Developing a Tenant and Lease Resilience Score, The CCIM Tenant Resiliency Index (TRI)

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The CCIM Tenant Resiliency Index (TRI)

1. Introduction

Commercial Real Estate leaders from CCIM (Certified Commercial Investment Member) and the Homer Hoyt Institute held a think tank conference concerning how COVID-19 pandemic may have and could permanently alter the Commercial Real Estate (CRE) industry.[1] Among the many topics discussed, one stood out as requiring further research. A new concern within the industry is whether tenants could work remotely and maintain their revenue stream. In the past, credit scores and financial condition dominated risk analysis. But now, new questions arose, particularly for office and retail tenants and leases. This research is focused on office and retail tenants and leases and did not delve specifically into industrial property nor multifamily.

A new perspective on tenant resiliency resulted in trying to answer the question of what information do we wish to have for risk analysis, that may not have been seen as important, prior to the 2020-2021 pandemic that shut down so many tenants. The task of trying to measure tenant resiliency is the aim of this research.

During the COVID-19 pandemic, a few academic papers (Wang and Zhou, 2020, Steig, 2020, and Williamson, 2020) address the resilience and performance of firms during this unprecedented time. Wang and Zhou found that firms who are more resilient to a pandemic are those firms that allow a relatively higher fraction of jobs to be performed remotely.[2] Although such firms may outperform, this trend toward working from home (WFH) has had a greater impact on occupancy rates in CRE spaces and may portend a new hybrid approach to work that allows for some downsizing. The return in late 2021 of Face-to-Face interactions (FTF) has been welcome in the office market as well as brick-mortar retail spaces. The pandemic also illuminated the benefits of single tenant net leases as they were considered more financially secure and less volatile investments.[3]

Researchers at JLL identified obsolescence as a gateway towards understanding resilience. They identified the three key factors that drive obsolescence to be legislation, corporate requirements, and technology[4]. Sharing a similar sentiment, Deloitte believes that both owners and operators should align their mindset

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[1] January 20, 2021 was the initial thinktank discussion including representatives from the Homer Hoyt Institute and CCIM leadership.

[2] Wang, Chongyu, and Tingyu Zhou. "Face-to-Face Interactions, Tenant Resilience, and Commercial Real Estate Performance." *SSRN*, 8 Dec. 2020.

[3] Seaward, Steig, et al. "Single Tenant Net Lease Retail Report 2020." Colliers, www.colliers.com/en/research/single-tenant-net-lease-retail-report-2020.

[4] Williamson, Karen. "From Obsolescence to Resilience." JLL, mts.sustainableproducts.com/Capital_Markets_Partnership/DueDiligence/4/JLL-Obsolescence-Resilience.pdf.

to the tenant's investment decision making[5]. An accurate TRI measurement system help offer insights into whether a tenant can sustain operations through an economic downturn or pandemic-like event.

Below we refer to a TRI Scorecard but the name that might be used when released is the CCIM Tenant Resiliency Index.

