



REAL ESTATE DEVELOPERS

Rating Methodology

The construction industry plays a very important role in the economic development of any country. In fact, the performance of this industry is one of the key indicators used in many developed countries to monitor the state of the economy. In the United States for example, new housing start-ups are tracked on a monthly basis to gauge public sentiment regarding the economy. The reason for using construction industry data is that trends in this industry generally mirror activity in the economy as a whole. This is because apart from the direct benefits of the creation of new housing and infrastructure, construction activity yields several other benefits.

A close examination of the dynamics of this industry will clearly highlight its critical role in economic development. Foremost, any construction activity, whether it be related to infrastructure or industrial development or housing or recreation, represents a very long-term investment and hence a significant commitment by the investor to the economy he is investing in. Since construction involves the creation

of immovable assets it represents a far more permanent creation of wealth than say investment in the stock market, which can flow out very quickly in case a country faces an economic downturn. Secondly, the construction industry is a major end consumer for several capital intensive industries such as steel and cement and for smaller industries such as paints, pipes, wiring etc. Thus a robust construction industry spurs economic activity in a large number of upstream industries, therefore attracting investment in these sectors and creating employment.

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Thirdly, construction activity by itself is highly labour intensive, requiring large amounts of skilled, semi-skilled and unskilled personnel. Again, in developing economies, where unemployment tends to be a chronic problem, this is an invaluable advantage.

In view of the above factors it is not surprising that investment in construction projects, either directly by the government itself or through encouragement of private sector activity (or even a combination of both), has been a popular

tool for governments looking to boost economic activity.

The Pakistani Context

The construction industry in Pakistan has gone through a rough patch with its compound annual growth rate (CAGR) in the three years upto FY2002 being well below two percent as compared to a CAGR of nearly four percent for the overall GDP of the country during the same period. This shows that instead of being a source of economic stimulus, the

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construction industry has actually lagged behind the rest of the economy in terms of growth. The negative perceptions regarding macroeconomic and political instability and the law and order situation have deterred serious investors. This situation was exacerbated by the increase in efforts to document the economy during the last four years, as the construction industry used to receive a very large proportion of its investment from the undocumented section of the economy.

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judged by the fact that despite a rapidly growing population base, it has failed to tap into the potential demand in this area. This is starkly illustrated by the results of the 1998 population census, which showed that the average number of persons per household had increased an alarming 16% over 1960 due to the fact that the rate of increase in

housing stock was lower than the population growth rate by a significant 0.55% in the intervening period. Just to restore this situation back to the 1960 level, would have required the immediate addition of 3.05m housing units in 1998. This situation has only worsened since. A similar situation exists in the case of non-housing construction activity, particularly infrastructure development. The need for attention in this area is probably as great if not more than the housing crisis as the on going shift in the urban-rural mix of Pakistan's population (reflected by the fact that 32% of the country's housing units were in urban areas in 1998 as compared to only 21% in 1960) is putting tremendous pressure on the infrastructure of the country's urban areas.

However, some signs of improvement in the construction industry are becoming visible. Although comprehensive data in this regard for FY2003 is yet to be made available by the State Bank of Pakistan, one of the key indicators of construction activity i.e. cement sales has registered approximately a twenty percent increase in volume terms during FY2003 over its previous five year average.

This change has been triggered by a number of factors. Firstly, the recent stabilization in the country's macro economic situation along with the prospect of continuity of current economic policies has started the process of restoring investor confidence. Secondly, the unprecedented liquidity levels in the economy, creat-

ed by a combination of efforts to eliminate informal remittance channels, decreased government borrowings and an increasing reluctance of expatriate Pakistanis to keep their savings abroad in the post 9/11 scenario, have already caused a country-wide surge in the price of all forms of real estate. At the same time, increased liquidity in the banking

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The current investment in real estate may carry a very large proportion of speculative investment or investment by persons not finding any other avenue (the stock market, despite its spectacular performance over the last one and a half years, is still viewed with a great deal of skepticism by the individual investor, while the debt market is not sufficiently developed to absorb any significant amount of the available liquidity). Speculative holdings, however, are not sustainable and will eventually have to be put to use sooner or later in order to provide a return to the investor.

