CRITERIA FOR RATING REAL ESTATE INVESTMENT TRUSTS AND OTHER COMMERCIAL PROPERTY COMPANIES

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Scope of the Criteria

1. The *Criteria for Rating Real Estate Investment Trusts and Other Commercial Property Companies* ('Property Criteria'), is intended to illustrate the rating guidelines that GCR follows when according a rating to a commercial property company or property funds. GCR defines commercial property companies as those companies that derive a substantial majority of their earnings from rental income, or other forms of recurring income that is ultimately sourced from rental income, such as dividends from other commercial property investments or mortgage related lending. This definition accommodates the varied legal structures evidenced by property funds including, Real Estate Investment Trusts (REITs), corporate real estate operating companies, and commercial property funds (collectively referred to as property funds). Property development companies, where the majority of income derives from the sale of properties fall under the general Criteria for Rating Corporate Entities, but the property component analysis may draw substantially from the principles discussed in this methodology.

2. Conversely, as commercial property companies essentially comprise a niche sector within the general corporate environment, GCR draws heavily upon the Criteria for Rating Corporate Entities, Nov 2021 ('Corporate Criteria') to guide the property criteria in areas of convergence. Where the reader may benefit by making reference to the corporate criteria, this is clearly indicated, as well as the potential justifications for disparity.

Summary of the Criteria Changes

3. The major amendment to the criteria is to combine the portfolio composition and portfolio performance assessments into a single portfolio quality score. GCR has recognised the high correlation between the sub-factors that comprise these two broad categories of analysis and therefore these are more accurately reflected in a single score. Nevertheless, the Criteria still outlines the two broad categories and their sub-factors to provide greater insight into GCR's portfolio evaluation process. Importantly, portfolio quality for property funds retains its greater weighting, while earnings performance is not considered as a standalone component.

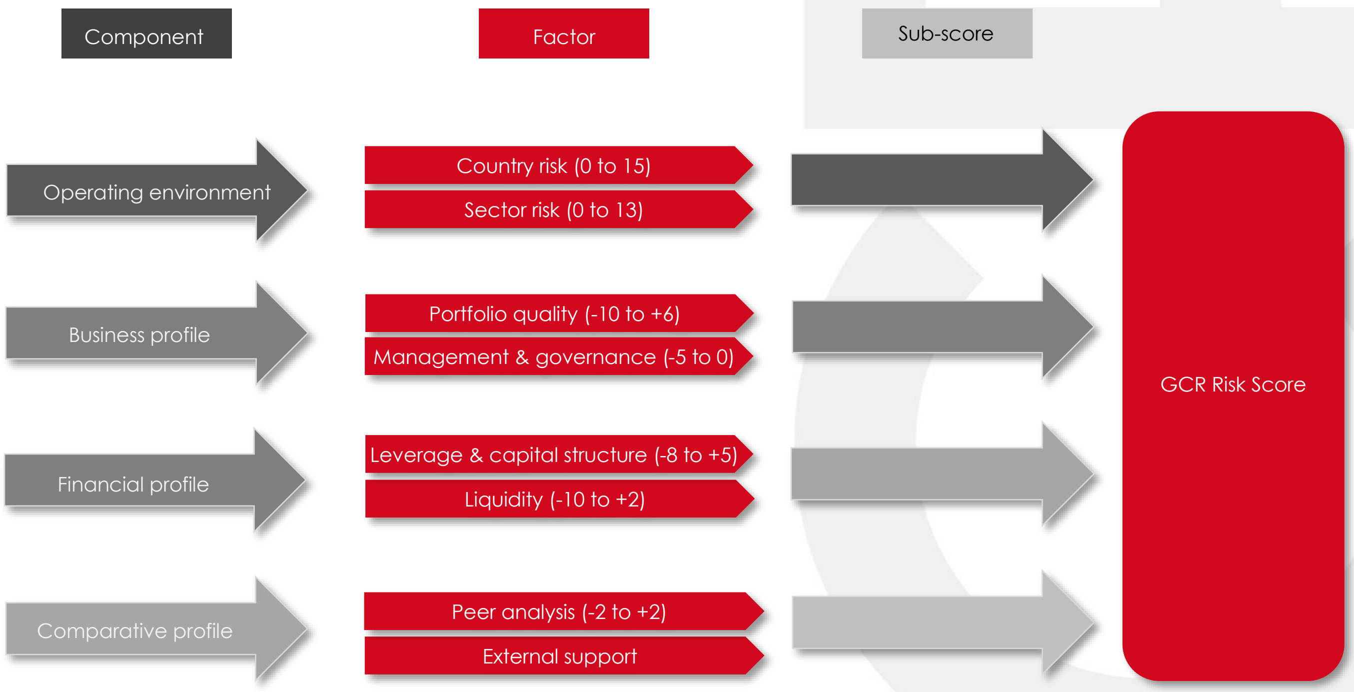
4. The Operating Environment segment of the sector risk score has also been amended, as per the changes to the Corporate Criteria. While the previous criteria presented sector risk as a combination of three distinct factors, the current criteria encompasses a more holistic approach to the sector risk scoring (Component 1, factor B), taking cognizance of the relativity between different sectors in different geographies.

An Overview of the Ratings Framework

5. In order to improve the comparability and transparency of the ratings, GCR has adopted a framework (see below) with publicly available scoring for the major rating components. The goal is to provide stakeholders (issuer, investor, regulator, counterparty etc.) with a view of each of the major rating drivers and ultimately what factors may change the ratings in the future.

6. GCR adopts four major rating components (operating environment, business profile, financial profile and comparative profile), which are all broken down into two or three major factors, with a positive or negative score assigned to each. The accumulation of the scores determines the GCR Risk Score, which is translated using the GCR Anchor Credit Evaluator and some final rating adjustment factors into issue(r) credit ratings.

