



Fostering Real Estate Risk Ratings in the United States

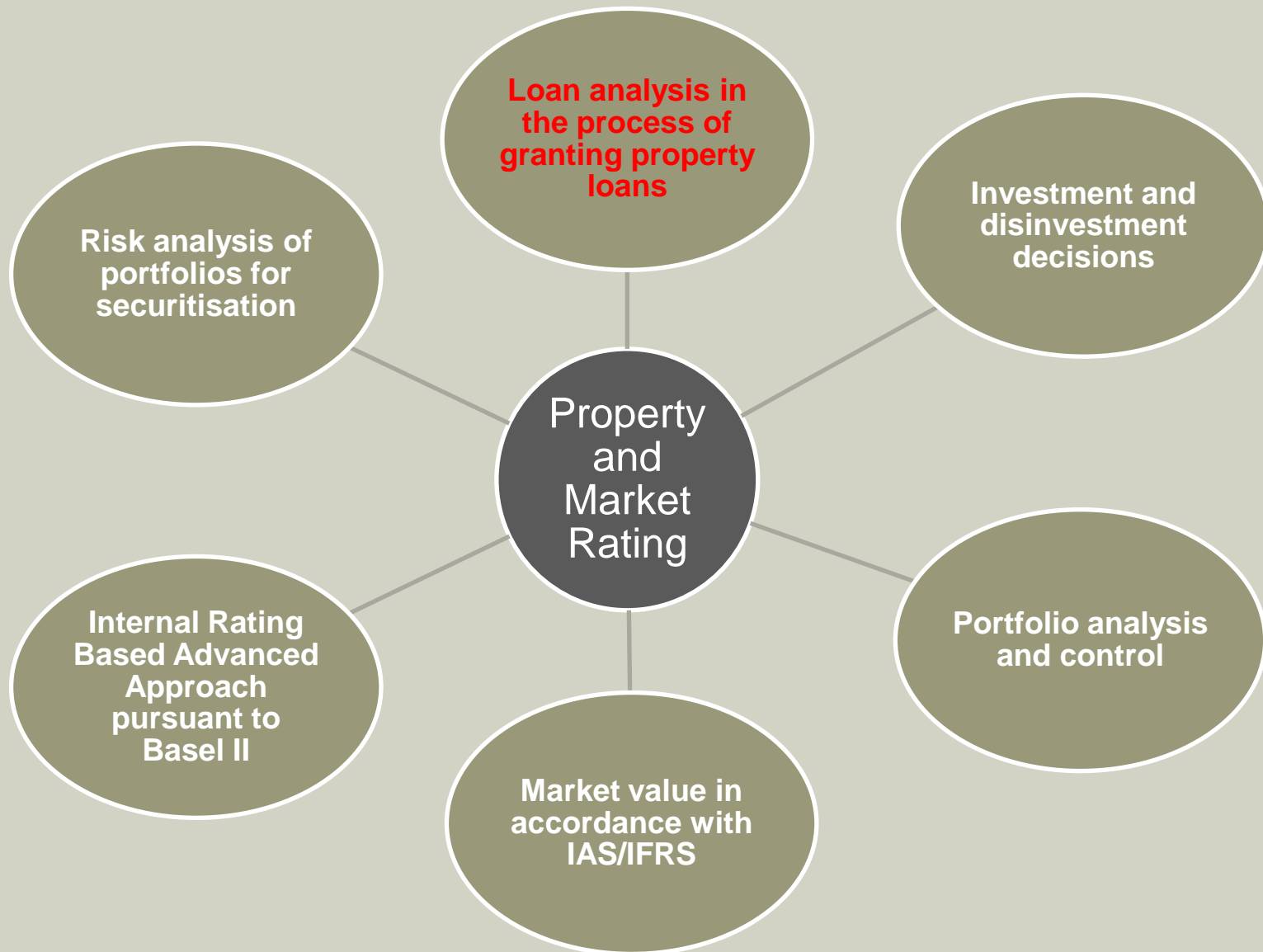
HypZert

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Reiner Lux, HypZert GmbH, Berlin/Germany





