The Pakistan Credit Rating Agency Limited

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Rental Real Estate Investment Trust (REIT) Fund Rating Criteria

Assessment Framework

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Summary

This methodology outlines PACRA's approach to assigning Rental REIT Fund Rating, an independent opinion on the capacity of a Rental REIT Fund to maintain stable rental income, and risk factors impacting value of REIT assets over the foreseeable future.

It is important to understand that Rental REIT Fund Rating differs fundamentally from the traditional credit rating, which reflects an entity/issuer's ability to meet its financial obligations. PACRA's opinion is based on evaluation of the following factors: i) Profile, ii) Economic and Industry Risk, iii) Asset Quality Risk, iv) Financial Risk, and v) Management Review.

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1. Introduction

- **Overview:** Pooled investment, Close-end funds
- **REIT Industry Structure:** Distinction between Direct Investment and SPV structure
- **Scope**: Opinion on a Rental REIT fund's capacity to maintain stable rental income, and risk factors impacting value of REIT assets over the foreseeable future.
- **Regulatory Framework:** Real Estate Investment Trust Regulations, 2022 and Listing on PSX
- **Rating Framework**: Qualitative and quantitative factors, all factors assessed on standalone and relative basis
- **Rating Scale**: AAA(rr) to B(rr)

1.1 Overview: Real Estate Investment Trusts (REITs) are investment vehicles designed to mobilize resources from a large pool of investors and, in turn, provide them access to income-generating real estate assets. A REIT is structured like a traditional closed-end mutual fund, however, instead of stocks and bonds, a REIT investor owns real estate backed units that sell like any other units/listed security, enabling the unit holder to invest directly in real estate. Returns for the investors are in the form of either rental income distributed through dividends or capital gains through price appreciation of the underlying assets reflected in the unit price. REITs generally distribute majority of their profits (over 90% in Pakistan) to their unit holders to receive favorable tax treatment under Pakistan's tax laws. REITs enable investors to have a direct exposure with low individual investments to a relatively illiquid asset class with sizeable initial capital requirement.

1.2 REIT Industry Structure: REITs fall under two structures:

i. Direct Investment Structure – REIT Scheme directly invests in the REIT project.
ii. Special Purpose Vehicle (SPV) Structure – REIT Scheme invests in SPV for execution of REIT Project. Following conditions should be met:
   a) With the consent of Trustee, RMC shall appoint SPV through SPV Management Services Agreement to set the terms
   b) If there is any change in structure of REIT, RMC shall get approval of Unit Holders through Special Resolution
   c) REIT Scheme shall own at least 75% share capital of SPV
   d) No change can be made in SPV Management Services Agreement without consent of Trustee and a prior notice of at least seven days to Unit Holders

1.3 Types of REITs: The REIT industry has two distinct elements: REIT Management Company (RMC) and REIT funds. REIT funds can be structured as three different models – Rental, Developmental or Hybrid REIT funds. These are briefly described below:

