The IPF Research Session

IPF/IPD Property Investment Conference

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The Treatment of Covenant Strength by the Property Industry

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IPD/IPF Property Investment Conference Brighton,
2008

Structure

- The importance of covenant strength
  - Income as the key driver of return
- Macroeconomic context
  - Liquidations and default
- The pricing of covenant strength risk
  - Lender's perspective
  - Investor's perspective
- Property pricing
  - Market evidence ~IPD data
  - Valuer's perspective - *work in progress*
  - Reporting of covenant strength risk- *work in progress*

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Research Methodology

- Part quantitative, part qualitative
- Insolvency & delinquency data from D&B
- Yield data from IPD
- Interviews with lenders (8) & investors (9)
  - May to August 2008
- Questionnaire survey of valuers
  - October 2008
- Research carried out during period of considerable financial turmoil

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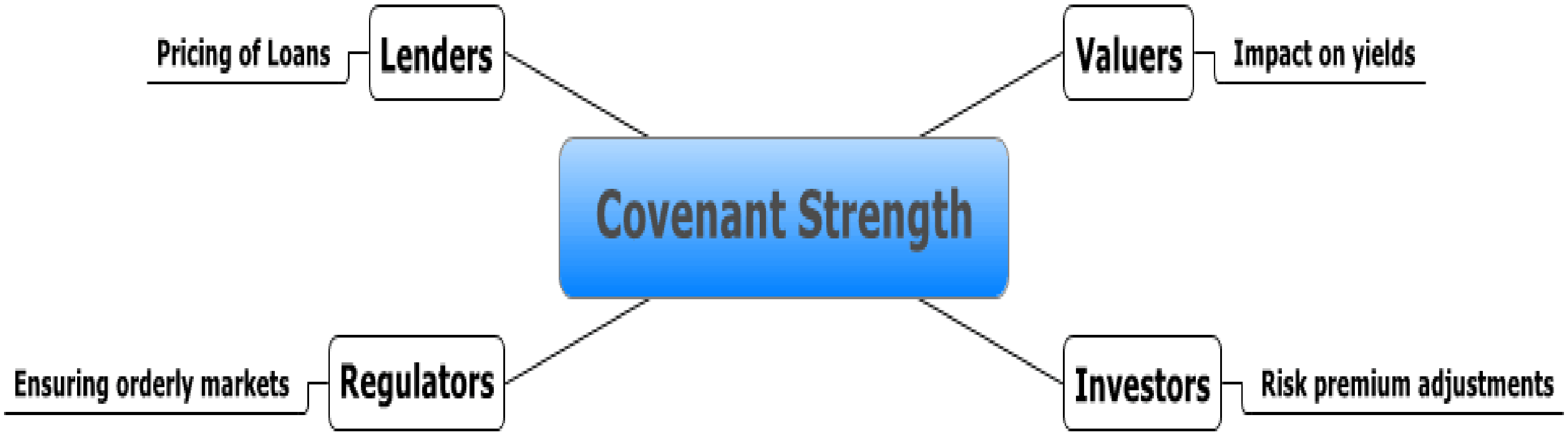
The UK Property Market -2007/08/09 - the "triple dip"

The Market Dips

- 1st The fall in capital values
- 2nd The "credit crunch" effect
- 3rd The economy and occupier market

