Fostering Real Estate Risk Ratings in the United States

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Risk Management – Real Estate Collaterals

- Monitoring & Forecast
- Property and Market Rating
- LGD Grading
- Determination of MLV
Fields of Application

- Loan analysis in the process of granting property loans
- Investment and disinvestment decisions
- Portfolio analysis and control
- Market value in accordance with IAS/IFRS
- Internal Rating Based Advanced Approach pursuant to Basel II
- Risk analysis of portfolios for securitisation
Rating in the Financial Sector

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 standardized 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)

#### Criteria Class 1

**Market**
- **National**
  - 1 2 3 4 5 6 7 8 9 10 weight 20%
  - Area of use 3 5 10%
  - Socio-economic development 2 10%
  - Overall economic development and international attractiveness 3 15%
- **Regional**
  - 2 80%
  - Area of use 4 5 10%
  - Socio-economic development 2 5 10%
  - Economic situation and attractiveness 1 5 15%
  - Property market: residential 5 40%

**Rating for Criteria Class 1:**

#### Criteria Class 2

**Location**
- Suitability of the micro location for property type and target group 3 20%
- Image of the quarter and the location 3 20%
- Quality of transportation infrastructure of the plot and quarter 3 20%
- Quality of local utility facilities of the plot and quarter 2 20%
- Accessibility 3 5 10%

**Rating for Criteria Class 2:**

#### Criteria Class 3

**Property**
- Design/typical of construction 1 3 5 10%
- Property condition 4 20%
- Plot situation 2 10%
- Architectural sustainability 4 20%
- Profitability of the building concept 5 10%

**Rating for Criteria Class 3:**

#### Criteria Class 4

**Quality of the Property Cash Flow**
- Tenant/empty situation 3 20%
- Rent growth potential/valuation growth potential 7 15%
- Letting prospects/on-going 2 5 10%
- Vacancy/vacancy situation 5 10%
- Recoverable and non-recoverable operating expenses 3 5 10%

**Rating for Criteria Class 4:**

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### Property and Market Rating for Completed Properties

**Result of the Property and Market Rating for Completed Properties**

<table>
<thead>
<tr>
<th>Class</th>
<th>Very good</th>
<th>Good</th>
<th>Slightly above average</th>
<th>Average</th>
<th>Slightly below average</th>
<th>Poor</th>
<th>Very poor</th>
<th>Overall</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criteria Class 1 - Market</td>
<td>1</td>
<td>2</td>
<td>3</td>
<td>4</td>
<td>5</td>
<td>6</td>
<td>7</td>
<td>8</td>
</tr>
<tr>
<td>Criteria Class 2 - Location</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Criteria Class 3 - Property</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Criteria Class 4 - Quality of the property cash flow</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
<tr>
<td>Overall rating for the completed property</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
<td>3</td>
</tr>
</tbody>
</table>

**Criteria Class 5**

**Development risks/capital**
- Setting and selling 3 30%
- Planning and permits 4 20%
- Construction and costs 5 10%

**Rating for Criteria Class 5:**

### Definition property and market rating for completed projects:

The project rating is a standardized procedure aiming to display the quality of a project in its relevant market taking into account the sustainable quality of a fictitious 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.
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.

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

- Property: 20%
- Location: 30%
- Quality of the property cash flow: 30%
- Market: 20%
Criteria Classes + Weighting for Warehousing, Distribution and Production Properties

- Office, retail, residential: 30%!
Sub-Criteria

- 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.

