Rating Methodology - Debt Backed by Lease Rentals Discounting

[Issued in March 2023]

Background

Lease rental discounting (LRD) is essentially a loan facility availed by a company/ firm against the rental from various types of properties, viz., commercial, retail, warehouses, etc., earning a specified amount of rentals at scheduled intervals. The quantum of debt facility to be extended by the lenders is typically assessed based on the valuation of rental properties and discounted value of expected rentals from such properties. The rentals and other incidental revenue derived from such properties are deposited into designated escrow account and the application of such funds generally concurs with the well-defined waterfall mechanism with statutory payments and debt commitments being the priority. Usually, in construction phase, the developers avail term loan and post construction and tie-up with tenants for rentals; such term loan gets converted into LRDs in order to take advantage of lower finance costs as LRDs are considered relatively safer with cash flows being monitored by lender through escrow and waterfall mechanism and debt service reserve account (DSRA).

Methodology and its scope

CARE Ratings Limited (CARE Ratings) analyses various risk factors associated with leased out properties, such as type of asset, location, maintenance of properties, occupancy level, lock-in tenure, loan to value, lease terms, debt to rentals, tenants' profile and track record of developer in leasing out the facilities. Emphasis is also placed on the cash flow analysis and evaluation of financial flexibility available to the developers by determining the manner in which projected rental cash flows (net of operational expenditure like CAM charges, electricity charges, property taxes, insurance, etc) will be applied towards debt commitments.

The developers often execute residential and commercial projects for sale along with the leasing projects, in such cases, this methodology is applicable on factors over and above those covered in the methodology on Real Estate projects (wherever applicable). Furthermore, this methodology should not be construed as comprehensive list of all the factors that are reflected in ratings, however, it covers the parameters that are most critical to understand. The various critical aspects which CARE Ratings considers for rating a typical LRD loan can be inferred from the chart below:

A. 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 the peers with limited experience. The management quality of the property developer/manager influences the ability to negotiate favourable terms with tenants and lenders, and also to attract and retain tenants.

CARE Ratings takes cognisance 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 focused on cash flow analysis, CARE Ratings also reviews other qualitative elements, such as auditor qualifications, pledge of promoter shareholding, RERA details etc., to analyse if there are any critical observations against the developer and related financial implications.

Experience of promoters/top management in real estate development

The experience and track record of the promoters/management in the line of business is given significant importance while evaluating management competency and quality. Considering the capital-intensive nature of the business, a company with financially strong promoters enjoys an advantage over others as its ability to infuse and/or raise funds in a timely manner is better.

Real estate space developed & leased out by the group in the past

Completed real estate projects in the past and leasing of the same indicates the operational level expertise of the promoters. Furthermore, CARE Ratings places emphasis on various details of the past projects such as scale, location and types of projects executed (commercial malls, commercial offices, warehouses, etc.) to better understand the experience of the developer.

Constitution of the entity

The legal constitution of an entity indicates the level of oversight and hence has a bearing on the governance and transparency requirements to which an entity is subjected to. Partnerships/proprietorships are subject to comparatively milder disclosures and regulatory requirements than private/public limited companies. Such entities also carry an inherent risk of withdrawal of capital which is factored appropriately in the ratings of partnerships/proprietorship concerns.

Organisational structure and group support

Typically, forming special purpose vehicles (SPVs) for undertaking different functions and projects is a general norm in the industry.

Accordingly, in a group structure where leasing projects are being executed through SPVs, such SPVs are usually analysed with project-wise cash flows 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 and inter-company transactions are carefully evaluated. Also, 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 the parent and is generally factored in the analysis. Please refer to CARE Rating's website www.careedge.in for CARE Rating's criteria on notching by factoring linkages in the rating.

