Identifying Risk Perceptions by Real Estate Investors and Banks

The Experts’ View 2014

REAL ESTATE FINANCE
Researchers:

**Nyenrode Center for Real Estate Finance**
Prof. dr. Tom M. Berkhout MRE MRICS
Prof. dr. Ad J. Kil

**ING Real Estate Finance**
Drs. Jan-Evert Post
Drs. Jantine Schrader MSRE

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Preface

We are pleased to present you with the results of the 2014 ING REF Nyenrode survey, which was conducted amongst ING Real Estate Finance clients in Europe’s listed and non-listed institutional real estate sector as well as our contacts in the property financing sector. The study explored the differences and alignment in risk perception between real estate investors and bankers. The nature of the study was such that the findings are more general in nature, rather than providing in-depth background to the participants’ reasoning. Nevertheless, the outcomes provide useful insights into risk drivers and their importance within the industry.

When real estate investors consider investment strategies and opportunities, which risk drivers do they attach most weight to in their decision-making? And how do they expect banks to weight these risks? And to what extent do investors’ views actually match bankers’ perceptions? The study shows that there are many similarities but also some striking differences. The main observations include:

• Both investors and banks find property market risk by far the most important risk category. While investors focus more on yield and pricing, banks put more emphasis on cash flows (which need to be sufficient to service the debt).
• Banks attach more weight to management risk than investors. While this is also expected by investors, they still underestimate the importance that banks attach to this issue.
• Real estate investors also take the overall country risk into account, and expect bankers to do this as well. In reality, banks attach far less weight to this issue.

To a large extent the results of the survey show the alignment between investors and banks on risk drivers in our industry. This shows that banks can be a reliable and informed partner for investors. They understand the market and are looking at the same drivers. Still, the fact that banks seem to attach less importance to property market risk triggers another question: is this driven by banks that fund themselves through Pfandbriefen and perhaps focus more on quantitative recording of mortgages to access their funding, as opposed to truly taking a qualitative view on the property to be financed? The difference in the perception of the importance of country risks is an interesting one. It looks as if banks are taking a more opportunistic approach to this issue whilst attaching more importance to deal- and property-related risks, rather than the bigger picture country view. This may be partly related to the fact that real estate is a local business, with teams on the ground, chasing local opportunities.

On the other hand, most investors (who participated in this survey) follow a multi-country strategy, and will probably have a more explicit view on the fundamentals of the markets in which they invest. The current level of activity in our sector suggests that investors are fronting developments, already factoring in economic developments that yet have to materialise. Banks that support this, basically show loyalty to their clients. These kind of topics should also be part of an intensive and cooperative dialogue between banks and investors. This creates mutual understanding on risk appetite and perception and also allows for both parties to challenge each other on strategic views.

But by not assessing macro-risks when allocating capital across the bank’s portfolio, the portfolio effect for a bank can range from anything between ‘optimal by accident’ to ‘exactly wrong’. By only addressing the asset- and property market-specific risks on a deal-by-deal basis, banks might lose the long-term perspective on a specific market and the way in which various markets interrelate. In last year’s study we noticed a further concentration of banks’ activities on a country-by-country basis, a trend supported by regulations limiting banks’ activity outside their national markets. This could contribute even further to a trend of less attention being paid to strategic portfolio allocations. Of course it is easy to rely on your clients’ management views, but perhaps banks should put more effort into developing balanced views of market fundamentals. In this regard, I am very curious what the results of the ECB’s asset quality reviews and stress tests will bring us later this year, and I am looking forward to a discussion on this topic within the industry.

I hope this report will provide you with food for thought for such a discussion and I wish you pleasant reading.

Jan-Evert Post
Member of the Global Management Team of ING Real Estate Finance
Summary

Aim and methodology
The aim of this study was to identify differences and similarities in risk perceptions between real estate investors and their banks. The study was conducted through an online survey in which 25 (listed and non-listed institutional) real estate investors and 27 bankers participated and gave their views on the importance of various risk drivers. Five main risk categories were identified: Country Risk, Property Market Risk, Financial Risk, Structure Risk and Management Risk.

Main results and conclusions
The relative importance of five main risk categories; the investors' view, the investors' perception of the banks' view and the bankers' view
Each respondent weighted the five main risk categories: Country Risk, Property Market Risk, Financial Risk, Structure Risk and Management Risk, with the total for all categories being 100%. It turns out that Property Market Risk (approx. 40%) is the most important category for investors, closely followed by Country Risk (25%). The other three categories are deemed less important.

