Rating Methodology - Real Estate Sector

[Issued in March 2023]

Industry Overview:

Real estate sector plays an important role in the Indian economy. It is one of the largest employers after agriculture and 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 transparency levels have improved after the introduction of Real Estate Regulation and Development Act, 2016 (RERA) and various other regulatory initiatives. Though, industry is still characterized with fragmented structure, tightening of regulatory norms has contributed towards consolidation of industry and greater accountability.

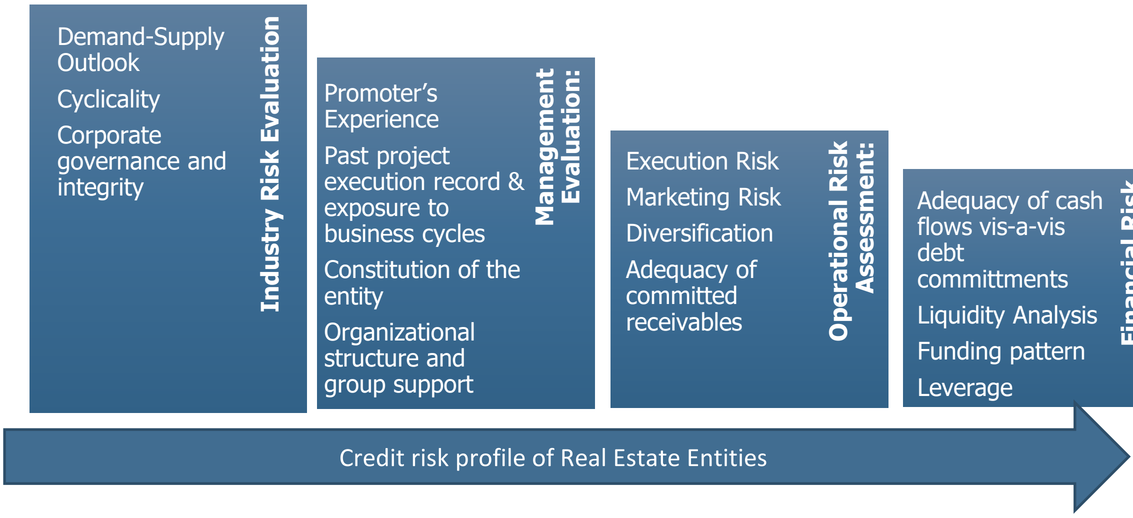
Methodology and its scope:

The methodology covers various risks associated with the real estate entities, where the primary business model is to construct and sell residential or commercial space. For commercial projects that are being undertaken for leasing, CARE Ratings has laid out separate methodology and hence developers with primary business model of leasing are assessed differently as outlined in criteria paper on 'Debt backed by Lease Rental'.

Evaluating 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 a) different revenue-recognition policies followed by entities b) the profits for a given period may vary significantly from the cash flows and c) the revenue booking may fluctuate widely from one period to other, depending upon the stage of execution of various ongoing projects.

Given the nuances of real estate sector, greater emphasis is placed on evaluating various operational parameters covering execution and marketing risk alongside cash flow analysis, and financial flexibility of developer. Furthermore, with highly fragmented nature of industry, evaluation of management quality is also of utmost importance. In view of above, real estate rating framework focuses on various factors covered under four risk heads, as listed below:

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 impacted by transparency issues. All such factors call for in-depth industry analysis. CARE Ratings takes into consideration the below-listed aspects to assess the industry risk:

Demand Supply Outlook

- Demand at industry level is driven by demographic trends such as income levels, property prices, urbanization, movement in interest rates, etc.
- At the entity level, demand is primarily linked to factors such as brand awareness, location, construction quality, parity between product and customer taste.
- Inventory supply is largely linked with prevailing price trend and unsold inventory in the micro-market. Lower demand-supply mismatch indicates stability in prices.

Cyclicality

- The sector has close linkages with the economy and therefore is highly cyclical in nature. A typical real estate project has a gestation period of three to four years and any adverse change in the macroeconomic factors in the interim period can affect the cash flows of the developer.

