

RATING METHODOLOGY

DEBT SECURITIES ISSUED BY MALAYSIAN REAL ESTATE INVESTMENT TRUST (REITS)



OVERVIEW

The rating methodology on Malaysian real estate trust funds (M-REIT) will focus on the asset quality of the pool of properties in the portfolios, the factors that will impact on the performance of the property market and the evaluation of the property managers appointed to manage the M-REITs. The rating approach will also assess the M-REITs financial performance with emphasis on their liquidity and funding position in relation to their abilities to service interest payments and repay principal obligations on debt securities issued. This is pertinent from a credit perspective as REITs are often required to have high income distribution and hence have limited cash retention.

As the domestic REIT sector continues to evolve in terms of asset size and diversity since the first launch of M-REIT in August 2005, MARC Ratings will assess the prospects for the industries on which the demand for the assets in the portfolio will depend. In addition to commercial properties, the M-REIT sector includes industrial, retail, hotel, hospital, and plantation assets. There are 11 M-REITs listed on the Bursa Malaysia stock exchange, of which two are based on Islamic Syariah principles, as of April 2010, with total asset size of RM8.8 billion. This is expected to increase to about RM14 billion by year-end with the listing of three more REITs. MARC Ratings will also focus on the regulatory framework including the tax structure as well as gearing limits in relation to the ability of M-REITs to undertake growth strategies as well as honor debt obligations.

Contacts:

Rajaseharan Paramesran
Chief Rating Officer
rajan@marc.com.my

Lim Wooi Loon
Senior Analyst
wooloon@marc.com.my

+603 2717 2900
www.marc.com.my

The rating factors can be summarized as follow:

- Asset quality – property market trends, freehold/leasehold, age, type and size of properties, location, accessibility, market value of each asset.
- Operating strength – rental stability and sustainability, tenant composition, tenancy terms, asset and geographic diversity
- Management - track record, external and internal growth policies, fee structure.
- Financial analysis – profitability, liquidity and funding, capital structure.

ASSET QUALITY

MARC Ratings will assess the risk profile of each particular type of asset in the M-REIT portfolio by focusing on the macroeconomic and microeconomic factors that will impact on the performance of the asset. These include examining property market cycles, the supply and demand dynamics in the areas where the properties are located, the outlook for economic growth and the interest rate environment.

MARC Ratings will view properties located in or near the economic growth areas to have a more competitive edge than those in areas where diminished prospects for growth is envisaged. Other factors that will determine the strength of demand such as government efforts to lure potential industries and/or creation of economic zones through the provision of tax and other incentives will be considered.

MARC Ratings will take into consideration that different classes of assets have different level of riskiness. For instance should economic policies favor more service oriented enterprises, interest in commercial properties could gain and conversely demand for industrial properties could wane if factors such as relocation to lower wage countries gather pace. Another example is hospital assets which are perceived to have a higher degree of risk relative to commercial assets given the specialized nature of the latter that may restrict its ability to be converted to an alternate space.

MARC Ratings will examine the location of the property in terms of maturity and accessibility. Other considerations include evaluating the acquisition price of the assets, redevelopment potential, tenure of the property (freehold/leasehold), and remaining years left if the property has leasehold status. In addition, its size, age and condition by segregating the properties by number of years since construction which will provide an indication on refurbishment and upgrading requirement and hence potential for yield accretion will be assessed. For the performance of the M-REIT, MARC Ratings views the quality of asset as

crucial in tenant retention, improving occupancy levels as well its marketability. In its assessment, MARC Ratings will also seek the latest valuation report on each of the properties in the M-REIT portfolio from qualified valuers and conduct on site inspections of the main assets.

OPERATING STRENGTH

MARC Ratings will evaluate the ability of the properties to generate sustainable and stable rental streams relative to the portfolio's debt obligations. The portfolio's diversity in terms of asset usage, geographic and tenant-mix are factors that would support its operating stability. In general, MARC Ratings considers a geographically diversified portfolio to be more favorably inclined to generate sustainable cash flow, though the benefits from the diversification could be tempered should the assets, despite being in different locations, are seen to be susceptible to similar risk factors. Similarly M-REIT portfolios that have assets concentrated in any one area, for example commercial properties in Kuala Lumpur City Centre will not be seen as detrimental to the evaluation of the portfolio as MARC Ratings will assess the competitiveness of the properties.

