

Private Markets Insight

Rethinking real estate credit
underwriting

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**Federated
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Not everything that counts can be counted:

Rethinking real estate credit underwriting

Mistaking the map for the territory can lead to expensive misjudgements. Maps, though incredibly useful, are distortions of that which they represent. The same is true for credit metrics and other investment ratios. Loan to value (LTV) is the clearest example in real estate credit. It feeds our desire for quantitative measurement, but credit models that are excessively sensitive to such metrics will overlook important risks.

At Federated Hermes, we believe abductive reasoning is essential for establishing qualitative risk factors and must be central to the underwriting process.



Don't mistake the map for the territory

Standardised measures help us make sense of complexity. The Mercator projection of the world map enables us to read wind directions in straight lines, but it distorts the shapes and sizes of the countries, famously making Greenland appear the size of Africa when it is, indeed, 14 times smaller. While maps remain invaluable, we cannot mistake the map for the territory.

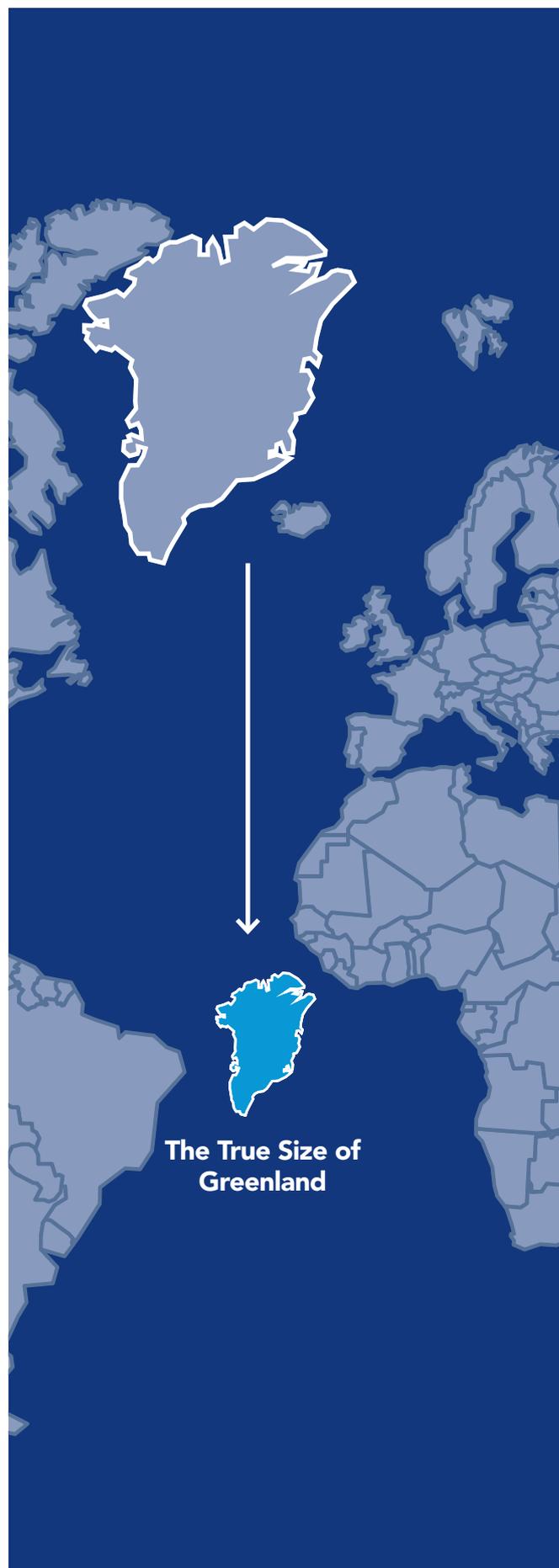
So too with risk metrics: they are representations that simplify the real world and, in doing so, we suffer a loss of fidelity. When lenders underwrite loans with a heavy emphasis on just a handful of risk metrics, gross distortions are incorporated into the outcome.

