Rating Methodology

Corporate and Public Sector Debt

Global Criteria for Rating Property Funds and Commercial Real Estate Companies

Updated February 2018

Related research

Global Master Criteria for Rating Corporate Entities, updated February 2018

Rating philosophy

GCR accords ratings to property funds and commercial real estate companies (hereafter referred to as property companies unless specifically indicated otherwise) utilising the same rating scale and definitions that are applied to other corporate Issuers. Thus, property company credit ratings are a measure of the ability of an Issuer to honour its financial obligations to senior unsecured creditors, relative to other Issuers. Credit quality and default risk is assessed over both the short term and the long term, with a separate short term and long term rating accorded.

- Short term ratings provide an indication of an Issuer's ability to meet its financial obligations over the following 12 month period, including interest payments and debt redemptions.
- Long term ratings reflect an Issuer's ability to meet its financial obligations over a period greater than 12 months, including interest payments and debt redemptions. This encompasses an evaluation of the organisation's current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.

Typically, a strong linkage exists between short and long term ratings. However, as the rating process is dynamic, the linkage may be broken in certain circumstances, at the discretion of the Rating Panel. GCR's approach is to integrate quantitative analysis with a strategically based qualitative analysis. The objective is to assign ratings that are applicable throughout the various stages of a business cycle, as well as examining the ability of an Issuer to meet its obligations under reasonable and stressed scenarios.

The name of the Criteria was amended to Global Criteria for Rating Property Funds and Commercial Real Estate Companies to emphasise its applicability to a wide range of property company structures. Aside from some amendments to terminology and broader definitions, there are no material amendments to the previous Criteria for Rating Property Funds, published in February 2017. The update of this Criteria will not have an impact on any existing Issuer ratings. Going forward, the updated Criteria will be applied to all property company ratings.

Rating methodology

The criteria outlined in this document are intended to illustrate the broad rating guidelines that GCR follows when according a property company rating. GCR defines property companies as those that derive a substantial majority of their earnings from rental income, or other forms of recurring income that is ultimately sourced from rental income, such as dividends. This definition accommodates the varied legal structures evidenced by property companies including, Real Estate Investment Trusts (REITs) and real estate operating companies. Property development companies, where the majority of income derives from the sale of properties fall under the general Corporate Rating Criteria, but the property component analysis may draw substantially from the principles discussed in this methodology. Overall, the approach taken is modelled on the corporate credit rating methodology, integrating quantitative analysis with a strategically based qualitative analysis. As this criteria focuses on those risk indicators pertinent to the property industry, readers are advised to review *GCR's Global Master Criteria for Rating Corporate Entities*, for a more comprehensive discussion of GCR's rating philosophy.

Ultimately, the goal of any credit analysis is to determine if and to what extent future cash flows cover interest and principal payments. In some ways earnings from property companies are more predictable as they are based on contractual rentals that are often signed over multi-year leases. The relative uniformity in the structure of property companies and in particular also lends itself to establishing general financial benchmarks, against which all are considered. Such benchmarks are based on international studies, where significantly more default data exists, but adapted to take cognisance of the particulars of the property sector in emerging markets, where necessary. Nevertheless, as each Issuer has unique characteristics and assumes varying levels of risk, assigning a credit rating is a dynamic process. Thus, the individual financial metrics or credit ratios are not considered solely against a specific benchmark, but their strength and relevance is determined by their relationship to all other property company characteristics.

GCR's analytical process focuses on the following key areas:

1. Economic and sector analysis
2. Business model and investment strategy
3. Real estate portfolio
4. Financial analysis
5. Funding and liquidity profile

1. Economic and sector analysis

No property company is immune to the economic environment. The sector is highly cyclical, and generally mirrors the overall health of the economy. Whilst a broad economic overview is undertaken, all factors are assessed with regard to their effect on the supply and demand for rental space. Where economic growth is robust, demand for property could be expected to increase, with a positive effect on rental yields. Nevertheless, economic growth can be confined to particular industries that do not require space, or require specialised types of property. Economic analysis is most useful in assessing the relative risk weightings that should be assigned to the different property classes i.e. office, industrial, retail, etc.

