

Methodology

*Rating Real Estate Entities*

APRIL 2011



*Insight beyond the rating.*

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# Rating Real Estate Entities

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## Introduction to DBRS Methodologies

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- In general terms, DBRS ratings are opinions that reflect the creditworthiness of an issuer, a security or an obligation. They are opinions based on an analysis of historic trends and forward-looking measurements that assess an issuer's ability and willingness to make timely payments on outstanding obligations (whether principal, interest, dividend or distributions) with respect to the terms of an obligation.
- DBRS rating methodologies include consideration of general business and financial risk factors applicable to most industries in the corporate sector as well as industry-specific issues and more subjective factors, nuances and intangible considerations. Our approach is not based solely on statistical analysis but includes a combination of both quantitative and qualitative considerations.
- The considerations outlined in DBRS methodologies are not intended to be exhaustive. In certain cases, a major strength can compensate for a weakness and, conversely, there are cases where one weakness is so critical that it overrides the fact that the company may be strong in most other areas.
- DBRS rating methodologies are underpinned by a stable rating philosophy, which means that in order to minimize the rating changes due primarily to economic changes, DBRS strives to factor the impact of a cyclical economic environment into its rating as applicable. Rating revisions do occur, however, when it is clear that a structural change, either positive or negative, has transpired or appears likely to transpire in the near future.
- As a framework, DBRS rating methodologies consist of several components that together form the basis of the ultimate ratings assigned to individual securities. Assessments typically include the industry's business risk profile, the company's general business risk profile, the company's financial risk profile and considerations related to the specific security.
- To some extent, the business risk and financial risk profiles are interrelated. The financial risk for a company must be considered along with the business risks that it faces. In most cases, an entity's business risk will carry more weight in the final issuer rating than will its financial risk.

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## Business and Financial Risk Overview

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- On a high-level macro basis, DBRS has a consistent approach to determining the issuer rating of an entity that is common across many industries. (See the appendix for the definition of "issuer rating.") Our high-level approach can be broken into three stages, as shown on the opposite page.
- Where applicable, DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. DBRS typically assesses five areas to establish the overall BRR for an industry:
  - Profitability and cash flow.
  - Competitive landscape.
  - Stability.
  - Regulation.
  - Other inherent industry considerations.
- Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching this analysis.
- Using the same factors across different industries provides a common base with which to compare the business risks of various industries, even when they are distinctly different. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus. For additional discussion on industry BRRs, please refer to the Industry Business Risk Ratings and Industry Business Risk Rating Definitions sections in the appendix.



- It is important to note that the ratings for company-specific business and financial risks as provided under Stage 2 of this document should not be taken as final issuer ratings. For example, an individual company may fit into the “A” range with respect to the analysis of its business risk, but its financial metrics could be more in the BB category. It would be incorrect to believe that the final issuer rating in this case would be either “A” or BB. In determining the final issuer rating, both of these two major areas must be considered. For additional discussion on this topic, please refer to the Interrelationship between Business and Financial Risk section in the appendix.

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### Three Stages of DBRS Rating Analysis

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#### Stage 1: Industry Business Risk Rating

Consider the overall business risk rating (BRR) for the industry.

Industry Business Risk Rating

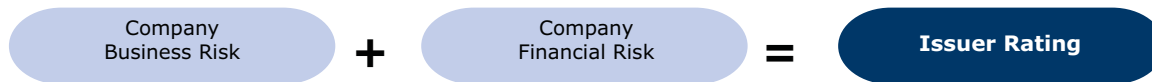


#### Stage 2: Issuer Rating

Consider the strength of the individual issuer:

- (a) First assessing how the company’s BRR compares with the industry BRR.
- (b) Then assessing the company’s financial risk.

Taken together, these factors will determine the company’s issuer rating.



The **long-term rating** puts more emphasis on business risk than the short-term rating does.



The **short-term rating** stresses financial risk as well as business risk, but places more emphasis on financial risk and liquidity than the long-term rating does.

#### Stage 3: Rating the Security

Consider covenant and ranking issues that exist for specific securities, using the issuer rating to determine specific security ratings.



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## Stage 1: Industry Business Risk Rating for the Real Estate Industry

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The real estate industry encompasses real estate investment trusts (REITs) and real estate operating companies (REOCs) principally engaged in the ownership of real estate across each of the following major subsectors: retail, office, industrial, multi-family residential and hotels. The property management area is also included as part of this industry, if combined with real estate ownership in one or more of the five sectors mentioned. On a stand-alone basis, however, property management, real estate brokerage and real estate advisory businesses would be covered under other DBRS methodologies, although we would refer to this base real estate methodology when and if applicable.

The BRR for the real estate industry is derived from a qualitative assessment of the industry's characteristics and serves as a backdrop for the analysis of a company's financial risk profile, which is considered in concert with other qualitative factors unique to the company. DBRS considers the BRR to represent the rating of an average company within the industry. DBRS views the BRR for the overall real estate industry as being largely BBB (low), having assigned BRRs to each of the major subsectors within the industry as follows:

- Residential (multi-family): BBB (low)
- Retail: BBB (low)
- Industrial: BBB (low)
- Office: BBB (low)/BB (high)
- Hotels: BB

Support for these BRRs is provided through the assessment of the five major categories that DBRS uses to determine industry BRRs as follows, along with the five major subsectors within the real estate industry as outlined in Appendix A. It is important to note that the aforementioned BRRs should be considered as a general guideline for rating a diverse set of global real estate markets. DBRS considers a combination of factors, such as (but not limited to) stability, regulation and economic conditions, when determining whether real estate markets in other countries should be adjusted higher or lower than the global BRRs listed above. For example, DBRS would consider Canada to have modestly stronger BRRs in each real estate subsector.

### INDUSTRY PROFITABILITY AND CASH FLOW

- Profitability is generally lower than the average among other industries as real estate companies have high levels of interest and depreciation expense due to the capital-intensive nature of their business. Changes in the market value of assets can also affect the profitability of a real estate company through capital gains/losses.
- Cash flow generation is typically stronger and better than in many other industries as operating expenses and maintenance capex are relatively low in proportion to overall flows. Cash flow is affected by rental revenue, which is driven by the quality and location of properties, and generally low levels of cash tax paid (particularly for REITs). Other potential sources for changes in real estate cash flow include occupancy levels, expansion and/or redevelopment, re-merchandising of tenants, acquisitions, tenant bankruptcies, tenant inducements, leasing commissions and cost controls.

### INDUSTRY COMPETITIVE LANDSCAPE

- DBRS characterizes the competitive landscape of the real estate industry as normal relative to other industries as it is generally open to new entrants. However, barriers to entry can be high due to zoning restrictions, significant capital requirements, and the simple fact that good property locations cannot be duplicated.



