Rating Methodology – Real Estate Sector

[Issued in March 2021]

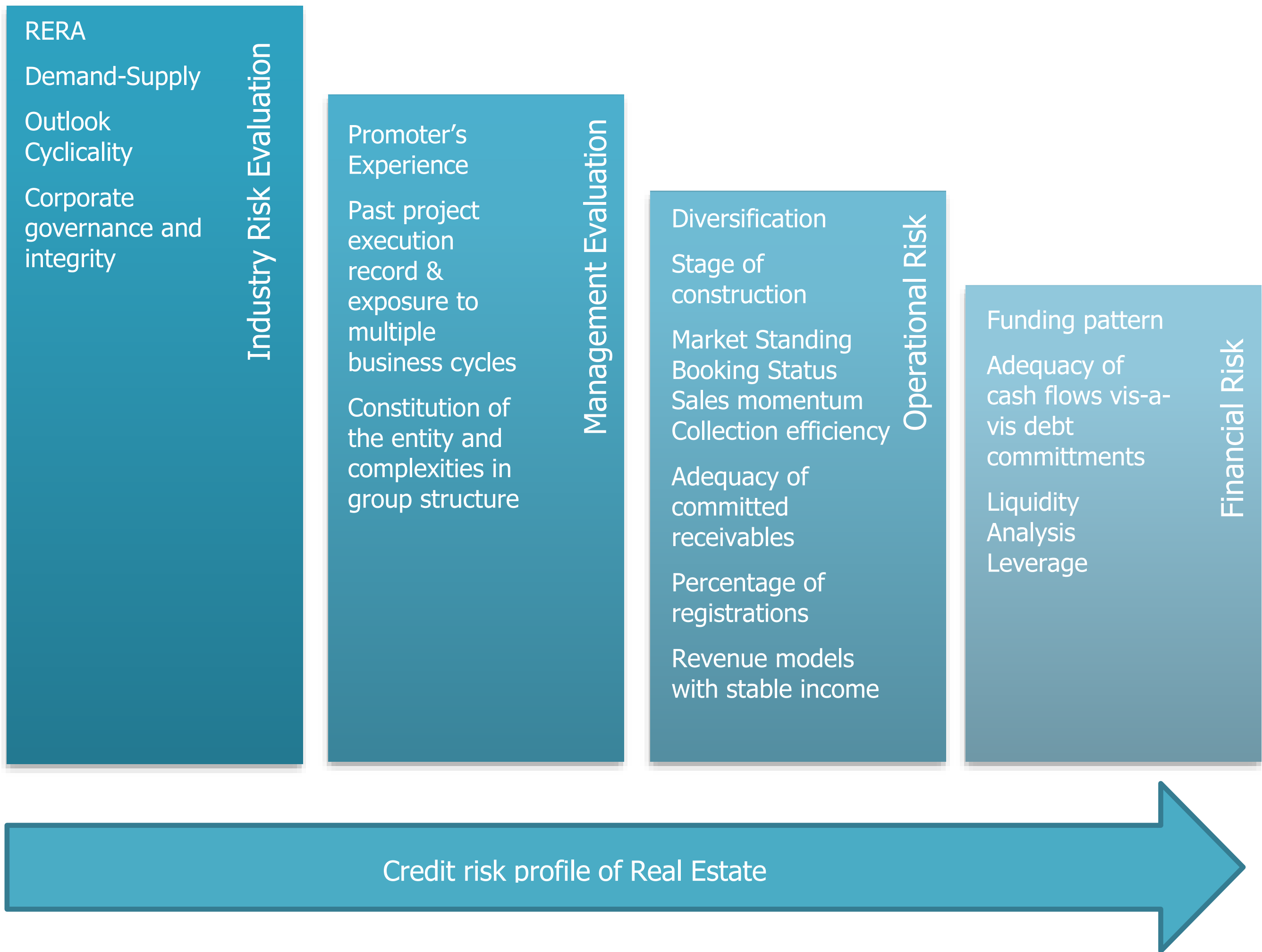
Industry Overview:

Real estate sector plays an important role in the Indian economy. It is one of the largest employers after agriculture & textile and has numerous allied industries like steel, cement, glass, sanitary fittings, plywood, concrete blocks, construction to name a few linked with it. Broadly, the sector can be classified into two segments- Residential and Commercial. In case of residential space, the demand is determined by a combination of factors like property prices, urbanization, interest rates, economic growth, income levels, etc., whereas the demand for commercial space is directly linked to the prevailing macroeconomic environment and foreign investments in India. The sector was not much regulated earlier, however, lately it is headed towards greater transparency and accountability after the introduction of Real Estate Regulation and Development Act, 2016 (RERA) and various other regulatory initiatives. Assessing the credit profile of a real estate entity calls for an entirely different approach when compared to a typical manufacturing concern. The sector is unique as direct comparison of financial performance of different players may not be meaningful due to different revenue recognition policies followed, thus placing greater emphasis on cash flow analysis.

Methodology and its scope:

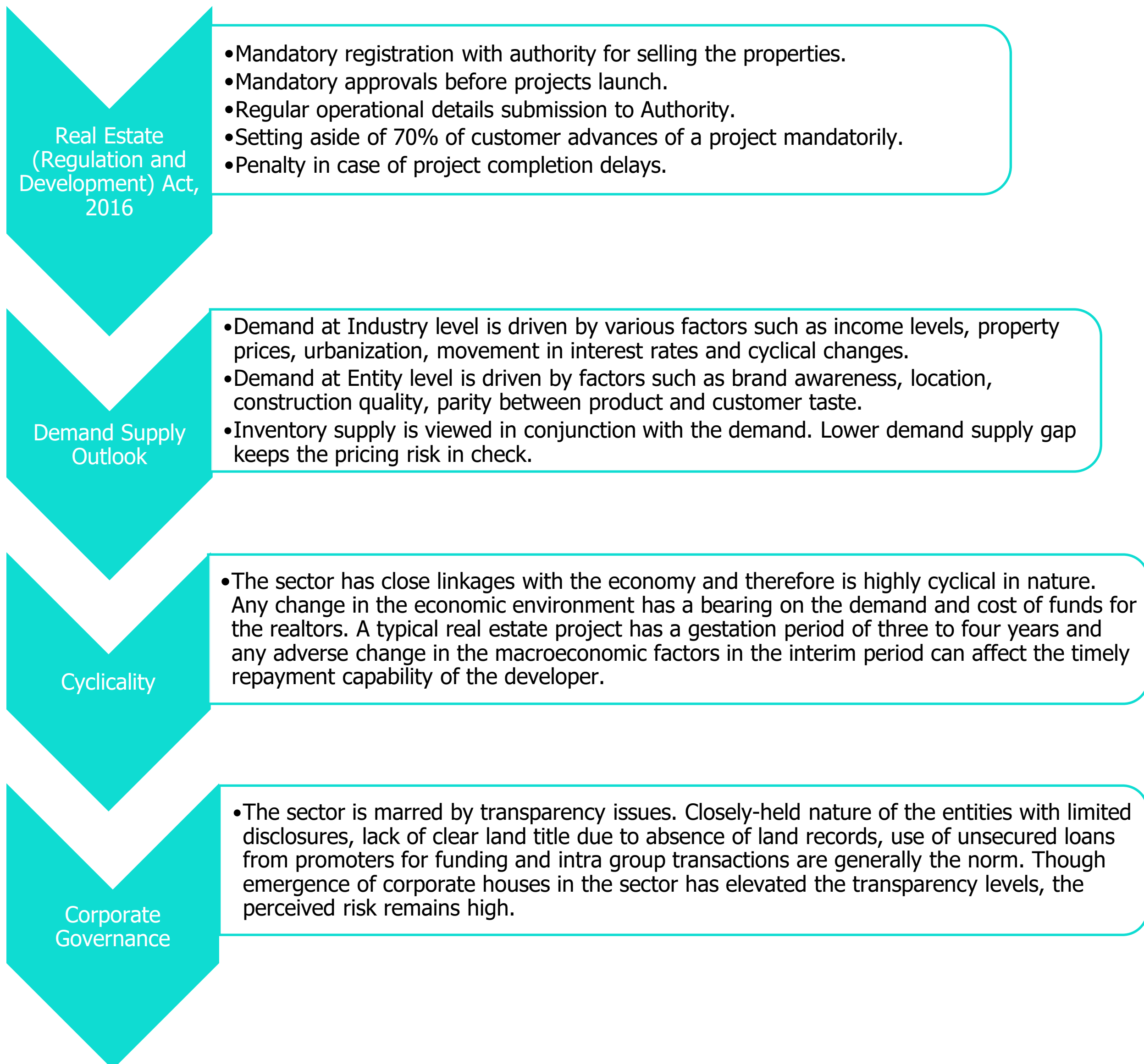
The methodology covers various risks associated with the real estate entities. While all the broad parameters have been covered in the methodology, different business models and group structures may call for deviation in the analysis. For instance, some players in the industry undertake various Real Estate (RE) projects through single entity, while others form distinct entities to undertake various projects. This apart, creating altogether a new SPV for undertaking various types of RE projects (residential, commercial projects for sale, commercial projects for leasing, etc.) and for carrying out various functions such as construction, marketing, facility management, land aggregation, etc., is also a usual norm in RE industry. Therefore, while analyzing such group structures, major emphasis is placed on the various RE projects being executed by the rated entity, however, depending on the criticality of the projects, complexity of business structure, constitution of the entity and level of operational and financial linkages with other group entities, CARE Ratings attempts to evaluate the execution, funding, and marketing risk associated with all the major projects in the group and seeks project-related details in this regard from the management.

