Rating Methodology – Real estate Investment Trusts (REITs)

[Issued in November 2020]

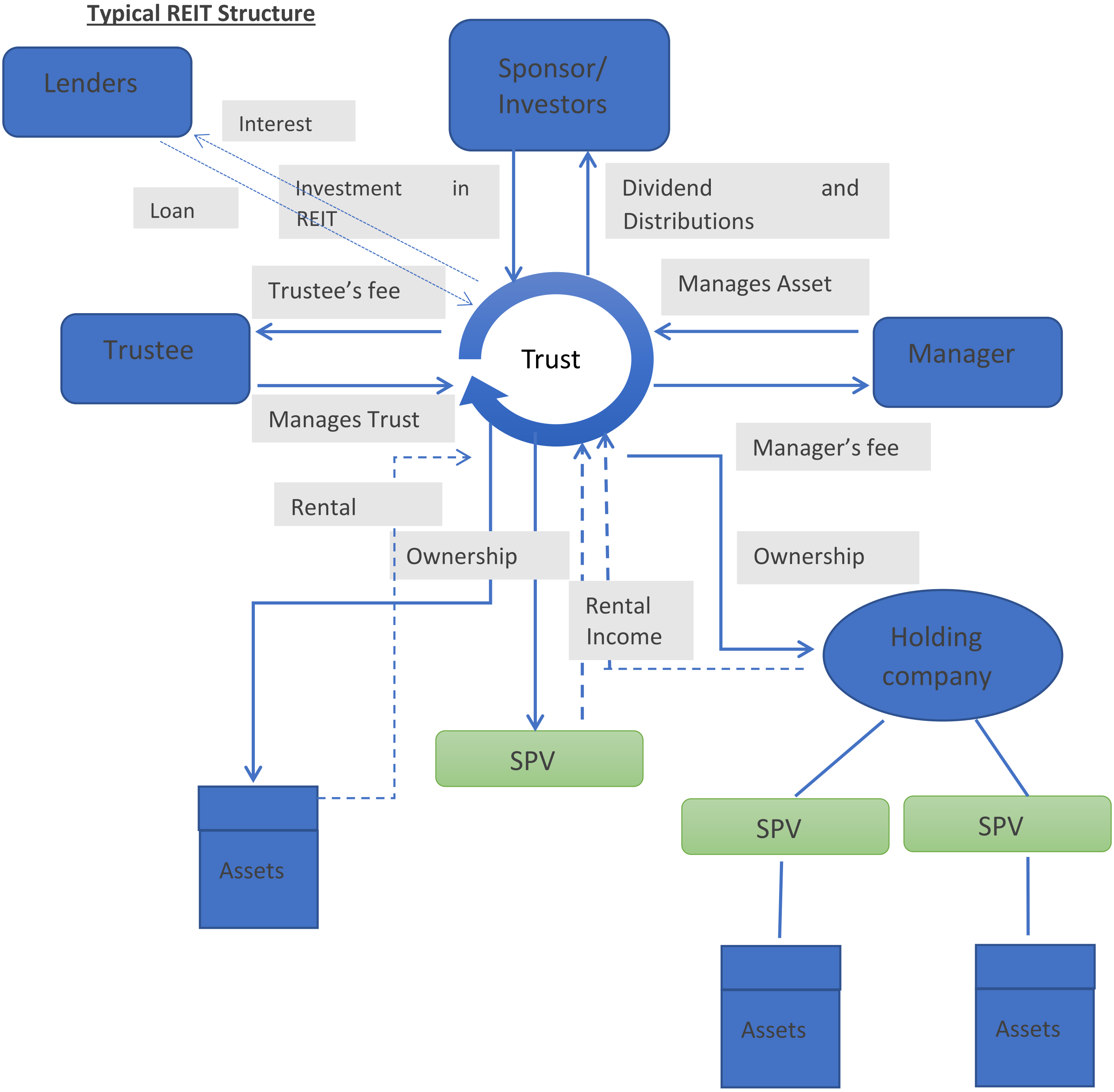
Overview:

India is a developing country and in order to be on a higher and firmer growth trajectory in the years to come, availability and existence of modern infrastructure (including real estate) becomes essential. The Indian real estate sector is well complemented by the demand for office & retail spaces as well as urban and semi-urban accommodations. Real estate sector has a significant role because of its multiplier effect on the overall economy. Also, real estate projects require long-term capital and India suffers from a its severe shortage. In this backdrop, Union Budget in February 2014 introduced Real Estate Investment Trusts (REITs) in India, and subsequently in September 2014, SEBI notified REIT regulations. The regulations were modified through various amendments thereafter to provide a further impetus to the launch of REITs in India.

