# Credit Rating Real Estate Companies

Overview of the methodical credit rating assignment
to real estate companies

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## 1 Subject

The credit rating methodology for real estate companies is primarily aimed at the following indirect forms of real estate investment in Switzerland:

- **Real estate companies**
- **Housing cooperatives**
- **Investment companies**
- **Real estate investment foundations**

The purpose of real estate companies is to acquire, develop, finance, build, rent, hold, and market one or more properties. The real estate sector is one of the most important sectors of the Swiss economy, accounting for around 15% of gross value added and the working population. Financing is typically provided by mortgage loans secured by real estate. The volume outstanding from banks alone amounted to around CHF 1,300 billion at the end of 2017. Recent trends indicate increased competition for bank financing through new offers from insurance companies and pension funds.

The risk profile of the real estate sector is characterized by (1) above-average stable cash flows from rental income, (2) highly segmented real estate markets due to geographical location and regulatory requirements, (3) above-average debt financing and collateralization of real estate, and (4) pronounced cyclical fluctuations in the value of real estate due to, among other things, changes in macroeconomic variables.

## 2 Principles

The credit rating methodology for real estate companies fully complies with the requirements of the general credit rating methodology for companies and the guidelines for the credit rating process. The present credit rating methodology extends and complements the general credit rating methodology for corporates with regard to the structural features and specific risk characteristics of real estate companies (see Figure 1).

When assigning issue ratings to subordinate debt claims of real estate companies, the credit rating methodology for issue ratings is also applied. For the credit rating of debt instruments secured by real estate, mortgage-backed bonds (covered bonds), and structured financing with tranches (notes), the Expected Loss Credit Rating Methodology[1] is applied.

This credit rating methodology serves as a guideline and orientation for the credit analysts in charge. Due to the strong segmentation in the real estate sector, one of the challenges in assigning credit ratings is the analysis and assessment of very specific business models with highly divergent structures of real estate portfolios. The credit rating analysts therefore have a margin of discretion in the evaluation and assessment based on this credit rating methodology.

[1] Available for download at www.fedafin.ch

In particular, analysts may, on a case-by-case basis, base their assessment on ratios and qualitative rating criteria that differ from the rating criteria set out in this document. For example, this may be appropriate for real estate companies with a very low credit rating or a very large share of project developments. Ultimately, it is up to the rating committee to make the final rating assignment.

## 3 Rating Criteria

Assigning a corporate rating to a real estate company involves the systematic analysis and evaluation of success and risk factors from three core areas. The three areas relevant to the rating include:

(1) the financial risk profile
(2) the business risk profile
(3) the support probability

The credit assessment covers both quantitative and qualitative matters. The comprehensive consideration of the risk-opportunity characteristics ensures a well-founded and objectively comparable rating of a real estate company. The evaluation of the financial risk profile as the starting point for the rating assignment leads to the anchor rating. Based on this, a supplementary assessment of the business risk profile leads to the stand-alone rating. The final review and assessment of any support features ultimately results in the issuer or company rating.

### 3.1 Financial Risk Profile

The assessment of the ability of real estate companies to pay their interest and debt service on time differs from companies in other sectors primarily in the above-average level of debt financing, its collateralization by real estate, and the cyclical valuation fluctuations of the real estate portfolio on the asset side of the balance sheet.

**Financial Rating**

The analysis of the financial risk profile therefore focuses on (1) the ability to refinance expiring liabilities, (2) the ability to cover current interest and principal payments, (3) the liquidity to bridge refinancing bottlenecks in the event of cyclical valuation losses, and (4) the profitability and efficiency of property management to generate sufficient cash flows. Within the scope of quantitative risk assessment, key figures from four areas are classified as fundamentally relevant to the credit rating:

**Income and cash flow**

- Level and volatility of operating cash flow
- Level and volatility of the EBITDA margin

**Capital structure and indebtedness**

- Adjusted equity ratio
- Collateralized debt as a percentage of debt

**Liquidity and financing**

- EBITDA in percent of interest and debt service
- Liquidity in percent of interest and debt service
- Unsecured properties in percent of property portfolio

**Profitability and efficiency**

- Level and volatility of rental income in percent of the income-producing real estate (IPRE)
- Level and volatility of the vacancy rate