Credit Rating

Assessment for the credit engagement

Solvency (PD-)Rating

Assessment of the expected economic potential/skills

of the borrower

Property and Market Rating

Assessment of the sustainable quality

of the collateral

Rating Definition for Completed Properties:

- Property and market rating is a **standardised** procedure aiming to display the sustainable quality of a property in its relevant market
- The quality of a property is judged by the **medium-term sales prospects** at a then **adequate price** between **Professionals** who have **access to all property and market information**
- The credit standing of the tenant and the borrower, as well as the default risk of the loan are not subjects of the property and market rating
- As a rating always makes a statement that relates **to the future**, the property and market rating **uses the future, medium-term sales prospects to judge the quality**

Rating Example of a Completed Property (Residential)



Valuer/Date:		Valuation dated:	
Address:		Original rating on:	Rating updated on:
Property Type:	Residential	Country:	Germany
		Region:	Munich

Criteria Class 1

Market	1	2	3	4	5	6	7	8	9	10	weight
national					5						20%
Acts of God						6					5%
Socio-demographic development							7				30%
Overall economic development and international attractiveness						5					15%
Political, legal, taxation and monetary conditions			3								10%
Property market: residential				5							40%
regional		2									80%
Acts of God				4							5%
Socio-demographic development			2								35%
Economic situation and attractiveness					1						15%
Property market: residential				2							45%
Rating for Criteria Class 1:							3				20%

Criteria Class 2

Location	1	2	3	4	5	6	7	8	9	10	weight
Suitability of the micro location for property type and target occupiers		2									45%
Image of the quarter and the location			3								5%
Quality of transportation infrastructure of the plot and quarter				2							23%
Quality of local supply facilities of the plot and quarter for target occupiers					2						23%
Acts of God						3					5%
Rating for Criteria Class 2:								2			30%

Criteria Class 3

Property	1	2	3	4	5	6	7	8	9	10	weight
Architecture/type of construction					5						7%
Fitout				4							3%
Structural condition			2								30%
Plot situation				2							50%
Ecological sustainability						4					3%
Profitability of the building concept					5						7%
Rating for Criteria Class 3:										3	20%

Criteria Class 4

Quality of the Property Cash Flow	1	2	3	4	5	6	7	8	9	10	weight
Tenant/occupier situation			3								10%
Rental growth potential/value growth potential							7				15%
Letting prospects/functionality				2							60%
Vacancy/letting situation					5						5%
Recoverable and non-recoverable operation expenses			3								5%
Usability by third parties and/or alternative use						3					5%
Rating for Criteria Class 4:										3	30%

Result of the Property and Market Rating for Completed Properties

	Excellent	Very good	Good	Slightly above average	Average	Slightly below average	Medium	Poor	Very poor	Disaster	Weighting
Criteria Class 1 - Market			3								20%
Criteria Class 2 - Location		2									30%
Criteria Class 3 - Property			3								30%
Criteria Class 4 - Quality of the property cash flow			3								20%
Overall rating for the completed property			3								100%

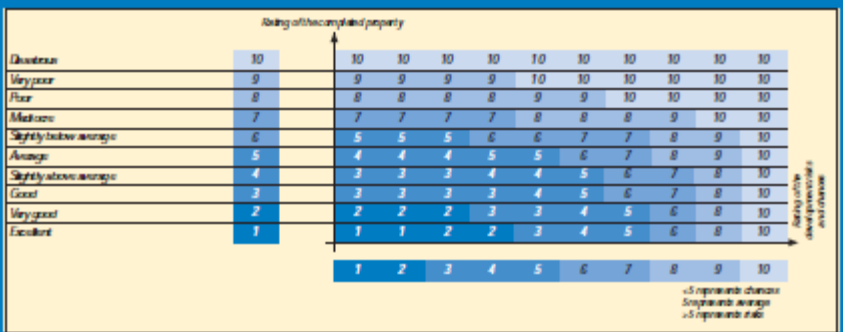
Property and Market Rating for Projects

Criteria Class 5

Development risks/chances	1	2	3	4	5	6	7	8	9	10	weight
Letting and selling											60%
Planning and permits											15%
Construction and costs											25%

