AREIP
Association of Real Estate Investment Platforms

Risk scoring process

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Risk scoring process

A key purpose of AREIP is to bring investors accessing real estate investment platforms more transparency and clarity across the different investment products that are available. This is to help investors understand the risks across products offered by different platforms so that they are better equipped to make appropriate comparisons across both individual investments and individual platforms.

AREIP aims to do this by adopting a common set of high standards by which the industry will operate, and by agreeing on common terminology and standardised risk metrics.

Here we outline the broad approach to developing the risk scores that all AREIP members publish for each of their investments.

Note that here we are considering the relative risk of the specific individual investment being offered and not the overall risk of the project of which it forms a part of, although there are some overall project inputs to the risk score. As a result, different investments in the same project will likely have different risk scores.

Risk score inputs

There are 5 broad concepts that are considered for each investment although not all of them are relevant for all investments. These are then brought together and consolidated in order to calculate the overall risk score as presented.

The 5 broad concepts assessed for each investment are:

1. Capital structure
2. Security pledged
3. Investment country risk
4. Property & development characteristics
5. Platform size

We will now consider each concept in turn and how it can have an impact on the overall risk of an investment

1. Capital structure

Outside of the actual physical build, operation and sale of property investment, one of the key areas of risk is where the investment sits within the capital structure of a project.

Senior capital

Investment

Junior capital

The less capital that sits senior to the investment means that there is less chance of a capital loss in the event of a default. This means less risk for the investment itself. This is calculated on a cost basis.
The more capital that sits junior to the investment means that there is more opportunity for that junior capital to absorb any potential losses in the event of a default. This means less risk for the investment itself. This is calculated on a cost basis. The ratio of senior and investment capital relative to the entire capital stack is referred to as “Loan-to-Cost” or LTC.

Specifically for development projects, where a borrower is adding value to the property through the development of a site, we add an additional risk measure where we consider the loan (with expected interest or profit share) as a proportion of the overall post-development value. This is called the “Loan to GDV’ ratio or LTGDV. The LTGDV reflects the proportion of the end value required to satisfy full repayment of the loan and interest, thereby also highlighting how much the scheme can fall in value before affecting the loan.

2.Security pledge

Any action that has been taken on a project to provide enhanced protection of individual investment risks will lower the overall risk to the investor. Here the key points that input to the risk score are:

Any charge on an asset

i. The first charge, where the property can be repossessed and sold to recover the investment in the event of a default. This is usually referred to as a Senior Loan.
ii. The second charge, sitting behind a senior lender but ahead of any equity provided by the borrower. In the event of a default, the property will be sold and the senior lender repaid first, with the second charge lender-paid from any remaining funds. This is usually referred to as a Mezzanine Loan.

Any additional security

i. This may include cross-collateralisation across more than one property so that in the event of a default, the investment can be recovered by selling the cross-collateralised site(s) as well.

Any personal guarantee

i. Borrowers may be asked to provide a personal guarantee. While this is a legitimate way to add further security, it is also used as a way to keep the borrower focussed on repaying the loan, especially in the event the scheme runs into trouble.

3. Investment country risk

The country in which the property investment is located is classified with reference to the JLL publication "The Global Real Estate Transparency Index 2020" which can be found **here**. This index rates individual country transparency through strengths and weaknesses across six key categories: investment performance measurement, market fundamentals, governance of listed vehicles, regulatory & legal environment, transaction process and sustainability transparency.

4. Property and development characteristics

Looking at the overall project, we have some other inputs that impact the risks inherent in all associated investments. These are:

Location
Lower-risk locations include core urban areas such as major cities with higher risk areas including Suburban or rural locations.

Project phase
A lower risk investment would be an established buy to let property whereas a higher risk investment would be a site that has yet to be granted planning permission.

Income generation
An asset investment would typically be a lower risk investment than a development project. It will be up and running, fully or partially tenanted and already generating an income.

Development risks
A general input on other development risks and includes whether these have been mitigated fully, partially or not at all.

Sales pipeline
If relevant, a lower risk investment would have a stronger sales pipeline in place ranging from some to all of the development pre-sold.

Timeline
A longer timeline for the investment will typically increase the risk profile of the investment.

Developer track record
A more established developer is likely to be a lower risk option in completing a development successfully.

5. Platform size

Investment platforms that have a smaller amount of assets under management typically bring higher risk with their investments that are outside of the investment itself. For instance, platform risk may be higher which could have a material impact on investor returns.

How to use the risk score

An individual risk score is produced for each investment that is available. This means that a project may offer, say, an equity investment and a debt investment which will have their own individual risk scores.

These scores are then mapped against the letter ratings that range from lowest risk at AAA through to AA, A, BBB, BB, B and finally CCC at the higher end of the risk range.

The underlying principal of the risk scores is that they are a relative measure that investors can use as a guide to help them understand the relative risk across different investments. They should never be used in isolation and appropriate due diligence should always be done on each and every investment that is being considered.

Risk scoring formula

The recommended scoring formula is only available to members and will be shared with them upon joining the association.

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