

MARC RATING METHODOLOGY



PROPERTY COMPANIES

INTRODUCTION

The property market is unique compared to other industries in two very important ways. Firstly due to the nature of the product, it is not possible to transfer a property from a market which has a surplus of that type of property to an area which is suffering from a scarcity of the same type of property. In other words, the property market tends to be local. This has given rise to the adage that the three most important things about buying a property are, "Location, location and location".

The second unique characteristic about the property market is that once a building has been constructed it stays "in the market" for the next 20 to 30 years. Therefore, when demand for a particular type of property drops, it is not possible for the supply to shrink to match the demand.

Another peculiar feature of the property market in Malaysia is that properties in the primary market are sold before they are completed and billings are issued as the construction of the property progresses. This means that the Purchasers of these properties carry some of the completion risk of the project. Consequently, the industry is heavily regulated in Malaysia, mainly by the Housing Development (Control and Licensing) Act 1966. Among the requirements of the Act is the need for Developers that fall within the ambit of the Act to obtain a

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Developer's Licence, an Advertising & Sales Permit and the need to open a special project account, commonly known as the Housing Development Account or the HDA account.

A systematic approach to rating a Property Development Company would consist of evaluating the following areas:

- Business Risk Analysis
- Financial Risk Analysis
- Management and Other Qualitative Factors
- Issue Structure and Terms

BUSINESS RISK ANALYSIS

In evaluating the business risk of a Property Development Company, it is necessary to consider the following factors:

Industry Outlook

The industry is cyclical in nature with the demand for property closely related to interest rate movement (negative correlation) and economic growth (positive correlation). It is therefore important for an analyst to know the point/position on the property cycle that the company is in when analysing the property market.

The industry is also highly fragmented with developers ranging in size from those with over a few hundred million in revenue to developers of a single property project comprising a few dozen houses.

Competitive Position

In examining the competitive position, the analyst is evaluating the competitive advantages an Issuer would have over its peers i.e. its strengths and weaknesses. The location of its properties and its geographical spread are the key determinants of the success of a Property Development Project. The size of the Developer's land bank is also important as this would indicate the sustainability of the Developer's revenue base.

The ability of the Developer to create uniqueness in respect of its housing projects (e.g. selling a lifestyle instead of selling houses) would enable the Developer to establish a strong market position and command a premium. Similarly, if the Developer chooses to retain some of the units developed (e.g. commercial or retail units) for rental income, the units would be able to command a premium on rental if they possess aesthetically pleasing or unique features.

Operation Risk

The operation risk would vary throughout the life cycle of a property development project.

During the planning stage, the risk involves the ability to conceptualise the development that would be in demand; obtaining all necessary approvals and ensuring the project commences/progresses as scheduled.

Other than the licensing requirement of the Housing Development (Control and Licensing) Act, additional approvals required for most development projects are:

- If the land use is incongruent with the proposed development project, approval has to be obtained to convert the land use e.g. the project land may have been earlier approved for agriculture which will require approval for the conversion of the land use to residential development, say. Land conversion premium would have to be paid to the State Authorities for the conversion.
- Planning approval would have to be obtained from the various city/town councils for the project itself. The layout plans would also have to be approved. This applies mainly for residential housing projects.
- The proposed building plan would have to conform to the building code and approval would have to be obtained from the various city/town councils.
- For large projects at sensitive areas such as on a hillside or near nature reserve, the Authorities may require an Environment Impact Assessment to be carried out.

To gauge the marketability of the properties being offered for sale, it is necessary to compare the proposed selling price with similar types of units in the surrounding area. Since the units are still being constructed, it may be necessary to price the units at a discount to completed units offered for sale in the secondary market. The discount usually ranges around 10% to 15%. For comparison purposes market value or the sales price should be measured according to value per square meter or per square foot (RM/m² or RM/ft²).

While the building is being constructed the main risks are to complete the project on time, within the projected construction cost and acceptable workmanship quality. The analyst should review the track record of the main contractor to determine its ability to complete the project on time and its reputation for workmanship.