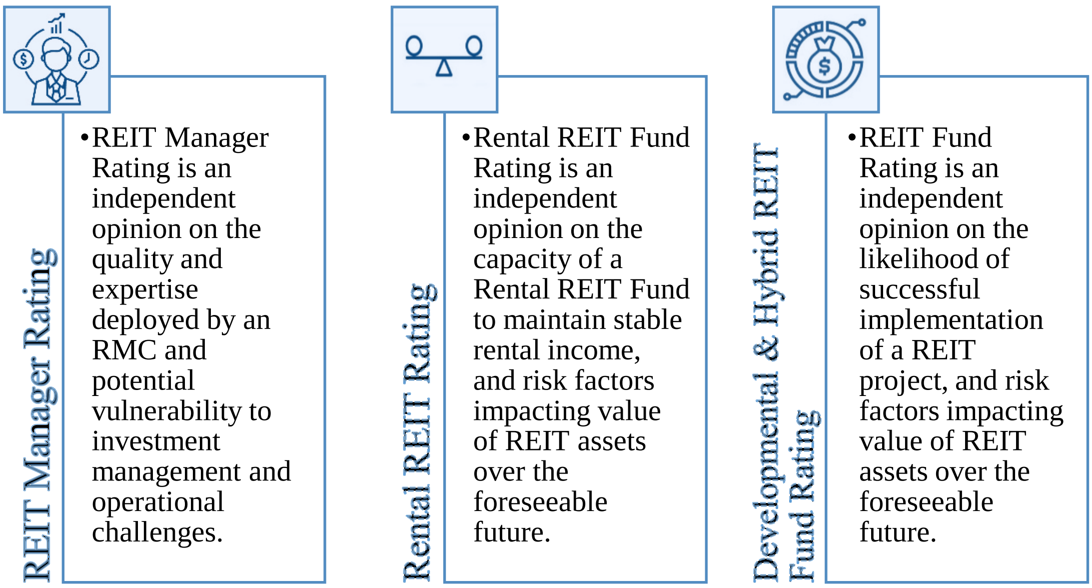
i. RMC – a public limited company licensed to undertake REIT management services
ii. Rental REIT funds – established with the objective of making investment in industrial, commercial or residential real estate for generating rental income
iii. Developmental REIT funds – established with the objective of development, construction, refurbishment, rehabilitation, management and/or operation of real estate for industrial, commercial, residential purpose or a combination of these
iv. Hybrid REIT funds – comprising developmental component as well as rental component

1.4 Scope: PACRA has developed separate methodologies to capture the distinct rating considerations attached to these elements of the REIT industry, depicted in the following diagram. **This methodology outlines PACRA's rating considerations for Rental REIT Fund Rating.**

1.5 Regulatory Framework: REITs are regulated by the Securities and Exchange Commission of Pakistan (SECP), which has issued a comprehensive set of regulations (REIT Regulations 2022, hereon referred to as "the Regulations"). Recently introduced amendments in the regulations are aimed at introducing new REIT products and decomplicating the registration and approval processes to encourage new entrants and improve industry competitiveness. Following are some of the key amendments:

- **i)** **Enhanced scope of REIT Assets** through addition of following real estate segments: agriculture, healthcare, transport, power, energy, telecommunication, water & sanitation, social, cultural & commercial segment.
- **ii)** **Addition of new types of REIT Scheme**: "Investment based REIT scheme" which can invest in multiple completed real estate units e.g. shops, hotel rooms, offices etc. where source of return for unit holders would be revenues generated from rental income.
- **iii)** **Reduction of total number of approvals** required by REIT from 7 to 4, with more responsibility placed with RMC and trustee for various steps.
- **iv)** **Valuer given liberty to decide valuation methodology**, while following requirements specified in relevant annexure of Regulations and industry/international best practices.

1.6 The Regulations address all aspects of REIT registration, operations, and roles and responsibilities of all parties including the RMC. REITs can be formed under Public and Private Partnership model (referred to as PPP REIT schemes) or otherwise directly or through Special



Purpose Vehicles (referred to as non-PPP REIT schemes). As per the Regulations, a non-PPP REIT scheme must be listed on the PSX within three years after its first financial close while in case of PPP REITs, it should be listed no later than after the first year of its commercial operations date. Some salient features of the Regulations are listed in the table below:

Minimum ownership requirement by accredited investor/RMC:	
In case of single strategic investor	25% of fund size
In case of multiple strategic investors	5% of fund size
Permitted borrowing without approval of unit holders	25% of fund size
Application for permission to form an RMC	PKR 0.25 million
Application for license to undertake or carry out REIT Management Services.	PKR 1 million
Application for the renewal of license to carry out an activity or function.	Nill
Launch REIT scheme	PKR 0.5 million
Annual Monitoring Fee to SECP (Rental REIT)	0.1% of fund size
Annual Monitoring Fee to SECP (Developmental REIT)	0.2% of fund size
Annual Monitoring Fee to SECP (Hybrid REIT)	0.15% of fund size