B. Business risk evaluation

Understanding business risk of an entity is a combination of assessment of asset profile and tenants' profile. CARE Ratings performs the detailed analysis of the assets being leased out and various aspects associated with the assets. The evaluation of asset profile provides broad indication about the market position of the developer after analysing various factors, such as property's location and asset quality, average lease rentals around the vicinity, and average occupancy ratio. These factors are considered in conjunction with other factors, such as promoters' track record and their exposure to various business cycles, competitive position and the leasing track record of the assets. Additionally, CARE Ratings evaluates the tenants' profile by taking various factors into consideration such as tenant concentration, types of tenants, credit quality of tenants and lock-in tenure of leases. The key factors relevant to assess the business risk are covered below:

Evaluation of execution risk in project stage entities

While assessing execution risk, there are various factors that requires consideration, such as experience of the developer in the industry and region of operation, construction progress of the portfolio and ability of developer to obtain timely approvals of the project. The real estate projects require multiple approvals from various authorities (central, state and local) at various stages of project execution. Delays in getting such approvals often hamper the progress of the projects as per the envisaged schedule. Once the facilities are constructed and the relevant spaces are leased out, term loan is normally converted into LRDs to get advantage of lower finance costs and efficiently manage debt servicing. Various factors which are considered while rating the project-stage entities includes stage of construction, past track record of developer in executing such projects, significance of the project to the group, track record of the group in supporting the SPV executing such project, percentage of Letter of Intent, if any, prevailing rental rates in the vicinity, terms of sanction, etc.

Location and construction quality

The type, location, upkeep of assets, surrounding infrastructure, various amenities provided are evaluated to determine pricing power to lease out the assets or roll over the already leased assets at envisaged rates. Grade A assets positioned at prime location attract strong tenants with high credit quality, thereby providing financial discipline to the company. Further emphasis is placed on the type of assets being leased out (viz., commercial offices, malls, warehouses, etc.) as the prime location differs for different types of assets. In case a location is remote, however, if it remains in proximity to the key industrial area, then it could be considered as prime for warehouses coupled with good approachability and vicinity. Similarly, the location covering prime areas of city and target population is considered crucial for shopping malls, prime location and good connectivity for offices spaces and proximity to factory location of the client and connectivity to state/national highways for warehouses.

With different asset classes being impacted differently and prone to different risks, while performing analysis, trends in vacancy rates, lease rentals, lease collection efficiency are considered to assess the credit profile of the company.

Market standing and demand-supply outlook

CARE Ratings views the market position of the developer to determine if the firm has established position in a particular micro market and if such leadership translates into strong pricing position. While analysing the demand in the micro-market where the property is located, CARE Ratings takes note of the proximity to key areas, presence of infrastructural amenities and attempts to understand the expansion plans of tenants through discussions with management and due diligence with tenants and other stakeholders on best effort basis.

CARE Ratings analyses demand-supply gap and accordingly determines if such scenario would mitigate or enhance the vacancy risk. Strong demand with weak supply in a micro market benefits the entity in filling the vacant spaces and would have a positive bearing on rental rates. Conversely, weak demand with oversupply could divert the existing tenants to other properties and thus weaken the customer stickiness. The entities in such cases face higher vacancy risk or renewals at lower than existing rentals.

Occupancy levels

CARE Ratings analyses the past vacancy trend of the properties forming part of the developer's portfolio, and the same is compared with the current vacancy level. The change in the occupancy rate is looked into to determine the reason for variation and future occupancies are delved upon. Lower occupancy level in the past could be due to properties under construction phase, however, reputed developers often let out the space by tying up with the tenants through letter of intent and thus the vacancy risk in future gets mitigated. Analysing past vacancy trend also provides an indication about the market position and the ability of the developer to fill the vacant spaces across all economic cycles.

CARE Ratings also assesses diversity in terms of geography, tenants, and industry of tenants. Properties located in multiple geographies are viewed positively as it protects the developer against the downturn in any single micro-market. Similarly, diversified tenant profile entails stability in the occupancy levels and cash flows. Furthermore, CARE Ratings also looks into EBITDA margin at an entity and asset level to understand operational efficiency.

Tenant profile assessment

CARE Ratings evaluates the tenants' profile by taking various factors into consideration, such as tenant concentration, industry concentration, lease terms, and track record of timely rental payments.

Typically, high tenant concentration could have a bearing on the occupancy of the rented property as the worsening of the credit quality of the single tenant could delay the collection of lease rentals which may in turn impair the financial capability of the lessee. While the property occupied by multiple and diversified set of tenants with high occupancy levels entails lower stress on cash flows. Nevertheless, major emphasis is placed on credit profile of tenants as in exceptional cases where properties leased out to single tenant with very strong fundamentals at favourable leasing/lock in terms, generally garner more stable cash flows as compared to multiple tenants with moderate credit profile occupying the property.

Similarly, high number of tenants from single industry, such as ITes, financial institutions, or automobile, etc., could result into higher vacancy if that industry witnesses slowdown.