The Importance of Covenant Strength



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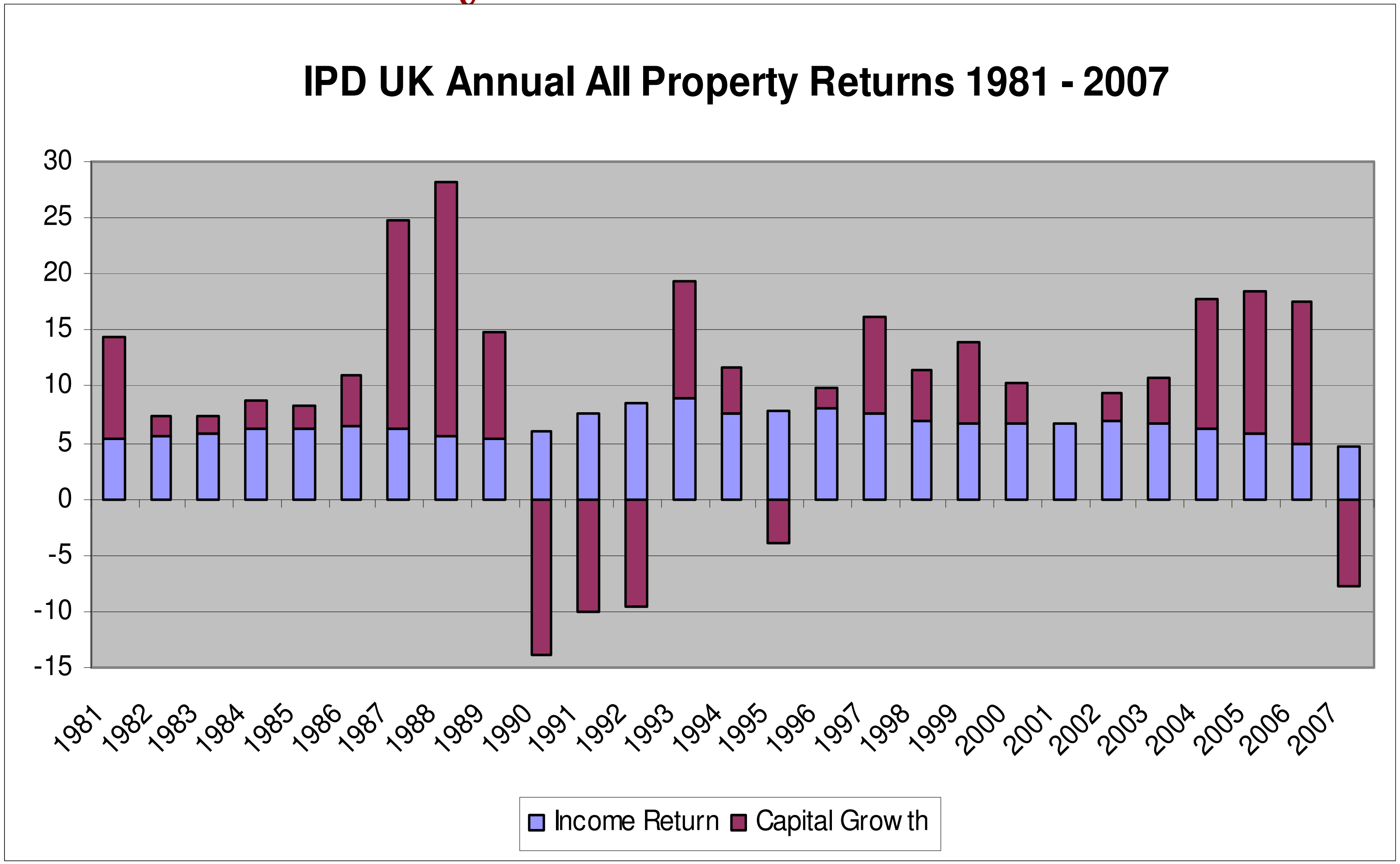
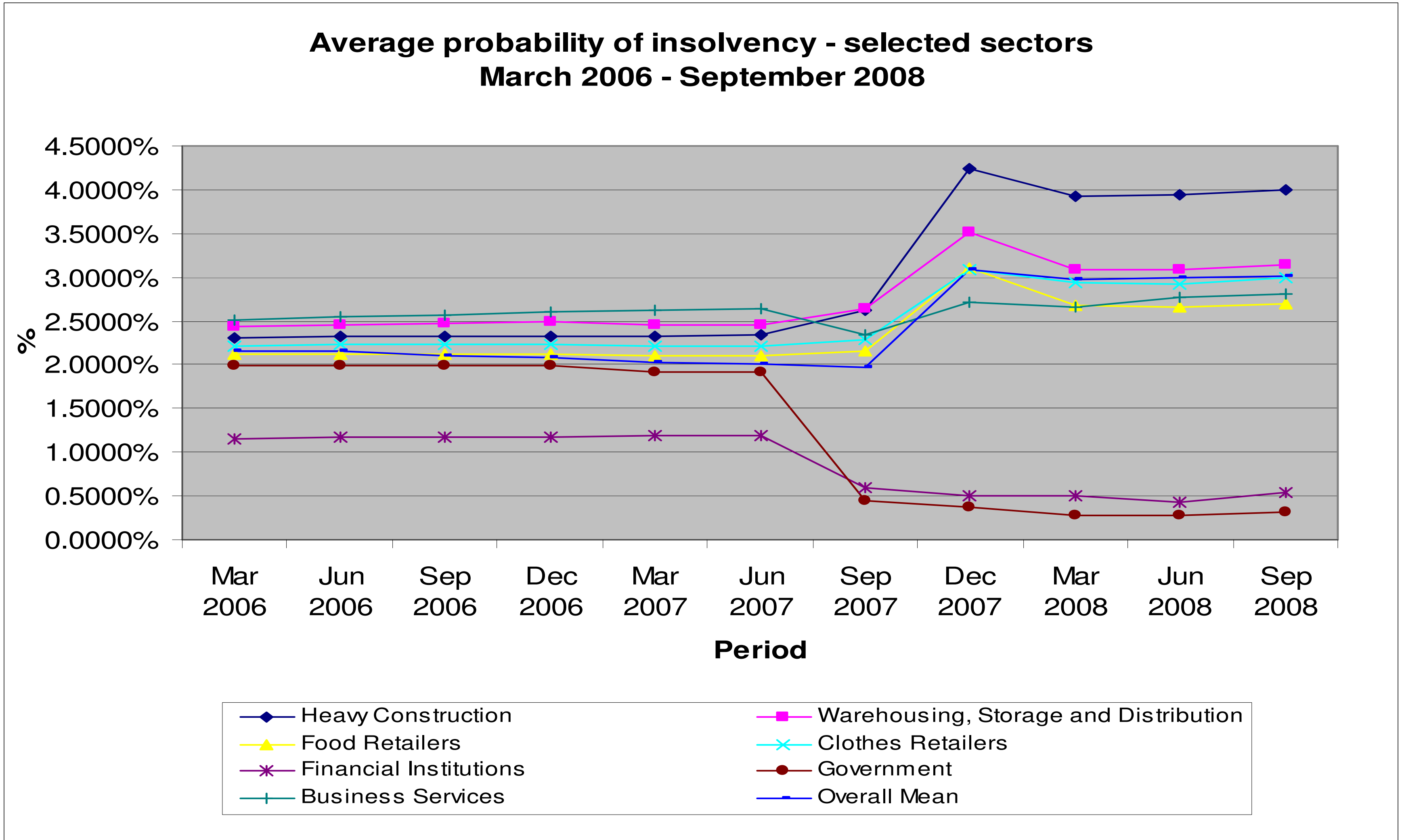
The Importance of Covenant Strength

