CRE loan and CMBS Rating Methodology

Feedback Report

Scope Ratings would like to thank market participants for their feedback on its new Commercial Real Estate (CRE) loan and Commercial Mortgage-Backed Securities (CMBS) Rating Methodology published on 3 November 2023. This report addresses comments received confidentially during the request-for-comments period ended 19 October 2023.

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Related Research

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Market participants' comments on an alignment of our relationship between probability of default and expected loss with that in our General Structured Finance Methodology[1]

We note the intended alignment of the probability of default and expected loss relationship with that of Scope's General Structured Finance Rating Methodology. What was the original rationale for having a different probability of default and expected loss relationship in the current CRE loan and CMBS Rating Methodology?

Scope's answer

Our ratings are driven by both expected loss and probability of default. All our ratings have the same definition[2], and they all have an equivalent default probability and expected loss rate as per our idealised expected tables[3]. We aligned the probability of default and expected loss modelling for CRE loan and CMBS transactions with other ABS transactions to improve consistency and comparability.

Market participants' comments on our amendments to our all-in refinancing rate framework[4]

In the current methodology, there is a component for asset-type specific minimum yearly amortisation premium within the all-in refinancing calculation, and with the removal of this, do you think you are still capturing the refinancing risk fully? This could be particularly relevant specially in the current high interest rate environment.

Scope's answer

The updated methodology continues to account for asset amortisation, although no longer as part of the all-in refinancing rate framework. CRE assets' depreciation rates are captured via our maintenance capital expense assumptions. By amending the framework, we acknowledge that CRE exposures are a perpetual levered asset class with typically no amortisation of the principal during the life of a CRE instrument.

Our stressed refinancing rate risk assessment framework, based on a debt yield approach, allows us to capture refinancing risk even in a higher-for-longer interest rate environment. We believe our amended all-in refinancing rate assessment is well suited for assessing refinancing risk in CRE debt instruments and better than a sole interest coverage ratio or loan-to-value based approach.

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Bloomberg: RESP SCOP

[1] Comment edited for clarity
[2] See Credit Rating Definitions
[3] Scope Ratings Idealised Tables
[4] Comment edited for clarity

Market participants’ comments on the introduction of a scoring framework for determining assumptions and the rateability of construction and refurbishment CRE transactions[5]

The framework for determining the rateability of transactions with construction risk includes terms that are difficult to interpret (e.g.: ‘The AAA time to practical completion’, ‘The AAA cost overrun’, ‘The AAA non-completed asset liquidation cost’). It would help if these were quantified and expressed in simpler terms. Equally, we would like to understand how the AAA assumptions were defined (i.e. 40%, 25% and 20%). If you consider the rating stresses for time to complete and cost overruns and then factor in that these delays/increased costs will need (as part of a AAA stress) to be fully covered by initial debt structure. In practical terms, this would mean that a project will almost certainly be unviable due to the implied financing costs and a stabilised collateral value out of line with the debt quantum.

Overall, it would be helpful for the construction piece to have extended guidelines. However, it seems very difficult to get to < 2 with the proposed scorecard.

Effectively, there is one category for construction scale and one for complexity. This means that for large scale and complex projects you will need every other factor to get a score of 1 just to be considered rateable. This seems very punitive for some transactions. Furthermore, the scorecard seems very penalising around the contractor’s quality and procurement method, as there is a very small number of contractors that are investment grade.