Given that different property types have varying degree of risk, the composition of the portfolio in terms of revenue contribution will be assessed. A fairly diversified revenue base will be seen to contribute to greater stability to the portfolio's operating cash flow.

In evaluating the operating strength of the REIT portfolio, tenant-mix is an important factor to provide a better guide to the performance of the portfolio going forward. In this regard, MARC Ratings will evaluate the quality of tenants from the list provided by management by assessing their creditworthiness, the diversity of major tenants, the percentage of rental space occupied by major tenants and the nature of the tenancy agreements which include average length of tenancy, number of future renewal periods, rental step-up clauses, termination clauses etc. MARC Ratings will also examine historical tenancy statistics i.e rental aging analysis, default rates and eviction statistics, and evaluate management policies that are in place to minimize these risks,

MANAGEMENT

MARC Ratings will examine the caliber and track record of the manager of the M-REIT portfolio by evaluating its policies on tenant selection and management strategy in relation to its ability to execute yield accretive strategy by growing the portfolio and undertake plans to improve asset value (eg. refurbishment) and the manager's past and current investment criteria which is crucial in determining the prospects for the M-REIT. Management with strong property sourcing capabilities or has been able to create a 'brand' for its chain of properties will be viewed

more favorably. MARC Ratings will ascertain if the investment plans are in line with its vision and assess its track record of successful implementation to date.

Management's risk appetite in relation to its acquisition and divestments and the terms of its compensation package will be considered. Where frequent asset sales pattern is detected to generate short-term capital gains, MARC Ratings may be inclined to view such actions less favorably and as contributing to earning fluctuations.

The manager's role in carrying out effective risk management will be assessed by examining internal policy on managing tenant risk, liquidity risk in relation to the M-REIT's debt obligations, gearing levels and debt maturity risk profile. In addition, the manager's ability to provide timely valuation reports on all of the M-REIT's properties, and other reports as required by regulatory authorities will be taken into consideration.

FINANCIAL ANALYSIS

MARC Ratings will analyze the financial performance of the M-REIT by focusing on key financial ratios bearing in mind that distribution of a significant portion of its earnings is an intrinsic characteristic of a M-REIT. Among the profitability measures that will be assessed are as follow:

- Operating income (NOI)/net operating cost
- Operating margins
- Dividend payout ratio
- Expenses/Operating Income
- Return on Assets

A trend analysis of these measures will indicate the ability of the M-REIT to undertake operate within the parameters of its stated objectives and help identify contributing factors to the strength and weakness of its performance. The dividend payout will provide insights on the M-REIT's financial policy on balancing income distribution to unit holders and payment to creditors and its cash retention capacity to fund future growth of its business. MARC Ratings will seek to obtain financial projections and will make appropriate adjustments by taking into consideration management plans to gauge the M-REIT's performance going forward.

Cash flow coverage ratios are an important measure to assess the extent to which M-REIT's financial obligations are covered by its operating cash flow. Among the key cash flow protection measures analyzed are as follow:

- Cash Flow From Operations (CFO)/Interest Coverage
- CFO/Debt payments
- EBITDA/Interest
- Debt Service Cover Ratio (DSCR)

MARC Ratings will also carry out sensitivity tests to assess the sustainability and stability of the future cash flow projections by varying the occupancy levels, rental rates, interest payments as well as other inputs. Where assets in the pool are encumbered, MARC Ratings will seek to separate the cash flow generated from the assets to obtain the M-REIT's actual free cash flow position.

MARC Ratings will examine the M-REIT's capital structure by focusing on the following key leverage ratios:

- Total debt/Capital
- Short-term debt/Capital
- Long-term debt/Capital
- Debt/Market value
- Debt/EBITDA

The M-REIT's gearing level will be compared with its internal policy as well as to the prevailing limit set by the regulatory body which has set the statutory debt limit at 50% of asset value. MARC Ratings will assess the ability of the M-REIT to manage its capital prudently while balancing its need for growth by borrowing against the assets. MARC Ratings will examine the collateral margin on the assets to determine the available buffer should the value of the assets deteriorate.

