The treatment of covenant strength

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The paper below outlines the findings of the research funded by the IPF Research Programme 2006-2009 into the treatment of covenant strength by valuers, lenders and investors active in the UK property market.

Introduction

Income is the key driver of property returns and the downturn in the property market has brought into sharp focus the importance of the security of the income stream in the pricing of real estate. Over the 26-year period 1981 to 2007, the IPD UK average total return was 10.7% pa, with income return at 6.6% pa (standard deviation of 1%) and capital growth 4.1% pa (standard deviation of 8.1%). The stability of the income return is one of the key features of real estate both as an investment and as a security, hence the importance of evaluating covenant strength in the risk pricing process.

A key element in a normative model of property pricing focuses on cashflow risk and the factors that influence the covenant strength of the party contracted to pay the rent. Cashflow risk is affected by both exogenous and endogenous factors. Exogenous factors comprise for example, general economic conditions, finance rates, level of taxation and legislative changes. Normally of greater significance are endogenous factors for example, tenant, location, prospects for rental growth, building condition, obsolescence, letting risk and lease arrangements.

In the implicit method of valuation, all risks are encompassed within the 'all risk yield'. The level of the risk premium required depends upon the interaction between the health of the economy, the property market, the sector and individual property characteristics. This paper focuses on the risk of default and the level of risk premium which should be applied over conventional gilts – a risk-free proxy.

Property cycle

Previous research by Key et al (1994) has shown that the property cycle directly feeds off the economic cycle. Bond yields and inflation are key drivers of property yields and investor sentiment. GDP, consumer spending (retail), financial and business services (office), manufacturing activity (industrial) are a primary influence on rental value. The economic cycle impacts on the ability of occupiers to pay the contracted rent. At the portfolio level fund managers need to be aware of the differing volatility in returns between the sectors and across geographical areas, which may 'stress' the income return component. The systematic risk should be appropriately priced.

Default

The level of default is fundamental to an understanding of covenant strength due to the impact on future income streams and to the value of the property investment. In recent decades, the level of company liquidations has been relatively low, of the order of 1%, increasing as expected, during recessionary periods. Analysis by Dun & Bradstreet over the period March 2006 to September 2008 showed that the probability of insolvency during most of 2006-07 was between 2% and 2.6%. For certain sectors this increased significantly from June 2007, with the construction sector for example increasing to 4.6%, as the current economic downturn took effect. Analysis on the probability of delinquency showed a similar trend and since the Q3 2007 there has been a significant increase in the probability of companies likely to be come delinquent.

It is essential that those involved in the pricing of property interests are aware of the different sector volatility and a higher risk weighting should be applied to those sectors that are more volatile.

IPD results

How have capitalisation rates been affected by covenant strength in the market? Initial analysis of IPD UK data from 2003 to 2007 showed no relationship between the equivalent yield and covenant strength. Further analysis, combining lease length and covenant strength with the equivalent yield, produced more insightful results, if unconvincing. These results show that higher risk covenants tied to a short lease result in higher yields, whereas low risk covenants in longer leases produce lower yields reflecting the differential risk profiles. Nevertheless, it is evident that in the early part of the analysis period across all sectors, the market added only a very small additional risk premium to reflect the differences in covenant strength and lease length. This risk premium increased significantly during 2007. However, the results are not statistically different suggesting that trying to deconstruct the risk premium into individual components is very difficult due to the large amount of 'noise' in the pricing process.

At all the phases of the property cycle, covenant strength should be subject to rigorous analysis. Clearly in the down phase of the cycle, the risk of default is higher, but it is equally important that in-depth analysis of tenants is carried out in the up-phase of the cycle to prevent mispricing of tenant risk at a time when the market is being swept along by 'irrational exuberance' and less thought is being given to the likely performance of the tenants in falling markets.

Valuers

A questionnaire survey of valuers was undertaken in 2008 to attempt to quantify the basis point change to the equivalent yield that would be applied to valuations under a number of different combinations of covenant strength and lease length and to track any change in margin from December 2006 to September 2008.