Figure 1: GCR Ratings Framework Diagram for REITs and Commercial Property Companies



Component 1: Operating Environment

(0 to 28: 28 best)

Operating Environment

Factor A: Country Risk (0 to 15)

- GDP Per Capita
- World Bank Governance Indicators
- WEF

Factor B: Sector Risk (0 to 13)

- Cyclicality
- Country Business Environment
- Industry Dynamics

7. The core of the rating framework is based on GCR's opinion that a property fund's operating environment frames its creditworthiness. As a result, the operating environment analysis contributes the largest component of the underlying risk score for the GCR rating methodology. Essentially, GCR combines elements of macro-economic and sectoral analysis, sometimes weighted across countries, to anchor the property fund to its current operating conditions.

8. Whilst the direct link to sovereign strengths and macro trends may not be as obvious for property companies as it is for financial institutions (for example), GCR is of the view that the wealth of households and the political/business environment are *essential* considerations in respect of their creditworthiness. This is because studies demonstrate that the performance of most entities within a country is highly correlated with that country's GDP performance and other financial indicators. Furthermore, property funds are still be exposed to factors such as the domestic credit environment, regulatory pressures, and the funding dynamics within a given geography.

Component 1, Factor A: Country Risk Score

(0 TO 15: 15 BEST)

9. GCR's country risk scores are determined by a country risk panel in line with the '*Country Risk Score*' methodology as highlighted in the '*Country Risk Criteria*' and are published on the GCR website. A property fund that is domiciled and operates in a single country will receive that country's risk score. However, where a property fund is exposed to a number of countries, either through direct property holdings or through investments, the score will reflect the weighted average of the country risk scores to which it is exposed. Preference is given to the entity's country of domicile or where the majority of its operations are undertaken. Typically, another country must contribute over 10% of the weighted average operating income or asset base to be included in the blended country risk score, but adjustments may be made to reflect the importance (or lack thereof) of the country diversification in the property fund's strategy.

Component 1, Factor B: Corporate Sector Risk Score

(0 TO 13: 13 BEST)

10. It is GCR's opinion that the overall economic conditions within a particular industry will be one of the key drivers of financial performance for the individual entities. Being private entities, property companies are subject to the same systematic risks that impact broader corporate entities. Accordingly, the property criteria makes use of the same analysis for calculating the Sector Risk score, as detailed in the *Corporate Criteria*. In brief, GCR considers the Property Sector Score in terms of 1) industry cyclicality 2) effectiveness of the business environment within a jurisdiction and 3) industry dynamics. The first two factors provide a ranking of risk that is applicable across all industries or countries. The scoring is between 0 (weakest) and +13 (strongest), but the ultimate score accorded will be determined in relation to the country risk score.

Component 1, Factor B1: Cyclicality

11. The cyclicality of an industry refers to the sensitivity of the industry's performance (or lack thereof) to broad economic factors (although cyclicality may also be a factor of sector specific trends). The cyclicality of an industry is considered to be an inherent operating condition, relatively consistent across the world and generally will not change (or will only change gradually over the long term). The property sector does evidence cyclicality, which is usually manifested in terms of movements in vacancy levels, rental rates and valuations. Nevertheless, as much of the income is locked in through multi-year rental agreements, actual earnings can adjust relatively slowly to changes in the environment. Thus, in GCR's experience earnings volatility for property fund earnings tends to be below moderately low, even for underperforming entities. This informs GCR's opinion that (notwithstanding some differences across property classes, which is captured as part of the portfolio quality assessment) property funds evidence below average cyclicality.

Component 1, Factor B2: Country Business Environment

12. GCR recognises that the risk related to an industry is highly dependent on the jurisdiction wherein the corporate is headquartered or conducts its operations. For property companies, jurisdiction considerations are particularly important as their income generating assets are fixed. GCR believes that property companies domiciled in countries that are characterised by a stable operating environment,

with strong capital markets and a legislative/regulatory environment that is supportive of the private sector are typically more creditworthy than those operating in jurisdictions with large bureaucracies, weak financial markets and unpredictable legal systems, all else being equal. To rank the effectiveness of a particular country's business environment, GCR considers a host of factors related to the jurisdiction including, *inter alia*; the financial system, the legal environment, quality of infrastructure, ICT adoption, macro-economic stability, and the labor market. Positive scoring will depend on a country receiving relatively high rankings for the various factors in GCR's analysis, while countries with poor rankings will be penalised. Scoring considerations may be modified by an assessment of progress/deterioration relative to previous years.

Component 1, Factor B3: Industry dynamics

13. In GCR's opinion, the credit ratings for most property companies will not deviate substantially from the average credit rating of similar companies in the same jurisdiction. Accordingly, it is critical to understand the property dynamics of the specific jurisdiction wherein the entity is domiciled/operates. These dynamics can fluctuate over a fairly short space of time and need to be monitored on an ongoing basis. To this end, GCR will periodically publish opinion pieces on property sector dynamics in key markets, which will be used in calculating the Sector Risk Score for the rated property companies. The opinion is influenced by both industry specific (barriers to entry, technology and disruption, the profitability of the industry) and external characteristics (regulations, legislation, and politics), which are considered together to arrive at a risk score.