## INDUSTRY STABILITY

- The real estate industry displays a slightly higher degree of stability than other industries on average. Real estate cycles typically last nine to ten years, which is generally longer than the cycles that occur in other industries. Cycles can be affected by a number of factors, including employment trends, economic growth, interest rates, new supply and inflation.
- Tenant leases, which can range in length from month-to-month to long-term leases in excess of 20 years, add an element of stability to real estate cash flow as tenant net rental rates are locked in for the period of the lease.
- Although relatively stable compared with other industries, cash flow stability can vary across each real estate segment. Hotels and office, for example, can experience substantial volatility in cash flow.

## INDUSTRY REGULATION

- Regulation of the real estate industry is generally minimal and mainly centers on zoning laws and building codes. However, the amount of government regulation can vary in each real estate segment. For example, rental rates in the multi-family residential segment are regulated in certain Canadian provinces and any changes to rental rates must adhere to government guidelines; density restrictions often vary based on jurisdiction.

## OTHER INHERENT INDUSTRY CONSIDERATIONS

- Real estate markets can become illiquid during an economic downturn, which can make asset disposal at reasonable prices difficult. Changes in building design and efficiency are gradual. Real estate can also be affected by natural disasters.

## Stage 2: Issuer Rating

To move from the generic industry BRR toward the issuer rating for a specific company, two tasks must be performed. Specifically, we must determine the business risk and the financial risk for the individual company.

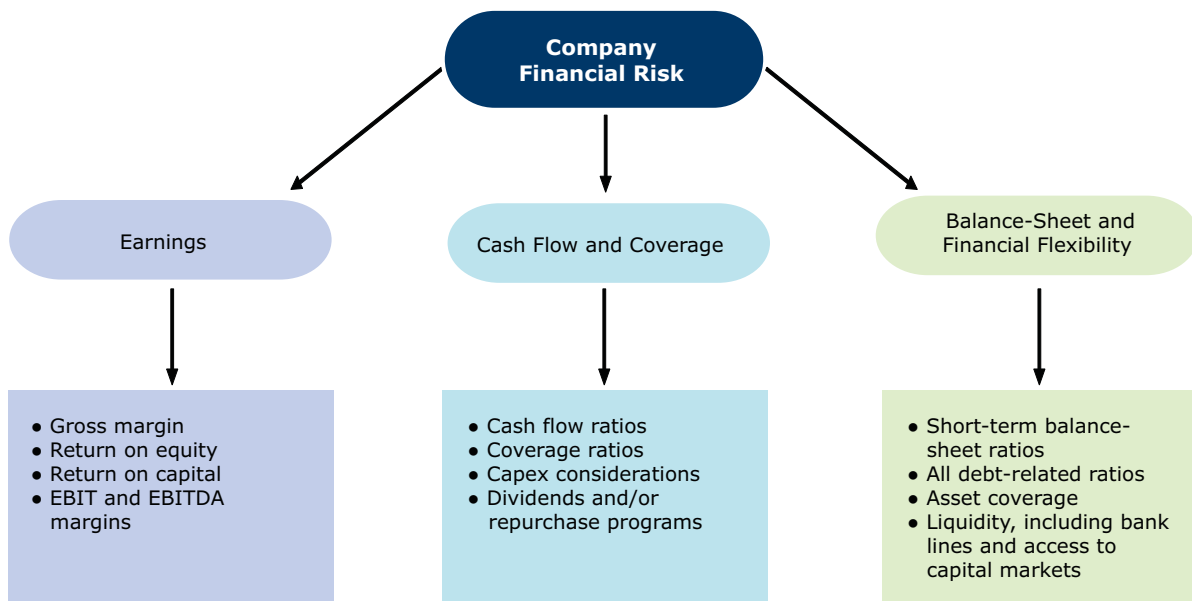
### BUSINESS RISK PROFILE

- The business risk profile of the issuer may be better or worse than the industry average due to the presence of unique attributes or challenges that exist at the issuing entity. While not exhaustive, the list of critical factors outlined in the previous section could result in a specific issuer rating being different from the industry BRR.
- This methodology also provides some guidance on which factors are considered the most critical for the industry in question. Issuers may also have meaningful business lines in addition to the base business that extend beyond their most prominent industry, which could add significant attributes or challenges.

### FINANCIAL RISK PROFILE

- The graphic below is a visual display of the key financial risk profile considerations that are discussed in the Company-Specific Financial Risk Factors section of this methodology, although even the detail provided there is not meant to be exhaustive.
- The discussion will note that DBRS often makes calculation adjustments in key ratios for risks related to a variety of areas. In some cases, a relationship with a parent or associated company will also be important.

#### Key Financial Risk Metrics





## Company-Specific Business Risk Factors

- We now consider if an individual company in the real estate industry would be better, worse or the same as the industry BRR. Our focus here is on the critical business risk factors that relate to this industry in particular. The five critical factors used to determine the industry BRR are applied by DBRS to compare numerous industries and are thus more general in nature.
- By analyzing these key drivers (which will vary on an industry-by-industry basis), the essential strengths and challenges of each industry are captured in an accurate fashion, and transparency is provided. The analysis below is connected to the industry BRR in that the industry BRR establishes where an average company would be considered to score on the matrix. For example, an industry with a BRR of BBB would mean that the following matrix describes the scoring of an average company within the BBB column.
- In determining the overall credit quality of a real estate entity, DBRS reviews the following key business factors:
  - **Asset Quality:** Location of properties (primary or secondary markets), market position and age.
  - **Lease Maturity Profile/Tenant Quality:** Length of lease terms, credit quality of tenants.
  - **Diversification:** Geographic, asset type, tenant, properties (total number).
  - **Portfolio Size and Scale:** National, regional or local presence.

### Company-Specific Business Risks – Critical Factors

| Rating<br>Business Strength   | AA<br>Exceptional  | A<br>Superior   | BBB<br>Adequate   | BB<br>Weak                                       | B<br>Poor   |
|---|--|---|---|--|---|
| <b>Asset Quality</b>  | • Many trophy assets, with exceptional leadership in multiple markets. | • Many trophy assets, with superior leadership in multiple markets. | • Adequate asset quality, with leadership in at least one market. | • Weak asset quality and market leadership.      | • Poor asset quality and market leadership.           |
| <b>Lease Maturity Profile/Tenant Quality</b>                        | • Very low amount of space maturing per year.                          | • Low amount of space maturing per year.                            | • Reasonable amount of space maturing per year.                   | • High concentration of space maturing per year. | • Very high concentration of space maturing per year. |
| <b>Diversification – Geography, Asset Type, Property and Tenant</b> | • Exceptional portfolio diversity.                                     | • Superior portfolio diversity.                                     | • Adequate portfolio diversity.                                   | • Weak portfolio diversity.                      | • Poor portfolio diversity.                           |
| <b>Portfolio Size and Scale</b>                                     | • Well above average in size and scale.                                | • Above average in size and scale.                                  | • Average size and scale.   | • Below average in size and scale.               | • Well below average in size and scale.               |

### ASSET QUALITY

An important factor in the rating of a real estate entity involves an overall assessment of the quality of the portfolio of real estate assets. The quality of the portfolio in a competitive real estate market can have a significant influence on the stability of cash flow through economic cycles, whether national or local. DBRS reviews the following categories when assessing asset quality.

