Debt valuation

Recommended policies and best practices

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Chatham FINANCIAL

Access advantage

Introduction

Purpose
The purpose of this document is to provide a framework for understanding best practices in marking debt to market for the purpose of financial reporting. While details for appropriate methods for valuing debt are found in Chatham's white paper, this document is focused on clarifying policy and practice nuances related to debt valuation.

Updates
We expect this document will be updated both with new topics as well as to clarify existing topics.

Timing of market conclusions

Background
For a variety of reasons, fund managers may differ in practice when valuation conclusions are derived during the quarter. Given the illiquid nature of real estate, this does not often pose problems for the valuation of real estate assets; however, information regarding debt is more readily available. Consequently, the timing of when market information is pulled for the purpose of valuing debt can meaningfully impact valuation conclusions in comparison to another fund manager, with the same debt profile, who finalized market information at another point during the quarter.

Best practice
Finalize quarterly market data on the 15th of the last month of the quarter.

Frequently asked questions
Q: What does it mean to finalize market data?
A: Market conclusions, such as market interest rates, are derived using the latest available market information on the 15th of the last month of the quarter.

Q: Are adjustments made to market conclusions between the 15th and the end of the quarter?
A: Adjustments may be made for factual changes such as the incorporation of an updated property value, principal balance, or other property or loan modifications. Changes in market data such as Treasury yields or coupon rates are subject to materiality thresholds (see Materiality thresholds section).

Q: How does this impact draft valuations?
A: If draft quarter-end valuations are disseminated prior to the 15th of the last month of the quarter, market conclusions as of the date of the draft valuations should be used. Final valuations will then be refreshed using market data as of the 15th of the last month of the quarter and disseminated as specified in client engagements.

Q: What if the 15th falls on a non-business day?
A: Use the nearest business day to the 15th. For instance, when the 15th falls on a Saturday, market data should be finalized on the 14th. When the 15th falls on a Sunday, market data should be finalized on the 16th.

Materiality thresholds

Background

Changes in benchmark rates such as the U.S. Treasury yield impact lending rates for commercial real estate. However, short-term market volatility does not always result in meaningful changes to lending rates. Lenders may adjust credit spreads, apply coupon floors or take other measures to offset volatility. When there is a meaningful shift in the markets, it takes time for commercial real estate lenders to reset return requirements and spread pricing, making it difficult to support changes to market rate conclusions for the purpose of valuation.

Best practice

For the purpose of quarterly valuations, final market assumptions should not be refreshed once market data is finalized unless there is a movement of more than 20 basis points in the 10-day average of the 10-year U.S. Treasury yield or the equivalent national benchmark rate for international investments.

Frequently asked questions

Q: Why use a 10-day average?
A: Lenders often look for sustained movements in benchmark rates before reevaluating yield or resetting spreads. For material movements in the market, this can take two weeks or more. A 10-day average incrementally recognizes significant movements in the market as it becomes sustained.

Q: How was a 20-basis point threshold selected?
A: Various thresholds were considered for defining materiality including 15, 20, and 25 basis points. Using those thresholds, thirteen quarters from Q1 2016 through Q1 2019 were back tested to identify when each hypothetical threshold was triggered and if there was enough information or momentum in the market to warrant a change in lending rates within a two-week period. As expected, a 15-basis point threshold was breached most frequently—six times in 2016, once in 2017, three times in 2018, and once in Q1 2019. A threshold of 25 basis points was breached only once in the last three years. While 20 basis points was only exceeded twice, in both cases the markets had clearly moved in a short time period. Based on anecdotal feedback, markets that resulted in movements below 20 basis points did not generate enough momentum to justify immediate changes in lending rates.

Q: What is the process for refreshing market data if the materiality threshold is exceeded?
A: If the materiality threshold is breached between when market data is finalized and the end of the quarter, market research is performed to understand changes in both the benchmark rate as well as any changes in spreads for each loan. Therefore, while exceeding the materiality threshold will trigger new valuations, changes to the market rate conclusions will often not necessarily equal changes in the benchmark rates. Market interest rate conclusions will be made consistent with Chatham debt valuation methodologies as described in the most recent version of Chatham's white paper, Debt valuation methodologies for real estate investments.