

RATING METHODOLOGY – Commercial Real Estate

The Islamic International Rating Agency offers ratings for all types of commercial enterprises as well as governments and financial institutions. In recognition of the important distinctions between conventional finance and Islamic finance, IIRA has modified its core rating definition to ensure it is useful to lenders or investors providing funding that are Shari'a compliant. IIRA's rating is:

An independent, objective opinion regarding the relative capacity to meet financial obligations, including Islamic returns.

This brief paper describes many of the more important analytical tools employed by the analysts and rating committee to determine appropriate ratings for real estate developers, investors and operators. The real estate industry has become an important component of the GDP of the current markets of IIRA. Because of the cyclical nature of the industry, and the obvious building boom in most centers, the principles described in the methodology are believed to be useful for analysis of the industry as a whole.

IIRA's rating on real estate pertains to the overall rating of the developer and is not a rating of a particular project unless a specific project rating is requested. The rating is assigned after taking into account market characteristics, the organizational structure and management quality of the developer, and finally assessing each of the projects in the portfolio the developer is executing, thereby arriving at a final credit rating for the developer.

The basic rationale behind the assigned rating would always be an educated forecast of future net free cash flow. The question that needs to be answered is whether the project(s) executed by the developer will be able to generate enough cash flows to meet the commitments that the developer has made to the stakeholders.

The term developer is defined by IIRA as an individual or company promoting the project, sometimes owns the land on which the project is to be constructed, markets the projects, selects the primary contractor (and sometimes subcontractors) and arranges for the institutional financing of the project.

Role of Real Estate / Construction

The real estate sector plays a key role in the development and progress of any economy and is often considered as the leading indicator of the economic health of any country. In the USA, for example, new housing start-ups are tracked on a monthly basis to gauge public sentiment regarding the economy.

Some of the important characteristics of the real estate / construction sector are highlighted below:

- It generally represents a significant commitment by the investor to the economy where he is investing. Since construction involves creation of immovable assets it represents a far more permanent creation of wealth compared to portfolio investment, which can flow out very quickly in case of downturn.
- The construction industry is an end user for several capital intensive industries like steel, cement and some of the relatively smaller industries like paints, wires, electrical equipment etc. Therefore a robust construction industry generates activity in these industries.
- The construction industry is generally labor intensive and therefore is a vehicle for job creation, which is one of the important challenges for a developing economy.

Real Estate in GCC

The real estate boom in the GCC started in the early 2000's with Dubai's decision to allow free hold property rights for expatriates. This decision was followed by the other emirates of the United Arab Emirates as well as other GCC countries and has been a major driver of growth in almost all the GCC economies. The rising price of crude oil has helped sustain liquidity in these countries contributing to the steady growth of the real estate industry as financing has been readily available. Moreover, it has allowed the respective governments to create suitable infrastructure, something which is necessary for the development of real estate sector.

It is without dispute that there is a construction boom across most GCC countries. The aggregate amounts of expenditure across these markets are estimated to exceed USD 1 trillion encompassing all products. The contribution of the construction and the real estate sector toward the GDP of GCC economies averages around 8% with KSA being the lowest at around 4.5% to UAE being highest at around 16%.

As a precondition to rating any type of real estate enterprise, IIRA begins with the numbers that define the market. By product (single family, apartments, retail of various configurations, distribution, manufacturing, etc.), it is imperative to know:

- Economic growth driving demand and demographic patterns
- Current supply
- Occupancy/Vacancy rates
- Lease rental rates
- New supply under construction and the schedule for completion

The Islamic International Rating Agency (IIRA) has designed a real estate rating methodology. IIRA's Real Estate Developer Rating provides an independent and objective opinion on the relative financial capability of the developer in line with its commitments. The idea is to provide the stakeholders with a balanced view of the strengths and weaknesses of the developer and to create a healthy environment in the industry. IIRA will analyze all ongoing projects of the developer and arrive at an overall rating of the developer.

The many facets of a developer's activities are completely analyzed including the performance of his architects, engineers, contractors, and other necessary support personnel.

Who are the beneficiaries of IIRA's Real Estate Developer Rating

IIRA's Real estate rating offers a useful comparative tool to the industry. The specific benefits to each of the constituents are outlined below:

1. Real Estate Developers

A developer rating gives real estate developers a tool to highlight their strengths in project execution and marketing. It can thus be used to command a better price. The rating increases visibility and substantiates the informal word-of-mouth mode of appraising developers.

2. The rating also acts as a benchmark for developers and helps them to identify their shortfalls vis-à-vis the best practice in the industry. This will lead to continuous improvements in quality and service levels.

The rating will help contribute to healthy competition among the real estate developers

3. Further, a good rating can also help developers to mobilize institutional funds at reduced cost and other financial services for their projects and enhance their potential ability to market the project.

