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Rating Income Funds

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DBRS Stability Rating Overview

WHAT IS A STABILITY RATING?
A stability rating provides an indication of both the stability and sustainability of an income fund’s cash distributions per unit. In other words, it is a fund’s ability to generate sufficient cash to pay out a stable level of distributions on a per-unit basis over the longer term. DBRS’s stability ratings apply through a cycle, and hence, in the absence of highly unusual circumstances, will not change due to cyclical, non-structural moderate variations in income as these are already considered in the rating assigned to the fund.

CASH DISTRIBUTIONS
Cash distributions are defined as the total amount of cash paid out to unitholders. Most funds pay cash distributions to unitholders on a quarterly or a monthly basis. Income funds generally aim to pay out all of their cash available for distribution to unitholders. However, cash distributions paid to unitholders may differ from cash available for distribution.

• A fund may elect to pay out slightly less than the total cash available for distribution in order to reserve an amount of cash for periods where cash available for distribution declines or to fund periodic increases in maintenance capital expenditures.
• A fund may elect to pay out more cash distributions than it has generated as cash available for distribution for such reasons as seasonality, a cyclical downturn or an economic shock. The shortfall is typically funded with a cash reserve, credit facilities or the issuance of new units. The risk of such events causing a drop in cash available for distribution is factored into the stability rating. Since a fund cannot continue to pay out more than it generates as cash available for distribution for a sustained period, distributions would eventually have to be reduced.
The Seven Key Factors in a Stability Rating

Although the evaluation process to establish a stability rating is comprehensive and covers a wide range of factors, some of which may be unique to an individual income fund, DBRS identifies seven key factors in assigning a stability rating. Each factor is assigned a relative grading of “superior,” “moderate” or “weak,” using the symbols below. The number of superior, moderate and weak gradings are then counted and used to determine the stability rating in accordance with the rating scale definitions in the attached Appendix.

Each factor is assigned a relative grading of “superior,” “moderate” or “weak,” using the symbols below.

![Superior](Image)

![Moderate](Image)

![Weak](Image)

(1) OPERATING CHARACTERISTICS

Of the seven key factors considered when determining a stability rating, operating characteristics is generally the most important factor and is typically given the largest weighting in the stability rating process. A fund with an asset base that is able to generate predictable and stable cash flow consistently over the longer term will generally receive a higher stability rating. Operating characteristics include (a) the characteristics of the industry in which the fund’s operations exist and (b) fund- or company-specific characteristics.

(a) The characteristics of the industry include the degree of cyclicality and seasonality of the industry, regulatory framework, trade restrictions, weather, economy, technological change, environmental issues, the degree of industry competition, barriers to entry, general industry trends that may affect future pricing and sales volumes and other structural issues that could impact operational performance.

(b) Fund- or company-specific characteristics include the stability of pricing, the product line(s), brand name(s), access to markets/distribution and other characteristics of the revenue stream, such as sales agreements and counterparties. The stability and predictability of the fund’s operating costs are also considered, along with the operating experience and history of the fund (track record), any restrictions imposed on the operations of the fund that are governed by its Declaration of Trust and Trust Indentures, as well as any supporting contractual agreements.

A fund consisting of assets that generate revenues through long-term sales agreements or contracts with creditworthy counterparties, along with stable and predictable operating costs, will typically rank as “superior” in operating characteristics. Conversely, a fund that generates its cash from a commodity with pricing volatility and does not have long-term contracts to lock in a stable revenue stream will typically rank as “weak” in operating characteristics.