In commercial mortgage lending, loan-to-value (LTV) has acquired near-mythic authority. It guides investment mandates, draws lines between "senior" and "whole" loans, or investment grade and non-investment grade risk, and even acts as a shorthand for portfolio risk overall. But any single number that is easy to calculate and feels comfortable to quote often tells us very little about the actual risk. The probability and severity of default are hard to express in a number.

As a risk indicator, LTV has some value but an overreliance on this measure in credit underwriting models can be dangerously misleading.

Consider two hypothetical loans, one financing a property at 50% LTV and one financing another property at 60% LTV. These cannot be put in order of risk without knowing the assets, locations, tenancy structures, maturity profiles, and supply & demand outlooks.

Real estate is not homogenous inventory; it is shaped by human preferences that don't sit neatly in a spreadsheet.



The quantitative metric trap

Measurement confers a sense of control: “what we can measure we can manage” is the commonly held belief. But the ease of measurement is not the same as relevance to risk. Consider the “big three” lending ratios:

- **Loan to value (LTV):** Captures capital structure at a single point in time but ignores the point in the cycle and tells us nothing about exit-risk. A 60% LTV on the same building in 2019 and 2026 can imply very different risks because market values are completely different.
- **Debt yield:** Indicates how far yields could widen before debt is impaired but says nothing about the likelihood of such widening.
- **Interest cover (ICR):** Treats all coverage the same regardless of income concentration or lease term profile. A single-tenant asset with 2.0x ICR behaves like an on/off switch, and may be worse than a 1.25x interest cover from a diversified pool of tenants.

Risk is the fact that more things can happen than will happen. It is a forward-looking judgment around the distribution of possible outcomes. In private market investments these distributions are often not normal distributions. Knowing that a 60% LTV implies a 40% value cushion does not tell you whether a 40% decline is possible, plausible, likely, or near impossible for that asset. Sensitivity tables that show the combined impact of two variables go a step further than a single metric but still leave the central question unanswered: how likely is a loss-making joint move of variables? Every metric is designed for one thing and taking it as a proxy for risk as a whole is a dangerous shortcut.

What counts but can't be counted

Qualitative forces in real estate (such as functional obsolescence, planning risk, brand strength, micro location quirks, reputational issues and design popularity) often move outcomes away from the gentle hum of a bell curve towards step changes and possibly all-or-nothing cliffs.

People naturally take comfort in basing decisions on measurements. Microsoft Excel, still the lender's most popular tool, gives absolute priority to numbers over narrative. But our investment approach must incorporate the fact that not everything we count counts and not everything that counts can be counted. Qualitative risk categories (sponsor track record, asset quality, micro-market elasticity, stakeholder alignment) heavily shape profit and loss distributions even when they defy clean measurement.

Even some factors that we can accurately measure on a linear scale may not translate into risk in a linear way. The age of a building can be clearly measured and may have some bearing on risk. It may be true that a 10-year-old building is twice as old as a 5-year-old building, but it is not necessarily twice as risky, just like 20 degrees Celsius is not twice as warm as 10 degrees Celsius¹. When we financed a boutique Stockholm hotel located in a 400-year-old building, we did not consider that 40x worse than if it had been a 10-year-old building.

When a measure becomes a target, it ceases to be a good measure

Because LTV is simple and intuitive, it dominates “black box” credit models. Even if not sure how the credit model “does its thing”, teams learn where the approval cliffs lie: 59% is within bounds, 60% is out of bounds. But are you really taking less risk at 59% than at 60%? Or has the proxy been gamed to get the deal through a credit committee?

The inevitable result is that the teams start underwriting to the model, not to the risk. If the quantitative model allows loans at 59% LTV but has no way to judge the quality of the asset, the asset quality in the portfolio will suffer over time, and an LTV of 59% may no longer represent a low-risk loan. This is a perfect example of Goodhart's Law: when a measure becomes a target, it ceases to be a good measure. There are plenty of properties that we would not finance even at 40% LTV, whereas for others we are perfectly happy at 65%.