The correlation between economic growth, rental demand and construction is not always linear. While periods of economic expansion would suggest an increase in the amount of new developments, often such expansion is associated with increased construction utilisation across the economy. Thus, while demand may warrant new developments, higher construction and financing costs may hamper the viability of such projects. Conversely, in times of slower economic activity, rental demand may be weak, but lower construction costs might make projects attractive. Counter-cyclical trends can also emerge where buoyant market conditions spur new developments, resulting in a glut of new space being released to the market and ultimately pushing rental yields lower. Critical to GCR's analysis is thus weighing up the various factors at work in both the broader economy and the property sector, to develop an in-house view of the short, medium and long term prospects of the industry. Cognisance is taken of the relative lag between changes to economic fundamentals and its impact on performance, in part due to the medium term leases often in place. This is particularly true in the retail property class, where lease periods are usually longer.

The health (or lack thereof) of the property industry is most clearly identified by the vacancy rates that prevail. Where vacancies have risen above the long term average, rental yields are likely to come under pressure. Nevertheless, not all property classes will be equally affected by specific economic conditions, while even within each class a particular node may be more resilient to downturns than others. Thus, although GCR's economic overview begins with a review of macro-level trends, the analysis shifts towards more micro-level trends, being particular property classes, specific nodes, as well as grades within each node.

2. Business model and investment strategy

Legal framework
In many jurisdictions, property companies are incorporated under specific REIT legislation. While some of the particulars of REIT legislation may differ across jurisdictions, the main underlying characteristics are similar, and thus allow for comparison across countries. More importantly, REITs are designed to offer special tax benefits to investors in that recurring net income is not taxed as long as it is paid out as a distribution to shareholders. REITs are also exempt from capital gains tax on the sale of immovable property, shares in other REITs and underlying subsidiaries. To qualify as a REIT in most jurisdictions, a property fund is required to pay out at least 75% of its taxable earnings available for distribution in each financial year to its investors. Nevertheless, in practice, REITs tend to distribute 100% of the permitted amount to fully benefit from the tax exemption. This does limit a REIT's ability to build up a cash reserve, requiring liquidity to be measured by other means.

In jurisdictions where the necessary REIT legislation does not exist, GCR provides ratings to other types of property fund structures. Most of these are designed to mimic the tax advantages of a REIT. Nevertheless, as the varied legal structures can create different obligations or restrictions on the operations of the fund, the unique nuances of each structure needs to be clearly understood to determine the rating impact.

Common for smaller private property companies is to be incorporated in terms of the general company legislation in a particular country. Such property companies are generally subject to the normal corporate tax regulations within the country. These companies tend to be much smaller in size and more highly geared. Risk factors on non-REITs are also exacerbated by the relative lack of regulatory oversight. Nevertheless, the fundamental principles of property analysis should in the main, be applicable in all cases.

Investment strategy
A property company's investment strategy can minimise or increase its risk return profile. In GCR's view, business risk could be heightened by property companies that target aggressive development or redevelopment activity. The latter could stem from consecutive acquisitions of undervalued properties (ie. those that are mothballed or have low occupancies) for refurbishment. The build for sale strategy or where developments are done on a speculative basis, is viewed as very high risk and is evaluated accordingly.

Similar risk factors could also derive from a company with an unduly high appetite for property acquisitions, even for established properties with stable long term leases in place. That said, consideration will be given to contextualise the property company's business model, which in many instances focuses on a specific niche of the property industry, where management has developed expertise. Additionally, the company's mandate may allow for investments in other listed property securities, giving exposure to other regions and/or property classes.

Conversely, certain REITs tend to be more risk adverse, with the management and investors in the fund targeting a smoothed rental yield above the return that can be obtained from fixed income securities. Such funds are inclined to favour established properties, with stable long-term leases in place, and may also prefer to minimise funding cost variability by fixing interest rates.

Overall, GCR's analysis aims to balance the rated property company's strategy against asset portfolio appreciation and rental yield returns achieved.

Management assessment

Ultimately, the successful execution of the property company's strategy relies, to a large extent, on the strengths and capabilities of management. For property companies, management functions are generally split into asset management and property management. Asset management involves the strategic oversight of the fund, including decisions as to which properties to buy/sell, what sectors to invest in, whether to progress with major capex, as well as the maintenance of relationships with large tenants. The property management function relates to the day-to-day management of the individual properties including, tenanting the buildings, collecting rentals, managing debtors, general maintenance and smaller capex items. In many instances the property management function is outsourced to third party managers that specialise in a particular class of property or a region. However, the current norm is to retain some or all major functions in-house due to the expertise of the management team. GCR does not consider any management strategy to be more or less risky. Rather, management quality and fund performance is measured relative to the key strategic objectives.