Definition property and market rating for completed projects:

The project rating is a standardised procedure aiming to display the quality of a project in its relevant market taking into account the sustainable quality of a fictitiously completed property and development risks. The quality is judged by the sales prospects of the project on the rating date at an adequate price between professionals who have access to all property and market information. The credit standing of the tenant, the borrower and other participants in the project, as well as the default risk of the loan are not subjects of the project rating.



Result of the Property and Market Rating for the Project

	Excellent	Very good	Good	Slightly above average	Average	Slightly below average	Medium	Poor	Very poor	Disaster	Weighting
Overall rating for the completed project											
Criteria Class 5 - Development risks/chances											
Overall rating for the completed property											

Property Classes

Residential Use

- single-family home
- two/three-family house
- multi-family house
- condominium

Commercial Use

- Retail
- warehouse/distribution
- production
- office
- hotel
- special properties

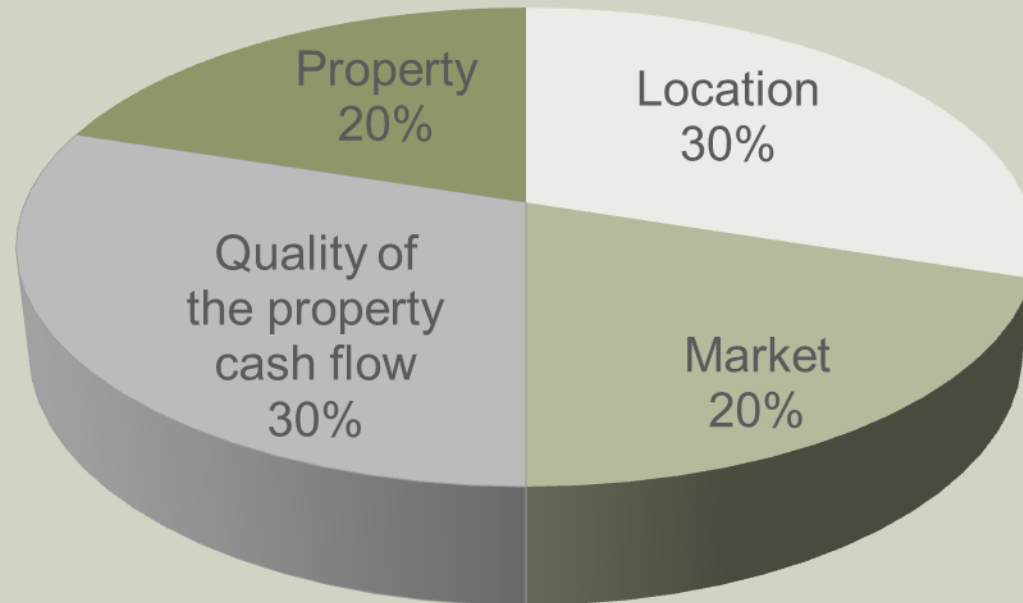
Mixed-use objects

- The property and market rating employs a **scale** following the pattern used by rating agencies and internal rating scales used by banks
- It consists of **10 grades**, with 1 representing an excellent rating and 10 representing a disastrous one. The average rating is set at 5. As the 'disastrous' rating is only given under specific circumstances, 5 represents the middle of the scale that is used normally