Corporate Governance

- The sector is impacted by transparency issues. Closely-held nature of the entities with limited disclosures, lack of clear land title due to absence of land records, use of unsecured loans from promoters for funding and intra group transactions are generally the norm. Though with applicability of RERA and increasing presence of corporate houses, the transparency level is gradually elevating, the perceived risk hitherto remains high.

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, thus, evaluates the vintage of developer in the area of operations, execution and marketing track record with respect to type of project being undertaken, the resourcefulness of the promoters, its growth plans, and leverage policies. This apart, CARE Ratings also takes into cognizance, the other qualitative elements such as auditor qualifications, pledge of promoter shareholding, RERA details to get an understanding if there are any litigations 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 by the group in the past

Completed real estate projects in the past indicate the operational level expertise of the promoters. A considerable scale of development undertaken in the past demonstrates better execution track record of the developer. To understand past experience of the developer, CARE Ratings also places emphasis on various details of the past projects such as scale, location, and types of projects undertaken (villa, gated communities, townships, commercial spaces, etc.).

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.

Organizational structure and Group support

Typically, forming SPVs for undertaking different functions and projects is a general norm in the industry. Accordingly, in a group structure where real estate 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 the group level and inter-company transactions are carefully evaluated. Also, financials, including cash flow details and operational details of other real estate entities of the group 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. 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 the entity and the parent company. The 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

Execution risk

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. In this regard, CARE Ratings looks at below parameters to assess execution risk:

- **Execution track record:** The scale of the 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 is comparable with aggregate area developed till date, it reflects better execution capability of the developer. The type of projects, viz., affordable, mid segment, luxury is also considered to assess if developers have adequate experience in dealing with different project types.

- **Stage of construction:** To assess the construction progress, ratio of percentage of cost incurred to total estimated project cost is considered. This is also generally evaluated in conjunction with the physical progress of the projects and construction schedule, if any. Advanced stage of construction indicates low execution risk. CARE also monitors the update on construction progress as per the RERA website (wherever available).

- **Regulatory Risk:** Real Estate industry is marked by high level of regulations and thus execution is critically dependent on timely receipt of multiple approvals and regulatory clearances from various authorities (Central, State and Local) at various stages of construction. Delays in getting such approvals often hamper the progress of the projects as per the envisaged schedule. This can impact the saleability and in-turn the collections which may elevate the funding risk for players, highly reliant on customer advances.

CARE Ratings considers various aspects such as track record of entity's compliance with respect to regulatory stipulations, adherence to various approvals, ongoing litigations (if any), legal risk associated with land titles, etc. Thus, a developer with a track record of adherence to various regulatory guidelines and strong regulatory framework in place, is viewed favourably.

Marketing Risk

Marketing risk is largely determined by parameters such as location and construction quality of the projects, track record of the developer in selling the similar type projects or projects in a given micro-market, comparison of quoted price vis-à-vis current market rate, and competition from projects. While, such parameters provide an understanding about the market standing of the developer, inference for future sales is also drawn by considering various critical parameters listed below:

- **Booking status:** Higher booking ratio implies favourable market standing of the project. For computing booking ratio, percentage of area/ units booked out of launched area/ units is considered.

- **Registrations:** Higher percentage of registrations (wherever registrations are done at construction stage) out of booked units is positively correlated to lesser number of cancellations. However, legislatures in different geographies stipulate different rules and regulation, thus registration of units is not a mandatory norm during the construction phase, in few states. CARE Ratings emphasizes on the track record of cancellations in such cases.
- **Sales velocity:** Good market standing of the developer ensures quick sales velocity and thereby regular cash inflows. CARE Ratings looks at the ratio of 'months to sell the unsold inventory' which provides an understanding about the estimated period within which the unsold inventory gets converted into sales based on the current sales momentum. Lower ratio indicates greater sales velocity or lower quantum of unsold inventory lying with the developer.

Adequacy of committed receivables

CARE Ratings focuses on the ratio of committed customer advances (receivables) from confirmed sales to fund the balance cost of the projects under implementation and repayment of outstanding debt. Since the ratio will vary depending upon the stage of execution of various projects in the portfolio, the trend of this ratio is looked at for the past period. Lower ratio implies that there will be higher dependence on fresh sales or promoter contribution to fund the future project costs and debt payments.