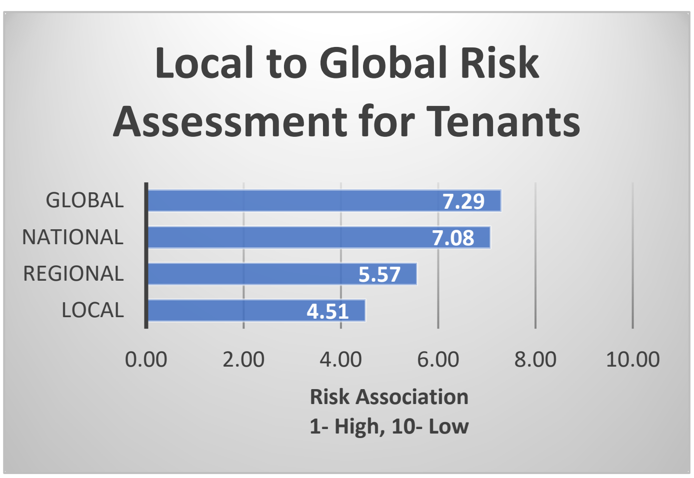
2. Survey Instrument and Data

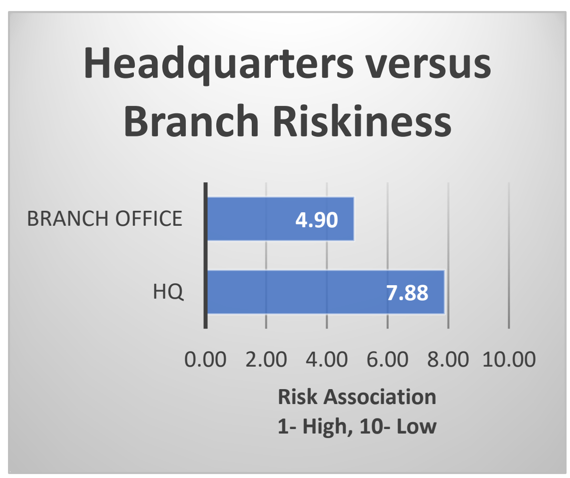
Prior to developing a survey instrument, several roundtables and focus groups brainstormed a list of potential criteria that could be utilized in a TRI. Starting with a modest group of CCIM and Homer Hoyt leaders and then providing that as fodder to three dozen Policy Advisory Members of the Burnham-Moores Center for Real Estate, in the spring of 2021, we came up with a list of potential criteria. A survey was developed and tested on a few professionals familiar with CRE. This survey was then sent randomly to CRE Professionals via contacts of Dr. Norm Miller on LinkedIn. Once the sample crossed 75 respondents, we started to analyze the results, and more responses continue to confirm prior results. Our 99 observations are summarized below.

3. Survey Results

Headquarters as a signal of stability

To begin the survey, participants were asked to assign a weight on a scale from 1 to 10 for each tenant classification in terms of lease default risk. On average, the responses favored both global tenants and those who operate in a headquarters as they assigned a lower risk association of 7.29 and 7.88, respectively. Meanwhile, both local-based tenants and branch office are perceived to have a higher risk profile than those who operate on a grander scale. To corroborate HQ's having a greater risk profile, prominent retailers were forced to cut their real estate portfolios as much as 30% as is the case for Ralph





[5] Berry, Jim, and Kathy Feucht. "2021 Commercial Real Estate Outlook." Deloitte Insights, 3 Dec. 2020, https://www2.deloitte.com/us/en/insights/industry/financial-services/commercial-real-estate-outlook.html

Lauren. During the height of the pandemic, REI sold their recently built headquarters centered around nature and collaboration, for reasons that enticed Facebook to purchase the building.[6]

Industry Sector

Industry sectors are seen as very critical factors in determining tenant resiliency. Participants are asked to assign a risk ranking on a scale from 1 (high risk) to 10 (low risk) for the industry categories below. *Figure 2* illustrates the disparity of perceived average risk for 28 different industries. Utility and Government tenants maintain the lowest risk profile with a weighted average of 9.3 which is closely followed by Health-Related Services (Hospitals, Medical Clinics, and MOBs) with low-risk rating of 8.1. The

[6] Thomas, Lauren. "Covid Changed How We Think of Offices. Now Companies Want Their Spaces to Work as Hard as They Do." *CNBC*, CNBC, 10 Mar. 2021, https://www.cnbc.com/2021/03/10/1-year-into-covid-employers-rethink-offices-and-function-matters-most.html.

highest risk profiles belonged to Theaters and Fitness Centers with a risk rating of 4.0 and 4.1, respectively. Supported by Figure 2, Deloitte recorded average rent collections for industrial, office, apartments, and healthcare-based REITs exceeded 90% during April-July 2020 period.[6] In contrast, the rent collections for U.S shopping center REITs decreased 50% in April and continued to recover to 80% in August.[7] Interestingly, CBRE recently reported that as a result of resilent employment, the tech industry office submarket remained the most resilient throughout the pandemic in contrast to other office submarkets.[8]

Risk by Tenant Size and Remote Work Potential

The size of a firm can greatly impact a tenant's risk profile as larger firms tend to hold a lower risk profile compared to smaller firms. Here, *Figure 3* shows lease risk in terms of employee size. Participants assigned a firm with 100+ tenants with a low risk profile of 7.26 and a higher risk profile of 4.58 to tenants with an employee base between 0-25 employees.