Further, the government has also taken various measures to boost the construction industry. Prominent amongst these are the significant enhancement of tax deductions/credits for persons acquiring housing finance and enactment of a substantially improved foreclosure law that provides for recoveries without the

involvement of the courts. Other fiscal incentives provided include reduction of central excise duty on cement and its complete removal on cables and wires. There has also been an appreciable decline in stamp duty rates on property transfers. Additionally, commercial banks have been permitted to allocate 3% of their income from consumer finance (including housing finance) as a contingency reserve against future bad debts from such lending and mortgage documentation has also been simplified. Banks are also keen to exploit the area of mortgage finance since internationally it has proven to be a very secure form of business. In fact, the new Basle accord on capital adequacy (Basle II) proposes a risk-weight of only 35% for such financing in view of the lesser risk associated with it.

Coming at a time when financial institutions in Pakistan are finding margins in their traditional lines of business shrinking rapidly, and thus eyeing the more profitable area of housing finance (in addition to other forms of consumer finance), these steps are expected to stimulate demand for construction activity.

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ties take the form of private limited companies. All of the above are subject to a generally low level of regulatory requirements. Financial disclosure requirements in the case of the first two are close to non-existent, while the building standards to be followed and their enforcement vary widely from area to area even within the same city. This scenario has made financial institutions wary of lending funds to this sector, particularly in view of the fact that these institutions generally do not have the necessary expertise to assess real estate developers.

What Benchmark should be Used?

In June 1999, JCR-VIS had published a methodology for the grading of construction projects that had used a different scale than the one used for standard credit rating. This was based on our research of similar practices being followed in India. Recently, the other credit rating agency in Pakistan has adopted the same approach for real estate developers and projects. The concept was to make the potential customers of real estate developers/ projects aware of their relative standing within the construction industry.

However, being a service industry, a rating agency has to constantly reassess its methodologies in order to ensure that its products serve the needs of the users of its ratings. During the course of our continuing research on the construction industry we have identified two shortcomings in the separate grading system.

Firstly, a separate scale for relative standing within an industry is only relevant when a large number of entities are rated on that scale.

Ratings of just one or two entities

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on a separate scale are not informative. Secondly, as highlighted above, the key problem for the construction industry is its limited access to institutional financing. This can only be addressed by providing a comparison of the risk involved in lending to a real estate developer with the risk associated with lending to an entity belonging to any other sector. In order to achieve this goal it would be necessary to rate real estate developers on the same scale used for other entities. The regulators have also made public statements about the need for credit rating of real estate developers, so that the stronger parties among them are able to access funding from the financial institutions. A further drawback is that the real estate developers will not be able to use ratings on the separate scale to tap the capital markets.

In view of the above discussion, JCR-VIS believes that it will be in the best interests of the construction industry if real estate developers are rated on the standard credit rating scale.

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This revision in approach is consistent with JCR-VIS' efforts to minimize the number of different scales in use in

order to avoid confusion in the users of our ratings. In this connection we have already harmonized the ratings of modarabas from the separate modaraba rating scale previously in use to the standard credit rating scale (Modaraba Rating Scale, Special Report - October 2002). It is also important to note that the major rating agencies in the world seldom use separate rating

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scales for rating of various sectors. Such a need only arises when the rating agency is carrying out a rating other than a credit rating e.g corporate governance ratings.

Rating Methodology

Before we elaborate our method of analyzing real estate developers it is necessary to define this term. For the purpose of this methodology a real estate developer is an entity whose primary

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aim is to build and sell a project or to function on a build, operate and transfer (BOT) basis. Hence, this definition is mainly limited to entities involved in the development of housing and commercial development projects, although it may also include infrastructure projects executed on a commercial basis. The methodology given below is given in terms of evaluating a single project. However, since it would be very difficult to legally ring fence simultaneously ongoing projects of a real estate developer from one another, we would analyze all of these and arrive at an

overall rating for the developer. Also, in the absence of this form of ring fencing, it would not be possible to assign ratings to individual projects.

