ICRA

ICRA Rating Feature

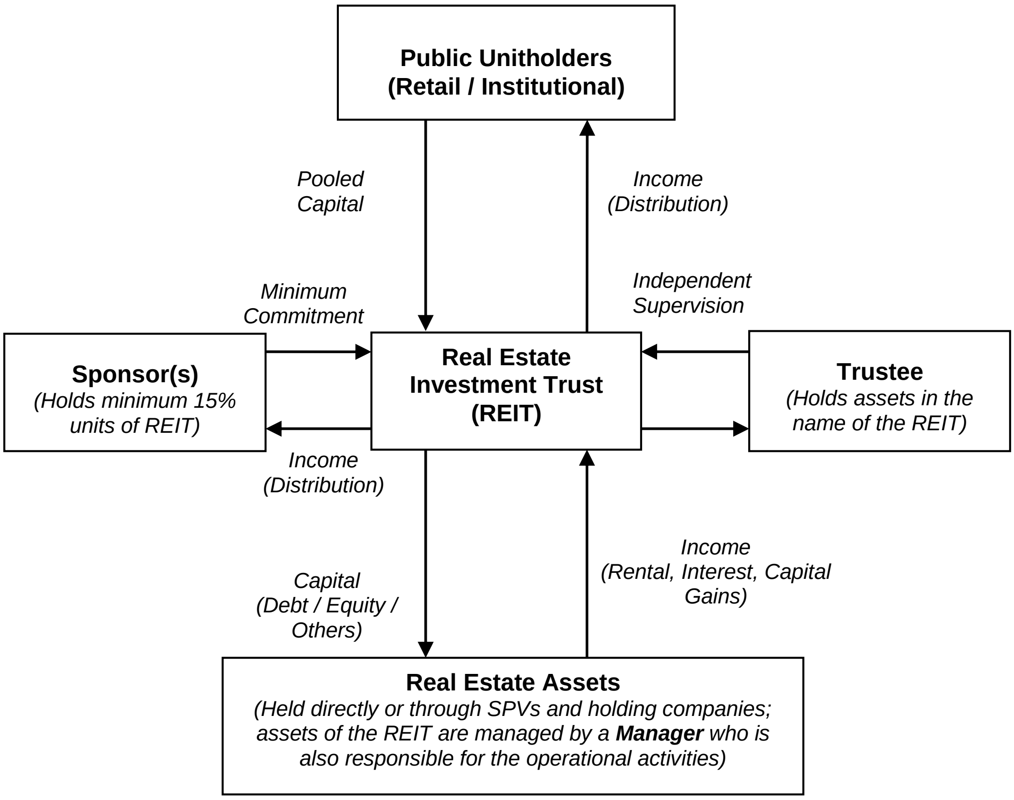
Rating Methodology for Real Estate Investment Trusts (REITs)

Overview

Real Estate Investment Trusts (REITs) act as vehicles for owning and operating revenue generating real estate assets and distributing cash flows from them to the unit-holders. Structured like a mutual fund, REITs utilise the pooled capital of an investor base to deploy across various income-producing real estate assets such as office space, shopping malls, hotels, resorts, self-storage facilities and warehouses. REITs provide an avenue for retail as well as institutional investors to participate in real estate ownership, management and development.

The Securities and Exchange Board of India (SEBI) notified the regulations for establishing REITs in September 2014 through the SEBI (Real Estate Investment Trusts) Regulations, 2014. This was subsequently amended in November 2016 through the SEBI (Real Estate Investment Trusts) (Amendment) Regulations, 2016 to provide a further impetus to the launch of REITs in India. As per the REIT regulations, a REIT is to be incorporated as a "trust" under the Indian Trusts Act, 1882, and registered with SEBI. The units in the trust are to be listed on stock exchanges and be traded. The parties to the REIT are to be the sponsor (or the promoter), the trustee and the property manager(s). A REIT could own the underlying assets directly or through special purposes vehicles (SPVs), with intermediate holding companies also permitted (subject to certain regulations). Further, REITs are permitted to raise external debt, either directly or through the SPVs, subject to a cap of 49% of the total REIT asset value. A graphical representation of a REIT structure along with the various stakeholders is shown below.