The respondents were also asked how they think banks weight these five main risk categories. They believe that banks pay more attention to Management Risk, at the expense of Property Market Risk which they believe banks find less important than themselves. The other three categories are felt to be of equal importance.

When looking at what bankers actually perceive as important, the Management Risk is indeed of higher importance to them than to investors. However, bankers find Property Market Risk just as important as the investors do. The actual discrepancy is found in Country Risk, which bankers feel is less important than investors do. This picture is further reinforced when Management Risk is taken out of the equation. Property Market Risk is of equal importance to bankers and investors and Country Risk is less important, in favour of Structure Risk and Financial Risks (each a little more important to bankers than to investors).

A closer look: the importance of underlying aspects
Each risk category is composed of several underlying aspects. In a further set of questions it was asked if these aspects are taken into account when assessing investment opportunities and strategies. The answers could be a) never, b) rarely, c) sometimes or d) always.

Within the Country Risk category, the following aspects were taken into account: GDP growth, employment, inflation, political stability, market orientation, size of the population, growth rate of the population, consumer confidence and wealth. Each of these aspects were taken into account more often by investors than by banks. This is however not what investors predicted; they believe that banks take this into account more often than they actually do.

The Property Market Risk category is made up of: pricing/yield change, vacancy rates, demand, rental growth, investment volumes, pricing/absolute yield, and real estate spread on government bond yields. Each of these aspects is deemed very important by both investors and banks, even a bit more important to banks than to investors. The exception is the real estate spread on government bond rates, which is taken into account far less often by banks than by investors. Interestingly enough this aspect is not related entirely to the property market, but also partly to Country Risk.

Within the Financial Risk category (currency risk, interest rate risk, availability of debt), banks and investors are more or less in accordance, with the exception of currency risk, which is more important to investors than to banks. Overall, the aspects within this category are of lesser importance than the aspects of Property Market Risk.

The Structure Risk category consists of: concentration risk, diversification benefits, type of entity, fiscal burden and exit risks. Here we find some discrepancies: most aspects are more important to banks than to investors. The biggest differences are in concentration risk, diversification benefits and - most importantly - exit risk. The fiscal burden is more important to investors.

The final category is Management Risk, which takes into account: morale of business partners, potential exposure to controversial topics, experience with the asset class, tenure of key people, operational risk and track record of key people. The picture for this category confirms that this issue is more important to banks than to investors. This was also expected by investors, but the bankers put an even greater emphasis on this issue than anticipated by the investors. The exception is operational risk, which is more important to investors than to banks.

Overall, most answers given on the single aspects were either ‘sometimes’ or ‘always’, confirming that the aspects which are relevant to the industry were included in this survey. It does not distinguish the relative importance of each of the aspects: what are the current priorities or concerns? A follow-up question was therefore posed, in which the respondents were free to mention any aspect important to them.
Dive deeper: what are currently the most important aspects in the industry?

In the final section of the survey each respondent was asked to name the three aspects which are currently most important. The investors were asked to comment both on what is important to them and on what they perceive to be important to banks. Bankers also indicated what they considered to be important. The answers given were allocated to the five main risk categories and a category for other answers (which do not relate to any of the five categories).

For investors, most answers related to Property Market Risk, whilst the ‘Other’ category came second. The remaining four categories each received a similar amount of answers, the number for Management Risk being the least. Many answers within the ‘Other’ category related to specific asset circumstances, such as asset quality, location and catchment area.

Most of the bankers’ answers related to Property Market Risk and Management Risk, emphasising the importance of these two. However, the answers for Property Market Risk were more frequently the most important aspect, rather than the second or the third. Furthermore, a large number of answers related to Structure Risk, with exit risk being mentioned very frequently. In the ‘Other’ category the bankers, like the investors, also stressed the importance of asset-specific circumstances.

Looking at the aspects which the investors perceive as being most important to banks, most answers related to Other, closely followed by Property Market Risk. Within the ‘Other’ category, answers mainly related to either asset-specific circumstances or to risk assessment in general. Only one answer related to Country Risk, the other categories each had a similar number of answers. Within Structure Risk the importance of exit risk was echoed.

Taking a closer look at the answers within Property Market Risk, the bankers’ answers related more often to cash flow (securing the debt service coverage), while investors put greater emphasis on pricing and yields.
Chapter 1: Introduction and methodology

Introduction
When considering investment opportunities or setting investment strategies, real estate investors have a view on the risks and value drivers attached to these opportunities and their strategy. The investors also hold a view on the banks’ perception of these risks: which do they find important and which are of lesser influence on decision-making? Investors’ and bankers’ perceptions of relevant risk and value drivers may not always match, with a variety of consequences. We feel it would be valuable for these parties to know to what extent the perception of risk drivers match. In essence, this study aims to identify just that: the degree of matching perceptions of risk and value drivers between investors and banks. In order to have a more complete picture, both investors and bankers were asked to give their view on the risks taken into account when assessing possible investments (by their clients). With these answers it is possible to see if there is a difference in the way investors expect their banks to behave and the way in which bankers actually behave.