The debt maturity profile will be examined with emphasis on the structure of its repayment schedule and where lumpy maturities exists, MARC Ratings will be concerned on the ability of the M-REIT to refinance the debt, which is usually the case, on a timely basis. Where the M-REIT will need to initiate asset sales for repayment, MARC Ratings will assess the time frame needed. In addition MARC Ratings will assess whether adequate banking lines are available to the M-REIT in relation to debt repayment and acquisition plans.

This methodology should be read in conjunction with MARC Ratings' "Corporate Debt Ratings" methodology which is available on our website at www.marc.com.my.

Disclaimer

Copyright © 2022 MARC Ratings Berhad and any of its subsidiaries or affiliates ("MARC Ratings") have exclusive proprietary rights in the data or information provided herein. This report is the property of MARC Ratings and is protected by Malaysian and international copyright laws and conventions. The data and information shall only be used for intended purposes and not for any improper or unauthorised purpose. All information contained herein shall not be copied or otherwise reproduced, repackaged, transmitted, transferred, disseminated, redistributed or resold for any purpose, in whole or in part, in any form or manner, or by any means or person without MARC Ratings' prior written consent.

This report is strictly confidential and privileged and is intended solely for the information and benefit of the addressee or recipient. If you are not the intended recipient, and/or have received this report in error, please delete this report and do not copy, disseminate, distribute or disclose the content of this report to any other person.

Ratings are solely statements of opinion and therefore shall not be taken as statements of fact under any circumstances. The information which MARC Ratings relies upon to assign its ratings includes publicly available and confidentially provided information obtained from issuers and its advisers including third-party reports and/or professional opinions which MARC Ratings reasonably believes to be accurate and reliable to the greatest extent. MARC Ratings assumes no obligation to undertake independent verification of any information it receives and does not guarantee the accuracy, completeness and timeliness of such information. MARC RATINGS OR ITS AFFILIATES, SUBSIDIARIES, DIRECTORS AND EMPLOYEES DISCLAIM ANY WARRANTY, EXPRESS OR IMPLIED, INCLUDING BUT NOT LIMITED TO ANY WARRANTY AS TO THE ACCURACY, COMPLETENESS OR TIMELINESS OF ANY INFORMATION CONTAINED HEREIN FOR ANY PARTICULAR PURPOSE AND SHALL NOT IN ANY EVENT BE HELD RESPONSIBLE FOR ANY DAMAGES, DIRECT OR INDIRECT, CONSEQUENTIAL OR COMPENSATORY, ARISING OUT OF THE USE OF SUCH INFORMATION. MARC will not defend, indemnify or hold harmless any user of this report against any claims, demands, damages, losses, proceedings, costs and/or expenses which the user may suffer or incur as a result of relying on this report in any way whatsoever. Any person making use of and/or relying on any credit analysis report produced by MARC Ratings and information contained therein solely assumes the risk in making use of and/or relying on such reports and all information contained therein and acknowledges that this disclaimer has been read and understood and agrees to be bound by it.

A credit rating is not a recommendation to buy, sell or hold any security and/or investment. Any user of this report should not rely solely on the credit rating and analysis contained in this report to make an investment decision in as much as it does not address non-credit risks, the adequacy of market price, suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security concerned.

Ratings may be changed, placed on MARCWatch, suspended or withdrawn at any time for any reason at the sole discretion of MARC Ratings. MARC Ratings may make modifications to and/or amendments in credit analysis reports including information contained therein at any time after publication as it deems appropriate.

MARC Ratings receives fees from its ratees and has structured reporting lines and compensation arrangements for its analytical members in a manner designed to promote the integrity of its rating process, and to eliminate and/or manage actual and/or potential conflicts of interest.

© 2022 MARC Ratings Berhad

Published and Printed by:

MARC RATINGS BERHAD 202001041436 (1397757-W)
19-07, Level 19, Q Sentral, 2A Jalan Stesen Sentral 2, Kuala Lumpur Sentral, 50470 KUALA LUMPUR
Tel: [603] 2717 2900 Fax: [603] 2717 2920
E-mail: ratings@marc.com.my Website: www.marc.com.my