For comparison purposes, the construction cost for a building is often measured in terms of cost per square meter or cost per square foot (RM/m² or RM/ft²). There is no standard construction cost. The construction cost is influenced by various factors, namely;

- **The amount of earthworks required** Buildings constructed on land with a high gradient or housing projects constructed on land with undulating gradient would necessitate a higher expenditure for earthworks, foundation.
- **The type of soil** This would influence the construction cost for the foundation of the building. For large projects especially if they involve high rise buildings, it is advisable to conduct a soil test especially if the soil consist of limestone or reclaim land or is a former mining land. If the area is rocky, the costs of earthworks and foundation would be higher.
- **The design** For aesthetic reasons, some buildings are designed with unique features. This can result in higher construction cost but buildings which are considered aesthetically pleasing can command a premium.
- **The height of the building** This would have a direct impact on the cost of the foundation required and the construction of the additional floors would require additional building materials.
- **Finishing** The finishing used would influence the cost of construction. The use of more expensive materials such as marble slab instead of concrete tiles would increase the cost of the building. The cost of the finishing for a building can range from around 10% (basic) to 20% (extensive) of the total cost.

Other than the above factors, a change in Government policy can indirectly influence the cost of construction. The price of certain essential building materials such as steel and cement are heavily influenced by the Government. Therefore, any changes in Government policy in this area would influence the cost of construction.

The construction industry in Malaysia is also highly dependent on immigrant labour, a large number of whom previously did not have the requisite permit to work in Malaysia legally. Any changes in Government policy can affect the supply of labour. The Government crackdown on immigrant labour in 2005 caused the construction industry to slow down in that year.

After the property is completed and vacant possession has been handed over, the main risk would be to ensure that the completed units are free from defects during the liability period of 18 months after delivery of vacant possession.

For commercial properties and retail properties, the Developer may sell some of the properties to settle or pay down any bridging loans and rent out the rest of the building to generate a flow of steady rental income. It may take some time before the property generates sufficient rental income to service debt obligations.

The management team must have the necessary experience and technical expertise to manage the building especially if it is a retail complex. For a retail complex, it is necessary to ensure that the building has the correct tenant mix (to project a certain image or to cater to a specific niche), with an anchor tenant to draw the crowds, sufficient parking bays and regular promotions being carried out. The catchment area for the retail complex would also be an important factor to consider. Therefore, management track record in managing commercial properties is an important consideration especially in weathering adverse market conditions.

FINANCIAL RISK

Evaluating the Financial Risk of the Issuer is an important component of a rating exercise. An evaluation of the Financial Risk would entail an analysis of the following factors:

Profitability

The sustainability of a company over the long term depends on its profitability. In analysing the profitability of a company, it is important to analyse the earnings before interest, tax, depreciation and amortisation. Of equal importance is to review the earnings growth trend and return on assets.

Cash Flow

While it is important to review the cash flow of an Issuer for any debt issue, the review of the cash flow for a project under development is essential whilst the project is in the construction stage. When reviewing the cash flow of an ongoing project, it should be noted that funds from any bridging loans are usually released against Architect's Certificate of Works Done.

The main components of a cashflow are:

- The cash inflow which would depend on two main variables i.e. the take up rates of the properties and the construction schedule. Deciding on the potential take up rates and the timing of the launches are highly judgemental. If the analyst is unfamiliar with the market conditions in respect of the locality of the property under financing, it would be advisable to discuss with property valuers and real estate agents who are familiar with that particular market.

- Since the progress payments billings are based on the Architect's Certificate of Works Done, the pace of construction would determine the cash inflow. Normally, there would be a delay of a few months between the time the construction cost is incurred and the proceeds from the progress billings are received.
- Once the construction schedule has been determined by the developer, the cash flow can be determined.
- After the cash inflow and outflow have been computed, the financing requirement will then be known.

The Purchasers would often obtain Housing/Term Loans from financial institutions (the End-Financiers). The end-financiers would release the redemption sum directly to the bridging financier. It should be noted that the first 10% (paid upon signing of the Sales & Purchase Agreement) usually is credited directly into the HDA account and would not be used to redeem the property purchased. It is only the subsequent progress payment proceeds that would be used to redeem the property.

