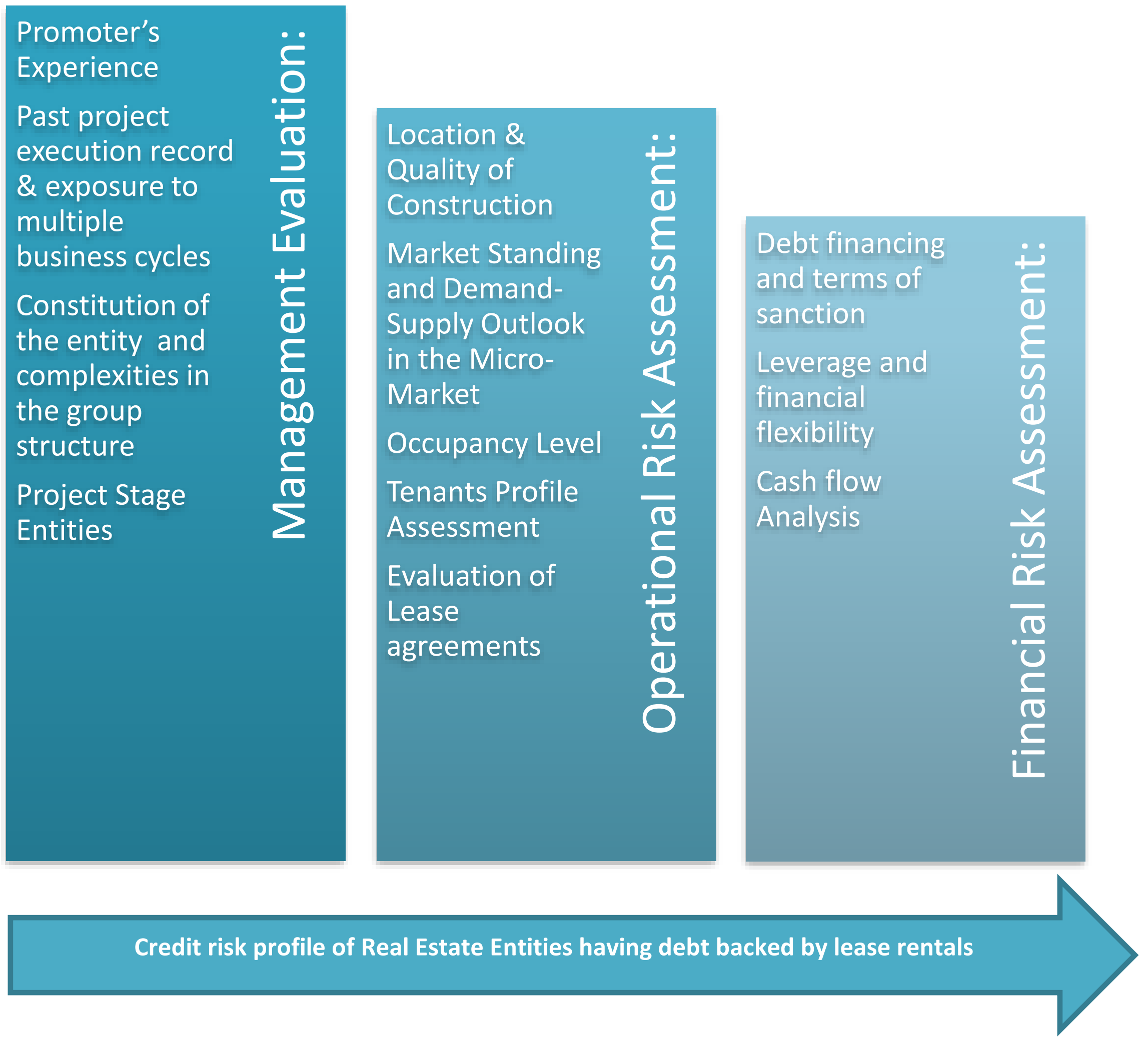
Rating Methodology - Debt backed by Lease Rentals Discounting

[Issued in March 2021]

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 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 usually 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). CARE Ratings analyzes various factors such as type of asset, location, maintenance of properties, occupancy level, lock-in tenure, loan to value, lease terms, tenants' profile and track record of developer in leasing out the facilities. Emphasis is also placed on 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) 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 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 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.

Experience of promoters/top management in real estate development

Having the top management and promoters with experience in the main line of business, the rated entity can be steered to achieve its stated goals. They shall generally be able to resolve the challenges and take critical decisions to achieve the desired success.

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

Higher space developed & leased in the past indicates better track record of developer in completing the projects within timelines and leasing it out. Furthermore, CARE Ratings places emphasis on timeliness within which past projects were completed & leased out as well as the similarity in the types of projects executed (Commercial Malls, Commercial Offices, Warehouses, etc.) to better understand the experience of the developer.

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 large number of sister concerns in the form of special purpose vehicles and inter-corporate dealings require thorough review. Similarly, the wholly-owned subsidiary/ SPV of larger group is generally viewed favorably as against the joint ventures or partnership constitution of the entity considering the differences in regulations & disclosures.

Evaluation of project stage entities

While rating the project stage entities/SPVs, CARE Ratings takes into account the strength of group/ promoter and the support available to SPVs. Such companies do not generate cash flows for initial few years during the construction of leasing facilities. Normally, the construction of such facilities is funded through equity and debt in the form of term loans, having moratorium. 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 LOI, if any, prevailing rental rates in the vicinity, terms of sanction, etc.

Group Support

In a typical group structure where leasing 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 the parent company. Extent of notch up/down is however dependent on various factors as laid out in detail in the methodology on factoring linkages.

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 analyzing various factors such as property's location & 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 & 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:

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. If the 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 is considered crucial for shopping malls and offices spaces.

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

Market Standing and Demand-Supply Outlook

CARE Ratings looks at 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 analyzing the demand in the micro-market where property is located, CARE Ratings takes note of 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 analyzes the past vacancy trend of the properties forming part of 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. Analyzing past vacancy trend also provides an indication about the market position and the ability of 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 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. Favorable credit quality of tenants indicates the stability of rental inflows and likelihood that the terms of lease agreements will be honored 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

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. 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. 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. Typically, retail malls would have shorter notice period compared to other two types of assets. 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 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 utilization of loans is also thorough looked into. The key parameters considered while analyzing 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 utilized for meeting the debt commitments on priority after meeting the statutory obligations and remaining amount could be utilized 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, 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 analyze 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. While the projects are normally executed under Special Purpose Vehicle 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 cognizance while analyzing 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 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. In this regard, Debt Service Coverage Ratio (DSCR) is computed to evaluate the times of cash cover available to the company for servicing the debt commitments. While computing DSCR, 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 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 DSCR over the projected period is considered as a critical metric to evaluate the financial risk profile of the entity. An adequate DSCR throughout the tenure with presence of DSRA thus entails comfortable financial risk profile.

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 evaluates if significant buffer is available to meet the repayments due in the subsequent year.

Real Estate Investment Trust (REIT)

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. While assessing the REITs, CARE Ratings analyzes the overall REIT structure and assets profile in accordance with its methodology on analysis of REITs (which is available on our website www.careratings.com) in conjunction with this methodology.

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.

[For previous version please refer 'Rating Methodology – Debt backed by LRD' issued in February 2020]

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