(2) ASSET QUALITY

Asset quality takes a variety of factors into consideration, including, most importantly, the remaining economic life of the asset(s) held by the fund, which can vary from short term, such as with oil and gas reserves (assets that decline with the level and duration of production), to the extremely long economic life of leasable real estate and power generation facilities (provided the assets are adequately maintained). Funds comprising assets with long remaining economic lives and manageable and predictable maintenance capital expenditure requirements will typically receive a higher stability rating. Conversely, funds comprising assets with short economic lives or funds that require significant capital expenditures to maintain their economic value will typically receive a lower stability rating. Asset quality also includes the condition, location, utilization, product differentiation, risk of obsolescence and inherent value of both tangible and intangible assets, including contracts.
(3) FINANCIAL PROFILE

Financial profile takes into consideration the strength of the fund’s balance sheet and its ability to finance working capital requirements, capital expenditures, seasonality and economic shocks without exposing cash distributions to undue risk. Since income funds typically pay out all or a majority of their cash available for distribution (operating cash flow less maintenance capital expenditures) to unitholders, little or no cash is available to finance growth, large capital projects or unexpected costs. Several factors are considered in assessing a fund’s financial profile, including but not limited to (a) the level of debt in the fund’s capital structure, (b) cash reserves, (c) credit facilities, (d) the fund’s ability to access the equity capital markets and (e) maintenance (or “normalized”) capital expenditure requirements. In addition, how these factors weigh in assessing a fund’s financial profile is somewhat dependent on the operating characteristics of the fund itself.

Debt can be used to leverage and improve a unitholder’s total return, but it can also increase the fund’s financial risk. High debt levels expose an income fund to interest rate risk and refinancing debt maturities during periods of high or rising interest rates may have a material negative impact on cash available for distribution. As a result, a greater proportion of cash will be required to cover higher interest costs, leaving less cash available to pay out to unitholders. Key ratios used to measure financial risk are (a) total debt-to-capitalization, (b) cash flow-to-debt and (c) EBITDA and EBIT interest coverage.

For example: In real estate, DBRS focuses on the key financial ratios found in the table below.

<table>
<thead>
<tr>
<th>Real Estate Industry Financial Metrics</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Key Ratio</strong></td>
</tr>
<tr>
<td>EBITDA interest coverage</td>
</tr>
<tr>
<td>Debt-to-EBITDA</td>
</tr>
</tbody>
</table>

The level of debt that an income fund can support is dependent on the operating characteristics of the fund itself. Funds with a stable, predictable or guaranteed revenue stream and with low and stable operating costs are able to support a higher level of debt than a fund without these characteristics.

An income fund with an asset base that generates operating cash flow that varies with seasonality or economic cycles will require strong sources of liquidity in the form of cash reserves (cash set aside during periods of stronger-than-normal cash flow) or credit facilities to support a stable level of cash distributions during periods of weaker-than-normal cash flows.

Since income funds pay out all or a majority of cash available for distribution to unitholders in the form of cash distributions, little or no cash remains to finance growth. Hence, growth is typically financed with debt and/or equity through the issuance of new units. In general, larger funds have better access to the equity capital markets (see Size and Market Position) and will be less dependent on new debt to finance growth.

In general, a fund will rank as “superior” in the financial profile category if it has the ability to finance working capital requirements, growth capital expenditures, seasonality and economic cyclical without exposing cash distributions to undue risk. In general, funds with higher debt levels will receive a lower ranking (“moderate” or “weak”) for financial profile.
(4) DIVERSIFICATION
In general, the more diversified the asset base and the revenue stream of the fund, the greater the degree of stability of cash available for distribution over the longer term. Diversification is measured in a number of ways, including (a) by product, (b) by geographic location, (c) by market and (d) by customer. Concentration in any of these four categories will typically result in a “moderate” or “weak” ranking for diversification, while strong diversification in all of these categories will typically result in a “superior” ranking.

(5) SIZE AND MARKET POSITION
Size and market position are characterized by (a) market capitalization; (b) the size of the fund’s asset base, including breadth and scale of operations; and (c) pricing power, which is largely dependent on market share, competition and barriers to entry. Not all of these characteristics will apply to every fund. For example, competition and pricing power is extremely important to business or specialty funds, but they do not apply to power funds with long-term energy sales contracts.

(a) Larger funds, in terms of market capitalization, generally have better access to the equity capital markets. Access to the equity markets provides greater flexibility to finance the growth of a fund’s asset base. Growth in a fund’s asset base will typically enhance the stability of cash flows.