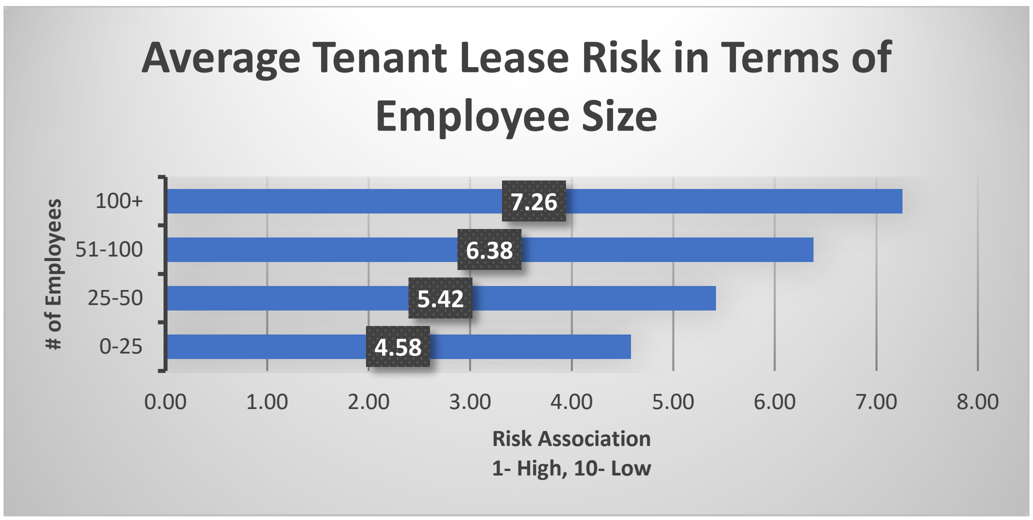


Figure 3 Average Tenant Lease Risk for Each Range of Employees

Figure 2 Mean Risk Associated to Each Industry Sector (as of 9/6/2021)

During the COVID-19 pandemic, some firms were able to operate remotely while still honoring lease contracts. Tenants who were more resilient to social distancing performed better than those operating in a customer centric environment.[9] Respondents were asked if the ability to work remotely significantly impacted lease risk and over 60% of answered Probably or Definitively Yes.

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[7] Hudson, Kris. "Tech Industry Remains Biggest Force in Office-Leasing Activity despite Pandemic-Induced Slowdown." CBRE, CBRE, 22 Oct. 2020, https://www.cbre.us/about/media-center/denver-sees-robust-tech-job-growth-and-moderate-office-rent-growth-in-cbres-annual-tech-30-report

[8] Wang, Chongyu, and Tingyu Zhou. "Face-to-Face Interactions, Tenant Resilience, and Commercial Real Estate Performance." SSRN, 8 Dec. 2020. See Face-to-face Interactions, Tenant Resilience, and Commercial Real Estate Performance by Chongyu Wang, Tingyu Zhou : SSRN

Is the ability of employees to work remotely a significant lease risk factor?	
Response	**Percentage**
Definitely Yes	22.7
Probably Yes	38.6
Might or might not	27
Probably Not	4.5
Definitely Not	0

Financial Condition

The financial condition of a tenant strongly signals whether they can withstand tumultuous economic conditions or pandemic conditions such as like COVID-19. To determine which financial metric is most influential, participants were asked to rank each measurement by level of importance on a scale from 1 (Least important) to 10 (Extremely important) in terms of tenant risk. The measurements include the following: Solvency Measured by Month-Month of Operating Cash Reserves, Current Ratio, and Total Debt: Total Assets. Solvency proved to be the most important financial metric with a "Very Important" rating of 7.59. The solvency financial metric can offer further insight into a tenant's liquidity especially during uncertain times such as COVID-19. Meanwhile, Current Ratio and Total Debt: Total Assets were deemed "Moderately/ Very Important" Financial metrics.

