and has had severe implications forowners, developers, managers and investors alike. Environmental andconstruction exposures, catastrophic modeling, stricter lender requirements,and complex requirements involving distressed banks are just some of the risksfacing the real estate industry. The researcher however will examine the realestate risks and its implication of project viability.

1.3 OBJECTIVESOF THE STUDY

The following are the objectives of this study:

1. Toidentify the risks involved in real estate investments.
2. Toexamine the effect of real estate risk on project viability
3. Toidentify ways to minimize risk in real estate investment.

1.4 RESEARCH QUESTIONS

1. Whatare the risks involved in real estate investments?
2. Whatis the effect of real estate risk on project viability?
3. Whatare ways to minimize risk in real estate investment?

1.5 HYPOTHESIS

H_O: Real estate risk does not affectproject viability

H_A: Real estate risk does affectproject viability

1.6 SIGNIFICANCE OF THE STUDY

The following are the significance of this study:

1. Resultof this study will educate the general public, investors and estate managers onthe real estate risks, how it can be minimized and its implication on projectviability.
2. Thisresearch will also serve as a resource base to other scholars and researchersinterested in carrying out further research in this field subsequently, ifapplied will go to an extent to provide new explanation to the topic.

1.7 SCOPE/LIMITATIONS OF THE STUDY

This study on real estate risk and its implicationon project viability will cover all the risks an investor is exposed to in realestate with a view of understanding its effect on viability of project.

LIMITATION OF STUDY

Financial constraint- Insufficient fund tends to impede theefficiency of the researcher in sourcing for the relevant materials, literatureor information and in the process of data collection (internet, questionnaireand interview).

Timeconstraint- The researcher will simultaneously engage in this study withother academic work. This consequently will cut down on the time devoted forthe research work.

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