(b) In general, funds with a larger portfolio of income-producing assets are better able to maintain stable cash flows over the longer term. The impairment of a single asset within a larger group of assets will have less of a negative impact on cash flows than the impairment of a single asset within a smaller group of assets. In addition, a larger asset base generally provides greater economies of scale.

(c) A fund that generates its cash flow from an operating entity that has pricing power in a particular industry or marketplace is generally better able to maintain stable distributions to unitholders as pricing power should allow the entity to maintain stable ratings. An entity with a dominant or significant share of a particular market or industry with high barriers to entry will typically have pricing power.

(6) SPONSORSHIP/GOVERNANCE

Sponsorship
Income funds are sometimes sponsored or controlled by a strong parent entity. For example, a larger corporation may retain a significant equity interest in an income fund that the corporation brought to the market. This allows the corporation to control the operations held by the fund. Good sponsorship can potentially provide benefits to the fund, including (a) a steady source of new projects/asset acquisitions; (b) financial assistance in the event of unforeseen difficulties at the fund; (c) higher visibility, given the large investor base typically following the sponsor’s activities; and (d) management/technical support. In addition, unitholders of a fund with a significant ownership held by a strong sponsor benefit from the sponsor’s interests being aligned with the interests of unitholders. While sponsorship is usually a positive factor, it can be a negative factor in the event that the sponsor’s management is so focused on its own operations that the business of the fund is given insufficient attention or if conflicts of interest arise. In this event, dedicated management at the fund level is preferable to a distant sponsor-related management team, especially for funds of sufficient size.
Governance
Governance encompasses three key elements: (a) management accountability, (b) shareholder rights and (c) transparency.

(a) Income fund management is provided either through direct employees of the fund ("internal management") or through a separate management company ("external management"). The type of management used and the associated compensation arrangements have implications for the alignment of management and unitholder interests. Typically, management compensation, including incentives, is tied to the fund’s performance in an attempt to reward and encourage good performance. One example of incentives involves management (usually external) receiving an increasing proportion of distributable cash flow as the fund’s per-unit amount rises. (For example, management might receive 25% of all distributions above $1.00 per unit.) This provides management with an incentive to grow the business as rapidly as possible. However, it can also be detrimental as the management may complete acquisitions that are not in the unitholders’ best interests (e.g., higher risk). In addition, management’s higher return means that unitholders will receive less than the full benefit of distribution increases in excess of a predefined level. Over time, this can reduce the attractiveness of new issuance of fund units.

There can also be corporate governance issues and inherent conflicts of interests that arise from having external management, which can result in significant problems if management’s interests are not aligned with those of the fund’s unitholders. Many funds are operated by separate management companies that are paid management fees and may also pass through their costs to the fund. Conflicts of interest are also inherent in the sponsorship arrangement as the sale of assets from the sponsor to the fund is a non-arm’s-length transaction that must be closely monitored for fairness.

(b) Shareholder rights are managed by the fund’s trustees and board of directors. Hence, independence of the trustees and board of directors is key to protecting shareholder rights. In terms of ranking a fund’s governance, preference is given to funds with a board of directors that has a significant proportion of independent directors. Consideration is also given to the independence of committees of the board (i.e., compensation committee, audit committee), the number of times per year the board meets (i.e., how active is the board) and the amount of discretion given to management without having to go to the board for approval.

(c) Transparency is characterized by the amount of public disclosure provided by the fund regarding its operations, governance and financial reporting. Transparency also includes management accessibility. Greater transparency allows for a more accurate assessment of the predictability of a fund’s cash flow.

(7) GROWTH
The growth factor considers the ability of an income fund to (a) generate sufficient cash from operations to internally fund maintenance capital expenditures and a consistent level of distributions per unit over the longer term and (b) grow its cash available for distribution on a per-unit basis with its existing asset base.

