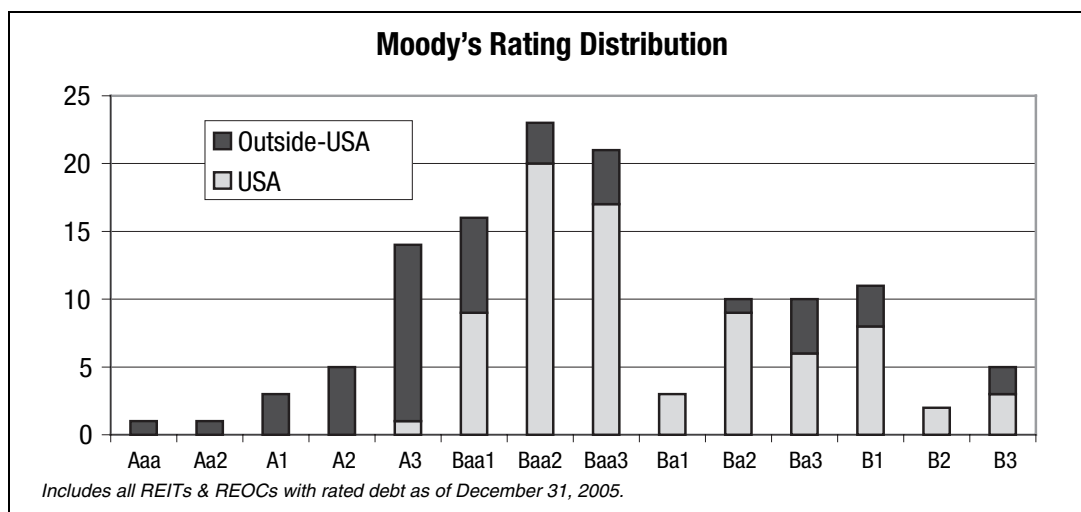


| Contact | Phone |
|--|-----------------|
| New York | |
| Philip Kibel CPA | 1.212.553.1653 |
| Karen Nickerson CPA | |
| Merrie Frankel Esq. | |
| Brian Harris CPA | |
| Christopher Wimmer CFA | |
| Lori Halpern | |
| Maria Maslovsky | |
| Angela Burriesci | |
| Dan Michles | |
| Lin Zheng | |
| John J. Kriz | |
| <i>Managing Director - Real Estate Finance</i> | |
| London | |
| Niel Bisset | 44.20.7772.5454 |
| Paul Marty | |
| Hong Kong | |
| Clara Lau | 852.2916.1121 |
| Esther Lee | |
| Kaven Tsang | |
| Tokyo | |
| Tomomichi Nagaoka | 81.3.5408.4000 |
| Takuji Masuko | |
| Shinsuke Tanimoto | |
| Sydney | |
| Peter Fullerton | 61.2.9270.8100 |

Rating Methodology for REITs and Other Commercial Property Firms

This rating methodology focuses on real estate investment trusts (REITs), real estate operating companies (REOCs) and other commercial property firms¹. Moody's rates the securities of over 130 REITs and REOCs globally, which have a median rating of Baa2, at the lower end of the investment grade level. This rating methodology is part of Moody's effort to outline the systems we use for rating property firms. Our goal is to provide investors and issuers a transparent set of guidelines to allow them to better understand our rating process and how we reach our rating decisions. This rating methodology should be used in conjunction with our prior publication, [Key Ratios for Rating REITs and Other Property Firms](#)².



1. Please see Appendix 1 for more details on the types of real estate companies and regional differences. This methodology does not address commercial property firms that are principally developers.
 2. "Key Ratios for Rating REITs and Other Property Firms," December 2004.

REIT and Other Commercial Property Firms' Ratings

Moody's REIT and REOC rating process, like all of Moody's ratings processes, is based on cooperative working relationships with relevant experts. In the case of REITs and REOCs, Moody's analysts who specialize in financial institutions, structured finance and other industries (*e.g.*, retail, non-bank finance, lodging and health care) all participate in the rating process.

REITs and REOCs issue both unsecured debt (which is the subject of this study) and mortgage debt (usually non-recourse) which subordinates the claims of the unsecured creditors. Ratings assigned to unsecured debt of a REIT or REOC tend to be lower than those assigned to mortgage-related transactions, primarily due to the absence of liens, deal structure, subordination and management's ability to adversely change such items as strategic models, asset composition, capital structures and leverage. The crux of Moody's fundamental analysis is to determine the quality, diversity and sustainability of a firm's earnings and cash flows relative to cash needs, and to translate those judgments into the likelihood of default, and recovery rates, assuming default.

Rating Models

Moody's is often asked about our use of quantitative rating models. We use such models as part of the input into assigning ratings. Quantitative factors are not the sole determinants of ratings, however, as ratings are also affected by such more qualitative factors as governance, the aggressiveness of management strategy, sector leadership, our expectations of business and financial plans and the like.

Our quantitative model focuses on four measures that have proved to be particularly important to estimating the creditworthiness of commercial property firms.

| Quantitative Variable | Concept |
|--|---|
| Gross Assets | Proxy for leadership and diversity, both of which are positive creditworthiness characteristics. While asset size is positively correlated with higher ratings, bigger is not always better. Size is also a key rating driver in other financial services sectors, such as insurance and banking. The amount of asset size that translates into leadership varies by property type and geographic market. |
| Use of Secured Debt | Speaks to financial flexibility, effective subordination of unsecured lenders, unsecured debtholder recovery and the financial risk appetite of management. |
| Volatility of Return on Average Assets | Profit volatility relates to coverage, cash flow and the stability of the business model in adverse environments. It is particularly relevant for more volatile real estate sectors, such as health care and lodging. |
| Return on Average Assets | Return robustness relates to success in strategy and business model, and vulnerabilities to that success. Differentials in returns generally result from difficult property sectors, high risk appetites, concentration risk or poorly run firms. |

Core Rating Drivers for Property Firms³

There are six core factors that drive Moody's real estate company rating outcomes. Each core factor has qualitative and quantitative sub-factors that Moody's considers, too. The table below outlines these six core factors, the reasons behind their relevance, and metrics used in conjunction with them. In specific, we map the qualitative aspects to the quantitative metrics outlined in our "Key Ratios for Rating REITs and Other Property Firms" report.⁴ We further examine each core factor in detail in the following sections. It is best to review this section in the context of the entirety of this report. The core rating factors include:

1. Liquidity and Funding
2. Leverage and Capital Structure
3. Market Position and Asset Quality
4. Profitability and Sustainability of Cash Flows
5. Internal Operating Environment
6. External Operating Environment

Based on our ratings model, Moody's Rating Driver Grid (Appendix 2) and an application of the Rating Driver Grid to a hypothetical US retail REIT (Appendix 3), factors one through four referenced above tend to have greater effects on the ratings outcome than do factors five and six.

3. See Appendix 2 for a summary of Moody's rating driver grid and Appendix 3 for an application of the rating driver grid to a hypothetical US REIT.

4. "Key Ratios for Rating REITs and Other Property Firms", December 2004.

LIQUIDITY AND FUNDING

Analytical Underpinning

- A company's ability to service and repay debt — especially under adverse operating conditions — is correlated with its liquidity, and funding sources/structure
- Due to the capital-intensive nature of commercial real estate, and REITs' minimal cash retention capacity, liquidity and funding issues take on particular relevance

Key Metrics

- Funding Capacity
- Funding Structure
- Free Asset Base
- Dividend Payout Ratio

Key Considerations

- Adequacy of liquidity sources, especially size, usage and structure of bank lines
- Funding Structure:
 - Debt maturity laddering
 - Dividend coverage

Key Considerations by Rating Categories

| Investment Grade | | |
|--|--|---|
| Aa | A | Baa |
| More than 75% availability on its credit line on average; bank line is more than enough to cover one year's cash needs | More than 60% availability on its credit line on average; bank line is enough to cover one year's cash needs | More than 50% availability on its credit line on average; bank line is enough to cover close to one year's cash needs |
| Annual debt maturities <10% of total debt | Annual debt maturities <10%-15% of total debt | Annual debt maturities <15% - 20% of total debt |
| Average dividend payout <50% FFO | Average dividend payout 50% - 60% of FFO | Average dividend payout 60% - 90% of FFO |
| Close to 100% unencumbered portfolio | Portfolio >80% unencumbered | Portfolio >60% unencumbered |

| Non-Investment Grade | |
|--|---|
| Ba | B |
| Less than 50% availability on its credit line on average | Less than 40% availability on its credit line on average, and credit line is likely secured |
| Annual debt maturities >20% of total debt | Annual debt maturities >25% of total debt |
| Average dividend payout >90% of FFO | Average dividend payout >100% of FFO |
| Portfolio is >40% unencumbered | Portfolio is mostly encumbered |

Our assessment of a REIT's or REOC's liquidity consists of an examination of the relationship between its sources of liquidity, such as borrowing capacity, cash balances, operating cash flow and unencumbered assets, and its intermediate-term fixed obligations, including capital expenditures. The firm's debt maturity structure is a focus because the bunching of maturities can present liquidity challenges. The more that debt maturities are spread over time, the more financial flexibility a firm will have. Multi-year committed bank lines from core relationship banks with covenants that are not likely to be tripped in adversity (MAC clauses and ratings triggers being distinctly negative characteristics) can enhance financial flexibility and serve as a stable source of funding. However, these facilities are best viewed as temporary liquidity sources. Heavy reliance on these facilities is risky for property companies given the long-term nature of the assets, and inherently limited cash retention capacity in the case of REITs.