Chart 1: Real Estate Rating Framework:



A) Industry Risk Evaluation

The real estate sector is cyclical having direct linkage to macroeconomic scenario, interest rates and income levels. Apart from being cyclical, the sector is also highly fragmented, capital intensive and marred by transparency issues. All such factors call for in-depth industry analysis. CARE Ratings takes into consideration below listed aspects to assess the Industry risk:



B) Management Evaluation

A developer with an understanding of local area nuances, established brand image in the area of operations, demonstrated track record of quality construction and timely delivery has a competitive advantage. Besides, the companies that have been through various business cycles are generally better placed when compared to peers with limited experience. CARE Ratings takes cognizance of resourcefulness of the management/promoters, financial strength of the group, and involvement of the group in other business segments. While the rating exercise is highly focused on cash flow analysis, CARE Ratings also reviews the significant accounting policies, notes to accounts, contingent liabilities/off balance sheet items, auditor qualifications, etc., to analyze if there is any material impact on the financial capability of the developer. Furthermore, RERA website is also viewed to understand if there are any critical observations against the developer.

Experience of promoters/top management in real estate development

The experienced top management and promoters in the main line of business can steer the rated entity to achieve its stated goals. They are equipped to resolve the challenges and take critical decisions to achieve the desired success.

Real estate space developed by the group in the past

Completed real estate projects in the past indicate the operational level expertise of the promoters. Significant scale of development undertaken in the past entails better experience of the developer in terms of execution. CARE Ratings places emphasis on various details of the past projects such as scale, location, types of projects undertaken (villa, gated communities, commercial spaces, etc.), to better understand the experience of the developer in the past.

Constitution of the entity and complex group structure

Constitution of an entity determines the levels of disclosure, transparency and the legal comfort that may be derived by the various stakeholders. The company having high number of sister concerns in the form of special purpose vehicles and an inter-corporate dealing requires detailed analysis.