Note that in testing the final tenant resiliency measure, unless a tenant was a public firm, most brokers did not know these three measures below.

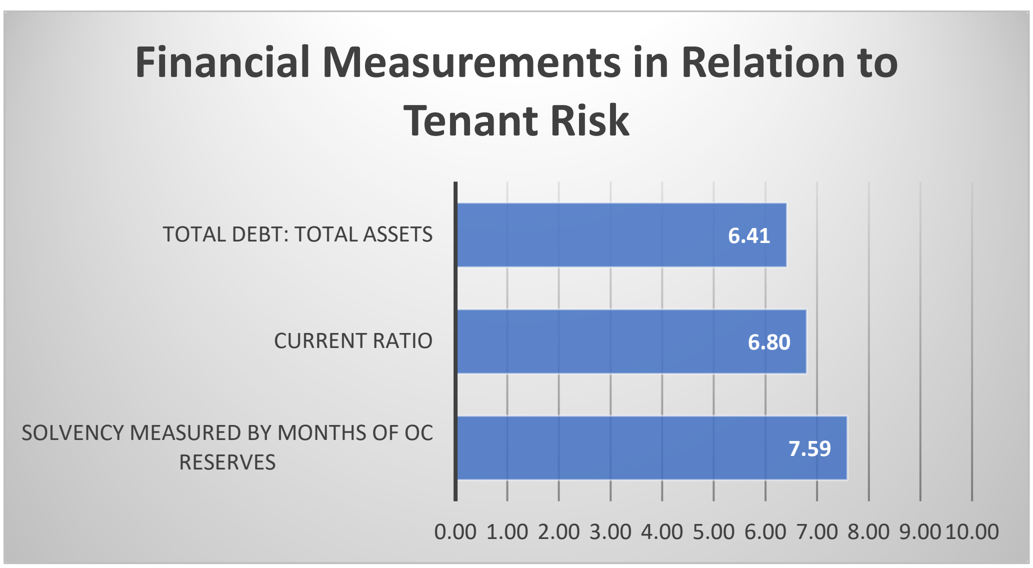

Figure 4 Importance of Each Financial Measurement in Terms of Tenant Risk

The pandemic illuminated the financial reserve shortcomings within many companies. To become more responsive to a pressured financing environment, CRE tenants could implement a data-driven red flag finance function to enhance their responsiveness and efficiency to potential recessionary scenarios in the future.[10] The established technology industry established its value during this period as it did not depend on bricks and mortar for sales, nor the physical supply chain for delivery.[11]

Profitability and Growth

In this section, participants were asked to assign a risk metric for questions centered around a tenant's profitability and growth. To begin, participants correlated the years in business with tenant risk. As shown in *Figure 5*, Younger firms had a higher average risk association of a 3.55 while gradually increasing to a 5.81 after 5 years and reaching 7.90 as a tenant's business achieves 11 years of operation. Similarly, *Figure 6* shows responses regarding the level of importance for years of profitability of newer vs. seasoned firms. The results proved to be fairly similar as particiapnts favored the sentiment of "Moderately/Very Important" with importance ratings of a 6.12 and 6.5, respectively. In addition, participants were asked to relate the annual growth rate of gross revenues of the past 3 years to tenant risk on a scale from 1 (high risk)- 10 (low risk). Participants continued to rank the level of importance for being a top 10% industry leader in respect to tenant risk which attained an average of 7.70 or "Very Important" sentiment. Lastly, to specify profitbaility metrics for the retail indsutry, repsondents were asked to rate the level of importance of retail sales per squarefoot and profit margin metrics. Ultimately, the results demonstrated a similar response as it too was deemed "Very Important" with an average of 7.33. Corresponding to and supporting these metrics, tech dominated submarkets continued to generate the strongest rental gains and office space absorption rates, equating to a quarter of the sublease space on the market.[12]