Component 2: Business profile

Component 2, Factor A: Portfolio quality

(-10 TO 6: 6 BEST)

14. In the property sector, the business profile factor is a reflection of portfolio quality assessment. This is because the property sector is so broad, with millions of private property owners, that no one player can be said to be dominant in the market (although strong positions can be achieved in specific subsectors in specific locations). Rather, it is the quality of the property portfolio that will determine the resilience of a particular fund through the cycle. Property funds with stronger property fundamentals will generally have greater pricing power in upcycles, while being better positioned to retain tenants through economic downturns. GCR thus considers overall portfolio quality to be a more relevant predictor of a property fund's risk and the differentiating factor between competing funds. As a consequence, the business profile assessment has been given a higher weighting by expanding the potential scoring scale from 'very weak' (-10) to 'very strong' (+6). The Earnings Performance factor, utilised as a separate assessment for corporate entities in the Financial Profile component, forms part of the portfolio quality assessment factor for property companies.

Portfolio quality

Factor A1: Portfolio composition

- Size
- Diversification
- Sectoral preference
- Development pipeline

Factor A2: Portfolio performance

- Vacancy rates
- Rental rates
- Tenant quality
- Lease maturity
- Operating performance

15. The portfolio quality assessment factor is based on an analysis of a number of sub-factors meant to ascertain the robustness of a fund's property portfolio. While a single risk score is accorded, the assessment is considered in two broad categories, being portfolio composition and portfolio performance, under which the sub-factors are allocated. This reflects both the very high correlation between the two categories, whilst allowing the analysis greater ability to pinpoint the problematic factors. For example, property portfolios evidencing advantageous characteristics tend to report above average performance. However, during market slumps particular high-quality asset classes can be adversely impacted or conversely some funds that specialise in lower quality assets and are able to extract above average returns despite the disadvantages. To this end, while quantitative metrics form the basis for GCR's credit risk score for both the quality and performance of a property portfolio, the score may be adjusted for subjective factors that take into account each entities' particular strategy.

Component 2, Factor A1: Portfolio composition

16. The assessment of portfolio composition primarily focusses on those sub-factors that will reduce an entities operating risk, and as a corollary on factors that could be assumed to support robust long-term income growth. Sub-factors are considered in a holistic fashion, recognising that there is a myriad of ways to structure a fund to a achieve a strategic outcome. Nevertheless, most positive factors could also be considered negative traits in different circumstances. Key sub-factors include:

17. **Size**: GCR views larger funds, as measured by the gross value of investment assets, to be less risky. Scale allows for a fund to entrench its relationships across all market participants (developers, brokers, tenants) to become a preferred partner/investor. Larger funds are also better positioned to absorb shocks to specific assets/sectors exposures than smaller funds, as well as benefitting from the greater financial flexibility and more potential funding options that derive from a larger asset base. To be accorded the highest score for portfolio quality, the value of a fund's assets must be in excess of USD20bn, comparable to some of the larger global REITs. However, in practice most REITs, particularly in emerging markets, are much smaller and GCR thus allows for greater risk scoring differentiation at lower portfolio values.

18. **Diversification**: GCR considers funds that are more diversified to be less risky as there is a lower correlation between the performances of individual properties. Diversification is measured both by geography and by property class, as well as the concentration towards individual properties. To receive positive risk scores for geographic diversification, property funds should evidence a spread of assets across at least three major cities or regions, with some asset and income diversification away from the core jurisdiction of operations. GCR also considers diversification by property class to be positive as each property class tends to exhibit varied correlations to the overall economic environment. Well diversified funds tend to exhibit strong positions in three or more property classes. There are many property funds who specialised in a particular property class or region. Such funds may be somewhat penalised for lack of diversification, but the assessment may be adjusted to account for the benefits of specialisation, if demonstrated through robust performance metrics.

19. GCR will only include geographies or sectors where the fund has a meaningful investment in the diversification consideration. The threshold for a geography/sector to be considered material to the

portfolio is around 10%, but this may be adjusted in depending on how these exposures align with the fund's strategy. GCR may also penalise funds for having too much diversification if the granularity of the portfolio leads to a disparate portfolio that is cumbersome and costly to manage.

20. A diversification assessment is also applied to income by analysing a property fund's exposure to particular tenants (even over multiple properties). This is most relevant to retail portfolios, where large retail chains will let space in multiple properties, but the analysis is applicable to all property classes. Where a very high concentration to a particular tenant is evidenced, the tenant quality assessment (as discussed on page 9) becomes more critical in determining the risk to a fund.

21. Apart from the quantitative assessment, GCR may adjust the risk score based on some more subjective factors:

22. (**Positive/negative**) A fund has a strong position in key global gateway cities or cities that are undergoing particularly favorable economic growth, as well as in the most desirable nodes within those cities. Conversely, if the properties are located in cities/nodes with weak fundamentals, or risk factors related to the city/country/region are considered to be very high, diversification benefits may be negated.

23. (**Positive/negative**) A fund's portfolio includes a number of marquee assets, and/or evidence other features that provide a tangible competitive advantage. Conversely the diversification benefits of poor quality properties may be discounted.

24. **Sectoral preference:** Each property class performs differently depending on the specific market conditions. Such trends may be structural in nature or reflect shorter term exposures to a particular market dynamic. Accordingly, GCR will assume a relative ranking of property class creditworthiness that is applicable to the prevailing operating environment in a specific country/region. The risk assessment attributable to each class is then modified by a factor that takes into account current dynamics in the operating environment. These modifications may be positive or negative. GCR's views for each property class will be disseminated through the publication of periodic property industry opinion pieces. Some adjustment may also be made where a fund includes properties that are materially above or below the average quality of properties in the sector. A positive adjustment may also be made where a fund has demonstrated particularly strong capabilities in a property class.

25. **Development pipeline:** Successful development activity is important for a property fund to sustain long term asset value growth above the market average. However, by its nature, development activity entails numerous risks. Thus, while a moderate level of development activity is necessary, GCR views excessive development activity as increasing the risk profile and will make a downward adjustment to the risk score. In general, no negative adjustment to the score will be made where development activity accounts for less than 10% of the portfolio. At higher levels of development activity, the extent of the negative adjustment will depend on other risk mitigating factors, such as whether the development is pre-let or pre-sold, whether it is greenfield or brownfield and the developer's track record of tenanting new

developments. In exceptional cases, a small upward adjustment may be made where a fund has explicitly committed to following a very conservative investment approach.