A REIT is a corporation or a trust which utilizes 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.

REITs are beneficial to both the investors and the real estate industry. REITs provide the investors with an investment avenue which is comparatively less risky (because of investment in completed properties and in a wide number of properties) than investing in under-construction properties, and provides regular income. REITs provide the sponsor (a developer or a private equity fund) long term capital, avenues of exit and enable them to invest in other projects. REITs will infuse additional transparency and liquidity in the Indian real estate market.

Typical REIT Structure



Salient features of SEBI guidelines on REITs:

Brief description of the key features of the REIT regulations introduced first in September 2014 and later updated in September 2016 and June 2020 that impact their credit profile is tabulated below:

Structure of REIT & distribution of cash flows	REITs to hold controlling interest in assets either directly or through SPV. Investment trusts can invest in two-level SPV structure through holding company, subject to the following: a. Investment trusts to have right to appoint majority directors in the SPV(s) b. Holding company to distribute 100% cash flows realised from underlying SPVs and at least 90% of the remaining cash flows c. Atleast 90% of net distributable cash flow of SPVs to be distributed to REIT Mandatory sponsor holding of atleast 25% of the total units of the REIT after initial offer on a post-issue basis for a period of three years from the date of listing as per guidelines issued in June 2020.
Conditions on investment in assets	At least 80% of the value of the REIT assets shall be in completed and rent generating real estate properties. REITs can invest up to 20% in under-construction assets. REIT shall invest in at least two projects, with one project attributing to not more than 60% of the value of REIT assets.
Leverage	REIT can raise debt up to a maximum of 49% of the value of its assets on consolidated basis. External credit rating would be required in the event the consolidated debt and deferred payments exceeds 25% of the asset value

Scope:

The rating of debt at REIT level or at SPV level is an opinion on repayment capacity of REIT in a timely manner. The rating neither signifies the returns to the unit holders nor does it signify any potential yield levels to the unit holders, and thereby should not be construed as a rating of REIT's units. It is an indicator of the credit quality of portfolio of assets which are part of the REIT's portfolio. The ratings neither predict a specific level or range of performance of a REIT (measured in terms of the net asset value or otherwise) over any given time period nor do they opine on the suitability or otherwise of an REIT for investment or any other purposes. Finally, it is to be noted that REIT rating is not a measure on the adequacy of market value or address the extent to which trust expenses and costs may reduce distributions to the unit holders.

Important features of REIT (listed):

I. The REITs are to hold controlling interest and not less than 51% of the equity share capital or interest in the SPVs.
II. REITs can invest in two level structure through holding company (holdco) wherein holdco holds controlling interest and not less than 51% of the equity share capital or interest in the underlying SPVs.

III. REIT shall have right to appoint majority of board of directors in the underlying SPVs.

IV. Mandatory distribution of at least 90% of the net distributable cash flows by SPVs and 100% of the net distributable cash flows by holdco to the REIT.

V. The aggregate consolidated borrowings and deferred payments of the REIT, net of cash and cash equivalents shall never exceed 49% of the value of the REIT assets.

VI. Mandatory sponsor holding of atleast 25% of the total units of the REIT after initial offer on a post-issue basis for a period of three years from the date of listing.

VII. At least 80% of the value of the REIT assets shall be in completed and rent generating real estate properties. REITs can invest up to 20% in under-construction assets.

VIII. External credit rating would be required in the event the consolidated debt and deferred payments exceeds 25% of the asset value.

IX. All related party transactions to be on an arm’s length basis.

X. A full valuation shall be conducted by the valuer not less than once in every financial year and within three months from the end of financial year and no valuer shall undertake valuation of the same project for more than four years consecutively.

XI. A half yearly valuation of the assets of the REIT shall be conducted by the valuer for the half-year ending September 30th for a publicly offered REIT for incorporating any key changes in the previous six months and such half yearly valuation report shall be prepared within 45 days from the date of end of such half year.

Responsibilities of Investment Manager as listed under SEBI guidelines

I. The investment manager must make the investment decisions with respect to the underlying assets or projects of the REIT including any further investment or divestment of the assets.

II. The manager shall ensure that the investments made by the REIT are in accordance with the investment conditions specified and in accordance with the investment strategy of the REIT.

III. The manager shall undertake management of the REIT assets including lease management, maintenance of the assets, regular structural audits, regular safety audits, etc. either directly or through the appointment and supervision of appropriate agents.

IV. The investment manager must ensure that the real estate assets of the REIT or SPV have proper legal titles, if applicable, and that all the material contracts including rental or lease agreements entered into on behalf of REITs or SPV are legal, valid, binding and enforceable.