An important assessment of management includes their years of fund management experience and expertise. Strong management teams (even in relation to external managers) tend to be highly experienced, either in respect of the property sector in general, or to niche segments. Key management performance indicators include a track record of identifying promising investment opportunities, bringing new developments to fruition on time and within budget, and ensuring consistent income growth is achieved through variable market cycles. Also crucial is assessing the accuracy of management's internal property valuations. This is measured by comparing the carrying value of properties sold to the eventual sales price achieved. Where the carrying value is consistently lower than the sales price, this indicates conservative valuation policies and greater reliance can be assigned to management valuations.

The expectation is that, in the absence of specific regulations (such as the requirement in several jurisdictions for listed entities to have all properties valued by an external valuer on a rolling three year basis), most property companies adhere to industry best practice with regard to the frequency and veracity of valuing their underlying property portfolios. Where this is not conducted during the ordinary course of business, or where there is some concern as to the veracity of the valuation, GCR will request external valuations of a sample of properties.

3. Real estate portfolio

GCR analyses the quality of a real estate portfolio, by considering both the underlying fundamentals of individual properties, and the characteristics of the portfolio as a whole. As property is an illiquid asset class, where each asset is generally of high value, diversification is crucial to minimise risk factors. Portfolio size is an important risk mitigant to the extent that it enhances diversification and in turn resilience in a cyclical downturn. However, where size is driven by a few very large properties, concentration may exacerbate risk factors. GCR considers portfolio diversification in terms of:

- **Geography** - whether by country, province, city or node. Other factors include urban versus rural properties or CBD versus suburban.
- **Class of property** - office, retail, industrial, residential or hotels. The relative benefits or risks from exposure to particular sectors will shift over economic cycles, so no property class is preferred by GCR. No preference is expressed for a particular grade of properties. Nevertheless, trends have generally evidenced better performance of A-grade properties through the cycle, due to the ability of landlords to reduce rentals if necessary.
- **Number of individual assets** - more properties imply greater diversification. However, high granularity particularly those with many smaller assets is often at the cost of more cumbersome management.
- **Single tenanted versus multi-tenanted buildings** - single tenanted buildings

generally offer more stable rental inflows and ease of management compared to multi-tenanted buildings, which are administratively intensive. However, this gives rise to tenant concentration risk, as rental arrears would be much higher in the case of a single tenant default, or vacancies could increase significantly should the tenant choose not to renew the lease. In a large fund, with numerous small tenants, such costs may be negligible.

- **Pricing power** - the above factors are considered in terms of their impact on pricing power. Thus, geographic concentration may facilitate above average rental escalations if space in a certain node is in high demand. However, rentals may be limited by a concentration of single tenanted buildings, for fear of losing the tenant.

Tenant base

The quality of a portfolio is also assessed in relation to the stability of its rental inflows. This is primarily a factor of tenant quality, the terms of the lease agreements and the likelihood that all terms will be honoured over the life of the lease. Where possible, this is assessed by investigating the composition of tenant lists. For larger portfolios where this may not be possible, factors such as the length of tenancies, leasing procedures and the level of arrears could provide a proxy for tenant quality. Tenant quality is particularly important with regard to single tenanted buildings, and robust credit assessment procedures need to be in place. Key considerations in this regard include:

- **Tenant grade** - Major tenant concentrations or tenant industry concentrations are evaluated. Where tenants comprise predominantly large national or multi-national corporations, greater comfort can be placed on the durability of lease contracts. The credit rating of companies may also be taken into consideration, with higher rated companies more favourably considered. Government/sovereign tenants are considered low risk, albeit this is weighed against the challenges of late rental payments that may arise, as well as an increase in bureaucracy and regulatory rigour required to maintain such relationships.
- **Vacancy rates** - while vacancy levels tend to follow general economic trends, they also point to the quality of a portfolio. Good quality properties will tend to report above average occupancies throughout economic cycles.
- **Lease maturity** - ideally maturities should be smoothed over a multi-year period, with maturities in each year not exceeding 20%. A longer dated lease profile is also positively considered in terms of stability of earnings.
- **Escalations** - leases generally incorporate rental escalation clauses, set at or slightly above the inflation rate. Such clauses help to maintain consistent growth in rental income, even when a portion of leases may not be renewed.