Exhibit 1: Graphical Representation of a REIT Structure in India



A REIT's credit rating is an opinion on its ability to service its debt obligations in a timely manner. This entails an assessment of the operational and financial risk profile of the REIT's portfolio of assets on a consolidated basis. The analysis takes into account the external debt availed or proposed to be availed at the consolidated REIT structure and the explicit or implicit support extended by the REIT to the SPVs. A REIT's credit rating is not a reflection of credit worthiness of the individual SPVs of the REIT, pricing of the units issued by REIT or its market performance and potential returns to the unit holders.

ICRA's credit assessment of a REIT is based on a consolidation of the business and financial risk profile of the REIT with that of its SPVs. Accordingly, the rating of a REIT benefits by virtue of asset diversification and the associated cash flow diversification. Moreover, the REIT regulations impose certain conditions on the operational and financial profile of a REIT, which favourably support their credit profile. These include mandatory distribution of available free cash flows at the SPV level, cap on the under-construction areas in the portfolio, limits on permissible leverage levels, enhanced disclosure norms, which are enforced by an independent trustee and regulation of the sponsor holding in the REIT. While the credit rating of the REIT is not an opinion on the credit-worthiness of the underlying SPVs or the ability to service the internal debt infused by the REIT, the quantum and terms of such debt become important for analysing the REIT's credit profile since they have a direct impact on the distributable cash flows available to the REIT.

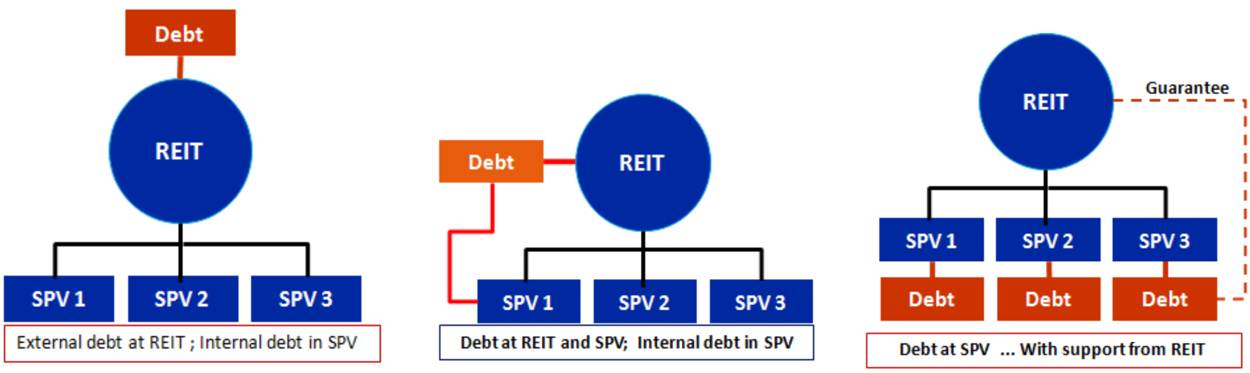
Salient features of REIT regulations which govern their operations

The business and financial risk profile of REITs are governed by the REIT regulations, which were initially notified in September 2014 and subsequently amended in November 2016. A brief description of the key features of the REIT regulations that impact their credit profile is given below.