Component 2, Factor A2: Portfolio performance

26. Portfolio performance assesses how the property fund has actually performed, given the advantages or disadvantages described in the preceding sub-factors. More importantly, GCR believes that the underlying trends that will drive a property fund's earnings are appropriately identified by assessing vacancies, rental escalations/reversions and the property expense ratio. Key sub-factors include:

27. **Vacancy rate:** Perhaps the clearest measure of a property portfolio's performance is its vacancy rate. As a rule, the lower the vacancy rate, the better a property portfolio is performing and the greater will be its ability to negotiate above average rental rates. GCR assesses this sub-factor on the absolute vacancy level (with lower scores assigned to higher vacancy rates) as it is best reflective of the quantum of revenue foregone. Nevertheless, the assessment will also consider the vacancy rate relative to the average property class/nodal vacancy rate and against historical trends within the fund. Where the assessment indicates outperformance relative to the market, or an improvement to the internal trend, a positive adjustment to the risk score may be made (if not already captured in a strong risk score).

28. **Rental rates:** GCR determines trends in rental performance by assessing a combination of in force rental escalations and reversions on the renewal of lease contracts. Escalation rates are important as they provide an underpin for consistent growth in rental income. The reversion trend provides more of an insight into the current market conditions. Thus, the ability of a property fund to achieve stable or positive rental reversions throughout the cycle is evidence of market outperformance. Negative reversions are characteristic of funds where performance is highly dependent on market conditions, or may signal that prevailing rental rates are above the market average (which may also be an indication that properties are overvalued).

    Tenant retention statistics can provide important insight into a property fund's escalation rates and the movement in vacancies. For example, property funds may prioritise tenant retention at the expense of negative reversions upon lease renewals, while other funds will be more focused on rental rates at the cost of income forgone.

29. **Tenant quality:** The higher the tenant quality the more likely a tenant will be to be able to honor a long-term lease, notwithstanding economic conditions, and the less problems the fund will likely face with rental collections and other management issues. Property funds that attain a positive risk score will generally report over 50% of income deriving from large national or multi-national corporations. Further uplift may be accorded where the proportion of high-quality tenants is well above 75% or where the tenants comprise global blue chip corporations. Where necessary, GCR may perform an internal credit assessment on particular tenants to ascertain their credit quality. This will usually only be applied in cases where the exposure to a particular tenant or tenant group is atypically high.

30. **Lease maturity:** The Lease maturity profile is considered both in terms of its weighted average expiry and by identifying any concentrations. For a fund to attain strong positive risk score it should report a long-

dated maturity profile, with maturities not exceeding 25% in any given year. Where a high concentration is evidenced, a fund should be able to demonstrate proactive steps to renew the lease (or replace the tenants) at least 6 months ahead of maturity. Conversely, a short-dated maturity profile is associated with much greater portfolio volatility, in that vacancy rates and rentals tend to fluctuate, leading to an unpredictable earnings trajectory.

31. **Operating performance:** GCR's utilises various operating metrics to provide an indication of a property fund's ability to manage its internal expenditure across the cycle and relative to its peers. To directly assess property management and the ability of the fund to pass on exogenous cost increases to its tenants, a property expense ratio is calculated by dividing direct property costs (including municipal charges, electricity, water, security, and general property maintenance) by direct property income (excluding income earned from investments). However, as funds may generate investment and other income (in addition to rental income), a broader operating margin ratio may be more meaningful.

Table 1: Portfolio quality

Score description	Score	Portfolio composition (typical descriptors)	Portfolio performance (typical descriptors)
Highest	5 to 6	Very large property portfolio value - in excess of USD20bn. Diversification in at least 3 global gateway cities in at least 3 different countries/regions, marquee properties within these cities with strong competitive advantage features. Wide network of relationships with key global players (developers, agents, tenants etc.) along with market leading management and systems. Low risk development pipeline.	Global blue chip tenant profile, with long dated lease maturity profile (typically over 7 years). Long term vacancy rates below the industry average. Sustained positive rental price movements. Very strong cost management and wide operating margin.
High	2 to 4	Large property portfolio value. Strong diversification within its core market, as well as partial diversification into other markets, with a weighting towards better performing sectors and geographies. Some marquee properties within these cities evidencing competitive advantage features. Demonstrated market leading competencies in two distinct property classes. Wide network of relationships with key players in core markets (developers, agents, tenants etc). Low risk development pipeline.	Blue chip tenant profile within the core operating jurisdiction, with long term lease maturity profile (+3.5 years). Long term vacancy rates below/in line with the industry average. Sustained positive rental price movements. Strong cost management and wide operating margin.
Intermediate	-1 to 1	Mid to large portfolio within a jurisdiction. Geographic diversification within its jurisdiction, as well as some property class diversification, but concentration may be evidenced. Meaningful exposure to well performing sectors, with a mix of above average and average properties in the portfolio. Moderate to low risk development pipeline.	Tenants are mainly of a good quality (c.60% of rental income), but a meaningful percentage of weaker tenants may also be evidenced. Vacancy rates fluctuate around the industry average. Rental rates do evidence some contraction during weak property markets. Expenditure and operating margins are stable but may show some fluctuations due to market conditions.
Low	-2 to -5	Small property portfolio, with average to below average quality of properties, but may feature some competitive advantages. Moderate levels of diversification by geography and property class. Moderate to high development risk may be present.	Tenant quality is fairly weak, with a short dated lease maturity profile. Vacancy rates tend to be above the industry average. Rental rates are mainly below the industry average. Operating margin below the industry average, with cost pressures evidenced.

