Caribbean Information &
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METHODOLOGY FOR REAL ESTATE INVESTMENT TRUSTS

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse real estate investment trusts (REIT). REITS can be in the form of a corporation, trust or association that owns or finances income-producing real estate.

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INDUSTRY RISK

Characteristics of Real Estate (RE) in Trinidad and Tobago

- Volatility of RE values and rents

- Demand / supply dynamics

- Impact of government and banking policies
  - Entry barriers
  - Legal and commercial framework for property ownership and lease contracts
  - permitting / licensing process related to RE development, and any regulations pertaining to rental rates
  - Ease of obtaining building permits and issues in respect to clean property titles
  - Tax incentives pertaining to RE development activities
  - Environmental concerns
  - Availability of mortgages and other forms of financing
  - Transparency and availability of reliable market data

BUSINESS RISK

Profile of the Real Estate Investment Trust (REIT)

- **Overall size and market position (as an owner, manager or both)**
  - In the broader real estate sector
  - In the markets in which it directly participates
  - Track record, reputation, and pricing power

- **Quality of the asset portfolio**
  - Property type mix and concentrations (retail, office, multifamily, hotel, warehouse)
  - Geographic markets and concentrations (country, city, and region)
  - Property development / re-development as part of the portfolio
  - Individual building quality
    - Development or acquisition cost, market valuation
    - Number of units and square footage class A, …
    - New property age and the quality of maintenance
    - Occupancy rate and average rental rate per unit of measure
    - Tenant mix and retention rates
    - Credit quality of major tenants and any industry concentrations,
    - Types of leases and lease rollover schedules
    - Flexibility to re-configure space / risk of building obsolescence
    - Revenues, expenses and cash flow

- **Key Metrics:**
  - Rental rates
    Comparisons may require adjustments for consistency, e.g. under "triple net" leases, property-related operating costs are almost all passed through to the tenant. Implications include:

    - Investments in tenant improvements
      - New leases and lease renewals may require REIT investments in tenant improvements. (In fact, high rental rates may require high investment requirements typically associated with an aging or lower quality portfolio.
    - Trade-offs between rental rates and occupancy levels
      - Premium rental rates that result in a material decline in occupancy may not optimize cash flow.
    - Scheduled lease maturities
      - Above-current-market leases that are nearing expiration likely will result in a decline in rental income.

  - Asset valuations
    Market valuations change over time (in absolute terms and relative to market indices).
    - The changes may indicate the relative desirability of a REIT's properties, its ability to attract tenants at market-level or even premium rents, and, ultimately, its ability to obtain financing at both the property and corporate levels.
    - A key consideration is always the basis used for valuing real estate properties. Companies that report under IFRS generally carry properties on a mark-to-market/fair-value basis, with changes in value flowing through the income statement. (Companies that report under U.S. GAAP generally use historical cost-basis accounting.)

FINANCIAL RISK

Profitability

- Level of profitability

- Volatility of profitability

- Key Metrics:

  - <u>Net operating income (NOI)</u>
    Operating revenues (rental income, land and property sales, tenant recoveries and other income) less property and related expenses (real estate taxes, land and property sales operating costs, maintenance costs, marketing and other property expenses).

- This measure excludes general and administrative expenses, interest expense, property impairment charges, non-recoverable development costs, depreciation and amortization, gains and losses from property dispositions or revaluations, allocations to non-controlling interests, reorganization items and extraordinary items.
- With property details, NOI/revenues and NOI/invested assets can be calculated on both portfolio and property-by-property bases without the distortion of property under development.

- EBITDA margin

  Revenue minus operating expenses, plus depreciation and amortization expenses, including impairments on noncurrent assets and impairment reversals. Dividends (cash) received from affiliates, associates and joint ventures accounted for under the equity method are added, while the REIT's share of profits and losses from these affiliates is excluded.
  - The EBITDA margin is affected by the structure of a REIT's leases and is the primary profitability metric for (non-triple net lease) real estate companies.
  - This measure is intended to focus on recurring earnings. Generally, realized gains and losses are excluded to provide the ongoing profit potential of the underlying property portfolio. Other non-recurring items that are excluded encompass restructuring or cost-reduction programs, reverse asset-impairment charges and the fair-value fluctuations in asset values, derivative instruments and the company's own debt.
  - Under triple net" leases, property-related operating costs are almost all passed through to the tenant. REITs with a concentration of these leases have EBITDA margins that are significantly higher, although these margins do not necessarily indicate superior profitability because return on capital (ROC) could be low. Comparisons among REITs' operating performance may be affected by different property tax regimes, and changes in property values that are marked to market.

- Funds from operations (FFO)

  EBITDA minus net interest expense minus current tax expense (plus or minus all applicable adjustments)
  - Real estate companies that use historical cost-basis accounting (e.g. U.S. GAAP), may have asset depreciation for financial reporting that has little relation to real estate market values. In assessing such companies, accumulated depreciation is added back to reported equity. (Previously recorded impairment charges are not added back to reported equity.) For real estate companies that use mark-to-market accounting (e.g. IFRS), depreciation is not recorded.
  - This measure is not intended as a measure of cash nor dividend capacity. More detailed disclosure regarding capital spending, for example, would permit calculation of Funds Available for Distribution.