(a) A fund that consistently pays out more in cash distributions than it generates in cash available for distribution (operating cash flow less maintenance capital expenditures) will ultimately have to reduce its cash distributions. On the other hand, a fund that consistently generates cash available for distribution that exceeds what it pays out in cash distributions to unitholders is more likely to raise its level of distributions per unit over time.
(b) By nature, income funds generally have limited growth potential from internally generated cash as funds typically pay out all or a majority of their cash available for distribution as cash distributions to unitholders. Hence, little or no cash is retained to fund growth opportunities. Growth opportunities are generally financed through the issuance of new equity units and/or debt. In assessing growth, several factors are considered including, but not limited to, the following:

- The dilution effect of raising equity through the issuance of new fund units in order to finance an accretive acquisition or development project. While an acquisition may be accretive to growth in cash available for distribution on an aggregate basis, the dilution effect will limit growth in terms of cash available for distribution on a per-unit basis.
- Growing the asset base in order to maintain the stability of cash distributions per unit. A fund with a declining asset base will have to replace its asset base in order to just maintain the stability of cash distributions per unit. Hence, growth in cash available for distribution per unit would be limited in this case.

DBRS also evaluates the potential impact of dilution as a result of the conversion of existing financial instruments (e.g., convertible subordinated debentures) into additional trust units on cash available for distribution per unit. Consequently, DBRS calculates the relevant per-unit ratios on both basic and fully diluted bases in order to capture the potential impact of dilution.

The majority of income funds will rank as “moderate” for growth. Funds with a declining asset base will typically rank as “weak” for growth. Funds with the ability to improve cash available for distribution on a per-unit basis with their existing asset base will typically rank as “superior” for growth. This may be achieved through the improvement of operating efficiencies, innovation or steady organic growth in the fund’s customer base.
DBRS currently covers income funds in the real estate sector:

**REAL ESTATE INVESTMENT FUNDS (REITS)**

Real estate assets are well suited for the income fund structure. Most REITs have property portfolios that are underpinned by leases that pay contractual rental rates for a fixed time period, often ranging between five and ten years. This generally results in stable cash flow generation. However, there are a wide range of asset classes (including office, industrial, retail, residential and hotels) in the real estate sector that have uniquely different fundamentals and risks that affect cash flow stability. For example, residential leases can range from one to two years in duration, but this segment tends to be among the most stable real estate asset class. Hotel properties are subject to daily changes in occupancy and tend to be more affected by seasonality and the vagaries of the economic cycle. For most REITs, portfolio size and diversification is good, and underlying assets are generally long-life with reasonable capital expenditure requirements that permit most cash flow to be distributed. REITs are typically rated in the STA-3 range.

**Typical Structure of an Income Fund**

![Diagram of Income Fund Structure]
DBRS stability ratings apply to the distributions paid by an income fund to its unitholders. Ownership interests held by unitholders are in the form of equity interests in the income fund. Income funds typically hold equity and/or debt investments in an operating company that generates cash from the direct or indirect ownership of income-producing assets or subsidiaries. Cash flow from the operating company flows back to the income fund in the form of interest payments and dividends. Typically, the size of an income fund’s debt investment in an operating company is such that the tax deductibility of the interest payments results in the operating company paying out little or no income tax.
Appendix A: The DBRS Stabililty Rating Scale

An income fund stability rating provides an indication of both the stability and sustainability of the income fund’s distributable income. Rating categories range from STA-1 to STA-7, with STA-1 being the highest. In addition, DBRS further separates the ratings into “high,” “middle” and “low” subcategories to indicate where they fall within the rating category. Ratings take into consideration the seven main factors of: (1) operating and industry characteristics, (2) asset quality, (3) financial flexibility, (4) diversification, (5) size and market position, (6) sponsorship/governance and (7) growth. In addition, consideration is given to specific structural or contractual elements that may eliminate or mitigate risks or other potentially negative factors. Funds that have halted or deferred distributions will be carefully assessed and assigned to the category deemed most appropriate, given that fund’s specific circumstances.

