Caribbean Information &
Credit Rating Services Limited

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METHODOLOGY FOR CONSTRUCTION, PROPERTY DEVELOPMENT & RENTAL COMPANIES

The following rating methodology is the generalized version of the methodology that CariCRIS would use to analyse real estate firms.

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1. Cyclicality – HIGH RISK

Residential property development - Key drivers of cyclicality include consumer confidence, disposable income, employment levels and growth, household formation and other demographic trends, property supply conditions, the availability of mortgage loans and consumer financing rates, and the extent of investor demand in the market. The availability of mortgage loans sometimes depends in part on government programs.

Commercial property development (esp. office and retail) – Key drivers are GDP growth, managements' view of economic growth prospects, employment levels and growth as well as property market supply conditions. For large-scale building development, the availability of construction-related and mortgage financing is also critical. In some markets, buying (or developing) and selling of properties by nonstrategic investors can also affect the market at times. Selling price competition can be intense, varying over the course of the cycle.

2. Level and trend of industry profit margins – HIGH RISK

Cyclical demand results in high earnings volatility for homebuilders and developers. To meet demand, they must maintain sufficient land and work-in-progress inventory. In a downturn this exposes builders and developers to valuation losses and substantial carrying costs related to unsold properties. In this regard, developers with large-scale projects face greater risks than homebuilders.

At times builders may be subject to increases in the cost of building materials and labour, which squeeze margins if they are unable to pass along these higher costs. Developers of technically demanding projects may also be subject cost overruns from construction problems and delays.

3. Competitive risk and growth – MEDIUM RISK

Barriers to entry are relatively modest in many local markets. However, it takes considerable capital, access to land, construction project management and marketing capabilities to compete on a national/multi-project level. During difficult markets, an important differentiator is access to capital. Given the much greater scale, technical and marketing challenges, and funding requirements related to large development projects, barriers to entry for developers are typically higher than for homebuilders.

4. Risk of secular change and substitution of products, services, and technologies – MEDIUM RISK

Given the breadth and scope of the industry participants, any provider of housing units--for sale or rental--may be considered a competitor. Likewise, users of commercial properties generally have a range of alternatives, such as newly constructed or existing properties, renting or buying, and various grades of property types.

5. Risk in industry growth trends – MEDIUM RISK

Long-range demographic trends are favourable for demand in residential and commercial property development. As a result, revenue growth generally is expected to exceed GDP growth during economic expansions, though downturns can be more severe than those in the general economy.

BUSINESS RISK FACTORS

Competitive advantages

a. Size and market share. Companies with greater scale and market share may be better able to attract capital to support growth, gain economies of scale, enjoy better access to well-situated land parcels, create some pricing advantage, retain access to the best sub-contractors and vendors, and support investment in systems to enhance sales effectiveness and better understand its target end market.
b. Effectiveness of marketing strategy. Reflected in its reputation, the variety and appeal of the property designs it offers, the attractiveness of its development, including location and amenities, and its price strategy. Performance indicators include the rate of new orders, contract backlog value, order cancellation rates by market, and average selling price per unit compared with market averages.
c. Land procurement. The ability to source attractively situated land parcels in sufficient quantity to support growth. This may be particularly critical for developers that operate primarily in densely populated urban areas.
d. Sales support. Some builders and developers offer mortgage finance assistance, which can help customers to obtain financing in a timely fashion and also generate fee income for the company
e. Business strategy execution - The developer's ability to undertake large-scale, complex projects may be a key differentiator, but such projects also add to execution and concentration risks. Developers also must manage the balance between building residential or commercial buildings, and whether to sell properties for immediate returns or hold onto properties for recurring income. The need to adapt to changing market conditions--particularly in that are subject to rapid acceleration or deceleration of demand and where reliable market data may not be available--adds to management challenges.

Operating efficiency

- Ability to procure attractively situated land parcels on a cost-effective basis.
- Working capital management, including control of land and building inventory.
- Cost structure, as influenced by building/construction, marketing, and overhead costs.