Clarity of interpretation of the last two categories would be useful (‘pre-let’ and ‘tenant covenant’) as they do not apply for built-to-rent assets. The proposed scoring table seems to focus mainly on construction risks and not so much on the overall assessment of the construction phase of the project:

a) Business risk (e.g. project key competitive advantages, location of the asset being built, contractual risk allocation and experience of the various stakeholders). For example, in assessing the sponsor/developer quality, the sponsor experience should be assessed by specialist areas, which is particularly relevant for construction/refurbishment deals. (e.g. experience in residential vs office).

b) Financial risks (e.g. certainty of sufficient funding during construction to cover construction costs, including how cost overruns or delays are dealt with). For example, are costs overruns done on a ‘catch-up’ basis or do you draw on the contingency first? We believe that if the cost overruns need to be funded by additional equity, this provides material protection because it means that, i) the sponsor injects equity at an earlier stage when there likely still is equity upside and ii) the ring-fenced contingency is not drawn upon until much later in the process.

c) Transaction structure (e.g. debt funding as proportion of total costs, timing of sponsor equity to be drawn). One of the key mitigants of construction risk is a type of ‘equity first’ funding structure. What this means in practice is that the projects are very significantly de-risked by the time any equity is drawn.

Scope’s answer

CRE construction financings are exposed to additional credit risks compared to income-producing CRE. Therefore, realistic CRE construction financings are unlikely to be commensurate with the highest ratings. The scoring framework restricts rateable projects to the ones with a score lower than 2. This effectively limits the rateability of complex large-scale construction projects in their early advancement phases.

The definitions and application of ‘time to practical completion’, ‘cost overrun’ and ‘non-completed asset liquidation cost’ are described in section 4.4 Construction and refurbishment risk – scoring framework. Their quantifications in absolute terms for a 24-month project are presented in Figures 12 to 14 of the same section.

A highly complex large-scale construction project will likely score 5 in the first two categories. To be rateable, eight other criteria should not score more than 9 together (e.g. seven scoring 1 and one scoring 2 as a maximum).

The framework considers the construction phase of a project by considering the advancement to date of a project as one of the criteria.

[5] Comment edited for clarity

Prelet refers to secured future rental income, via forward executed lease agreements, expressed as a percentage of the total future estimated rental income for the property.

Tenant covenant refers to the quality of future tenants that have already committed to the property and the length of their leases.

We provide criteria-specific guidelines to assess the riskiness of a project. Quantitative guidelines are provided for five out of ten criteria while a qualitative assessment is required for the five other criteria. A qualitative assessment and expert judgment will be especially required to assess counterparty quality. Sponsors and contractors will be assessed on their capacity, ability and experience in completing projects on time and on budget (e.g. varying by real estate sector – commercial versus residential, complexity – low-rise versus high-rise, etc.).

We generally give limited quantitative benefit to uncommitted, unguaranteed equity support while we may consider it in a qualitative manner. We will quantitatively disregard coverage of cost overruns from equity unless a strong and tangible cost overrun guarantee is in place. We will model drawings as per the instrument's agreement and 'equity ahead of debt' drawings will generally result in a better credit assessment than 'debt first or 'pari-passu equity-debt' drawings (all else equal).

Market participants' comments on our updates of the illustrative rental value haircuts, property and vacancy costs and capitalisation rates[6]

The illustrative ranges of capitalisation rates have changed year-on-year, including some significant ones. Market participants would welcome more guidance on the methodology in terms of the correct application of those values. For example, how these apply to valuers' data at different points in time? Are these consistent with long-term market averages (i.e. trough a full economic cycle)?

Scope's answer

Our approach to determine our B and AAA capitalisation rates, and the interpolation between these two rating levels, have been consistent. However, results, in terms of stressed capitalisation rates and absolute stress levels expressed as a percentage of actual capitalisation rates, as the ones presented in our methodology, are a function of the point in time valuation of a property.