Smaller property companies evidencing higher asset and/or tenant concentrations, typically represent greater credit risk. This is because their income streams can be substantially impaired by a problem at a single property or the non-renewal of a lease agreement by just one tenant. Credit quality is thus assessed, not by the portfolio diversification approach, but rather by taking account of tenant quality. To this end, GCR assigns credit ratings to all tenants (either using GCR ratings or those provided by another recognised rating agency) and then calculates the average credit quality of the income stream, as weighted by the leases. Having a long dated lease maturity profile is of critical importance under this assessment and GCR generally expects around 50% of the leases to extend for periods longer than the debt maturities. Whilst weighted average credit quality may be high, the smaller size and greater concentration means that ratings for such companies tend to be capped in the 'BBB' rating band.

Developments and acquisitions

The greater the level of property development activity, the greater the risk associated with a portfolio. Property companies involved in ongoing acquisitive activity also reflect a higher risk profile. Similar to other properties, development projects and acquisitions are assessed based on their underlying fundamentals, as well as their contribution to the overall portfolio. Additionally, the transaction should align with the property company's risk/return profile. Other mitigating factors include the property company's track record in delivering on projects on time and within budget, the magnitude of projects and backlog, as well as sizeable pre-lets and tenant specific builds, where occupancies are contractually committed beforehand. GCR considers development and/or acquisition activity to be high risk when it accounts for more than 15% of the portfolio value.

4. Financial analysis

Quantitative analysis involves scrutinising the corporation's financial position and cash generation over a five-year period (with the exception of newly established companies), as this gives a good indication of performance through at least one economic cycle. As the rating process explicitly excludes any type of audit, accounting quality is also assessed by taking cognisance of the accounting firm used and by examining accounting policies such as; consolidation principles, property revaluation policies and the treatment of any off balance sheet items. GCR's analysis has been streamlined to increase scrutiny of cash flows, and as such, non-cash items, such as straight-lined rental accruals, are excluded from ratio analysis where practicable.

Financial performance

Financial performance is assessed not only relative to historical performance, but also in relation to budgets provided by management. This allows for due consideration to be taken of the climate and circumstances under which the financial results were produced.

Compared to other corporate Issuers, property companies tend to exhibit a more stable and predictable revenue and profitability profile, driven by contractual rental escalations and the addition of new properties, whose income can also be fairly accurately forecast. In addition, cost factors can also be accurately projected, as many of the day-to-day servicing and property management costs are contracted to outside parties at a predetermined rate. This necessitates a clear understanding of the contractual terms and obligations before the quality of earnings is considered. GCR assigns a great amount of importance to the consistency and sustainability of revenue and cash generation. Property companies that aggressively manage their property portfolios or consistently have large development and/or other capital expenditure pipelines are considered riskier (all other things being equal), as they evidence much greater variability in rental income flows and earnings. As properties are traded in and out of the portfolio, rental income may also deviate markedly, due to project deferrals related to a new development or enhancements to a pre-existing property.

Municipal rates and utility charges represent an expense over which the property company has little control. Although most pass on utility charges and municipal fees directly to the tenant, the administrative burden and credit risk is usually placed on the property company to settle the bill and collect from tenants afterwards. Concerns about these charges have been heightened by rising tariffs, which impact the overall cost to tenants. As tenants can only absorb a limited increase in the all-in cost of occupancy, where this is utilised for municipal costs, less is available for the landlord. Thus, GCR may also examine internal procedures for dealing with municipal disputes, as well as the history of successful resolutions.

Sustainable earnings are measured by recurring operating income, which includes rental income, management fees earned from third parties and other sources of ongoing income (inter alia). For 'A' band rated property companies or higher, the operating income margin *(*operating income over revenue) should equate to between 60% and 70%. Property companies may also have an investment portfolio that contributes towards the operating result, but only where such investment income is demonstrated to be recurring. Profits earned on sales are explicitly excluded from the operating result as they are non-recurring and can fluctuate greatly, while property revaluations are unrealised and thus non-cash.

GCR assigns ratings to an entity primarily based on the extent to which operating profit and cash flows cover interest and principal payments. Of paramount importance is the analysis of the property company's cash generation capabilities. Cash flow analysis focuses on the cash flows generated by an Issuer's core businesses, which are expected to be sustained going forward. For REITs, there is typically a close linear linkage between operating profit and operating cash flows, with the only major usage of cash being for the net interest charge. As most income and expenses are contractual, with little need for inventory, working capital requirements are generally low and primarily a function of rentals in arrears. Thus, working capital absorptions are a useful indicator of problems concerning debtors' collections or tenant quality.

