Yardi Investment Suite

Investment, NOI and Covenants: Managing the Risks

In any business cycle, investors and asset managers need to draw on all available strategies and tools, including the most effective technology.

TOPICS COVERED IN THIS YARDI SPECIAL REPORT

- Assessing risk management amid market turmoil
- NOI and debt covenants: a crucial connection
- Reading real estate cycles post-pandemic
- Navigating a tight lending environment
- How automation enhances decision-making

The commercial real estate industry is on high alert, and for good reason. The Federal Reserve's long string of interest rate hikes, a series of high-profile bank failures and post-pandemic inflation are among the economic factors that are producing a cautious outlook among investors and asset managers.

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RYAN SEVERINO
Columbia University & New York University

Recent history suggests a major bright spot. "It's not 2008 or 2009, not remotely," observed Ryan Severino, an economist and adjunct professor at Columbia University and New York University.

But though we seem not to be witnessing a replay of the Great Recession, capital sources are raising standards and lending more cautiously. That poses a challenge to the Fed's goals of financial stability, full employment and under-control inflation. And though the current situation is not a replay of previous crises, the central bank is "working with a different calculus than just a year ago," Severino said.

For capital professionals working the long game, this could be troubling. Some readers may remember a brief period in the early 2000s, when the economy was enjoying a prolonged upward trajectory and some otherwise savvy market participants were embracing the notion that real estate was no longer cyclical. As the end of that decade showed all too clearly, that is not the case. But the COVID-19 pandemic has challenged traditional notions.

"We're in a period in which we can't think about cycles independent of disruption," observed Hugh Kelly CRE, a veteran real estate economist and principal at Hugh Kelly Economics in Brooklyn, N.Y. The scale of the COVID disruption made modeling cycles unusually difficult, "which is tough for financial and investment analysts," he noted.

DEBT COVENANTS VS NOI

Figuring into that modeling is the hit taken by office values. During the first quarter of 2023, office leasing demand slipped 10.7 percent year-over-year, marking the third consecutive quarter of slowing, according to JLL. While signs were emerging that interest rate hikes were reducing inflation, the bank failures added volatility to the capital markets, JLL noted, creating concerns "that diminution of office values over the past year will lead to further credit challenges to banks with large commercial real estate exposure."

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CHRIS BARBIER
Yardi

Clearly, and that raises a crucial—and often overlooked—risk factor for lender covenants. The fluctuation in values and operating incomes can create a push/pull between NOI and lender expectations. In any economic climate, the dual factors of asset performance and debt covenants must be seen in tandem; at a time of economic slowdown, potential risks are heightened.

"In addition to whatever volatility you're seeing in terms of occupancy and its impact on NOI, it could ultimately impact your debt service," said Chris Barbier, Philadelphia-based senior director of investment management at Yardi Systems. Add another layer of risk into the mix if you are working with variable-rate loans, where that debt service can fluctuate.

This is especially true of larger entities, where "the people who handle each of those things are on different sides of the house," said Alex Droste, global real estate platform leader for Alter Domus. Asset managers tend to focus on property performance and valuations, while monitoring covenants is typically a task handled by loan administrators and providers of allied services. That disconnect points to a need "to combine those exercises for a more cohesive view."

Lenders expect their clients' assets to continue to perform at pre-approved levels: leases meeting specified square footage or dollar value. The risk arises when performance levels dip "below a threshold or trigger a potential covenant," Barbier observed. As lenders strive to avoid such outcomes, their due diligence, underwriting and loan parameters are increasingly strict.

"Despite the fact that we're not reliving the days of 15 years ago," Kelly said, "there are still performance issues that are likely to cause write-downs." In such an environment, strong lender relationships are especially important.

Such close ties are far more than feel-good add-ons, and Barbier points to banker familiarity as a bargaining chip. "Clients have told us it's a great negotiation tactic to see how many loans they have with, say, J.P. Morgan, before they go for their next loan with Morgan."

Engaging in systems and practices by rote or habit, without questioning their efficacy, is a recipe for disaster. Take, for instance, what Barbier refers to as a key-person dependency, whether that person works for the lender or for you. It is a reliance that only introduces another needless level of risk to an already risk-laden exercise.

Barbier emphasizes the importance of bridging the gap between the underlying asset and the loan. "I'm not talking so much about the terms of the loan, the calculations and amortization," he said. "I'm talking more about the critical dates and covenants and the things that pose the risks to the organization."

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>
> **ALEX DROSTE**
> *Alter Domus*

The issue, he argues, is not so much such factors as loan terms, calculations and amortization; instead, it's "the critical dates and covenants and the things that pose the risks to the organization." And with a dependence on one person, achieving that connection can be severely hampered.

The loss of that key contact, an increasingly common occurrence when professionals are more mobile than ever, can lead to disconnection. If that person is charged with the manual interpretation of NOI data into a spreadsheet, the chance of human error rises. And when that responsibility sits at a single desk, there may be no process for flagging approaching deadlines.

Beyond retention concerns, there is also the issue of access to critical records. A persistent urban legend tells of otherwise savvy global property owners keeping their leasing and lending documents in shoeboxes. "That sounds extreme, but it's really not that far off," Droste said. "We've seen instances of firms keeping their critical documents in old-school filing cabinets, and we end up harvesting all of the data and systematizing it the best we can."

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>
> **HUGH KELLY**
> *Hugh Kelly Economics*

Happily, he reports, this is now the exception rather than the rule. "Most of our clients are keeping themselves up to date with covenant monitoring. I see very few instances of someone actually missing a deadline."

Kelly agrees with both the urban legend and the industry's characteristic savvy. "Some people are hyper-organized, and some just aren't," he observed. "The urban legend isn't baloney, but it's not the dominant behavior of true professionals."

Minimizing human error and eliminating old-fashioned filing systems are clear benefits of automation. An administrator's job is to handle the back-office grunt work for clients, Droste noted. That means either increasing the number of federal tax deposits (FTDs) or increasing the use of technology. He emphasized that one thing is certain: "With all of the regulatory reporting we have to do and all of the different investor reporting we have to compile, the need for seamless automation is clear."

Ryan Severino agrees, citing the increased challenges of transactions and operations. "The industry is becoming too sophisticated and too complex for us to rely on older methodologies," he said. That principle extends beyond monitoring debt covenants to other performance benchmarks, such as energy efficiency. "It's all part of the same narrative," he said. "The world is changing … faster than ever. We need to respond appropriately to that."

Ultimately, successfully bridging the gap between building performance and lender expectations comes down to how well asset managers can monitor the massive number of moving parts involved. The question becomes: How well can you make holistic, proactive decisions based on the captured data and in-place processes?

The other piece of this is transparency, "and giving all the different stakeholders in the business access to that loan information for their different pieces of risk management," said Barbier. He pointed to Yardi's Debt Manager, which interfaces with the firm's Voyager platform, as a proven tool to facilitate the integration of performance and debt obligations.

Such an application is indispensable to identifying a loan, with its financial details and covenants, and then integrating that information with comprehensive data on the collateralized assets. That practice enables the asset manager to bridge the gap between a property or portfolio and the liability.

A proactive approach, greater efficiency and transparency are the watchwords not just of today's economic climate but of the fast-moving, complex environment that characterizes CRE in all business cycles. More than ever, successful management of all moving parts that go into NOI—and asset value—demands automation.

As Hugh Kelly points out, "Automation is wonderful in speeding up and drilling down into data to facilitate analysis." And getting complete, accurate data onto the desk of the decision-maker is essential, especially in a market that is still too volatile to let your guard down.

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