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Putting a Leash on Risk

Towards Evaluating Commercial Properties

By Wayne E. Etter

Many lenders no longer actively pursue commercial real estate loans. Because of the widespread delinquencies of commer cial real estate loans made in the 1980s, lenders apparently believe other sectors offer fewer problems, more opportunities or both. Additionally, bank risk-based capital regulations and proposed insurance company regulations require significantly more capital for commercial real estate loans than for some other types of loans and assets.

The amount of capital required is based on the risk class of the particular loan or asset. For example, investments in U.S. government securities are considered risk-less; commercial real estate loans are in the most risky category. A bank with assets concentrated in commercial real estate loans (or other assets considered equally risky) needs more capital than if it invests in less risky assets or loans. Because capital has a cost, many commercial banks find that investing in U.S. government securities is more profitable than extending commercial real estate loans. With similar rules set to take effect in the life insurance industry, that industry's role as a supplier of commercial real estate loans may diminish.

Among lenders who consider making new commercial real estate loans, many are unwilling to make them on a nonrecourse basis; they require personal guarantees in addition to liens on the property. While other sources of commercial real estate financing, such as real estate investment trusts, are increasingly important, the issue of evaluating project risk appears to be central to the current problems of financing commercial real estate.

Almost everyone who considers the problem of analyzing commercial real estate suggests increasing the discount rate as a means of compensating for risk. Increasing the discount rate reduces the present value of the estimated cash flows and, therefore, the property's value because it is risky. Although this approach is correct, this "Instructor's Notebook" focuses on **controlling risk rather than adjusting for risk.** Paying a smaller price for risky real estate does not eliminate the risk–the buyer just loses less.

Although several risks affect real estate value, three risks–financial, business and management–are discussed here. Financial risk (the possibility of inadequate income to service debt) is present when debt is used. The investor and the lender must be convinced that the debt can be managed if the *pro forma* projections made when the property is financed are achieved. The principal reasons why the debt service requirements may not be met are business risk (the property may fail to generate sufficient income) and management risk (the property's managers may fail to respond properly to changes in the business environment and, therefore, fail to earn a satisfactory return).

A property's income stream is the principal determinant of its value and the source of the loan's repayment unless the loan is otherwise secured. Thus, if the property's income stream varies over time, there is great potential for default if the loan amount is determined, for example, by assuming a 95 percent occupancy rate and lending 75 percent of a property's capitalized value.

If the degree of business and management risk is assessed and variation in the property's income stream over time is highly probable, less debt should be used.

Rating properties according to the expected stability of the income stream permits lenders to loan an appropriate amount for specific properties so total risk is not excessive. Although this would be a new approach to financing real estate, it is similar to the approach used in home mortgage lending.

A prospective homebuyer cannot get a large loan just because an expensive home is being purchased. This is true even though the loan amount normally is limited to a percentage of the home's value; this allows the lender to foreclose on the asset in the event of a default and sell it for an amount equal to or greater than the unpaid loan balance. However, foreclosure and sale are the lender's last resort; lenders prefer to have the loan repaid as agreed.

To help ensure this result, lenders qualify the prospective borrower's ability to repay the loan by considering the applicant's current income and financial situation, credit history and employment record. If the applicant has an erratic income or employment history or if an excessive proportion of the applicant's current monthly income is required to service the requested loan, the lender refuses to grant the loan. Evaluating the stability of a commercial property's expected income stream is an entirely analogous analytical problem.

As in home mortgage lending, the beginning point in assessing the riskiness of a commercial property's income stream is developing a list of factors contributing to exists currently in the market? How likely is new space to enter the market? What is the attitude of local planning authorities toward new space?

- The competitive position of the property must be assessed. Evaluate the property's site, age, size, construction quality and design relative to similar properties.
- The property's performance must be assessed. Analyze occupancy, tenants' credit quality, type of lease, average lease rates and length of lease. When appropriate, tenant mix must be evaluated.
- Additional factors must be considered for to-be-developed properties. These include the developer's reputation and experience and the amount of pre-

leasing. However, to-be-developed properties should be scrutinized more than seasoned properties because they have no market or operating history. Many properties developed in the 1980s never achieved their *pro forma* projections; perhaps to-be-developed properties should be financed with more equity than seasoned properties until their *pro f*orma projections are achieved.

Identifying these factors is an ideal project for organizations of real estate professionals. Once general agreement is reached about which factors should be included and their relative importance, a rating scale could be constructed.

Rating a property forces the analyst to consider carefully each property characteristic in relation to other comparable properties in the market area. For example, "Retail Center A" with several "mom and pop" tenants on month-to-month leases has a much less predictable income stream than "Retail Center B" with national credit tenants on income stream fluctuations. The factors must be developed separately for each property type (multifamily residential, office, retail, industrial). Furthermore, the major property types must be subdivided into groups of existing properties, to-be-developed properties and properties of varying size. Other property categories are possible. The important point is to compare only like properties within the relevant market area.

What factors are included? The following suggestions are a starter list; they are not all-inclusive.

- Economic differences among market areas are important.
- Supply and demand conditions in the property's market area must be evaluated. Determine if an unmet need can be satisfied. How much vacant space long-term leases. Thus, Retail Center A receives a lower score because it has more business and management risk. For the more subjective factors, scaling may be difficult.

A property's total score varies inversely with business and management risk; a low score indicates more business and management risk. When this is the case, the amount of debt financing should be limited because the addition of financial risk creates excessive total risk. For example, assume two properties are identical except for risk:

	High-risk property	Low-risk property
Potential gross income	$100,000	$100,000
Percentage allowed for operating expenses and debt service	x .60	x .90
Funds available for operating expenses and debt service	$60,000	$90,000
Operating expenses	- 30,000	- 30,000
Available for debt service	$30,000	$60,000
Divide by mortgage constant	.1275	.1275
Allowable debt	$235,294	$470,588

At any given mortgage constant, $60,000 will service twice as much debt as $30,000. This approach allows the risky building much less debt financing and achieves a result similar to what is observed in other enterprises. Risky businesses qualify for less debt than safer ventures.

Should an acceptable means of rating projects be developed, the regulators might reduce the amount of capital required when lenders grant an appropriate amount of credit to finance commercial real estate. And even when debt financing is not used, an analysis of a property's business and management risk is useful. A proper assessment of such risk assists in the assembly of all-equity portfolios with a given risk level.

Finally, a project risk rating scale recognized by the market would increase real estate's liquidity. Illiquidity is a major real estate risk; if illiquidity can be reduced, there is a positive impact on real estate values.

Dr. Etter is a professor with the Real Estate Center and of finance at Texas A&M University.

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