The Pakistan Credit Rating Agency Limited

Methodology
Project Grading

Table of Contents

Summary

This methodology describes PACRA's approach to grading real estate projects, designed to opine on the execution prospects of a real estate project as per plan and ability to transfer as per terms. PACRA's analysis is based on four key elements, namely: project management systems, business risk, performance risk, and financing risk. Project specific factors along with exogenous factors are taken into consideration. The grading is not a recommendation to lend/do business/invest with a certain project.

Analyst Contacts
Usama Liaquat
+92-42-3586 9504
usama.liaquat@pacra.com

Zoya Aqib
+92-42-3586 9504
zoya.aqib@pacra.com

The Pakistan Credit Rating Agency Limited
Head Office
FB1 Awami Complex
Usman Block, New Garden Town
Lahore
Phone +92 42 3586 9504

Karachi Office
PNSC Building, 3rd Floor
M.T. Khan Road, Lalazar
Karachi
Phone +92 21 3563 2601

0. Introduction

0.1 Real estate is considered an important sector in Pakistan. One important factor which could discourage lenders, and investors (intermediary investors as well as end-users) is the credibility of developers and the reliability of completing projects on time and without cost overruns. This factor assumes greater significance in the backdrop of a number of failures in the past relating to property development and housing schemes. What could provide a degree of comfort to lenders and investors? This factor has prompted PACRA to launch a system of grading real estate projects. PACRA grading, an independent opinion, aims to serve as a tool for identifying risks associated with the concerned project. The grading of real estate projects is designed to opine on the execution prospects of a real estate project as per plan and ability to transfer as per terms. Where needed, PACRA may engage an external consultant to have a more detailed technical insight into the project whose grading assignment is under process.

0.2 The grading is expected to facilitate the overall growth of the real estate sector by providing developers with incentives to conform to their promise.

0.3 A graded project enhances the confidence of the end users and provides comfort to lenders of these projects, thereby facilitating the flow of institutional funds to the project/project owner. Besides benefiting the sector participants and end-users (investors/customers), the grading is designed to provide objective opinions as inputs in the pricing and credit decisions of banks/financial institutions. The grading is not a recommendation to lend/do business/invest with a certain project.

0.4 Following broad factors are looked at while reaching at a project grading opinion:

Project Grading - Key Factors	
Management Systems	Evaluation of the management systems used to execute and monitor the project.
Business Risk	Evaluate the risks emanating from the project and developer’s choice of market and project.
Performance Risk	Evaluate the performance of construction-related activities for the project.
Financing Risk	Looks at the components of project financing and their timelines to estimate whether the required funds would be available for on-time delivery.

1. Management Systems

Project Management Systems		
Sr.	**Factor**	**Explanation**
1	**Project Planning and Management System**	Evaluate the usage of software and MIS tools used to aid the planning and monitoring of project activities
2	**Pre-commencement Activities**	Evaluate the planning function with regards to comprehensiveness before the commencement of project construction
3	**Regulatory Approvals**	System for seeking approvals once the design phase has been completed
4	**Title management system**	Evaluation of the system for ensuring land titles are valid and as per requirements
5	**Provisioning for Utilities**	Evaluate the methods for ensuring utility connections
6	**Contractor and Supplier Selection**	Process for selecting contractors and suppliers
7	**Process for activities**	How completed activities are verified and ensured?
8	**Coordination Mechanism**	Formal and informal communication; coordination of project activities involving different partners
9	**Reporting Quality**	Frequency of reports, details/ level of depth in reports
10	**Project Manager**	Experience of project manager and his ability to provide input to stakeholders on various activities
11	**PM Team**	Evaluate the depth of project management team and the setup for segregation of duties
12	**On-site Supervision**	Site supervision system of the developer
13	**Resource availability**	Availability of resources (manpower, machinery, procurement) for construction
14	**Resource Utilization**	Utilization of resources on site

2. Business Risk

Business Risk		
Sr.	**Factor**	**Explanation**
	A) Project specific data	
1	**Type of Project**	Relates to the ultimate usage of the constructed entity, which impacts its marketability
2	**Target Market**	What is the target market for the developer's project/s?
3	**Location risk**	Dynamics of the local market, based on the characteristics of the city in which the project is located (including accessibility, infrastructure, etc.)
4	**Project Concept risk**	Whether the concept of the project (design, utility and scale) is expected to aid or hamper sales
5	**Pricing of Project**	Whether pricing corresponds to the target market
6	**Key Selling Point (KSP)**	If sufficiently differentiated from substitutes in the local market
7	**Current Stage of Construction**	Percentage completion achieved at the time of grading
8	**Viability of sales plan**	Whether the timelines and price points in the sales plan are achievable and whether they will be communicated to the target market in time
9	**Regulatory Risk**	Risk of intervention from a regulatory body based on project design elements and/or political risk
	B) Exogenous factors	
1	**Economic Cycle**	Impact of economic cycle, through construction and sales period
2	**Brand Recognition**	Ability of the developer to attract buyers based on previous history and reputation in the market
3	**Developer structure**	Incorporation and structuring of the developer's business