V. The investment manager must appoint the valuers, auditor, registrar and transfer agent, merchant banker, custodian and any other intermediary or service provider or agent as may be applicable with respect to activities pertaining to the REIT in a timely manner.

VI. The manager shall appoint an auditor for a period of not more than five consecutive years.

VII. The manager shall arrange for adequate insurance coverage for the real estate assets of the REIT.

VIII. If the REIT invests in under-construction properties, the manager may undertake the development of the properties, either directly or through the SPV, or appoint any other person for development of such properties and shall oversee the progress of development, approval status and other aspects of the properties up to its completion.

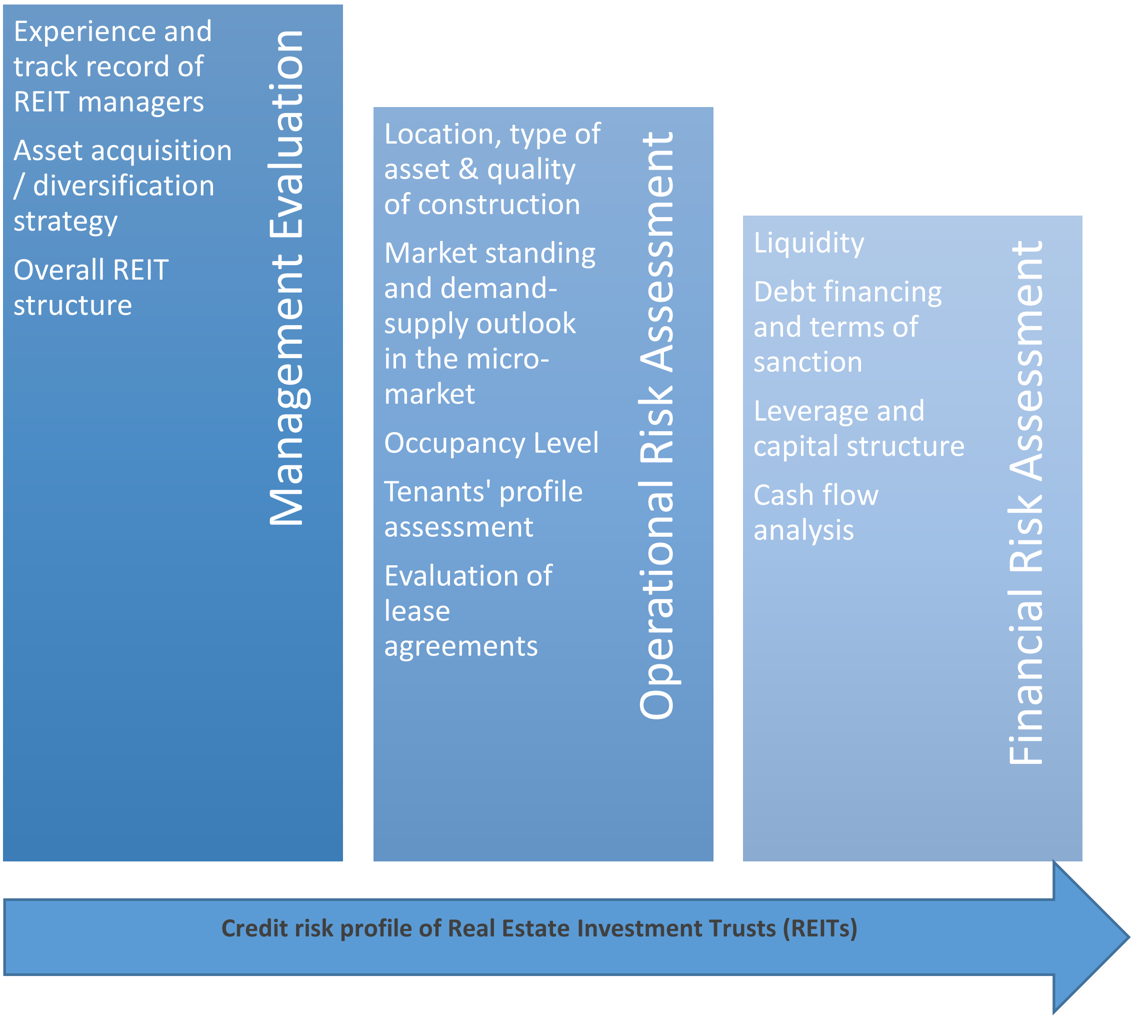
IX. The manager shall ensure that it has adequate infrastructure and sufficient key personnel with adequate experience and qualification to undertake management of the REIT at all the times.

X. The manager shall be responsible for dealing with all matters relating to the issue and listing of the units of the REIT.