| Ranking of Liquidity Sources | |
|--|---|
| Balance Sheet Cash | Cash is the most reliable source of liquidity. However, for REITs, cash is limited by the requirement to distribute taxable income, and property firms usually carry little cash. |
| Committed and Undrawn Borrowing Facilities | Facilities generally have covenants that can limit access, but usually have enough cushion to provide a reliable source of funding.* |
| Operating Cash Flow | The contractual nature of rents for certain property sectors provides some degree of reliability. We examine all cash flows, and score them according to reliability. (See ranking below of relative volatility of property types.) |
| Asset Sales | Though asset values can change materially and quickly, and asset sales can take time, properties — particularly unencumbered properties — have proved relatively reliable cash sources. However, even partly liquidating a firm is not an encouraging sign. |
| Access to Capital Markets | Given the capital-intensive nature of real estate and REIT earnings payouts, access to capital markets is important. However, often-fickle capital markets leaves this source undependable. |
| * “Moody’s Top Ten Credit Issues for REITs’ Bank Revolving Credit Facilities”, September 2004. | |

When examining a REIT or a REOC, we also examine covenants related to bank facilities, bonds and the like that may limit liquidity to the REIT or REOC in a stress situation, or that could restrict the sale or encumbrance of a REIT’s portfolio. We also evaluate a REIT’s or REOC’s access to (and track record in) debt and equity markets. Because REITs distribute most of their cash flow, a firm’s ability to repay its debt is a direct function of its ability to raise cash. For REITs and REOCs, properties that are free and clear of mortgages are also sources of alternative liquidity, via property-specific debt, or even sale.

LEVERAGE AND CAPITAL STRUCTURE

Analytical Underpinning

- Unencumbered assets add to financial flexibility and bondholder recovery protection
- High leverage drains cash resources and particularly heightens vulnerability to operating reversals
- REITs’ requirement to pay most, if not all, of taxable income reduces internal capital generation
- Debt covenants may limit the range of leverage and capital structures, and support free assets underpinning bonds

Key Metrics

- Capital Structure — Total leverage and secured debt levels
- Debt covenant package
- Stock Market Valuations and Bond Pricing

Key Considerations

- Overall leverage
- Relative secured debt levels, amount of encumbered assets and cash flow

Key Considerations by Rating Categories

| Investment Grade | | |
|---|---|---|
| Aa | A | Baa |
| Debt + preferred / Gross Assets <15% or Net debt / EBITDA <3.5X | Debt + preferred / Gross Assets <30% or Net debt / EBITDA <4X | Debt + preferred / Gross Assets <50% or Net debt / EBITDA <6X |
| Essentially no secured debt | Secured debt as a percentage of gross assets <10% | Secured debt as a percentage of gross assets <20% |
| Superior access to all sources of private and public capital | Excellent access to all sources of private and public capital | Good access to all sources of private and public capital |

| Non-Investment Grade | |
|---|---|
| Ba | B |
| Debt + preferred / Gross Assets >50% or Net debt / EBITDA >6X | Debt + preferred / Gross Assets >60% or Net debt / EBITDA >7X |
| Secured debt as a percentage of gross assets <30% | Most all debt is secured |
| Sporadic access to many sources of capital | Sporadic access to most sources of capital |

The liquidity, earnings volatility, cash-retention capacity and capital-intensive characteristics of REITs and REOCs are important characteristics that drive leverage analysis. Appropriate leverage levels for a given rating vary from case to case. For instance, having more stable income streams (such as from long-term triple-net leases on high-quality buildings with investment-grade tenants) can support more leverage at a given rating level.

Many REITs have stated objectives of maintaining leverage within certain ranges, the ranges partly driven by bond and bank loan covenants. Moody's analysis tends to measure leverage against the potential value of assets or gross book value, rather than total market capitalization, given the volatility of equity markets, though the market's determination of a firm's value is examined, too. To strengthen and diversify their capital structures, some REITs and REOCs issue preferred stock. Moody's usually views preferred stock as "debt-like" and folds it into our quantitative analysis as such⁵.

The balance between secured and unsecured debt is another important analytical consideration. For the unsecured bondholder, the existence of a pool of unencumbered assets (the larger, more diverse and high quality the better) adds to a REIT's financial flexibility. The presence of mortgage debt (including non-recourse, though such debt can provide some flexibility, mostly limited to extreme stress) effectively subordinates unsecured bondholders and decreases a REIT's or REOC's financial flexibility. The larger the ratio of unencumbered assets to total debt, and in particular, total unsecured debt, the more flexibility a given REIT generally has in repaying its unsecured debt at maturity, and a higher recovery in the event of default would be more likely. We measure this by percentage of NOI by percentage of value and by number of properties. It is also useful to examine the maturity structure of mortgages, which speaks to liquidity needs, and the likelihood a firm can take steps to unencumber itself.

When looking at secured debt, a distinction between recourse and non-recourse is made. In Moody's opinion, non-recourse debt is less likely to jeopardize a stock of unencumbered assets in a given property portfolio, reflecting the ability to walk away from the obligation without many direct consequences. However, debt is still debt, and Moody's anticipates that most REITs and REOCs would fulfill obligations — including non-recourse obligations — in most circumstances.

Significant financial and strategic flexibility is lost through mortgage finance. First, mortgaged assets are more difficult to sell, partly because of restrictions or penalties related to transference. Even when there are no such obstacles, purchasers of mortgaged properties consider the impact of assumed debt on their overall borrowing mix, and measures such as interest costs and maturity laddering. Because the property and the mortgage are joined at the hip, both need to be appealing to make a sale work, and a bad mortgage on a good property decreases the property's value and salability. Second, mortgage agreements typically restrict the ability of an owner to reposition properties; this makes "fixing" problem properties even more challenging. Also, recasting the first mortgage to raise the LTV can be difficult, if not impossible, and the same applies to obtaining a second mortgage — much of the value of the asset gets sequestered, and the asset cannot be used as a source of alternative liquidity. In some mortgage structures, even finding someone to call and discuss the issue with is difficult. These factors make the mortgaged asset less flexible, thus impairing asset liquidity and constraining a firm's ability to reposition or finance its portfolio.

Moody's examines and stresses the level of variable-rate debt, the goal being to determine to what extent a firm's cost of funds is vulnerable to rising or falling interest rates, and how rates are correlated to cash flows from assets. Some assets "reprice" rapidly due to short-term leases (such as apartments). To the extent lease rates float in similar manners to debt, the level of floating rate debt that can be carried at a given rating level will vary. For property companies, most variable rate debt comes from the revolver, and high revolver usage also impairs liquidity and financial flexibility. In specific, it diminishes the ability to close quickly on acquisitions, fund development or other capital expenditures, and serve as bridge financing for other cash needs. It is important to separate the discussions of variable rate and term structure.

5. "An Application of Moody's Tool Kit: The Analysis of Preferred Securities Issued by US Real Estate Investment Trusts (REITs)," May 2005.

The requirement that REITs disburse most, if not all, of their net income as dividends reduces internal capital generation and therefore fundamentally crimps leverage capacity.⁶ Some REITs have negative cash retention — uncommon among investment-grade firms — once dividends and capex are considered, though dividend reinvestment plans have often been sources of capital, such as for many Australian property trusts (“LPTs”). It is important to examine firms’ actual payouts, which can exceed cash-generating capacity (due, perhaps, to a profit downturn that a firm believes will correct itself soon so that a dividend cut is not needed) and thus further crimp financial flexibility. Moody’s REIT ratings methodology also includes analyses of what could jeopardize a company’s REIT status. This varies by nation and includes involvement in prohibited activities, improper dividend payouts or concentrated ownership. Such an event would adversely affect a company’s financial strength because failure to qualify as a REIT would usually subject the company to severe tax or other penalties, and may be an event of default or acceleration under borrowing arrangements. REOCs, because they do not have to meet the requirements that REITs must meet, can engage in a wider range of real estate-related and other activities and can better manage their dividends, although they do not enjoy REITs’ favored tax treatment.

Moody’s analysis also includes a review of a property firm’s stock market valuations and bond pricing. We examine a property firm’s relative stock performance against peers; relative Price/Earnings multiple and trends in the multiple (for REITs we use Funds from Operations⁷ as the proxy for earnings); and debt and credit default spreads. Stock market performance also speaks to capital access, as well as shareholder pressures and expectations being placed on management. If a firm’s stock price or P/E is weak, management might be tempted to boost leverage, buy risky assets, or otherwise shift the firm’s risk profile to rectify the situation. Also, a low stock price can deter management from issuing common stock. Given that REITs are structurally unable to retain much, if any, cash, this is an especially important point. Bond and CDS pricing provide benchmarks for how bond investors are viewing the company and the likelihood of capital access.

MARKET POSITION AND ASSET QUALITY

Analytical Underpinning

- Different property types have varying degrees of risk
- Market leadership results in more pricing power and better deal flow
- Institutional-quality, well-leased and tenanted assets have higher liquidity, more cash flow stability and greater leverageability

Key Metrics

- Size and Asset Market Value
- Asset, Geographic & Tenant Diversification
- Development Activity

Key Considerations

- Market share/leadership:
 - Size and growth rate
 - Strength of franchise/brand
- Portfolio diversity:
 - Geographic
 - Tenant and industry
 - Asset
 - Asset type
 - Economic
- Development activity
- Asset modernity, functionality, location

6. Payout rules vary by nation.

7. Funds from Operations (FFO), as defined by NAREIT, is GAAP Net Income less gains/losses from asset sales, plus depreciation and amortization related to real estate, adjusted for unconsolidated partnerships and joint ventures, extraordinary items, cumulative effect of changes in accounting principles and discontinued operations.