It should also be noted that for the sale of residential units that are governed by the Housing Development (Control & Licensing) Regulations 1989, Property Developers are required to use the prescribe standard Sales & Purchase Agreement. The standard Sales & Purchase Agreement sets out the percentage of the Sales & Purchase price that can be billed regardless of the actual construction cost. For example, if a house is constructed on a hilly terrain, the actual cost for the foundation could be more than 10% of the Sales & Purchase price, but under the standard Sales & Purchase Agreement, the Developer can only bill 10%.

After the framework for the cashflow has been prepared, different scenarios such as changes in interest rate or take up rate or construction cost can be easily generated. The stress test could then be carried out and the viability of the project assessed.

Capital Structure/Financial Flexibility

The ability of a company to repay its debt especially under conditions of financial stress is correlated to its Capital Structure and Financial Flexibility. Key considerations for assessing the Capital Structure and Financial Flexibility of a company are as follows:

- **Unencumbered Assets** The availability of unencumbered assets would allow the Developer to raise additional funds (either by sale of the asset or as security for loans) in times of financial stress. The presence of unencumbered assets also enhances the recovery rate for the unsecured lenders in a liquidation scenario.
- **Unutilised credit lines** Ideally, this should be sufficient to cover one year's cash requirement.

- **Short Term Debt** Debts maturing in less than one year (or short term debt) should be less than 10% of the total debt. A concentration of short term debts can pose a risk to the company in times of financial stress as the possibility of lenders recalling the short term debts increases.
- **Debt leverage** The Developer should have a low debt leverage ratio and a high Debt Service Coverage Ratio. Developers that have a more stable income (e.g. from a stream of continuous housing projects or a significant recurring rental income stream) can support a higher level of debt leverage. Similarly, Developers that can command a premium on their housing projects (i.e. enjoy a good market position) and have higher gross profit margins can support a higher debt burden. When measuring debt leverage, it would be good to adjust the carrying value of the properties on the company's balance sheet to the current market value, where possible.
- **Access to Capital Market** Another important consideration is the ability of the company to raise additional funds from the capital market (for public listed companies). Important factors to consider are the Price/ Earnings Ratio and the Market Capitalisation of the company.
- **Dividend Payout** The dividend payout ratio should be less than 50% of the profits to ensure that sufficient cash is retained in the company.

MANAGEMENT AND OTHER QUALITATIVE FACTORS

The track record of the Developer in their past developments is also an important consideration. Since sales are often made before the completion of the property, purchasers would hesitate to buy properties from a Developer who does not have a good market reputation unless the properties are sold at a significant discount to the market. Besides the management's track record, other factors to consider include:

- **Corporate Structure** Having a major shareholder controlling the company can be a stabilising factor and provide the management with the flexibility to focus on its long term plans. A level of integration (e.g. construction and manufacturing of building materials) would enable the company to enjoy economies of scale and enhance their profit margins.
- **Management Depth** It is also important to assess the experience of the middle level management especially its operating and technical competencies. Another important consideration is how long the senior management has been operating as a team. Equally important is succession planning especially when senior

management are near retirement age and have dominant roles within the company.

- **Strategic Vision** The Management's strategic vision for the company and plans for its long term growth should also be considered. Does the company plan to grow organically or through acquisition? An aggressive acquisition strategy can stress the management team and the company may experience integration problems. When reviewing the company's plans for future growth, a comparison between projects in the pipeline and the company's resources needs to be undertaken to ensure that the company can complete the projects without straining its resources.

ISSUE STRUCTURE AND TERMS

The Issue Structure and Terms should be congruent with the business and financial profiles of the Issuer. Factors to consider include:

- Tenure of the Bond
- Repayment schedule
- Ranking of the debt
- Coupon rate
- Designated Accounts
- Credit enhancements e.g. Bank Guarantee or Corporate Guarantee etc.

