December 2018

JCR-VIS MANAGEMENT QUALITY RATINGS

REIT Management Company

JCR-VIS Credit Rating Company Limited's definition of Management Quality (MQ) Ratings consistently applies across various types of investments, including the category of REIT Management Companies (RMCs). This applies to both Rental or Developmental Real Estate Investment Trust (REIT) funds. The Management Quality rating scale for RMCs is appended with the suffix RMC to distinguish it from other MQ Ratings outstanding by JCR-VIS.

The conduct of RMCs, akin to other types of investment managers, is evaluated in context of best practices in the investment management industry. Broadly speaking, the methodology remains consistent with our other MQ rating assessments. This document captures those specific areas as well that are innate to the real estate business or stem from the specific regulations introduced for REITs and therefore require consideration while assessing RMCs.

The investment strategy, asset selection process, decision-making process, negotiating skills, policies on the purchase and sale of properties, information collection systems, methodologies for evaluating asset performance, and administrative framework are some of the areas that will be covered during the rating process by JCR-VIS. Management meetings are a very important part of the rating process, which may be extended to the key personnel of some of the institutions engaged for their professional services.

Mentioned below are key areas that are reviewed at the time of assessment of any RMC:

- Management and Governance
- Investment Process
- Self Regulation

Qualitative Analysis

- Asset Under Management
- Performance of Assets Under Management
- Financial Strength

Quantitative Analysis

Qualitative Analysis

Management & Governance

The governance practices instituted at any organization are evaluated with keen interest by JCR-VIS. A Board of Directors (BoD) comprising a blend of professionals, with relevant industry experience can provide better guidance in strategic matters to the management team, to benefit all stakeholders.

Adequate representation of independent directors on Board is also considered positive from a rating perspective. While JCR-VIS views an independent management favorably, which has powers to manage the day-to-day operations of the company; the quality of input provided by the Board in terms of the broad policy guidelines is also considered important. Moreover, JCR-VIS also evaluates the Board's access to information, necessary to fulfill their duties, and the extent to which the Board exercises funds' oversight, either directly or through its constituted committees.

JCR-VIS evaluates how the organizational structure facilitates decision-making and timely response to environmental influences. To avoid ambiguity, the organization's hierarchical pattern must be distinctly defined so that the employees are aware of their job definitions, responsibilities and authorities and there is sufficient segregation of functional duties.

An important aspect of the rating process includes an in-depth review of profile of key personnel. The experience and discipline of key personnel are critical to the success of the company. They are assessed for their educational background and experience of real estate markets, research and financial analysis; a company must possess staff skill set in line with the requirements of its planned activities. This also involves appraising senior management and any committees involved in investment decision making. Reliance on few key employees and lack of succession planning may adversely impact ratings. Even in case of small organizational setups, it is important to have personnel for key positions in place so that the investment decision making process is not affected.

It may not be uncommon to find that some of the parties involved in a specific REIT scheme may have common shareholders. Moreover, there is possibility that sponsors of an RMC may hold assets that may compete with those held by a REIT scheme managed by an RMC, or a REIT scheme proposed to be launched by an RMC may purchase property from one of its sponsors. These situations may pose varying degrees of conflict of interest, which need to be managed effectively. This also makes policy with respect to related party transactions particularly important; these contracts must be executed at an arm's length basis.

The assets held by REITs are required to be stable, cash-flow generating properties in case of Rental REITs and properties having not more than 5 years' construction period (in case of Development REITs). There are various other regulatory requirements also in place which have to be satisfied prior to launch of a REIT Scheme. In view of this, turnaround time for the launch of a REIT fund may be lengthy, requiring significant investment in terms of time by the management.