XI. The manager shall ensure that computation of NAV of the REIT is based on the valuation done by the valuer and is declared no later than fifteen days from the date of valuation (shall be disclosed to the stock exchanges) and such computation shall be done and declared not less than once every six months.

XII. The investment manager must declare distributions to the unit holders in accordance with regulations

Rating methodology for REIT :



Management/Sponsor Evaluation:

As per SEBI guidelines, REIT managers should have at least five years of 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.

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 (including asset acquisition/diversification & fund raising) inherent in operating a REIT.

Operational Risk Assessment

The most important driver of the REIT's credit rating is the credit quality of its assets. CARE recognizes that the entire cash flow which is available to the REIT to service its debt (holdco and SPVs) is to be generated by its investments in real estate assets.

However, if there are any restrictions with respect to fungibility of cash flows of any particular SPV, the same will be excluded from pooling of cash flows. For example: LRD assets housed under REIT.

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 (for e.g. office space, mall or hotel) in which the REIT has invested is assessed as different type of properties have different risk profiles. Another important focus is on the REIT's competitive position, which is indicated by whether the REIT is the 'landlord of choice' in its core markets. Apart from these, business risk analysis will include the analysis of following parameters:

a. **Location, type of asset and quality of properties** – The marketability of a fund's property and hence the strength of its cash flows is likely to be driven by its geographic location and property quality. Key factors to note here will be location of property, whether in the central business district of key cities, proximity to residential areas and has access to skilled labour or not.

   Diversification in terms of type of assets, location in different areas of a city as well as different cities is also considered. Generally, a portfolio which relies on only one or two properties for the majority of net operating income would be considered less diverse. The number of properties added to the portfolio over the years is also taken into account.

Quality of a building including age, size and state of maintenance will also be critical as it helps in judging the ability of the property to retain existing tenants as well as attract new tenants.

b. Tenancy profile, occupancy levels & evaluation of lease agreements – REIT's ability to lease or rent out the properties to established corporations (with a strong credit standing) across diversified business sectors is analysed. Number of tenants added over the years as well as overall occupancy levels during the past three years is seen. Long-term leases provide stability to the income of the portfolio and regular review of rent provides scope for increase in the income.

Further, development and acquisition pipeline of a REIT is looked into.

Financial Risk Analysis – Financial risk analysis includes analysis of the following factors:

a. **Liquidity -** REIT's cash flow position and working capital lines will be assessed by CARE 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. The timing of debt repayments is important and hence well staggered debt repayments are considered as positive from liquidity perspective.

b. **Leverage, capital structure, debt financing and terms of sanction**- REIT's ability to retain excess cash is limited by compulsory distribution of dividends that amounts to 90% of net distributable cash flows. Due to constraints on retaining excess cash, almost all acquisition and development growth is financed through raising additional equity or debt. REITs' ability to repay its debt also may hinge on its ability to raise funds. A REIT may adopt the following options for reduction/refinancing its debt; disposal of assets, raise funds in the debt market or the equity market or avail mortgage financing. Analysis of financial and non-financial covenants is important in case of funds are raised through debt market. The ability to exercise these options will depend on the prevailing market conditions, debt to market capitalization, asset quality and the status (encumbered or unencumbered) of the assets.

c. **Cash flow and earnings–** Like in the case of a real estate entity, even in case of a REIT, cash flow analysis is crucial. Cash inflows are affected by factors such as the quality of assets, lease structures, tenant quality, occupancy rates, prospects for rental growth, borrowings, equity issuance and asset sales. Cash outflows include operating costs, asset maintenance, taxes, asset acquisitions, dividend payments and debt repayments. A REIT's ability to generate high, consistent returns with revenue growth is analysed. These are reflected in the operating margins, volatility of returns and earnings growth rate. Interest coverage ratio is also considered. Cash flow coverage of the REIT's debt obligation is a primary rating factor and to assess the stability of the cash flow, sensitivity analysis is conducted.

CARE reviews the rating whenever a new significant asset is added or divested from the portfolio and if it denotes a deviation from the stated investment policy, the asset acquisition may impact the REIT's credit quality. The rating will normally correspond to the current portfolio of assets and impact of any new additions or deletions will also be considered.

Conclusion:

REIT is a vehicle to invest in income generating real estate assets. REITs are governed by SEBI guidelines. Guidelines have been revised over a period to attract interest of investors and recently unlisted private REITs have been exempted from restriction on leverage and mandatory distribution. The rating outcome is ultimately an assessment of credit quality of portfolio of assets housed under REIT, stability of cash flows and debt protection metrics, refinancing risk, financial flexibility and management risk.

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