Conditions on Investment in Assets	• Not less than 80% of the value of the REIT assets shall be in completed and rent generating real estate properties; hotels, hospitals and convention centres, which form a part of the composite real estate projects, are also permitted real estate assets • Not more than 20% of REIT assets shall be in the form of other permitted assets, which include under-construction properties • REIT shall invest in at least two projects, with one project attributing to not more than 60% of the value of REIT assets
Distribution of Cash Flows	• REIT or SPV shall distribute not less than 90% of net distributable cash flows to its unitholders / REIT not less than once every six months • Intermediate holding company shall distribute 100% of the cash flows received from underlying SPV and at least 90% of the cash flows generated by it on its own • If any property or shares is sold by the REIT / SPV / holding company, it shall distribute at least 90% of the sale proceeds; unless the REIT proposes to reinvest the sale proceeds into another property within a period of one year
Debt	• REIT can raise debt (net of cash) up to a maximum of 49% of the value of its assets on consolidated basis; further an external credit rating would be required in the event the consolidated debt and deferred payments exceeds 25% of the asset value

Source: SEBI

Debt could be raised by the REIT at any of these levels / combinations



As permitted under the regulations, the REIT can raise external debt either at the trust level (from banks / financial institutions) or at the SPV level. The consolidated debt is required to be capped at 49% of the value of the REITs' assets. The debt raised at the SPV level could be guaranteed by the REIT, if the cash flows at the SPV level are expected to be inadequate or volatile. In a few cases, even if the SPVs cash flows are adequate, the REIT can guarantee the debt at SPV for credit enhancement purposes. The REIT can also invest in the SPVs and intermediate holding companies through debt instruments.

ICRA's Credit Risk Assessment Framework

This rating methodology explains ICRA's approach to assess the business and financial risk profiles of REITs. It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing risks that are likely to affect rating outcomes. This document does not include an exhaustive discussion of all the rating factors that our analysis considers, but provides an overall perspective of the considerations that are usually the most important.

Since the REIT can operate through a multi-level structure involving holding companies and SPVs, the rating takes into account the consolidated business and financial risk profile of the REIT. The approach for consolidation in REITs is broadly similar to that detailed in ICRA's note "Financial Consolidation and Rating Approach" available on ICRA's website. The REIT regulations mandate distribution of specified percentage of free cash flows; moreover, the REIT is required to have majority shareholding and board representation in the SPVs which would provide it with a high degree of control over these entities. These factors validate the consolidated approach taken for rating REITs. At the same time, special attention is paid to the terms and covenants of any external debt availed in the SPVs and holding companies, their impact on the distributable free cash flows and the matching of timing of cash flow distribution to the REIT with the latter's payment obligations.

For analytical convenience, the key factors are grouped under the following broad heads — Business Risk Assessment, Financial Risk Assessment and Management Risk Profile.

Credit risk categorisation

Business Risk

- Assessment of individual assets
  - Asset location and quality
  - Demand-supply dynamics
  - Trends in occupancy and rentals
  - Salient features of lease agreements
  - Tenant profile and counter-party credit risk
  - Project implementation risk
- Portfolio diversity

Financial Risk

- Stability of cash flows
- Leverage and capital structure
- Debt coverage and liquidity
- Capital expenditure and growth plans
- Interest rate and forex risk
- Structural factors

Management Risk

- Management and trustee profile
- Governance structure, systems, processes, policies and strategic intent

Business Risk Assessment

Assessment of business profile of individual assets and SPVs

REITs are intended to primarily hold completed and rent-generating assets. Though the REIT regulations permit REITs to invest in hotels, hospitals and convention centres which are part of the composite real estate project, the majority of the asset portfolio would comprise rent generating assets such as office parks, retail malls, etc. Hence, the framework for assessing the business risk profile of REIT assets would largely follow from the framework detailed in ICRA's rating methodology note for "Debt Backed by Lease Rentals" available on ICRA's website. The key assessment parameters are broadly summarised below:

Asset location and quality

REITs are set up with the objective of generating predictable and stable cash flows over the long term from its investment portfolio. The long term stability of the property cash flows will depend critically on its location and asset quality. A prominent location within the key business districts / shopping hubs of a metro city would be a supporting factor in achieving healthy occupancy levels. Further, connectivity with the major residential areas and presence of effective transportation options also increase the attractiveness of the property. Property specifications and quality of construction and maintenance are also key drivers for attaining high occupancy. A well maintained, strategically located property having requisite amenities and specifications is likely to result in higher occupancy over the long term on account of stickiness of tenants as well as ability to attract new tenants, if required.