Diversification

CARE Ratings considers the project portfolio of the developer to evaluate if such portfolio is well diversified in terms of revenue streams, geographical positioning as well as construction stage of the projects. The developer having a 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. Similarly, a developer having presence in few geographies is protected from any downturns in a single micro market. Furthermore, the mix of projects at initial stage and advanced stage ensures consistent cash inflows and exposure to different business cycles.

D) Financial risk assessment

Financial risk assessment broadly involves assessment of cash flow position, liquidity position, leverage and financial flexibility of the entity. For evaluating financial risk profile of the entity, CARE Ratings also considers the past financial performance of the entity and reviews accounting policies, notes to accounts, contingent liabilities/off balance sheet items. The key parameters considered in the analysis are covered below in detail:

Cash coverage ratio (CCR)

CARE Ratings considers the cash flow position of the projects covered in the analysis for the next few quarters to understand the inflows and outflows of real estate entity. In this regard, only the projects which are reasonably certain to be launched in medium term are considered for the analysis.

Inflows are usually in the form of project receipts (collections from sales and leasing income, if any), debt, promoter's contribution, and support from group companies while outflows include project expenses (construction expenses, finance cost, land cost including commitments under Joint Development Agreement (JDA), administration & marketing expenses), corporate expenses, if any, and repayment of debt obligations. While analysing inflows, CARE Ratings also assesses the collection efficiency (collections realized out of invoice raised) of the developer.

CCR indicates the level of cushion available to the company for meeting the debt obligations. 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, lower collections from sold units, decline in price of unsold units, increase in finance cost or construction costs, etc.

Liquidity Analysis

The availability of adequate liquid funds can protect the company against any unprecedented downturn in the economy, impacting the cash flows. CARE Ratings also factors in the structural elements of the debt such as presence of escrow mechanism and ring-fencing of cash flows, availability of adequate funds in Debt Service Reserve Account (DSRA) so as to cover few months' debt servicing obligations as they provide some cushion to the liquidity. CARE Ratings also looks into the ratio of liquidity coverage which determines, liquidity buffer available to cover the debt obligations due in the following year. Furthermore, CARE Ratings' methodology on 'Liquidity Analysis of Non-financial sector entities' is also followed for assessment of liquidity position.

Availability of land bank

The size of available land bank (either owned or acquired under JDA) 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.

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 acquisition of land for a project is more often funded through the promoter's contribution, while the construction of projects is funded through external sources. Furthermore, 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 the developer with slow sales momentum may have to resort to avail debt or unsecured loans from promoters/ group companies, which could result in high leveraging.

Leverage

To assess leverage position, CARE Ratings looks at the proportion of project cost which is funded through debt and an entity with low leverage is viewed positively due to its better financial flexibility and ability to avail additional debt during unprecedented economic scenario. CARE Ratings also focuses on the ratio of the 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. Also, while assessing debt position, lease rental discounting (LRD) loans are discerned with construction finance loans/other debt instruments as, generally, an entity with higher proportion of leasing portfolio enjoys benefit of low average cost of debt, and lower volatility in cash flows.

Environmental, social and governance risk

Environmental, social and governance (ESG) risks tend to be high for real estate as building construction stems out environmental issues and social & governance issues also need consideration. CARE Ratings broadly evaluates these risks with the objective to assess the direct and indirect impact of these risks on the entity and how it is mitigating or plans to mitigate the impact of such risks on its credit profile.

The efforts taken by the company towards a healthy environment would include fostering eco-friendly buildings, increasing the amount of green space, or using environmentally-compatible energy sources, water conservation, waste management etc. 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. Analysis of social aspects in real estate includes understanding developer's participation in the rehabilitation of public spaces, labour relations, policy on health and safety standards 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 organization/group structure including related party transactions, any non-compliance-related issues, or fines/ penalties in the past and changes in systems to mitigate such risk in 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 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 conditions, and other considerations.

[For previous version please refer 'Rating Methodology - Real Estate Sector' issued in March 2021**]**

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