#### *Location/Market Position*

- The location and market position of a property plays an important role in the overall rating assessment of a real estate entity. A property with a good location will attract better-quality tenants and retain greater value over time.
- This includes consideration of whether assets are located in primary or secondary markets and have a dominant market position (including the size of individual properties and their desirability to tenants).

## AGE OF THE BUILDINGS AND OVERALL MAINTENANCE AND CONDITION

- Certain asset types have higher ongoing maintenance requirements (non-recoverable) or require tenant inducements to maintain the competitive position of the property (e.g., hotels and office buildings).
- As well, a portfolio of older properties on average may require substantial capital investments and could be more susceptible to new competition or a new format for that asset type.

## LEASE MATURITY PROFILE/TENANT QUALITY

Lease maturities and historical occupancy trends are key factors in assessing the future stability of cash flow for real estate entities.

- This includes a review of the amount of leaseable area maturing over the next five to ten years for a particular asset type. An unusually large amount of maturing space exposes the real estate entity to re-leasing risks, including declining occupancy levels and/or declining market rents.
- Consideration is given to whether major tenants are going to renew leases and if there is a concentration of lease maturities in any one year. However, DBRS notes that lease maturities also often represent an opportunity for growth, assuming market rents are above embedded rental rates in existing leases. Therefore, an aspect of this analysis is to closely monitor the trends in average net rents for the entity compared with the trends for average market rents and the corresponding outlook. Again, the ability to re-lease space in the future must be considered for each asset type. In general, low levels of lease maturities and market rents that are above embedded rents will enhance the stability of cash flow and are viewed positively from a rating perspective.
- The average length of leases, tenant inducements, leasing commissions and important clauses, such as go-dark clauses for major tenants, are also factored into the analysis as they may affect the stability of cash flow.
- In addition, the overall credit quality of the tenants and the ability of tenants to renew or expand space requirements are important factors in the overall assessment of cash flow stability.

## DIVERSIFICATION

There are various forms of diversification for real estate portfolios that can have a stabilizing effect on cash flow. DBRS focuses on the following types of diversification.

- Geographic Diversification - Real estate portfolios that are geographically diversified tend to have less exposure to economic cycles in any one region and typically generate more stable cash flow. DBRS also considers the strength and industry composition of local or regional economies in areas where the real estate entity is focused.
- Diversification by Asset Type (Hotel, Industrial, Multi-Residential, Office and Retail) - Real estate portfolios that are diversified across more than one asset type have less exposure to fundamentals specific to a single asset type.
- Property Diversification - A real estate portfolio comprising a large number of properties represents lower risk as each property only accounts for a small fraction of the total portfolio.
- Tenant Diversification - A tenant base that has less reliance on any single tenant and that comprises high-credit-quality tenants enhances stability to cash flow and is positive from a rating perspective. However, there are circumstances where the existence of a key high-credit-quality tenant under a long-term lease may offset the negative aspect of reduced tenant diversification. DBRS reviews the contribution of the top tenants in terms of leaseable area and net operating income to evaluate tenant concentration risks.

## PORTFOLIO SIZE AND SCALE

- The overall size and scale of a real estate portfolio by leaseable area and number of properties can greatly enhance the stability of operations and reduce several types of concentration risks.
- Larger portfolios with a national presence benefit from diversification and economies of scale.
- Local scale is also taken into consideration along with its benefits, including local market and leasing expertise, and tenant relationships.



## COMMON BUSINESS CONSIDERATIONS

- There are two major considerations that were not included with the prior analysis but can have a meaningful impact on an individual company in any industry: country risk and corporate governance (which includes management). These areas tend to be regarded more as potential negative issues that could result in a lower rating than otherwise would be the case, although DBRS would certainly consider exceptional strength in corporate governance as a rating attribute.
- In most cases, our focus on the two areas is to ensure that the company in question does not have any meaningful challenges that are not readily identifiable when reviewing the other business risk considerations and financial metrics outlined in this methodology.

### *Country Risk*

- Governments often intervene in their economies and occasionally make substantial changes that can significantly affect a company's ability to meet its financial obligations; therefore, considerations include the company's main location or country of operation, the extent of government intervention and support and the degree of economic and political stability.
- As such, the sovereign rating itself may in some cases become a limiting factor in an entity's rating, particularly when the sovereign has a lower rating and the entity does not have meaningful diversification outside its domestic economy.

### *Corporate Governance*

- Effective corporate governance requires a healthy tension between management, the board of directors and the public. There is no single approach that will be optimal for all companies.
- A good board will have a profound impact on a company, particularly when there are significant changes, challenges or major decisions facing the company. DBRS will typically assess factors such as the appropriateness of board composition and structure, opportunities for management self-interest, the extent of financial and non-financial disclosure and the strength or weakness of control functions. For more detail on this subject, please refer to the DBRS criteria *Evaluating Corporate Governance*.
- With respect to the pivotal area of management, an objective profile can be obtained by assessing the following: the appropriateness of core strategies; the rigour of key policies, processes and practices; management's reaction to problem situations; the integrity of company business and regulatory dealings; the entity's appetite for growth, either organically by adding new segments or through acquisition; its ability to smoothly integrate acquisitions without business disruption; and its track record in achieving financial results. Retention strategies and succession planning for senior roles can also be considerations.



## Company-Specific Financial Risk Factors

### KEY METRICS

- Recognizing that any analysis of financial metrics may be prone to misplaced precision, we have limited our key metrics to a small universe of critical ratios. For each of these ratios, DBRS provides a range within which the issuer's financial strength would be considered as supportive for the same level of business risk as the real estate industry. For example, a company where the outlook for both business risk and financial risk metrics falls within the BBB category would, all else being equal, be expected to have an issuer rating in the BBB range.
- To be clear, the ratings in the matrix below should not be understood as the final rating for an entity with matching metrics. This would only be the case to the extent that the business risk of the company and a wide range of other financial metrics were also supportive. The final rating is a blend of both the business risk and financial risk considerations in their entirety.

