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TRANSCRIPT

Understanding Tenant Default Risk with Income Analytics

Featuring:

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Matt Richardson, Co-Founder & CEO of Income Analytics

Rene:

My name is Rene Veerman. I'm Head of Real Estate at MSCI, and today I'm speaking with Matt Richardson, CEO and co-founder of Income Analytics. Matt, thank you for taking the time to speak with me today. You are co-founder of Income Analytics. What is Income Analytics? And what was the reason to start it? And one of the key scores that you generate at Income Analytics is the income scores. Could you tell us a little bit about that?

Matt:

It's probably just based on the fact that we're in the commercial real estate market for the best part of 30 odd years. And Income Analytics was really set up to answer a very simple question, which I've never found a suitable answer to. And that is, what's the probability that the tenant in my building is gonna go bust during the term of the lease? It might sound like a very simple question. It's one that's never really been answered by the industry. And it's so fundamental to what we do. And that was what Income Analytics was set up to do, just answer that simple question, and put a number on it. And it's tremendously important, as you know, because up till now, we've been through COVID. What we what we see is the importance of the cash flow from buildings, you know, this is what actually drives returns. Your own numbers MSCI show this, the bulk of your return for investors comes out of the income return. And yet very little research has ever been done on how good tenants are, how secure they are, et cetera. So that's really what Income Analytics was set up to do, answer that question. In terms of, you know, why it's so important? In the last few years, we've seen a huge amount of capital flowing into the market. You know, we've seen huge upturn in global demand for commercial real estate investment, primarily because of low interest rates, but also because, you know, people are looking to diversify portfolios, and that's simply not a return in the bond market. And so the income piece of this has to suddenly become really, really important to everyone and people are waking up to the fact that property isn't just about valuations. It's about cash flow, it's about cash business. And let's not forget those cash flows that service the debt, it's those cash flows that pay the insurance premium out, it's those cash flows that manage and support all of those pension schemes that invest in that sector. So, you know, we felt was a real demand for this, and as I said, having worked in the industry for over 30 years, I couldn't find a quantitative measure of risk. And that was why we invented the models to create the income scores, which are a quantitative measures of cash risk effectively for real estate investors. And that's a global first effectively. And really, what we're trying to do, I suppose with this, is bring commercial real estate into line with the other asset classes.

Rene:

Thank you, Matt. That was very helpful. Can you tell me a little bit more detail about the income score, how it actually makes things comparable for investors and what people should pay attention to?

Matt:

If you look at the whole industry, the way that we've looked at tenant risk and cash flow risk has been to look at credit rating. And a credit rating isn't actually a measure of cash flow risk. It's a point in time analysis of the credit worthiness of a company. We felt that wasn't the right answer to the question. What we felt was more applicable was actually, why don't we look at how companies fail, 'cause when they fail, they don't pay their rent. So that was our starting point. It was to shift the industry away from its sort of slight addiction to credit reports, and start focusing on quantitative measures of corporate failure. And that is what the income and the income scores are about. What they are, is measuring the probability that company will fail. We came across a lot of work that have been done by the credit reference agency, Dun and Bradstreet in this area with something called their failure scorecard. And they maintain a global database of companies that fail and look at the various factors that feed into that. What we've done effectively is built a series of models. Over regression models effectively, they go back in time, and look at the different factors that affected different companies, different sizes and different sectors, and that ultimately led to them failing. And using that data, we were then able to go back over time and look at the history of patterns that occur, 'cause there are very established patterns of how companies respond to different types of economic environments. And the income scores were developed from those to effectively say, how frequently to certain types of companies with certain characteristics in a specific market go bust. So we move away from this credit rating idea of how credit worthy is something to actually basing it on outcome numbers, real numbers, things that happened. And actually, this is not revolutionary. What we've done here is brought a lot of the analytical tools from the bond market, you look at how the rating agencies in the bond market look at default, they look at the regression models, and they look at the history of how frequently certain types of companies default on their bond payments. And really, we've done the same thing, but we've done it in a bigger universe. Instead of companies that have issued bonds, we're looking at 420 million companies around the world that potentially all pay rent to the landlords. And we're looking at the patterns in those. And that's what the scores are the scores have been designed, so that the user can look in and, and create a quantitative measure of risk, i.e, not a subjective label, like a low risk or a series of numbers and letters. It's an actual percentage probability that can be applied to a cash flow. But against the rent, I've actually quantified in cash terms. And that's what the income scores really add value to process. Just for the first time I have a subjective measure of how probable it is, my cash flow could be lost through a corporate failure. And I can apply that whether I'm a valuer, whether I'm investor, whether I'm a lender.