- Income as the key driver of return

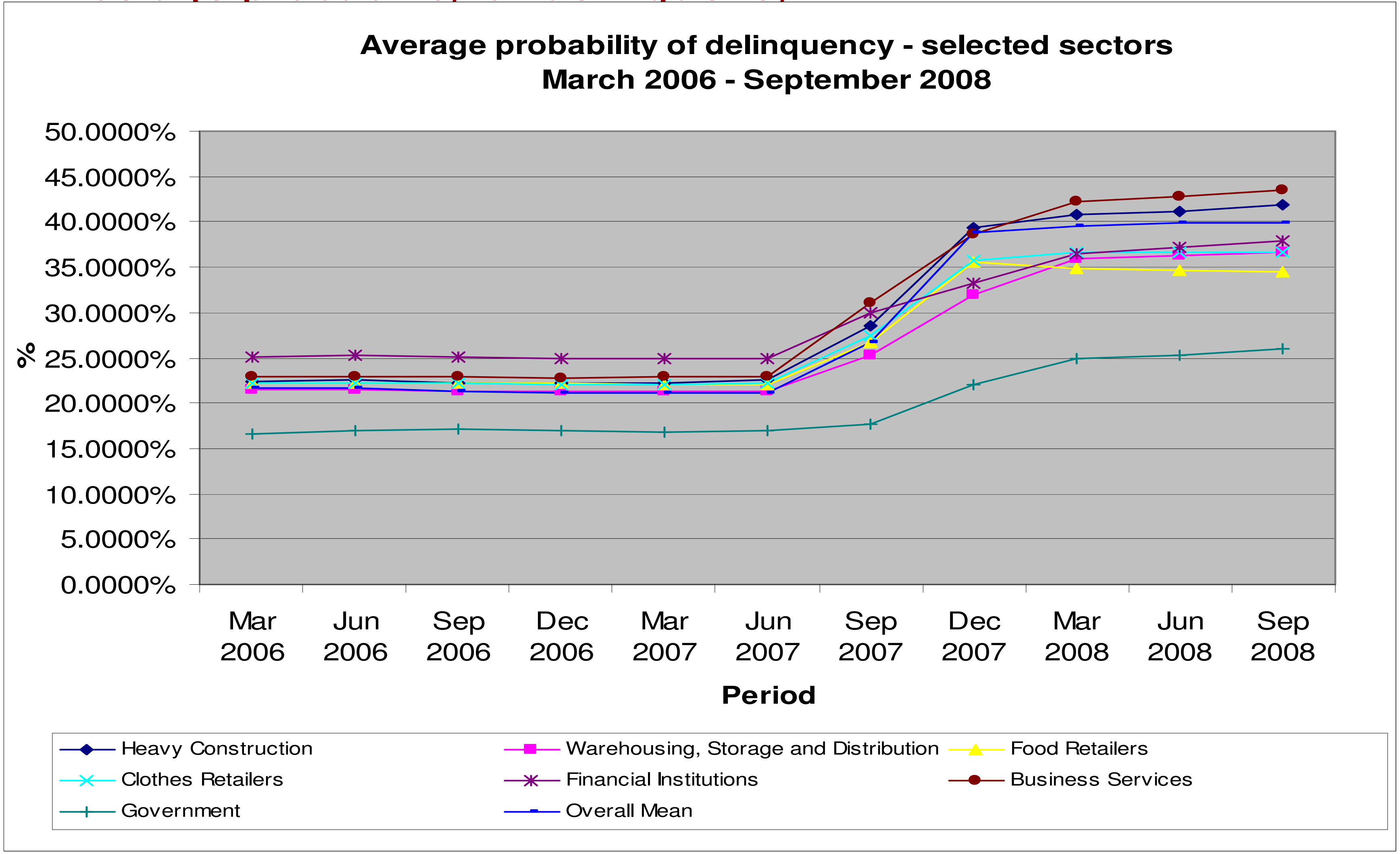


Average probability of insolvency

Source: D&B



Average probability of delinquency



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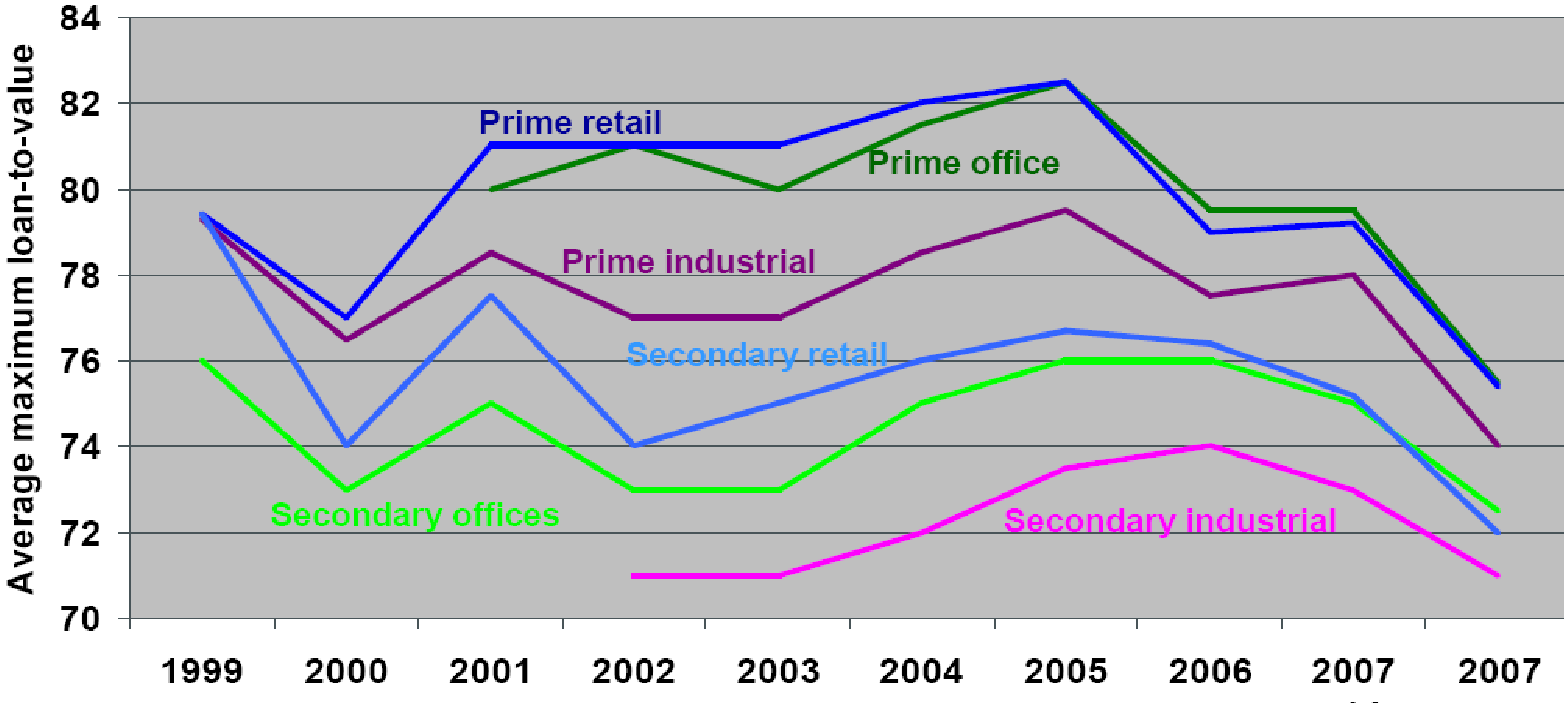
Lender's Perspective
- balance sheet & securitised loans

