



ProMS[®]

**Establishing a framework for
Commercial Real Estate Risk
Management**

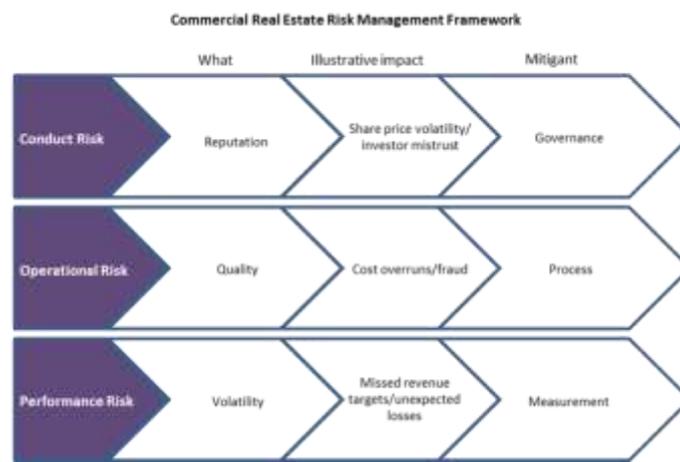
Radley & Associates

Establishing a framework for Commercial Real Estate Risk Management

Executive Summary

Risk management is now an essential part of the way in which investment firms operate. How should Commercial Real Estate (CRE) firms respond to this new environment?

In this article we explore the three main areas that CRE investment firms must focus on and suggest that the first and most important step is to create clear Board level accountability for Conduct, Operational and Performance Risk.



Introduction

The recent turbulence in financial markets has resulted in increased interest in how companies and funds should manage risk. Regulation is increasing, for example; AIFMD, Stress Testing and IFRS9 that puts pressure on management to address this issue.

Investors and regulators are demanding that firms demonstrate their cognisance of the risks they face and show how they are actively managing them. Risk management is firmly on the agenda as an essential not a 'nice to have' capability.

We are regularly asked by property executives to advise REITS, Property Funds and Private Equity firms how to put in place appropriate risk management. "Should we hire a risk director? With what mandate: reporting to whom?"

The initial problem we face is 'what do we mean by risk' because every executive has a different view: ranging from something bad appearing in the media; to an anchor tenant defaulting; to having buildings located in uninsurable flood plains; to suffering a loss on a hedged or FX position; or unexpectedly high levels of redemption for an open-ended fund.

Creating an appropriate Risk Management Framework for Commercial Real Estate (CRE)

It is helpful to classify the three main types of risks faced by CRE investment firms according to the following:

1. Conduct risk
2. Operational risk
3. Performance risk

Commercial Real Estate Risk Framework



1. Conduct Risk

Clarity and accountability of governance processes are essential in any large organisation and the types of risk associated with Governance and Conduct should form the basis of the Executive and Non-Executive Board's principle role. There is nothing unique about these risks or the means to manage them in the commercial real estate environment as compared to any other industry. We recommend that firms use established best practices as provided by a number of professional bodies.

2. Operational Risk

Managing operational risk is essentially good housekeeping. All firms should strive for operational quality as it improves efficiency, reduces costs and prevents costly failures and overruns.

The sorts of operational risks that a CRE investment firm runs include:

- Failure to put in place actions that mitigate changes to planning, safety, environmental, human resources or other regulations
- Cost overruns
- Poor capture of financial data and inaccurate reporting
- Inadequate insurance cover
- Fraud
- Contractual errors

The most effective way to manage operational risk is to have clear accountabilities and processes for managing these areas. It has long been recognised in industries where quality is critical, such as aircraft safety or even manufacturing excellence, that process and culture are key to reducing operational risk. Many firms have adopted quality assurance programmes such as ISO 9000 or GE's Six Sigma to identify areas of operational risk, create the measures and processes to manage operational failures.

3. Performance Risk

The management of Performance Risk is the least developed area of risk management in Real Estate firms. REITS and Property Investment Funds are closer to pure financial services firms than most other commercial companies. Investors in either funds or the equity of REITS tend to compare the performance of their investment with other financial instruments (bonds, debt or equities) in two main dimensions: what is my expected return and what is the volatility (or uncertainty) of that return.

Performance Risk is the measure of how likely the investment will provide the returns the firm has projected – or in other words 'will I get my money back, and if I do, how much am I likely to get?' How much leverage should we use before risk becomes unacceptable? What is an 'unacceptable' level of risk and how should we measure it?