Interest coverage ratios are deemed key credit protection metrics. Given the large debt facilities often employed, the extent to which operating profit covers interest provides a strong indication as to the financial stability of the property company, as well as its ability to raise additional facilities when necessary. As the interest charge generally accounts for a sizeable portion of overall expenditure, many property companies prefer to utilise fixed interest rate contracts or interest rate hedging instruments to underpin the interest expense. In this way, a major risk factor can be minimised and relatively stable yields offered to investors. In light of this, GCR uses several interest coverage metrics to gain a complete picture of the interest rate risk.

- Gross interest coverage assesses the ability to honour interest rate obligations in the event that hedges are unavailable. Ultimately, a property company is expected to cover its interest obligations and only thereafter claim its rights from the hedge counterparties. For 'A' band rated entities, gross interest coverage should be maintained above 2x.
- Net interest coverage examines the interest charge after all interest risk mitigants, such as hedging instruments and capitalised interest on development funding, have been accounted for. Where hedging procedures have been consistently applied, very stable net interest coverage is generally reported. GCR expects net interest coverage to be at least 2.5x for 'A' band rated entities.
- Cash flow coverage of interest attempts to isolate the level of cash available to settle all cash interest charges. The metric is calculated by dividing cash generated by operations plus the net interest charge, by net interest.

4. Funding and liquidity profile

As properties are relatively expensive assets, acquisitions and redevelopments are generally financed utilising a large portion of debt. Property companies thus require a flexible financial structure to ensure their ability to take advantage of opportunities. Such financial flexibility derives from the quantum of debt currently in the portfolio and can be impeded by higher gearing levels. In addition, factors such as the diversification of funding sources and the structure of existing debt impact on overall financial flexibility.

The ability of a property company to assume additional debt is most clearly reflected in the gearing of the underlying portfolio. GCR utilises two key gearing ratios to analyse financial flexibility:

Loan-to-value ratio ("LTV") is a measure of debt relative to the value of underlying properties. The ratio indicates the size of asset sales that would be required under a stressed scenario. To the extent that the LTV ratio is very conservative, a property company would have to dispose of fewer assets to cover maturing obligations. Besides leaving more of the portfolio intact for investors, selling fewer properties would likely result in a lower discount having to be applied in the event of a fire sale. Where a property company's investment mandate allows for a large portfolio of indirect property investments/securities, a more accurate measure of the LTV may be determined by summing up the value of these investments and property assets. GCR expects 'A' band rated property companies to report LTV ratios below 40%. For 'BBB' band rated property companies, an LTV ratio up to 50% may be acceptable, but sustained levels above 45% may indicate excess gearing.

The debt to operating income ratio measures the extent to which the earnings from both direct and indirect property investments can meet principal repayment obligations if necessary. As a benchmark, GCR requires the debt to operating income ratio to be 400% or below for 'A' band rated property companies. This metric may, however, become inflated where a property company acquires some new properties that only contribute rentals for a portion of the year, but for which debt funding

has already been raised. In such circumstances, GCR will focus on forward looking earning based gearing calculations as determined by internal models or as provided by management.
Diversified sources of funding enhance a property company's financial flexibility. Diversification may be across various banks and financial institutions, or through different types of facilities. Apart from traditional bank funding, such sources may also include private loans, listed debt programmes and/or securitisation vehicles. Although broader funding diversification is usually preferable, GCR also recognises the benefits of strong banking relationships. Thus, where a fund can demonstrate a long standing and dynamic relationship with a particular financial institution, this may mitigate the risk of funding concentration.

Shareholder support forms an important alternate source of funding. While raising additional equity can often be a cumbersome and costly process, shareholder support can significantly reduce risk factors. Having a relatively small and prominent group of key shareholders may streamline the process significantly. On the other hand, maintaining strong support from large institutional investors is critical, as the broader asset management market represents a much larger pool of potential funding. Overall, shareholder support is assessed by examining the diversification of shareholders and the success of past capital raising exercises.

Financial flexibility may, however, be limited significantly by the terms and conditions imposed by existing lenders. Secured debt programmes and securitisation vehicles often include onerous financial covenants, which may greatly reduce the ability of a property company to raise additional debt financing. Securitisations and secured debt may also encumber a high portion of assets, making it much more difficult to dispose of properties. GCR considers a ratio of unencumbered assets to total assets of 33% to provide sufficient flexibility. Cognisance is taken of the fact that REITs often encumber almost all property assets so as to benefit from larger banking facilities and more favourable interest rates. This flexibility tradeoff is considered in the context of a REIT's financial requirements and its overall credit standing.