1.7 Rental REIT Fund Rating Framework: PACRA follows a comprehensive framework when assigning Rental REIT Fund Rating, comprising both qualitative and quantitative analyses. The factors considered during evaluation include: i) Profile, ii) Economic & Industry Risk, iii) Asset Quality Risk, iv) Financial Risk, and v) Management Review. PACRA attempts to analyze a REIT not only on a standalone basis but also in the relative universe, where applicable.

1.8 Rating Scale: Rental REIT Fund Rating scale ranges from AAA (rr) (fund having exceptionally strong capacity to maintain stable rental income, and risk factors impacting value of REIT assets are negligible over the foreseeable future) to B (rr) (fund having weak capacity to maintain stable rental income, and risk factors impacting value of REIT assets are very high). The scale is appended with "+" and "-" signs to denote relative status within each category except "AAA (rr)" and B (rr)".

2. Profile

- **Portfolio Mix:** Property, segmental and geographic diversification in portfolio

2.1 Portfolio Mix: Rental REITs hold completed, rent generating assets in industrial, commercial or residential real estate segments. PACRA looks at composition of the REIT fund's portfolio and degree of diversification in terms of the number of properties and underlying real estate segments. A fund with a single underlying property or multiple properties within a single real estate segment would generally be considered riskier due to higher risk of disruption. This does not entail that a fund specializing in a certain real estate segment would necessarily be at a disadvantage. Nor does it imply that simply higher number of properties would assure high stability in rental income and appreciation in asset value. In case of multiple properties, PACRA would assess diversification at segment and geographic level. Meanwhile, individual asset quality of each property would be assessed as per the criteria outlined in Section 3 of this methodology, and will be factored accordingly into the rating opinion.

3. Economic & Industry Risk

- **Economic Overview:** Linkage of real estate industry with macroeconomy
- **Industry Dynamics:** Systemic risks and operating environment

3.1 Economic Overview: The real estate industry is strongly correlated with overall economic conditions. Macroeconomic indicators like GDP, manufacturing activity, interest rate environment and favorable policies exhibit a favorable correlation with the real estate demand and, in turn, prices. It is also viewed by investors as a viable investment venue. In a growing economy, with low interest rates, capital availability becomes high, resulting in higher purchasing power and creates interest for investors. Therefore, more commercial real estate projects are likely to be initiated. Interest rates can have a dual impact. In addition to capital access, high interest rates may end up negatively impacting demand for REITs as investors opt for safer investment options such as bank deposits or government securities. Meanwhile, population demographics, urbanization rate and political stability are other important factors when analyzing real estate trends. Budgetary allocation by the government for infrastructure development also plays an important role in the development and growth of the industry as investors are attracted and encouraged to invest through various schemes and incentives.

3.2 Conversely, in times of low economic growth, REIT returns may suffer as property prices stagnate and the market becomes illiquid. Rental income may also get impacted due to likelihood of low occupancy and inability to increase or recover full rental payments. In such conditions, negotiating power of property owners over tenants is also likely to be compromised. PACRA closely monitors economic conditions for indicators of negative movement in the economy and factors the same in its rating assessment.

3.3 Industry Dynamics: PACRA analyzes the real estate industry in context of the local economy and regulatory environment. REITs are a relatively new entrant in Pakistan's market. However, progressive regulatory reforms in recent years have encouraged several new entrants. At the time of this document's publication, 22 RMCs have obtained licenses to provide REIT management services. These numbers reflect the addition of 7 RMCs in the past year, reflecting the improvement in the sector's attractiveness for investors. REITs remain a tax friendly investment avenue, given 90% of its profits are distributed.