3. Performance Risk

Project Performance Risk		
Sr.	**Factor**	**Explanation**
	A) Timeliness	
1	**Viability of Master-plan**	To judge whether the project as conceived is viable for implementation
2	**Master-plan**	Level of adherence to the process and milestones laid out in the master plan
3	**Project Priority**	Priority of project within the portfolio of the developer
4	**Status of Current Delays**	Delays in construction activities completed so far
5	**Origin of Delay**	Ascertain why the delays were experienced. The earlier the delays are in the lifecycle of the project, the more likelihood that they may be recouped later
6	**Time Recovery Measures**	Presence of and effectiveness of time recovery measures in the contracts with construction partners
7	**Parallel Execution Capacity**	Evaluate whether the developers and the contractors for the project have ability to execute multiple activities at the same time
8	**Financial Penalties**	Penalty on developer from the customer and penalty on contractors from the developer
	B) Quality of Execution	
1	**Quality Control (QC) Structure**	Evaluate the QC function implemented by the developer for the said project
2	**Independence of QC**	Evaluate the degree of independence of quality control mechanism
3	**Workflow**	Evaluate the placement of QC staff in overall project management
4	**Environmental**	Assessment of environmental impact of project – usually through mandated EIA (Environmental impact assessment Report)
5	**Quality of Delivered Activities**	Evaluate quality of constructed structure

4. Financing Risk

Project Financing Risk		
Sr.	**Factor**	**Explanation**
1	**Project Financial Feasibility**	Can the project be completed (as per its design and construction schedule) in the specified cost?
2	**Financial Statements**	Quality and transparency of financial statements including market value assessment
3	**Capacity to Pour- in more Equity**	Evaluate whether the developer can contribute more equity into the said project from other project
4	**Coverage of cost till Completion**	Percentage of outstanding costs covered through equity, advances and credit lines
5	**Project Breakeven**	Calculate break-even point with respect to sales/rentals
6	**Sales Plan**	How and when the project is to be sold completely or rented out
7	**Project Leveraging**	To reflect flexibility towards taking on bridge financing
8	**Project Encumbrance**	Whether any liens exist for the land of the project
9	**Profile of buyers**	Payment history and/or credit rating and profile of buyers of the project
10	**Liquidity**	Assess the liquid assets of the developer (including cash, unused portion of bank lines, mutual funds or stock investments)

Project Grading

Project grading reflects opinion on execution prospects of a real estate project as per plan and ability to transfer as per terms.

Scale	Definition
PG1	**Very strong.** Highest prospects of successful implementation of real estate project and transfer as per terms. The project risk factors are very low
PG2++ **PG2+** **PG2**	**Strong.** High prospects of successful implementation of the real estate project and transfer as per terms. The project risk factors are low
PG3++ **PG3+** **PG3**	**Good.** Good prospects of successful implementation of the real estate project and transfer as per terms. The project risk factors are moderate
PG4++ **PG4+** **PG4**	**Adequate.** Adequate prospects of successful implementation of the real estate project and transfer as per terms. The project risk factors are relatively high
PG5	**Weak.** Weak prospects of implementation of the real estate project and transfer as per terms. The project risk factors are very high

Outlook (Stable, Positive, Negative, Developing) Indicates the potential and direction of a rating over the intermediate term in response to trends in economic and/or fundamental business/financial conditions. It is not necessarily a precursor to a rating change. 'Stable' outlook means a rating is not likely to change. 'Positive' means it may be raised. 'Negative' means it may be lowered. Where the trends have conflicting elements, the outlook may be described as 'Developing'.

Rating Watch Alerts to the possibility of a rating change subsequent to, or, in anticipation of some material identifiable event with indeterminable rating implications. But it does not mean that a rating change is inevitable. A watch should be resolved within foreseeable future, but may continue if underlying circumstances are not settled. Rating watch may accompany rating outlook of the respective opinion.

Suspension It is not possible to update an opinion due to lack of requisite information. Opinion should be resumed in foreseeable future. However, if this does not happen within six (6) months, the rating should be considered withdrawn.

Withdrawn A rating is withdrawn on a) termination of rating mandate, b) the debt instrument is redeemed, c) the rating remains suspended for six months, d) the entity/issuer defaults., or/and e) PACRA finds it impractical to surveill the opinion due to lack of requisite information.

Harmonization A change in rating due to revision in applicable methodology or underlying scale.

Surveillance. Surveillance on a publicly disseminated grading opinion is carried out on an ongoing basis till it is formally suspended or withdrawn. A comprehensive surveillance of grading opinion is carried out at least once every six months. However, a grading opinion may be reviewed in the intervening period if it is necessitated by any material happening.