The survey; methodology
In this report we provide an overview of the views held by real estate investors and bankers on five risk categories relating to real estate investments and on aspects of these categories: (1) Country Risk; (2) Property Market Risk; (3) Financial Risk; (4) Structure Risk; (5) Management Risk.

The results were obtained through an online survey using Qualtrics (a tool to create and manage online surveys). Analysis was carried out using Excel.

The survey consisted mainly of closed questions. The first part of the survey consisted of some general questions regarding the profile and background of each investor or bank. The second part focused on several aspects that were distinguished for these categories. The results section sets out per issue how the questions were posed and how the results were collected and analysed. It is worth noting up front that in some categories there was a great deal of variance in the answers. On some issues respondents have a low level of agreement (= a high standard deviation). Where appropriate, this is reflected in the way the results are presented.

The group of respondents consisted of experts from real estate companies and funds (referred to as ‘investors’) and experts from banks (referred to as ‘bankers’). The participants operate in countries including Austria, Belgium, the Czech Republic, France, Germany, Hungary, Italy, the Netherlands, Poland, Spain and the UK. The investor respondents were all from institutional parties.

A fully representative sample cannot be established from a statistical perspective, because there is no insight into the total population of real estate investors in Europe. The participants were selected from ING REF’s client population. A total of 60 experts from real estate investment companies and funds were invited to participate in the survey. Of these, 25 completed the survey, giving a response rate of 42%. In addition, 77 real estate bankers were also invited to take part, of whom 27 completed the survey. This gives a response rate of 35%. By research standards both response rates can be considered very satisfactory. The survey among the investors was conducted over the period May through July 2014; the survey for the bankers took place during July 2014.

Risk categories
Five main risk categories were distinguished, based on perceived common practice in the market:
• Country Risk (including macro-economic, demographic and political aspects of a country);
• Property Market Risk (including rental growth, vacancy risk, yields);
• Financial Risk (e.g. interest rate risk, the availability of debt);
• Structure Risk (e.g. legal and fiscal aspects);
• Management Risk (such as the track record of management).

Figure 1: Risk categories

Management Risk
- Track record own people
- Operational risk
- Tenure of key people
- Potential for exposure to controversial topics
- Morale of business partners
- Experience with asset class

Country Risk
- Stability
- GDP growth
- Size of population
- Inflation
- Employment
- Market orientation
- Growth rate population
- Consumer confidence
- Wealth

Structure Risk
- Concentration risk
- Diversification benefits
- Type of entity
- Fiscal burden
- Exit risk

Property Market Risk
- Pricing - absolute yields
- Rental growth
- Vacancy rate
- Pricing - yield change
- Demand
- Investment volume
- Real estate spread on government bond yield

Financial Risk
- Currency (level of exchange rate risk)
- Interest rate risk
- Availability of debt
Chapter 2: Results

Investors’ risk perception
How do investors perceive risk when assessing investment opportunities or setting their investment strategy? The respondents were asked to weight each of the five risk categories listed, with the sum of all categories totalling 100%.

When assessing possible investments/setting investment strategies investors rate Property Market Risk as the most important risk category by far, followed by Country Risk. Financial Risk and Structure Risk are felt to be of almost equal importance. Management Risk is perceived as least important by investors. Illustrated in a ‘spider web’ this paints the following picture:

As shown above, in this graph we see Property Market Risk on the right-hand side with a score of almost 40 points out of 100, illustrating that investors see this category as dominantly important. The second most important risk category for investors is Country Risk (approx. 25 points out of 100). By contrast, note the score for Management Risk (about 10 points out of 100). Now we have an insight in the way investors perceive risk when assessing investment opportunities or setting their investment strategy.

Investors’ view of banks’ risk perception
The investors were also asked how they think banks would weight these risk factors when reviewing the investor’s investment opportunities and strategies. Is there a difference between these two perspectives?

There are indeed differences. When we look at the way banks are expected to view these risk factors, this gives the following picture:

Investors assume banks look less at Property Market Risk and more at Management Risk. While investors think Management Risk is the least important for their own assessments, they put this factor in third place in their assumptions of the banks’ view. With regard to the other categories (Financial, Structure and Country Risk), the investors believe that they and the banks share the same view.

