CREFC Europe   Income Analytics

WEBINAR

How well do you know your tenant's income risk?

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2021 will see commercial real estate tenants pay rent of more than US$1,400bn.

In a low capital growth market commercial real estate becomes a fixed income style investment with a floating capital opportunity attached. But, in the current pandemic, it's important to understand the occupier, their business environment, along with specific requirements.

That need is all the greater in the many parts of the real estate market seeing increasing operating risk for landlords and their investors and lenders.

But how do investors, landlords, property professionals and lenders rate, analyse and monitor their income risk and what tools and data exist to support them in this task?

This question was put to a panel of experts, who took part in a webinar, a partnership between CREFC Europe and Income Analytics, that was made up of:

Zara Walsh
head of valuations and performance reporting, IPUT (Irish real estate investor)

Hugo Denée
managing director, Longstock Capital (previously MD Squarestone until Sept 2020)

Siobhan Gall
deputy head, Regions Team, Real Estate Finance, HSBC

Charlotte Aschan
director (valuation), Savills

Opening presentation
Matthew Richardson
CEO Income Analytics

Moderator
Mike Philips
UK editor, Bisnow

> “The value of your real estate investment is ultimately determined by the level, duration and quality of the rental income paid by your tenants,”

Andrew Baum. Professor of Practice, SAID Business School, University of Oxford

Simply put, real estate has always been about income, said Matthew Richardson, co-founder and CEO, Income Analytics, in his pre-panel presentation, while highlighting the quote by Professor Andrew Baum.

What the global Covid:19 pandemic has highlighted is, said Richardson: “We are now living in a low interest rate environment for the foreseeable future where it’s the income properties of real estate that are drawing the capital in from other markets. It’s never really been any different.

“It’s the piece of the puzzle we can control and ultimately it will deliver around 70% of total return. What we do need to do is begin to understand how data from big company credit reports can help us.”

To do this, Richardson urged that “as an industry we move away from looking at relative credit ratings and subjective labels, and try to focus in on failure data, which is mapping what’s happened and how often companies do go bust.

“That’s the key metric for us… [And] by doing that we can begin to build out and start looking at things like forward projections of data. We can map to other instruments, whether they be debt or equity instruments and begin to express potential loss in cash terms, which is ultimately, as an industry, where we want to get to.”

What’s important, said Richardson, is: “As an industry we need to bring ourselves into line with the other competing asset classes and try and get a place at that table by providing the kind of metrics and transparency investors are used to seeing in the equity and debt markets.”

Main targets are:

- Quantative measures
- The ability to map the defaults to the length of the lease.
- Monitor the financial health of your portfolio income 24/7
- Standardise a scoring system, so that a letting agent in Taunton and a banker in New York can at least understand what the counterparty risk is in percentage terms and express it in a way that we can begin to communicate with the other institutional investment markets.

Panel Discussion

Mike Philips (MP) _ Zara Walsh, IPUT with a history going back 50 years, how are you viewing and analysing income and tenant risk in the current market from the perspective of a long-term institution?

Zara Walsh As an income-based fund, security of income has always been key to us. In addition to looking at lease length, break options and rent we analyse a tenants covenant and their ability to pay rent and are always trying to find new and innovative ways to monitor this.

There is a growing emphasis in terms of monitoring tenant's covenant, which is something we have been doing, but over the last number of years our level of analysis has been increasing as the nature of companies, and the duration of company life has changed.

Going back two-decades the life span of companies on the Stock Exchange was anything up to 40 years. Now with a lot of tech, and start ups this is reducing. This means looking at the viability of companies / tenants on an on-going basis.

This takes time, so we are always looking at more efficient ways in which to measure risk and just having one simple way of looking at income is not the way to do it. We are looking at multiple including working with INCANS, in addition to in house systems.

We are seeing a changing dynamic in terms of the emphasis on monitoring tenant risk as ultimately it feeds into both the income and capital side of the Fund. Transparency for us is key and being able to inform our stakeholders and external valuers of movements in covenant strength (positive or negative) is crucial.

MP - Hugo Denee, from a private company perspective, how are you measuring and analysing income, why it's important, and what part does it play in your business?

Hugo Denée Previously when I was at Squarestone we had 29 buildings and about 250 tenants. Our strategy was to purchase what we saw as decent buildings with longevity in terms of location and quality.

When the pandemic hit, our equity stakeholders and lenders suddenly became really interested in which tenants were going to fail. To allay fears, we undertook detailed analysis of each tenant, downloading credit safe reports and then ranking all our tenants where we thought the failures would occur, who were most at risk, who we would negotiate hard with, and who we would help.

Having gone through that, especially in the short run where potential failures are important, knowledge of your portfolio and an ability to manage your credit risk and be one step ahead of the curve is crucial. At Squarestone we had good rent collection record over the last year, which was better that a lot of people who own towers in the centre of London.

When comparing regional real estate to central London], I'd rather buy a decent building in the centre of Birmingham, let to someone I didn't know than a buy a building in the middle of a field let to the government for 10 years because at some point you are going to have to re-let that building. The underlying mantra is, 'would I lose sleep if the tenant left this building tomorrow?' Ultimately, it doesn't matter who the tenant is.

MP _ Siobhan Gall, as a lender, how is your underwriting and view on the income side of things?

Siobhan Gall It's vital. We're real estate lenders, but we lend against the cashflow. That's our source of ongoing debt service through the life of the facility and we obviously take security over the asset, but that's as a secondary source of repayment.

We use upfront analysis and due diligence from day one. Clearly over the life of a loan things can change, so we work with our customers to understand what the best options are for replacing those tenants or giving them extensions.