Group Support

In a typical group structure where real estate projects are being executed through SPVs, such SPVs are usually analyzed on a standalone level. However, with high level of financial and operational linkages between various real estate entities of the group, CARE Ratings generally attempts to understand the risks at group level. Accordingly, financials, including cash flow details and operational details of other group entities are generally assessed on best effort basis. CARE Ratings also attempts to assess the level of support extended by parent and is generally factored in the analysis. Hence, in line with CARE Ratings' methodology on factoring linkages, ratings of an entity may be adjusted on the basis of credit strength of the parent and strength of linkage between entity and parent company. Extent of notch up/down is, however dependent on various factors as laid out in detail in the methodology on factoring linkages.

C) Operational Risk Assessment

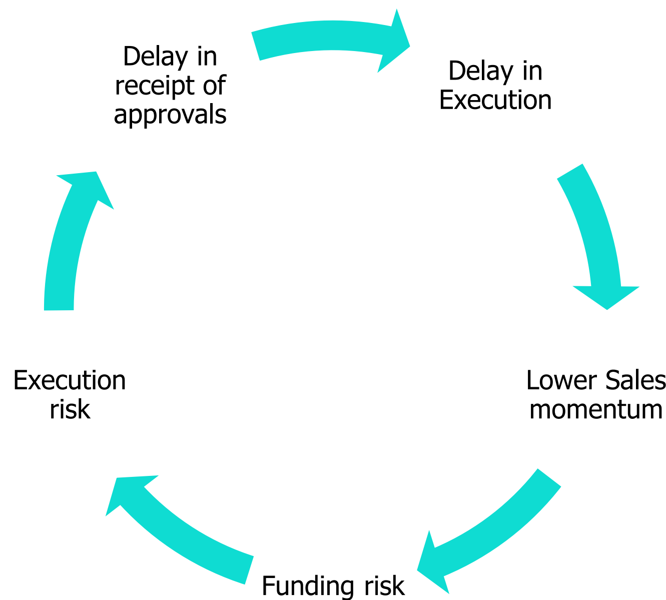
Diversification

CARE Ratings takes into account the project portfolio of developer to evaluate if such portfolio is well diversified in terms of revenue streams, geographical positioning as well as construction stage of the projects and other revenue-sharing models such as asset light models. The developer having mix of projects for sale and leasing is viewed favourably as leasing projects provide consistent cash inflows even in the times of slowdown, while the projects for sale secure funding from customers during the construction phase of the project. This apart, projects being undertaken by the developer in the established micro-markets are viewed favourably. CARE Ratings further evaluates presence across multiple geographies/ jurisdictions during the rating analysis. Furthermore, the mix of projects at initial stage and advanced stage ensures consistent cash inflows and exposure to various business cycles. Asset light models, through joint development agreements (JDA), enable developers to significantly increase the scale of operations without

excessively leveraging their balance sheets, while land aggregation on the other hand ensures that the developer does not have to share part of the revenue/profits with a third party, albeit at the cost of considerable investment for the acquisition. CARE Ratings views asset light model positively which reduces the funding pressure thereby reducing strain on the cash flow compared to the projects having land being debt funded. However, CARE Ratings also takes note of presence of land bank acquired at historical costs which provides the developer with a competitive advantage in terms of pricing and financial flexibility in terms of sale of land parcels, if required.

Execution risk

CARE Ratings takes into account experience of the developer in the region and the construction contractor, associated, if any, stage of execution of the project and status of approvals to analyze project execution risk. The real estate projects require multiple approvals from various State and Central Government Authorities at various stages of project execution. Delays in getting such approvals often hamper the progress of the projects as per the envisaged schedule. This can impact sales and collection in the projects hampering execution. It may also trigger funding risk as major reliance is often placed on customer advances. Developers with better market standing are more likely to withstand such cycles.