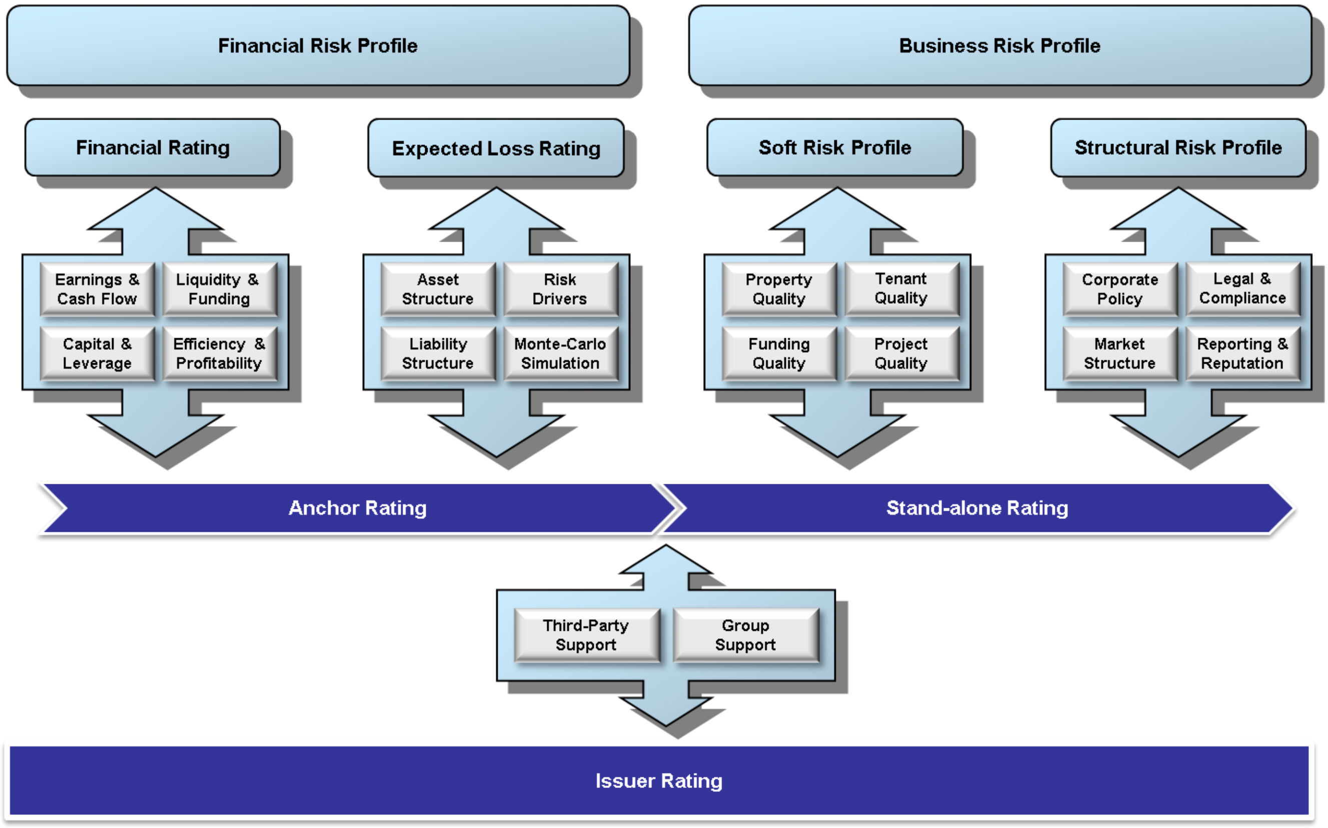


*Figure 1: Rating methodology real estate companies*

The EBITDA margin provides an objectively comparable measure of the earnings power of a real estate company. The volatility of the EBITDA margin provides an indication of the stability of earning power. Volatility is significantly influenced by the sustainability of the business model and the structure and size of the real estate portfolio.

The adjusted equity ratio reflects the capital requirements of a real estate company, irrespective of the current status of the real estate cycle. The valuation is based on an equilibrium capitalization rate for rental income from income-producing real estate (IPRE). An important aspect in assessing capital requirements is the proportion of liabilities secured by real estate in relation to total liabilities or assets. The higher these values are, the riskier the risk profile of a real estate company or its primarily unsecured obligations.

The earning power and liquidity to ensure ongoing interest and debt service as well as payment obligations in phases of falling property prices are the determining risk factors for the credit rating. The proportion of the real estate portfolio available as collateral for refinancing is particularly significant in the event of price corrections in the real estate sector. Collateral provided by a real estate company for existing obligations is not available for refinancing purposes or as an asset in the event of bankruptcy for creditors of unsecured debt.

The profitability and efficiency of real estate management depend heavily on the business model and the structure of the real estate portfolio. Business models of real estate companies that can demonstrate their ability to generate high and stable rental income and low vacancy rates have a positive effect on the credit rating.

### Expected Loss Credit Rating Methodology

No Financial Rating can be assigned to real estate investment companies and real estate investment foundations on the basis of the above-mentioned ratios. The significance of rating relevant data and information provided by real estate companies can also be considered insufficiently robust. Reasons for this are sometimes an insufficient track record, strongly fluctuating financial plans or low volumes and granularity of the property portfolio. These characteristics are often found in (1) young or newly founded real estate companies, (2) real estate companies with rapidly growing or shrinking real estate portfolios, or (3) small and locally oriented real estate portfolios.