### Real Estate Industry Financial Metrics

| Key Ratio  | AA         | A               | BBB             | BB              | B          |
|--|------------|-----------------|-----------------|-----------------|------------|
| EBITDA interest coverage   | > 3.5x     | 3.0x to 3.5x    | 2.0x to 3.0x    | 1.5x to 2.0x    | < 1.5x     |
| Debt-to-gross book value (including convertibles/preferred shares) | < 35% debt | 35% to 50% debt | 50% to 65% debt | 65% to 75% debt | > 75% debt |

### Other Financial Considerations

|                   |  |  |   |   |   |
|-------------------|--|--|---|---|---|
| Liquidity         | <ul style="list-style-type: none"> <li>• Exceptional internal liquidity.</li> <li>• No need for external funding to cover at least one year's cash needs.</li> </ul> | <ul style="list-style-type: none"> <li>• Superior internal liquidity.</li> <li>• Minimal need for external funding to cover at least one year's cash needs.</li> </ul> | <ul style="list-style-type: none"> <li>• Adequate internal liquidity.</li> <li>• Some reliance on external funding to cover one year's cash needs.</li> </ul> | <ul style="list-style-type: none"> <li>• Weak internal liquidity.</li> <li>• Some reliance on external financing to cover one year's cash needs.</li> </ul> | <ul style="list-style-type: none"> <li>• Insufficient internal liquidity.</li> <li>• Must rely on external funding to cover one year's cash needs.</li> </ul> |
| Access to capital | <ul style="list-style-type: none"> <li>• Exceptional access to all sources of private and public capital.</li> </ul>   | <ul style="list-style-type: none"> <li>• Superior access to all sources of private and public capital.</li> </ul>  | <ul style="list-style-type: none"> <li>• Adequate access to all sources of private and public capital.</li> </ul>   | <ul style="list-style-type: none"> <li>• Weak access to many sources of capital.</li> </ul>   | <ul style="list-style-type: none"> <li>• Poor access to many sources of capital.</li> </ul>   |

- While the data in the above table are recognized as key factors, they should not be expected to be fully adequate to provide a final financial risk rating for any company. The nature of credit analysis is such that it must incorporate a broad range of financial considerations, and this cannot be limited to a finite number of metrics, regardless of how critical these may be.
- DBRS ratings are based heavily on future performance expectations, so while past metrics are important, any final rating will incorporate DBRS's opinion on future metrics, a subjective but critical consideration.
- It is also not uncommon for a company's key ratios to move in and out of the ranges noted in the ratio matrix above, particularly for cyclical industries. In the application of this matrix, however, DBRS is typically focusing on multi-year ratio averages.
- Notwithstanding these potential limitations, the key ratios are very useful in providing a good starting point in assessing a company's financial risk.



- It is important to note that actual financial ratios for an entity can and will be influenced by both accounting and accounting choices. In Canada, this will include the shift to International Financial Reporting Standards (IFRS). DBRS acknowledges that IFRS and other accounting choices will have an impact on the financial metrics of the companies that it covers. The financial risk factors include ratios based on data from company financial statements that are based on Canadian Generally Accepted Accounting Principles (GAAP) and U.S. GAAP, for the most part. When company financial statements are based on GAAP in other countries, including IFRS, the ratios and ranges may need to be redefined.
- Recognizing that the metrics in the table above do not represent the entire universe of considerations that DBRS examines when evaluating the financial risk profile of a company, the following provides a general overview that encompasses a broader range of metrics and considerations that could be meaningful in some cases.

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## Overall Considerations in Evaluating a Company's Financial Risk Profile

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In addition to the information already provided with respect to key financial metrics, the following financial considerations and ratios are typically part of the analysis for the real estate industry. As it is not possible to completely separate business and financial risks, note that many of the following ratios will relate to both areas.

- Capital structure: Overall debt levels, type of debt (e.g., unsecured, secured, fixed-rate, floating-rate), debt maturity profile.
- Liquidity and sources of capital: Availability of capital and variety.
- Cash flow performance: Stability of cash flow and growth potential.
- Key financial ratios: Leverage and coverage ratios.

### *Capital Structure*

As a result of the long-term nature of real estate cycles, the contractual nature of real estate cash flow and the capital intensity of the industry, real estate entities tend to carry a higher degree of balance-sheet leverage relative to most other industries. When assessing a real estate entity's balance sheet and capital structure, DBRS considers a variety of factors, including the use of leverage, interest-coverage and fixed-charges-coverage ratios, debt maturity and refinancing risk, fixed-rate versus floating-rate debt, average coupon interest cost, cash balances and other potential sources of liquidity.

Although DBRS recognizes the importance of the debt-to-capital ratio as an indicator of indebtedness, the book value of shareholders' equity of real estate entities may not be reflective of the fair market value of their property assets. As a result, DBRS tends to place greater emphasis on coverage ratios as a measure of credit strength. DBRS also closely considers the impact of secured debt as it relates to the position of unsecured debtholders. In general, credit ratings will be more negatively affected in the following instances:

- (1) The greater the amount of secured debt ranking ahead of unsecured debtholders.
- (2) The less unencumbered the assets available to satisfy unsecured debtholders.

As well, the extent to which secured debtholders have recourse to the real estate entity beyond the secured assets will also negatively affect the position of the unsecured debtholders. DBRS notes that the existence of an unencumbered pool of assets improves financial flexibility since these properties may be more easily sold (i.e., more liquid) and may be used as security should public unsecured debt markets not be available. The analysis considers the coverage ratios to the extent that there is a pool of unencumbered properties (without recourse by secured debtholders) available to satisfy the obligations of unsecured debtholders.



This sometimes involves making estimates of sustainable cash flow from unencumbered properties and the interest expense for unsecured debt only to more closely consider the extent to which unsecured creditors are protected from a cash flow perspective.

As well, DBRS considers the existence of a pool of unsecured assets available as potential security for unsecured debtholders, which reduces refinancing risk. For example, the pool of assets could be used as collateral to raise mortgage financing to repay bullet maturities on unsecured debt should the public debt markets not be accessible. Refinancing risk is an important issue for REITs given that most of the cash flow is paid out in distributions, which causes them to rely on mortgages, public equity or debt markets for refinancing needs.

## LIQUIDITY AND SOURCES OF CAPITAL

Real estate entities generally benefit from having access to a variety of capital sources, including mortgages (traditional and structured such as commercial mortgage-backed securities), unsecured debt, bank lines and equity markets. However, given the severity of past real estate downturns, certain capital sources, such as unsecured debt, have been unavailable at times. As well, given that many real estate entities are structured as REITs and, therefore, retain very little internal cash flow, many are heavily reliant on capital markets to fund capital requirements (or repay debt).

## CASH FLOW PERFORMANCE

Real estate entities have high levels of depreciation and amortization, relatively high levels of deferred taxes and other kinds of non-cash items. For this reason, DBRS believes cash flow rather than net income is a more appropriate measure for assessing a real estate entity's financial performance. Real estate cash flow is contractual in nature, underpinned by leases, which can range in length from month-to-month to long-term leases in excess of 20 years, depending on the requirements of individual tenants. This adds an element of stability to real estate cash flow as tenant net rental rates are locked in for the period of the lease. However, net rental rates for certain real estate segments, such as office, can experience substantial volatility. During periods when net rental rates are depressed, tenant leases may be struck at low rates, which landlords must endure for the term of the new lease. In addition, substantial tenant inducements, either in the form of cash supplements or free rent, may be required to secure (key) tenancies.

