July 2018

Rating Methodology for REITs and REOCs

Summary

This rating methodology adopted by China Chengxin (Asia Pacific) Credit Ratings Company Limited ("CCXAP") applies to Real Estate Investment Trusts ("REITs"), real estate operating companies ("REOCs"), and other commercial real estate companies with similar business nature of REITs and REOCs.

A REIT is a collective investment scheme constituted as trust which invests in real estate properties with the aim of providing long-term returns to investors from the rental income generated from the properties. A REOC is similar to a REIT focusing on rental income from real estate investments, except that REOC reinvests the earnings into its business, rather than distributing the dividends to investors like REIT does.

This new rating methodology replaces the "Rating Methodology – REITs and REOCs" published by CCXAP in March 2016. The new version follows the core rating principles of the previous version with some amendments, which helps better reflect the credit quality of REITs and REOCs. No rating changes will be resulted from the implementation of this new rating methodology.

This rating methodology introduces the key determinants for rating REITs and REOCs. CCXAP assigns credit ratings to them using its rating scale.[1]

Introduction of Rating Methodology

The key rating determinants for the assessment of a company focusing on rental income are divided into qualitative determinants and quantitative determinants. The rating methodology provides a summarized guidance for the important factors used in assigning ratings, but it does not include every aspects of rating consideration. As a result, the mapped rating may not match the final rating of each company.

[1] For details of CCXAP's rating scale, please see "Rating Process - Rating Definition and Meaning" at www.ccxap.com.

In this rating methodology, there are three rating factors comprising 15 sub-factors as follows:

Rating Factors	Sub-factors
Business Profile	Operational Environment
	Market Position
	Asset Quality
	Diversification
	Occupancy Level
	Development Project
Financial Strength	Total Assets
	EBITDA/Revenue
	Total Debt/Total Capital
	Net debt/EBITDA
	Unencumbered Assets
	Secured Debt
	EBITDA/Interest
Financial Flexibility	Liquidity Coverage
	Access to Capital

Key Rating Determinants

Rating factors and sub-factors are discussed in details in this section, including their rationale, measurement and how they will affect the rating.

(1) Business Profile

In the evaluation of business profile, CCXAP reviews the broader real estate markets as well as the company's competitive position and property portfolio. The business profile factor captures the non-financial aspects of the company.

(i) Operational Environment

CCXAP starts the credit analysis from evaluating the market conditions where the company operates. The company's business operation is affected by economic growth and industry policies, including both macroeconomic conditions and regional developments. CCXAP considers the business risks associated with the property development and management as well as the company's operating history in dealing with the risks. For the real estate industry, such risks affect property prices, rental rates, development activities, and leasing terms. We also asses the regional operating environment in terms of historical trends of rents, capital values, and general occupancy level of the markets in which the company operate. Companies that operated in markets characterized by limited supply and structural undersupply typically have higher scores for this sub-factor.

(ii) Market Position

CCXAP uses market share, relative ranking, franchise value, and develop strategy to measure the competitiveness of a real estate company. CCXAP opines that companies with higher market share and higher operating revenues are more resilient to the market downturn. We also assess the

Company’s abilities to transform its market position into pricing power. Companies with leading market positon or high franchise value, in which evidently help enhance its pricing power in its service regions, may obtain higher score in this sub-factor.

(iii) Asset Quality

Volatility or stability of rental incomes and asset values are affected by the asset quality of the company’s real estate portfolio. CCXAP evaluates the asset quality based on geographic location, property age, property size, potential tenant types, asset class, and other unique elements. Assets of above-average quality can generate relatively stable returns and cash flow in different stages of an economic cycle.

(iv) Diversification

In assessing the diversification factor, CCXAP considers the company’s geographic allocation, property mix, and tenant mix. The tenant analysis includes the company’s exposure to the largest tenants and the quality of these tenants. A higher level of diversification can help insulate the company from influences of a specific region or single tenant.

(v) Occupancy Level

CCXAP assesses this factor based on the operating performance of a real estate company compared with its peers, both on a portfolio basis and on a property-by-property basis. The operating performance includes rent per square meter, occupancy rate, tenant retention, and the distribution of leasing expiration. The ideal combination is premium rental rate and high occupancy rate.

(vi) Development Projects

CCXAP considers the number, size and quality of the company’s development projects. Companies with a number of large scale development projects may give pressure on its resources due to the property development projects generally required sizable initial investments with extended construction period. We typically consider the size of the development portfolio as a percentage of total assets. High ratio of development portfolio/total assets may be treated as an indicator of carrying more risks on development projects. Apart from the size of the development projects, we also evaluate the development stage & quality of projects, and management risk appetite as well as development track record. Companies with aggressive development strategy to pursue speculative opportunity will limit its credit rating under this sub-factor.

(2) Financial Strength

In the evaluation of financial strength, CCXAP reviews the financial metrics and trends. The financial strength factor captures the financial aspects of the company.

