



## REAL ESTATE GRADING METHODOLOGY

### INTRODUCTION

The real estate sector has assumed considerable importance in Pakistan with the expectation that this could soon emerge as the critical catalyst for stimulating investment and industrial activity in the country. However, there is one important factor which could discourage both lenders and investors (home owners). This concerns the credibility of developers and the reliability of completing housing projects on time and without cost overruns. This factor assumes greater significance in the backdrop of a number of scams in the recent past relating to property development and housing schemes. What could provide a degree of comfort to lenders and investors? This factor has prompted PACRA to launch a system of grading real estate developers and projects. The PACRA grading, an independent opinion on the relative performance capability of the relevant real estate entity, aims to serve as a tool for identifying risks associated with the concerned entity. The grading of real estate developers is designed to make investors (end user/buyer of property) aware of the developer's relative capacity to deliver as per specified terms and quality parameters, and transfer of ownership on time. The grading is expected to facilitate the overall growth of the real estate sector by providing developers with incentives to conform to fair trade practices and legal requirements. A grading is assigned in collaboration with NESPAK, a leading engineering consultancy organization in the country. NESPAK provides technical expertise which supports the analysis being conducted at PACRA.

PACRA's comprehensive offerings include instrument and entity credit ratings, insurer financial strength ratings, fund ratings, asset manager ratings and real estate gradings.

PACRA's opinion is not a recommendation to purchase, sell or hold a security, in as much as it does not comment on the security's market price or suitability for a particular investor.

A graded project would lend itself to a more accurate and reliable estimation of risks associated with the real estate project/project promoter. This enhances the confidence of the end users and provides comfort to lenders of these projects, thereby facilitating the flow of institutional funds to the project/project owner. Besides benefiting the sector participants and end users (investors/customers), the grading is designed to provide objective opinions as inputs in the pricing and credit decisions of banks/financial institutions. The grading is not be a recommendation to lend/do business with or not to lend/not to do business with a certain entity/project.

### Grading Methodology

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## METHODOLOGY (PART 1)

### CRITERIA TO ASSESS DEVELOPERS

#### **BUSINESS RISK DETERMINANTS:**

- **Sector specific risk:** Overview of the state of the economy and its near and medium term prospects. Sectoral presence of the developer/builder enterprise and revenue generation capacity.
- **Market Position:** The position of the developer vis-à-vis other players and the developer's general reputation in the market.
- **Project Composition:** Project mix in terms of the number and value of projects in hand.
- **Adherence to project time schedules:** Present state of all the projects undertaken by the developer and the extent of adherence to milestones indicates the chances of any time overruns.
- **Project Quality track record:** The quality of the completed projects has a vital bearing on the developer's business risk. The quality consciousness of the developer refers to the quality procedures adopted at the various project sites, material procurement and inspection systems adopted by the developer.
- **Project Management and Systems for timely completion:** The internal planning and project management systems adopted, extent of review meetings at the on going project sites, nature of construction agencies deployed and construction techniques adopted can significantly affect the progress at the worksites.
- **Management Quality:** Organisation structure, commitment of the management, management policies and human resources deployed.
- **Extent of legal compliance and documentation:** Conformity with building bye-laws and regulations and trade practices followed. Extent of documentation also has an important bearing.

- **Contract Composition:** Indicates the nature of contracts entered into by the developer with the construction agencies which influences the risk sharing in case of any delay or deviation.
- **Past projects track record:** Track record of the developer in terms of quality, timely completion and transfer of ownership to the customers.
- **Dispute and litigation track record:** Nature and extent of litigation against the developer by government/semi government/public sector agencies and the general public.
- **Customer satisfaction:** Extent of satisfaction of the customers/investors and redressal of grievances of the purchaser/investor; specifically, the system and timeliness of handling queries and complaints.

#### **FINANCIAL RISK DETERMINANTS:**

- **Profitability:** Important indicator of developer's financial strength.
- **Leverage:** Developers that are highly leveraged face bigger problems during economic downturns.
- **Financial Flexibility:** Financial flexibility refers to the company's ability to arrange funds in case of a liquidity crunch and erratic cash inflows.
- **Working Capital Management:** Control of receivables and advances from customers and working capital management thereby requiring less interest-bearing working capital support from external sources.
- **Insurance Cover:** Insurance cover taken by the developer for its various projects reduces the risk in case of any contingencies.
- **Accounting Quality:** Includes accounting practices and standards followed.
- **Contingent Liability:** Any contingent liability that may significantly affect the risk profile of the developer.