Rene:

Thanks for that. Matt. You mentioned, lenders, valuers and investors as potential clients and as actual clients of your product. You've worked as an investor for a long time as head of research. How would investors use this information in their overall investment process?

Matt:

I think it can be applied throughout the entire investment process from filtering and underwriting through property management to disposal and for portfolio construction, et cetera. But the cash flow derived from property is the core component there. So whether one is looking at putting a tenant into a building, you're gonna be using this kind of information to assess the risk associated with the tenant failing, and therefore defaulting on the rent. It could be simply used in that regard. It can be used in asset underwriting as an approach because of course, you're effectively buying a building an asset, which has a cash flow of future cash flow associated with it. And again, the same question, how secure is that cash flow? What risks Should I attach to part or all of that cash flow failing or defaulting. As a manager, obviously, it's extremely valuable to be able to mark to market my risk every day. So I can actually look and see, how is the potential loss of cash flow, likely to affect me today and going

forward, and I can monitor that. And that's incredibly useful for things like the compliance teams, or management reporting. And it's in the larger houses, it's extremely useful for things like comparables with equity and debt exposures, because actually, many investors may well hold equity in a company, they may well hold fixed income, and they may well hold leases against that company, which is another form of counterparty risk. So the way this data can be used as well, is to give you a holistic view of your risk across all of your asset types. And then again, with disposal, you know, we can look at we can model? What are the impacts, finally, of removing certain types of cash flows, sectors, certain qualities and cash flows from our portfolio? And how do we reshape the strategy and structure of the portfolio going forward? There really has application through the entire phase.

Rene:

Thank you. You mentioned the comparison to other asset classes, and one of the things you're doing is creating a debt equivalent rating on investments. Could you tell us a little bit about how you do that? And what compatibility opportunities to create?

Matt:

Sure, I mean, it's an area I'm continually shades had plenty of discussion with investors. But one of the big problems that we found in commercial real estate, and it goes you know, we go back through every cycle. commercial real estate invariably is at the heart of whenever there's a downturn, you invariably find that commercial real estate markets play a very large part. And a core part in that is the slight disconnect between those in the real estate markets and those outside. And there's the old adage that potentially a lot of investors and bankers don't understand real estate and most people in real estate don't necessarily understand finance and banking. What we set out to do here, once we could measure the probability of a failure, or potential failure in the future, what we were able to then do is say, Well, actually, how would that compare with the current, you know, projected failure rates in the corporate bond market. Now, we're not assuming that a property is the same as a bond, it has the bond like qualities, it has a duration risk, has cash flow attached to it, et cetera. But what we were trying to do was catch the risk in a way that other sectors, particularly the banks, the fixed income sector, could understand quickly, where the risk sat. Now we're not saying necessarily a building can be triple B or double B. But what we can say is that the risk of the cash flow failing as a percentage attached to it, and we can map that into the bond market and say, what does that look like? What does it feel like? Well, it looks akin to the same level of risk as if I was taking the sake of argument, a triple B bond or a double B bond. And the reason that's very important is, many people will understand the quality of that risk in an instant. If I say low risk, or I use a subjective label, that's not something I can feed into a model. And so this is comes back to this very important point that we discussed right at the beginning. What we're trying to do here is move the industry away from subjective labeling towards quantitative measures of risk that can be applied to investment strategies, and underwriting. That's why this is I think, really, really important.

Rene:

Thank you very much, Matt. This is very interesting. It's very exciting time for MSCI and Income Analytics. The first Income Analytics product will be launching on the MSCI platform in the coming weeks. So please do look out for more information about this at either MSCI or Income Analytics. Thank you very much.

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