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The Commercial Property CEO's Risk Agenda

Radley & Associates

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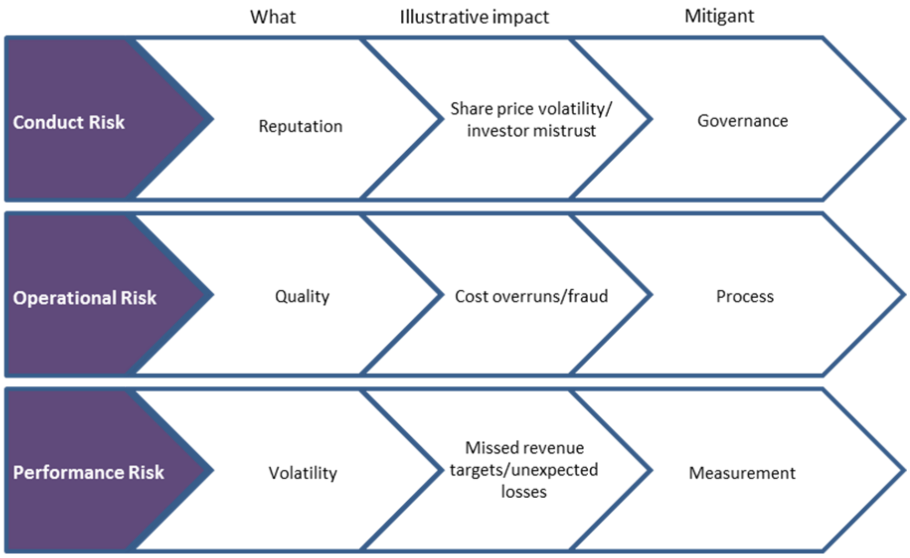
Executive Summary

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? Is it merely a matter of putting in place a compliance function, hiring a Risk Director or is it a more fundamental shift in the way firms operate?

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.

Commercial Real Estate Risk Management Framework



Introduction

The recent turbulence in financial markets has resulted in increased interest in how companies and funds should manage risk. Regulation is increasing and it is no longer sufficient to say 'we have good management and trust our auditor to highlight any issues'.

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 having buildings located in uninsurable flood plains; to suffering an unexpectedly large loss on a hedged position.

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

The first task in defining how to manage CRE risk is to differentiate categories of risk and devise appropriate actions or processes according to the best means of measuring and managing them. The simplest way to think about the problem is to classify the main types of risks:

Commercial Real Estate Risk Framework

Conduct Risk

This includes everything to do with the failure of the firm to implement appropriate governance. The sorts of risks include: not anticipating future business conditions or constraints (regulatory, legal and tax etc.), the honesty and integrity of directors, bribery, staff bullying, lack of transparency and poor accountability.

Operational Risk

Inadequate management processes lead to operational risks. These range from failure to plan for changes to regulation, planning or sustainability to buying buildings without due diligence (are the lease contracts as described, are the buildings in a flood plain, is adequate insurance in place etc.). Risks that are of particular concern to regulators include keeping records in banker's boxes and doing critical analysis with error prone, unauditable, Excel spread sheets. Operational risk also includes fraud by staff, contractors, suppliers and customers.

Performance Risk

Are we able to produce returns that meet investors' expectations and how much volatility there will be in those earnings? Is the level of growth and risk commensurate with projected earnings and have we fully understood the key drivers of earnings volatility – from changing market conditions to levels of leverage? Are we exposed to capital market risk – do our hedges increase or decrease our risk? Is our portfolio properly diversified against major market changes or is there concentration risk with too many buildings occupied by a single tenant or within highly correlated sectors?

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.

At its extreme, corporations that fail to manage these risks do not survive, for example, Enron, Anglo Irish Bank or Lehman Brothers. In lesser examples, if the market perceives that a firm is not adequately managing Conduct Risk investors will simply walk away.

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.

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; poor tenant credit quality, higher than projected CAPEX, unfavourable lease terms or over-rented units on short leases.

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.

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. Alongside debt there may be other non-property assets within a portfolio that pose unexpected risks.

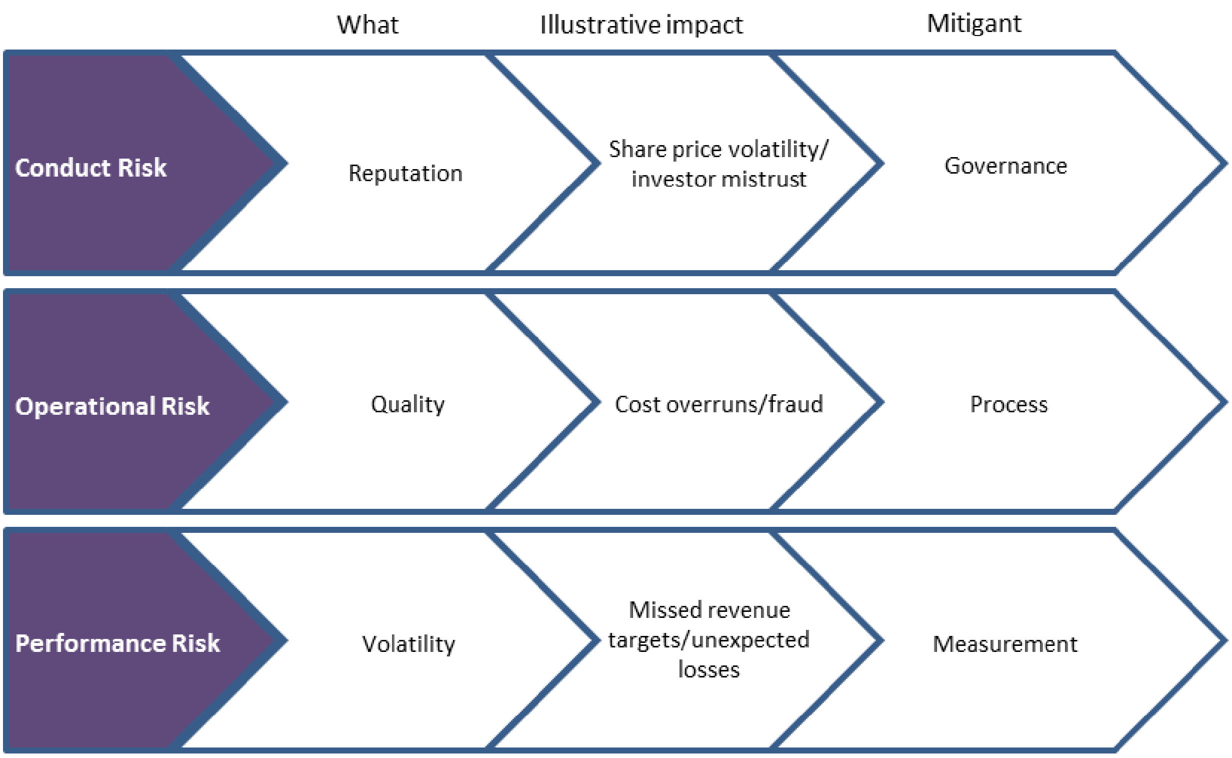
Market risk*:* is the unexpected movement in market factors that either reduce the cash flows or lower capital values (interest rates, inflation, GPD declines, tenant defaults, increased vacancy periods, lower than expected market rents etc.). It is also very important to be able to identify which of these factors are correlated (do they go bad together or are they unrelated?). 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 (JP Morgan's London Whale).

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

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.

Commercial Real Estate Risk Management Framework



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.

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