The calibration of covenant strength by the valuers reflected the changing market conditions, but while the suggested premium between risk scenarios was incremental, it was not uniform. Moreover, the results were at odds with the market data supplied by IPD, with the valuers reporting more distinct changes in yield to that reflected in the year end valuations of standing investments.

While it is acknowledged that the survey removed the 'noise' problem in the scenarios as the valuers were asked to concentrate only on the covenant strength and lease length impact, it would suggest that while, in principle, valuers recognise the different risk scenarios, in practice yield analysis rather than yield construction is the primary method of determining the initial yield. This tends to preclude the explicit calibration of covenant strength within the risk premium.

Lenders

Eight investment and commercial banks were interviewed in 2008 to consider their treatment and pricing of covenant strength in loan deals. Prior to mid 2007, the property market had been overheating partly due to the availability of cheap debt finance and the pursuit of a position in the market by the 'yield chasing' investor. During the growth stage of the cycle, lenders confirmed that while covenant strength was a relevant criterion in lending decisions it was not the dominant factor. Cashflow, lease length and re-letting prospects were more important considerations.

At the height of the market cycle, lending criteria were relaxed and questions must be asked how this was allowed to happen on such a grand scale. The performance of the FSA in 'promoting efficient, orderly and fair markets' has been called into question.

Doubts surround the calibration of the bank's risk scoring models. Speculation must be that the inputs to the model did not properly reflect the possible range of outcomes and misread the stage of the cycle. In considering the risk of default over the length of the lease, consideration should have been given to the likely market conditions throughout the lease and the loan term. That said, differentials in loan pricing were made between sectors recognising the different volatilities and characteristics.

The performance of credit rating agencies – key to the pricing of securitised products – has come in for some heavy criticism by the FSA, with default risk being significantly mispriced.

Heightened awareness and more accurate measurement of risk are also being driven by the increasing regulatory framework in particular the implementation of Basle II.

Investors

Nine UK institutional investors were interviewed and all recognised readily that covenant strength risk had not been appropriately priced during the upturn in the property cycle. There is clear evidence of mispricing of the systematic risk. Investors appear guilty of pricing at a point in the cycle rather than taking the longer view and pricing through the cycle.

It became clear that it is the combination of lease length and covenant strength which enables cashflow risk to be appropriately priced. Careful analysis is required to understand which sectors perform well in a buoyant economy and which are most affected by a downturn. The last 20 years has seen a significant reduction in lease length and the increasing prevalence of break options. This represents a significant shift of risk from tenant to landlord, which may not have been appropriately acknowledged in market pricing.

Covenant strength risk should be priced, not in isolation, but in conjunction with the mix of sector and property specific characteristics in order to reflect volatility in returns across the sectors and geographical areas.

Conclusion

At the outset of the research in March 2008, few could have forecast the level of turbulence that was to hit the financial markets and that by the end of the year the UK would officially be in recession. However, many had predicted that the UK commercial property market was overheating. The double digit returns of 2003 to 2006 told a story of capital value appreciation on the back of 'yield chasing' investors aided by cheap and available debt finance. In attempting to deconstruct the yield at this point in the cycle, either the risk premium was negligible or investors were adopting hugely optimistic rental growth prospects. The mispricing of systematic risk came abruptly to an end when investor sentiment turned and liquidity dried up. What lessons can be learned from this episode?

Fundamentally it is important for market participants to understand the link between the economic and property cycles. An appreciation of the stages of the economic cycle and how it feeds into the yield curve and rental growth is crucial, along with a clear understanding of the present, and likely state of the market at the end of the investment/lending period. Property pricing should reflect the systematic risk inherent in the market but is clear from the research that the UK market in recent years was swept along by short-termism, and this myopic view then exaggerated the correction that followed. Moreover, close attention should be paid to the differing volatility in returns between the sectors and across geographical areas. This exposes the need to conduct thorough research on the sectors as well as the individual tenant's financial strength.

The research has shown that the risk premium should reflect the contribution of covenant strength to the overall risk of the investment, both at property and portfolio level. Risk analysis going forward will have to be more robust in order to avoid a repeat of the 'irrational exuberance' which characterised the UK market in recent years.