### METHODOLOGY (PART 2)

#### CRITERIA TO ASSESS REAL ESTATE PROJECTS:

- **Completion risk:** This is the risk that the project may not be completed in time or at all due to faulty planning, cost overruns, wrong choice of construction agencies.

- **Price risk:** Price quoted should be reasonable and any risk of volatile prices due to supply-demand factors increases the price risk.

- **Resource risk:** The risk includes the non-availability or a possibility of an adverse price movement in construction inputs.

- **Quality and non-conformance risk:** This is the risk of nonconformance of laid down quality standards for construction processes and raw materials.

- **Policy risk:** This risk relates to consistency in government policies that could have a material impact on the project.

- **Project development risk:** This is a risk that the project development may not take place in an orderly manner if the agreement between the landowner and developer contains certain ambiguities.

- **Permission Risk:** This is the risk that official clearances like approved building plans, licences from competent authorities may not be forthcoming or subject to expensive conditions.

- **Interest Rate Risk:** This is the risk that the floating interest rate of the project, if any, would increase beyond the levels assumed for preparing projected cash flows.

- **Insolvency Risk:** This is the risk of insolvency of the Developer.

- **Site Risk:** This is the risk that the project site might have legal encumbrances.

- **Transfer of ownership risk:** This is the risk that the ownership title may not be transferred effectively.

- **Penalty clause:** Presence of a penalty clause in case of delay in handing over possession in time can act as a source of comfort to the investor.

- In addition to the project specific risks the past track record of the developer and its financial position have an important bearing on the grading of the project.

**PACRA GRADING SYMBOLS FOR REAL ESTATE DEVELOPERS AND THEIR IMPLICATIONS ARE AS FOLLOWS:**

<b>DG1</b>	<b>Very strong execution capacity.</b> The prospects of execution of real estate projects as per plan are the most promising.
<b>DG2</b>	<b>Strong execution capacity.</b> The prospects of execution of real estate projects as per plan are highly promising.
<b>DG3</b>	<b>Good execution capacity.</b> The prospects of execution of real estate projects as per plan are good. Project execution capacity can be affected moderately by changes in the real estate sector prospects.
<b>DG4</b>	<b>Adequate execution capacity.</b> The prospects of execution of real estate projects as per plan are adequate. Project execution capacity can be affected severely by changes in real estate sector prospects.
<b>DG5</b>	<b>Weak execution capacity.</b> The prospects of execution of real estate projects as per plan are poor.

*NOTE: A plus (+) or minus (-) may be appended to a grade to denote relative status within grading categories from DG2 to DG4.*

**PACRA GRADING SYMBOLS FOR REAL ESTATE PROJECTS AND THEIR IMPLICATIONS ARE AS FOLLOWS:**

<b>PG1</b>	<b>Very strong project execution capacity.</b> The prospects of execution of the real estate project as per plan are the most promising and the ability to transfer ownership as per terms is the highest.
<b>PG2</b>	<b>Strong project execution capacity.</b> The prospects of execution of the real estate project as per plan and the ability to transfer ownership as per terms are highly promising.
<b>PG3</b>	<b>Good project execution capacity.</b> The prospects of execution of the real estate project as per plan and the ability to transfer ownership as per terms are good. Project execution capacity can be affected moderately by changes in the real estate sector prospects.
<b>PG4</b>	<b>Adequate project execution capacity.</b> The prospects of execution of the real estate project as per plan and the ability to transfer ownership as per terms provide adequate comfort. Project execution capacity can be affected severely by changes in real estate sector prospects.
<b>PG5</b>	<b>Weak project execution capacity.</b> The prospects of execution of the real estate project as per plan and the ability to transfer ownership as per terms are poor.

*NOTE: A plus (+) or minus (-) may be appended to a grade to denote relative status within grading categories from PG2 to PG4.*