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By Fred Richard and Rocco Quaresima - Analysis of tenant credit quality is critical in valuing income producing property

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With the recent downgrade of the U.S. credit rating by Standard & Poor's from AAA to AA+, it reminds us of the importance to make certain a tenant's credit quality and the direction its credit may take is fully understood when analyzing income producing real estate. No entity is immune from a downgrade and investors' perceptions on a tenant's ability to fulfill its lease obligation are critical in estimating a property's value.

Various tools are available to the appraiser to assess the credit quality of tenants. The appraiser should look first to the credit rating agencies to determine if a rating is available for the tenant(s). Following the most recent financial crisis, the role of these agencies in the marketplace has been in the spotlight with many calling for reform of their practices. Although their role may evolve over the next several years, their opinions should still be gathered and analyzed by the appraiser.

The three credit rating agencies, Standard & Poor's (S&P), Moody's and Fitch Ratings, provide their rating information for free and a subscription to each is necessary as not all agencies rate the same companies. Investment grade tenants, or those with the highest creditworthiness, are companies with an S&P or Fitch rating of BBB- or better, or a Moody's rating of Baa3 or better. An outlook is provided with each rating, which is an opinion regarding its future direction. This outlook should be scrutinized to determine whether a company has the potential to fall from investment grade status.

In addition to analyzing information provided by the credit agencies, the appraiser should interview market participants as to their views of the tenant's credit quality and how their leases are typically underwritten. Market participants include investors and brokers, as well as the lending community. The results of these interviews will guide the appraiser towards reasonable assumptions to use in modeling cash flows generated by the leases.

Market participants may perceive a company as akin to investment grade status without the backing of a credit rating. Although a company is publicly traded, it may not be rated. However, its financial statements are available for analysis and the investment community may consider the company as investment grade quality with the financial strength to fulfill its contractual obligations.

The appraiser's determination of the tenant's credit quality will have a direct influence on the estimate of the property's market value. Tenant quality may have an impact on the selection of the vacancy and collection loss estimate, renewal probability, capitalization rate and discount rate. In developing a cash flow projection for a multi-tenant property, the appraiser has the ability to assign varying levels of vacancy and collection loss rates to different tenants based upon their credit quality. Through use of financial software such as ARGUS DCF, tenants can be assigned specific levels of collection loss during the terms of their contractual lease obligations. Credit tenants may be assigned no vacancy and collection loss, while tenants with a greater risk of default may be assigned a higher allowance. As both credit and non-credit leases roll, the appraiser can allocate more market oriented levels of anticipated loss.

Further, the tenant's credit quality may have an influence on the rates of return used in the valuation. Tenants with higher credit quality may warrant lower rates, while tenants with a greater risk of default may warrant higher rates. However, other factors including the duration of the leases, termination options, and other issues should also be considered when selecting rates. Ultimately, it is imperative that the appraiser extract rates from the market using the same method as that used to develop the cash flow projection for the subject property.

In summary, it is critical that the appraiser analyze the tenant's credit quality when valuing income producing property. The opinion of credit rating agencies is one tool the appraiser can use to ascertain credit quality, however, the opinions of participants active in the marketplace should also be gathered and analyzed. Once a tenant's credit quality is determined, the appraiser has tools at their disposal to accurately reflect the market behavior of investors in the valuation of the property.

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