Commercial Real Estate investors are looking for certainty and thus expect the REITS or Funds in which they invest to manage the risks and cash-flows so there is predictability in the earnings. CRE investors are interested in the bond-like quality of income from tenancies.

This investor demand places a great emphasis on CRE managers to provide accurate forecasts of their financial performance and a measure of the risk to earnings and capital growth. However, the industry has been very slow in creating or using the tools to measure performance risk. To properly manage Performance Risk it is essential that property companies can identify the internal and external factors that put their income at risk:

Asset risk: is the risk to the cash flows posed by the way in which an individual asset or building performs. Some examples are; tenant credit quality, higher than projected CAPEX, unfavourable lease terms or over-rented units on short leases. While some risks are related to the unique features of the building and its rent roll: many are strongly related to market

risks. It is critical to identify which risks are idiosyncratic and which are correlated to other assets in the portfolio.

Leverage Risk: is the increase in volatility of returns associated with different levels of leverage and different debt structures, such as maturity profile or different rate structures and adverse movements in inflation and interest rates.

Portfolio risk: represents the risks posed by the way in which a portfolio is composed, for example, tenant concentration, too many assets in the same sector or geography, or a large number of leases breaking at the same date. For open-ended funds the relationship between market risk and redemptions may present highly correlated risks. Alongside debt there may be other non-property assets within a portfolio that pose unexpected risks.

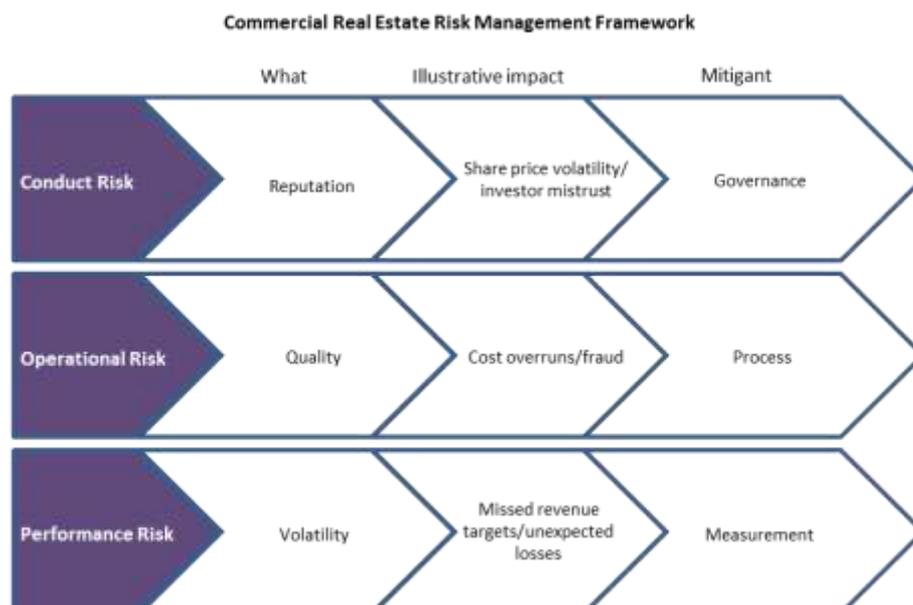
Market risk: is the unexpected movement in market factors that either reduces the cash flows or lowers capital values (interest rates, inflation, GDP declines, tenant defaults, increased vacancy periods, falling rents, foreign exchange movements for multinational funds etc.). It is also very important to be able to identify which of these factors are correlated (do they go bad together or are they unrelated?) and how they affect a building's value, its individual rental units and their tenants.

Many firms attempt to manage these risks through the capital markets via derivatives, hedging, swaps and other instruments that are potentially designed to be counter-cyclical to the exposures of the firm – but these can on occasion work in the opposite way to which they were intended unless carefully understood and measured.

The common factor for all these Performance Risks is that the most important element in managing them is to first be able to measure them.

Conclusion

The starting point for a discussion about CRE risk management is not necessarily a debate about organisational change or the hiring of a Risk Director but should initially focus on ensuring there is clear accountability at Board level for the identification, measurement, monitoring and management of these three categories of risk.



Radley & Associates is an independent firm dedicated to the development of advanced simulation based analytics for the Commercial Real Estate industry. Our clients include leading banks, fund managers and REITS. We have deep expertise in property, simulation modelling, econometric analysis and risk.

Radley Associates
19-21 Christopher Street
London
EC2A 2BS
0207 224 3079
www.promsinvestor.com