Rating Methodology - REIT (Fund Rating)

[In supersession of 'Rating Methodology – REITs']

Background

The introduction of regulatory framework for Real Estate Investment Trusts (REITs) has paved the way for the launch of REIT funds in India. The first REIT was launched in April 2019.

A REIT is a corporation or a trust which utilizes the pooled capital of many investors to purchase, and in most cases, operate income-producing real estate such as offices, apartments, shopping complexes, hotels and warehouses.

REITs in India would issue securities, which would be listed on stock exchanges. REITs will invest predominantly in completed commercial real estate assets (to comprise minimum 80% of net asset value as per SEBI guidelines), either directly or through SPVs. These will be closed-end schemes with a minimum subscription of Rs.2 lakhs, with each unit size being equal to Rs.1 lakh. To ensure regular income to the investors, it has been mandated to distribute at least 90% of the net distributable income after tax of the REIT to the investors.

CARE's Rating of REIT fund is an opinion on the REIT's investment quality, based on the fundamental assessment of the REIT. CARE-REIT rating is assigned on a five-point scale from 1 to 5, with 'CARE: REIT-1' indicating highest investment quality and 'CARE: REIT-5' indicating poor investment quality.

Rating Methodology

The REIT rating would encompass the three key factors

A. Business Risk – Analysis of underlying quality of assets
B. Financial Risk Analysis
C. Management/Sponsor Evaluation

A. Business Risk

Size of assets under management is assessed as larger REITs will have greater financial flexibility to sell non-core properties and focus resources on better-performing properties.

The type of property (office space, malls, hotels etc.) in which the REIT has invested is assessed as different types of properties have different risk levels. Another important focus is the REIT's competitive position, which is indicated by whether the REIT is the 'landlord of choice' in its core markets. Business risk is being analysed in *two dimensions* – '**prospects of higher returns**' and '**safety of returns'**.

The following tables attempt to explain these two dimensions of business risk analysis:

Factors determining prospects of higher returns

S.No		Remarks
1	Location of properties	Properties located in good locations with proximity to residential areas, access to skilled labour and access to public support are likely to command higher rent and in turn, generate higher returns.
2	Quality of properties	Good quality properties are likely to fetch higher rent. Quality measures include age, state of maintenance and availability of additional facilities / amenities
3	REIT's competitive position	REIT's competitive position is indicated by whether the REIT is the 'landlord of choice' in its core markets. This leadership position is likely to translate into higher rent/returns
4	Lease agreement with regular rent renewal clauses	Lease agreement with regular rent renewal clauses provides scope for increase in the income of the REIT, in a growing economy. Also, expansion plans of existing tenants help in determining scope for rental growth of the REIT.
5	Supply prospects and barriers to competition	If the supply is limited in the location of property, returns are likely to be higher. The ongoing and planned developments in the vicinity is also critical for determining supply

Factors determining safety of returns

S.No		Remarks
1	Diversification in terms of location	Portfolio with properties located in different areas of a city as well as different cities will generate more stable returns and can withstand economic cycles which may be affecting a specific region
2	Diversification in terms of tenant and industry	Properties leased to a large tenant base across diversified business sectors will have stable rent. A portfolio with less than 30% exposure to the top five tenants and less than 10% exposure to the largest tenant is seen positively.
3	Tenants with strong credit standing	Properties leased to established corporations with a strong credit rating are likely to have higher surety of rent
4	Long-term lease agreements	Long-term lease agreements provide stability to the income of the portfolio. Further, the extent of customization of the property (in terms of fit-outs etc.) by the tenant would act as

S.No		Remarks
		a deterrent against termination of the lease agreements when they come up for renewals
5	Market rents	If the rent charged by the property is lower than market rents, return is likely to be more stable. The actual rent commanded in properties let out is compared with the market rent in the area.

B. Financial Risk Score

Financial risk analysis includes examination of the following factors:

i. **Liquidity and Financial flexibility:** Liquidity is an important factor for capital intensive businesses like REITs. The cash flow position and working capital lines are monitored to ensure that there are adequate liquid reserves in terms of cash and credit facilities to meet short-term obligations including interest and principal payments of debt, expenditure for maintenance of properties and dividend payments.

REITs are capital intensive businesses and their ability to retain excess cash is extremely limited by compulsory distribution of dividends that amounts to 90% of taxable income. Due to constraints on retaining excess cash, REIT may have to borrow additional debt, raise additional equity or dispose assets in order to refinance debt or for new acquisitions. Disposing off high yield generating assets or raising additional debt may diminish the payouts to unitholders.

As per the SEBI guidelines, a REIT, on a consolidated basis, can borrow to the extent of 49% of the value of the REIT assets. Generally, a REIT with a conservative leverage (ratio of consolidated external debt to value of REIT assets) is viewed favourably, as the REIT can distribute the cash flows to unitholders only after the external debt is serviced. Also, if a REIT has maximum permissible leverage, its financial flexibility will reduce and reliance on additional equity or asset sale will increase, in case large funds are required for debt repayment or asset acquisitions.

ii. **Operating margins and Earnings –**A REIT's ability to generate high, consistent returns with revenue growth is analysed. These are reflected in the operating margins, efficiency, volatility of returns and earnings growth rate. Interest coverage ratio (including capitalized interest) is also considered.

Earnings of a REIT is best reflected by adjusted fund from operations (net income adjusted for depreciation, gain or loss on sale of property and the capital expenditure required to maintain the portfolio of properties).

C. Management/Sponsor Evaluation

As per SEBI guidelines, REIT managers should have at least five years' experience in fund management/ advisory services/property management in the real estate industry or in development of real estate. Accordingly, it is important to see whether the management team is experienced and well-qualified to handle the day-to-day operations of the REIT. The management team's ability in decision making, ability to execute their vision and strategic plans and the management's risk appetite are considered in CARE's criteria for Rating of REITs.

When compared to most other industries, REITs operate with lower liquidity (as majority of the income is distributed as dividend), which means that a liquidity crunch can destroy a poorly managed REIT. Also, tenants have a stronger negotiating power over the landlords when the real estate sector is going through recession. Therefore, it is crucial to understand how the management team will handle the various risks inherent in operating a REIT.

Moreover, CARE takes cognizance of the level of support provided by the sponsor to the REIT. Support could be by way of infusions of equity or sourcing of credit. A financially strong sponsor will be able to support the REIT, as and when required. Prior experience in real estate and the pool of assets owned by the sponsor will also be considered.

To conclude, the above quantitative and qualitative factors will be considered to arrive at a Rating for the REIT. However, these factors form a basic ground work for the rating process and as the market for REITs develops further, there can be further changes and refinements to the Rating criteria.

REIT Rating - Symbols and definitions

The symbols and definitions are given below:

Rating Symbol	Definition
CARE:REIT-1	REIT funds rated in REIT-1 category are judged to be of highest investment quality; likelihood of consistent returns over the foreseeable period is excellent
CARE:REIT-2	REIT funds rated in REIT-2 category are judged to be of high investment quality; likelihood of consistent returns over the foreseeable period is high
CARE:REIT-3	REIT funds rated in REIT-3 category are judged to be of good investment quality; likelihood of consistent returns over the foreseeable period is good
CARE:REIT-4	REIT funds rated in REIT-4 category are judged to be of average investment quality; likelihood of consistent returns over the foreseeable period is moderate
CARE:REIT-5	REIT funds rated in REIT-5 category are judged to be of poor investment quality; likelihood of consistent returns over the foreseeable period is low

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Disclaimer

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