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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 a trust which invests in real estate properties with the aim of providing long-term returns to investors from the rental income of the properties. A REOC is similar to a REIT that focuses on rental income from real estate investments, except that a REOC generally reinvests the earnings into its business, rather than distributing majority of profits to investors like a REIT does.

This new rating methodology replaces the "Rating Methodology – REITs and REOCs" published by CCXAP in July 2018, effective on 30 December 2019.

The implementation of this new rating methodology may cause rating changes on some of our rated entities. The information of the rating changes is available by clicking on the following link: [link], which lists out the affected entities and their rating changes.

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 REITs and REOCs 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.

In this rating methodology, there are 2 rating factors comprising 9 sub-factors as follows:

Rating Factors	Sub-factors
Business Profile	Operating Environment

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

	Scale Market Position & Asset Quality Development Exposure
Financial Strength	EBITDA/Revenue Net debt/EBITDA (Total Debt + Preferred Equity)/Total Assets Restricted Assets/Total Assets Fixed-Charge Coverage

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 considers the operating environment of a firm, a firm's scale, market position & asset quality and development exposure. This factor mainly captures the non-financial aspects of our evaluation.

(1) Operating Environment

The operating environment of REITs and REOCs affects their business performance. We use forward-looking and qualitative approaches to assess a firm's operating environment, which include the strength of macro-economic condition, the stability and transparency of regulatory environment as well as the volatility of property market. Firms that operate in stable property markets with strong economic condition, stable and transparent regulatory environment will be in favor of their business operation and development. Higher rent levels, active leasing activities, large transaction volume (which increases market liquidity), as well as healthy growing trend in rent rate and property value are some of the characteristics that imply a positive operating environment. A firm that operates in markets characterized by limited supply and structural undersupply would typically have a higher rating for this sub-factor.

(2) Scale

CCXAP considers scale as an important indicator of a firm's ability to support its market position. Large property portfolio helps a firm to be more resilient to changes of market condition and better absorb changes in costs, thus enhancing the stability of its business performance. We typically use the fair value of total assets to measure a firm's scale. For firms without fair value amount, we may use the book value of total assets (calculated by total assets plus accumulated depreciation) or other reliable estimates. We also evaluate a firm's size of rental income and other stationary services income to understand its scale of recurring income from its investment property portfolio.

(3) Market Position & Asset Quality

CCXAP uses market share, franchise value, and competitiveness to measure the market position of a firm. CCXAP opines that a firm with higher market share and established brand could help increase its pricing power and earn extra rents. Generally, a firm that has strong leadership position in multiple asset types and in various geographic markets will have a higher rating for this sub-factor. We also measure a firm's capacity to maintain its market position and pricing advantage.

In addition, we will evaluate the overall asset quality of a firm's property portfolio and its operation performance. The asset quality of a firm's property portfolio will directly influence its cash generation, liquidity and financial performance. CCXAP typically evaluates a firm's portfolio diversification, asset location and liquidity, as well as the stability of asset performance. Portfolio diversification is important because it can help mitigate the negative effects of economic downturns in specific regions or cities. A firm with geographic, industry and tenant diversification in portfolio is expected to obtain a higher rating. Properties assets that are located in densely populated region such as central business or industrial area of major cities can also help a firm to maintain high occupancy rates and rent levels. In addition, if a firm holds a large amount of high-class properties or Class A properties, it may receive a higher rating in this sub-factor. High-class assets normally have stronger marketability and liquidity than low-class assets, as the formers have a wider universe of potential tenants and investors. We also take account of factors that may affect a firm's stability of asset performance such as the age of properties, physical condition of the building, expenditure needs for operation and maintenance, as well as other unique elements.

(4) Development Exposure

New development property may help a firm improve its asset quality in investment portfolio, generate cash flow upon completion, and capture a new potential for growth. However, large development exposure entails risks such as sourcing, funding, construction and lease-up risk, which may cause negative impacts on a firm's financial stability. CCXAP considers the degree of a firm's development exposure based on the number, size and quality of the company's development projects, as well as the nature of development. Companies with large-scale development projects may give higher pressure on risk management and financial stability. In addition, we assess a firm's track record to evaluate the management's risk appetite in business strategy. A firm with aggressive development strategy to pursue speculative opportunity will limit its rating. CCXAP may use development portfolio/total assets as an indicator in quantifying the development risk exposure. Nevertheless, we are more likely to use a qualitative approach in this sub-factor.