Debt issues for property development companies typically include Security and Support Arrangements. Examples of Security and Support Arrangements under the National Land Code 1965 are:

- a. A lien over the property by depositing the document of title (a Memorandum of Deposit setting out the terms and conditions is usually executed). The holder (i.e. the Lender) of a lien would be able to sell the property pledged. However, before the property can be sold, judgement has to be obtained against the Borrower before the Lender can exercise its right of sale. This method of securing pledged property is seldom employed and when used it is most often for a short duration. To further enhance the security arrangement and to prevent fraudulent transfer or sale of the property, it might be necessary to lodge a Private Caveat over the pledged property.
- b. A Private Caveat by itself does not secure the pledged property since it does not entitle the Lender to sell the pledged property. As elaborated above, a Private Caveat is often employed in

conjunction with a lien executed by way of a Memorandum of Deposit. A Private Caveat prevents any dealings in the property. Dealings include sale, transfer and lodgement of Legal Charge and Lien-holder's Caveat. A Private Caveat is valid for only six years.

- c. A Lien-holder's Caveat in contrast to a Private Caveat, entitles the holder to sell the pledged property in addition to preventing dealings in the property. However, to exercise the right of sale, the Lender would have to obtain judgement against the Borrower first. The lodgement of a Lien-holder's Caveat requires the physical possession of the title and the consent of the property owner.
- d. A Legal Charge over the property is the most secured form of security a Lender (Chargee) can take. As with a Lien-holder's caveat, a Legal Charge prevents any dealings in the charged property. However, unlike a Lien-holder's Caveat, the Chargee can foreclose on the charged property without having to obtain judgement against the Borrower first.

Besides securing the pledged property under the provisions of the National Land Code, the Lender can also secure the pledged properties by way of a Debenture. Debentures are usually taken as additional security arrangement in addition to a Legal Charge or Lien-holder's Caveat. For specialised assets such as retail complexes and hotels, it would be advisable for the Lender to have a Debenture as part of the security arrangement. Specialised assets of such nature often take time to be realised and in the meantime the Lender might want to appoint a Receiver & Manager to safeguard the asset and prevent the owner from "stripping" the asset.

The Bonds can also be secured indirectly by taking an assignment over the sales proceeds or rental proceeds. The assigned proceeds would then be used to service the interest and principal payments. Ideally, the assignor should have confirmed Sales & Purchase Agreements or Rental Agreements before the assignment.

The assigned proceeds can be channelled into a designated account and the monies applied for approved expenses according to an agreed order of priority of payments. An example of priority of payments is as follows:

- a. Payment of tax and other statutory payments.
- b. Payments of fees and other expenses.
- c. Payment into an Interest Service Reserve Account to service the interest payments for the Bonds.
- d. Payment into a Reserve Account up to an agreed amount to fund any payment requirements under the Debt issue in the event there

are insufficient funds in other designated accounts to make the required scheduled payments.

- e. Payment into a Redemption Account to fund the redemption of the Bond.

The assignment of sales proceeds and rental proceeds can be taken as additional security arrangement in addition to other security arrangement such as Legal Charge and Lien-holder's Caveat.

The security arrangement can be further enhanced by the addition of covenants (restrictive and positive) as part of the Loan/ Facility Agreement. The use of negative covenants that cap the debt leverage ratio are often used to mitigate the risk to lenders. While covenants offer additional protection for the debt holders, they seldom protect bondholders against all risks. However it does indicate to the company's management the amount of risk the debt holders are willing to bear.

MONITORING

After the issuance of the Bonds, the Issuer requires close monitoring and reporting for any changes to the sales of the underlying properties, to the construction schedule of the development and any changes to the development plan. For completed and operating properties (such as retail complexes and offices) monitoring must also be done on a regular basis to check on competitors in the surrounding area and the management of the properties.

MARC has refined its methodology for assessing Property Companies. This methodology partly amends and supersedes MARC's "Rating Approach to Property Companies" published in 2006. The revised methodology should be read in conjunction with MARC's "Corporate Debt Ratings" methodology which is available on MARC's website at www.marc.com.my.

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Published and Printed by:

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