Banking, Financial and Lending Institutions and Investors

A Real Estate Developer Rating provides the lenders' with an independent third-party opinion on the ability of the developer to deliver in accordance with the parameters and the time stipulated thereby enhancing the lender's confidence in the project(s) and the developer.

Government and Regulators

The ratings give an incentive to developers to not only maintain but also to improve standards to achieve higher rating. This is expected to facilitate the orderly growth of the sector, leading to a self-regulated industry framework. It may also help the regulators to regulate licenses in line with the rating.

IIRA'S RATING PROCESS

IIRA's ratings for real estate developers begin with assessment of the market. They encompass performance of all entities involved in a development project: i.e. it takes into account both

developer specific and project- specific factors. However, any discussion on specific real estate project must be preceded by a thorough discussion of market dynamics

Market Assessment

IIRA takes a detailed look at the market in which the particular real estate developer and its projects are located. The key data as noted above, include economic growth driving demand and demographic patterns, current supply, occupancy/vacancy rates, lease rental rates, and new supply under construction, and the schedule for completion. It is necessary to understand the dynamics of these data and the implications for the developer when changes occur.

Like many industries, real estate is cyclical. Population and economic growth creates demand for real estate in the economy. As demand exceeds supply, prices start to rise, attracting many industry players who rush in to get the benefit of higher profits. This leads to an oversupply situation, resulting in decline in real estate prices and leading the industry players to exit. Ultimately equilibrium between demand and supply is attained, stabilizing prices. However, due to population and economic growth, the demand exceeds supply again and hence industry enters into a new cycle.

IIRA looks at an exhaustive list of factors to analyze the demand and supply variables in the real estate sector such as

- The level of unmet demand in the real estate sector
- Nominal and Real GDP growth of the country
- Capital formation
- Per capita and disposable income of the population
- Growth in population, both indigenous and expatriate
- Growth in per capita and disposable income of the population
- Nature of business growth in the country and whether it is homegrown or expatriate ownership
- Number of industry players
- Status of the competition (i.e. few players dominating or fragmented industry)
- Regulatory environment
- Supply of construction materials (i.e. production or imports)
- Cost of construction materials and trends
- Status of construction activity
- Nature of new projects expected to be completed within next 2-3 years
- Historical and projected absorption rate of new projects

In addition to market and economic factors, IIRA examines a developer's ability to deliver based on the following broad categories

Developer Specific Factors

A) Historical Performance

A.1) Legal Track Record

IIRA assesses the extent of compliance with all legal requirements. This includes, among other things, compliance with building bye-laws of local authority, receipt of completion and occupancy certificates from the competent authority and transfer of clean title to investors / customers.

A.2) Construction Record

IIRA examines the scale and size of past projects that have been completed by the developer and the total value and area developed in the different product categories. The developer's commitment to safety as demonstrated by the quality of past projects is also considered. Other factors include the quality of on-site and off-site infrastructure provided to customers, compliance with agreed specifications as detailed in the agreement and the level of after-sales services.

A.3) Market perception and performance

IIRA takes note of the market perception and reputation of the developer and the brand value attached to its properties while assessing his track record. The sales record of past projects is a healthy indicator in this regard. Any complaints outstanding in the courts and other disputes are also factored in the rating exercise.

B) The Business

B.1) Organizational Structure

IIRA examines the organizational structure, role definition, staffing, management style and availability of a qualified talent pool within the organization. A professional approach on these parameters indicates the developer's vision and ability to do a long term business.

B.2) Budgeting and MIS

IIRA assesses the extent to which a developer adopts a structured approach to business management and controls. This includes among others factors like standardization of workflow processes, adherence to time schedules and cost estimates, material and labor specifications, project monitoring and ease of flow of information to investors / customers.

B.3) Strategic Planning

IIRA examines the strategic plans of the developer. This includes the vision as to the number of projects to be undertaken at one time, the kind of projects on which the developer wants to

concentrate and the related market opportunities, as well the perspective on backward integration, etc.

B.4) Geographic Diversification

Geographical diversification or diversification into related or other businesses provide strategic comfort as they reduce the concentration risk, help moderate the impact of adverse business cycles and provide an alternative source of funds, when required.

C) Financial Analysis

A developer's financial assessment is made to ascertain its ability to complete projects on time with adequate cash flows. Accounting conventions and rules for developers afford significant latitude for the companies. There is often a significant period of time when the company has invested in project infrastructure and begun construction on the revenue properties, but there are no tenants or lease rental income until the project is completed. Thus consideration must be given to resources available to service the financing.

In some cases, residential properties may be pre-sold resulting in cash flow and a reasonable certainty with respect to value. More often, construction costs must be funded and are recorded on a percentage of completion basis, presuming they will be recovered upon completion and lease-up or sale of the project. The economic validity of this proposition, of course, depends on the market and the company's ability to complete construction.