Key Considerations by Rating Categories

| Investment Grade | | |
|---|--|---|
| Aa | A | Baa |
| Superior franchise/brand, sees virtually all transactions in its markets. Gross Assets >\$20 billion* | Excellent franchise/brand, sees most transactions in its markets. Gross Assets \$10–\$20 billion | Good franchise/brand name, sees many transactions in its markets. Gross Assets \$2–\$10 billion |
| Superior portfolio diversity with no single location, tenant, industry or economic sector >5% of GLA or revenues | Excellent portfolio diversity with no single location, tenant, industry or economic sector >10% of GLA or revenues | Good portfolio diversity with no single location, tenant, industry or economic sector >15% of GLA or revenues |
| Development activity <5% of gross assets; superior development track record | Development activity <7.5% of gross assets; excellent development track record | Development activity <10% of gross assets, good development track record |
| Many marquis assets with superior leadership in multiple markets | Several marquis assets with excellent leadership in two or more markets | Good asset quality and leadership in at least one market |
| * Sizes are focused on the US market. Benchmarks for leadership vary from location to location, and property type to property type, depending on geographic size and characteristics. Thus, the amount of assets required to achieve leadership in a small market will likely be less than in a large market. | | |

| Non-Investment Grade | |
|--|--|
| Ba | B |
| Modest franchise/brand, Gross Assets <\$2 billion | Low franchise/brand, Gross Assets <\$1 billion |
| Material concentrations by tenant, industry or economic sector with concentrations >20% of GLA or revenues | Material concentrations by tenant, industry or economic sector with concentrations >25% of GLA or revenues |
| Development activity >10% of gross assets, variable development track record | Development activity >15% of gross assets, variable development track record |
| Many average or lower quality assets, little leadership | Mostly lower quality assets, little leadership |

The inherent riskiness of different property classes has a significant effect on our ratings of REITs and REOCs. One of the key attributes Moody's look for is stability of cash flows and values. Stable cash flows increase our confidence that the debt can be serviced on a timely basis, and stable values enhance the ability to sell or to refinance properties in order to have the capital available to meet debt service and grow the business.

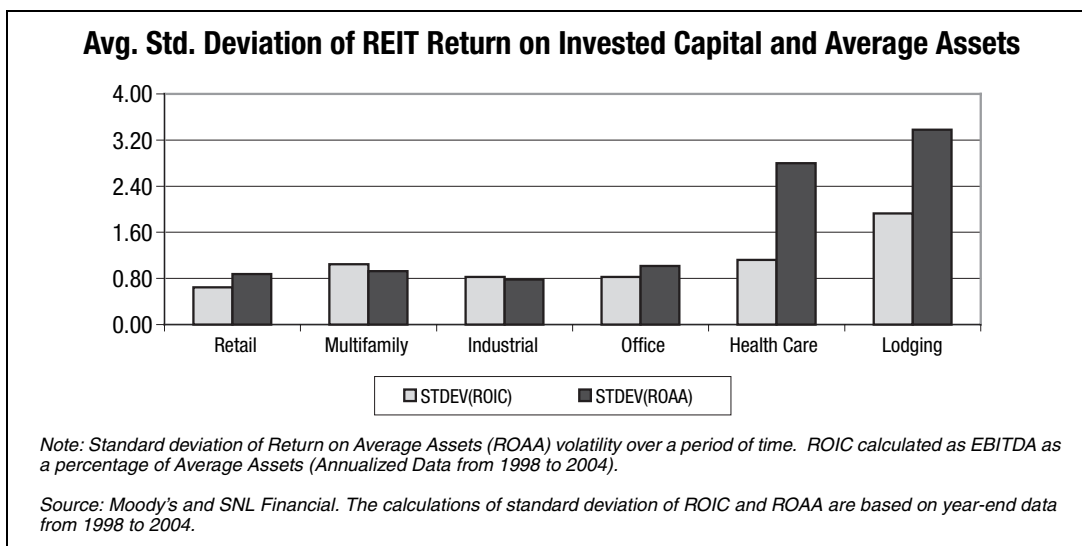
In specific, we look at a firm's geographic, tenant, industry and economic diversification, and lease structures, to help assess the overall quality of a REIT's or REOC's portfolio. Geographic diversification allows a firm to weather economic challenges in certain regions or cities *vs.* others. However, being diversified just by geographic footprint does not necessarily imply effective diversification, as different geographic markets can be correlated as they relate to economic and industry factors. For example, high vacancies for an office REIT due to a challenging technology or telecommunications environment could affect a REIT's cash flows with properties located in Northern California, Boston and Northern Virginia. Some leases, such as in Argentina, can be broken by the tenant at short notice. Other leases are long term, triple-net and fixed, perhaps with intermittent scheduled rate increases. Still others are long term with upwards-only rate revaluations; this is typical of the UK. Such differences in lease structures can affect property quality.

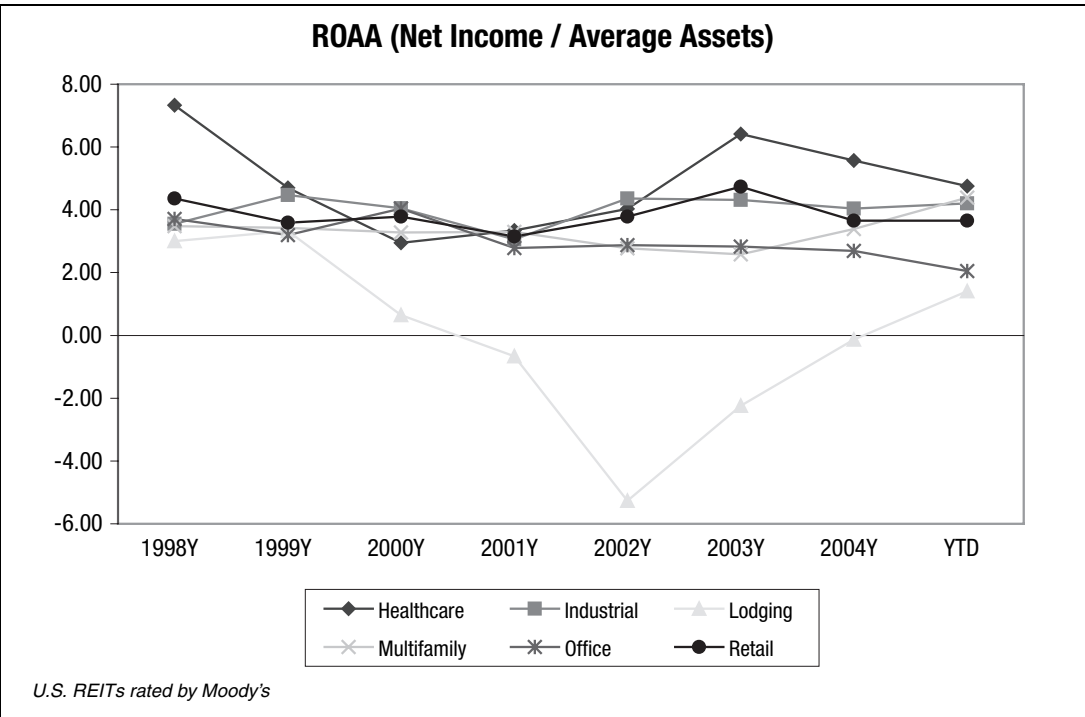
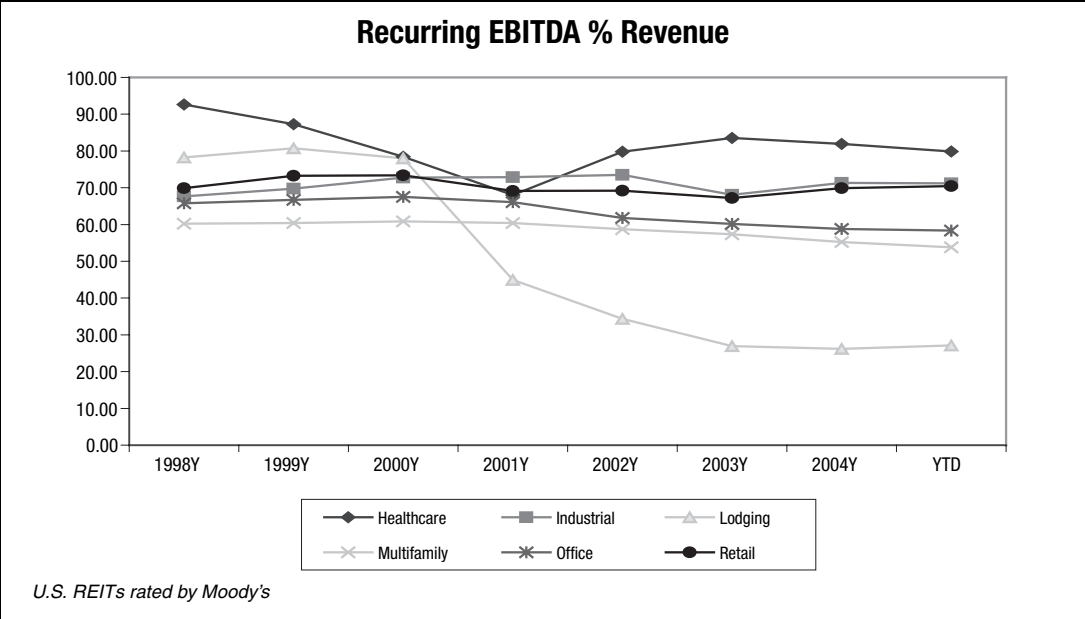
A diversified portfolio (by size, geography and tenant base) located in densely populated areas, in central or close-in suburban areas of major cities, is usually more stable. In general, Moody's believes that high-quality properties, commonly referred to as "Class A", offer the best protection. These assets enhance the flexibility of a REIT or REOC because there is a wider universe of tenants, and debt and equity investors. Liquidity in all its dimensions is better: Class A assets tend to have a higher likelihood of being more attractive and marketable than Class B and Class C assets at the time of sale or refinance. That is not to say, however, that Class B properties do not provide good protection, especially if the REIT or REOC specializes in the class and property sector. For example, in the USA Class A multi-family properties suffered more performance pressure than did their Class B counterparts during the early 2000 recession because the tenants in Class A apartments were more apt to be homebuyers, especially with the historically low interest rates. Class B tenants are more renters-by-necessity.