3.4 The COVID-19 pandemic had a negative impact on commercial properties, especially retail and office buildings. With lower footfall and consumer shift to online shopping and work from home protocols, several malls and commercial buildings faced pressure on tenancy and had to restructure rental agreements. Government's focus on the real estate and construction sector, including several incentive packages for the construction industry, ignited strong growth in recent years. However, a fast-rising interest rate environment and policy uncertainty with the incumbent government has impacted the sector. PACRA follows prevailing economic, regulatory and industry events and trends and duly incorporates it in its analysis and opinion formation.

4. Asset Quality Risk

- **Market Position**: Relative standing among peers in terms of property type, location, infrastructure, physical state
- **Tenancy Risk:** Tenancy contracts, rates and trends, concentration in tenant base
- **Legal Risk:** Legal title, documentation, transferability, disputes, approvals
- **Third-Party Service Provider Risk:** Servicing agreements, onboarding, performance

4.1 Market Position: Market position is determined with the perspective of customer interest for a particular property and is driven by a variety of factors including property type, location, infrastructure dynamics and physical state. Market position ultimately drives the occupancy of a property across changing market dynamics and economic shocks.

- **Type of Property**: Different types of properties exhibit varying degrees of business risk. PACRA considers demand for shopping malls and hotels to be highly sensitive to economic cycles while demand for schools, hospitals, residential and office space, is expected to remain more stable even in an economic downturn, hence providing more comfort to the rating. PACRA recognizes that such relationships may not always hold or be as straightforward. For example, demand for industrial properties like factories and manufacturing plants may show a mixed trend, depending on the demand-supply dynamics of the particular industry and its sensitivity to economic conditions.

  Investors and customers are becoming increasingly conscious about Environmental, Social and Governance (ESG) risks pertaining to Real Estate sector and projects. E&S risk become more important for rental REIT perspective as preference for "Green" buildings is gaining traction. These could impact the demand and eventual returns of the project. PACRA considers these risks in its evaluation to assess their impact on the final rating.

monitoring and controls

- **Event Risk:** Incorporating risk of unforeseen events

- **Geographic Location:** Strategically located properties with close proximity to residential and commercial areas are viewed positively. PACRA analyzes the ongoing and planned development in the area to form a view on demand prospects. Presence of substitute properties or threat of new entrants can impact market position.
- **Infrastructural Dynamics**: Connectivity to well-developed transportation networks for accessibility and availability of utilities (power, gas, water etc.) and parking space is considered favorable.
- **Physical State**: PACRS assesses the age, physical state, amenities and maintenance of the properties to estimate its useful life and prospects to maintain or improve income generation as well as remain competitive. A well-maintained property is more likely to result in long-term occupancy and ability to attract new tenants.

4.2 Tenancy Risk: To determine tenancy risk, PACRA looks at the underlying tenancy agreements, vacancy rates, and profile and diversity of tenant base.

- **Tenancy Agreements**: Longer term tenancy agreements, with prescribed rental increment clauses are viewed favorably since they mitigate the risk of unexpected vacancies and provide stable cashflows. PACRA examines average tenure of the agreements, expiry and opt out clauses, and backup plans if a major tenant leaves unexpectedly.
- **Vacancy Rates**: Higher vacancy rates relative to the industry can be an important indicator of troubles in property management or marketing. PACRA opines whether this is a temporary or one-off occurrence or whether a trend is developing.
- **Tenant Base**: Concentration of revenue among top 5 and top 10 tenants is considered. Less than 10% exposure to the top tenant is considered desirable. High-profile tenants, evergreen tenants or tenants with good credit ratings generally offer more comfort to the rating due to their financial strength and ability to honor contractual tenancy terms.

4.3 Legal Risk: PACRA evaluates the protocols in place for evaluation of legal risk as legal disputes pertaining to property can potentially cause huge losses or even lead to closure of projects or suspension of income. PACRA expects due diligence to be conducted pertaining to the legal status of the property, including ensuring the property is clear from any lien mark, stay orders against the transfer of the legal title, availability of complete documentation and approvals obtained from relevant authorities for real estate development and factors the same in its rating assessment accordingly.