Potential for changes in cash flow, either upward or downward, is dictated by the magnitude of tenant lease rollovers during a specific time period. Other potential sources for changes in real estate cash flow include occupancy levels, expansion and/or redevelopment, re-merchandising of tenants, acquisitions, tenant bankruptcies, tenant inducements, leasing commissions and cost controls. In analyzing the sustainability of cash flow, DBRS considers the extent that cash flow is generated by its core property portfolio compared with other sources such as development fees, asset management fees and joint ventures. The recurring nature of the cash flow must be assessed in the context of the overall business. Another important aspect of cash flow analysis for REITs is the payout ratio, which relates to the requirement to pay a significant portion of cash flow to unitholders in distributions or dividends. A high payout ratio can negatively affect the financial flexibility of a REIT in a couple of ways: (1) To the extent that cash is not retained, there is limited capital to reinvest to maintain or upgrade properties or to fund growth through acquisitions. This leads to reliance on external financing, which may not always be available. (2) There is less capital to repay debt, which weakens the debtholders' position as debt repayment may require refinancing.



## KEY FINANCIAL RATIOS

The key financial ratios for rating real estate entities focus on measuring the overall strength of the balance sheet and the ability to cover both interest and principal obligations from internally generated cash flow.

### *Leverage*

Total debt is measured in various ways, although measurements based on book value can be misleading to the extent that these often do not reflect the underlying value of real estate. The recent change in Canadian Generally Accepted Accounting Principles (GAAP) toward straight-line depreciation of real estate assets has highlighted this shortfall since the higher level of depreciation does not necessarily reflect the market reality of real estate values. On the other hand, placing too much reliance on market values (using equity market capitalization or applying cap rates to property income) can be problematic as equity valuations can be volatile and change quickly. In Canada, the focus has been on measuring leverage as a percentage of gross book value of assets since this is closer to a market proxy as it at least adds back depreciation of buildings.

### *Coverage Ratios*

In terms of coverage ratios, DBRS focuses on EBITDA interest coverage ratios and fixed-charges coverage since these ratios indicate the ability of the company to meet fixed obligations, including interest, preferred dividends and amortizing principal. These measures, including adjusted EBITDA, funds from operations and adjusted funds from operations, tend to be more relevant for real estate since these metrics focus on the underlying cash-generating capabilities, excluding non-cash expenses such as straight-line depreciation of buildings.

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### Key Financial Ratios and Operating Statistics for Real Estate Entities

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#### **Balance-Sheet**

#### **and Liquidity Ratios**

- Total debt
- Net debt-to-total capital
- Total debt-to-gross book value assets
- Secured debt-to-total debt
- Total debt-to-total market capital
- Non-recourse secured debt-to-total debt
- Unencumbered asset coverage
- Unencumbered assets-to-total assets
- Cash flow-to-debt
- Funding capacity

#### **Coverage Ratios**

- EBITDA interest coverage
- Adjusted EBITDA interest coverage
- EBIT interest coverage
- Fixed charges coverage (before and after principal amortization)
- Debt service coverage
- Adjusted unencumbered EBITDA interest coverage

#### **Profitability Ratios**

- Net rental margin
- Cash flow return on equity
- EBITDA margin
- Cash flow return on capital

#### **Operating Statistics**

- Leaseable area
- Occupancy levels
- Lease maturities
- Average net rents



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## Stage 3: Rating the Security

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With respect to Stage 3, the following comments describe how the issuer rating is used to determine ratings on individual securities:

- DBRS uses a hierarchy in rating long-term debt that affects issuers that have classes of debt that do not rank equally. In most cases, lower-ranking classes would receive a lower DBRS rating. For more detail on this subject, please refer to DBRS rating policy entitled “[Underlying Principles](#).”
- In some cases, issued debt is secured by collateral. This is more typical in the non-investment-grade spectrum. For more detail on this subject, please refer to [DBRS Rating Methodology for Leveraged Finance](#).
- The existence of holding companies can have a meaningful impact on individual security ratings. For more detail on this subject, please refer to the criteria [Rating Parent/Holding Companies and Their Subsidiaries](#).

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## Appendix A: BRR Considerations for the Real Estate Subsectors

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### RESIDENTIAL (MULTI-FAMILY)

The BRR for the residential (multi-family) subsector is BBB (low). This assessment takes into consideration that DBRS views the asset class as a necessity-type asset (people must live somewhere) and as one of the more stable subsectors of real estate. Apartments produce stable cash flow from a diverse tenant base. Although apartment tenant rollovers are frequent because of short-term leases (typically one year or less) and the covenant of tenants is generally weak, vacancy rates for apartments are traditionally very low. For example, in Canada, the strong fundamentals of the multi-family asset are primarily the result of a decline in new apartment construction in most of the country's major cities over the last few decades, an aging population base, the growing youth job market and increased immigration to major cities. The continuing strong demand for rental accommodation has resulted in low vacancies and, therefore, more stable cash flow compared with commercial real estate assets. However, apartments have recently faced increasing competition from condominium developments and affordable home ownership in large cities, given historically low financing rates. This, combined with the need to invest capital to improve the attractiveness and competitive position of properties, creates some challenges to cash flow stability.

#### Positive Factors

- A necessity-type asset with steady demand for rental housing.
- Growing population and household formation help drive residential rental demand.
- Generally strong locations near major urban centres provide support to property asset values and occupancy levels.

#### Negative Factors

- A low interest rate environment encourages home ownership versus renting.
- Jurisdictions with rent controls reduce profitability and limit ability to pass on rising costs.
- The term of a lease (rental period) is usually relatively short, at one year, and tenants are non-creditworthy.
- Competition from condominium development and other forms of rental supply.

### RETAIL

The BRR for the retail subsector is BBB (low) and takes into consideration that retail property types generally provide relatively stable cash flow, underpinned by tenant leases of either five or ten years' duration, often with one or more five-year renewal options built into the lease. Net rental rates tend to be more stable than most other real estate subsectors and provide greater certainty to cash flow. There are various categories of retail assets, including super-regional malls, regional malls, community and strip shopping centres and power centres. Super-regional and, to a lesser extent, regional shopping centres in secondary markets tend to benefit from dominance in their respective markets, which can act as a barrier to entry and adds to cash flow stability. The quality of a mall and its sales performance depend largely on location (including access), tenant mix (anchor strength) and surrounding population density. Lower-quality malls are generally more vulnerable to competition from new retail formats (power centres) and economic conditions. Grocery- and drugstore-anchored neighbourhood retail centres tend to be relatively stable, given that these properties operate in high customer traffic areas and offer daily-necessity goods. In addition, well-located power centres anchored by strong national big-box retailers and discounters are also considered to be fairly stable.

#### Positive Factors

- Long-term tenant leases of five to ten years.
- Tenant mix is usually diverse, adding to stability.
- Location is key for the three major types of centres – strip malls, community centres and super-regionals.
- Land for centres often carries alternative uses, such as residential.
- The long and tough zoning process reduces competition, making it harder for competitors to start up new centres.