Investment Process

At the core of RMC's activities are the investment processes put in place to manage funds. While in general, this would include research capabilities, risk management infrastructure and investment decision making process for any asset management company, an RMC has added responsibilities stipulated under the regulations. These include various activities prior to the launch of the REIT scheme, such as conducting due diligence to certify and ensure that the title to the real estate to be acquired for the purposes of the REIT Scheme is free from all defects and encumbrances; arranging transfer of real estate in the name of Trustee of the REIT Scheme; ensuring that all material contracts, including agreement for purchase of real estate, rental agreements, service providers' agreements entered into for furtherance of the objects of the REIT Scheme are legitimate, valid, binding and enforceable by or on behalf of the Trustee in accordance with the stipulated terms of such contracts and agreements. More importantly, the RMC would also be engaged in the development of business plan for a REIT scheme. In case of Rental REITs that provide an exit mechanism by way of sale of property held by the REIT, timely decision making in case of depleting rental yields, for instance, may assume significant importance in terms of total return generated for the investors. These activities require business, financial and legal acumen specific to the real estate sector to support ratings.

Various activities under regulations are required to be outsourced; third parties may include Property Manager, Development Advisor, Project Accountant, Trustee, Valuer, External Auditors, Shariah Advisor and the Registrar. JCR-VIS will evaluate the mechanism in place to solicit the services of various third party service providers, within the parameters laid down under regulations, and post-facto monitoring of their compliance within the established criteria. The performance of REITs managed by an RMC is highly dependent on the strategy and abilities of certain outside parties such as Property Manager in case of Rental REITs and Development Advisor in case of Developmental REITs; the skill and experience of the management and employees of the same also assumes significance in the rating process.

For any fund manager, having access to market related data is considered critical for informed decision making. Given the absence of formal data sources such as housing price index or rental yields in Pakistan, as is the case in more developed economies, an RMC may have to rely on informal data sources. This means that the responsibility of developing even an initial database falls on to the shoulders of the RMC itself and it may need to rely on multiple channels such as property agents, real estate brokers, auctions, advertisements, to establish a sense of the market. JCR-VIS evaluates the depth of research undertaken and the tools used for both general market analysis and individual property assessments, as it feeds into the decision with respect to the launch of a particular REIT scheme.

Management quality rating process also involves review of the practices and procedures to identify and analyze risks that are inherent in the specific geographic/market segment in which a REIT scheme is proposed to be launched. The risk and control functions must be represented at the executive level, with regular review of risk indicators. A well-sourced and independent risk function is considered favorably from a rating's perspective. JCR-VIS also reviews the actual investment decision making process and whether it allows for all relevant personnel to voice their opinions.

Self-Regulation

JCR-VIS places special emphasis on controls relating to conflicts of interest and overall control environment in a company, including internal audit and compliance set up and reporting mechanisms; the policy framework must address all work flows. JCR-VIS analyzes the operating procedures and management's ability to effectively carry out operating functions in line with the defined policies. This analysis includes historical review of company's compliance with regulations and internal policy framework. A review may be made as to the existence, frequency and causes of any violations.

An evaluation of information systems is also carried out to assess company's ability to efficiently conduct day-to-day activities and generate the relevant reports for management's review. This includes analytical tools for performance and risk analysis. Seamless workflow for NAV calculation, validation and assessment is considered favorably by JCR-VIS. Back-up procedures must be adequately defined, implemented and tested to ensure un-interrupted operations.

Quantitative Analysis

Assets under Management

By regulations, REITs are required to be structured as close-end scheme, in addition to which Developmental REITs, by definition, will have a limited life while Rental REITs may also be launched for a specific term. This implies that growth in assets under management will primarily be driven by the launch of new funds. The ability of a company to identify new projects and launch REITs, in line with its business plan, will be evaluated by JCR-VIS.

Performance of Assets under Management

REITs, in itself is a new investment class in Pakistan, introduced only recently in view of which there is no historical data available which may be used as a yardstick to gauge performance of REIT funds. In addition to this, there are no readily available indices for the real estate sector, though informal sources do provide some indication of trend in rentals in certain geographic segments. There may be additional difficulties attached with evaluation of the performance of developmental REITs.

Given this limitation, JCR-VIS will evaluate the business plan for each fund and the basis used to determine the projected return for investors; post launch performance will be evaluated against the same. As a number of REITs are launched, peer group comparison may also become possible over time while launch of sector specific indices may also provide a good benchmark for performance evaluation.