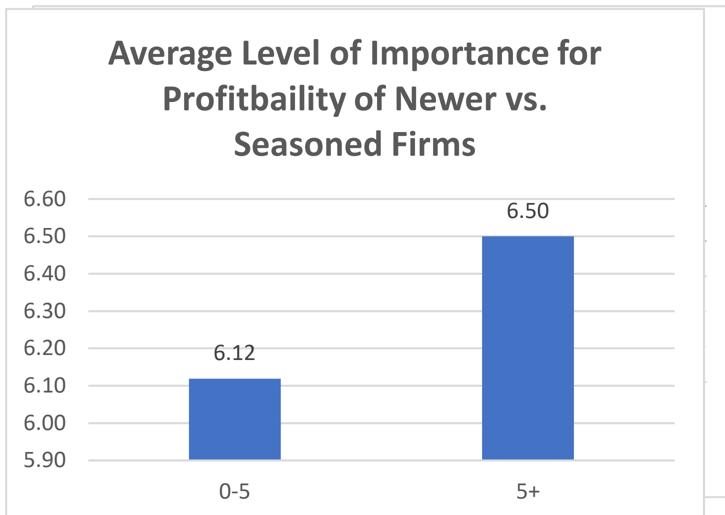

Figure 5 Correlation Between Years of Operation and Tenant Risk

Figure 6 Average Level of Importance for Profitability of Newer vs. Seasoned Firms

Level of Importance for:	Importance Measure
Being top 10% industry leader in respect to tenant risk	7.70
Retail sales/ sf and profit margin metrics	7.33

[10] Berry, Jim, and Kathy Feucht. "2021 Commercial Real Estate Outlook." Deloitte Insights, 3 Dec. 2020, https://ww2.deloitte.com/us/en/indsutry/financial-services/commercial-real-estate-outlook.html

[11] Hudson, Kris. "Tech Industry Remains Biggest Force in Office-Leasing Activity despite Pandemic-Induced Slowdown." CBRE, CBRE, 22 Oct. 2020, https://www.cbre.us/about/media-center/denver-sees-robust-tech-job-growth-and-moderate-office-rent-growth-in-cbres-annual-tech-30-report

[12] Hudson, Kris. "Tech Industry Remains Biggest Force in Office-Leasing Activity despite Pandemic-Induced Slowdown." CBRE, 22 Oct. 2020, https://www.cbre.us/about/media-center/denver-sees-robust-tech-job-growth-and-moderate-office-rent-growth-in-cbres-annual-tech-30-report

Figure 7 below illustrates a much higher risk rating of 4.61 for tenants who have an annual growth rates (AGR) in revenues of 0-5% in contrast to those who have an AGR of above 5%, at a moderate risk of 6.38 for a 5-10% AGR and a lower risk of 7.07 for 11%+ AGR respectively.