Demand-supply dynamics

The demand-supply outlook for the micro-market where the property is located has a direct bearing on occupancy levels and rentals, thereby making it an important consideration from the rating perspective. While estimating demand for the property, ICRA takes into account various factors such as project location, top industries and business houses in the region, expansion plans of existing tenants and likelihood of tenants vacating the property in search of bigger/better or cheaper properties. In addition to the existing supply in the particular region, the ongoing and planned development in the vicinity is a key factor in determining the expected occupancy levels and lease rentals. The demand-supply situation is also very critical in determining the likelihood of the lessor being able to let out any un-leased portion in the project as well as the likelihood of attracting new tenants should any vacancy arise. In addition, ICRA takes into account the vacancy rates, and trends in lease rentals as well as the property rentals in similar properties in the vicinity while projecting estimated occupancy and rentals for the properties under consideration.

Trends in occupancy and rentals

Occupancy level and average rent rates are the two main variables that determine the level of cash inflows or net operating income (NOI)[1] for a rent-generating property. These parameters are driven by the various business risk factors discussed above; moreover, they are also interlinked to some extent. In ICRA's experience, sustainability of high rentals, if not backed by strong location advantages and superior quality of development, could be tested in the long term. ICRA believes that competitive rentals allow the property to attract and retain tenants and thereby result in high occupancy rates. The trend in historical occupancy and rent rates in the subject property are analysed and is used by ICRA while projecting the future occupancy and rent rates for the property. A strong track record with consistently high occupancy levels in the past and ability to achieve rental growth in line with market rates is viewed positively.

Salient features of lease agreements

ICRA evaluates the salient features of the lease agreements, which typically include lease tenure expiry schedule, lock-in expiry schedules, security deposits collected from the tenants, rent revision schedules, rent free period, renewal options available to lessee and common area maintenance charges. These have an important bearing on the quantum and predictability of the projected cash flows from the property.

Tenant profile and counter-party credit risk

Strong credit profile of the tenants in conjunction with the commitment demonstrated in the past towards timely rental payments would indicate high ability of the asset to generate cash flows as per the contractual terms. Besides, ICRA also takes into account the client concentration prevailing for the property - higher the degree of concentration, larger would be the reduction in occupancy ratio and cash flows should the tenant vacate after expiry of the lock-in period. ICRA also looks at the sectoral profile of the tenants in the REIT assets – a high concentration on any particular sector can expose the cash flows of the REIT to any downturn in demand due to the sector's business outlook changing.

Further, the relationship of the tenants with the lessor, presence of the tenant in its other properties, tenants' future growth plans and the positioning of the subject property in their future plans are some of the key determinants affecting lease renewal prospects. Understanding tenants' future growth plans or their view on continuity in a particular property is difficult to judge or forecast, but at the same time it is a key determinant of the adequacy of cash flow; therefore, it becomes a key variable for sensitivity analysis.

[1] *Net operating income (NOI) is defined as lease rental income (excluding maintenance) less property tax and insurance expenses*

Project implementation risk

REITs are permitted to have up to 20% of their asset portfolio in the form of under-construction properties. This exposes the REIT to project risk in relation to the ongoing development. ICRA analyses the project's execution risk, regulatory risk and funding risk, as typically done for project stage issuers, for the under-construction asset(s). The focus is on identifying the key risks which could impede the timely commissioning of the asset, evaluating market factors that will impact the operational metrics post commissioning, and estimation of the net free cash flow addition to the REIT from the asset on completion. Projects which are brownfield expansions of existing operational assets are typically seen more favourably from a business perspective because of the track record demonstrated in the operational asset. Likewise, projects that are expected to generate high free cash flows (because of good profitability or limited leverage deployed in construction) are also seen favourably.

