Real Estate Risk Assessment

Sustainable Real Estate Markets - Restoring Confidence in Financial Markets

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MIPIM
Cannes
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Background to Risk Assessment in Real Estate (PaM Model)

Investors and financial market analysts require a more scientific approach to understanding holding risk, liquidity and volatility in RE Markets.

The regulatory gap exposed by inadequate information on real estate risk has eroded prudent mortgage underwriting practice and hampered the effectiveness of monitoring by regulators and the role of Rating Agencies.

- TEGoVA 2003 standard
- European Property Federation 2003-2005 report
- RICS 2007 report
- Basle II & Basle III
- UNECE/REM
  (i) UNECE Policy Framework for Real Estate Markets - Principle 7
  (Transparency/Valuation)
  (ii) Future advisory work-RE property and market risk evaluation for RE backed financial products
Volatility - a characteristic of real estate markets. Real estate investment is differentiated from stock market investment by:

- Heterogeneity of assets and players
- Illiquidity - Large lot sizes
- Significantly gearing – bank borrowing
- Cycles characterised by leads and lags due to supply constraints
- Medium to long run hold periods
- Opacity - limited market data

- Lack of transparency and illiquidity contribute to volatility and undermine investor confidence.
How do we manage real estate risk?

- Indices, such as IPD, track historic market performance.
- Valuation assesses spot market prices.
- Modern portfolio theory facilitates portfolio diversification, concentration; moderating sector risk.
- The quality of real estate as collateral for loans is recognised by credit risk scoring, loan to value ratios (LTV) and interest cover.
- Research; Identifying the demand and the supply pipeline and shifts in capital markets provides transparency and aids understanding of the dynamics of real estate markets.

A more robust process of fundamental analysis of RE assets is vital to move risk management out of the Dark Ages.
Active RE markets and economies depend on bank lending
RE Lending is constrained by balance sheet issues, regulatory gold-plating, lack of inter bank lending & moribund securitisation (ABS)markets
Reigniting the market for ABS is essential to free up bank balance sheets to enable lending, facilitating economic growth

“Looking ahead, a self-sustained revival of the ABS market requires fundamental changes. It is high time to rise to the challenges of transparency, standardisation and product simplicity. This is where the industry has to step up its efforts in order to help decisively in restoring confidence in the securitisation markets.”
José Manuel González–Páramo of the European Central Bank

Fundamental real estate analysis (PaM) can enhance confidence in the performance of debt and equity investment in real estate and derivative financial products
Potential scope of work REM-Real Estate Risk Assessment

- PROBLEM OF RISK IN REAL ESTATE LENDING
- APPROACH TO REAL ESTATE LENDING RISK
- PROPERTY MARKET AND RISK RATING SYSTEMS
- REVIEW OF VALUATION STANDARDS
- OUTLINE OF TEGOVA PROPERTY MARKET AND RISK RATING SYSTEM
- PRACTICAL APPLICATION OF PROPERTY MARKET AND RISK RATING SYSTEMS
- REM RECOMMENDATIONS AND POLICY OPTIONS
Example of the new approach to risk initially promulgated by TEGoVA - PaM

- PaM is a method of measuring the underlying quality of a property and mid-term marketability.
- PaM provides an analysis of the risks and potential inherent in a property or portfolio.
- Credit risk scoring is not specifically incorporated the focus is on the asset.

It assesses four key property fundamentals:

i  Market

ii  Location

iii  Property

iv  Cash flow

PaM is complementary to Valuation. But Valuation sets out only what a typical purchaser would pay in the spot market on a specific valuation date. Valuation can be affected by transient market sentiment. It is no indicator of the medium and long term sales prospects of a property.
**Property and Market Rating Model**

1. **Market Environment** 20%
   - Socio-economic/demographic/real estate cycle

2. **Location** 30%
   - Suitability/standing/transport infrastructure/facilities/environment

3. **Property** 20%
   - Construction/layout/sustainability/energy performance

4. **Quality of cash flow** 30%
   - Tenant situation/rental & value growth/letting prospects/vacancy situation/expenses

**Overall Property Market Rating 1-10**

Quality/marketability/sustainable value

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### Real Estate Market Rating is comparable to Rating Agencies Credit Scores

<table>
<thead>
<tr>
<th>Aaa to AA3</th>
<th>A1 to A3</th>
<th>Baa1 to Baa2</th>
<th>Baa3 to B1</th>
<th>Ba2 to Ba3</th>
<th>B1</th>
<th>B2</th>
<th>B3 to Caa</th>
<th>Moody's</th>
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<td>A+ to A-</td>
<td>BBB+ to BBB</td>
<td>BBB- to BB+</td>
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<td>B+</td>
<td>B</td>
<td>B- to C</td>
<td>S &amp; P</td>
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<tr>
<td>excellent</td>
<td>very good</td>
<td>good</td>
<td>above average</td>
<td>average</td>
<td>poor/ special mention</td>
<td>very poor/ substandard</td>
<td>doubtful</td>
<td>loss</td>
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<td>1</td>
<td>2</td>
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<td>4</td>
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<td>6</td>
<td>7</td>
<td>8</td>
<td>9</td>
</tr>
<tr>
<td>Excellent</td>
<td>very good</td>
<td>good</td>
<td>slightly above average</td>
<td>average</td>
<td>slightly below average</td>
<td>mediocre</td>
<td>poor</td>
<td>very poor</td>
</tr>
</tbody>
</table>
PaM

- **Identifies:**
  - Underlying Asset Quality/Sustainability of values
  - Relative Volatility – similar to Beta ratings
  - Liquidity or relative marketability

- **Provides:**
  - Enhanced transparency

- **Enables:**
  - Informed analysis and portfolio diversification by risk segmentation (a bottom up approach to risk)
  - Effective portfolio management optimising future performance
  - Risk appraisal
How Property and Market Rating add value?

1. Investors (Draft AIFM Directive requires Risk Management)
   1. Transactions
   2. Portfolio Management
   3. Analysis
   4. Marketing
   5. Reporting

2. Banks
   1. Basle III
   2. Loan pricing
   3. Management
   4. Covered bonds/securitisation
   5. Risk management team dialogue with property bankers

3. Valuers (KSWS3)
   1. Valuation check
   2. Consistency
   3. Risk premiums
   4. Analysis
   5. Quality of advice
Property & Market Rating
PaM Software Development Concept

Concept:
• Low cost
• User friendly
• Quick and efficient in use
  o Development in disk format (CDs)
  o Future Development may be web based
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