PIA Property Investment Advisors, Inc.

Real Estate Insights

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The Game of Inches: The Impact of Small Changes on Investment Returns

Although the football field is 100 yards – 120 if you include the end zones – a common axiom for any fan is that the game itself is one of inches.

Al Pacino, acting as coach Tony D'Amato in *Any Given Sunday*, said:

> *"You find out that life's this game of inches. So is football. Because in either game – life or football – the margin for error is so small. I mean one-half a step too late or too early you don't quite make it. One-half second too slow or too fast and you don't quite catch it. The inches we need are everywhere around us. They are in every break of the game, every minute, every second."*

Little did coach D'Amato know that the idea that the smallest of factors is the difference between winning and losing is as equally true in investing as it is in football.

For example, let's consider two scenarios of opportunistic real estate development.

The first is a 250-unit apartment complex that costs $40 million to build and expects to earn $3 million in net operating income (NOI) upon stabilization.

A typical construction loan during favorable market cycles is 75% of construction costs. Let's assume this first scenario is one of those times, meaning you'd need to invest $10 million in equity to fund that project.

The second scenario is an identical 250-unit apartment complex that will also earn $3 million in NOI upon stabilization. Except this one is slightly more expensive because land, labor, and lumber costs have risen, and instead costs $42.5 million to build.

Additionally, economic conditions caused the bank to tighten lending standards so they only lend 70% of the proposed construction budget. As a result, you'll need $12.75 million in equity to fund the project.

For both projects, development and construction go according to plan and stay on budget.

Let's assume you are able to build, lease, and sell each project in three years. Both are valued on their $3 million of NOI. Interest rate conditions are slightly better when you sell the first project, and buyers value it using a 6.0% cap rate, but buyers value the second at a 6.25% cap rate. Taken together, a 6.25% increase in construction costs, a 5% lower loan-to-value from the bank, and a difference of just 0.25% in cap rate doesn't sound like much, but the cumulative effect reduces your return by more than 50% over three years as shown in the table below:

	Scenario 1	Scenario 2
Development Cost	**$40,000,000**	**$42,500,000**
Loan-to-Value	75.0%	70.0%
Loan Amount	**$30,000,000**	**$29,750,000**
Equity Investment	**$10,000,000**	**$12,750,000**
Net Operating Income	**$3,000,000**	**$3,000,000**
Sale Cap Rate	6.00%	6.25%
Sales Price (*NOI / Cap Rate*)	**$50,000,000**	**$48,000,000**
Capital Returned (*Sales Price – Loan Amount*)	**$20,000,000**	**$18,250,000**
Net Capital Returned (*Capital Returned – Equity Investment*)	**$10,000,000**	**$5,500,000**
Return after 3 years	**100.0%**	**43.1%**
Annualized Return	**26.0%**	**12.7%**
Cap Multiplier	**2.000**	**1.431**

At PIA, we monitor these data points closely when making investment decisions. Opportunities like the first scenario were readily available in prior years.

But recently we have seen the cycle begin to turn and, in a series of small, incremental changes, we have seen increasing construction costs and cap rates, as well as tighter lending standards. Combined, these slowly erode potential returns.

While investment is not exactly a game of inches, it is certainly one where the smallest changes can determine whether you win or lose.

"The cumulative effect of small changes in costs, cap rates, and lender's terms can have an outsized impact on investment performance. Anyone investing in real estate should monitor these metrics closely."
– Chris Boggs, President