#### Negative Factors

- Anchor tenants are relatively few, and can have countervailing power over owners.
- Anchor tenants often compose 60% of a centre, and pay low rents which barely cover operating costs of the centre.
- Property taxes on most centres are relatively high.
- Low consumer expenditure and high unemployment affect vacancy and hurt profitability of centres.
- Only 40%-50% of the square footage in a shopping centre pays rent, which is profitable for commercial retail units (CRUs).

## INDUSTRIAL

The BRR for the industrial subsector is BBB (low) and takes into consideration that industrial property types generally provide stable cash flow from net rental rates that are less volatile over time. Industrial properties usually consist of light/flexible space and distribution and warehouse facilities, which can be single- or multi-tenanted build-to-suit properties. Although industrial tenants are generally under short-term, triple-net leases, well-located industrial properties in larger urban markets have generally experienced stable net rental rates historically. However, industrial properties that are subject to greater environmental issues, property age, certain building characteristics (e.g., lower ceiling height and small bays) and tenant concentration constitute greater risk. As well, manufacturing-based industrial real estate can be relatively less stable, given its exposure to export markets (mainly the United States) and foreign exchange rates. The most stable industrial properties are light/flexible space, including distribution facilities, which typically has low maintenance and leasing costs. Higher-quality industrial properties are suitable for various industries and are usually located near major roads and/or highways and have good access to railways and airports.

The BRR for the industrial segment is rated BBB (low) and takes into account the following factors:

#### Positive Factors

- Tenants comprise a broad range of businesses that are reflective of the overall economy.
- Location of land is generally away from areas where land costs are high.
- Leases are typically triple net and allow for the recovery of taxes and operating costs.
- Short construction periods.
- Lower maintenance capital requirements and leasing costs.

#### Negative Factors

- Sensitive to economic conditions, a contraction in economic activity reduces demand for industrial space.
- The term of a tenant lease is generally shorter, vacancy rates can be volatile.
- Buildings are often built to suit, with various types of building layout and requirements, such as height and bay length.
- Tenants are generally of lower credit quality.

## OFFICE

The BRR for the office subsector is BBB (low)/BB (high) and takes into consideration a number of factors. First, the office sector can experience significant volatility in net rental rates because of its correlation with economic and business conditions and the resulting influence on demand and supply of office space. Any oversupply may take years to be absorbed because of the long lead times to build, which tends to create greater relative volatility in occupancy levels and rental rates (both positive and negative). Also, there is less tenant loyalty in the office asset than in other classes as office space is generally viewed as overhead to be minimized. In addition, lease terms usually do not correlate with the length of the financing period. During periods of oversupply or weakening demand, the costs of re-leasing space, including tenant inducements and commissions, can place significant pressure on cash flow. As well, office properties can require significant capital investment to maintain their attractiveness for tenants.



#### Positive Factors

- Lease terms of five years, with major tenants under longer-term leases.
- Good locations in central business districts, urban and suburban markets.
- Low interest rates make office rental lower cost and much more attractive to tenants and landlords.
- Mortgages are long, often ten years, which provides stability to revenue.
- The onerous difficulty of relocating from a rental property often encourages tenants to remain in place.

#### Negative Factors

- Moderate to high sensitivity to the economy, and rents relatively volatile.
- High sensitivity to new supply, longer construction periods of three to four years.
- High cost associated with re-leasing space (e.g., tenant improvements and leasing commissions).
- Taxes are high, as governments view commercial real estate as a prime taxation area.
- Substantial land is available for future building in most markets.
- The zoning process is long and onerous.

## HOTELS

The BRR for the hotel subsector is BB. Hotels are viewed as higher-risk as “tenant leases” are on a day-to-day basis and operating performance can be highly seasonal and affected by a number of destabilizing factors. Average daily room rates can fluctuate substantially in short time periods, and occupancy levels can experience significant volatility, which results in greater uncertainty of cash flow. Given a relatively high fixed-cost structure, hotels have high operating leverage, which results in significant volatility in cash flow. In addition, hotels are management intensive and require ongoing capital maintenance to remain competitive.

#### Positive Factors

- Good brand recognition and strong marketing and reservation systems names enhance cash flow stability.
- Revenue can be diverse, consisting of room rental, restaurants and events such as corporate events.
- Good locations near major attractions, airports and urban markets.
- Assets are long life, with moderate levels of capital spending (although higher than other real estate subsectors).

#### Negative Factors

- Leases are short term – 24 hours – which adds to instability of cash flow.
- Seasonal and cyclical nature of business creates unstable cash flow.
- Capital and labour intensive.
- Higher maintenance expenditures; operations of hotels are expensive.
- Rates paid for hotel rooms are subject to a wide range of taxes not levied on other types of real estate.
- High proportion of fixed costs leaves hotels vulnerable to volume changes.