4.4 Third Party Service Provider Risk: As per the REIT Regulations, third parties are required to be appointed by an RMC to provide certain services through Service Level Agreements (SLAs). PACRA considers the quality and terms of engagement for these parties while control mechanisms to monitor their performance and comprehensiveness of related contingency planning are also evaluated. This is important to prevent potential disruption in operations due to negligence or underperformance by service providers which can end up impacting property quality and tenant satisfaction. Some key parties which are scrutinized during this analysis include: Valuer, Development Advisor/Property Manager and External Auditor.

- **Valuer:** The Valuer is appointed with by the RMC (with consent of trustee) for valuation of REIT assets. PACRA assesses the independence of the Valuer, its listing position on the panel of valuers maintained by Pakistan Banks' Association (PBA), and experience in the field since it directly impacts the value of the REIT assets.
- **Property Manager:** Smoothly run daily operations are essential for tenant satisfaction and property preservation. The Property Manager is responsible for managing and maintaining the property on a daily basis. Here, PACRA reviews the experience, track record and market reputation of the designated personnel/entities to determine their ability to ensure maintenance and upkeep. SOPs outlining regular maintenance and support

services, along with systems in place to document and address tenant complaints and grievances are analyzed. Easy and efficient complaint systems with short resolution timelines are considered positively. The degree of oversight and supervision and sharing of related MIS is also considered.

- **REIT Auditor:** Assessing the quality of the REIT auditor is crucial to establish the integrity of its financial statements and reporting. PACRA reviews whether the external auditor is on the panel of approved auditors maintained by the State Bank of Pakistan and/or has a satisfactory QCR rating to form its opinion.

4.5 Event Risk: Incorporating the risk of unforeseen events that can cause a disaster, into a rating opinion is challenging, given their unpredictable nature. However, their potential impact makes them a consideration. These events may be external (economic changes, regulatory changes, litigations, or natural disasters such as earthquakes, landslides or flooding) or internally driven (unrelated diversification or strategic restructuring) and can lead to sudden and material shocks to rental income. PACRA evaluates any third-party guarantees or insurance arrangements in place to mitigate such risks. PACRA also applies its analytical judgment in assessing the likelihood of such occurrences and potential impact, insofar as may be possible, and assesses the REIT fund's track record, expertise of RMC and level of financial discipline to incorporate the same into its ratings.

5. Financial Risk

- **Cashflows**: Ability to raise cash, strategic investors' financial profile, liquid assets, borrowing lines
- **Coverages:** Quantum and stability of cashflows, coverage of costs
- **Capital Structure:** Leveraging, financial flexibility

5.1 Cashflows: Properties with strong market position (in terms of location, amenities, and physical state) and financially strong, diversified tenant profiles are generally likely to generate more stable cash flows. Longer tenure of rent agreements and regular rent renewal clauses would also favorably impact stability of cash flows. Given the liquidity constraints posed by high dividend distribution requirement to maintain tax free status, it is crucial for PACRA to assess the REIT's ability to raise cash, internally or through the strategic investor. Herein, special consideration would be given to existence of liquid assets, available borrowing lines and access to capital markets to sustain ongoing operations including proper maintenance and upkeep of the properties and all related services and amenities, and cover incurrence of unexpected costs (e.g., financial penalties or fines from legal authorities or third parties). The quality and market position of properties in the REIT's portfolio factor in here as important determinants of occupancy and, hence, rental income and value of REIT assets.

5.2 Coverages: Key cash flow measures used by PACRA include a REIT's Funds from Operations (FFO) and Adjusted Funds from Operations (AFFO) where AFFO accounts for the impact of ongoing maintenance expenses, capital expenditure and impact of any rent increases and advances received from tenants PACRA analyzes the adequacy of coverage provided by cash flows to outstanding costs, including debt principal and interest payments.