Bankers’ views of investors’ risks
Now that the similarities and differences between the investors’ view and what they presume the bankers’ view to be have become clear, this can be compared with the data provided by the respondents from the banks. This leads to the intriguing but complicated question:

What are similarities and differences – when it comes to assessing investment opportunities and strategies – between investors’ view, what they think the banks’ view is, and what bankers’ view actually is?
If bankers’ actual view is added into the equation, it turns out that investors are right to think that banks find Management Risk more important. However, whilst they expect banks to look less at Property Market Risk (perhaps they feel that they are the experts and banks are not), in reality bankers find this aspect almost as important as investors do. Contrary to what is expected by the investors, bankers perceive Country Risk as much less important than investors do. The bank respondents in general do show more consistency in their views, meaning that the standard deviation on their responses is lower.

Putting all three dimensions into a ‘spider web’ gives the following picture:

Figure 4: Risk perception by investors and bankers on five risk categories

The next section will examine this in more detail. Each risk category is made up of several aspects. When exploring the responses given on the aspects, does this show the same trends as those illustrated above?

Risk categories: focus on aspects

In the next set of questions each respondent was asked if they (investors, their view of banks and bankers) take into account a number of aspects that relate to each overall risk category. For each aspect the respondent could indicate if it was a) never, b) rarely, c) sometimes or d) always taken into account.

In order to analyse these answers, scores were assigned to each answer: 0 for never, 1 for rarely, 2 for sometimes and 3 for always. Total scores per aspect were calculated (corrected for the number of respondents) in order to get an idea of the perceived importance of each aspect.

This gave the following findings:

1) Country Risk

Within the Country Risk category the following aspects were taken into account: GDP growth, employment, inflation, political stability, market orientation, size of the population, growth rate of the population, consumer confidence and wealth. The most important aspect within Country Risk is political stability, but it is taken into account far more often by investors than by bankers. In fact, all aspects have a higher score with investors than with the bankers. This difference could probably be explained by the fact that almost all investors that participated have a multiple country strategy. In their investment decision-making they probably have therefore explicitly determined in which countries they (wish to be or) are present. To assess this, they will probably consider this fundamental aspect of each country. Bankers will probably have a less explicit view on this issue. However, this is not predicted by the investors, who expect banks to find this topic of almost equal importance.
2) Property Market Risk
In the Property Market Risk category, respondents were asked to indicate how often they take account of the following aspects: pricing/yield change, vacancy rates, demand, rental growth, investment volumes, pricing/absolute yield, and real estate spread on government bond yields.

In line with what was found above, aspects of Property Market Risk have the highest scores for both investors and bankers. However, this is not predicted by the investors, who expect banks to find this of lesser importance than themselves. In reality bankers actually take the aspects into account more often than the investors themselves, with the exception of ‘difference between property yields and government bond yields’, which banks take into account only sometimes. Another significant difference worth noting is that bankers look at vacancy risk more often than real estate investors do. For the other aspects the difference is smaller. Could the reason behind this be that real estate investors believe that they are the experts on this topic and the bank couldn’t possibly find this as important as they do? After all they are banks, and not real estate investors.

It seems that bankers, as providers of funds with a property as collateral, are slightly more interested in risks related to the property itself and the market for that specific property than investors.

3) Financial Risk
When looking at Financial Risk, the following aspects were identified: currency risk, interest rate risk and availability of debt. On these aspects, investors and bankers are more or less in agreement, with the exception of currency risk, which is taken into account less often by bankers than by investors.

4) Structure Risk
The next category to be explored was Structure Risk: this category consists of a number of different aspects, namely concentration risk, diversification, type of entity, fiscal burden and exit risk. All these aspects are of greater importance to bankers than they are to the investors, with the exception of fiscal burden. However, the differences are not significant, which is in line with what was found earlier with the weightings attributed to the overall category of Structure Risk.
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5) Management Risk

Finally the category of Management Risk was examined more closely. This category comprises the following aspects: morale of business partner, potential for exposure to controversial topics, experience with asset class, tenure of key people, operational risk and track record of key people. As expected from the weightings given on the overall risk categories, bankers find Management Risk aspects more important than investors do. The only exception is operational risk. For bankers Management Risk is probably very important since they will assess not only the quality of the underlying assets to a loan, but they will also look at the capabilities of their counterparty in managing the underlying asset. This will be of even greater importance in the case of debt facilities that are unsecured, e.g. corporate loans.

What are currently the most important aspects in the industry?

In the final section of the survey each respondent was asked to name the three aspects currently most important to them. This provides some further guidance on the degree of alignment on risk perception between real estate investors and their banks.