Scale of projects under implementation vis-à-vis development track record till date

The scale of ongoing projects is compared with the aggregate scale implemented in the past to assess whether the projects currently being undertaken are not very large compared to the past projects executed by the developer. If the proportion of area under development as compared to the aggregate area developed till date is comparable, it implies smoother execution of the projects. The type of projects, viz., affordable, mid segment, luxury is also considered to assess if developers have adequate experience in dealing with different project genres. Furthermore, the existence of tight regulations, volatility in demand, contraction of liquidity from the banks and financial institutions makes it imperative to perform the project-

specific analysis. Accordingly, stage of construction, regulatory approvals, sales details and means of funding are evaluated project wise.

Booking Status

Higher booking ratio implies favourable market standing of the project leading to smooth cash inflows. Evaluation of marketing strategy of the developer is thus essential as often the intention is to hold the inventory in order to take advantage of rising prices; however, at the same time huge unsold inventory imparts pressure to sell the inventory at lower prices in order to secure the payments thereby exposing the developers to pricing risk. For computing booking ratio, percentage of area/ units booked out of launched area/ units is considered. Furthermore, the ratio is analyzed in combination with the construction status as the nascent stage of construction is often linked to higher unsold inventory. Location of the projects, product offering, and price quoted vis-à-vis current market rate, competition from projects in the vicinity are the parameters looked into to determine sales risk. Significant deviation in quoted prices from market prices provides an insight about market standing of the developer.

Quantum of registered units

Higher percentage of registrations (wherever registrations are done at construction stage) out of sold units is positively correlated to lesser number of cancellations and it further indicates high level of confidence of buyers in the project, primarily being end users. However, legislatures in different geographies stipulate different rules and regulation, thus registration of units is not mandatory norm in all the states. CARE Ratings emphasizes on the track record of cancellations in such cases. The mix of customers into end-users and investors is also assessed as these have bearing on the overall cancellations. Higher proportion of end-users in a project is viewed favorably.

Sales momentum

Good market standing of the developer ensures quick sales velocity and regular cash inflows. The estimated period within which unsold inventory gets converted into sales based on the current sales momentum is also looked into. Lower estimated cycle indicates greater sales velocity or insignificant quantum of unsold units lying with the developer.

Funding structure and collection efficiency

CARE Ratings looks at the funding mix wherein the proportion of funding through debt, customer advances and promoters' fund is thoroughly assessed. Higher reliance on customer receipts is generally viewed unfavourably as this could lead to cash flow mismatch and later developer may have to rely on debt/external funding to meet the balance project cost. Reputed developers with favorable market standing of the projects usually receive decent bookings even if the project execution is at initial stage. The construction of the projects in accordance with the timelines envisaged would ensure timely collection of customer advances by the entity based on construction stage, thereby safeguarding the funding for future construction. Off-late, RERA has also defined construction-linked payments to be made to developers. Assessment of collection efficiency is critical as higher collection efficiency is linked to lower reliance over debt/ other funding sources.

Adequacy of committed receivables

CARE Ratings focuses on the adequacy of committed customer advances (receivables) from confirmed sales in order to fund the balance cost of the projects under implementation & repayment of outstanding debt. Furthermore, evaluation of cash flow position is undertaken to assess if cash inflows in the projected period are adequate to meet the cash outflows.