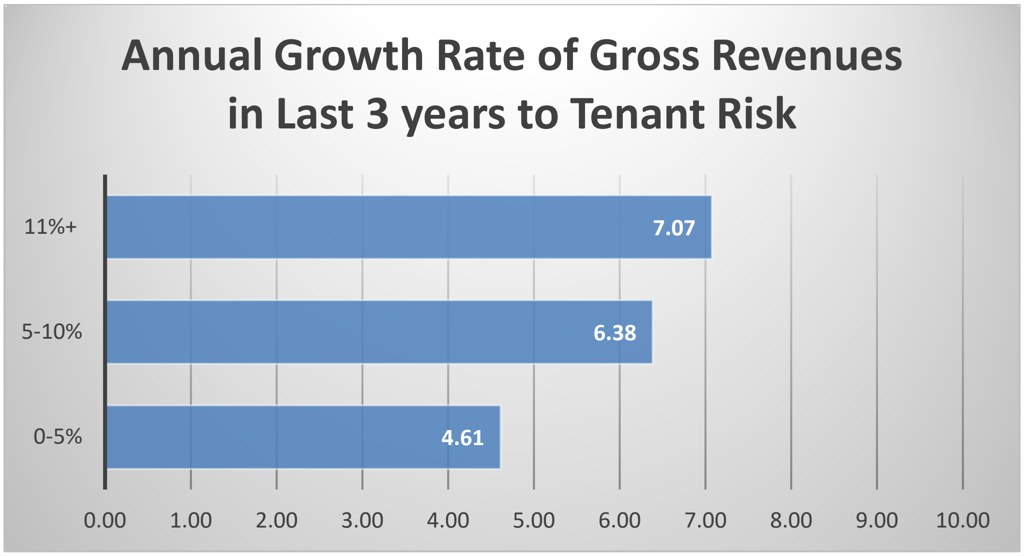

Figure 7 AGR of Gross Revenues to Tenant Risk

Length of Lease and Lease Terms

Is tenant resiliency reflected by length of lease and specified lease terms? To further address this matter, participants were asked five related yes/no questions and to rank the importance of each question at the end of the section. To begin, participants were asked if a NNN lease impacts tenant risk, of which 76% voted yes. Interestingly, participants exhibited little favorability for whether a longer lease lowers risk as 54% responded "yes" and the remaining 46% answered "no". In turn, respondents proceeded to answer if larger deposits significantly lower risk of which roughly 71% of participants communicated "yes". To lower risk, 76% of the respondents said that it is necessary for a tenant to present a letter of credit from the bank in the case of rent deficiency. Similarly, 57% participants shared that automated rent collection lowers risk. Overall, the average scoring deemed that NNN leases, and the requirement of a Letter of Credit are viewed as most important in evaluating tenant risk, while automated rent collection is the least important.

Level of Importance in Lowering Tenant Lease Risk	Importance Rating
Does a NNN lease lower tenant risk?	6.62
Does Tenant have a longer lease?	5.79
If Tenant Has a Larger Deposit	6.43
Letter of Credit Required for Lease Deficiency	6.45
Automated Rent Collection	5.05

Tenant Improvements Paid for by Tenant and Uniqueness of Space

Do tenant improvements affect the risk profile of a tenant? Participants were asked what percentage of tenant improvements (TI's) correlates to a lower risk profile. On average, participants identified that if 62% of the TI's are paid for by the tenant, then that can lower their tenant lease default risk. In terms of customized spaces, 73% of participants hinted that it was a factor that increased tenant lease risk. Lastly, participants were asked to provide a $TI/sf that is considered significant of which they responded $50/square foot or more. According to Deloitte, US shopping center REITs have been able to significantly recover from the 50% decline in rent collection with the offset of TI improvement and Leasing commission costs.[13]

Economic and Political Climate of City, County, and State

To further create an accurate tenant resiliency index, respondents were asked to assign a level of importance to questions centered in the economic and political climates where the tenant operates. In terms of relative cost of doing business and the tax environment in the country or market of operation, participants assigned a "Moderately Important" ranking of 6.13 for tenant risk analysis. Similarly, the importance of local regulatory environment shared the sentiment of "Moderately Important" with a ranking of 5.93. Lastly, the importance for economic base resiliency and stability of the metropolitan region in which the tenant is located was deemed "Very Important" with a ranking of 7.13.

Level of Importance for:	Importance Measure
Relative cost of doing business and tax environment in the country for tenant risk analysis	6.13
Local regulatory environment on tenant risk analysis	5.93
Economic base resiliency and stability in metro/ region for which tenant is located	7.13

[13] Berry, Jim, and Kathy Feucht. "2021 Commercial Real Estate Outlook." Deloitte Insights, 3 Dec. 2020, , https://ww2.deloitte.com/us/en/indsutry/financial-services/commercial-real-estate-outlook.html

Overall Weighting of Various Tenant and Lease Risk Factors

To standardize the index, participants were asked to assign a weight of 1-10 based on level of importance for each of the sections listed above. The average weighting is displayed in *Figure 8*. Profitability and Growth in conjunction with the Financial Conditions were most important in analyzing tenant risk. While Tenant Size and Economic/ Political Climate shared a “Very Important” sentiment, but not as important as the financial measurements. This feedback along with other inputs provided directly to the researchers was used to develop the beta test TRI Scorecard.