## Detail the Characteristics of Each Real Estate Subsector

| BRR  | Multi-Family Residential<br>BBB (low)  | Retail<br>BBB (low)   | Industrial<br>BBB (low)   | Office<br>BBB (low)/BB (high)  | Hotel<br>BB   |
|--|--|---|---|--|---|
| <b>Types</b>   | <ul style="list-style-type: none"> <li>High-rise and garden multi-family properties.</li> </ul>  | <ul style="list-style-type: none"> <li>Regional malls, power centres, grocery-anchored, unanchored neighbourhood centres, strip centres, lifestyle centres.</li> </ul>                            | <ul style="list-style-type: none"> <li>Light/flexible space, distribution or warehouse facilities.</li> </ul>   | <ul style="list-style-type: none"> <li>High-rise office towers or mid-rise buildings.</li> </ul>   | <ul style="list-style-type: none"> <li>Luxury, upscale full-service, mid-market with limited service, economy.</li> </ul>   |
| <b>Location</b>                                      | <ul style="list-style-type: none"> <li>Near areas of employment in urban or suburban markets.</li> </ul>   | <ul style="list-style-type: none"> <li>High-traffic and high-visibility locations, with good access to transportation routes and close to residential communities.</li> </ul>                     | <ul style="list-style-type: none"> <li>Close to highways and major roads, rail and airports,</li> </ul>   | <ul style="list-style-type: none"> <li>Central business district, suburban or urban markets.</li> </ul>  | <ul style="list-style-type: none"> <li>Suburban/urban, close to transportation hubs, metropolitan areas and tourist destinations.</li> </ul>                                  |
| <b>Sensitivity to Supply and Construction Period</b> | <ul style="list-style-type: none"> <li>Medium to long construction periods.</li> <li>Sensitive to new home and condominium developments.</li> </ul>  | <ul style="list-style-type: none"> <li>Medium to long construction period.</li> </ul>   | <ul style="list-style-type: none"> <li>Shorter construction period.</li> </ul>  | <ul style="list-style-type: none"> <li>High sensitivity to new supply, with longer construction periods.</li> </ul>  | <ul style="list-style-type: none"> <li>High sensitivity to new supply within local markets.</li> </ul>  |
| <b>Capital Expenditures</b>                          | <ul style="list-style-type: none"> <li>Moderate amount for renovations and common-area upkeep.</li> </ul>  | <ul style="list-style-type: none"> <li>Low to moderate, depending on retail layout (unenclosed or enclosed).</li> </ul>   | <ul style="list-style-type: none"> <li>Relatively low cost of re-tenanting space and retrofitting space.</li> </ul>   | <ul style="list-style-type: none"> <li>Moderate to high.</li> <li>High cost associated with re-leasing space (e.g., tenant improvements and leasing commissions).</li> </ul> | <ul style="list-style-type: none"> <li>Relatively high because of need to maintain attractiveness of properties.</li> </ul>   |
| <b>Lease Profile</b>                                 | <ul style="list-style-type: none"> <li>Average length of renting (one year or less).</li> </ul>  | <ul style="list-style-type: none"> <li>Lease terms for non-anchor tenants range from five to seven years.</li> <li>Lease terms for anchor or major tenants range from ten to 20 years.</li> </ul> | <ul style="list-style-type: none"> <li>Three to five years in term.</li> </ul>  | <ul style="list-style-type: none"> <li>Lease terms of five years, with major tenants under longer-term leases.</li> </ul>  | <ul style="list-style-type: none"> <li>Daily leases (24-hour period).</li> </ul>  |
| <b>Tenant Profile</b>                                | <ul style="list-style-type: none"> <li>Numerous tenants.</li> <li>Non-creditworthy tenants.</li> </ul>   | <ul style="list-style-type: none"> <li>Fashion, service providers, discounters, grocery and drug stores.</li> <li>Investment-grade (major tenants) to speculative-grade tenants.</li> </ul>       | <ul style="list-style-type: none"> <li>Single- or multi-tenant properties, with tenants from various industries.</li> <li>Speculative-grade tenants.</li> </ul> | <ul style="list-style-type: none"> <li>Multi-tenant properties.</li> <li>Tenant quality can range from speculative to investment grade (e.g., government).</li> </ul>        | <ul style="list-style-type: none"> <li>International, domestic traveller tenants, speculative-grade tenants.</li> <li>Non-creditworthy tenants.</li> </ul>                    |
| <b>Rental Rate Volatility</b>                        | <ul style="list-style-type: none"> <li>Low rent volatility (necessity-type asset).</li> <li>Several Canadian markets are rent controlled.</li> </ul> | <ul style="list-style-type: none"> <li>Low to Moderate: Dependent on the type of retail (discretionary or non-discretionary products).</li> </ul>   | <ul style="list-style-type: none"> <li>Low: Dependent on location and space adaptability, new supply.</li> </ul>  | <ul style="list-style-type: none"> <li>Moderate to High: Sensitive to economy and new supply.</li> </ul>   | <ul style="list-style-type: none"> <li>High: Room rates and occupancy (revenue per available room (RevPAR)) can vary significantly depending on short-term demand.</li> </ul> |
| <b>Interest Rate Sensitivity<sup>1</sup></b>         | <ul style="list-style-type: none"> <li>Affordability of homeownership and new condominium development.</li> </ul>                                    | <ul style="list-style-type: none"> <li>Low interest rates support consumer spending.</li> </ul>   | <ul style="list-style-type: none"> <li>Low interest rates support economic expansion.</li> </ul>  | <ul style="list-style-type: none"> <li>Low interest rates support economic expansion and job growth.</li> </ul>  | <ul style="list-style-type: none"> <li>Low interest rates support economic expansion.</li> </ul>  |

1. Interest rates also generally have an inverse relationship with real estate property values, and rising interest rates increase the cost of financing for all asset types.

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## Appendix B: General Rating Considerations

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### INDUSTRY BUSINESS RISK RATINGS

- DBRS uses the concept of business risk ratings (BRRs) as a tool in assessing the business strength of both industries and individual companies within many methodologies across the corporate finance area. (DBRS does not typically use this approach for most financial, government and public finance sectors, where the industry is more challenging to define and this approach is not as useful.)
- The BRR is assessed independently of financial risk, although in some cases there are subtle but important links. As an example, the very low business risk profile of many regulated utilities has historically allowed this sector to operate with debt levels that would not be acceptable for most other industry sectors. Given this reality, it is difficult to consider the utility industry's BRR without acknowledging to some degree that the industry operates with sizable debt levels. This type of relationship exists with many industries, although typically to a much lesser degree.
- When a BRR is applied to an industry, there is an acknowledgment that this is a general assessment and there may in fact be a wide disbursement in the business strength of individual entities within the industry. Nonetheless, this assessment is beneficial to enabling DBRS to clearly delineate our industry opinion and is a useful tool when comparing different industries. An industry BRR is defined as being representative of those entities that the market would consider as "established," meaning that the group of companies being considered would have at least reasonable critical mass and track records. As such, the BRR for an industry does not consider very small players, start-up operations or entities that have unusual strengths or weaknesses relative to the base industry.
- DBRS methodologies note whether they apply to global industries or more specific countries or regions. When analyzing individual credits, DBRS considers the degree to which regional considerations may differ from the geographic area applicable within the industry methodology. Many entities have business units that transcend industries and in these cases, more than one BRR would be considered, including the possible benefits or challenges that may exist when all businesses are analyzed as part of a combined group.
- The BRR is a tool that provides additional clarity regarding the business risk of the industry overall, but it should be viewed as just one aspect in the complex analysis of setting ratings and should by no means be seen as either a floor or ceiling for issuers within a given industry. Although DBRS does not anticipate volatility in an industry's BRR, changes are possible over time if there are meaningful structural developments in the industry. When such a change does occur, DBRS will make this clear and note any impact on related individual ratings within the industry as applicable.
- DBRS assesses five areas to establish the overall BRR for an industry. Although there is an overlap in some instances (to some degree, in the long term, all five factors tend to relate to profitability and stability), DBRS has found that considering these five measures in a separate fashion is a useful way of approaching its analysis. In all cases, DBRS uses historic performance and our experience to determine an opinion on the future, which is the primary focus.

### *Industry Profitability and Cash Flow*

- When ratios such as return on equity, return on capital and a variety of cash flow metrics are considered, some industries are simply more profitable than others. While standard economics would suggest a reversion to the mean through new competitors, this often occurs at a very slow pace over a long time horizon and in some cases may not occur at all because of barriers to entry.
- The benefits from above-average profits and/or cash flow are substantial and include internal capital growth, easier access to external capital and an additional buffer to unexpected adversity from both liquidity and capital perspectives.
- Some industries and their participants have challenges or strengths in areas such as research and development (R&D), brand recognition, marketing, distribution, cost levels and a potentially wide variety of other tangibles and intangibles that affect their ability in the area of profitability.

