Rating Methodology for debt backed by Lease Rental Discounting (LRD).

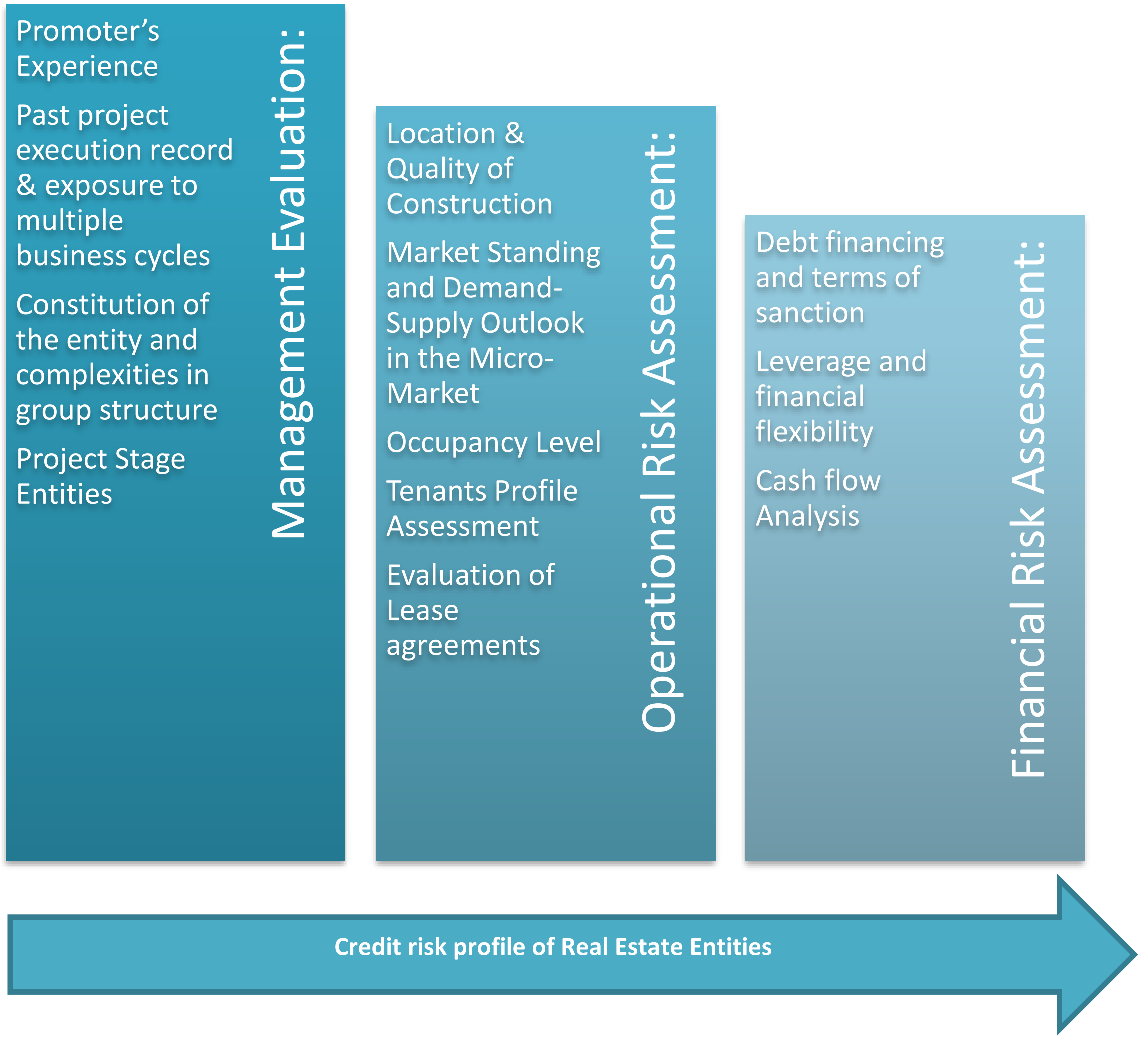
[Issued in February 2020.]