Lowest	-6 to -10	Very small property portfolio. Average to below average quality of properties. Diversification benefits are minimal. High development risk may be present.	Tenant quality is mainly weak, with a short dated lease maturity profile. Vacancy rates tend to be well to be above the industry average. Rental rates are mainly below the industry average. High property expense ratio that is under continued pressure, combined with weak operating margin.

The above boxes highlight typical characteristics of a highest, high, intermediate, low, and lowest assessments. It is likely that an entity has one or more characteristic across different boxes. GCR allow analytical decision making to decide what are the most pertinent factors for each rated entity. However, to achieve a stronger score the entity is likely to a number of cumulative strengths. Conversely, any one risk can bring the score down to a weak level.

Component 2, Factor B: Management & Governance

(-5 TO 0: 0 BEST)

32. The Corporate criteria has adopted the universal GCR Management & Governance criteria. For more information on how this score is derived please click here.

Component 3: Financial Profile

(-18 TO 7: 7 BEST)

33. By their nature, property funds utilise debt to sustain growth in their portfolios. The actual quantum of debt may fluctuate depending on a fund's risk tolerance, but the use of gearing is inherent to the property sector. Highly rated property companies thus require a flexible financial structure, with sufficient sources of liquidity, to ensure their ability to meet all financial obligations and take advantage of opportunities. Financial flexibility derives primarily through lower levels of gearing, but factors such as the diversification of funding sources and the structure of existing debt maturities also impact on overall financial flexibility.

Financial profile

Factor A: Leverage & capital structure (-8 to +5)

- Ratio analysis
- Capital structure assessment

Factor B: Liquidity (-10 to 2)

- Uses versus sources analysis
- Structural adjustments

Component 3, Factor A: Leverage and Capital Structure

(-8 to +5: 5 BEST)

34. GCR's assessment of leverage and capital structure utilises a mix of quantitative debt service and cash flow metrics, combined with a more subjective assessment of the appropriateness of the capital structure. The quantitative assessment of gearing focuses mainly on debt service coverage metrics. Historical debt coverage service trends are extrapolated, along with expected cash flows, to determine two-year forecasted ratios (where possible). In general, GCR will use net gearing (gross debt minus cash and unpledged liquid assets) to calculate gearing metrics for property funds. In cases where cash may be earmarked for investment purposes, gross gearing metrics may be applied.

35. Determining the correct value of the investment portfolio is the other critical component of the capital leverage and capital structure assessment. For most property funds, investment assets primarily comprise of properties for rental, but may also include investments in property related securities (such as the equity of listed REITs) or mortgage-backed debt instruments. GCR will generally exclude assets linked to loans to development partners or other related entities from the investment portfolio calculation, as well as assets not forming part of the core investment strategy. In general, GCR will rely on the valuations performed by reputable property valuation professionals/firms. However, adjustments to the asset value

could be made where GCR considers the property valuations to be questionable, or has some concerns as to the valuation methodology. GCR will also stress asset valuations to determine the sensitivity of key gearing metrics to changes in asset value. Where there is a high sensitivity to asset pricing, GCR may opt to accord a risk score aligned with the lower leverage band.

36. Many REITs structure investments in other countries, or in other sectors, as separate operating entities in which they hold an equity share. On an equity accounted basis, the REIT's financial statements may not fully reflect the risk factors in the separate operating entity, even where there may be a significant economic interest. Accordingly, GCR's policy is to consider material operating investments on a look through basis. Whether the investment is proportionally consolidated or fully consolidated will be determined by the rating committee, depending on such factors such as the size of the shareholding, the operational independence of the entities, branding, and the presence of independent shareholders. Factors such as cross guarantees to debt facilities, or group wide covenants would suggest full consolidation.

37. There are three main metrics that are utilised when assessing debt, with the typical scoring bands (from a minimum of -8 to a maximum score of +5) detailed in table 3. The outcomes for each metric will be assessed relative to each other, as well as to typical characteristics in the market as a whole.

38. **Loan to Value**: Calculated as the percentage of debt to investment assets. In essence, the metric reflects how much gearing is being utilised to finance the fund's core operations and as a corollary it also gives an indication of the fund's potential funding flexibility, with a lower loan to value suggesting greater flexibility. It also provides an indication of how sensitive gearing is to changes in asset values.

39. **Debt to operating income:** A measure of the extent to which the profits generated by on-going operations (before interest and exceptional items) could meet debt principal obligations. The key benefit of this metric is that it incorporates all core profits that the entity has earned and over which it has a legal claim, irrespective of the terms of payment. GCR will usually assess this metric on a rolling forward looking basis, which should account for earnings drag from new acquisitions/investments.

40. **Operating income to net interest coverage:** Examines the ability of the corporate entity to honor its main recurring debt service obligation, that is interest payments. Typically, GCR will offset interest income against the interest charge, but non-cash interest income and other interest risk mitigants such as hedging instruments and capitalised interest on development funding will be excluded from the calculation. These mitigants may, however, be included in alternate coverage metrics.