Portfolio diversity

Diversity in the asset portfolio aids the credit profile of the REIT as it can mitigate the risks of cash flow shock in any of the operational assets. ICRA evaluates the diversity of the portfolio, based on the geographical presence of the assets, sectoral profile of the tenants and degree of co-relation between the business risk profile of the assets. Material presence in multiple markets (cities as well as micro-markets) can mitigate the risks of adverse demand-supply scenario in any specific market. Moreover, a wide distribution in the sectoral profile of the tenants (such as IT/ITES, BFSI, manufacturing, etc) can reduce the risks of reduction in demand from any particular sector. Even when the REIT portfolio is diversified with the presence of retail malls, hotels, etc as part of composite projects, the performance of these assets could be linked to some extent to the occupancy in the office parks. In this context, a well diversified asset base spread across multiple geographies with no single asset dominating the cash flows and low receivable concentration from any single counter party is viewed favourably. The REIT regulations mandate certain level of diversification as no project can attribute to more than 60% of the value of the REIT assets.

Financial Risk Assessment

Stability of cash flows

For assessing the stability of cash flows, ICRA considers parameters such as the past track record of fund flows from operations, nature of the underlying assets, contractual terms relating to rent rates and their escalations, diversification in tenant profile, cost structure for maintenance services and agreements with tenants for recovery of the same. Here emphasis is laid on the predictability of cash inflows and ability of the manager to exercise better control over operating costs. For projects with short operational track record, the projections are drawn based on base case estimates of occupancy, rent rates, collection efficiencies, etc with various sensitivities imposed to account for the limited track record of such parameters.

ICRA also notes that the stability of cash flow associated with different segments of commercial real estate, such as office, industrial and retail, can be different. Cash flows from office properties can be considered to be most stable and predictable given the longer lease terms, stickiness in lease renewals, fixed rent rate agreements and relatively lower vulnerability to general macro-economic trends. On the other hand, leases in the retail segment are subject to various additional risks such as variable rent rates (due to revenue share arrangements), shorter lease terms, risks of diminishing property attractiveness due to competition and variability in footfalls and shopping spends due to changes in macro-economic conditions. It is also observed that the fixed operating costs involved in a retail property could be higher on account of the increased marketing, security, housekeeping and power charges as compared to an office property. These variations are appropriately factored in by ICRA while assessing the stability of cash flows and estimating the level of operating expenses in its projections.

Leverage and capital structure

ICRA evaluates the leverage level in a REIT as the ratio of consolidated external borrowings (excluding security deposits) to the value of the REIT assets. Though the valuation of the assets as done by an independent valuer on half-yearly basis is primarily relied upon, ICRA also carries its own assessment by using known market values in comparable properties and / or discounting the projected cash flows of the property. Generally, a conservative leverage ratio is viewed favourably as it lowers the committed financing outflows, reduces refinancing requirements and provides headroom for drawing additional debt to meet exigencies or fund future growth plans. The REIT regulations impose an upper cap on the permissible leverage in the REIT on a consolidated basis; if a REIT is leveraged to the maximum extent possible, it will reduce its financial flexibility and increase dependence on further equity raising or asset sale in case of large funding requirements towards under-construction projects or acquisitions.

Debt coverage and liquidity

ICRA evaluates the debt-servicing ability of the REIT by analysing the debt service coverage ratios (DSCR) both on consolidated and standalone basis. The cash flows available for debt servicing are estimated after subtracting statutory payments due, operational expenses, overheads and taxes from the cash inflows and compared with the committed debt servicing payments due. The DSCR ratios under various sensitivity scenarios of occupancy, rent rates and operating costs are estimated and their adequacy for the rating category is established.