Background

Lease rental discounting (LRD) is essentially a loan facility availed by a company against the rental properties with the types of commercial, retail, warehouses, etc. earning a fixed amount of rentals at scheduled intervals. The quantum of 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 escrowed account and the application of such funds usually concurs with the well-defined waterfall mechanism with debt commitments being the priority. Usually, in construction phase, the developers avail term loan with high moratorium period and post construction and tie up with tenants for rentals; the developers get the debt converted into LRDs in order to take advantage of lower finance costs as LRDs are considered relatively safer with cash flows being ring-fenced through DSRA, escrow and waterfall mechanism. CARE Ratings analyzes various factors such as type of asset, location, asset quality and marketability of the 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 net projected rental cash flows 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). Further, this methodology should not be construed as comprehensive list of all the factors that are reflected in ratings, however 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, involvement of the group in other business segments and level of Corporate Governance in its dealings. While the rating exercise is highly 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 the factors such as litigations against developer or long pending projects or substantial support extended to related parties etc. indicating the unfavourable position of the developer.

Experience of promoters /top management in real estate development

Having the top management and promoters experienced in the main line of business, the rated entity can be steered to achieve its stated goals. They shall 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. Further, 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 timelines for completing of future projects.

Constitution of the entity and complex group structure

Constitution of an entity may determine 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 viewed positively 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 or conversion facility. 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. 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 group in supporting the SPV executing such project, percentage of LOI, if any, ongoing rates, terms of sanction etc.

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 & construction quality of the properties, 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 & construction quality of the assets forming part of developer's portfolio is critically evaluated as it indicates the market position of the lessor to lease out the assets or roll over the already leased assets at desired rates. Grade A assets positioned at prime location attract strong tenants with high credit quality and facilitates the firm in maintaining the pricing power. 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 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. Thus, proximity to key locations is viewed favorably in terms of drawing the tenants towards the property, minimizing vacancy risk.

Market Standing and Demand-Supply Outlook

CARE Ratings looks at the market position of the developer to determine if the firm is frontrunner in micro markets 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, current and future developments in the locality, outlook of the industries located in such area, expansion by existing tenants, presence of infrastructural amenities such as parking facility, power and water backup, recreational facilities, etc.

Supply in the market is mainly driven by the upcoming properties in the vicinity, availability of the space, movement in the input costs, existing tenants profile, rental rates and vacancy trend.

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 would detract the existing tenants 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 deviation in the occupancies is looked into to determine the reason for variation. 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. The other reasons for lower current or past occupancy level could be economic downturn, ageing of property, locations turning unappealing, etc. Analyzing past vacancy trend also provides an indication about the market position and 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 tenant concentration or industry concentration covered briefly in upcoming section is viewed adversely. Strong diversified portfolio entails stability in the occupancy levels and cash flows.

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.

- High tenant concentration is viewed adversely 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.
- Similarly, high number of tenants from single industry such as ITes, Financial Institutions, or Automobile etc. could result into higher vacancy if such industry to which tenant belongs witnesses slowdown.
- Leasable area being occupied by multiple tenants having strong fundamentals belonging to different sectors also contributes towards better occupancy ratio and thereby keeps cash flow volatility in check to larger extent. The credit quality of tenant is thus essentially 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.
- 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 capital cost incurred.

Evaluation of lease agreements

The various features of lease agreements such as lease tenor, lock-in period tenor, provision for 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 and accordingly intensify the credit risks. Further, reputed developers tie up into the leasing agreement with certain tenure of lock-in period and often lease rentals are linked to fixed escalation during such period. The sizeable lock in tenure with fixed escalation gets the occupancies contractually committed beforehand and thereby the risk of vacancy gets mitigated. 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 rating 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, overall gearing 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 are essentially given an emphasis to understand the level of discipline reflected from such terms. Presence of defined mechanisms such as routing of rent through escrow account and thereby discipline of such cash flows entails timely serving of debt commitments. In such mechanisms, escrow account typically remains in control of the lender and accordingly rental receipts are first utilized for meeting the debt commitments and remaining amount could be utilized for other expenses based on the approvals from lender. Maintenance of Debt Service Reserve Account (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. The time gap available between rent receipt date and the loan repayment dates also provides additional comfort as sufficient time gap between the two events 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 buffer 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 one of the most important metric to analyze the financial profile of an entity, however, 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 thus the gearing levels of such entities normally tend to be high. CARE Ratings, therefore, also takes into account the ratio of loan to value, based on latest asset valuation report in conjunction with the overall gearing ratio to determine the financial flexibility of the company. However, sanction terms and relationship with lender is 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.

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, promotion income 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. 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.

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, 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 company's financials based on past trends and future strategies, competition, industry trends, economic condition and other relevant considerations.

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