An additional consideration when assessing the level of asset encumbrances relates to unsecured creditors. By its nature, the existence of secured facilities will adversely impact the position of unsecured creditors, as they will rank subordinate in a default situation, leading to lower expected recoveries. GCR thus calculates the level of unencumbered assets relative to unsecured creditors, to determine whether average recoveries could be expected. Where expected recoveries are deemed to be below average, the credit rating (pertaining specifically to unsecured creditors) would necessarily be constrained.

Maturity concentration of debt represents a key risk with regard to property companies, as property assets are illiquid and cannot be disposed of on short notice. This risk is best mitigated by a well-spaced maturity profile, where maturities do not exceed more than 30% of facilities in a given financial period. Where there are substantial short term maturities (over the next 12-24 months), GCR expects the Issuer to have started refinancing or redemption arrangements at least six months in advance. For facilities that will be redeemed, GCR requires that cash trapping mechanisms are instituted. However, where this may pose regulatory issues for property companies, alternate funding mechanisms may be employed.

Liquidity
For REITs, liquidity cannot be measured by cash on hand, as cash balances are usually maintained at a nominal level. This is because all cash profits are usually disbursed to shareholders, while any excess cash is normally used to offset debt to avoid interest leakage. In addition, REIT legislation in many jurisdictions does not permit REITs to utilise cash income to settle debt, rather property funds are required to refinance debt through new facilities or asset sales.

Accordingly, access to funding on demand is the key liquidity metric that must be considered. Such funding derives primarily from the unutilised portion of existing loans. Whilst GCR recognises that loan facilities may be withdrawn at any time, greater weighting is given to such facilities where they are underpinned by a mortgage agreement. The greatest weighting is given to committed facilities for which commitment fees are paid, as these cannot generally be withdrawn by the bank without penalties.

A ratio of 33% of unutilised facilities to existing facilities is used to benchmark available liquidity. However, as each property company's obligations may differ, optimal liquidity requirements must be assessed on an individual basis. This is calculated as the ratio of unutilised facilities to all cash requirements over the following 12 months, including short-term debt, maturing issues and committed capex or other expenditure. GCR expects a ratio of above 1.2x for 'A' band rated REITs. Where applicable, GCR may also consider exchange traded securities in support of liquidity. In such circumstances, cognisance is taken that in a stressed scenario, such securities would likely be sold at a discount.

As a proxy for the availability of new facilities, GCR calculates the value of the secured mortgaged property relative to the size of the loan facility. To the extent that the property value significantly exceeds the facility amount, this suggests that raising the facility limit would not be problematic.

Conclusion

The property sector presents a unique asset class that, in many ways, lends itself to the credit rating process. The stability of earnings allows for more accurate assessment of an Issuer's ability to service its financial obligations, while the active market for property transactions makes valuing the underlying security more predictable. However, the sector also poses unique challenges to the credit rating process, arising from the mismatch between the long term nature of the assets being acquired, relative to the much shorter duration funding that is available. In addition, while liquidity facilities are constantly required, funds are unable to build up cash reserves.

GCR's quantitative analysis ultimately seeks to quantify the divergent impact the various financial factors will have on a fund's capacity to generate cash into the future. Nevertheless, the qualitative characteristics of our analysis cannot be over-emphasised and it remains critically important to look "beyond the numbers" to evaluate the intangible strengths and weaknesses of an entity.

Annexure 1: Issuer versus Issue Ratings

Corporate credit ratings issued by GCR are typically an expression of an Issuer's ability to service all of its debt and other obligations. This is an assessment of the entirety of the Issuer's asset base, cash flows and operations relative to all of its obligations. Most significantly, this relates to the interest bearing obligations of an Issuer, which are generally underpinned by a legal obligation to make repayments, and can most easily lead to a default of the Issuer. However, a complete credit assessment requires that the Issuer's ability to meet all liabilities, including the ongoing ability to meet its operating expenses and trade creditors *inter alia*, be considered.

