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VIS
RATING METHODOLOGY

Real Estate Investment Trusts (REITs)

Given support on the regulatory front, Real Estate Investment Trusts (REITs) is now accepted as a mainstream investment vehicle that enables investors to pool in their resources to take exposure in the real estate sector, an otherwise illiquid asset class. Investments in REITs tend to be tax efficient and invested amounts could be much lower vis-à-vis direct exposure. As the concept of REITs gains foothold, it brings in the much needed transparency in the real estate sector, given the disclosure requirements associated with formal REITs.

As per the applicable rules in Pakistan, REIT scheme will be structured as a closed-end scheme, to be launched by a REIT Management Company (RMC) and could be a rental REIT, developmental REIT or a hybrid of the two[1] . While some of the risk factors across these two types may be common, unique risk factors applicable to the evaluation of Rental REIT Schemes have been focused on in this methodology paper. Depending on the property market segment in which a particular fund operates, certain criteria factors may assume greater level of significance than others. It also follows that certain property types may be rated higher than others; the competitive advantage associated with any property could be derived from a captive market, strategic location or any other unique selling proposition. Property types which have significant longevity and may not be easily replaceable over the foreseeable horizon may be rated on the upper end of the rating scale.

The methodology is organized into five key components:

1 Please refer to Appendix 1 for definitions and minimum capital/size requirements stipulated in the regulations

External Operating Environment

The rating process initiates by examining the external operating environment in general and the property market in specific. A stable political and economic environment is considered favorable from a ratings perspective, as it would in general lead towards higher demand for space; e.g. growth in GDP and job creation can point towards higher demand for office space; increasing income levels can have a positive impact on the hospitality and retail mall segments. In view of this, among others, VIS tracks trends in GDP, job growth, inflation and interest rates.

In more documented economies, building permits provide insight into the future real estate supply levels and are considered one of the leading economic indicators as growing construction activity can have a positive impact on multiple ancillary industries and provide opportunities for growth in the job market; on the other hand, declining housing prices can have a negative impact on the economy in several ways. In case such data is not readily available from a formal platform; other sources of information may be used, wherever possible, to track the trends in real estate sector by VIS.

VIS evaluates the factors affecting demand and supply position as well as the ease with which properties may be placed on rent. Tenancy laws, legal infrastructure, trends in rental rates, occupancy levels, pace of fresh supply of properties and their absorption rates are some of the key variables that are to be considered. VIS also tracks the shifts in property market fundamentals over time. While VIS incorporates a certain degree of shift in demand/supply patterns in its ratings, material shifts in the same could call for a re-assessment of the outstanding ratings. Market fundamentals would also affect the ease with which a fund may be able to churn the properties held in its portfolio, if so permitted by its constitutive documents.

Business Risk Profile

The business risk profile of a REIT fund is a key rating factor; different property types are expected to exhibit varying degree of exposure to business risk factors. As most REITs focus on a particular sector of the real estate market, such as apartments, office buildings, hotels, health care, shopping malls, and the like, these REITs are subject to specific risks associated with that particular sector. Additionally, many REITs may own properties that are concentrated in a particular region or geographic location, which subject them to the risk of particular conditions specific to that location as well as the probability of natural/climatic hazards specific to the region. In assessing the business risk of a rental REIT fund VIS considers the following:

1. **Market Position:** The market position of a property (and/or its sponsors) can be an important indicator of a fund's ability to withstand economic downturns; historical evidence with regards to occupancy levels and/or internal growth during a difficult operating environment can provide an indication of the same. For example, in case of hospitality sector, VIS may look at factors such as change in revenue per room from the peak to trough of a business cycle in view of the fact that market position can translate into better pricing power.
2. **Property Quality & Diversification:** The marketability of a fund's property and hence the strength of its cash flows is likely to be driven by its geographic location and property quality. Factors such as physical condition, location dynamics including law and order situation, ease of access and barriers to competition that can protect a particularly property from erosion in economic value are assessed for impact on the likely performance of a REIT fund; potential exposure to environmental or regulatory risks are also evaluated herein.