Moody's analysis includes an examination of a REIT's or REOC's property investment portfolio and the relevant markets in which its assets, or operators, are located. Matters such as occupancies, lease expirations, market rents, regulatory trends, and the physical condition and competitiveness of the properties are also evaluated, as are each property's location dynamics, tenant or operator mix and quality, supply prospects and barriers to competition that can protect the property from economic value erosion. We also assess the likely performance of a REIT's or REOC's portfolio under adverse scenarios, such as high vacancy rates and low rents, as well as differing capex needs. We further examine known and potential environmental and regulatory liabilities. Moody's seeks to understand the effects of both national and regional economic trends on the property portfolio, and the extent to which the REIT or REOC can manage its position. We also examine the REIT's or REOC's economic role in the context of national and regional economic development.

REIT AND REOC SECTOR DIFFERENCES

Cash flow characteristics vary by property type, and the quality of individual real estate assets varies, too, even within sectors. The table below indicates property types from most stable to least stable. Though this ranking is most applicable to the USA, it is indicative of other property markets, too. However, risk characteristics of different property sectors can and do vary by sector and subsector by nation. For example, housing is heavily government influenced in most nations, and this can markedly affect apartment values. Also, zoning, development approvals, property lease laws, and industry structures affecting the mix and quality of tenants, to name but a few factors, all affect the volatility of cash flows and values of various property sectors, and all of these factors can vary by nation, and by region within a nation. Due to risk/quality overlaps between sectors, and the presence of distinct subsectors, this ranking is only broadly indicative.





More

Stability

Less

Varies

Regional Malls/Outlet Centers

- Tend to have considerable barriers to competitor entry
- Vulnerable to competition from discounters/Big Box, a growing worry especially for “B” and “C” quality malls in moderate-income areas; B and C malls are becoming a less and less stable asset sub-class
- Capital- and management-intensive; premium on management and size of portfolio
- Challenges with anchor consolidation and drawing power
- Substantial ownership consolidation, with several emerging leaders
- Outlet is a distinct sub-type, highly consolidated, premium on tourist/urban locations and property size
- Lifestyle centers rising, but resilience of new properties not yet proven; location, size and tenant mix/lease structure especially important
- Focuses: tenant mix; location; regional and national leadership of owner; tenant sales per square foot; occupancy costs
- Outlook: widening volatility difference between strong/weak properties and large/small owners

Community Retail

- Offer day-to-day necessities rather than luxury items, tend to be more resistant to recessions
- Often are dependent on rents from lower quality — often local — tenants, or from weakening anchors in the volatile grocery or discount sectors
- Rising threat of discounters and supercenters, especially for less well positioned properties in moderate income areas; this is a growing challenge, likely resulting in a rise in the sector’s volatility
- Larger, multi-anchored properties more resilient
- Focuses: traffic, visibility and infill nature of locations; anchor health and leadership; size of center and of anchors, and number of anchors
- Outlook: widening volatility difference between strong/weak properties and large/small owners; ownership consolidation rising

Multifamily

- Short-term leases
- Weak ability to control a market area
- Vulnerable to changes in local labor markets
- Vulnerable to single-family affordability — rising homeownership reduces MF demand
- Strong asset liquidity
- In USA, GSE funding is ample and stable
- REITs often in markets with high home prices, boosts MF demand and revenue stability
- Focuses: location in high barrier-to-entry market; regional diversity; property modernity; diversity by property subtype; cost mgt
- Outlook: volatility characteristics should remain stable

Industrial

- Warehouses, light assembly, flex space and distribution facilities
- Modest capital expenditure required for tenant rollover
- Short construction periods mitigate overbuilding risks
- Many triple-net lease structures
- Location often crucial
- Obsolescence and shorter term leases, commodity nature of asset
- Majority of tenants tend to be smaller and of modest credit quality
- Focuses: product and geographic franchises; property modernity; diversified tenant bases and tenant leadership; 3PL skills for large warehouse subsector; use of funds and JVs; location, esp. proximity to key road networks, airports, rail
- Outlook: volatility characteristics should remain stable

Office

- Lease terms are often short, vary by market
- Assets subject to fairly rapid obsolescence and new supply
- Capital-intensive, with low barriers to entry in most markets
- High cost of re-leasing space (tenant improvements and leasing commissions) constrain cash flow
- For CBD class A properties, tend to see higher credit tenants and longer term leases
- Focuses: leadership in high barrier-to-entry-markets; geographic, economic and asset diversity; tenant quality and diversity; asset modernity; use of JVs
- Outlook: volatility characteristics should remain stable

Health Care

- Funding vehicles for the health care industry — healthcare facilities and mortgages
- Vulnerability to volatility of operators’ business fundamentals; endemic operator concentrations
- Exposure to government-driven funding shifts (especially Medicare and Medicaid in USA), which are linked among operators
- Certificates of Need and similar rules limit building for some property subtypes, such as skilled nursing and acute care hospitals
- Low barriers to entry in assisted living facilities
- Complex management issues with medical office buildings, importance of being “on campus”
- Positive demographic trends
- Focuses: asset type, payment and tenant diversity (usually linked); location; tenant underwriting and monitoring skills
- Outlook: volatility characteristics should remain stable

Lodging

- Operating business characteristics are important
- Changeable net operating income due to daily movements in occupancy and room rate; particularly sensitive to economic conditions
- High operating leverage and capex
- Management- and capital-intensive
- Modest barriers to new construction
- Focuses: diversity by location/guest driver, flag, operator and lodging subsector; modernity of asset
- Outlook: volatility characteristics should remain stable

Mortgage REITs

- Tend to have high levels of secured debt, with vulnerability to shifts in advance rates on secured debt
- Tend to have high levels of short-term debt
- Often have complex, opaque interest rate vulnerabilities
- Credit risk of assets varies widely, from negligible to high
- Commercial mortgage REITs tend to have chunky assets that are illiquid; RMBS assets tend to be liquid, easy to fund
- Effective leverage can be high
- Focuses: leverage; ALM risks; capital structure and funding risk; asset quality/liquidity/finance-ability

For lodging, healthcare and commercial mortgage REITs in particular, to be placed in the same rating categories as the other property sectors requires them to employ more conservative capital structures and higher levels of liquidity and performance.

SUSTAINABILITY OF CASH FLOW AND EARNINGS

Analytical Underpinning

- High, consistent returns, with revenue growth, indicate an attractive business segment, good management and a sound business plan
- Lease structures are indicative of earnings predictability

Key Metrics

- Earnings Momentum
- Fixed Charge Coverage
- Gross Margins

Key Considerations

- Operating margins, efficiency
- Volatility of returns
- Earnings growth rate

Key Considerations by Rating Categories

| Investment Grade | | |
|--|---|--|
| Aa | A | Baa |
| Recurring EBITDA margins >75%, leads peers | Recurring EBITDA margins >65% | Recurring EBITDA margins >55% |
| Volatility of return on average assets (standard deviation of ROAA) <0.5; ROAA >7% | Volatility of return on average assets (standard deviation of ROAA) <0.75; ROAA >5% | Volatility of return on average assets (standard deviation of ROAA) <1.0; ROAA >4% |
| Earnings growth has been consistently positive, leads peers | Earnings growth has been mostly positive | Earnings growth varies with cycles, but is positive long term |
| Fixed charge coverage consistently >4X | Fixed charge coverage consistently >3X | Fixed charge coverage consistently >2X |

| Non-Investment Grade | |
|--|--|
| Ba | B |
| Recurring EBITDA margins >50% | Recurring EBITDA margins <50% |
| Volatility of return on average assets (standard deviation of ROAA) <2; ROAA >2% | Volatility of return on average assets (standard deviation of ROAA) <3; ROAA <2% |
| Earnings growth variable, flat to slightly positive long term | Earnings growth variable, flat to down long term |
| Fixed charge coverage usually <2.0X | Fixed charge coverage usually <1.7X |

The commercial real estate industry is cyclical and capital-intensive by nature, and real estate cash flows are therefore volatile. Operational cash flows are ultimately reflective of the quality of a REIT's portfolio (see above) and of its management's ability to create and enhance the value of its assets. In general, cash inflows are affected by such factors as the quality and type of the real estate portfolio, lease structures, tenant quality, the prospects for rental growth, borrowing, asset sales, equity issuance and occupancy rates. Cash outflows include debt service, asset acquisitions, taxes, asset maintenance, dividend requirements and capital improvements.

The consequences of the low level of retainable cash at REITs are multifold. Retained cash flow endemically is thin and cannot, therefore, be used to fuel growth, or service debt. The only way to grow is to constantly raise capital — equity and/or debt, or through asset sales. Similarly, the only way to repay debt, under normal conditions, is through refinancing — again, capital access. These inherent characteristics are important when analyzing the financial flexibility of a REIT. Retained cash, in the case of REOCs or REITs paying (relatively) low dividends, has many positive attributes, from strengthening bondholders' position (more cash is available for debt repayment and long-term growth) to providing a lower cost of capital for the REIT. To the extent REITs are able to achieve greater earnings retention there is a better cushion for bondholders. Many REITs use dividend reinvestment programs (DRIPs) as a means to encourage shareholders to reinvest in the company. The extent to which DRIPs are successfully utilized varies from company to company and region to region. In Australia, for example, DRIP acceptances are often in the 40%-50% range, and have provided a significant source of funding for many LPTs, which is the Australian term for a REIT.