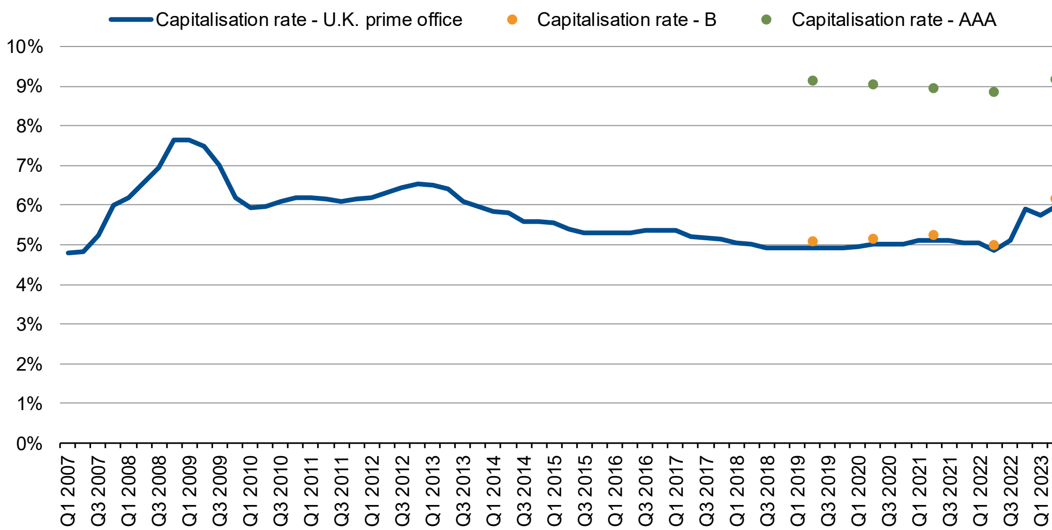
We generally derive the B rating-conditional capitalisation rate using the latest market value of the capitalisation rate plus a volatility buffer equal to half a standard deviation of the annual capitalisation rate change over a six-month period. The AAA capitalisation rate reflects a three-year downturn with through-the-cycle average minimum and maximum capitalisation rates increasing to three times their historical annual standard deviation (with a floor based on the average volatility of comparable jurisdictions and a minimum distance of 50% to the actual capitalisation rate). We adjust the multiplier to the standard deviation if capitalisation rate volatility in the observed period differs significantly from average observations. We apply a linear interpolation between B and AAA capitalisation rates for the other rating categories. Our $CapitalisationRates_{C}$, $CapitalisationRates_{CC}$, $CapitalisationRates_{CCC}$ and $CapitalisationRates_{B-}$ capitalisation rates have a floor at the B category. Our period of observation typically spans from 2007 to 2023 but may vary according to the property type and the location.

The point-in-time valuation of a property primarily matters to determine our stressed capitalisation rates and absolute stress levels expressed as a percentage of actual capitalisation rates. Our illustrative stressed capitalisation rates and illustrative absolute stress levels expressed as a percentage of actual capitalisation rates are valid for most recent (H1 2023) property valuations. Such illustrative assumptions must not be used for property valuations performed at a different point in time. For those, stressed capitalisation rates and absolute stress levels expressed as percentage of actual capitalisation should be derived over a different period (i.e. the period of observation should end at the date of the property valuation).

Our B stress level capitalisation rates accordingly move as the latest market level of capitalisation rates evolve plus a volatility buffer. So do our B level 'absolute stress levels expressed as percentage of actual capitalisation rates'. Our AAA level is a function of through-the-cycle average minimum and maximum capitalisation rates and volatility and it will change if either of these two elements change over the observed period.

[6] Comment edited for clarity

Figure 1. Observed UK prime office capitalisation rates and our associated capitalisation rates



UK Office – prime (London excluded)	As of Q2-2022		As of Q2-2023	
	B	AAA	B	AAA
Stress capitalisation rate (%)	5.0%	8.85%	6.1%	9.2%
Absolute stress levels expressed as a percentage of actual capitalisation rates (%)	3%	82%	3%	54%
Average (minimum – maximum observed)	6.2%		6.2%	
Standard deviation	8.2%		9.2%	

Source: Scope Ratings

Changes to the Rating Methodology after the call for comment

No analytical changes have been made as a result of comments received but we added some further editorial clarifications as a result. The final version of the CRE loan and CMBS Rating Methodology is available on www.scoperatings.com.

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