Before commencement of the analysis of individual construction projects being executed by the real estate developer being rated, JCR-VIS' analysts carry out an in-depth review of the abilities of the developer himself. This would typically cover a study of the track record of the developer to see the performance of past projects, particularly with a view to examining project initiation and monitoring procedures and the availability of the resources required to implement these procedures, including areas such as criteria for pre-qualification of other project participants, evaluation of tender documents and performance guarantees, procedures for awarding contracts, quality controls and ability to monitor the progress of the various project participants in relation to their respective deadlines. The real estate developer must also be in a position to deal with potential non-technical issues pertaining to the project such as obtaining of permits, etc.

Finally, the financial strength of the real estate developers (including potential impact of off balance sheet contingent liabilities such as litigation and performance bonds) is assessed along with an examination of the presence of any credit enhancing features e.g guarantees, support

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of multilateral institutions, etc. Such an analysis would typically emphasize on cash flow coverages along with debt leverage and property value to loan ratios. Real estate developers exhibiting a higher degree of financial flexibility would be able to achieve better ratings.

Once a basic assessment of the expertise and financial strength of the real estate developer has been completed, our methodology calls for the evaluation of each individual project being undertaken by the developer at the time of the rating along with any planned projects covered in the rating horizon. The first factor to be considered is the possession of clean title to the project property by the real estate developer and consequently his ability to transfer the title onwards. If a project does not meet this criterion, the litigation risk alone arising from such a situation would be so high as to preclude the issuing of an investment grade rating to the real estate developer.

The next factor is the participant risk of the project. This is a large area covering construction contractors, equipment suppliers, architects and any other independent experts involved in the project (e.g engineering consultants, surveyors etc.). The construction contractors are examined for their in-house design capability, proven ability to meet deadlines, and most importantly the availability of the right team for the project. Similarly, other project participants are also evaluated with respect to their ability to

deliver the required services in their area of expertise.

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essary. Our protocols governing such advice are very stringent and analysts are encouraged, wherever possible, to avoid disclosure of the client's name to the expert. On the other hand, the name of the concerned expert is notified to all entities in respect of which such expert advice is used.

Once the ability of the various participants to execute the given project has been established, JCR-VIS' methodology calls for a study of the completion risk of the project. This is a critical part of the rating exercise because repayment schedules are generally tied to projected completion times. In order to assess the completion risk, the first step is the evaluation of the project schedule. Ideally, the project should be divided into several distinct parts, each of which has to be completed by a specific date. Enough room should be left in the schedule to cover for unforeseen events. Experienced sponsors and constructors can determine this flexibility by looking at previous projects and the nature of the project in hand. An appropriate mix of contractual bonuses and penalties must be used to reward timely work and discourage the missing of targets respectively. Also, there should be as little reliance as pos-

sible on external factors. As the number of such factors grows, the control of the project participants over timely completion diminishes. Completion risk levels are also

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determined by the engineering complexities associated with the project. The greater the complexities, the higher is the probability of difficulties faced in the execution stage and consequently the risk of exceeding the budgeted timeframe. Time overruns generally also cause cost overruns, the impact of which on a construction project is discussed below.

Timely completion by itself does not guarantee in any way the success of the project, as a significant operating risk also exists. Operating risk for construction projects basically takes two forms: quality and costs. Quality can in turn take the form of technical performance i.e. whether the engineering of the project is upto the desired specifications or aesthetics i.e. whether the desired sensory affect has been created (the latter is more important in housing projects). In both cases, a failure to

A cost overrun can pose significant problems to the project sponsor as it involves arranging of further financing

achieve the desired standard will either result in time and cost overruns or the sale value of the project being reduced.

Operating cost risk implies that the project may be significantly over budget even while meeting the project specifications

and time schedule. A cost overrun resulting from any of the two quality risks (or from delayed completion as discussed earlier) can pose significant problems to the project sponsor as it involves arranging of further financing, to be repaid out of the same inflow from the sale of the project, which is already being used to pay off the original debt. Therefore, depending on the extent of the cost overruns, the project viability may be badly affected.