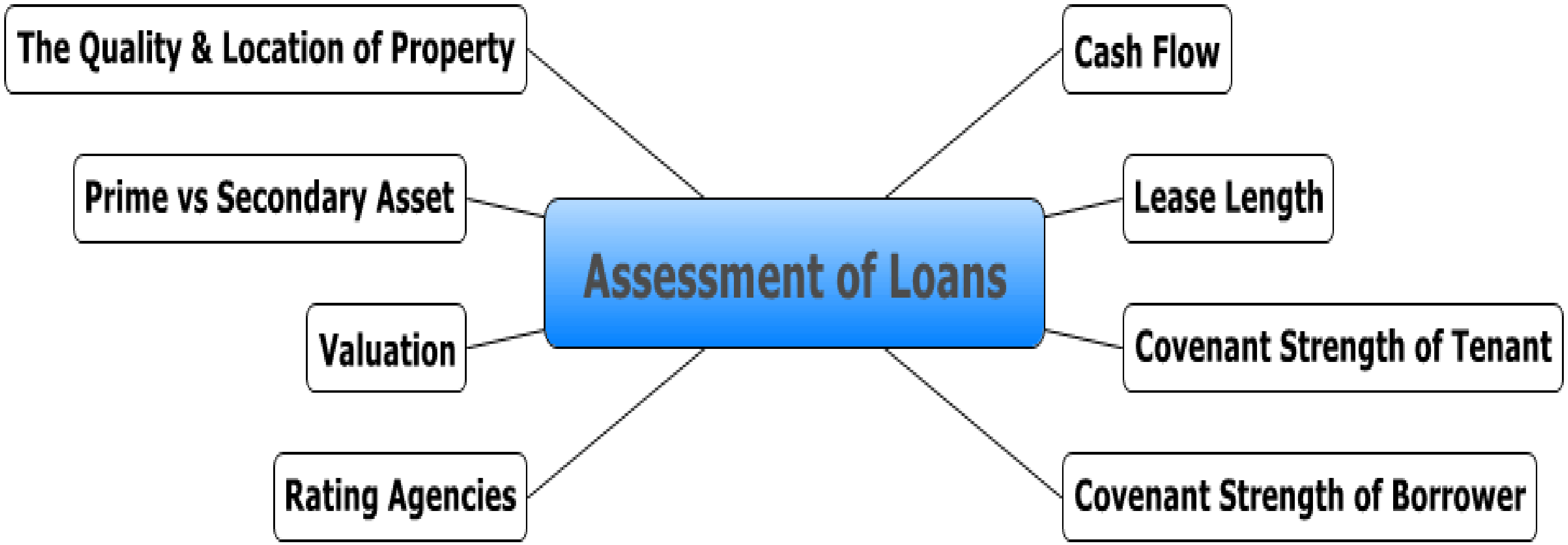
- Sharp differences in behaviour & pricing
- Pre August 2007: strong growth in lending
  - by end 2007, 11% of total lending to property
  - covenant strength insufficiently weighted
- Post August 2007 ~ severe illiquidity
- Repricing
  - LTV decreasing
  - Interest cover ratio increasing
  - Margins increasing, over LIBOR, not base rate

Loan to Value Ratio

(Source: De Montfort University)



Lender's Assessment of Loans



Pricing of Loans

No consensus on weighting, but key factors

Balance Sheet

- Property fundamentals
- Strength of the borrower
- Strength of tenant
- Cash flow of the scheme
- Lease length & reletting
- Level of return
- Existing customer

Securitised

- Expected ***rating*** of securitised vehicle
- Strength of the tenant
- Cash flow of the scheme
- Sector prospects
- Property fundamentals
- "Velocity of capital"

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Example of pricing of senior debt

