Rating Methodology

TRIS RATING
A Strategic Partner of S&P Global

Rating Methodology for Real Estate for Rent Companies

16 December 2024

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OVERVIEW AND SCOPE OF THE CRITERIA

The criteria apply to entities that derive more than two-thirds of their EBITDA from rental income. Such entities are, for instance, real estate investment trusts (REITs) and commercial real estate companies. In this paper, these entities are collectively referred to as real estate for rent companies (RERCs). The criteria do not apply to certain types of REITs or commercial property firms requiring significant operations, such as hotels, hospitals, and nursing homes. This article supersedes the "Rating Methodology for Real Estate for Rent Companies" published by TRIS Rating on 15 July 2021.

SUMMARY

In assigning a rating to RERCs, TRIS Rating applies the same rating framework as that used for general corporates. The rating framework starts with the determination of the anchor rating, followed by adjustments with other credit considerations (OCCs) to derive the standalone credit profile (SACP) of the rated entity. Lastly, if the rated entity is a part of a business group, its SACP may be enhanced or constrained by the group credit profile (GCP) in line with TRIS Rating's "Group Rating Methodology" to determine the issuer credit rating (ICR). However, for REITs, their ratings are generally independent from their shareholders/sponsors due to their trust-based structure.

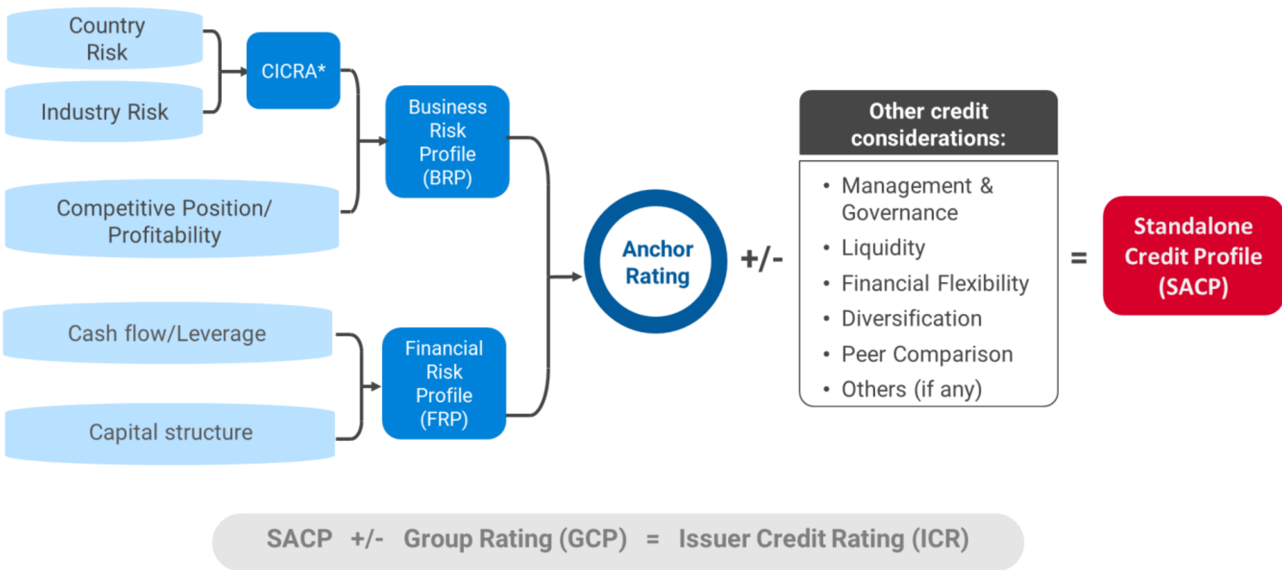
The anchor rating is determined by the analysis of the business risk and financial risk profiles. The business risk profile comprises the assessment of industry risk, competitive position, and level and volatility of profitability. For RERCs, the industry risk is considered low due to the moderate volatilities in revenues and earnings and low risk of competition. For an entity that operates outside Thailand, we also take into consideration the impact of economic risk, financial system risk, and regulatory risk in the countries of operation.