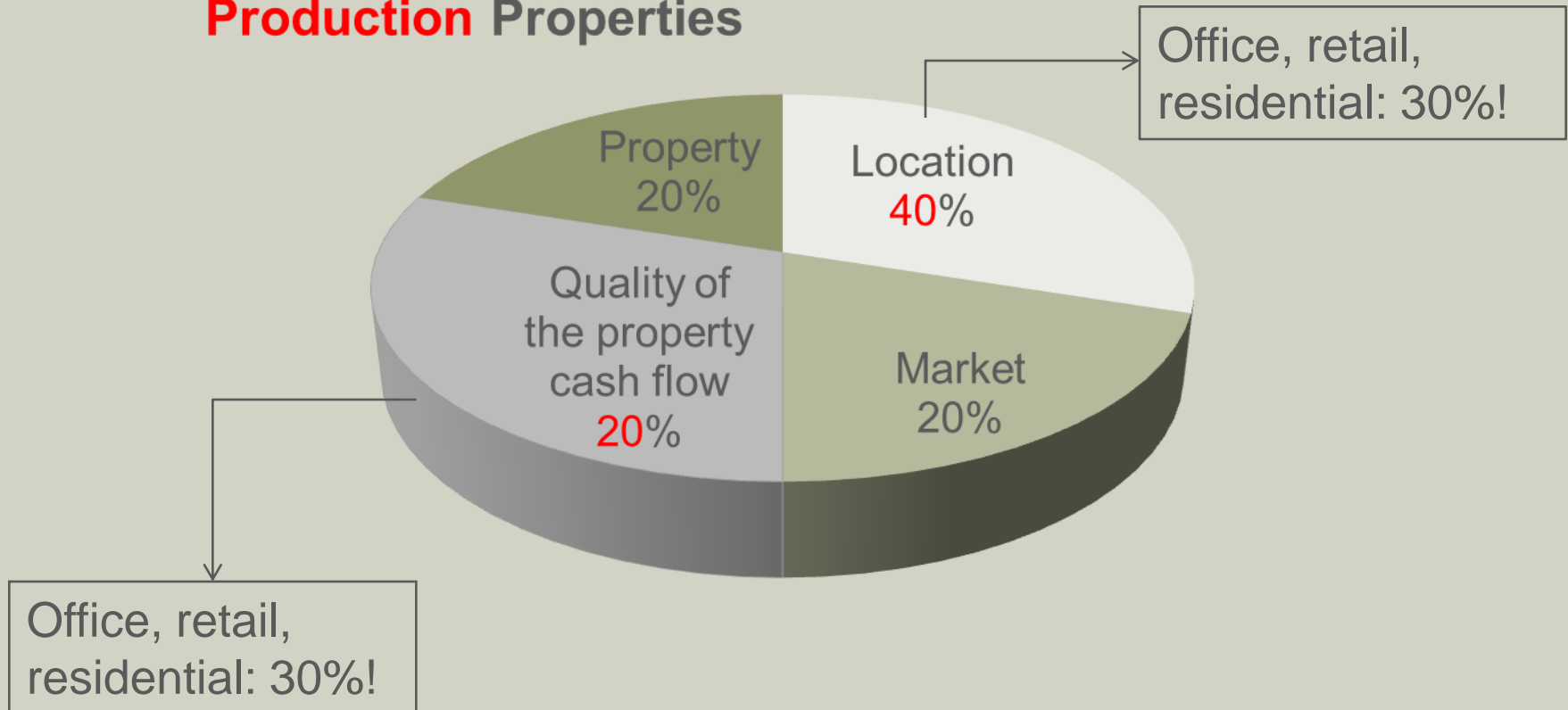
excellent	very good	good	slightly above average	average	slightly below average	mediocre	poor	very poor	disastrous

- The essential factors influencing the sustainable quality of a property were determined in expert surveys and are classified according to topics in the **4 criteria classes**: market, location, property, and quality of the property cash flow

Criteria Classes + Weighting for **Office**, **Retail** and **Residential** Properties



Criteria Classes + Weighting for Warehousing, Distribution and Production Properties



- Each criteria class consists of several **sub-criteria** that are weighted according to their influence on the medium-term sales prospects of the individual property in its relevant market
- Basic **weighting** of the sub-criteria is **different for each property type**
- (i) Example: 1.1.2 Socio-demographic development

Retail	Residential	Office	Warehousing...
20%	30%	10%	15%

- (ii) Example: 2.1 Suitability of the micro location for the property and target occupiers