The credit quality of tenant is evaluated to determine the certainty of committed rental inflows from such tenants. Favourable credit quality of tenants indicates the stability of rental inflows and likelihood that the terms of lease agreements will be honoured over the life of leases, even during the downturn.

CARE Ratings also attempts to understand other critical factors, such as significant investments by tenants in fit-outs, other challenges in shifting from existing property, etc., to gauge the tenant stickiness toward the property. Typically, when fit-out costs are borne by the lessees, the likelihood of tenants occupying the premises over the agreement period remains higher, as it makes economic sense for the tenants to recover the costs incurred.

Evaluation of lease agreements and lease renewal risk

The various features of lease agreements such as lease tenor, lock-in period tenor, renewal of lease, security deposits, notice period, rental escalations, etc., are evaluated. For understanding lease renewal risk, CARE Ratings looks into weighted average lease expiry (WALE) vis-à-vis average maturity of residual debt. If the expiry of most of the lease agreements falls near to or beyond loan tenure it provides stability in the cash flows and reduces the credit risk of the entity to major extent. Typically, retail malls would have shorter leasing period compared to other two types of assets. This can enable malls to attain positive pre-leasing spread post vacancy. While the lease agreements expiring within the loan tenure expose the entity to roll-over risk, tie up of leases with sizeable lock-in period and regular escalations over time ensures stability in rental income and overall cash flows, reducing the vacancy risk. CARE Ratings also takes into account the timeframe of notice periods covered in the underlying lease agreements. Shorter notice period could adversely impact the occupancy level of the entities especially during downturns. Thus, longer lease tenor with reasonable lock-in periods as well as availability of renewal clauses with fixed escalations and higher tenure notice periods provide stability to the cash flows and are seen as credit positive.

C. Financial risk evaluation

While assessing the financial risk profile, CARE Ratings takes note of the critical ratios of debt to equity, loan to value, debt to rental/debt to net operating income and the results are compared with the peer firms with the similar asset portfolios. Lower ratios imply 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. CARE Ratings also looks into robustness of sanction terms of loan facility with rent receipts flowing to designated escrow account, DSRA and well-defined waterfall mechanism. The funding pattern of the entity and utilisation of loans is also looked into thoroughly. The key parameters considered while analysing financial risk are covered below in more detail:

Debt financing and sanction terms

The sanction terms of LRD loan are viewed to understand if such terms stipulate the entity to maintain additional security measures such as ringfencing of cash flows, maintenance of DSRA, time gap between rental receipt date and scheduled repayment dates, etc. Presence of defined mechanisms such as routing of rent through escrow account and thereby discipline of such cash flows entails timely servicing of debt commitments. In such mechanisms, escrow account typically remains in control of the lender and accordingly rental receipts are utilised for meeting the debt commitments on priority after meeting the statutory obligations and remaining amount could be utilised for other expenses based on the approvals from lender. Maintenance of DSRA is another aspect which provides liquid cushion in repayment of debt particularly in case of delay in payment of rent by the tenants or in case of tenant vacating the space. Usually, a DSRA equivalent to one to three months of instalments is maintained by the companies in accordance with the sanction terms. The time gap available between rent receipt date and the loan repayment dates also provides additional comfort as sufficient time gap between the two dates mitigates the risk arising out of delay in rental payment by the tenant. This apart, the company's free liquid balances are also looked into to understand the level of cushion available to the company in the form of cash and bank balance/unencumbered liquid investments, thereby protecting the company against any unprecedented downturn in the economy.

Leverage and financial flexibility

Gearing is an important metric to analyse the financial profile of an entity, since the capital base required for acquisition/construction of assets in the real estate industry is normally high and the assets are largely funded through external borrowings. Therefore, strong promoters / institution backed entities have greater financial flexibility / refinancing options. While the projects are normally executed under SPV having lower net worth base, the gearing levels of such entities normally tend to be higher. CARE Ratings, therefore, also takes into account the ratio of loan to value, based on latest available asset valuation report in conjunction with the overall gearing ratio to determine the financial flexibility of the company. However, sanction terms are also given cognisance while analysing the financial flexibility of the company as refinancing could be limited if the sanction terms stipulate strong covenants directly or indirectly restricting the entity to raise additional debt. While assessing the financial profile of an entity, CARE Ratings also evaluates another important metric of 'debt to rental'. The ratio indicates the number of years, an entity will take to repay the entire debt at average annuity income. Lower the ratio, better the financial capability of entity. An entity with lower gearing, loan to value and debt to rental is viewed positively due to its better financial flexibility and the ability to avail additional debt during unprecedented economic scenario.

