CORPORATE DEBT

RATING METHODOLOGY

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

MARC

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.

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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.

Published and Printed by:

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