Retail	Residential	Office	Warehousing...
30%	30%	25%	10%

1. Criteria Class 'Market' (national and regional) – Office	20 %
1.1 national	30 %
1.1.1 Acts of God	5 %
1.1.2 Socio-demographic development	10 %
1.1.3 Overall economic development and international attractiveness	30 %
1.1.4 Political, legal, taxation and monetary conditions	15 %
1.1.5 Property market: office	40 %
1.2 regional	70 %
1.2.1 Acts of God	5 %
1.2.2 Socio-demographic development	15 %
1.2.3 Economic situation and attractiveness	35 %
1.2.4 Property market: retail	45 %
Result for the market rating	100%

2. Criteria Class 'Location' – Office	30 %
2.1 Suitability of the micro location for the property type and target occupiers	25 %
2.2 Image of the quarter and the location	15 %
2.3 Quality of transportation infrastructure of the plot and quarter	25 %
2.4 Quality of local supply facilities of the plot and quarter for target occupiers	15 %
2.5 Acts of God	20 %
Result for the location rating	100%

Criteria Class 3 - Office

3. Criteria Class 'Property' – Office	20 %
3.1 Architecture / type of construction	20 %
3.2 Fitout	10 %
3.3 Structural condition	15 %
3.4 Plot situation	25 %
3.5 Ecological sustainability	10 %
3.6 Profitability of the building concept	20 %
Result for the property rating	100%

Criteria Class 4 - Office

4. Criteria Class 'Quality of the property cash flow' – Office	30 %
4.1 Tenant / occupier situation	20 %
4.2 Rental growth potential / value growth potential	30 %
4.3 Letting prospects	20 %
4.4 Vacancy / letting situation	10 %
4.5 Recoverable and non-recoverable operating expenses	10 %
4.6 Usability by third parties and/or alternative use	10 %
Result for the rating of the quality of the property cash flow	100%

- For the reliability of PaM it is crucial, that valuers share a **common understanding** of the rating of the subjective sub-criteria
- => Measuring standards must be **defined at a national level** for each of the sub-criteria differentiated by property types standards
- These standards must determine the standard representing the **average for each criterion** in the relevant market, so allowing assessment of whether the property in question is better or worse than that average
 - The prospects and risks of the property and its medium-term development will be measured against this average, which is to be seen as the **benchmark** for each criterion

Example Criterion 2.1: Suitability of the micro location for the property type and target occupiers

<p>Rating 1–2:</p> <p>First-class office location, where the property to be assessed enjoys a particularly prominent position and is designed accordingly</p>	<p>Rating 5:</p> <p>Average office site with no special features. Similar properties are present in this location. The architecture of the property to be assessed is in keeping with the immediate environment</p>	<p>Rating 8–9:</p> <p>Basic and rather sidelined position. The surrounding area is characterised by negative factors such as sewage plants, manufacturing industries, etc. A property of this type is out of place here</p>
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Example Criterion 3.1: Architecture / type of construction

Rating 1–2:

Property is representative and makes an impression externally; also in the long term. Striking architectural elements; excellent façade design. Representative, distinctive entrance area/lobby. High-quality type of construction and well-designed exterior areas

Rating 5:

Property typical of local type of construction; adequate for the local market. Architecture has no striking (negative/positive) design elements. Property in harmony with existing constructions in the area. Acceptance of the architecture by a large target group

Rating 8–9:

Property not typical of local market construction style; not representative. Architecture does not appeal to target occupiers at all. Ugly exterior; insufficient lighting, bad building proportions, low quality type of construction

Example Criterion 4.1: Tenant/occupier situation

Rating 1–2:

Lease agreements with renowned users and with remaining terms to maturity longer than is typical on the market; No influencing/favoring third-party-rights

Rating 5:

Balanced mix of tenants, remaining terms to maturity of lease agreements typical of the market and lease agreement standard typical of the market. No or minor impact by third-party-rights

Rating 8–9:

Worse than typical regional market tenant or user structure. Short-term leases in a weak market. Affecting third-party-rights with strong restrictions for the tenant/user

From the Criterion to the Rating

Criteria class 1 (CC 1)

Criteria	A	B	C	D
Basic weigthing within criteria class 1	20 %	40 %	15 %	25 %
Rating	4	6	5	3
Correcting factor	-	-	-	-



Rating of the criteria class	5
Weight of the criteria class	20 %

CC 2



4
20 %

CC 3



7
20%

CC 4

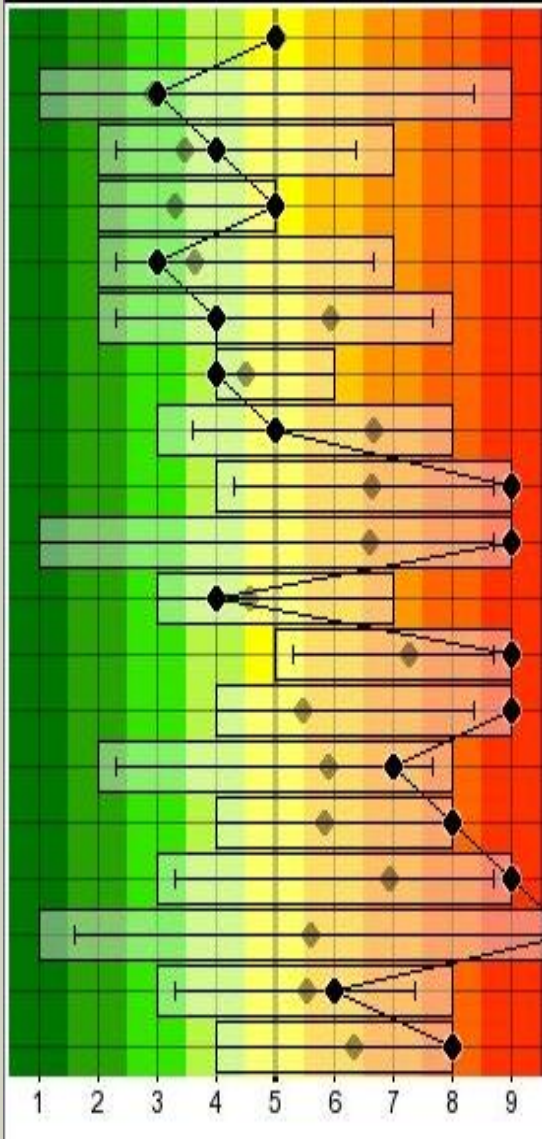


5
30%



Rating of the property	5
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Chances and Risks Profile of a Property