In assessing competitive position, we take into consideration the competitive advantage, scale, scope and diversity of an entity's asset portfolio, and its operating efficiency. For RERCs, we assign more weight to the competitive advantage, as well as scale, scope and diversity of its assets than the efficiency of its operations. In assessing the level and volatility of profitability, we focus on the EBITDA margin and pretax return on permanent capital (ROPC) of the entity.

In assessing an entity's financial risk profile, we focus on financial ratios in relation to its cash flow and leverage like debt to EBITDA, EBITDA interest coverage, funds from operations (FFO) to debt, and debt to capitalization ratios. Generally, we examine financial ratios for the past two years, the current year, and projections covering at least the next two years. Greater emphasis is placed on the current and forecasted ratios.

In assigning ratings to REITs, we also assess their ability to comply with the Securities and Exchange Commission (SEC) regulations to maintain their status. According to SEC rules, a REIT's revenue must primarily come from renting or subleasing properties it owns, rather than operating a business by itself. In addition, a REIT must distribute at least 90% of adjusted net profit as dividends. REITs that comply with the regulatory requirements are entitled to receive a corporate income tax waiver.

RATING METHODOLOGY



*Note: * Corporate Industry and Country Risk Assessment*

1. BUSINESS RISK PROFILE

The business risk profile comprises assessments of the corporate industry and country risk, competitive position of the rated entity in comparison with industry peers, the ability of the rated entity to generate profit, and the volatility of its profits. The competitive position is primarily assessed based on three factors 1) competitive advantage, 2) scale, scope, and diversity of assets, and 3) operating efficiency.

1.1. Industry Risk Analysis

TRIS Rating assesses real estate for rent as a "low risk" industry since earnings of companies in this industry typically derive from renting out properties whose maturities are generally longer than one year. Historical data show that the volatilities of revenues and earnings of RERCs during an economic downturn are moderate but could vary by subsector. The key subsectors are office, retail, and industrial (warehouses and ready-built factories). An event, such as the Coronavirus Disease 2019 (COVID-19) pandemic, may cause a higher degree of impact on the operating results of RERCs that offer office and retail space due to the shift to work-from-home, as well as on-line meeting and shopping. In addition, the increasing supply of office space in the medium term may exacerbate the oversupply of office space which could cause depressed occupancy rates and rental rates in the short to medium term. On the contrary, warehouses tend to benefit from increased demand for e-commerce and on-line shopping.

The intensity of competition in the industry is comparatively low due to the moderate barriers to entry with low risk of substitution and relatively stable profit margins. The business is somewhat capital intensive due to the large amount of investment needed to acquire or develop new properties and maintain existing properties. Despite the market being rather fragmented, only a few developers have large and well-diversified asset portfolios. The industry growth trend is relatively stable.

1.2. Competitive Position

Below are the key factors to be considered in assessing the competitive position of an entity:

- **Competitive advantage**

  Generally, competitive advantages are derived from asset quality, market position of the RERCs, as well as the ability and experience of the management to foster growth and to time the acquisitions and disposals of assets. However, the competitive edges of RERCs could vary based on asset type. For example, the

demand for office buildings and apartments is mainly driven by location and asset quality rather than brand, while demand for retail space is based not only on location but also on brand and franchise network.

Asset quality is typically linked to the location, age, and condition of properties. A good-quality asset is expected to achieve a higher occupancy rate and rental yield compared with peers. The market position of a RERC is usually reflected in its ability to attract and retain high-quality tenants while maintaining pricing power and profitability. In addition, a RERC's ability to maintain or increase market share amid economic downturns or in highly competitive environments, is also a strong indicator of its competitive edge. We also take into consideration the past performance of the management team and its business strategies to pursue growth and survive economic downturns.

We look at the following key metrics to gauge a RERC's competitiveness: 1) percentage of occupancy 2) achieved rental rate and net operating income compared with peers, 3) market share, and 4) percentage of lease renewals or rollover rates.