- Accounting and analytical adjustments which may be appropriate for calculating metrics:
  - Straight-line rent
    The analytical focus is on cash rent actually received in a given period. Under accounting principles, a tenant may have no rent for an initial period, but that is averaged over the life of the lease.
  - Unconsolidated / consolidated affiliates
    The industry commonly conducts a meaningful portion of business through related real companies. The economic reality, not accounting basis, should determine whether it is appropriate to consolidate, on a pro rata basis, the earnings, debt and interest expense of these entities and exclude the dividends received. Alternatively, consolidation for accounting purposes does not necessarily mean that a RE company will support the debt of an ailing affiliate.

Cash flow, liquidity and leverage ratios

- From a credit perspective, the optimal goal is cash flow maximization. The pattern of cash flow generation – current and future – in relation to cash obligations is often the best indicator of a REIT's financial risk.

- REITs generally are viewed as less inclined than other corporates to defer or suspend dividends on preferred stock and other types of hybrid capital because provisions almost always prevent issuers from paying dividends on common stock when this has occurred.

- The "total coverage" ratio helps to gauge the degree of conservatism / aggressiveness of the REIT's dividend policy. A total coverage ratio below 1.0 times (x) on a sustained basis may indicate an aggressive strategy.

- For a REIT with solid banking relationships, high credit standing and prudent financial management, the analysis of liquidity may include the undrawn portion of bank lines as a source of funds based on a 6-month time horizon.

- Most U.S. REITs use amortizing mortgage debt as a property-level funding source, and the ongoing amortization payments are tantamount to being another type of fixed charge. When this is the case, fixed-charge coverage becomes a more important metric than either debt/EBITDA or EBIDTA interest coverage

  Key metrics:

  - <u>Debt/EBITDA</u>
    Where Debt = gross financial debt (e.g. bank loans, debt capital market instruments, finance leases) minus surplus cash (plus or minus applicable adjustments), and
    EBITDA = Revenue minus operating expenses, plus depreciation and amortization expenses, including impairments on noncurrent assets and impairment reversals (plus or minus applicable adjustments). Dividends (cash) received from affiliates, associates and joint ventures accounted for under the equity method are added, while the REIT's share of profit and losses from these affiliates is excluded.

  - <u>EBITDA interest coverage</u>
    Where interest is the reported interest expense, including noncash interest on conventional debt instruments (e.g. payment-in-kind, zero-coupon and inflation-linked debt) minus the sum of interest income and dividend income (plus or minus all applicable adjustments).

  - <u>Fixed-charge coverage</u>

EBITDA (as defined above) / interest incurred (including capitalized interest) plus regularly scheduled debt principal amortization plus preferred dividends.

- Debt/debt plus equity
  Debt (as defined above) / debt (as defined above) plus common equity and equity hybrids and minority interests (plus or minus all applicable adjustments).
  - This traditional measure of financial leverage best reflects the means by which a REIT has chosen to fund its property.

  - For REITS that use mark-to-market accounting, the ratio of debt to assets or debt to capital is useful as a measure of financial leverage because the valuation of properties on the balance sheet should better reflect current market realities.
  - For REIT that use historical cost-basis accounting, there is a supplementary ratio of debt-to-debt-plus-equity on an undepreciated basis--i.e., accumulated depreciation is added back to equity.

- Total coverage ratio
  EBITDA (as defined above) / common and preferred dividends plus interest expense plus required debt principal amortization.

Capital structure

- Access to capital markets
  - During cyclical swings in the real estate market, even the strongest REITs may have their access to new funds – including uncommitted bank lines – curtailed. This has been the case particularly of unsecured debt. Lender diversity is also a consideration, to the extent that the REIT is reliant upon a limited number of financing providers.

- Debt maturity structure
  - Because of real estate market cycles, it is important to consider an extended timeframe, not just the next few years. Debt for this purpose also includes debt amortization payments and may include a pro rata share of any unconsolidated debt. Unless the REIT's debt load is relatively modest, front-ended debt repayments may pose a higher risk.

- Fixed-rate versus floating-rate debt
  - If the debt is floating rate, the analysis should identify whether the REIT has taken measures to mitigate interest-rate risk, such as entering into swaps.

- Bondholder / lender-friendly restrictive maintenance covenants

- These provisions could limit the REIT’s ability to incur additional debt, especially if it experiences financial distress.

- Unencumbered or lowly-leveraged assets
  - These may provide some financial flexibility if additional debt is permitted under operating restrictions, but mortgages on these assets are not presumed to be a ready source of cash in the liquidity analysis.

- Unanticipated cost inflation
  - The provisions of long-term leases are important, as they may limit the REIT’s ability to pass along unanticipated costs and thus squeeze profitability.

MANAGEMENT RISK

Management and governance

- Same methodology as other issuers, but some points to emphasize:

  - Current and expected functional and legal organizational structures
  - Effective board of directors' oversight
  - Alignment of compensation with the interests of the debt and equity holders
  - Risk management capabilities (e.g. replacement cost property insurance)
  - Track record executing key projects and achieving targets

FINANCIAL PROJECTIONS

Base case assumptions and financials

Scenario testing key assumptions