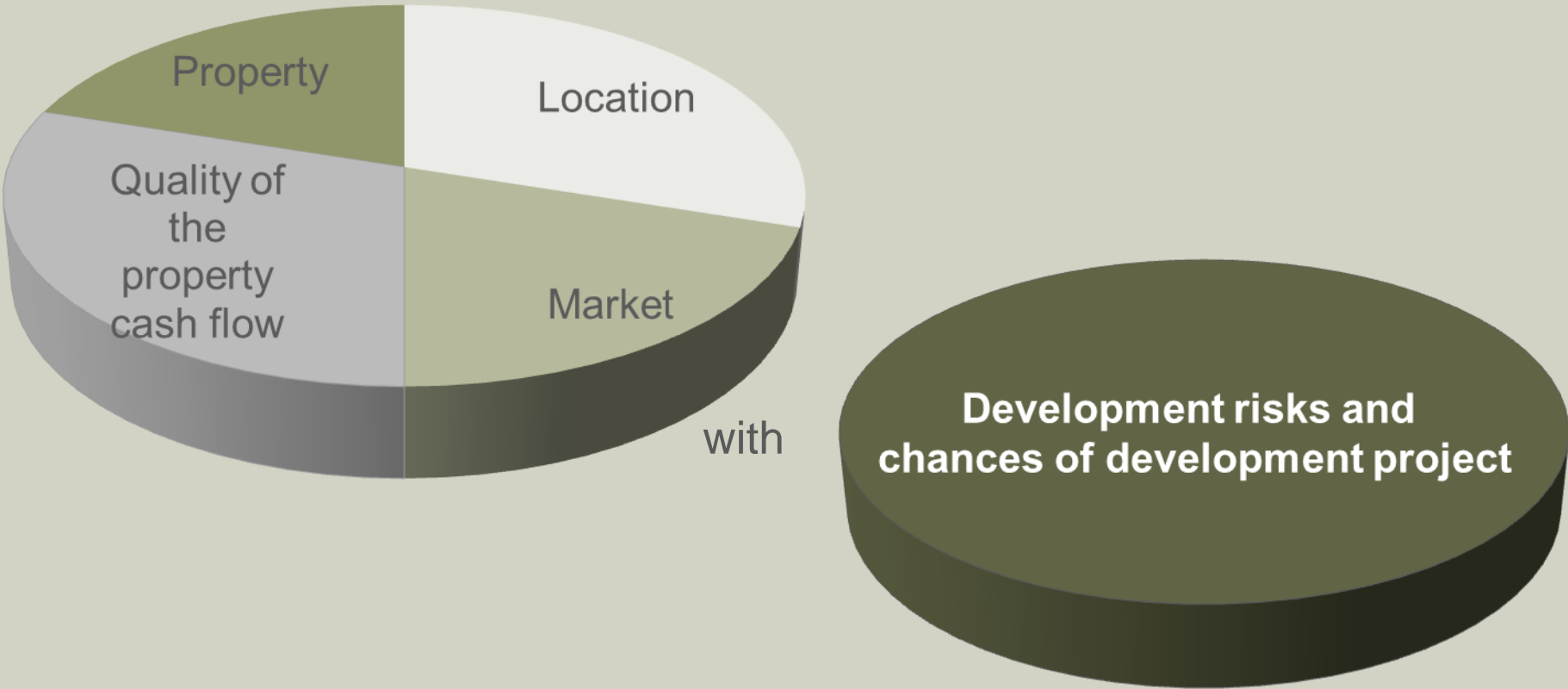


- Market national
- Market regional
- Image of the quarter and location
- Suitability of micro location
- Quality of transport infrastructure
- Quality of local supply facilities for target occupiers
- Acts of God
- Architecture /type of construction
- Fit out
- Structural condition
- Plot condition
- Ecological sustainability
- Profitability of the building concept
- Tenant / occupier situation
- Rental / value growth potential
- Letting prospects
- Vacancy / letting situation
- Operation expenses
- Usability by third parties

■ Source: VÖB-Service GmbH

Rating definition for projects:

- Project and market rating is a **standardised** procedure aiming to display the quality of a project in its relevant market taking into account the **sustainable quality** of a **fictitiously completed property** and the **development risks and opportunities**.
- To arrive at a rating for a development project, all the above mentioned criteria classes have to be rated **as if the property had been completed**.
- Assessment has to concentrate on the sales prospects of the hypothetically completed property, because that is the conclusion of the development project for those who have invested in it.
- However, a specific **5th criteria class** **‘Development risks and chances of a development project’** must be added to assess the development risks and opportunities inherent in the project.



5. 'Development risks and chances of a development project' – Office

(Weighting see table on next sheet)

5.1 Letting and selling	60 %
5.2 Planning and permits	15 %
5.3 Construction and costs	25 %
Result for the rating of development risks and chances	100%

- **Quality assessment** of real estate and real estate markets through property and market rating
- **Standardised** process ensures efficient handling and rating with relatively little effort
- **Forward looking** assessment process
- Outcome provides a **benchmark for medium-term sales prospects**
- Identification of risks and opportunities to **support the credit decision**
- Minimum requirements as well as well-defined rating criteria and processes facilitate **transparency** of ratings

=> Property and market rating as an efficient and transparent procedure for chances & risks valuation and quality assessment of properties for financial institutions, companies and investors



Thank you for listening!

Property and Market Rating

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