It has become clear how often investors and bankers look at certain aspects of the five main risk categories. It was found that for most aspects the majority of answers were either ‘sometimes’ or ‘always’. This indicates that the risk framework as set out in the introduction is more or less a common way of thinking in the real estate sector. It is good to know that there is a common understanding between banks and their clients. However, it would be good to know which aspects, out of all those mentioned or even ones that were not included in the survey, are currently perceived as most important to the industry. Therefore each respondent was asked to name the three issues currently most important to them. In the bankers’ survey respondents were asked which aspects are currently most important when reviewing their clients’ investment strategy. The investors were asked which aspects are currently most important to them and in addition they were asked which aspects are currently most important to banks.

When each answer is allocated to the five main risk categories (and each answer that does not fit in any of them is allocated to ‘Other’) this provides further insight into which risk types are important to real estate investors and their banks.

Most answers from investors can be allocated to Property Market Risk, which once again emphasises the importance of this issue. After that there was a variety of answers that could not be allocated to any of the categories.
These answers cover a variety of topics, but the majority relate to asset-specific circumstances such as location (mentioned very often), the catchment area and the quality of the asset. The third most important category is Country Risk, but the number of answers for Structure Risk and Financial Risk is not really much lower; or at least the difference is less than one would have expected based on the answers given earlier. Management Risk is once again the least important issue.

When looking at the answers given by bankers, the same number of answers was given to both Property Market Risk and Management Risk (22 answers each). Property Market Risk aspects were mentioned more often as most important (rather than second or third). The third most important category for bankers in this regard was found to be Structure Risk (with half of the answers given relating to financial structure, and exit risk also being mentioned very often). Bankers also gave quite a few answers in the ‘Other’ category. The majority of the answers related to asset-specific circumstances, just like the investors’ answers in this category. Location and asset quality were mentioned most often. Furthermore, the relationship between client and bank is mentioned a couple of times. Country Risk and Financial Risk were found to be of lesser importance.

Interestingly enough, when we look at what investors believe to be the most important aspects to banks, Country Risk is only mentioned once. Most answers given are in the ‘Other’ category. Again, a large number of answers related to asset-specific circumstances such as asset quality and location. A lot of investors also mentioned the importance to banks of risk assessment in general. One respondent expressed this as ‘SAFETY, SAFETY, SAFETY’. This suggests that banks are perceived as very risk-averse. One investor commented: ‘the opinion of the chief risk officer seems more important…’. Most answers relate to Property Market Risk, closely followed by Structure Risk and Financial Risk. Management Risk has fewer answers in total than Structure Risk and Financial Risk, but is mentioned more often as most important. Within Structure Risk exit risk again is mentioned very often.
Chapter 3 Conclusion

The results provide some insights into the extent to which real estate investors and banks have similar approaches in their risk assessment. The survey shows that to a large extent real estate investors and banks are on the same page when it comes to choosing which risk categories to take into account as well as their importance. Nevertheless, when examined in more detail some differences were found between the investors’ and the banks’ perception. The most important highlights are:

• Investors believe that banks are less interested in Property Market Risk, but that view is not shared by bankers. Actually, bankers share the view of investors. Both investors and bankers attach most weight to Property Market Risk. When looking at the individual aspects that make up Property Market Risk, banks even seem to be more focussed on this than investors.

• Investors believe that banks attach more importance to Management Risk, and this view is shared by bankers. However, management risks are of less importance to investors themselves.

• Several aspects of Country Risk are far more important to investors than to bankers. Investors also believe that these aspects are important to banks, but that is not the case.

• Bankers attach slightly more weight to Structure Risk and Financial Risk than investors.

• Within Property Market Risk, the aspect of the spread between the government bond yield and real estate yields is deemed much more important by investors than by banks. This is interesting, since this aspect is partly related to the property market, but partly also to country fundamentals.

• For bankers the most important aspects at the moment are related to Property Market Risks, Structure Risks and Management Risks. To investors, the most important aspects at the moment are related to Property Market Risk.

• When pinpointing the most important aspects at the moment, both real estate investors and banks also name aspects that cannot be allocated to any of the five main risk categories. These aspects mainly relate to property-specific circumstances, such as location, quality of the building and catchment area.

• To investors, the most important aspects at the moment for banks are in the Other category. A large number of the answers relate to risk assessment in general, indicating that banks are perceived as risk-averse.

• When asking both investors and bankers what the three most important aspects are at the moment, the highest number of answers from both relate to the property market. However, investors place more emphasis on yield and pricing, whilst bankers are more focused on rental income and cash flow.
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