REITs' dividend requirement is a major cash flow analytical factor, as are their asset sale restrictions. In most cases, REITs still tend to pay dividends well in excess of the minimum tax requirement, depleting the cushion that results from depreciation and amortization.

In the case of US REITs that are structured as UPREITs (Umbrella Partnership REIT) — whereby the REIT owns an interest in an Operating Partnership, which in turn owns the real estate assets — most all of the unitholders of the operating partnership have contributed assets to the REIT. Often these asset contributions, for tax purposes, have sales restriction arrangements incorporated into the contribution agreement. These sales restriction arrangements usually restrict the REIT from selling the contributed asset for a certain amount time (sometimes many years) unless the party that contributed the property agrees to the sale or the sale is conducted as a tax-free exchange. These restrictions, especially during a stressful operating environment, can restrict a REIT's ability to access quality cash flow from its portfolio. In other cases, the REIT is required to maintain secured debt against the property — again to protect the tax status of the contributor. This, too, hurts a REIT's flexibility. These characteristics become especially problematic if the contributing party is also a REIT manager or Board member, with conflict of interest concerns.

INTERNAL AND EXTERNAL OPERATING ENVIRONMENT

Analytical Underpinning

- Company track record is an indication of future performance under adverse operating conditions
- Ownership/corporate structure/governance indicate factors motivating management's actions; checks and balances
- Depth of organization relates to company's ability to respond to changing market and operating conditions, and affects the scalability of a company
- Management vision and risk appetite suggest potential volatility in growth, earnings and capital structure
- Economic environment plays a role in funding ability and cash flow stability
- Property market fundamentals influence current and future performance and cash flow stability
- Competitive position suggests property firm's ability to weather adverse market conditions

Key Metrics

- Historical financial statement analysis
- Corporate governance assessment
- Risk management assessment
- GDP, job growth, yield curve data
- Local property market conditions and supply
- Size and asset market value

Key Considerations

- Management strategy, risk appetite and governance
- Depth of organization – MIS, personnel skills and size
- Joint ventures and Fund businesses

Key Considerations by Rating Categories

| Investment Grade | | |
|--|---|---|
| Aa | A | Baa |
| Superior management team, organizational flexibility and depth, and governance JVs and fund business solidly established, represent <5% of revenues | Excellent management team, organizational flexibility and depth, and governance JVs and fund business well established, represent <10% of revenues | Good management team, organizational flexibility and depth, no acute governance problems JVs and fund business are relatively recent, represent <15% of revenues |

| Non-Investment Grade | |
|--|--|
| Ba | B |
| Moderate depth of management team and organizational flexibility, some key-person risk JVs and funds business unproven, represent >15% revenues | Modest depth of management team and organizational flexibility, likely key-person risk JVs and funds business unproven, represent >20% revenues |

INTERNAL OPERATING ENVIRONMENT

The dynamics of the commercial property industry require Moody's to consider, for instance, the nuances of particular property types, as noted above. Just as critical is Moody's consideration of each issuer on its unique merits. We look to the internal operating environment for a particular issuer and focus on track record, corporate structure, management vision, risk appetite, joint ventures, fund businesses, and covenant considerations, which are discussed below in greater detail.

Company Track Record

How long the business has been operated as a REIT or REOC is factored into Moody's analysis. REITs and REOCs that have been around for several years have demonstrated management's relative ability to weather adverse real estate and capital market conditions, as well as provided insight into their risk temperaments. Many REITs and REOCs do not have a long history operating as public companies, and in these cases we look at how successfully management has operated as a company before converting to a public REIT or REOC.

Ownership/Corporate Structure⁸

Major inside ownership is often viewed as a stabilizing factor to the extent that senior management is motivated to develop the company conservatively and with a long-term vision. Also of importance is the management structure of a given REIT or REOC. Is the REIT or REOC self-managed or externally advised? Is it fully integrated? Self-managed and fully integrated (meaning the firm is responsible itself for most key functions, such as development, acquisitions, underwriting, asset management, asset sales, finance) REITs and REOCs tend to have the most operational flexibility and less potential for conflicts of interest. For example, potential conflicts may arise when a company is externally managed pursuant to a management agreement that was not negotiated at arm's length, or when the management company manages or leases properties on behalf of third parties or itself. Management agreements are also examined to determine the motivations of managers, and whether, for example, managers are paid by size, short-term performance or long-term performance.

For US REITs, the distinction between the traditional REIT *versus* the UPREIT structure is also considered. In assessing an UPREIT, we seek to understand the legal and accounting aspects of the structure and potential for structural subordination, the strategic rationale, and particularly any potential conflicts of interest.

8. Special Comment: "Observations Of Governance In U.S. REITs," September 2005. Rating Methodology: "U.S. and Canadian Corporate Governance Assessment," August 2003.

Depth of Organization

Moody's analysis incorporates our evaluation of the REIT's or REOC's operating skills and technological development. This relates to how well the firm approaches operating challenges (such as tenant bankruptcies or new supply) and opportunities (such as replacement of tenants, large acquisitions and strategic mergers) in order to maximize the value of its property portfolio and business platform. We also focus on management's ability to shift resources, including the firm's informational and technological infrastructure, in response to changing market conditions. The quality, depth, and relevance of the information made routinely available to management are of particular interest.

Moody's examines how long the senior management has been a team, as well as its management style and temperament, depth and succession plans. This is especially significant when the most senior managers are approaching retirement age and have had dominant roles, such as founding the company and maintaining key relationships with tenants and financing sources. The composition, quality and independence of a REIT's board, and the relationships among board members and management, are important to explore, and can sometimes be crucial rating drivers.

Management Vision and Risk Appetite

We review the nature, realism and success of management's long-term strategies, including plans for growth. As a means to supplement internal revenue growth, many companies actively engage in acquisition and development. Moody's assesses the related risks in the context of the REIT's or REOC's resources, capital structure and operating strategies. Our analysis considers risk factors such as market risk, project risk, and management's track record with regards to adding value. A company that grows too quickly may experience integration challenges and weaker underwriting if it has not properly enhanced its internal controls. With regards to development, Moody's considers the size and mix of the pipeline relative to the company's asset base, as well as history of completing projects on time and on budget. In addition, Moody's distinguishes between those projects that are at least partially pre-leased and those that are more speculative. Insofar as a strategy appears to be aggressive, we more closely seek to understand how management intends to implement such a strategy. Management's track record is also scrutinized when assessing their ability to create and enhance the value of property assets and accessing the capital markets.

Joint Ventures and Fund Businesses

Joint ventures and fund businesses provide other means of capital access for REITs and REOCs and diversification of earnings, but are complex structures and create varying degrees of transparency and risk issues. In addition, a REIT's or REOC's earnings quality can be diminished if a large proportion of earnings is being generated by these structures. All the same, joint ventures and fund businesses provide a mix of ratings-positive and ratings-negative characteristics, with the exact balance being a function of particularities for the deals, and the overall percentage of such deals in the REIT. In modest amounts, and for the right reasons, JVs and funds can be a plus. Funds, however, which tend to be institutional investment vehicles in which the REIT takes a small stake, and from which the REIT generates development, promote, management and similar fees, can best be seen as a distinct line of business, as opposed to JVs, which are more means of executing acquisitions, attracting capital, leveraging the business strategy or reducing the concentration of individually large assets.

| Benefits of JVs and Funds | Challenges of JVs and Funds |
|--|---|
| <ul style="list-style-type: none"> • Alternative source of capital and cash • Short-term stable stream of cash flow from management and leasing fees • Permits participation in deals the REIT could not do on its own • Can dilute concentration of large assets • Boost REIT's control over a property sector or geographical region by allowing it to manage more properties with less capital commitment • Diversifies property firm's business, potentially providing more diversification of income streams, asset types and location • Partner may offer expertise the property firm does not have | <ul style="list-style-type: none"> • Diverts management time from core business; high "hassle factor" • JV and funds investments are illiquid, and <i>de facto</i> control is limited, too • Winding up JVs and funds can be complex and create substantial funding needs to buyout partners • Conflicts of interest may arise in form of allocation of tenants, assets or resources • Is a more leveraged, risky strategy than direct ownership, often done to "make the numbers work" due to the modest returns on the asset • Transparency challenges surrounding fee structure (true deal economics), performance, debt obligations, liquidity/sale limitations • Usually have high levels of secured debt |

Transparency varies with the type of joint venture or fund. In general, REITs tend to participate in co-investment JVs, which have relatively good transparency, and are, for the most part, evaluated on a *pro rata*, consolidated basis. These co-investment JVs are usually intermediate-term arrangements in which risks are shared based on the ownership percentage, often with large institutional partners. The REITs retain the management and leasing fee income generated from the properties, and generally have a defined exit strategy for the venture. Moody's views REITs' JV development agreements with private developers as less transparent. Under a development agreement, the JV develops the property and, after the property has been stabilized, sells the property back to the REIT. These JV developments are usually shorter term arrangements in which risks are not shared equally and the REIT is usually committed to buy the property. REITs that are involved with development joint venture agreements are commonly evaluated on a fully consolidated basis, as they are really financings.

| Analytical Framework for Property Investment Structures | |
|--|--|
| Merchant Building | <ul style="list-style-type: none"> • Growth trajectory of revenues as percentage of total revenues; analyze stability • Income from development fees and gains is haircut to reflect volatility of this source of cash flow; over time and with stronger track record, these reductions can be reduced |
| Real Estate Funds | <ul style="list-style-type: none"> • Fund business is new to REITs and have not yet been proven as sustainable businesses • As a track record is created, a rising portion of these revenues would count as recurring • Assets on balance sheet are illiquid, not leverageable |
| Joint Ventures | <ul style="list-style-type: none"> • Balance sheet and income statements are analyzed on a <i>pro rata</i> consolidated basis • If the JV is strategic to the REIT's overall business, we fully consolidate • Viewed as less risky than fund businesses |
| Non-domestic Investments | <ul style="list-style-type: none"> • Subject to a high level of scrutiny, additional worries include skill base of REIT, FX and tax risks, and liquidity |

Moody's is concerned with these alternative strategies for growth, and continues to monitor the trajectory of these revenues as a percentage of total revenues, and analyze their stability. As part of the analysis of performance, we take a material haircut on income that is derived from development fees and any gains or fees from merchant building, as this type of income is more volatile than cash flow generated by the core asset-owning business of the REIT. Over time and with a stronger track record, these haircuts are reduced, but such cash flows are generally inherently less dependable than cash flows from rent.