Financial Strength

Unlike other MQ rating assessments by JCR-VIS, financial strength of an RMC assumes greater weightage in the overall assessment. An RMC is required to have minimum equity of Rs. 50m, as per regulations. This sets the base level of equity required by an AMC. Previously, the RMC was also required to hold a minimum of 5% units of every REIT fund launched by it throughout the life of the REIT fund till its winding up and these units could not be sold, transferred or encumbered before certain time duration. However, in 2017, the regulations have been relaxed in this regard whereby the sponsor or RMC should collectively hold a minimum of 20% of units issued.

Depending on the size of funds proposed to be launched, the resource requirement for an RMC would be determined. Inability of sponsors to arrange funds necessary to satisfy the minimum holding requirement may impair a company's ability to launch funds; in view of this, the financial strength of the RMC and its sponsors assumes added significance in the overall assessment process.

JCR-VIS evaluates both business and financial sustainability of any organization. Earnings from core operations should be sufficient to meet operating costs on an on-going basis. Any form of external support available to the management company is factored in, where appropriate.

Conclusion

Globally REITs are now accepted as mainstream investment vehicles that enable investors to pool their resources to take exposure in an otherwise illiquid asset class, while also featuring lower initial investment requirement vis-à-vis direct exposure. JCR-VIS believes that there is significant growth potential in the REITs sector in Pakistan and entry of participants in the same may also lead to the development of ancillary services / service providers. Institutional practices and rating attributes may also evolve over time.

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Mr. Ahmad possesses 30+ years experience in financial risk assessment with focus on Islamic finance, venture capital and general management. He has top level management experience at international level in the fields of credit ratings, Islamic and conventional financial risk assessment modeling, industrial management and construction engineering. Mr. Ahmad is an active participant at international forums on Credit Ratings. He obtained his B.S in Civil Engineering from NED University of Engineering and Technology, Karachi. He also has Masters Degrees in Engineering and Business Administration from USA. He could be contacted at faheem@jcrvis.com.pk

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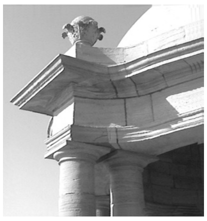
National Excellence, International Reach



Jahangir Kothari Parade

JCR-VIS Credit Rating Company Limited is committed to the protection of investors and offers a blend of local expertise and international experience to serve the domestic financial markets. With its international reach, JCR-VIS is positioned to aim for an international mark. In this regard, the global experience of our principal, Japan Credit Rating Agency, Ltd. has been invaluable towards adding depth to our ongoing research endeavors, enriching us in ways, that enable us to deliver our responsibilities to the satisfaction of all investors.

The edifice of the Jahangir Kothari Parade has stood proudly through the years and is a symbol of our heritage. Its 'Dome' as the most stable of building structures, exemplifies architectural perfection. Committed to excellence, JCR-VIS continues its endeavor to remain an emblem of trust.

Jahangir Kothari Parade (Lady LLoyd Pier)
Inspired by Her Excellency, The Honorable Lady Lloyd, this promenade pier and pavillion was constructed at a cost of 3 Lakhs and donated to the public of Karachi by Jahangir Kothari to whose genrosity and public spirit the gift is due. Foundation stone laid on January 5, 1920. Opened by Her Excellency, The Honorable Lady Lloyd on March 21, 1921.

Dome: A roof or vault, usually hemispherical in form. Until the 19th century, domes were constructed of masonry, of wood, or of combinations of the two, frequently reinforced with iron chains around the base to counteract the outward thrust of the structure.

Origins: The dome seems to have developed as roofing for circular mud-brick huts in ancient Mesopotamia about 6000 years ago. In the 14th century B.C. the Mycenaean Greeks built tombs roofed with steep corbeled domes in the shape of pointed beehives (tholos tombs). Otherwise, the dome was not important in ancient Greek architecture. The Romans developed the masonry dome in its purest form, culminating in a temple built by the emperor Hadrian. Set on a massive circular drum the coffered dome forms a perfect hemisphere on the interior, with a large oculus (eye) in its center to admit light.

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