Rating Methodology

Homebuilders and Real Estate Developers Rating Methodology

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SCOPE OF THE CRITERIA

The criteria on "Homebuilders and Real Estate Developers Rating Methodology" describe the key credit factors that TRIS Rating uses when assigning ratings to companies that generate a majority of their income from the development and sale of newly constructed residential, commercial and industrial properties.

The criteria are not applicable to real estate companies that generate a majority of their income from renting out their properties, whose rating criteria follow "Rating Methodology for Real Estate for Rent Companies". However, it is not unusual for a company to develop property both for sales and for rent.

SUMMARY

The rating framework for homebuilders and real estate developers follows the "Corporate Rating Methodology", where we start with an assessment of the business risk profile (BRP) and financial risk profile (FRP) to arrive at the anchor rating. Then, we may adjust the anchor rating with other credit considerations (if any) to get the standalone credit profile (SACP). Lastly, if an entity is a part of a group of companies, we will incorporate the extraordinary support (or negative intervention) from the group members to the SACP to arrive at the issuer credit rating (ICR).

The BRP is comprised of an assessment of industry risk (which incorporates country risk), competitive position and profitability of that entity. We classify the homebuilding and real estate development industry as a "moderately high risk" industry with relatively high volatility of revenues and earnings, as well as moderate growth prospects and a moderate degree of competition. In assessing the competitive position, we focus on the market position, product diversity, and operating efficiency. For the profitability, we focus on both the level and volatility of profitability of that entity.

For the FRP, we emphasize not only the capital structure of the entity but also its ability to generate cash flow to service its debt principal and interest payments. Three core ratios used to determine the financial risk profile include the debt to capitalization ratio, the debt to earnings before interest, taxes, depreciation, and amortization (EBITDA) ratio, and the funds from operations (FFO) to debt ratio. We also look at the EBITDA interest coverage ratio as a supplementary ratio. All ratios are adjusted.

RATING METHODOLOGY

Rating Framework

<table>
<tr><td>Country Risk</td><td rowspan="2">Corporate Industry and Country Risk Assessment (CICRA)</td><td rowspan="4">Business Risk Profile (BRP)</td><td rowspan="6">Anchor Rating</td><td rowspan="6">+/-</td><td>Other Credit Considerations (OCC)</td><td rowspan="6">=</td><td rowspan="6">Stand-alone Credit Profile (SACP)</td></tr>
<tr><td>Industry Risk</td><td>- Management & Governance</td></tr>
<tr><td>Competitive Position</td><td rowspan="2">Overall Competitive Position</td><td>- Liquidity</td></tr>
<tr><td>Profitability</td><td>- Financial flexibility</td></tr>
<tr><td colspan="2" rowspan="2">Cash Flow & Leverage</td><td rowspan="2">Financial Risk Profile (FRP)</td><td>- Diversification</td></tr>
<tr><td>- Peer comparison
- Others</td></tr>
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SACP	+/-	**Group Credit Profile (GCP)**	=	**Issuer or Company Rating**

KEY RATING FACTORS

1) Business Risk Profile (BRP)

The business risk profile focuses on assessing an entity's exposure to country and industry risks, competitive position of an entity compared with industry peers, and its profitability. The competitive position incorporates an assessment of 1) the competitive advantage; 2) scale, scope, and diversity of products; and 3) operating efficiency. For the profitability assessment, we look at both the level and volatility of profitability in comparison with industry peers.

1.1. Country Risk

Most rated real estate developers, especially homebuilders, focus on the domestic market. Thus, their businesses are exposed to economic factors, government policies, and regulations specific to Thailand. However, for entities that operate in other countries, country risk factors also have a critical bearing on entity creditworthiness. For country risk, we focus on economic growth, government support, the depth and breadth of capital markets, and the legal framework. The country risk exposure is determined by using revenues, earnings, or assets contributions from that country.

1.2. Industry Risk

The homebuilding and real estate development industry is considered to have a "moderately high risk" level. This reflects the high volatility of revenues and earnings, as well as moderate growth prospects and moderate degree of competition. Generally, demand for real estate is rather cyclical and tends to move in tandem with the domestic economy. However, demand from foreign buyers and/or investors also plays a significant role, especially for industrial properties.

- **Volatility of revenues and earnings**

  Demand for real estate usually moves in tandem with the economy but with a higher degree of volatility. Performance of SET-listed property developers during downturn periods (1995-1999 and 2005-2009) showed an average peak-to-trough (PTT) decline in revenues of about -61.36% in 1995-1999 and no growth during 2005-2009, and an average PTT decline in EBITDA margin of -145.45% in 1995-1999 and -18% in 2005-2009. Based on the significant declines in revenues and profitability during the downturn periods, we classify the volatility of revenues and earnings of homebuilders and real estate developers as high risk.