### DBRS Stability Rating Scale

| STA-1      | Highest stability and sustainability of distributions per unit. |
| STA-2      | Very good stability and sustainability of distributions per unit. |
| STA-3      | Good stability and sustainability of distributions per unit. |
| STA-4      | Adequate stability and sustainability of distributions per unit. |
| STA-5      | Weak stability and sustainability of distributions per unit. |
| STA-6      | Very weak stability and sustainability of distributions per unit. |
| STA-7      | Poor stability and sustainability of distributions per unit. |

Note: All ratings categories are broken into “high,” “middle” and “low.”

### STA-1
Income funds rated STA-1 have the highest level of stability and sustainability of distributions per unit. Funds with this rating have a superior combination of the following factors: good history of operating performance, outstanding financial flexibility, high quality assets, good diversification, large size in terms of breadth and scale of operations and a strong industry structure. The fund is likely to have strong sponsors or owners or specific structural or contractual elements that eliminate or mitigate risks or other potentially negative factors.

### STA-2
Income funds rated STA-2 have very good distributions per unit stability and sustainability. The fund exhibits performance that is only slightly below the STA-1 category, typically shows above-average strength in areas of consideration, and possesses levels of distributable income per unit that are not likely to be significantly negatively affected by foreseeable events. The fund is above average in many, if not most, areas of consideration.

### STA-3
Income funds rated at STA-3 have good distributions per unit stability and sustainability, but performance may be more sensitive to economic factors, have greater cyclical tendencies and may not be as well diversified as an STA-2, resulting in some potential for distributions per unit to fluctuate. The fund will not be above average in all areas of consideration, but will tend to outperform in many areas. STA-3 is usually the highest rating category for a new and smaller fund and also often represents a ceiling for some of the better commodity-oriented funds.
STA-4
Income funds rated at STA-4 have adequate distributions per unit stability and sustainability, but distributions per unit are affected by one or more factors, such as cyclicality, seasonality and commodity price fluctuations, and economic cycles have a comparatively greater influence over performance when compared to higher rating categories. There may be concentration issues where a lack of diversity may affect stability.

STA-5
Income funds rated at STA-5 have weak distributions per unit stability and sustainability. The fund is subject to many of the same cyclical, seasonal and economic factors as in the STA-4 rating category, but the lack of diversification is generally more pronounced and the fund will tend to be below average in several areas.

STA-6
Income funds rated at STA-6 have very weak distributions per unit stability and sustainability. The fund will tend to be below average in many areas of consideration. There may be a high degree of volatility associated with current levels of distributions per unit and the ongoing operational performance and financial flexibility of the fund is weak. The fund may also be relatively new and small, and have limited sponsor support.

STA-7
Income funds rated at STA-7 have poor distributions per unit in terms of stability and sustainability. The fund is below average in most areas of consideration. There is a high degree of volatility associated with current levels of distributions per unit. In addition, depending upon the specific circumstances, this category may also contain those income funds that have ceased distributions.
Appendix B: Additional Financial Ratios

(1) DECLARED DISTRIBUTIONS PER UNIT
Declared distributions per unit indicate the distributions declared by the fund on a per-unit basis and are representative of the cash generated by the fund during a given period.

(2) CASH AVAILABLE FOR DISTRIBUTION PER UNIT
Cash available for distribution per unit represents the cash that is available to be distributed by the fund on a per unit-basis to its unitholders after maintenance capital expenditure requirements have been met. DBRS defines cash available for distribution as operating cash flow less maintenance capital expenditures.

(3) NET INCOME BEFORE EXTRAORDINARY ITEMS PER UNIT
Net income before extraordinary items per unit represents recurring net income on a per-unit basis.

(4) DECLARED DISTRIBUTIONS-TO-CASH AVAILABLE FOR DISTRIBUTION
This ratio represents the proportion of declared distributions that are funded through cash available for distribution. Over the long run, this ratio should not exceed 100%, otherwise external financing will be required to meet the deficiency.