In addition to balance sheet value and liquidity, the analysis necessarily evaluates funding sources such as funding lines available or investors to support project development. The availability and utilization of the funding sources for both completed and on-going projects are analyzed.

These are important considerations in determining a developer's financial flexibility. It is viewed in relation to the number of projects under development and the funding tie ups for the same. The ability to generate funds whenever needed either through equity or debt is an important factor considered in financial flexibility.

Survey of Project Specific Factors

IIRA then looks at each of each project for many specific risk factors commencing from the demand / supply risk of the project and down to specific operational, legal and financial risk.

i) Demand and Supply Risk

As discussed above, demand risk is evaluated in terms of the overall economic situation of the country, the disposable income of consumers and current supply. It also assesses the demand for specific products like residential, office or retail, and target market characteristics (upper, medium or lower end of the market).

IIRA also assesses the number of projects similar to the one which is rated and the competitive advantages or disadvantages of each of them. An undersupply or oversupply of similar projects could be a significant determinant of the final rating

ii) Legal Risk

A perfected legal title for the land is necessary for the project. IIRA assesses whether the title is clear and marketable and whether the property is free from encumbrances. The origins of all title documents are examined and legal opinion is sought if deemed necessary.

Zoning restrictions and requirements are known.

IIRA also studies the development agreements between the land vendor and the developer to understand what kind of development can be made on the particular land and the terms and conditions for the development.

IIRA also closely examines the sale agreement between the developer and the buyer to understand the rights and duties of each of the parties. Particular attention is given to whether the contract is fixed price or whether the developer is allowed to increase the price due to abnormal increase in material, labor or other related cost.

IIRA also examines whether there are escrow laws available and enforced. This provides significant comfort that the inflows for the project would be used for the project itself and will not be diverted for other projects / investments.

iv) Participant Risk

The fact that a developer normally engages a number of other parties to complete the project requires IIRA to assess the capability of all likely participants in the development process. These may include, but are not limited to, consultants, architects, primary contractors, various sub-contractors, equipment suppliers, and the like. IIRA assesses the capacity of each of them because failure of one of them to complete its part may lead to delay or non-completion of the project. IIRA particularly examines the engineering requirements for specific equipment, raw

materials and man-power in order to assess the probability that these would be available on time for the completion of the project. It also examines the sources and supply of raw material and confirms the availability and cost characteristics of the same.

v) Completion Risk

Completion risk is a result of several factors and is directly linked to the complexity of the project itself. These factors include:

Structural quality which is the ability to translate the plan into a sound civil structure

Infrastructure around the project like parks, roads, sewerage, water and electricity

Finishes both external and internal

vi) Weather Conditions and other natural factors

The rating takes into account whether there are specific natural factors which may be a hindrance to the completion of the project i.e. in some countries the rain is a factor and it may not allow the project to be completed on time. Therefore the timing of the construction becomes a significant factor to consider.

vi) After –Sales Services / Maintenance Requirements

IIRA evaluates the extent and type of after-sales services or maintenance planned by the developer for the project. This is generally stipulated in the sale agreement.

vii) Financial Risk

IIRA examines the financial aspect of the project. How much equity has been invested, what is the cash inflow expected from investors and at what stage, what percentage of sales is forecast before the construction, during the construction and after the construction and are these realistic in terms of past and future market projections. IIRA also examines the contingency plans in case forecast sales do not happen. Are deep pockets to inject cash available or are significant lending lines and pricing in place.

viii) Likelihood of Time and Cost Overruns

The demonstrated ability of the developer to complete and deliver projects on time is one of the key factors. Are there external factors which may hinder this ability like delayed development of infrastructure by the competent authority?

Apart from external sources, the key factors affecting the timely completion of the project are adequate cash flows and monitoring systems to ensure adherence to schedules. Delayed funding inflows, problems with availability or cost of building materials, low project sales and limited financial flexibility may adversely impact the timely completion of project.

The existences of punitive clauses in favor of the buyer are also studied to understand their impact on the developer and the project.

IIRA also evaluates the likelihood of cost overruns. It studies the various supply contracts, timing of procurement, and nature of contracts with the primary contractor and other sub contractors. It also examines whether there are stipulations in the sales agreements allowing any cost overrun to be passed to the buyer.

PROJECT RATING

IIRA will provide a rating for a stand along project if (a) the particular project is a legal entity in itself (b) the cash inflows and outflows from the project are ring-fenced from the other projects of the same developer and (c) the legal agreements between the stakeholders like developer, buyer and , financial institutions are executed in the name of the legal entity and not the developer.

IIRA's rating scales and definitions may be found at www.iirating.com.