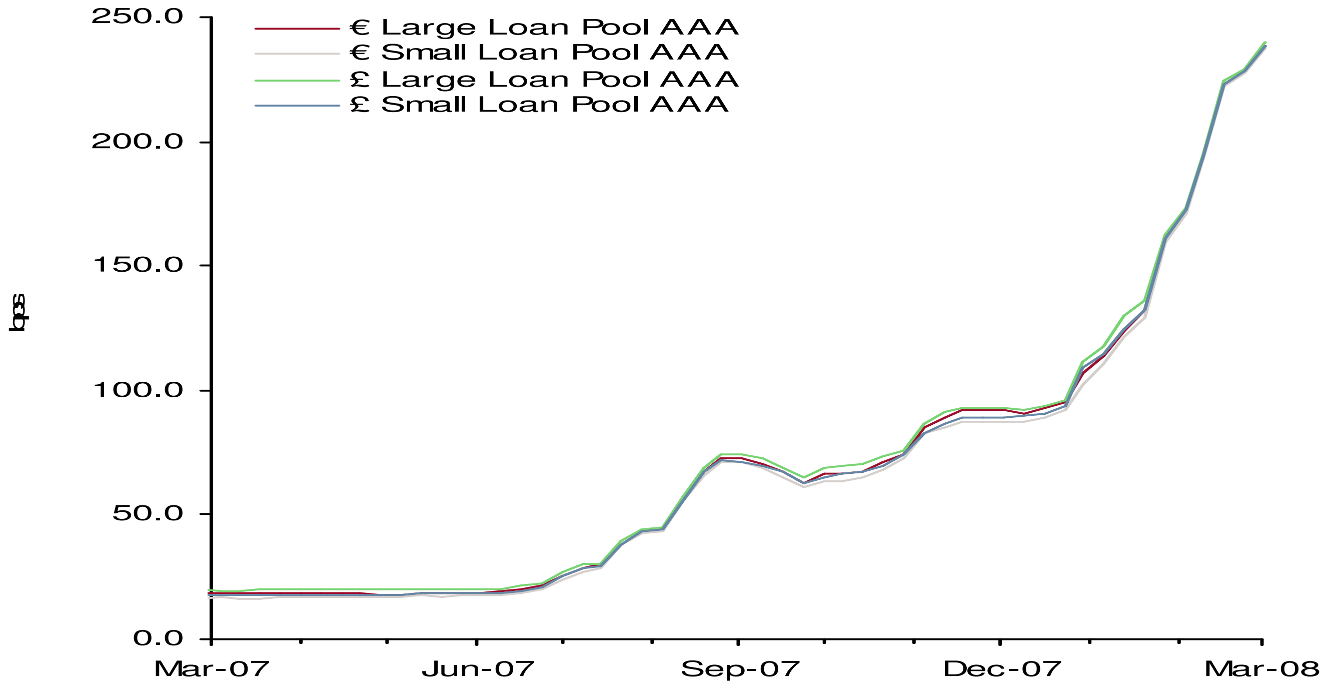
- 10/15year lease, good covenant

	Prior to mid 2007	2008
LTV ratio	>80%	<75%
Margin (in bps)	<100	>140-170
Interest cover	1.15	1.35 -1.45
Fees (in bps)	35	100