Moreover, VIS evaluates a fund's geographic & tenant diversification, tenant profile and rent agreements. A REIT fund that features a diversified portfolio, in terms of geographic and tenant base is likely to be rated higher vis-à-vis a fund having higher degree of concentration; however, there may be instances where mitigating factors in case of the latter may drive up the ratings, depending on the characteristics of the property or the tenant profile. It may also be pertinent to mention here that geographic diversification may not necessarily be effective if different geographic markets are correlated in terms of their exposure to various economic and industry risk factors. Moreover, by regulations, a REIT fund may only invest in a single project. This implies that ability to diversify a REIT fund's portfolio geographically may be restricted in the domestic context. The level of diversification is also evaluated at the tenant level; as a general rule of thumb, properties having less than 30% exposure to top 5 tenants are likely to score well on this factor, unless this risk is well mitigated by other factors.

Well executed rent agreements are considered positively from a ratings perspective. Moreover, the length of rent agreements provides an indication of the stability of cash flows that will be generated by a fund. At one end of the spectrum are rent agreements which may be terminated at short notice, which may lead to sudden variations in occupancy levels and may be most vulnerable to changes in the external environment versus long term rent agreements, with built-in rent escalation clauses, which are likely to result in a steady stream of rental income and are viewed favorably from a ratings perspective. Tenure of rent agreements may vary by property type; apartments, hotels and retail space may entail short term rent agreements versus long dated agreements for health care facilities and office space. Generally speaking, high switching costs and networking effects may deter tenants from terminating agreements; the former may be true for office occupants whereas the latter may be applicable to retail mall tenants.

3. **Legal Risk:** The availability of clear and unencumbered legal title and complete documentation pertaining to ownership of property and rental deeds is vital for REITs sector to grow. Along with these, compliance with all applicable building codes and other applicable regulations in addition to availability of completion certificates from the relevant building authority are considered during the ratings process, as these are necessary pre-requisites to the very launch of a REIT fund.

Business risk characteristics within a certain market segment, such as housing, may also vary with location; for instance, legal risk, as manifested in property title documents may be less of a concern in the recently emerging housing projects vis-à-vis earlier settlements.

Management and Governance

With respect to intangibles, competitive intangibles, such as management skills, are paramount. Given the role of both REIT Management Company (RMC) and Property Manager in conducting the affairs of a REIT fund, management meetings with key personnel of these institutions is an integral part of the rating process of a REIT fund. These institutions are evaluated in terms of their strength, experience and previous know-how in the real estate sector. VIS primarily considers a company's transparency, financial prudence, and management credibility. The ability of a company to hire or retain qualified personnel in the positions of leadership, management and investment team will signify its ability to sustain operations.

The investment strategy, growth strategy, asset selection process, decision-making process, negotiation skills, policies on the purchase and sale of properties, information collection systems, methodologies for evaluating asset performance, and administrative framework are some of the key factors to be considered.

Servicing Entities

Any Rental REIT scheme would have four to six independent third party service providers which in turn will be appointed by the RMC; these may include Property Manager, Trustee, Valuer, External Auditors, Shariah Advisor & Registrar. From the maintenance of REIT property to the timely disclosure of financial statements and holding of trust property on behalf of the unit-holders, these third parties provide services that are critical to the protection of interests of various stakeholders and in turn affect the overall marketability of a REIT fund. In view of this, an appropriate mechanism must exist at the RMC level which provides the basis for soliciting the services of various third party service providers.While regulations provide for the mechanism of replacement of various servicing entities, continuity is viewed positively. It is for this reason that in addition to the management related factors of the servicing entities, financial viability is also important to the extent that it ensures continuity of operations and services to the REIT fund.

Regulations limit the maximum fee [2] that may be paid to RMC or the trustee; fees for other service providers are negotiable. Given the limited number of players that be positioned to enter into the REITs sector at present, it may not be uncommon to find that some of these servicing entities may have common shareholders, particularly in the case of RMC and property manager. While to an extent this may ensure alignment of interests, it may also pose some degree of conflict of interest. This makes disclosure with respect to policy for related party transactions particularly important; these contracts must be executed at an arm’s length basis.

Operating Performance & Financial Flexibility

The operating performance of a REIT fund is a manifestation of its exposure to various business risk factors and management’s skill set.

The stability of a REIT fund’s cash flows would be determined by the property quality, structure of rent agreements, occupancy ratio and financial health & profile of its tenants whereas return would be determined after taking into account both variable and fixed costs. Generally, costs to be borne by the REIT fund are variable in nature and linked to the level of operating income. Rental REITs are expected to be able to receive favorable tax treatment, provided they distribute 90% of profits to shareholders. While this special tax status is one of the main benefits of the Rental REITs, the inability to retain profits beyond a certain level is factored into the rating assessment, in context of the financial flexibility required to provide for capital expenditure on the property, if any. In an another context, ability to off-load property held by a fund in anticipation of market downturns or to re-direct resources towards a better investment opportunity can add to the financial flexibility of a fund and will be viewed favorably.