The issue is credit analysis is often backward looking against credit ratings compared to what's available from Companies House and its ratings. Also working with valuers in understanding the track record, is important. Property valuation is all to do with the quality and duration of that income.

It is currently an interesting time, as what we are seeing across all markets is reductions in lease lengths and knowing what the asset is, and who it is applicable to is more important than ever given how fluid things are now. In terms of shortening average lease, it does heighten the risk because you then have less visibility on cashflow over the period.

MP _ Charlotte Aschan, from the view of the valuation industry to what degree is, and should it take income into account versus that pure look at capital values?

Charlotte Aschan They go hand in hand. You need the quality of the income stream to pay your loan, but you also need the fundamentals of the property. With short leases, our valuation is becoming much more explicit in terms of what happens if the tenant breaks, or if the expiry is quite short-term.

It's less about pricing in the yield and just be absolutely clear in the valuation process. But, if you haven't got a tenant and they are not paying the rent, it will hit the whole income stream. For us, it's always been quite a subjective process looking at the covenant strength. Yes, we have the Dun &Bradstreet, but they are often out of date. We look at what's going on in the press and looking at tenants' reports and accounts. But, equally, we're not chartered accountants – we're not qualified to do that.

There's also a lot of valuer judgement – so a tool like Income Analytics helps us. It would be great if it were adopted standard wide because at least then we'd all have the same metric to measure against.

MP _ Is the valuations industry, and the RICS, getting their heads around the shift to more operational real estate with inherently short-term leases as seen in the flexible office sector? And how are you valuing income in those operational sectors?

SG Historically, the method has been to look at the core income. If you take a serviced office income, you take the core effecting your market rent and you put a yield against that. You then tranche any additional income with a high yield.

But, as these products become more standardised, the whole industry is adapting.

In my world of commercial property, the office market is changing, the retail market is changing, the only one that is really flying is the distribution market – that will hit our sector anyway. It's all becoming about alternatives and the mix of uses.

MP _ What about the impact of Covid: 19, and the pandemic, on the commercial property sector? In terms of the data how is it possible to judge and underwrite the quality of income, especially in sectors like retail at a time of such volatility?

MR If we are using hard data, we need to be focused on a quant model. The scores only change when the facts change and what we have seen is the need to be careful jumping to assumptions.

At the beginning of this year, we assumed all the retail scores were going to go off a cliff and indeed, a lot did. But it was only as the data became available that they were able to be marked down.

There was a sector markdown from numerous referencing agencies, but there must be caution in saying the whole sector is in trouble because bigger retailers, who have had access to capital markets, have taken on board a lot of cheap cash on their balance sheets in the last 12 months. They don't necessarily look in a bad way, depending on where you look in the retail space.

People are moving in different directions and a lot of those retailers are also part of the boom in the distribution business that have done well out of home deliveries.

MP _ Charlotte, on the valuations side... we have seen a rapid shift in take-up of turnover leases in the retail sector. How is that affecting your job, and how are you valuing that inherently more uncertain income? Has the valuation profession got its head around that change?

CA In reality, we haven't seen that many of them, but it's something that has come in more in the last year, but again we have always looked to where there have been turnover leases as usually they pay a base rent and then it is putting a different yield on that turnover element.

This does have one advantage because with the turnover rent you do get a better clarity into the quality of the tenant as they need to provide the turnover figures.

MP _ Siobhan, as a lender, how are you seeing the retail sector, hotels and other asset classes that have had their incomes challenged such as student accommodation?

SG A key thing we've seen through the pandemic is stronger relationships between landlord and tenant. Understanding what each party wants and needs and where those strong relationships exist has translated into better collection rates. Gone are the days of signing a lease and putting it in a draw for the next 20 years – you need to be close with what's happening and we, as lenders, are part of that as well.

MP _ Hugo, it seems we are moving to a world where there's a big divergence between assets with 10/15 years of secure income, to those with shorter incomes. Is that an opportunity for companies like yourselves to bargain hunt what the bigger institutions aren't keen on?

HD If you believe in what you've bought you shouldn't be frightened of short-term income. You could have a 20-year-lease to WeWork with four years rent free and never see any rent from that. Whereas shorter leases mean shorter rent frees periods and you start collecting rent quicker.

MP _ How are you seeing change of use playing into strategies currently?

HD There's been a lack of office build for 15 years and a large chunk has been taken out in change of use, so the market has naturally shifted to accommodate today's demand/supply dynamics. Coming out of this there will be more flexibility and ability to change use, and it's only a good thing because it means the market is more dynamic and will bend its way to see what is right.

MP _ If you had to pick one sector that's going to outperform, offer the best total return, not just income return over the next few years, which would you pick?

HD Not retail, or shopping centres, unless they're decent because they have lost so many anchors, tenants, they're basically development sites so I probably wouldn't touch retail. And not industrial, although I get the value in an Amazon shed, but not a metal bashing industrial unit in the back end of Wales – why has that a similar rate.

So, it's offices. If you chose, well just buying fundamentally decently located offices in the cities that will exist in the next 100 years at good prices will look after you.

ZW Logistics and distribution are key sectors now to invest in and we see prime retail warehouses as a sub-set to logistics. Also, good quality, well located office buildings that have high sustainability credentials and are let to strong covenants with robust credit ratings.

SG Logistics and distribution is a relatively easy answer currently. While we are seeing the large sheds with extremely keen yields, the multi-let side of things is quite interesting and we're not building an awful lot of that as new kit, so there's possibly opportunities there.

MR There's going to be some good, counter cyclical plays in retail, and I agree with choosing the retail warehouse, where yields are going to be extremely attractive. There's also going to be some exceptionally good money to be made in the leisure sector as so much stuff will be blown out as we emerge from the pandemic.

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