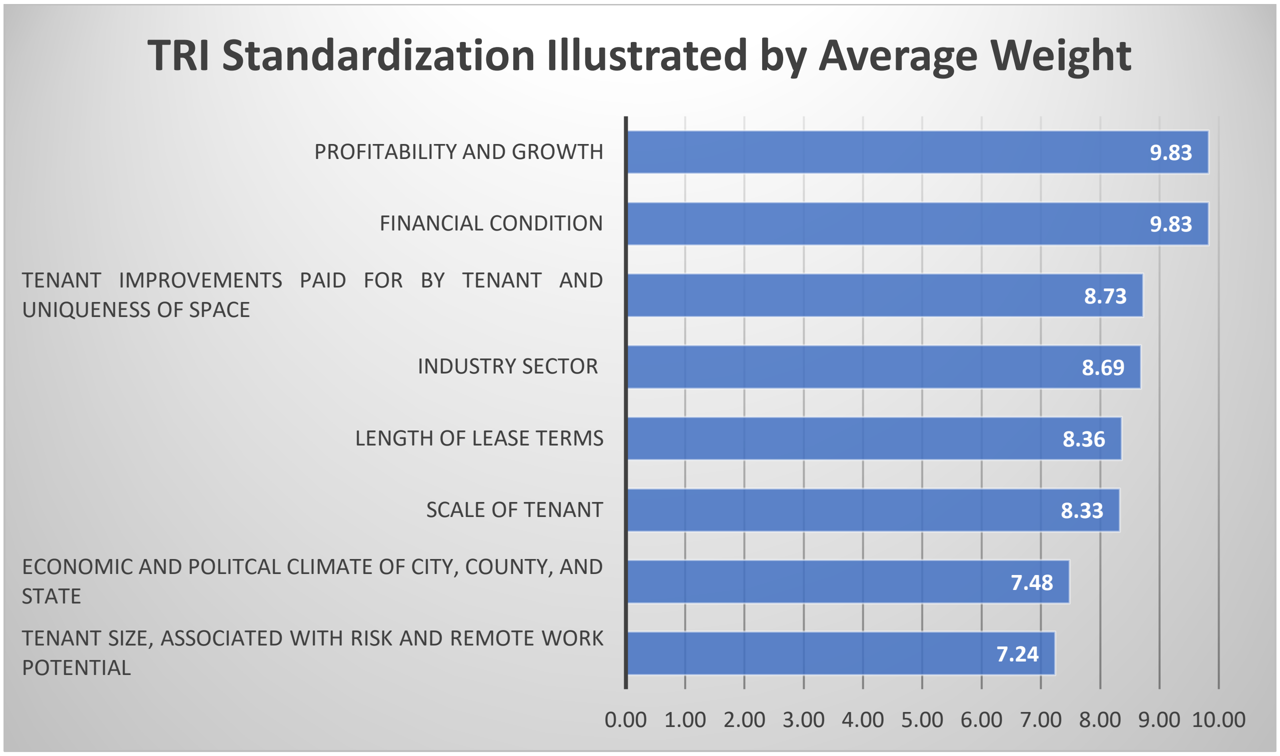

Figure 8 Standardization of Each Section by Level of Importance

4. Tenant and Lease Resilience Score

Based on a test of the beta TRI, utilizing the data gathered above, the following results were obtained, with an average score of 67.5, as shown in Figure 9 below. It is hard to know if above average leases were selected, as the sample below is fairly small, at 27. At the same time, it is okay if the average lease has a score above 50, as long as we know what it is. If an item in the scorecard was left blank it received an average score by default on the item, and if an entire scorecard was left blank the score would be exactly 50.

Note that all of the respondents to the scorecard were able to answer all questions except for the question on current ratios related to financial solvency. Only a few respondents could answer this question and perhaps that was a result of being a public firm. This suggests that if we can rely on the overall financial condition statements, we will be able to get better results. While the current ratio is great information, it is also important to make this scorecard simple and reasonably correct, without over burdening anyone.