Return to investors may be broken down into the realized rental income received as dividend and price appreciation in the units of the fund. From an investor’s perspective, a REIT fund that is able to generate positive real returns is likely to be viewed more favorably versus a situation where investor’s return is not able to keep pace with inflation. While on one hand dividend yield would depend on fund specific factors, the general trend in rental yields in any market is also likely to be a key determinant of the same. Likewise, appreciation in the unit price of the fund would depend both on dividend yield and market forces. Moreover, ability to actually realize the price appreciation may depend on the liquidity in the secondary market allowing the investor to off-load his holding; however, these factors that are beyond the scope of the rating methodology at hand.

2 Please refer to Appendix 2 for various fees to be incurred by a REIT Fund

Appendix 1

REIT Scheme: means a real estate investment trust which is a closed end scheme launched by the RMC and registered under the Real Estate Investment Trust Regulations and includes Development REIT Scheme, Rental REIT Scheme or a Hybrid REIT Scheme

REIT Fund: means the fund raised through issuance of units; the REIT fund is required to have a minimum fund size of Rs. 2b for a Rental REIT Scheme or a Developmental REIT Scheme and Rs. 3b for a Hybrid REIT Scheme

Rental REIT Scheme: means a REIT scheme established with the objective of making investments in commercial or residential real estate to generate rental income

Developmental REIT Scheme: means a REIT scheme established with the objective of development of such real estate for industrial, commercial or residential purposes, through construction or refurbishment

A **REIT Management Company** shall:
(a) at the time of applying for a license as a NBFC, have a paid-up capital of at least Rs. 50m and its equity shall not be less than its paid-up capital
(b) before applying for the approval of the Offering Document, increase its paid-up capital to at least Rs. 200m
(c)after the approval of the Offering Document, maintain equity of at least Rs. 200m

Appendix 2

Maximum Fee Thresholds	Rental REIT	Developmental REIT
RMC – Management Fee	Upto 3% of annual operating income of REIT Scheme	Fund size < 1 billion - upto 3% 1 billion < Fund size < 5 billion - upto 2% Fund size > 5 billion - upto 1%
SECP	0.1% of initial REIT Fund	0.2% of initial REIT Fund
Trustee	0.6% of annual operating income of REIT Scheme	Upto 0.2% of initial REIT Fund
Property Manager	As negotiated by the RMC	
Valuer	Negotiable	

RATING SCALE & DEFINITIONS: REIT RATING SCALE

AAA
Highest degree of stability in NAV. Risk is negligible with very low sensitivity to changing economic conditions

AA+, AA, AA-
High degree of stability in NAV. Risk is modest but may vary slightly from time to time because of changing economics conditions

A+, A, A-
Moderate degree of stability in NAV. Risk factors may vary with possible changes in the economy

BBB+, BBB, BBB-
Adequate degree of stability in NAV. Risk factors are considered variable if changes occur in the economy

BB+, BB, BB-
Low degree of stability in NAV. Risk factors are sensitive to changes in the economy

B
Very low degree of stability in NAV. Risk factors are capable of fluctuating widely if changes occur in the economy

The REIT rating scale of 'AAA' to 'B' is appended by the letter (rr) to denote Rental REIT ratings and (dr) to denote Developmental REIT ratings, and to differentiate it from the nomenclature used for issue and issuer ratings.

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Founder, VIS Group
Chairman, Association of Credit Rating Agencies in Asia

Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA.

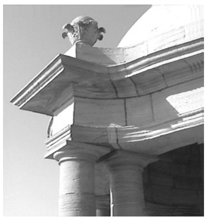
Muniba Khan
Senior Manager

Muniba Khan is involved in the credit analysis of various industrial companies and financial institutions. She has been associated with VIS since 2013 and her overall experience in ratings includes insurance, microfinance banks, commercial banks and manufacturing sectors. She holds a Masters degree in Business Administration from Institute of Business Administration, Karachi (IBA). She is also currently pursuing a Masters degree in Economics from IBA.".

Jahangir Kothari Parade (Lady LLoyd Pier)
Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.


Jahangir Kothari Parade

National Excellence, International Reach

VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, VIS continues its endeavor to remain an emblem of trust.

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