- **Scale, scope and diversity of assets**

  In assessing the size of a real estate company, we look at the fair market value and number of properties in its portfolio. For the aspect of diversity, we typically look at asset type, location, and tenants. Smaller RERCs and RERCs that are concentrated in terms of number of assets, locations, or tenants tend to have more volatile revenue streams in times of unfavorable economic conditions, when there is a severe damage to an asset in the portfolio, or loss of major tenants. On the contrary, large RERCs that have a diverse range of assets in different locations tend to have higher negotiating power and more options to offer tenants. In addition, diversification helps stabilize the income stream and alleviate the negative effects of downturns in a particular industry or location. The concentration of lease rollovers in any particular year is another important aspect to be looked into.

- **Operating efficiency**

  The ability to control operating and maintenance costs is another key success factor. However, this factor is less important compared to the prior two factors. RERCs that have lower-than-average operating costs are able to lower their rents to attract more tenants during an economic downturn. Generally, larger developers benefit from economies of scale since they are able to share some overhead costs among assets.

  For RERCs that have assets under development, the ability to complete projects on time and within budget is a key factor. However, REITs in Thailand typically involve minimal development risk due to regulatory restrictions. According to the SEC's regulations, the investments of a REIT in real estate under development, including the acquisition cost and the development cost, must be less than 10% of its total assets. This regulatory requirement is an important factor contributing to the low-risk nature of REITs compared with other types of RERCs. Other RERCs can mitigate development risk by entering into pre-lease arrangements with prospective tenants, whereby the prospective tenants commit to occupy some designated space as soon as the property is ready.

1.3. Profitability

For the profitability analysis, we look at both the level and stability of profit margin of an entity relative to peers that have the same asset types. A profitability ratio higher than the industry average may imply a competitive advantage over peers and/or the ability to control costs better than peers. Some companies may use a price-based strategy to gain market share. Thus, revenues may increase but profits may not rise in tandem. A decline in profitability may imply either a loss of competitiveness or a change in the operating environment due to excess supply or declining demand.

The key metrics used to evaluate profitability of RERCs are the EBITDA margin and the ROPC. Both ratios have limitations in providing an indication of an issuer's profitability. Due to the differences in lease term, a higher EBITDA margin of a company may not indicate superior profitability as its ROPC could be low. However, the ROPC could fluctuate based on the market value of an entity's assets. Thus, we would consider both profitability ratios of an entity compared with peers that have similar types of property, lease term, and markets served. We acknowledge that many RERCs regularly buy and sell properties, with any gains or losses considered part of

normal operations. However, when assessing profitability, we focus on the ongoing profit potential of the underlying property portfolio, excluding realized gains and losses from such transactions.

Table 1: Average Level of Profitability

Asset types	EBITDA margin	ROPC
Industrial estate	75%-90%	5%-10%
Office	60%-75%	
Retail	40%-80%	

In addition to the level of profitability, we also look at the stability of the profit margin. Entities with less volatile profit margins are preferred to those with higher yet more volatile profit margins. Volatility of profitability is calculated by using the standard error of regression (SER) of EBITDA margin and/or ROPC. Generally, we use at least seven years of historical annual data to calculate the SER.

2. FINANCIAL RISK PROFILE

In assessing an entity's financial risk profile, we focus on financial ratio analysis in relation to cash flows and leverage. Generally, we analyze the ratios of the past two years, the current year, and the ratios from a financial forecast covering at least the next two years. We also assign more weight to the current and forecast ratios. The key financial ratios used to assess the financial risk profile of a RERC include:

- Debt to EBITDA ratio
- EBITDA interest coverage ratio
- Debt to capitalization ratio
- FFO to total debt ratio

Most RERCs report property value using the fair-market value approach. The fair-market value reflects changes in the operating environment and the demand of properties, which makes the debt to capitalization ratio a meaningful tool to gauge a RERC's financial leverage. The calculation of all financial ratios is subject to the same adjustments of relevant accounting items as applied in our financial analysis for entities in the corporate sector. For details, please refer to TRIS Rating's latest publication on "Key Financial Ratios and Adjustments."