LTV is especially misleading at the portfolio level. A weighted average LTV of 60% can coexist with severe tail risks, poor granularity, or highly correlated exposures. Loss on one loan is not offset by “no loss” on another. An average tells you nothing about distribution shape, co-movement, or liquidation friction. The more the metric is elevated to the portfolio the lower the signal to noise ratio.

¹ When converted to Fahrenheit, the stated Celsius temperatures measure 50 degrees Fahrenheit and 68 degrees Fahrenheit; one is not double the other.





From post-mortem to pre-mortem: Introducing Abductive Reasoning

We are not advocating for the abandonment of traditional credit analysis, instead we are calling for the inclusion of abductive reasoning into the process. At Federated Hermes, we use abductive reasoning in our analysis to build a narrative and follow it from an imagined conclusion to its logically possible cause, incorporating qualitative considerations along the way.

We run a structured **pre-mortem** alongside traditional analysis. We assume that at loan maturity, our investment lost money. We then ask: What was the most likely cause? Are there any plausible pathways that got us there? The aim is not to predict, but to unearth the narratives that make loss coherent, and then, if possible, to mitigate those pathways now.

This mindset mirrors medicine. A medical post mortem explains why a patient died. A pre mortem brings the same analytical honesty to the present, before the death has happened, therefore introducing the potential to save the life.

Consider interest rates: few could predict the exact trigger for the change from “lower for longer” to the current higher interest rate environment but the future always contained rate rises as a possible path. A pre-mortem would have asked: What would put the refinancing of this loan at maturity at risk? Would an interest rate rise by several hundred basis points do it? How realistic is that path? The aim is not to predict macro movements; it is to be ready for the macro changes that could hurt your investment the most. In the super low-interest rate environment that meant including a significant portion of floating-rate loans in the portfolio.

Crucially, abductive reasoning excels at integrating qualitative elements into a coherent loss narrative, from regulatory turns to brand damage, to technology adoption curves. It invites imagination, not as fantasy but as disciplined scenario craftsmanship. The initial question is not “how likely is this exact scenario?” but “what does this scenario teach us about the vulnerabilities of our investment, and which mitigants are cheap, feasible, and robust?”

The aim is not to predict macro movements; it is to be ready for the macro changes that could hurt your investment the most.

Exploring large language models as an analytical tool

Where Excel is still the best tool for running cash flows, large language models (LLMs) are increasingly powerful for incorporating non-quantitative elements into analyses.

Although pre-mortems can be effectively undertaken without AI, emerging models are allowing us to visualise scenarios at speed.

Helped by LLMs, abductive reasoning can achieve three key things in portfolios:

- **Capture non-quantifiable drivers of risk:** It legitimises and helps us to structure qualitative judgments by making them central to the loss narrative rather than peripheral “colour.”
- **Expose step-change risks:** It highlights cliff dynamics (single tenant dependency, ESG driven obsolescence, legal outcomes) where normal distributions fail and averages mislead.
- **Align mitigants with real weak points:** Through the pre-mortem, we can potentially create a fix or structure for what would actually break, not just for what fits a spreadsheet cell.

What about covenants? Using LTV where it does work

Although LTV is suspect in underwriting and decision making, it is a useful monitoring tool. Once a loan is on the book, LTV can revert to its rightful role as one of a few key exposure gauges and governance triggers.

In illiquid investments, control matters; covenant lite loans remove these control levers just when you need them. LTV covenants, thoughtfully set and combined with information rights and cash controls, remain among the most effective early warning and intervention tools a lender has. A measurement tool used for measurement, not predominantly for decision making.

Conclusion

Risk is not a number; it's a story.

A story anchored in facts, context, and judgment. LTV was never meant to be a proxy for overall loan risk, and like other risk metrics it is built for specific tasks and using it beyond those boundaries invites false confidence.

Traditional credit analysis and Excel cash flow models are an important part of credit underwriting, but not the only part. Replacing metric absolutism with a dual system that combines quantitative analysis with narrative pre-mortems keeps us honest about what we know, what we don't, and what might hurt us anyway.



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