Table 2: Leverage and capital				
Score description	Score	Financial position - Leverage, Cash Flow, Coverage		
		Net Loan to Value ratio	Net debt to operating income	Operating income / Net interest
Highest	4 to 5	<15%	<2.5x	>6x
High	2 to 3	15%-30%	1.5x – 3.5x	4x - 6x
Intermediate	-1 to 1	30% - 40%	3.5x – 5x	2.2x – 4x
Low	-2 to -4	40%-55%	5x – 6.5x	1.2x – 2.2x
Lowest	-5 to -8	>55%	>6.5x	<1.2x

41. The structure of a property fund's debt is critical to maintaining financial flexibility. A high debt concentration represents a key risk with regard to property companies, as property assets are illiquid and cannot be disposed of on short notice. Accordingly, a property fund could experience funding pressure, even though it is moderately geared. This could arise where, for example, a property fund is overly reliant on a single source of funding, and that source experiences its own cash flow pressure, or where there are substantial short-term refinancing requirements during a period of low liquidity in financial markets. In both cases the property fund may have sufficient ability to sell assets, but this may not be realisable within the necessary timeframe. To achieve a high-risk score GCR would typically expect that not more than 40% of debt be maturing within two years, although even over the longer term GCR views a smoothed debt maturity profile to reduce risk.

42. To mitigate refinancing risk, GCR will seek to determine the strength and reliability of a property fund's access to additional debt facilities. A positive assessment primarily depends on the number of banks a fund has facilities with, how long those relationships have been in place, and the demonstrated access to loan funding from alternative financial institutions such as long-term insurers, pension funds or the debt capital market. The demonstrated funding position will then be adjusted to take into account GCR's assessment of current funding appetite, which considers a combination of prevailing financial market conditions (i.e., is there sufficient liquidity and risk appetite for financial institutions to lend) and the prevailing reputation of the property fund (are institutions prepared to lend to the particular fund at the moment).

43. A similar assessment is performed on a property fund's ability to raise equity capital. For listed funds, GCR will look at its historical track record of raising equity. Access to equity capital will be considered strong where there have been several successful equity issuances over the preceding three years, and the issuances were fully subscribed (or oversubscribed). For unlisted funds, where possible, GCR will make an assessment of the financial strength of the major shareholders, as well as their willingness to provide support in need. This too will be modified by an assessment of current equity market conditions and the prevailing reputation of the property fund.

44. Other capital structure considerations may be used to adjust the quantitative leverage score by one or more notches.

    i. (**Negative**) Currency risk can materially change the leverage position and liquidity dynamics of the entity (in the event of currency movements). GCR takes a highly negative view of property funds that finance properties in different currencies to the local currency of the jurisdiction wherein the property is situated, even where there is a rental peg to the US Dollar. If foreign currency debt is greater than 30% of total debt, and there are not sufficient currency hedges in place, GCR may make a negative adjustment to the score. The level of adjustment will depend on the amount of leverage and the foreign currency exposure/volatility.

ii. (**Negative**) Interest rate fluctuations can lead to substantial volatility in a property fund's operating cash flows. As rental contracts are usually fixed, exposure to adverse interest rate movements could result in interest coverage and general debt serviceability coming under pressure. To maintain stability, a property fund should fix at least 75% of its interest rate exposure. Below this level, a negative adjustment may be made, depending on other the amount of leverage and other debt characteristics.

iii. (**Negative**) Funding agreements that utilise various derivative instruments are negatively considered as they can distort the various credit protection metrics and disguise the actual risk and return related to a fund.

iv. (**Negative**) If debt is growing very quickly, possibly due to the rapid capital expenditure needs, we can also bring down the initial leverage score depending on the nature of the growth.

v. (**Negative**) Adverse shareholder rights/actions. If the quality of capital is potentially threatened by options held by the shareholder to force repayment, or if there are any other debt-like characteristics.

Component 3, Factor B: Liquidity

(-10 to 2: 2 BEST)

45. GCR applies a zero-tolerance approach to a lack of liquidity. This is because a company with the healthiest balance sheet and strongest competitive position can still fail if it does not have appropriate levels of, and control over, its liquidity. As a result, our assessment of weak liquidity can bring the ratings down to the lowest levels should we have concerns. GCR's analytical approach is based on a simple view of the entity's ability to meet its liquidity requirements over a rolling one to two-year period.

46. Available liquidity may differ for property funds as legislation in many jurisdictions does not permit REITs (or other property funds) to utilise operating cash flows to settle debt, rather cash profits must be paid out to unit/shareholders and property funds are required to refinance debt through new facilities or asset sales. GCR considers such legislation to be an inherent credit weakness for REITs, which will prevent most property funds from attaining a positive credit risk score for liquidity. To underpin their liquidity, property funds must demonstrate reliable ongoing access to capital and it is these capital structure considerations that link the financial profile to liquidity. In other words, those debt characteristics that are considered to enhance the capital structure, do so because they are congruent with greater access to capital, which is beneficial because it ultimately translates into increased liquidity.

47. Applying the uses versus sources approach to assessing property fund liquidity, GCR typically will include the following in sources where applicable:

    i. GCR calculates non-pledged, non-restricted cash that hasn't been earmarked for future capex. For property funds, this is cash that generally derives from capital raising exercises or asset sales, not operating activities.

ii. GCR includes the undrawn and available portion of committed facilities maturing after 12 months. Committed facilities are fairly common for property funds, as the facilities are generally secured by property mortgages. GCR may also include some non-committed facilities where the rated entity has a long-standing banking relationship with the lender, or where there is reasonable certainty that the funding lines are available. In regards to both committed and uncommitted lines, GCR will include the entire amount of credit available, up to but not beyond any covenant breach.

iii. GCR will include anticipated funds from core operations, net of expected dividend or distribution payments. As RIETs pay out the majority of cash this will generally be low. However, where the property fund has a demonstrated track record of retaining some cash, the projected retention amount can be included. This is measured by the ratio of dividend payments to free cash flow from operations, where a lower ratio indicates greater cash retention.

iv. GCR may include liquidity from contracted property or investment sales or from external support should the sources be reliable. GCR may only include properties for which sales agreements are already in place, but where the transfer has not occurred. GCR may include a portion of properties held for sale (but for which there are no sales agreements) if there is reason to believe that there is a strong chance the properties will be sold in the next 12 months. In such cases, GCR will apply a haircut to the value of properties held for sale to account for the vagaries of property sales.

v. Listed equity may also be included for liquidity purposes, with an appropriate haircut applied. The extent of the haircut will depend on the liquidity of the equity counter and the size of the shareholding, with less liquidity and a greater percentage shareholding requiring a larger haircut. Listed equity that comprises a core component of the investment portfolio will generally not be included in the liquidity calculation. Nevertheless, the potential liquidity support that can be derived from the equity may serve as a positive rating consideration.