While the DSCR at the consolidated level is an important parameter to evaluate, the DSCR at the REIT standalone level is also estimated to account to ensure that there are no mismatches in the net cash flows and committed payments at the trust level. Mismatches could potentially arise due to timing differences between cash flow distribution by SPVs and debt repayment dates, restrictions on distribution on cash flows from SPVs on account of the external debt taken at SPV level and higher leverage at REIT level to support under-construction assets in SPVs. Hence, alignment of the inflows with adequate cushion over payout dates for external debt, SPV debt (could be external or from REIT) and dividend to unit holders to avoid any mismatch between REIT obligations and inflows will be considered favourably. In addition, unencumbered cash balances and debt service reserve accounts (DSRA) at REIT level can provide liquidity support and help tide over short term cash flow mismatches.

Capital expenditure and growth plans

Since the REIT regulations permit up to 20% of the assets to be in the form of under-construction properties, the funding of such development projects could constrain the free cash flows of the REIT. In this context, the scale of ongoing development, proposed funding mix, tie-up of project specific debt funding and the business risks relating to the ongoing development are evaluated to understand the impact on the REIT's free cash flows. Even if the development is being undertaken through SPVs, the REIT may be required to extend funding support to the SPV for the development in case of any cost over-runs or delays in closure of debt financing.

The growth strategy of the REIT, both with respect to organic expansion as well as acquisition of completed properties, would also be evaluated to understand the potential impact on future leverage levels. The REIT managers' strategy of identification of asset pipeline, diversification goals, expected returns from new acquisitions and appetite for leverage are some of the key parameters that are considered.

Interest rate and forex risks

Foreign currency risk for a REIT can arise from the unhedged foreign currency borrowings which could have been raised to part-fund the project cost. As there is limited scope for a natural hedge, the focus of the evaluation is on the hedging policy of the issuer to mitigate risks for net foreign currency exposure. Similarly, the extent to which an issuer would be impacted by movements in interest rates is also evaluated.

Structural factors

Creation of debt service reserve account (DSRA) either in the form of cash deposits or in the form of a guarantee (DSRA Guarantee) so as to cover a few quarters of debt servicing obligations (both principal and interest) provides comfort on the liquidity profile of the REIT. Other forms of credit enhancement include senior-subordinate debt structuring, mandatory prepayments on activation of triggers, etc. ICRA also draws comfort from the restrictive debt covenants that the REIT will not raise any further external debt, lender's consent for addition of new assets and the presence of an experienced trustee / asset manager.

Other elements of credit risk assessment

Accounting quality: The REIT's accounting policies, notes to accounts, and auditor's reports are reviewed as part of the rating process. Any deviation from the generally accepted accounting practises is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations.

Contingent liabilities / Off-balance sheet exposures: The likelihood of devolvement of contingent liabilities / off-balance sheet exposures of the REIT (which could include guarantees from the REIT to various SPVs, bank guarantees given against security deposits, etc) and the financial implications of the same are evaluated.

Management Risk Profile

All debt ratings necessarily incorporate an assessment of the quality of the issuer's management, including the REIT's sponsor(s) and manager. Usually, a detailed discussion is held with the manager to assess various parameters such as:

a. REIT manager and trustee's experience and track record
b. Investment process and objectives
c. The policies on leveraging, rationale for debt raising, balance between leverage and returns, interest risks and currency risks
d. Asset acquisition / asset diversification strategy, assets in pipeline
e. Conflict of interest between sponsor, trustee, investment manager and project manager

Periodic interactions with the management provide insights into the operations of the REIT and further help understand the management's commitment to the business and strategies. The interactions with the management also help ICRA estimate the probability of the management's tendency to deviate from its business philosophy in times of stress.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements.

Overall, ICRA has a more favourable opinion on REITs that have diversified and high quality asset base, stable cash flows and strong counterparties. ICRA also draws comfort from strong DSCR and conservative leverage ratios. Presence of structural features like adequately funded DSRA with restrictive covenants on additional debt and lenders' consent for addition of new assets is a credit positive. The rating is also a function of the operational track record of the assets, the REIT's asset acquisition strategy and experience of investment manager and trustee. Material deterioration in risk profile of any underlying asset could adversely affect the REIT's credit profile.

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