Real estate funds are typically multi-investor vehicles, which include some level of modest co-investment and sometimes merchant building by the REIT. The REIT also provides advisory services which generate fee income from development, asset management, leasing and property management. The funds business is new to REITs, and they have not yet proved themselves as sustainable businesses. As funds tend to have finite lives, they do not have the revenue reliability of wholly owned assets, and we do not count earnings as recurring. Should a REIT develop a track record in the funds business, we would be able to count a portion of revenues as recurring, but it will take several years, and a demonstrated franchise and capacity to consistently create new funds, for this to happen. Although these fund structures provide other means of capital access for REITs and REOCs and diversification of earnings, real estate fund structures particularly contribute to transparency challenges. Also, there are potential conflict issues to consider between the REIT, which has its own assets and business, and those of its fellow fund investors. These funds liquidate at some point, and equity stakes in funds are highly illiquid until then. Fund structures can also take up much management time — especially senior management, a cost that often is ignored in profit computations. The fund business is also, at its heart, a new business line, and it is not yet clear that REITs will be successful in it. Can they keep creating new funds to replace those winding up? And do the costs — all of the costs — generate a competitive risk-adjusted return *vis-à-vis* wholly owned assets?

Joint Ventures (JVs)

Most REITs are considering, or have commenced, joint ventures to enhance investment returns through fees and promote structures. In many respects they are similar to funds, though usually less risky. Debt maturity schedules that do not incorporate the REITs' exposure to JV-level debt misrepresent the REITs' liquidity and leverage. Although JV structures usually allow for the REIT to retain control over the daily operations of the properties, as a practical matter, the REIT does have to consult with its JV partners on asset management matters. This can crimp the REITs' flexibility, and distract management's attention. JVs also tend to be burdened with mortgages (like funds structures), further subordinating bondholders and using scarce secured debt capacity. While in some cases a JV is needed due to the desires of existing owners, and can also be a diversification vehicle for particularly large assets, for the most part JVs are means of issuing perceived-to-be-cheaper "letter stock" and to boost nominal returns at the expense of transparency, higher real risk and control.

Investments Outside the Home Market

More REITs and REOCs around the world are expanding outside their home markets, often through JVs or funds, which can create governance, management, legal, currency, political, liquidity, tax, exit and cash flow complexities. There are also the benefits to consider: diversification, growth, leveraging a skill base into new markets, and better serving key tenants with worldwide operations. Moody's subjects these investments to a high level of scrutiny as it relates to earnings potential and risk/reward balance, and their effects on a REIT along the lines outlined above, as well as transparency, control, FX and tax matters. At this stage of development, we see international activities as a moderate risk. However, the strategic benefits and returns will need to be robust to compensate for the risks.

Covenant Considerations

Covenants play an important role in Moody's rating process, and they support ratings, which encompass both the likelihood of default and the loss content should default occur. However, the analysis focuses first and foremost on the fundamentals of the business.

*What covenants can do*⁹

We believe that covenants place meaningful parameters on the amount of risk that bondholders bear. Covenants also provide management with risk guidelines. Managements' strategies and goals may change over time, but covenants, generally, will not.¹⁰ Covenants can trigger a recapitalization or acceleration while the firm likely retains material value in its property portfolio, which should enhance recovery values for debtholders, including preferred stockholders. Also, if there is a major restructuring of a firm, its covenants may cause it to take out affected creditors.

What covenants do not do

Covenants seldom protect companies against event risk. REITs' bond covenants are not liens, and the bondholder has no control over the mix, quality or character of the unencumbered pool. Also, REITs are vulnerable to poor governance, risky and suddenly changed business or financial strategies, adverse regulatory and tax shifts, malfeasance and similar ills to which all operating businesses are exposed. Strong covenants do not make a weak firm or business model strong, and Moody's cannot dictate or require covenants.

We monitor covenant calculations, and regularly evaluate the level of cushion a property firm has before tripping a covenant. In the USA, most bond covenants relate to leverage limits, minimum unencumbered asset levels and minimum debt service coverages. However, our evaluation of covenants has an impact on the rating and the notching between different classes of rated securities.¹¹ We also make a clear distinction between bank line covenants and bond covenants. Bank line covenants apply for a shorter term and are also easier to amend and/or renegotiate. Firms' attempts to loosen covenants may indicate a rise in risk appetite, and this "signaling" characteristic is an important matter.

Moody's also notes the presence of any rating triggers or material adverse change (MAC) language in credit agreements. Such clauses are uncommon in the USA, but more prevalent in countries such as Australia. Moody's evaluates the risk that MAC clauses or rating triggers will be invoked, as such circumstances would limit access to the credit facility.

EXTERNAL OPERATING ENVIRONMENT

External operating risks can include national and regional economies, the overall availability of commercial real estate credit, development, tax policy, regulation, and FX and political risks. We focus on three key areas in this section: economic environment, property market fundamentals and leadership position.

Economic Environment

Real estate is a cyclical industry, generally lagging its national/local economy. Moody's looks to trends in GDP, job growth, inflation and interest rates to indicate future space demand, or lack thereof. For instance, job growth is more closely linked to the health of the multifamily and office sectors. The movement of interest rates, up or down, influences a property firm's ability to compete for acquisitions and its rate of growth, *inter alia*.

9. REIT rules in various countries (such as Japan and Singapore) also act like covenants, restricting, e.g., leverage and development.

10. Moody's notes that a handful of US REITs have altered their public bond covenants recently and we expect that more will. Changes that provide the REITs with more flexibility as it relates to total leverage and amount of secured debt is a concern. At this point, changes have tended to be on how items are defined, and these have not yet particularly concerned us. We have, however, not seen a change in REITs' overall appetite towards leverage and secured leverage. Should REITs start using the flexibility of less restrictive covenants and/or issue senior debt without key covenants (such as secured debt limits) to lever up and increase secured debt levels, reducing their unencumbered portfolio, we would expect negative rating pressure.

11. Refer to Moody's Special Comment, "REIT Rating Methodology: Notching Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale," August 2001.

The health of the capital markets directly affects REITs in particular, given their inherent need for external sources of capital. Cap rates and interest rates have diverse effects on REITs' and REOCs' businesses. Moody's has seen that in an environment where interest rates are low and in turn cap rates are low, REITs and REOCs tend to be net sellers of properties. In an environment of low cap rates a REIT's traditional model of capital recycling (selling older or non-strategic properties and using the proceeds to buy/build newer properties or properties in strategic locations, supplemented with debt and equity issuance) can be disrupted because accretive acquisitions are difficult, if not impossible. In this environment, REITs tend to be net sellers of assets to leveraged buyers, and on the flip side face an expensive real estate market. This environment forces them to perhaps execute non-accretive acquisitions, de-leverage in preparation for a more appealing acquisition market later on, shift the business model's risk up via JVs, funds and similar structures to boost nominal returns, or buy back shares and thus leverage up. While asset sales can demonstrate liquidity and high value of investments, they may come at the expense of lower intermediate-term yields on capital, and portfolio quality (better assets are sold).

Moody's monitors such economic factors and the effects of these factors on a REIT's capital recycling plans and overall business risk. We view the use of sales proceeds to de-lever as a temporary credit positive, but monitor ultimate composition and quality of a REIT's portfolio as result of being a net seller.

Property Market Fundamentals

Moody's ratings incorporate a level of tolerance for shifts in market fundamentals within each rating category. Trends in property market fundamentals will impact ratings if we anticipate pressures or benefits will be material and long-lasting, particularly with unanticipated shifts. We examine trends in the following key areas: market vacancies; trends in rental rates, concessions and occupancy costs; supply/demand conditions, in specific development pipelines and rate of new supply deliveries; and absorption trends. We also note demand drivers within local and regional markets, noting if there are particular concentrations in tenants or industries.

Competitive Position

An important focus is whether the REIT or REOC is the "landlord of choice" in its core markets, and whether this leadership position translates into a more profitable competitive position for firms. This leadership may be by type of asset, by location, or both. For example, Sun Hung Kai enjoys an excellent leadership position in multiple property types in Hong Kong, but only focuses on that location. Simon Property enjoys a strong franchise in regional malls and outlet centers in the USA, and Westfield has great strength in regional malls in Australia and New Zealand, and a good position in the USA. Some property types also lend themselves more to stable, profitable leadership than do others. Regional malls and self-storage, for example, have more capacity for franchise-building; it has proved difficult in many markets to generate real price-making leadership in office and apartments. The competitive leadership that is most supportive of high ratings is leadership in multiple asset types in multiple geographic markets, with that leadership translating into higher performance measures, such as occupancy and rate, and getting the first and last look on deals. The watchword is diversity with depth. Moody's focuses on a firm's economic, industry, sub-market and tenant diversification, too, in order to assess leadership resiliency and depth.