In the context of a specific credit rating assignment, analysts can therefore come to the justified conclusion that, as an alternative to assigning a financial rating, the assignment of an expected loss credit rating is appropriate. In such cases, the Expected Loss Credit Rating Methodology developed specifically for the Swiss real estate sector is applied, which is based on a semi-parametric hazard rate model. The conceptual basis of the methodology consists of the following three building blocks:

#### Replication of balance sheet structure as a mortgage pool

- Structure and valuation of real estate portfolio
- Conditions and collateralization of liabilities
- Ranking and waterfall for "Senior Unsecured"

#### Risk factors (hazard rates)

- Real Estate segment
- Current debt coverage (LTV)
- Current trend in unemployment
- Current interest rate spread at coupon

#### Monte Carlo simulation

- Random processes with mean-reversion property
- Correlation of segment-specific property prices

With the help of the risk tool, the default and loss probabilities of Swiss real estate companies can be modelled on a statistically sound basis.

## 3.2 Business Risk Profile

The financial risk profile is then complemented by a sound assessment of the business risk profile. Qualitative risk and success factors for real estate companies are systematically identified and evaluated by the rating team. The analysis and evaluation of rating-relevant institutional conditions for the provision of services complete the assessment of the business risk profile.

### Soft Risk Profile

Within the framework of the rating process, matters relevant to the creditworthiness of real estate companies are classified as fundamentally relevant for rating in four areas:

#### Structure and quality of the property portfolio

- Structure by segment, age, size, and standard
- Micro- and macro location
- Property valuation

#### Structure and quality of tenants and rental income

- Tenant type and structure
- Average (minimum) rental period

#### Structure and quality of collateralized liabilities

- Conditions (interest rate, maturity, amortization)
- Capital structure (upper limits)

#### Project profile real estate and other projects

- Proportion and type of development projects
- Other sources of income

The price sensitivity of real estate naturally also depends on qualitative characteristics. These include, for example, the age, living standard, and living space of a property. These characteristics are assessed together with the regional site and the local location. Project developments are considered separately and can be more or less risky depending on the business model.

The tenant structure can provide conclusions about the stability and potential of rental income. The spectrum can range from a single operating company to homogeneous groups of tenants to very heterogeneous groups of tenants.

Long tenancies, sometimes combined with minimum requirements in rental and operating agreements, are credit positive.

The structure and composition of debt financing can also provide information for the rating. Average short maturities, a high or variable interest rate, and low amortization obligations tend to increase the risk profile. Conversely, binding ceilings for real estate that may serve as collateral for mortgage financing are credit positive.

The valuation of the properties is carried out either internally or externally by third parties. The regulatory recognition and reputation of appraisers and their valuation methods and principles are assessed, as are the resulting estimates for property prices and capitalization rates.

**Structural Risk Profile**

Within the framework of the credit rating process, creditworthiness-relevant issues are classified as fundamentally relevant for real estate companies in four areas:

**Business model and strategy**

- Sustainability of the corporate strategy
- Financing and dividend policy

**Market structures**

- Market position
- Barriers to market entry

**Legal and regulatory risks**

- Regulatory conditions
- Operational and financial risk management

**Reporting and reputation**

- Quality of the information and data basis
- Reputation and image

The business model of a real estate company is reviewed for special risk characteristics and its sustainability. The core elements of this analysis are the assessment of corporate strategy, financing policy, and dividend policy. In the case of holding companies and group structures, additional circumstances relevant to the credit rating such as the granting of guarantees and shareholder loans as well as possible structural subordination are subjected to an assessment.

Market structures can have a significant influence on the credit rating assignment, depending on the corporate sector. In the real estate sector, market entry barriers are relevant in addition to the market position, especially due to planning and construction law. Depending on the business model and real estate portfolio, numerous other regulatory conditions may be the subject of an analysis.

In the real estate sector, operational risks are of above-average relevance given the density of regulation. The implementation of control and monitoring instruments is an indication of professional property management. Examples of this are effective compliance or effective management of liquidity and project risks.

A high-quality reporting is measured by transparency, consistency, and meaningfulness of the disclosed data and information regarding future business development. Reputation and image of a real estate company are an indication of professional and customer-oriented business conduct. Failure to do so can be reflected, for example, in negative reporting or legal disputes with authorities and clients.

### 3.3 Guarantees and Support

Finally, guarantees from third parties and possible facts that underpin the probability of financial support are systematically analysed and evaluated. Support aspects may be of importance, for example, in the context of assessments of real estate investment foundations or housing cooperatives. Support can have a positive effect on the rating assignment, but it can also affect the creditworthiness of the guarantor.