48. When examining uses GCR typically considers the following sources of liquidity pressure:

i. GCR will first look at debt maturities over a one year and two-year period. As property funds are inherently reliant on refinancing, this may be netted off against expected refinancing activities, where such plans are far advanced and can be shown to be reasonably certain. Where refinancing is less certain, such as for commercial paper, GCR expects property funds to maintain sufficient unutilised committed funding facilities to cover all outstanding maturities of less than six months.

ii. We include all planned capital expenditures and investment requirements over the two-year period. Property funds need to spend substantial amounts on maintenance on an ongoing basis, besides for expansionary spend to ensure its portfolio remains competitive in the market. GCR generally expects there to be definite funding plans in place for all major capex projects before they begin.

iii. Projected dividend payments that have not been netted against operating income.

iv. Any contracted extraordinary purchases and other discretionary elements of cash outflows. GCR will also overlay any other expected group liquidity needs or requirements.

49. Two other liquidity considerations are overlaid onto the uses versus sources analysis.

50. **Covenants**: The presence and proximity to covenants is an important factor when assessing the uses of liquidity. Typically, corporate debt facilities are granted subject to various financial and non-financial covenants. Where these covenants can lead to an acceleration of debt repayment or event of default, this will significantly increase risk for the corporate entity and constrain financial flexibility. The risk becomes more acute the closer an entity's metrics come to the covenant levels and the leverage score should be penalised. GCR also views rating-based triggers highly negatively. For all covenants, the extent of the negative adjustment would be dependent on the severity of the breach and the solutions that are contractually available to both debtors and creditors.

51. **Encumbrances:** GCR takes a negative view of significant levels of asset encumbrance. This is because unencumbers assets can more easily be used to obtain additional facilities in times of need. In addition, encumbrances can divert cash flows away from the servicing of general unsecured debt and can subordinate senior unsecured claims in liquidation. Consequently, as asset encumbrance increases, the issuer credit rating comes down. The negative impact of encumbrances may be moderated by high levels of overcollateralisation on facilities (calculated as the value of the encumbered assets over the outstanding quantum of debt). This is because GCR considers it more likely that facilities with high overcollateralisation could be discharged to settle several obligations or additional funding could more easily be raised under the same security package.

Table 3: Liquidity

Score description	Score	Typical descriptors
Highest	2	If the entity has sources of liquidity and unutilised facilities in place that cover more than 2x its uses over a one-year period and 1.5x over a two-year period. Furthermore, there is significant headroom in its debts' covenants before an acceleration of its longer-term funding or event of defaults would be triggered. Funding relationships with banks of good creditworthiness are strong and stable. Levels of asset encumbrance are low.
High	1	If the entity has sources of liquidity that cover more than 1.5x its uses over a one-year period and 1x over a two-year period. Furthermore, there is significant headroom in its debts' covenants before an acceleration of its longer-term funding or event of defaults would be triggered. Funding relationships with banks of good creditworthiness are strong and stable. Levels of asset encumbrance are moderate to low.
Intermediate	0 to -1	If the entity has sources of liquidity that cover between 1.0x and 1.5x its uses over a one-year period. GCR is comfortable with the covenant headroom and there are typically no rating triggers in the debt packages. Funding relationships are strong and stable. Asset encumbrance is in line with market norms and there is excess overcollateralisation.
Low	-2 to -5	If the entity does not have sufficient sources of liquidity to cover its uses over a one-year period. There is limited covenant headroom, which could cause penalties or an acceleration of debt repayments should the performance of the company deteriorate. High asset encumbrances. Funding, with moderate to low excess overcollateralisation.
Lowest	-5 to -10	If the entity has sources of liquidity that are insufficient to cover one years' use and there are no clear refinancing arrangements in place. If covenant breach is plausible, material and could result in an acceleration of funding or event of default. Negligible unencumbered assets and little or no excess overcollateralisation. The most severe negative scores will arise If funding partners are refusing to provide access to funds.

The above boxes highlight typical characteristics of a highest, high, intermediate, low and lowest assessments. It is likely that an entity has one or more characteristic across different boxes. GCR allow analytical decision making to decide what are the most pertinent factors for each rated entity. However, to achieve a stronger score the entity is likely to a number of cumulative strengths. Conversely, any one risk can bring the score down to a weak level.

Component 4: Comparative profile

(VARIOUS)

Comparative Profile
External Support
Group Support
Sovereign Support
Peer Comparison (+2 or -2)

52. The last risks score factor allows GCR to make a series of qualitative changes based on external or idiosyncratic factors, the most common one being ongoing group or extraordinary sovereign support.

Component 4, Factor A: Group Support

53. For details on group support please see the universal group support criteria.

Component 4, Factor B: Government Support

54. This factor is generally not applicable to property companies. Nevertheless, in an event where such support may be applicable, please see the country risk criteria.

Component 4, Factors A & B: External Support for a Corporate Entity

55. Support comes from shareholders, affiliates and/or governments. However, if both elements of support apply, we only take the higher of the two support options to avoid double counting.