Preferably a feasibility study should be prepared by an independent expert, so as to remove any sponsor biases

In order to understand the degree of operating risk, JCR-VIS takes an in-depth look at the feasibility study of the project. One of the key points even before we look at such a study is to see who has prepared it. Preferably a feasibility study should be prepared by an independent expert, so as to remove any sponsor biases. However, our analysts approach even such studies with a degree of professional skepticism as the experts are generally hired by the sponsors to undertake such studies and therefore may be prone to optimistic assumptions. In more developed economies, there is a tendency of lending institutions commissioning their own studies to cross check the results with those of the sponsor provided study. Our study basically involves a close look at the underlying assumptions in the feasibility and sensitizing these to determine the margin available in case of changes in key variables.

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A significant demand risk is also present in any construction project, even though it is some times mitigated through advance bookings. These have the double advantage of securing customers before completion of the project as well as reducing the amount of external financing required during the construction stage of the project. However, since such advance bookings are usually on an installment basis after a minimal down payment, this gives rise to credit risk due to the possibility of default on installments by the customer.

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In case of BOT projects, an additional factor of post-completion maintenance of the project is also considered. Internationally, specialist real estate managers are appointed in order to ensure that the intrinsic value of the project does not deteriorate. This is very important from the point of view of the lending institutions as the project is usually the primary collateral securing the financing.

Although this concept is currently present on only a limited scale in Pakistan, it needs to be developed urgently as it will provide significant additional comfort to institutions financing BOT transactions.

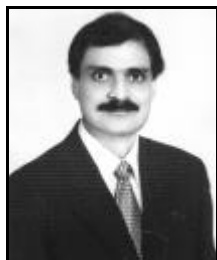
The external financing obtained for construction projects should generally be long-term in nature and ideally heavily back loaded even to the extent of a single bullet payment scheduled to coincide with the scheduled completion and sale of the project

Once the project viability is determined based on the above criteria, we commence the analysis of the financing of the project. Obviously, the greater the equity

participation by the sponsor the more confidence will be generated. The external financing obtained for construction projects should generally be long-term in nature and ideally heavily back loaded even to the extent of a single bullet payment scheduled to coincide with the scheduled completion and sale of the project. In the case of BOT projects, the repayment schedule can be based on installments after an appropriate grace period covering the construction and commencement of commercial activity.

JCR-VIS will also seek a written representation from the real estate developer that the project complies with all relevant legal and regulatory requirements. This is to avoid possible litigation and/or penalties, which may affect the viability of the project. In addition, proper insurance cover should be in place for all key aspects of the project.

As can be seen, the risks associated with a construction project, and hence the real estate developer, are varied and one or more may be realized during the course of any project. This is not unlike other green field projects, where the risk levels are also very high. Therefore, ratings for real estate developers will tend to be constrained unless substantial external support is available or risk has been diversified in a way so as to mitigate some of the factors mentioned above. **JCR-VIS**



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Faheem Ahmad has diverse experience with international consulting agencies in USA & Middle East. He has also held senior positions with local industrial and financial groups. In 1994, he established Vital Information Services (Pvt.) Limited, which is a leading capital market research house. VIS has the largest data bank of corporate Pakistan. His major research work includes copyrighted F&J financial strength rankings, Musharaka Variable Income Securities and stock market indices. VIS group includes JCR-VIS Credit Rating Company Limited and News-VIS Credit Information Services (Pvt.) Limited, the first private credit bureau of Pakistan. The majority of shareholders in group companies include the largest publication house in Pakistan and major financial institutions.

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Saad Ahmed Madani currently leads ratings of Industry, Corporate Governance Ratings and Islamic Finance at JCR-VIS. He is also involved in ratings of various leasing companies and commercial banks. Prior to Joining JCR-VIS he had completed his articles at a leading Chartered Accountancy firm in Karachi. Mr. Madani is an Associate member of the Institute of Chartered Accountants of Pakistan.

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 generosity 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.



Jahangir Kothari
Parade

National Excellence, International Reach

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.

JCR-VIS Credit Rating Company Limited

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