1. Example: 1.1.2 Socio-demographic development

<table>
<thead>
<tr>
<th>Retail</th>
<th>Residential</th>
<th>Office</th>
<th>Warehousing...</th>
</tr>
</thead>
<tbody>
<tr>
<td>20%</td>
<td>30%</td>
<td>10%</td>
<td>15%</td>
</tr>
</tbody>
</table>

2. Example: 2.1 Suitability of the micro location for the property and target occupiers

<table>
<thead>
<tr>
<th>Retail</th>
<th>Residential</th>
<th>Office</th>
<th>Warehousing...</th>
</tr>
</thead>
<tbody>
<tr>
<td>30%</td>
<td>30%</td>
<td>25%</td>
<td>10%</td>
</tr>
</tbody>
</table>
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%
## Criteria Class 2 - Office

### 2. Criteria Class ‘Location’ – Office

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>2.1 Suitability of the micro location for the property type and target occupiers</td>
<td>25 %</td>
</tr>
<tr>
<td>2.2 Image of the quarter and the location</td>
<td>15 %</td>
</tr>
<tr>
<td>2.3 Quality of transportation infrastructure of the plot and quarter</td>
<td>25 %</td>
</tr>
<tr>
<td>2.4 Quality of local supply facilities of the plot and quarter for target occupiers</td>
<td>15 %</td>
</tr>
<tr>
<td>2.5 Acts of God</td>
<td>20 %</td>
</tr>
<tr>
<td><strong>Result for the location rating</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
### 3. Criteria Class ‘Property’ – Office

<table>
<thead>
<tr>
<th>Criteria</th>
<th>Weight</th>
</tr>
</thead>
<tbody>
<tr>
<td>3.1 Architecture / type of construction</td>
<td>20 %</td>
</tr>
<tr>
<td>3.2 Fitout</td>
<td>10 %</td>
</tr>
<tr>
<td>3.3 Structural condition</td>
<td>15 %</td>
</tr>
<tr>
<td>3.4 Plot situation</td>
<td>25 %</td>
</tr>
<tr>
<td>3.5 Ecological sustainability</td>
<td>10 %</td>
</tr>
<tr>
<td>3.6 Profitability of the building concept</td>
<td>20 %</td>
</tr>
</tbody>
</table>

**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

<table>
<thead>
<tr>
<th>Rating 1–2:</th>
<th>Rating 5:</th>
<th>Rating 8–9:</th>
</tr>
</thead>
<tbody>
<tr>
<td>First-class office location, where the property to be assessed enjoys a particularly prominent position and is designed accordingly.</td>
<td>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.</td>
<td>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.</td>
</tr>
</tbody>
</table>
### Example Criterion 3.1: Architecture / type of construction

<table>
<thead>
<tr>
<th>Rating 1–2:</th>
<th>Rating 5:</th>
<th>Rating 8–9:</th>
</tr>
</thead>
<tbody>
<tr>
<td>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.</td>
<td>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.</td>
<td>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.</td>
</tr>
</tbody>
</table>
### Example Criterion 4.1: Tenant/occupier situation

<table>
<thead>
<tr>
<th>Rating 1–2:</th>
<th>Rating 5:</th>
<th>Rating 8–9:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lease agreements with renowned users and with remaining terms to maturity longer than is typical on the market; No influencing/favoring third-party-rights</td>
<td>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</td>
<td>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</td>
</tr>
</tbody>
</table>
From the Criterion to the Rating

<table>
<thead>
<tr>
<th>Criteria class 1 (CC 1)</th>
<th>CC 2</th>
<th>CC 3</th>
<th>CC 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Criteria</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>A</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>B</td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>C</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>D</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Basic weighting within criteria class 1</td>
<td>20 %</td>
<td>40 %</td>
<td>15 %</td>
</tr>
<tr>
<td>Rating</td>
<td>4</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>Correcting factor</td>
<td>-</td>
<td>-</td>
<td>-</td>
</tr>
<tr>
<td>Rating of the criteria class</td>
<td>5</td>
<td>4</td>
<td>7</td>
</tr>
<tr>
<td>Weight of the criteria class</td>
<td>20 %</td>
<td>20 %</td>
<td>20%</td>
</tr>
</tbody>
</table>

Rating of the property: 5
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 standardized 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.
Rating of Projects – Criteria Classes for Rating Projects

- Property
- Location
- Quality of the property cash flow
- Market

Development risks and chances of development 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%
Summary

- 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!

Dipl.-Kaufmann Reiner Lux
Managing Director