Table 2: Financial Risk Profile (FRP)

Degree of Financial Risk	EBITDA Interest Coverage (Times)	Debt to EBITDA (Times)	FFO to Debt (%)	Debt to Capitalization (%)
Minimal	> 8.0	<2.5	>30%	<25%
Modest	4.5-8.0	2.5-4.5	15%-30%	25%-35%
Intermediate	3.0-4.5	4.5-7.5	9%-15%	35%-50%
Significant	2.0-3.0	7.5-9.5	7%-9%	50%-65%
Aggressive	1.5-2.0	9.5-13.0	5%-7%	65%-75%
Highly leveraged	<1.5	>13.0	<5%	>75%

In addition to the leverage level, we also assess the term structure of an entity's outstanding debt, which in general should generally align with its cash inflows. Excessive reliance on short-term borrowings to fund long-term investments can lead to heightened liquidity and refinancing risks. Furthermore, we may apply stricter thresholds for evaluating the RERCs' FRP if the remaining lease terms on their assets significantly shorten. Lastly, we evaluate the level of interest-rate risk, particularly for entities with substantial long-term floating-rate debts.

3. OTHER CREDIT CONSIDERATIONS (OCCs)

The anchor rating, derived from combining the business risk profile and the financial risk profile, may be adjusted by other credit considerations that have not been captured in the business risk and financial risk profile assessments. These OCCs could be related to management and governance, liquidity profile, financial flexibility, diversification, or other factors (if any). The OCCs are the same as those described in the "Corporate Rating Methodology."

In assigning ratings to REITs in Thailand, we place more emphasis on financial flexibility since the related regulations require REITs to distribute at least 90% of adjusted net profit as dividends. Although REITs are able to reserve cash for debt repayments, they tend to retain small amounts of cash and pay dividends regularly. For that reason, REITs tend to rely on the capital market or bank loans to refinance their debts. However, we view that most REITs have the ability to seek bank loans if needed by providing their unencumbered assets as collateral. That should serve as a reliable source of liquidity in a downside scenario, if needed.

4. GROUP CREDIT PROFILE

For general RERCs, if the rated entity is a part of a larger business group, an assessment of the risk profile of the group may be necessary if the rated entity's business operations and financial health are closely related to the group. Depending on the results of assessment on the group credit profile, the standalone credit profile on the rated entity could be enhanced from the strength of the group credit profile to get the issuer credit rating. On the other hand, in case of a group credit profile that is weaker than that of the rated entity itself, the issuer credit rating on the rated entity could be capped by the group credit profile. Please refer to our latest "Group Rating Methodology" for more details.

However, for REITs, due to their trust-based structure, may consider as "insulated" entities, as sponsors typically lack control over key financial decisions, including dividend payments, borrowing limits, and assets transactions, which limits their influence on REITs' cash flows. According to regulatory requirements, a REIT must distribute at least 90% of its adjusted net profit as dividends to qualify for a corporate income tax waiver. Thus, sponsors have no control over dividend payments from REITs. Additionally, REITs are generally restricted in their ability to borrow, which reduces the sponsor's influence on REITs' leverage and financial strategy. Furthermore, although REITs typically purchase assets from their sponsors, sponsors generally cannot mandate that REITs purchase assets directly from them. This limitation helps preserve REITs' independence in asset acquisition decisions.

5. ISSUE RATING

We could rate its senior unsecured debt issue one notch below the issuer rating if the percentage of secured debt is higher than 35% of the fair market value of assets. In case that the company does not have the fair market value of assets, we will make an adjustment on a case-by-case basis. For companies with multiple business segments, we continue to apply a priority debt ratio threshold of over 50% as a basis for notching down the senior unsecured debt rating. For further details, please refer to our "Issue Rating Criteria".

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