- **Degree of competition and industry growth trends**

  Homebuilders and real estate developers are subject to a moderate degree of competition and have moderate growth prospects. Barriers to entry are considered moderate due to the capital-intensive nature of this business. Substitution risk is low and growth trends are usually in line with economic growth. In addition, there is some degree of product differentiation, thus, the competitive pressure on profit margin is considered moderate compared with other industries.

  However, for homebuilders, levels and trends of profit margins are rather cyclical, based on the balance of supply and demand in the market. Demand for housing is based on several factors, including consumer confidence and job security, population growth, availability of mortgages, and the degree of urbanization. Investment in infrastructure projects and additional demand from both domestic and foreign investors are major drivers that support growth in the short to medium term.

  For industrial property developers, both industrial parks and zones are under the oversight of two government agencies: the Industrial Estate Authority of Thailand and the Board of Investment; only qualified developers can operate industrial estates and provide privileges to their clients, such as the right of foreign companies to purchase land plots in the industrial estate. So new entrants face barriers to entry arising from regulatory requirements. There is a substitute in demand between land in industrial estates and land outside industrial estates or among estates in a certain region. The levels and trends of profit margins are rather cyclical, based on the degree of competition and market sentiment. In addition, apart from domestic economic factors, the growth of industrial estate demand is related to foreign direct investment. Investment promotions and privileges launched by the authorities, government industrialization policies such as industrial development (Industry 4.0), infrastructure investment and the Eastern Economic Corridor (EEC) project also support growth in the medium term.

1.3. Competitive Position

For competitive position, we consider three factors: 1) competitive advantage; 2) scale, scope, and diversity; and 3) operating efficiency. The weight assigned to each factor will be 30% for "competitive advantage", 30% for "scale, scope, and diversity", and 40% for "operating efficiency". Below are the details of each key factor considered in determining the competitive position of homebuilders and real estate developers:

- **Competitive advantage**

  For a homebuilder and real estate developer, we assess its competitive advantage based on its size and market share, brand position, pricing power, and product quality. For homebuilders, we focus more on their ability to source well-situated land plots in sufficient quantity to support growth and the ability to adjust products to match changing market conditions and customer preferences. For industrial estate developers, we put particular emphasis on their reputation and location of their industrial estates.

  Competitive advantage could be measured from the new sales, backlog, order cancellation, and the premium of selling price compared with peers. A developer will be considered as having a "strong" competitive advantage if it has a proven record of implementing business and marketing strategies to tap into a growing and competitive market, an ability to source land with good potential or in strategic locations, and an ability to outperform the market in terms of sales volume and premium pricing. On the other hand, a "weak" competitive advantage could be due to a small business scale, inconsistent or aggressive business and marketing strategies, and a lack of sufficient land banks to replenish and/or support growth.

- **Scale, scope, and diversity**

  In assessing scale, scope and diversity for a homebuilder and real estate developer, we focus on sales and the diversity its products in terms of product types, price range, and locations. For homebuilders, demand for housing is very dynamic and can be affected by changes in consumer preferences, urbanization, infrastructure development, or economic conditions. Only developers that have diversified product portfolios in terms of product types, price ranges, and locations will be able to quickly adjust their products to meet changes in market demand, causing their earnings to be more resilient than peers regardless of economic downturns.

For industrial property developers, scale and geographic diversity are more important. The variety of strategic locations offered helps attract customers of various industries while a sizable scale should allow the developer to offer better and more extensive infrastructure and related services to clients at a lower cost.

A developer will receive a "strong" assessment of scale, scope, and diversity if it has a large scale of operations and a diversified portfolio in terms of product types, price range, and geography. An entity will receive a "weak" assessment if it has a small scale of operations and concentration in the type of products offered and/or locations.

- **Operating efficiency**

Operating efficiency is usually reflected in the profit margin that an entity achieves. Better profit margins can come from the ability to pass along rising costs to customers or the ability to lower costs by adjusting products, standardizing production processes, or reducing overheads. Large developers usually benefit from economies of scale through the ability to procure land and raw materials on a cost-effective basis or the ability to standardize the construction process.

For homebuilders, we also look at the ability of developers to develop and transfer housing units in a timely and cost-effective manner with no major quality issues thereafter. Developers that focus on landed properties have to be able to match the pace of construction with the pace of sales. With the right balance, homebuyers do not have to wait too long to get their homes and developers do not need to carry too much inventory. Developers that focus on high-rise projects have different measures of operating efficiency. Developers of high-rises must secure enough presales, complete the construction, and transfer the units to buyers as scheduled. The quality of presales is more important for condominium developers. Developers that collect negligible amounts as down payments may expose themselves to the risk that buyers will cancel their purchases before the transfer date and end up with lower sales than expected. Delays in the completion or transfers of projects will cause damage both financially and to the reputation of the developer.