Cash flow analysis

CARE Ratings analyses the visibility and sustainability of the cash flows as against the debt servicing obligation of the company. The stability of cash flows can also vary depending on the industry segment (i.e., retail, office or warehouse) which was observed during COVID-19 wherein the retail segment recovered at a slower pace compared to other segments. Moreover, presence of under-construction loans will have a bearing on credit risk of LRD loans.

Inflows are usually in the form of rental cash flows, CAM income (net of operational expenditure like CAM charges, electricity charges, property taxes, insurance, etc), which will be applied towards debt commitments.

In this regard, cash coverage ratio (CCR) is computed to evaluate the times of cash cover available to the company for servicing the debt commitments. While computing CCR, the entire cash inflows consisting of debt drawdown, if any, lease rentals, parking charges, or any other income generated from the properties are plotted against operational expenses, payment of refundable security deposit in case of vacancies as well as projected expenses/ capital expenditure to arrive at available cash balances for debt repayments. CARE Ratings also evaluates the ratio with inclusion of opening cash balance/accumulated surplus to the inflows generated in particular projected period. Average CCR over the projected period is considered as a critical metric to evaluate the financial risk profile of the entity. An adequate CCR throughout the tenure with presence of DSRA thus entails comfortable financial risk profile. CCR is sensitised for the lack of rental escalation, change in vacancy rates, change in the interest rate, etc. Any large potential security deposit outflow during vacancy which may have an impact on cash flow will also have to be looked into.

Availability of liquid balances

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

Real Estate Investment Trust

A Real Estate Investment Trust (REIT) is a corporation or a trust which utilises the pooled capital of multiple investors to purchase, and in most cases, operate income generating real estate such as offices, shopping complexes, hotels and warehouses. While assessing the REITs, CARE Ratings analyses the overall REIT structure and assets profile in accordance with its methodology on analysis of REITs (which is available on our website www.careedge.in) in conjunction with this methodology.

Environmental, Social and Governance risks

Environmental, Social and Governance risks tend to be high for real estate as building construction stems out environmental issues and Social and Governance issues also need consideration. The efforts taken by the company towards a healthy Environment like fostering eco-friendly buildings, increasing the amount of green space or using environmentally compatible energy sources, water conservation, waste management etc. is factored in the analysis. The assessment would include an evaluation of the cash flow implications to develop strategies/initiatives to address these risks, spend on the product design to mitigate environmental risks and cost of processes to recycle, reuse and safely dispose waste. The assessment would also include the risk of levy of fines/penalties for not complying with regulatory norms with respect to the environment.

Real estate being a labour-intensive industry, social risks such as employee welfare, labour relations, accountability towards customers, social responsibilities, etc., need to be measured in terms of their short to medium-term impact on reputation, consequently translating into impact on future earnings and cash flows. For instance, health and safety standards to be checked with the frequency of accidents and mitigation policy adopted by company, labour relations to be checked with respect to the presence of unions and any events of labour unrest, etc. The analysis of social aspects in real estate also includes, for instance, participation in the rehabilitation of public spaces, etc.

Additionally, there are also several Governance-related impacts in the real estate sector. The analysis includes assessing the composition of the board, the level of compliance with governance rules and guidelines, transparency in disclosure of governance issues, the quality of financial reporting, complexity of organisation/group structure including related party transactions, any non-compliance-related issues or fines/ penalties in the past and changes in the systems to mitigate such risks in the future are to be evaluated, amongst others.

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 of 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 having debt backed by lease rentals. CARE Ratings also considers future estimation of the company's financials based on past trends and strategies, competition, industry trends, economic condition and other relevant considerations.

The operations of the commercial real estate properties were impacted by COVID-19. While credit profile for office space segment showed resilience, malls have been slowly recovering with easing of restrictions. CARE Ratings also attempts to assess the impact of the macro events on vacancies as well as rent negotiations.

[For previous version please refer 'Rating Methodology - Debt Backed by Lease Rentals Discounting' issued in March 2021**]**

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