5.3 Capital Structure: PACRA analyzes capital structure to determine a REIT's reliance on external financing. While there is no absolute ceiling for borrowing stipulated by the Regulations, from a rating perspective, REITs with conservative leveraging are viewed favorably. This is because higher borrowing and debt repayment leads to drain of cash resources and limited financial flexibility which impacts the REIT's ability to adapt to changing economic conditions or sustain shocks in business.

6. Management Review

- **RMC Rating:** Quality of REIT manager is determined under

6.1 The ability of a REIT fund to meet its investment objectives and adhere to stated policies depends on the RMC's expertise and quality of support systems. Therefore, an assessment of the RMC's qualification, experience, capabilities and track record are an integral part of the

PACRA's REIT Manager Rating methodology

rating process. The assessment of management quality may also provide a basis of how the fund might respond to future opportunities or stress situations under different market conditions.

6.2 RMC Rating: Opinion on quality of the RMC is directly derived from the RMC Rating, the criteria for which is detailed in PACRA's REIT Manager Rating methodology. During the evaluation process, PACRA reviews the policies and procedures developed by the management to meet its investment objectives and assesses the efficacy of the investment management process, the supporting organizational structure, internal controls, risk management, and reporting systems.

6.3 Analysis of arrangements with and quality of third-party services providers is conducted. Adequacy of the resources and appropriate segregation of duties to prevent conflict of interest is considered positively. Further, the profile of the RMC management team is assessed in terms of relevant experience and track record. A key measure of management effectiveness is its track record of delivering on past projections and sticking to strategies defined in its business plan. Investment process and quality of underlying research are also key considerations.

6.4 To determine the REIT fund's level of risk tolerance and confirming harmony in fund's stated objectives and the REIT manager's investment philosophy in future course of action, discussions with the RMC regarding investment strategy and outlook on business and industry are a vital part of the rating process. The framework deployed to ensure compliance with regulatory requirements and its actual effectiveness would likewise be an important consideration.

Rental REIT Fund Rating - Current
Opinion on the relative capacity of a Rental REIT fund to maintain stable rental income and risk factors impacting value of REIT assets.

Scale	Definition
AAA (rr)	**Exceptionally Strong** capacity to maintain stable rental income. Risk factors impacting value of REIT assets are considered negligible over the forseeable future.
AA+ (rr) AA (rr) AA- (rr)	**Very Strong** capacity to maintain stable rental income. Risk factors impacting value of REIT assets are modest over the foreseeable future.
A+ (rr) A (rr) A- (rr)	**Strong** capacity to maintain stable rental income. Risk factors impacting value of REIT assets may be vulnerable to changes in the economy over the foreseeable future.
BBB+ (rr) BBB (rr) BBB- (rr)	**Adequate** capacity to maintain stable rental income. Risk factors impacting value of REIT assets may be impacted by changes in the economy over the foreseeable future.
BB+ (rr) BB (rr) BB- (rr)	**Inadequate** capacity to maintain stable rental income. Risk factors impacting value of REIT assets are high.
B (rr)	**Weak** capacity to maintain stable rental income. Risk factors impacting value of REIT assets are very high.

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. ‘Stable’ outlook means a rating is not likely to change. ‘Positive’ means it may be raised. ‘Negative’ means it may be lowered. Where the trends have conflicting elements, the outlook may be described as ‘Developing’.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) cessation of underlying entity, c) the debt instrument is redeemed, d) the rating remains suspended for six months, e) the entity/issuer defaults., or/and f) PACRA finds it impractical to surveill the opinion due to lack of requisite information

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated rating opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of rating opinion is carried out at least once every six months. However, a rating opinion may be reviewed in the intervening period if it is necessitated by any material happening.