For industrial estate developers, the ability to acquire land in strategic locations on a cost-effective basis is the key aspect of operating efficiency since the cost of land is the largest component of an industrial estate's overall cost structure. The developer must plan ahead to secure land for new projects while continuously reviewing its land acquisition plans together with its expansion strategy. A track record of delivering projects on time and within budget is considered important. Major developers who have in-house construction teams can manage their development times and costs efficiently. We also consider a developer's inventory management. We found that major developers mitigate risk by maintaining appropriate land inventory at each location. They cut back on installation of infrastructure at a particular location when available land plots exceed what is required.

1.4. Profitability

We measure two aspects of profitability: the level of profitability and degree of volatility.

- **Level of profitability**

For the level of profitability, we focus on two key ratios: EBITDA margin, and the return on permanent capital (ROPC). Generally, the gross profit margin measures the ability of a developer to control development costs and set product prices compared with industry peers. However, in order to increase sales, some developers may use more marketing expenses instead of selling at lower prices. Thus, in our view, EBITDA margin, which has incorporated the selling and administrative expenses may better reflect the level of profitability than gross profit margin. However, in some circumstances, developers may develop projects jointly with partners. Thus, they may recognize only their share of profits (or losses) from the investment through affiliates or joint ventures. In these cases, the ROPC may better reflect the profitability of the company than the EBITDA margin.

Both ratios are calculated based on 5-year average data, covering two years of historical data and base-case forecast for the current year and the next two years. For homebuilders, the average EBITDA margin is in the 15%-25% range while the average pretax return on permanent capital is around 8%-15%.

- **Volatility of profitability**

To measure the volatility of profitability, we look at the standard error of regression, using 7-year historical data of EBITDA margin and/or ROPC. For homebuilders, the earnings and cash flow of developers that focus only on high-rise condominium projects are much more volatile than those of developers focusing on low-rise housing projects. Their profitability usually fluctuates based on the number of projects completed and transferred each year. These developers have to smooth out their earnings by carefully managing the number of project launches, constructs, and transfers each year. On the contrary, the profitability of developers that focus only on low-rise housing products is generally more stable due to their shorter construction time. However, in the last decade we have witnessed a strong growth in demand for condominiums and many developers have moved into condominium development to capture the growth in this segment. Nonetheless, in our view, we expect developers to have a good mix of products in order to support growth and ensure stable earnings.

Earnings of industrial estate developers that focus only on land sales are more volatile and more sensitive to economic cycles. Thus, most developers have sought to mitigate their revenue volatility by seeking to generate recurring income from renting out their assets, providing utility services and so on.

2) Financial Risk Profile (FRP)

TRIS Rating relies on the audited and/or reviewed financial statements. We focus on both qualitative and quantitative aspects for the financial risk analysis. In addition, we use consolidated financial statements, rather than company-only financial statements, to gain a complete picture of the issuer and any affiliated companies and to avoid inter-company transactions.

For the qualitative aspects, if the auditor expresses no opinion or has a qualified opinion with respect to major items in the financial statements, TRIS Rating will take a very conservative view on the rating. In some cases, we may not be able to assign a rating to a company. The rating will be adversely impacted if a company cannot provide reasons for a qualified opinion with respect to major items since the reliability of the financial statements will be brought into question.

For the quantitative factors, TRIS Rating may adjust the reported financial figures to ensure they are consistent and comparable with industry peers. Some adjustments we make are the same for all corporate issuers while some may be specific to this industry. We do not try to restate all reported financial figures. However, the adjustments should cover all the significant items that affect the key financial ratios and reflect the underlying financial condition of the company.

For the FRP, we focus on capital structure and cash flow to leverage ratios like the debt to capitalization ratio, the FFO to debt ratio and the debt to EBITDA ratio. We also look at the EBITDA interest coverage ratio as a supplementary ratio. All ratios are adjusted using the standard adjustments. For the details of adjustments, please refer to the latest “Financial Ratios and Adjustments”.

Table 1: Financial Risk Profile (FRP)

Degree of Financial Risk	FFO to Debt	Debt to EBITDA (Times)	Debt to Capitalization	EBITDA Interest Coverage (Times)
Minimal	>60%	<1.25	<20%	>15
Modest	40%-60%	1.25-2.0	20%-35%	10-15
Intermediate	20%-40%	2.0-3.5	35%-50%	6-10
Significant	10%-20%	3.5-5.0	50%-60%	3-6
Aggressive	5%-10%	5.0-8.0	60%-70%	2-3
Highly leveraged	<5%	>8.0	>70%	<2

3) Other Credit Considerations:

After analyzing the BRP and FRP, we will determine the anchor rating of a company. We may then make some adjustments to arrive at the SACP. For the key adjustments that we usually take into consideration, please refer to the latest "Corporate Rating Methodology." Lastly, the SACP could then be enhanced or capped by the group credit profile (GCP) (if any).

4) Group Credit Profile (GCP)

For the enhancement or negative influence of the group on the issuer credit rating (ICR) of a company, please refer to the latest "Group Rating Methodology", for more details.

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