Real Estate Accounting Treatments in the Credit Analysis

As part of our analysis, Moody's adjusts an entity's financial statements to arrive at their true economic substance. In certain instances, Moody's believes that the accounting does not reflect the economic substance of a transaction and, as a result, we adjust reported financial amounts to more closely reflect our view of the economics.

The four primary adjustments include our treatment of preferred stock¹², *pro rata* or full consolidation of joint ventures, adjusting the historical cost basis of assets, and the desegregation of certain operations classified as "discontinued" under Statement of Financial Accounting Standards ("SFAS") No. 144, "Accounting for the Impairment or Disposal of Long-Lived Assets" from operating results.

Preferred stock has many characteristics of debt since investors are "promised" a fixed dividend. In addition, we believe, over the long term as interest rates change, preferred stock will be redeemed to adjust a REIT's or REOC's cost of capital. As a result, the debt-like characteristics tend to override the equity characteristics. When analyzing leverage, preferred stock basket allocation for debt is included in the numerator of the leverage (*i.e.*, debt plus preferred stock divided by gross assets). For the calculation of fixed charge coverage, preferred stock dividends are folded into fixed charges, especially given REITs' dividend requirements.

12. For more details, reference Moody's Investors Service: "The Analysis of Preferred Securities Issued by US Real Estate Investment Trusts (REITs)," May 2005; and "Rating Methodology – Hybrid Securities Analysis," November 2003 and "Characteristics of a Basket C Perpetual Preferred," May 2004.

Joint ventures are generally treated as equity method investments¹³ under US GAAP. Equity method investments are reported on the balance sheet at the net investment, less any dividends paid, and adjusted for the company's proportional share of the JVs' net income or loss from the time of the investment. The JVs' income statements are also aggregated into one line item on the investor's income statement and represent the company's proportional interest in the ventures' current period net income or loss. Moody's believes this presentation tends to understate leverage and overstate operating performance. Our approach reverses the effect of equity method accounting and adjusts a company's outstanding debt and EBITDA for either its *pro rata* interest in the venture, or the venture is consolidated in total. Moody's evaluates the terms of the joint venture, as well as its strategic importance and long-term commitment, to determine whether to consolidate it fully or on a *pro rata* basis. International Financial Reporting Standards permit *pro rata* consolidation¹⁴ in many instances, and as a result an adjustment is unnecessary.

Moody's believes that US GAAP financial reporting can distort the true value of real estate companies' assets by representing them on a historical cost basis. In some nations, including those adopting International Accounting Standards (IAS), assets are (or will be upon the introduction of IAS in 2006) regularly revalued. This, too, can create distortions, the level of which depends on how often a company revalues its assets, and the dependability of the revaluations. Also, some firms using historical values turn their assets over often, resulting more or less in market values, whereas some others have owned assets for years, whose historical costs are well below market values. In an attempt to reduce this distortion, and create a truer comparison among companies, Moody's values assets accounted for under US GAAP on a gross basis (adjusting upward for accumulated depreciation) in leverage calculations, as well as on a market value basis, using conservative adjustments. These adjustments facilitate comparisons among property companies. In addition, for those companies revaluing real estate assets with a resulting income statement impact, we eliminate the unrealized income statement impact in our analysis. This treatment is similar to that of realized gains and losses in the calculation of FFO.

SFAS No. 144 requires that the historical and current revenues and expenses, including gain or loss on sale, of a "component" of an entity (a component is considered to comprise operations and cash flows that can be clearly distinguished, operationally and for financial reporting purposes, from the larger entity) held for sale or that has been disposed of, be classified as discontinued operations. For REITs this requirement normally results in properties held for sale or sold being classified as discontinued operations. As selling properties is a regular part of many REITs' normal business operations, this results in a significant amount of each period's earnings being classified as discontinued operations, with annual restatements to prior years for comparability. Moody's believes the "discontinued" classification of these activities makes it difficult to determine a REIT's real estate property business performance and therefore we combine discontinued operations related to these core activities with the operating income from real estate properties that continue to be owned but are not classified as held for sale.

Related Research

Special Comments:

[Observations Of Governance In U.S. REITs, September 2005 \(94031\)](#)

[An Application of Moody's Tool Kit: The Analysis of Preferred Securities Issued by US Real Estate Investment Trusts \(REITs\), May 2005 \(92580\)](#)

[Characteristics Of A Basket C Perpetual Preferred, May 2004 \(86981\)](#)

Rating Methodologies:

[Key Ratios For Rating REITs And Other Property Firms, December 2004 \(91014\)](#)

[Hybrid Securities Analysis — New Criteria for Adjustment of Financial Ratios to Reflect the Issuance of Hybrid Securities Product of the New Instruments Committee, November 2003 \(79991\)](#)

[REIT Rating Methodology: Notching for Differences in Priority of Claims and Integration of the Preferred Stock Rating Scale, August 2001 \(69700\)](#)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

¹³ APB Opinion No. 18, "The Equity Method of Accounting for Investments in Common Stock."

¹⁴ FRS 31, "Financial Reporting of Interests in Joint Ventures."

Appendix 1

Types of Real Estate Entities

- **REOCs.** A Real Estate Operating Company (REOC) is a general purpose corporation that is involved in the commercial real estate business as an owner/manager/developer. It is not constrained by regulation, and can enter or exit any line of business at will. A REOC, unlike a REIT, has no set dividend obligation, and is subject to corporate income tax.
- **REITs.** There are several forms of Real Estate Investment Trust around the world, with differences in what they are called, what their powers are and how they are regulated. As a general rule, REITs:
 - Focus solely on the real estate business as investors or lenders
 - Focus on passive income from rents on properties, or mortgage interest
 - Must pay out as dividends substantially all of their taxable income
 - Do not pay corporate taxes
 - Are publicly and widely held firms

Differences among REITs in various nations tend to be along the following lines:

- The type of legal entity, *e.g.*, corporation or trust
- The extent to which non-passive or non-real estate activity is permitted
- Whether the REIT is internally managed or externally managed
- Whether there are limits on leverage or development activity

A failure to comply with requirements could disqualify a company from REIT status. In turn, this would subject the company to negative tax events, or the tripping of debt covenants. Because of this, our REIT ratings include analyses of what could jeopardize a company's REIT status. Such an event would adversely affect a company's financial strength.

Regional Risk Considerations

Moody's employs the same analytic approach to evaluating real estate companies worldwide. However, REITs and REOCs in each nation have their own laws and regulations, and market practices and nuances which reflect the local political, social and economic climates. These include the character of bank relationships, the size and diversity of property markets and the character of market leadership, governance and capital structures, international activity, planning permission/zoning, leasing structures and accounting. Moody's incorporates these regional factors into its rating process.

Appendix 2

| Rating Driver | Key Considerations | Aa | A | Baa | Ba | B |
|--|---|---|--|---|--|--|
| Liquidity and Funding | <p>Adequacy of liquidity, esp. size, usage and structure of bank lines</p> <p>Funding Structure: - Debt maturity laddering - Dividend coverage</p> <p>Value of unencumbered pool of assets relative to unsecured debt</p> | <p>More than 75% availability on its credit line on average; bank line is more than enough to cover one year's cash needs</p> <p>Annual debt maturities <10% of total debt</p> <p>Average dividend payout <50% FFO</p> <p>Close to 100% unencumbered portfolio</p> | <p>More than 60% availability on its credit line on average; bank line is enough to cover one year's cash needs</p> <p>Annual debt maturities <10%-15% of total debt</p> <p>Average dividend payout 50% - 60% of FFO</p> <p>Portfolio >80% unencumbered</p> | <p>More than 50% availability on its credit line on average; bank line is enough to cover close to one year's cash needs</p> <p>Annual debt maturities <15% - 20% of total debt</p> <p>Average dividend payout 60% - 90% of FFO</p> <p>Portfolio >60% unencumbered</p> | <p>Less than 50% availability on its credit line on average</p> <p>Annual debt maturities >20% of total debt</p> <p>Average dividend payout >90% of FFO</p> <p>Portfolio is >40% unencumbered</p> | <p>Less than 40% availability on its credit line on average, and credit line is likely secured</p> <p>Annual debt maturities >25% of total debt</p> <p>Average dividend payout >100% of FFO</p> <p>Portfolio is mostly encumbered</p> |
| Leverage & Capital Structure | <p>Overall leverage</p> <p>Relative secured debt levels, amount of encumbered assets and cash flow</p> | <p>Debt + Preferred / Gross Assets <15% or Net debt / EBITDA <3.5X</p> <p>Essentially no secured debt</p> <p>Superior access to all sources of private and public capital</p> | <p>Debt + Preferred / Gross Assets <30% or Net debt / EBITDA <4X</p> <p>Secured debt as a percentage of gross assets <10%</p> <p>Excellent access to all sources of private and public capital</p> | <p>Debt + Preferred / Gross Assets <50% or Net debt / EBITDA <6X</p> <p>Secured debt as a percentage of gross assets <20%</p> <p>Good access to all sources of private and public capital</p> | <p>Debt + Preferred / Gross Assets >50% or Net debt / EBITDA >6X</p> <p>Secured debt as a percentage of gross assets <30%</p> <p>Sporadic access to many sources of capital</p> | <p>Debt + Preferred / Gross Assets >60% or Net debt / EBITDA >7X</p> <p>Most all debt is secured</p> <p>Sporadic access to most sources of capital</p> |
| Market Position & Asset Quality * | <p>Market share/leadership: - Size and growth rate - Strength of franchise/brand</p> <p>Portfolio diversity: - Geographic - Tenant name and industry - Asset - Asset type - Economic</p> <p>Development activity</p> <p>Asset quality</p> | <p>Superior franchise/brand, sees virtually all transactions in its markets. Gross Assets >\$20 billion</p> <p>Superior portfolio diversity with no single location, tenant, industry or economic sector >5% of GLA or revenues</p> <p>Development activity <5% of gross assets; superior development track record</p> <p>Many marquis assets with superior leadership in multiple markets</p> | <p>Excellent franchise/brand, sees most transactions in its markets. Gross Assets \$10 - \$20 billion</p> <p>Excellent portfolio diversity with no single location, tenant, industry or economic sector >10% of GLA or revenues</p> <p>Development activity <7.5% of gross assets; excellent development track record</p> <p>Several marquis assets with excellent leadership in two or more markets</p> | <p>Good franchise/brand name, sees many transactions in its markets. Gross Assets \$2 - \$10 billion</p> <p>Good portfolio diversity with no single location, tenant, industry or economic sector >15% of GLA or revenues</p> <p>Development activity <10% of gross assets, good development track record</p> <p>Good asset quality and leadership in at least one market</p> | <p>Modest franchise/brand, gross assets <\$2 billion</p> <p>Material concentrations by tenant, industry or economic sector with concentrations >20% of GLA or revenues</p> <p>Development activity >10% of gross assets, variable development track record</p> <p>Many average or lower quality assets, little leadership</p> | <p>Low franchise/brand, gross assets <\$1 billion</p> <p>Material concentrations by tenant, industry or economic sector with concentrations >25% of GLA or revenues</p> <p>Development activity >15% of gross assets, variable development track record</p> <p>Mostly lower quality assets, little leadership</p> |