Repricing of securitised loans

European 5-Year AAA CMBS spread

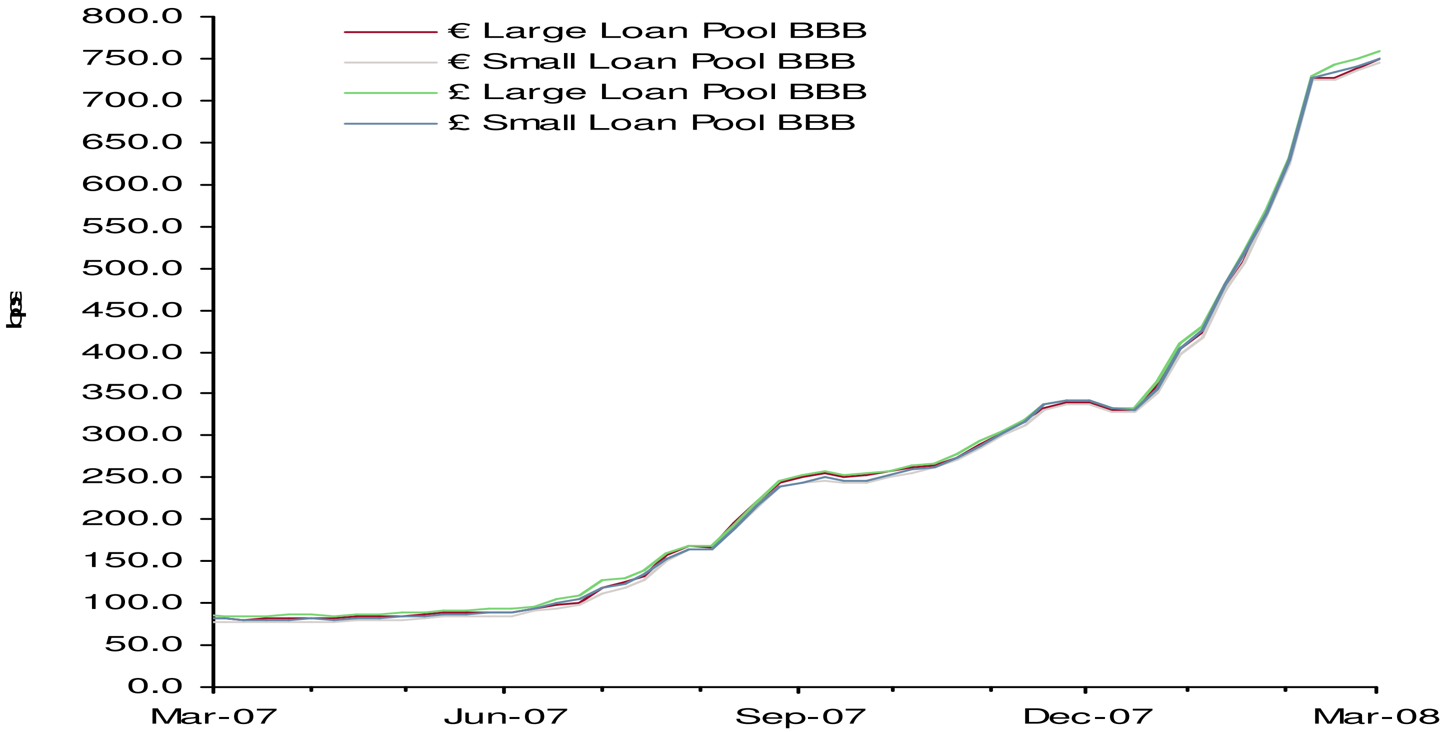
Source: MarkIT



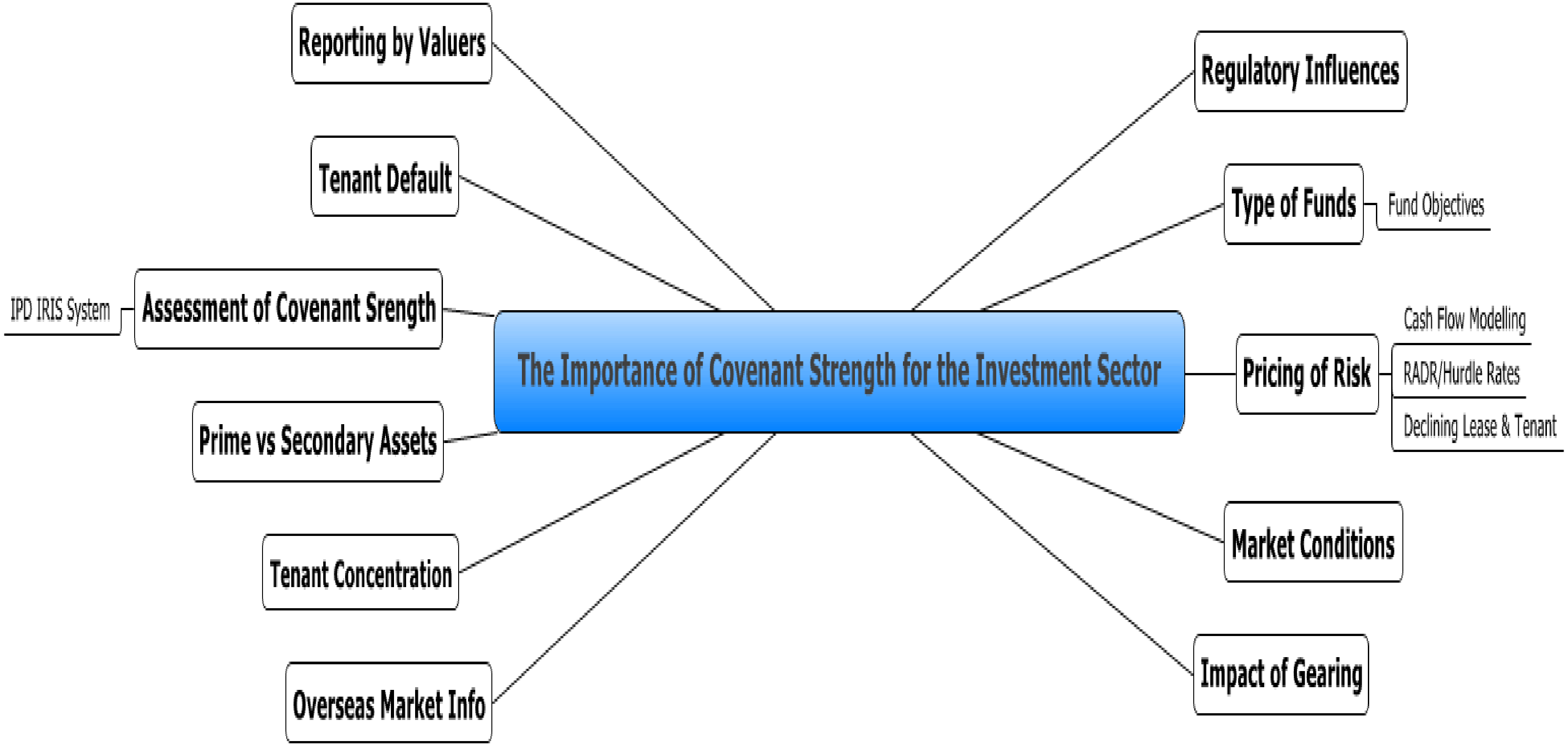
Repricing of securitised loans

European 5-Year BBB CMBS spreads

Source: MarkIT



Investor's Perspective



Risk Premium

3 key components highlighted:

→**Lease length**

→**Sector**

→**Covenant Strength**

Weighting depends on **stage of cycle**

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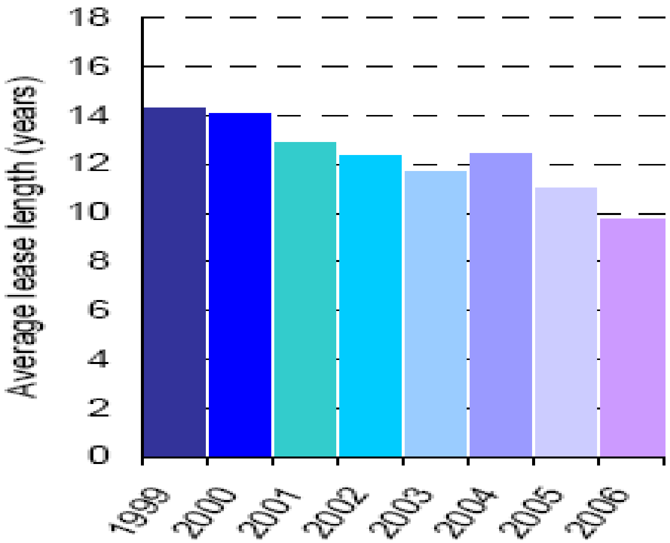
Average lease length

– weighted by rent passing

(Source BPF)



	Ave. lease length
1999	14.3
2000	14.0
2001	12.9
2002	12.3
2003	11.7
2004	12.4
2005	11.0
2006	**9.8**

Systematic and Specific Risk
- Sector risk a "semi systematic" risk

- Due to high lot size not always possible to fully diversify portfolio
- Return performance across sectors differ – certain sectors are more volatile than others
- Some viewed as defensive, others aggressive
- Need to consider β

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Beta Coefficients: 1981 to 2007

Source: IPD

Sector	Beta
Shopping centres	0.73
Retail warehouses	0.82
Office: City	1.17
Office: West End & Midtown	1.43
Industrial Rest of UK	0.82

Investor’s pricing of covenant strength

- Rising market: lower risk premium, but stage of cycle?
- Falling market: higher risk premium
  - **Combination of lease length, cov. strength and sector, vital**
- All investors tracked arrears to some degree, but no information on sector/ regional analysis
- Defaults expected to rise, but uncertain the impact an increase in default would have on overall portfolio returns
- Reporting of cov strength by valuers inconsistent

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IPD Analysis: impact of covenant strength on equivalent yields 2003 - 2007

- Initial survey showed no identifiable relationship between the equivalent yield and the credit risk score
- Reworked including unexpired lease length
- Cov. strength based on IPD IRIS bandings:
  - 0-15:high risk, …. 85-100 low/negligible risk
- Unexpired lease length (assumes break option exercised):

  0-5, 6-10, 11-15, 16- 20, 20 + years
- Weighted results

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An example, Offices South East

(Illustrates number of observations, mean equivalent yields are highlighted and standard deviations)

2007

		High	Med-High	Low-Med	Low	Neg
0-5 years	No	5	42	156	94	170
	Mean	7.79	7.26	7.40	7.43	7.33
	Std Dev	1.26663	0.86287	0.93050	0.89504	0.89568
6-10 years	No	13	50	104	80	163
	Mean	6.88	6.91	6.84	6.78	6.62
	Std Dev	0.79118	0.69054	0.81855	0.65824	0.74399
11-15 years	No	1	10	22	14	70
	Mean	5.39	6.52	6.27	5.95	6.22
	Std Dev		1.02001	0.63700	0.61529	0.68927
16-20 years	No		1	2		14
	Mean		6.50	5.96		5.84
	Std Dev			0.60494		0.48473
20+ years	No			1	3	16
	Mean			4.78	5.44	5.50
	Std Dev				0.27469	1.17019

		High	Med-High	Low-Med	Low	Neg
0-5 years	Equiv Yield	7.79	7.26	7.40	7.43	7.33
6-10 years	Equiv Yield	6.88	6.91	6.84	6.78	6.62
11-15 years	Equiv Yield	5.39	6.52	6.27	5.95	6.22
16-20 years	Equiv Yield		6.50	5.96		5.84
20+ years	Equiv Yield			4.78	5.44	5.50

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Offices South East - Yield Shift

bps movement from Dec 2006 to Dec 2007

Risk/ Yrs	High	Med-High	Low-Med	Low	Neg
0-5	118	63	62	68	69
6-10	94	81	75	90	70
11-15	15	88	58	45	78
16-20		143	59		68
20 +			-38	3	66

Conclusion

- Risk of default is increasing – income return under pressure
- "Cheap money" and over zealous lending fuelled price spike
- Investors strong pursuit of a "position" in market led to yield compression
- **Covenant strength insufficiently weighted by lenders and investors**
- Consistent calibration of the impact of covenant strength not possible, due to range of permutations
- Risk needs to be fully evaluated in conjunction with lease length, sector and stage of economic and property cycle

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