(i) Total Assets

In assessing the scale of a real estate company, CCXAP considers the absolute size of total asset, which reflects the number of properties and their market values. A larger size of assets under management can enhance operating stability throughout the economic cycle.

(ii) EBITDA/Revenue

In assessing profitability of a real estate company, CCXAP uses the EBITDA margin, which is calculated by dividing EBITDA by total revenue. Companies with higher EBITDA margin tend to have better quality of management to control operating costs.

(iii) Total Debt/Total Capital

In assessing the financial leverage of a real estate company, CCXAP uses the capitalization ratio, which is calculated by dividing total debt by total capital. Total debt refers to interest-bearing debt including bonds, notes, short-term and long-term borrowings. A higher leverage exerts pressure on the company's ability to raise funds and repay debts.

(iv) Net debt/EBITDA

In assessing the cash flow leverage, CCXAP focuses on the company's debt level relative to its expected cash flow. This indicator is calculated by dividing debt net of cash and cash equivalents by EBITDA.

(v) Unencumbered Assets

Unencumbered assets mean sources of liquidity. When facing financial difficulties, a real estate company may sell its unencumbered assets or pledge them as collaterals for borrowing. CCXAP uses the ratio of unencumbered assets to total assets to evaluate the company's financial flexibility. In addition, more diversity and higher quality of unencumbered assets, the better liquidity a company has.

(vi) Secured Debt

The unsecured bondholders are subordinated to the creditors of secured debts. While the financing cost of secured financing is usually lower than that of unsecured financing, secure financing has more stringent covenants for the company to comply with. CCXAP uses the ratio of secured debts to total assets to evaluate the company's financial flexibility to repay its unsecured debts.

(vii) EBITDA/Interest

CCXAP uses the interest coverage ratio to evaluate the company's ability to cover the interest payments of its debt. The interest is a sum of interest expenses and capitalized interests. In general, a ratio greater than 1 indicates that the company has more than enough coverage to pay off its interests.

(3) Financial Flexibility

Since real estate companies are capital intensive by their business nature, liquidity and funding are especially important for the financial flexibility. In the evaluation of this factor, CCXAP reviews the company's liquidity coverage and funding capacity.

(i) Liquidity Coverage

CCXAP compares the sources and uses of liquidity over the next 12-18 months to analyze the company's expected cash flow. Sources of liquidity include operating cash flow, lines of credit, cash balances, and asset sales. Uses of liquidity include debt repayments (interests and principals), dividend payments, and capital expenditures.

(ii) Access to Capital

Real estate companies rely on public and private capital to fund their investments and repay debts. CCXAP assesses the company's capability of using different types of financial instruments to raise fund in the capital markets.

Other Rating Considerations

Other than the factors and sub-factors discussed before, the availability of external support to a company when needed can help strengthen its credit capacity.

Corporate Governance & Management

CCXAP considers corporate governance, internal control, management quality, policies and procedures, organizational structure, ownership structure and related transactions. A heavy emphasis is placed on the quality of management and board of directors to ensure the proper operation of a company in the interest of its stakeholders.

Investment Risks outside the Home Market

Commercial real estate companies may have deep understanding of the market and locales in which they operate. However, successful companies may decide to further diversify its investment in other markets to capture opportunities through joint venture, funds, or setting up new companies. These investment activities may create different risks that the Company may not be familiar to deal with, such as political, government, management, tax, legal and currency risks.

Government or Parental Support

CCXAP gives consideration to company background and external support when assessing a company's overall credit strength. CCXAP believes that a company with government background may benefit from government support in the economic downturn. CCXAP also views that a company with strong shareholders may receive parental support of capital injection.

Copyright 2018. China Chengxin (Asia Pacific) Credit Ratings Company Limited. All rights reserved.

Important Information

All information published in this document belongs to China Chengxin (Asia Pacific) Credit Ratings Company Limited (CCXAP) and is subject to change without prior notice by CCXAP. CCXAP considers the information contained in this document reliable. However, all information is provided on an "AS IS" and "AS AVAILABLE" basis and CCXAP does not guarantee the accuracy, adequacy, completeness or timeliness of any information included in this document. None of the information may be used, including without limitation reproducing, amending, sending, distributing, transferring, lending, translating, or adapting the information, for subsequent use without CCXAP's prior written permission.

CCXAP is not liable for any in whole or part caused by, resulting from or relating to any error (neglect or otherwise) or other circumstances or other circumstance or contingency within or outside the control of CCXAP's or any of its directors, officers, employees or agents in connection with the procurement, collection, compilation, interpretation, analysis, editing, transcription, publication, communication or delivery of any such information, or any direct, indirect, special, consequential, compensatory or incidental damages whatsoever (including without limitation, lost profits), even if CCXAP, or representatives thereof, are advised of the possibility of such damage, losses or expenses.

China Chengxin (Asia Pacific) Credit Ratings Company Limited

Address:	Suites 805-808, Jardine House, 1 Connaught Place, Hong Kong
Website:	www.ccxap.com
Email:	info@ccxap.com
Tel:	+852-2860 7111
Fax:	+852-2868 0656