### *Industry Competitive Landscape*

- The competitive landscape provides information regarding future profitability for the industry and thus somewhat crosses over into the profitability and cash flow assessment, but competition is deemed worthy of separate consideration because of its critical nature.
- Participants in industries that lack discipline, produce commodity-like products or services, have low barriers to entry and exhibit ongoing pricing war strategies generally have difficulty attaining high profitability levels in the longer term. Certain industries benefit from a monopoly or oligopoly situation, which may relate to regulation.

### *Industry Stability*

- This factor relates primarily to the degree of stability in cash flow and earnings, measuring the degree to which the industry and its participants are affected by economic or industry cycles. Stability is considered critical as industries with high peaks and troughs have to deal with higher risk at the bottom of a cycle. As such, to some degree, industries with lower but stable profitability are considered more highly than industries with higher average profitability that is more cyclical.
- Some of the key factors in considering stability include the nature of the cost structure (fixed or variable), diversification that provides counter-cyclical and the degree to which the industry interrelates with the overall economy. Depending on the industry, economic factors could include inflation or deflation, supply and demand, interest rates, currency swings and future demographics.

### *Industry Regulation*

- Where applicable, regulation can provide support through stability and a barrier to entry, but it can also cause challenges and change the risk profile of an industry and its participants in a negative way, including the reality of additional costs and complications in enacting new strategies or other changes.
- As part of its analysis of regulation, DBRS also considers the likelihood of deregulation for a regulated industry, noting the many examples where this transition has proven to be a major challenge in the past.

### *Other Inherent Industry Considerations*

- Each industry has its own set of unique potential risks that, even if managed well, cannot be totally eliminated. Specific risks, the ability to manage them and the range of potential outcomes vary industry by industry. Two of the most common risks are changing technology and operational risks.
- Some of the other more common risks are in the areas of legal, product tampering, weather, natural disasters, labour relations, currency, energy prices, emerging markets and pensions.



## INDUSTRY BUSINESS RISK RATING DEFINITIONS

DBRS specifies the BRR for an industry in terms of our **Long-Term Obligations** rating scale. When discussing industry BRRs for an industry, DBRS typically provides either one specific rating or a limited range (such as BBB (high)/BBB). Using a range recognizes the fact that, by their nature, industry BRRs are less precise than a specific corporate or security rating as they represent an overall industry. In addition to relating to the industry level, these definitions also apply to the business risk of individual companies, which will fall more often in the very high and low categories (AA/AAA and B) than would be the case for an entire industry.

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### Industry Business Risk Ratings (BRRs)

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| Rating | Business Strength | Comment  |
|--------|-------------------|--|
| AA/AAA | Exceptional       | An industry BRR of AA/AAA is considered unusually strong, with no meaningful weakness in any individual area. It may include pure monopolies that are deemed essential (the primary case being regulated utilities, where the risk of deregulation is believed to be very low). Common attributes include product differentiation, high barriers to entry and meaningful cost advantages over other industries or entities. These and other strengths provide exceptional stability and high profitability. It would be quite rare for an industry to have a BRR in this category. |
| A      | Superior          | Industry BRRs at the "A" level are considered well above average in terms of stability and profitability and typically have some barriers to entry related to capital, technology or scale. Industries that have, by their nature, inherent challenges in terms of cyclicity, a high degree of competition and technology risks would be unlikely to attain this rating category.  |
| BBB    | Adequate          | Industry BRRs at the BBB level include many cyclical industries where other positive considerations are somewhat offset by challenges related to areas such as commodity products, labour issues, low barriers to entry, high fixed costs and exposure to energy costs. This rating category is considered average and many industries fall within it, with key considerations such as overall profitability and stability typically considered as neither above or below average.   |
| BB     | Weak              | An industry at the BB level has some meaningful challenges. In addition to high cyclicity, challenges could include the existence of high technology or other risks. Long-standing industries that may have lost their key strengths through factors such as new competition, obsolescence or the inability to meet changing purchaser demands may fit here. The culmination of such factors results in an industry that does not generally score well in terms of stability and profitability. For an entire industry, this is typically the lowest BRR level.                    |
| B      | Poor              | While not common, there are cases where an industry can have a BRR of B. Such industries would typically be characterized by below-average strength in all or virtually all major areas.   |



## INTERRELATIONSHIP BETWEEN FINANCIAL AND BUSINESS RISK

Having in mind the prior discussion on the typical importance that DBRS places on certain financial metrics and business strengths for the real estate industry, we provide some guiding principles pertaining to the application of DBRS methodologies, the first one being that, in most cases, an entity's business risk will carry more weight in the final rating than its financial risk.

Based on this underlying concept, we provide the additional guidance for individual companies with varying business risks:

- **For an Entity with a Business Risk of AA (Exceptional):** A company with a business risk of AA will almost always be able to obtain an investment-grade issuer rating. When financial metrics are in the BBB range, an entity with a business risk of AA would typically be able to attain an "A"-range issuer rating.
- **For an Entity with a Business Risk of "A" (Superior):** Unless financial strength fails to exceed the B range, superior business strength will typically allow the final issuer rating to be investment grade. Very conservative financial risk may in some cases allow the final issuer rating to be within the AA range, but this should not be considered the norm.
- **For an Entity with a Business Risk of BBB (Adequate):** At this average level of business risk, the level of financial risk typically has the ability to result in a final issuer rating from as high as "A" to as low as B.
- **For an Entity with a Business Risk of BB (Weak):** At this weak level of business risk, conservative financial risk can, in some cases, take the final issuer rating into the BBB investment-grade range.
- **For an Entity with a Business Risk of B (Poor):** It is not typically possible for a company with a business risk of B to achieve a final investment-grade issuer rating.

## DEFINITION OF ISSUER RATING

- DBRS Corporate rating analysis begins with an evaluation of the fundamental creditworthiness of the issuer, which is reflected in an "issuer rating". Issuer ratings address the overall credit strength of the issuer. Unlike ratings on individual securities or classes of securities, issuer ratings are based on the entity itself and do not include consideration for security or ranking. Ratings that apply to actual securities (secured or unsecured) may be higher, lower or equal to the issuer rating for a given entity.
- Given the lack of impact from security or ranking considerations, issuer ratings generally provide an opinion of default risk for all industry sectors. As such, issuer ratings in the banking sector relate to the final credit opinion on a bank that incorporates both the intrinsic rating and support considerations, if any.
- DBRS typically assigns issuer ratings on a long-term basis using its **Long Term Obligations** Rating Scale; however, on occasion, DBRS may assign a "short-term issuer rating" using its **Commercial Paper and Short Term Debt** Rating Scale to reflect the issuer's overall creditworthiness over a short-term time horizon.

## SHORT-TERM AND LONG-TERM RATINGS

- For a discussion on the relationship between short- and long-term ratings and more detail on liquidity factors, please refer to the DBRS policy entitled "**Short-Term and Long-Term Rating Relationships**" and the criteria *DBRS Commercial Paper Liquidity Support Criteria for Corporate Non-Bank Issuers*.

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