| Rating Driver | Key Considerations | Aa | A | Baa | Ba | B |
|---|---|---|--|--|---|--|
| Sustainability of Cash Flow & Earnings | Operating margins Volatility of returns Earnings growth rate | Recurring EBITDA margins >75%, leads peers Volatility of return on average assets (standard deviation of ROAA) <0.5; ROAA >7% Earnings growth has been consistently positive, leads peers Fixed charge coverage consistently >4X | Recurring EBITDA margins >65% Volatility of return on average assets (standard deviation of ROAA) <0.75; ROAA >5% Earnings growth has been mostly positive Fixed charge coverage consistently >3X | Recurring EBITDA margins >55% Volatility of return on average assets (standard deviation of ROAA) <1.0; ROAA >4% Earnings growth varies with cycles, but is positive long term Fixed charge coverage consistently >2X | Recurring EBITDA margins >50% Volatility of return on average assets (standard deviation of ROAA) <2; ROAA >2% Earnings growth variable, flat to slightly positive long term Fixed charge coverage usually <2.0X | Recurring EBITDA margins <50% Volatility of return on average assets (standard deviation of ROAA) <3; ROAA <2% Earnings growth variable, flat to down long term Fixed charge coverage usually <1.7X |
| Internal & External Factors | Management strategy, risk appetite and governance Depth of organization – MIS, personnel skills and size Joint Ventures and Fund Businesses | Superior management team, organizational flexibility and depth, and governance JVs and fund business solidly established, represent <5% of revenues | Excellent management team, organizational flexibility and depth, and governance JVs and fund business well established, represent <10% of revenues | Good management team, organizational flexibility and depth, no acute governance problems JVs and fund business are relatively recent, represent <15% of revenues | Moderate depth of management team and organizational flexibility, some key-person risk JVs and funds business unproven, represent >15% revenues | Modest depth of management team and organizational flexibility, likely key-person risk JVs and funds business unproven, represent >20% revenues |

* Size considerations are focused on the US market. Benchmarks for leadership vary from location to location, and property type to property type, depending on geographic size and characteristics. Thus, the amount of assets required to achieve leadership in a small market will likely be less than in a large market.

Note: This grid applies to commercial property owners, investors, developers and managers rather than merchant builders.

Appendix 3

Hypothetical US REIT Rating Analysis Using Rating Driver Grid

Following is an example of how Moody's Rating Driver Grid can be used to analyze creditworthiness and determine the ratings for REITs and REOCs. For illustrative purposes, the criteria for "A", "Baa" and "Ba" ratings have been included, along with recent data on this hypothetical firm. Moody's also uses past trend data, and rolling averages, to generate insight into REITs' past performance, as well as *pro forma* information, including *pro forma* data under different stress scenarios, to determine the likely direction of the firm, the latter being particularly important. Qualitative matters are important inputs to Moody's ratings — especially our judgment on whether we think the REIT is going to get better or worse, with what level of certainty, and why. Qualitative assessments also figure into the "scoring" of some criteria in the Rating Driver Grid. For example, in determining access to capital markets, Moody's assesses of the predilections of management to issue common stock, as well as comparative stock prices and P/Es, past success at securities issuance, and market tone. It is similar for determining the franchise for this retail REIT we are using as an example, which includes customer, tenant and vendor reputation and relationships, as well as the size and character of the REIT's property footprint. By using Moody's Rating Driver Grid, you can not only determine where a REIT would likely be rated, but also the characteristics most likely to drive an upgrade or downgrade.

For this US REIT, assumed to be an owner/operator/developer of regional malls and community shopping centers, we have a firm with an excellent market position and sound performance record, but with a comparatively weak balance sheet and unusually high development risk appetite for a retail REIT. Also, its range of scores on the factors is not very wide — low-A to high-Ba — and this lack of any glaring weaknesses tends to argue for a higher rating than a simple average would indicate. The REIT's liquidity is good on most measures, and although more liquidity resources would be a plus, it is not a dominant rating driver, and the relative value of better liquidity diminishes as it improves.

Secured debt is an important variable for Moody's, and it is high for this REIT — perhaps tied to the high level of JVs — but this is not uncommon for a REIT with many regional malls in its portfolio. Thus, the high relative burden of secured debt in our factor weighing is attenuated here. Leverage is comparatively high; this is also correlated to the high level of secured debt. Furthermore, given the comparatively robust nature of the asset class, and this REIT's high asset quality, a higher level of leverage is tolerable.

Franchise, asset quality and diversity for this REIT are a plus — a big plus — reflecting the high value of franchise in our rating approach, as well as the defensive traits and value franchise enjoys in the mall property space. Diversity is also a key rating matter, as history has demonstrated that concentrations create acute vulnerabilities to market change. Franchise and diversity tend to be "gateway" variables for achieving an "A" rating. The REIT's excellent asset quality gives material comfort on the re-financeability of its assets, the liquidity of its assets, occupancy trends, and the outlook for the level and stability of earnings.

These qualities are also reflected in the REIT's sound operating performance across all measures. The firm has strong earnings margins with modest to low profitability volatility — a plus. While the REIT's management is deemed excellent — consistent with its franchise and size — with at least a "good" grade being almost a necessity to achieve investment grade — the REIT is heavily exposed to JVs and funds. This is a drag in most cases, and in this one, too, but given the many malls the REIT owns, and the tendency to greater ownership concentration in the mall space, it is likely that some of these JVs reflect individually large assets that were JV'd in order to achieve greater diversity, or because the other owners did not want to sell, and we expect that these JVs will be eliminated over time.

Hypothetical US Retail REIT

| Rating Drivers | Sub-Factors | Figures for Sample REIT | Grid-Implied Rating | Figures | | |
|--|---|-------------------------|---------------------|------------|-----------|----------|
| | | | | A Grid | Baa Grid | Ba Grid |
| Liquidity & Funding | LOC Availability | 65% | | >60% | >50% | <50% |
| | Max. Annual Debt Maturity | 16% | | <10%-15% | <15%-20% | >20% |
| | FFO Payout | 55% | | 50%-60% | 60%-90% | >90% |
| | Amount of Unencumbered Assets | 55% | | >80% | >60% | >40% |
| High Baa | | | | | | |
| Leverage & Cap. Structure | Debt +Preferred/Gross Assets | 53% | | <30% | <50% | >50% |
| | Net Debt/EBITDA | 6.5X | | <4X | <6X | >6X |
| | Secured Debt/Gross Assets | 22% | | <10% | <20% | <30% |
| | Access to Capital | Good | | Excellent | Good | Limited |
| High Baa | | | | | | |
| Mkt. Pos. & Asset Quality | Franchise/Brand Name | Excellent | | Excellent | Good | Modest |
| | Gross Assets | \$14B | | \$10-\$20B | \$2-\$10B | <\$2B |
| | Diversity-location/tenant/industry/economic | Excellent | | Excellent | Good | Weak |
| | Development % Gross Assets | 13% | | <7.5% | <10% | >10% |
| | Asset Quality | Excellent | | Excellent | Good | Avg.-Low |
| Low A | | | | | | |
| Cash Flow and Earnings | EBITDA/Revenues | 67% | | >65% | >55% | >50% |
| | Std. Dev. ROAA | 0.81 | | <.75 | <1.0 | <2.0 |
| | ROAA | 4.5% | | >5% | >4% | >2% |
| | Fixed Charge Coverage | 2.7X | | >3X | >2X | <2X |
| High Baa | | | | | | |
| Internal & External Factors | Management | Excellent | | Excellent | Good | Moderate |
| | JV/Fund Business % Revenues | 20% | | <10% | <15% | >15% |
| Mid Baa | | | | | | |
| Final Rating | | | Mid/High Baa | | | |

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Authors

*Karen Nickerson
Philip Kibel*

Senior Associate

Lin Zheng

Production Specialist

Ida Chan

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