Different liabilities or obligations of an Issuer can report different levels of credit risk for reasons that include the size/quantum of the obligation, timing of the related payment, collateral, and other structural enhancements or legal characteristics. As a result, GCR also accords Issue ratings to specific debt Issues/Instruments and assesses these in terms of their unique credit risk characteristics relative to that of the Issuer as a whole. To the extent that the particular Issue has stronger recovery prospects than the Issuer as a whole (due to enhancements, which may take various forms), the Issue rating may be notched upwards from that accorded to the Issuer. Conversely, where such an Issue reports weaker recovery prospects than the Issuer as a whole, the Issue rating may be notched downwards from the rating accorded to the Issuer. An Issue may also be notched downwards in the case of subordination, either legal or structural.

In reality, given the complex nature of a corporate entity and its operations, it is usually not possible or practical to assess different likelihood of default across Issues as compared to that of an Issuer as a whole (such assessment falls under the purview of structured finance, and typically entails the full securitisation of assets and liabilities). However, many corporate debt Issues are usually accompanied by structural enhancements such as collateral pledged or a guarantee. As these features can improve the expected recovery to a debt funder in the case of a default on the Issue, and can readily be quantified, such structural enhancements are typically utilised to improve the credit risk profile of a specific Issue by a corporate. Such Issue ratings are examined in conjunction with the Issuer or corporate ratings accorded and are assessed in terms of GCR's *Global Structurally Enhanced Corporate Bonds Rating Criteria.*

GLOSSARY OF TERMS/ACRONYMS USED IN THIS DOCUMENT AS PER GCR'S CORPORATE GLOSSARY

Balance Sheet	Also known as Statement of Financial Position. A statement of a company's assets and liabilities provided for the benefit of shareholders and regulators. It gives a snapshot at a specific point in time of the assets the company holds and how they have been financed.
Budget	Financial plan that serves as an estimate of future cost, revenues or both.
Capital	The sum of money that is invested to generate proceeds.
Capital Expenditure	Expenditure on long-term assets such as plant, equipment or land, which will form the productive assets of a company.
Capital Gains	An increase in the price of a capital asset or investment such as property, land or securities.
Cash Flow	The inflow and outflow of cash and cash equivalents. Such flows arise from operating, investing and financing activities.
Commitment Fee	A fee paid by a borrower for a lender's commitment to make funds available when required.
Correlation	A term that describes the degree to which two variables move together. A correlation of 1 means that they move together exactly, while a correlation of minus 1 means that they move in exactly the opposite direction from each other.
Covenant	A provision that is indicative of performance. Covenants are either positive or negative. Positive covenants are activities that the borrower commits to, typically in its normal course of business. Negative covenants are certain limits and restrictions on the borrowers' activities.
Credit Rating	An opinion regarding the creditworthiness of an entity, a security or financial instrument, or an issuer of securities or financial instruments, using an established and defined ranking system of rating categories.
Credit Risk	The possibility that a bond issuer or any other borrowers (including debtors/creditors) will default and fail to pay the principal and interest when due.
Debt	An obligation to repay a sum of money. More specifically, it is funds passed from a creditor to a debtor in exchange for interest and a commitment to repay the principal in full on a specified date or over a specified period.
Debt Financing	Raising capital by selling debt instruments such as bonds, bills or notes.
Default	Failure to meet the payment obligation of either interest or principal on a debt or bond. Technically, a borrower does not default, the initiative comes from the lender who declares that the borrower is in default.
Diversification	Spreading risk by constructing a portfolio that contains different investments, whose returns are relatively uncorrelated. The term also refers to companies which move into markets or products that bear little relation to ones they already operate in.
Dividend	The portion of a company's after-tax earnings that is distributed to shareholders.
Equity	Equity is the holding or stake that shareholders have in a company. Equity capital is raised by the issue of new shares or by retaining profit.
Exercise	To exercise an option is to use the right of the holder to buy or sell the underlying asset on which the option is based at the strike price.
Exposure	Exposure is the amount of risk the holder of an asset or security is faced with as a consequence of holding the security or asset. For a company, its exposure may relate to a particular product class or customer grouping. Exposure may also arise from an overreliance on one source of funding.
Financial Year	The year used for accounting purposes by a company or government. It can be a calendar year or it can cover a different period, often starting in April, July or October. It can also be referred to as the fiscal year.
Fix	The setting of a currency or commodity price for trade at a future date.
Gearing	With regard to corporate analysis, gearing (or leverage) refers to the extent to which a company is funded by debt and can be calculated by dividing its debt by shareholders' funds or by EBITDA.
Gross Lettable Area	GLA is the portion of the total floor area of a building that is available for tenant leasing, and is usually expressed in square meters or square feet.
Hedge	A form of insurance against financial loss or other adverse circumstances.
Hedging	A financial risk management process or function to take a market position to protect against an eventuality. Taking an offsetting position in addition to an existing position. The correlation between the existing and offsetting position is negative.
Illiquid	Markets or financial instruments are described as being illiquid if there are few buyers and sellers. Assets may also be considered illiquid. It may be difficult, or even impossible, to find a reliable price for an illiquid security.
Institutional Investors	Financial institutions such as pension funds, asset managers and insurance companies, which invest large amounts in financial markets on behalf of their clients.
Interest	Scheduled payments made to a creditor in return for the use of borrowed money. The size of the payments will be determined by the interest rate, the amount borrowed or principal and the duration of the loan.
Interest Cover	Interest cover is a measure of a company's interest payments relative to its profits. It is calculated by dividing a company's operating profit by its interest payments for a given period.
Interest Leakage	Situation whereby a company has outstanding debt that yields a higher interest cost than the interest earned on cash balances.
Interest Rate	The charge or the return on an asset or debt expressed as a percentage of the price or size of the asset or debt. It is usually expressed on an annual basis.
Interest Rate Risk	The potential for losses or reduced income arising from adverse movements in interest rates.
Liabilities	All financial claims, debts or potential losses incurred by an individual or an organisation.
Liquidity	The speed at which assets can be converted to cash. It can also refer to the ability of a company to service its debt obligations due to the presence of liquid assets such as cash and its equivalents. Market liquidity refers