Component 4, Factor C: Peer analysis

56. GCR allow one positive or negative notch to create greater credit differentiation within the risk scoring model. Typically, this notch should be used when an entity is a generally better or worse performing company than its peer group, but the above criteria hasn't managed to reflect this. Most often, the entity will be a significant earnings and cash flow outlier.

Final Rating Adjustment Factors

57. Once the risk score and the ACE has been established, on either/both the national or international scale we can then create the formal ratings on different legal entities. For most property funds the ACE will be equivalent to the rated entity, being the group. Where this is not the case, we move off the risk scoring framework and start adjusting the national/international ratings because we are trying to establish the most applicable credit ratings hierarchy within a consolidated group.

Rating Adjustment Factor 1: Specific Structural Factors

58. As stated above, we will typically base our credit scoring on the financial and business characteristics of the immediate group (when there is one) around that legal entity. This is because we believe there is tangible likelihood of risk transfer either up from subsidiaries, across from sister companies or down from a holding company/parent. It is in this section that we address these risks, to hone in on the correct rating for that legal entity.

59. The Group Classification and Support Criteria is the predominant guide for this decision-making process. The following are the principles of the first adjustments.

60. There should be no adjustment from the ACE for the **major operating entity**, of the analysed analytical object. An example of this would be an operating entity that usually has above 50% of total group assets or capital. However, it could be smaller and still be operationally critical the group.

61. **Minor group Subsidiary/Affiliates** are analysed on a standalone basis and then allocated support uplift, if necessary, in line with the Group Classification and Support Criteria.

62. **Non-operating holding companies (NOHC):** Due to the fact that corporate entities are not regulated in the same manner as financial institutions, GCR does automatically notch down the ratings on NOHC, although an assessment will be made to establish if there are any structural or legal impediments to cash flow.

63. **Operating holding companies** typically will be treated like NOHC.

64. **Intermediate non-operating holding companies** typically will be treated like NOHC. However, if the group benefits from parent or government support and that support has to flow through the NOHC, then the ratings don't need to notched down.

Rating Adjustment Factors 2: Issue Rating(s)

65. The notching from the legal entity rating will depend on the nature of the instrument, whilst always respecting the credit hierarchy.

Table 4: Issue ratings

Debt Rating Types	Notching	Typical Characteristics
Secured Liabilities	+1 or more	See Structurally Enhanced Corporate Bonds Rating Criteria.
Senior Unsecured	0	Reflects the relevant legal entity rating on the company issuing the debt, including the government support uplift (if applicable).
Senior Subordinated	-1	Contractually subordinated non-perpetual and cumulative debt, with no discretionary/mandatory/statutory nonpayment or write down clauses and cannot delay coupon. Typically, would take losses at the same time but at a deep haircut than senior unsecured debt.
Junior Subordinated	-2	Contractually subordinated debt, typically non-perpetual and cumulative, but likely to have a discretionary/mandatory/statutory nonpayment or write down clauses. Should be able to take losses before senior unsecured and senior subordinated debt.
Hybrids (a)	-4	Contractually subordinated debt, typically perpetual, non-cumulative, likely to have a discretionary/mandatory/statutory nonpayment or write down clauses with trigger points as the entity remains a going concern.
Hybrids (b)	-5 or more	All of Hybrids (a) but also with the presence of capital/liquidity or rating triggers that would default the instrument as the entity remains firmly a going concern entity, i.e., before senior unsecured losses or other types of default. Notch down according to the proximity of the trigger, whilst respecting the credit hierarchy.

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S GLOSSARY

Bond	A long term debt instrument issued by either a company, institution or the government to raise funds.
Callable	A provision that allows an Issuer the right, not the obligation, to repurchase a security before its maturity at an agreed price. The seller has the obligation to sell the security if the call option holder exercises the option.
Capital Expenditure	Expenditure on long-term assets such as plant, equipment or land, which will form the productive assets of a company.
Capital Markets	The part of a financial system concerned with raising capital by dealing in shares, bonds, and other long-term debt securities.
Commercial Paper	Commercial paper is a negotiable instrument with a maturity of less than one year.
Commodity	Raw materials used in manufacturing industries or in the production of foodstuffs. These include metals, oil, grains and cereals, soft commodities such as sugar, cocoa, coffee and tea, as well as vegetable oils.
Country Risk	The range of risks emerging from the political, legal, economic and social conditions of a country that have adverse consequences affecting investors and creditors with exposure to the country, and may also include negative effects on financial institutions and borrowers in the country.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and interest when due.
Guarantee	An undertaking in writing by one person (the guarantor) given to another, usually a bank (the creditor) to be answerable for the debt of a third person (the debtor) to the creditor, upon default of the debtor.
Haircut	The percentage by which the market value of an asset is reduced. The size of the haircut reflects the expected ease of selling the asset and the likely reduction necessary to realised value relative to the fair value.
Hedge	A form of risk management aimed at mitigating financial loss or other adverse circumstances. May include taking an offsetting position in addition to an existing position. The correlation between the existing and offsetting position is negative.
International Scale Rating.	An opinion of creditworthiness relative to a global pool of issuers and issues.
Issuer	The party indebted or the person making repayments for its borrowings.
Long-Term Rating	A long term rating reflects an issuer's ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
National Scale Rating	National scale ratings measure creditworthiness relative to issuers and issues within one country.
Notching	A movement in ratings.
Ranking	A priority applied to obligations in order of seniority.
Real Estate Investment Trust	A REIT is a company that owns or finances income-producing real estate. REITs are subject to special tax considerations and generally pay out all of their taxable income as distributions to shareholders.
Senior	A security that has a higher repayment priority than junior securities.
Subordinated Debt	Debt that in the event of a default is repaid only after senior obligations have been repaid. It is higher risk than senior debt.
Unsecured Claim	Debt securities that have no collateral.