D) Financial Risk Assessment

In view of different accounting methods and principles followed by the entities, it becomes challenging to assess the financial risk by considering the financial statements. As per traditional accounting practice, certain entities followed percentage of completion method while others followed project completion method for revenue recognition. However, with the introduction of Ind AS-115, the real estate entities (on which Ind-AS is applicable) will be required to recognize the revenue on the basis of whether performance obligation is satisfied 'over time' or 'at a point in time', thus the revenue would be recognized once the company performs all its obligations. Resultantly, timing difference in the completion of various projects would potentially increase the time lag in recognizing the revenue which further impacts the financial position of the entity. The companies with higher proportion of lease income, however, remains less impacted. Thus, greater emphasis is placed on evaluating the cash flow positions of the entity and therefore combination of below factors becomes crucial for assessing the financial risk

Cash Coverage Ratio (CCR)

The real estate inventory requires longer timeframe for selling, thus cash flow management and financial flexibility is of paramount importance for timely servicing of debt obligations. Cash flow adequacy is determined by considering cash flow visibility against committed payments. CARE Ratings, while making the assessment, generally considers the cash flow position of the projects covered in the analysis for next few quarters to understand the inflows and outflows of real estate entity. Inflows are usually in the form of project receipts, debt, promoter's contribution, and support from group companies while outflows include project expenses (construction expenses, finance cost, land cost, administration & marketing expenses), corporate expenses, if any (at consolidated level), and repayment of debt obligations. CCR indicates the level of cushion available to the company in meeting the debt obligations. CARE Ratings also evaluates the ratio considering opening cash balance/accumulated surplus to the inflows generated in the projected period. This apart, actual cash flows generated are also compared with the initially projected cash flows and the reasons for shortfalls are carefully evaluated. The ratio being critical indicator of cash flow position of the entity is sensitized to accommodate various scenarios such as delays in project completion leading to lower cash flows from unsold units, fall in collections from sold units, decline in price of unsold units, increase in finance cost or construction costs, etc.

Availability of Liquid balances

The availability of adequate liquid funds can protect the company against any unprecedented downturn in the economy, impacting cash flows. CARE Ratings analyzes the percentage of repayments due in the following year being covered by the available unencumbered liquid investments and accordingly evaluatesif significant buffer is available to meet the repayments due in subsequent year.

Availability of land bank

The size of available land bank is crucial for the entity as developers often acquire lands in advance at lower cost and use it later for the projects under pipeline which provides flexibility to the entity in pricing the projects. Furthermore, the projects executed on the owned lands generally provide higher margin as compared to the projects where the land sharing rights are acquired. Additionally, the prime location and lower acquisition cost vis-à-vis the current market rates are viewed favourably.

Project funding pattern

The real estate business is capital intensive in nature and the entities require huge capital during various phases of project construction. The development of project initiates with acquisition of land which is more often funded through the promoter's contribution, while the construction of projects is funded through external sources. The funding pattern (Promoter Funds: Debt: Customer Advances) is a function of the sales momentum of the project and the reputation of the developer.

The developers with better market standing have the ability to achieve higher bookings and thus would place higher reliance on customer advances for funding the balance project cost. While lower sales momentum inducesthe developer to approach other sources of funding such as debt or unsecured loans from promoters/ group companies. However, extremely higher proportion of external funding through debt or customer advances as against promoter funds could result in substantial leveraging/dependence and thus needs a thorough assessment.

Leverage

As covered earlier, the proportion of external debt often remains low if the competitive position of the entity is strong since the inflows from customer advances are generally adequate enough to meet the project cost. To analyze the debt position, CARE Ratingslooks into the ratio of overall gearing and the results are compared with the peer firms with the similar asset portfolios. Lower ratio implies better financial discipline of the developer and strong ability to withstand economic cycles. The various financial ratios are correlated for analysis and are not seen in isolation.

Conclusion

The rating outcome is ultimately an assessment of the fundamentals and the probabilities of change in the fundamentals. Rating determination is a matter of experienced and holistic judgment by the Rating Committee, based on the relevant quantitative and qualitative factors affecting the credit quality of the issuer. CARE Ratings analyses each of the above factors and their linkages to arrive at the overall assessment of the credit quality of a real estate entity. CARE Ratings also considers future estimation of the company's financials based on past trends and strategies, competition, industry trends, economic condition and other considerations.

[For previous version please refer 'Rating Methodology – Real Estate Sector' issued in February 2020]

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