	to the ease with which a security can be bought or sold quickly and in large volumes without substantially affecting the market price.
Loan To Value	Principal balance of a loan divided by the value of the property that it funds. LTVs can be computed as the loan balance to most recent property market value, or relative to the original property market value.
Long-Term Rating	A long term rating reflects an issuer’s ability to meet its financial obligations over the following three to five year period, including interest payments and debt redemptions. This encompasses an evaluation of the organisation’s current financial position, as well as how the position may change in the future with regard to meeting longer term financial obligations.
Mandate	Authorisation or instruction to proceed with an undertaking or to take a course of action. A borrower, for example, might instruct the lead manager of a bond issue to proceed on the terms agreed.
Margin	A term whose meaning depends on the context. In the widest sense, it means the difference between two values.
Maturity	The length of time between the issue of a bond or other security and the date on which it becomes payable in full.
Off Balance Sheet	Off balance sheet items are assets or liabilities that are not shown on a company's balance sheet. They are usually referred to in the notes to a company's accounts.
Operating Cash Flow	A company's net cash position over a given period, i.e. money received from customers minus payments to suppliers and staff, administration expenses, interest payments and taxes.
Operating Profit	Profits from a company's ordinary revenue-producing activities, calculated before taxes and interest costs.
Portfolio	A collection of investments held by an individual investor or financial institution. They may include stocks, bonds, futures contracts, options, real estate investments or any item that the holder believes will retain its value.
Principal	The total amount borrowed or lent, e.g. the face value of a bond, excluding interest.
Real Estate Investment Trust	A REIT is a company that owns or finances income-producing real estate. REITs are subject to special tax considerations and generally pay out all of their taxable income as distributions to shareholders.
Redemption	The repurchase of a bond at maturity by the issuer.
Refinancing	The issue of new debt to replace maturing debt. New debt may be provided by existing or new lenders, with a new set of terms in place.
Revaluation	Formal upward or downward adjustment to assets such as property or plant and equipment.
Risk	The possibility that an investment or venture will make a loss or not make the returns expected. There are many different types of risk including basis risk, country risk, credit risk, currency risk, economic risk, inflation risk, liquidity risk, market or systemic risk, political risk, settlement risk and translation risk.
Secured Debt	Debt backed with or secured by collateral to reduce lending risk and thus the interest rate charged.
Shareholder	An individual, entity or financial institution that holds shares or stock in an organisation or company.
Short-Term Rating	A short term rating is an opinion of an issuer’s ability to meet all financial obligations over the upcoming 12 month period, including interest payments and debt redemptions.
Working Capital	Working capital usually refers to the resources that a company uses to finance day-to-day operations. Changes in working capital are assessed to explain movements in debt and cash balances.
Yield	Percentage return on an investment or security, usually calculated at an annual rate. Also an agricultural term describing output in terms of quantity of a crop.