Explicit support includes legally binding guarantees as well as liability, deficit, and financing guarantees. In the case of implicit support with legally non-binding guarantees, two categories of support providers can be distinguished:

### Support from third parties (public authorities)

- Economically or politically "too-important-to-fail"
- Significant control, ownership, or preemption rights

### Group internal support

- Intra-group operational or financial interdependence
- Intra-group support measures

The assessment of the likelihood of implicit support from public authorities is based on criteria such as the nature and scope of a statutory public service mandate, regional or systemic contagion risks at the expense of public financial budgets, or political opportunity costs of preserving the chances of re-election. In addition to significant control and ownership rights, pre-emptive rights - for example for the property portfolio of housing cooperatives in favour of the public sector - can also have a positive effect on the rating assignment.

Operational and financial dependencies can relativize the legal independence of different units. Examples of this are group structures with group-internal subsidiaries that run the group's core operating business. Concrete measures can support the assessment of the probability of intra-group support, for example in the form of a shareholder loan or a declaration of intent to waive a substantial portion of the dividend payment.

## 4 Rating Assignment

The starting point for assigning a credit rating to a real estate company is a quantitative risk assessment. This is based either on a parametric analysis of various key figures (Financial Rating) and/or a stochastic analysis of the expected loss (Expected Loss Credit Rating). An asymmetrically expanded Logit function serves as the methodological basis for the assignment of a financial rating (see Figure 2).

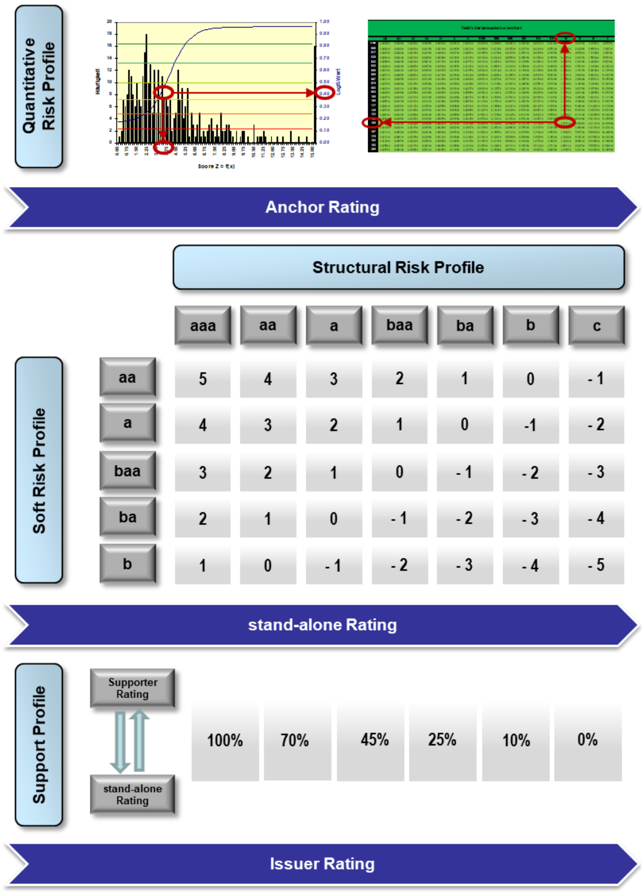


*Figure 2: Rating assignment real estate companies*

The business profile is assessed on the basis of a rating matrix with five levels for the qualitative risk profile and seven levels for the structural risk profile. The scope of a possible rating change is within a range of +/- five rating levels. The team of analysts may deviate from the standard with regard to the selection and weighting of rating-relevant risk and success factors if they consider this appropriate after assessing the specific individual case. This is intended to take account of the fact that in individual cases a very pronounced strength may outperform other existing weaknesses or, conversely, a very pronounced weakness may outperform other existing strengths.

The support profile is rated on a scale of six levels from 0% to 100%. The extent of any rating improvement depends on (1) the analysts' assessment of the probability of support and (2) the rating distance between the stand-alone rating and the rating of the support provider. If at the time the rating is assigned no own credit assessment is available as a reference, the corresponding issuer rating of another recognized credit rating agency can be used alternatively.

The final assessment by the team of analysts ultimately leads to a proposal for the rating assignment for the attention of the Rating Committee. The Rating Committee assigns the final rating to a real estate company in accordance with the applicable regulatory standards and fedafin's internal guidelines.

## Contact

fedafin AG
Galerieweg 8
9443 Widnau
Switzerland

Phone: +41 71 552 32 00
Email: info@fedafin.ch
Website: www.fedafin.ch

## Disclaimer