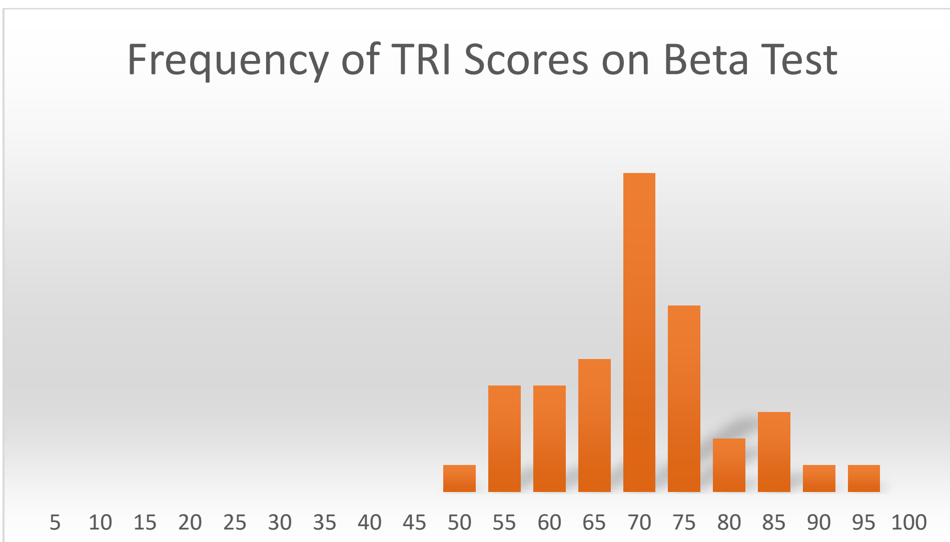

Figure 9 Beta test results from a small sample of mostly CCIM Instructors

The lease scorecard has now been tweaked slightly based on feedback from the initial beta test respondents. For example, utility companies are now grouped with government, and the scoring was tweaked to put more weight on government type tenants. We have also added self-storage and to tenant types. A new Beta 2 scorecard has now been developed and we expect an average score of about 70 to 75 on this new version. We also have discovered that few brokers can answer the financial condition metrics with specifics, but have some idea of profitability and growth rates, so these are more likely to drive TRI scores in the future.

Conclusions

A Beta 4 version of the CCIM Tenant Resiliency Index has now been developed and will be provided as an attachment to this white paper. Most of the factors included are common sense, but no one has aggregated these measures before. We may want to split out Retail and Office properties separately but then we will need to be careful about aggregate comparisons. This is an on-going research project with the input of CCIM leadership, faculty and members.

The Index does not allow for manipulation internally without a password. We will need further testing to be able to explain the relative rankings of tenants and leases, beyond those metrics which are, again, common sense. For example, longer term leases to government, utilities and or established tech companies will generally rise to the highest tenant resiliency scores. At the same time, we now have a fairly comprehensive and novel measurement of tenant resiliency based on the input of experts that did not exist pre-pandemic.

Resources

1. Wang, Chongyu, and Tingyu Zhou. “Face-to-Face Interactions, Tenant Resilience, and Commercial Real Estate Performance.” *SSRN*, 8 Dec. 2020. See Face-to-face Interactions, Tenant Resilience, and Commercial Real Estate Performance by Chongyu Wang, Tingyu Zhou : SSRN
2. See the Colliers Single Tenant Net Lease Retail Report 2020 | Colliers
3. See Karen Williamson at JLL, Youtube (299) From Obsolescence to Resilience - YouTube
4. Berry, Jim, and Kathy Feucht. “2021 Commercial Real Estate Outlook.” Deloitte Insights, 3 Dec. 2020,https://ww2.deloitte.com/us/en/indsutry/financial-services/commercial-real-estate-outlook.html
5. Hudson, Kris. “Tech Industry Remains Biggest Force in Office-Leasing Activity despite Pandemic-Induced Slowdown.” CBRE, CBRE, 22 Oct. 2020, https://www.cbre.us/about/media-center/denver-sees-robust-tech-job-growth-and-moderate-office-rent-growth-in-cbres-annual-tech-30-report
6. Thomas, Lauren. “Covid Changed How We Think of Offices. Now Companies Want Their Spaces to Work as Hard as They Do.” CNBC, CNBC, 10 Mar. 2021, https://www.cnbc.com/2021/03/10/1-year-into-covid-employers-rethink-offices-and-function-matters-most.html.