2. Financial Strength

In the evaluation of financial strength of REITs and REOCs, CCXAP reviews their financial metrics and trends. The financial strength captures the financial aspects of a firm.

(1) EBITDA/Revenue

In assessing profitability, CCXAP uses the ratio of earnings before interest, taxes, depreciation and amortization to revenue (EBITDA/Revenue). Firms with higher EBITDA margin tend to have stronger profitability as well as better quality of management in controlling operating costs.

(2) Net Debt/EBITDA

The ratio of Net Debt/EBITDA is used as an indicator of a firm's debt service ability and leverage. It measures a firm's debt levels relative to its expected property cash flows. Net debt is calculated by total debt minus cash and cash equivalents.

(3) (Total Debt + Preferred Equity)/Total Assets

The ratio of total debt plus preferred equity to total assets is an indicator of a firm's balance sheet leverage. Preferred equity has characteristics of debt as investors are paid a stationary dividend. Normally, a firm may redeem preferred equity to adjust its cost of capital when interest rates change. Thus, we believe the debt-like characteristics of preferred equity are likely to override the equity characteristics. Total debt refers to all interest-bearing debts including bonds, notes, short-term and long-term borrowings. The higher of a firm's balance sheet leverage, the lower scoring will be in this sub-factor.

(4) Restricted Assets/Total Assets

CCXAP uses the ratio of restricted assets to total assets to evaluate the company's financial flexibility. Restricted assets are assets that are set aside for a particular purpose, primarily to satisfy regulatory or contractual requirements, which are segregated from other assets to mark clear delineations of their use. In a stressed situation, a REIT or REOC may sell its unrestricted assets or pledge them as collaterals for borrowings. That said, the unrestricted assets could be a source of liquidity that provide financing buffer to a firm. We expect a firm with a low ratio of restricted assets would have a higher rating in this sub-factor.

(5) Fixed-Charge Coverage

CCXAP uses Fixed-Charge coverage to evaluate the company's ability to pay interests and other fixed charges from its operation, as measured by EBITDA. The interests are measured by interest expenses plus capitalized interests; and preferred stock dividends are generally included in other fixed charge because we consider that the preferred stock of REITs or REOCs to have more debt-like characteristics.

Other Rating Considerations

In assessing the overall creditworthiness of the company, other than the factors and sub-factors discussed above, CCXAP considers corporate governance and management, investment risks outside the home market, access to capital, liquidity management and event risk.

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

Firms may have deep understanding of the market and locales in which they operate. However, successful companies may decide to further diversify their 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.

Access to Capital

The availability of access to capital is important for REITs or REOCs as their businesses are capital intensive and are subject to cycles in capital markets. In particular, REITs require ongoing access to external sources of capital to support their businesses as they have dividend distribution requirements and have limited ability to retain cash. We may evaluate a firm’s track record of raising funds from all sources of public and private capitals as well as its diversification in financing portfolio and uses of financial instruments.

Liquidity Management

Liquidity is a critical rating factor for REITs or REOCs. Liquidity can be particularly important for non-investment grade issuers which typically have less operating and financial flexibility. CCXAP may evaluate a firm’s reliable sources of liquidity (such as unused available bank facilities, expected operating cash flow and capital market offerings) to cover its expected uses of cash (such as debt repayments, dividend payments and capital expenditures) over the next 12-18 months. If a firm has weak liquidity management or its sources of liquidity that do not cover near-term cash needs, we may notch down its rating.

Event Risk

CCXAP will consider the possibility of unexpected events that could cause a sudden and sharp decline in the issuer’s overall credit profile, including asset sales, spin-off, capital restructuring program, change of major shareholders, mergers and acquisition and significant restructuring program.

External Support

From the perspective of external support, CCXAP considers both shareholder support and government support that a firm would receive to decrease the likelihood of default.

Shareholder Support

The support from shareholders benefits the company’s future development and overall credit strength. In terms of shareholder strength, CCXAP considers the nature of the holding company, industry competitiveness and financial status. In addition, CCXAP uses a firm’s development strategy, market position, ownership structure and importance to the shareholder to evaluate the availability of shareholder support.

Government Support

Government support means that when a firm is facing severe pressure of debt servicing, the government may provide support to serve debt or take actions to avoid default. In assessing the support from the government, we may consider the following factors such as a firm’s assets importance to the government, the legal requirements and degree of oversight from the government, government support and bailout histories, as well as the financial strength of the government.

Important Information

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