Commercial Real Estate Rating Methodology

Executive Summary

Commercial Real Estate (CRE) refers to properties that are exclusively used for business-related activities and given on lease for income generation. It mainly includes office spaces, retail stores, malls, industrial units and healthcare units. CRE entities generally avail debt, which is backed by expected rentals to be received in future from these properties to refinance their project loans in the form of Lease Rental Discounting (LRD) or other bank facilities, the former being the most common. These rentals are deposited into a designated escrow account with a well-structured waterfall mechanism towards debt servicing. Rental income primarily depends on a property's quality, location, tenant mix, occupancy level, and lease agreements and renewal clauses.

The pandemic, at the fag end of Q4FY20, started wreaking havoc across the globe. While overall, India was not spared either, specifically, realty was one of the most affected sectors. The sector was already reeling from the effects of demonetization, GST and RERA implementation when the coronavirus pandemic hit and further worsened conditions for it. With the complete shutdown of business and construction activities, the sector received a major blow, the effects of which are expected to subside only after complete normalcy is restored.

The lockdown imposed in 2020 and 2021 to curb the spread of the virus compelled corporates to opt for a work-for-home option, thereby treating the pandemic situation as a health emergency. To provide some relief to tenants, CRE owners were compelled to either reduce or waive-off rentals and introduce innovative and attractive rental plans such as "acquire immediately" and pay after three months or get three additional months at the end of the lease tenure. However, these schemes have not stopped a multitude of tenants (mostly start-ups and the tech industry) from giving-up their rental spaces and opting out of their lease agreements, which compounded issues for CRE owners with no takers for vacant spaces.

Low confidence in income stability and economic recovery has been carried forward during the current year as well, with subdued market activity. The net absorption levels remained subdued and could not keep pace with the new launches, resulting in only a marginal increase in overall vacancy levels during H1CY. While investor sentiment is seeing an upward trajectory, the sustenance of recovery depends heavily on the impact of the vaccination drive. However, with corrected rentals and various custom-made solutions, and tempting offers by developers, demand for CRE is expected to increase. Following post-pandemic trends can be observed in the sector:

1. Sanitised ambience with a focus on ensuring safety for staff and customers
2. Wellness facilities to ensure hygiene in the workplace
3. Cellularisation, i.e., dividing office spaces into different cells to ensure social distancing

Scope of Criteria

The document provides a brief analysis of the attributes considered by Brickwork Ratings (BWR) while arriving at the rating of CRE projects/entities. The scope of this document is to capture the important aspects of various risks associated with creditworthiness of entities, while arriving at the rating of these projects/properties. A summary of the effect of these attributes on the overall credit quality of developers and entities are highlighted, which helps ascertain the debt servicing capability vis-a-vis the expected cash flow from rentals.

Risk Assessment and Rating Criteria at Brickwork Ratings

BWR factors in the various quantitative and qualitative risks that commercial developers are exposed to, while assessing the risks in these projects/entities. As highlighted above, the key risks that entail CRE projects are the various credit/default risks, macroeconomic risks, industry/regulatory, environmental and geopolitical risks. The risks and the way in which they are incorporated in the rating framework are discussed in detail below.

A. Industry Risk

CRE is fragmented and is characterised by the presence of large and unorganised small developers. The industry is cyclical in nature, especially office space additions and mall rentals, and has a direct correlation with public spending, capital expenditure towards office space additions, new buildings for malls and the macro-economic environment. Moreover, demand and supply within the real estate industry vary with geography, including the project location and proximity to various amenities, and the expectation of stability in future income and capital price appreciation. Real estate projects are subject to various regulatory risks due to approvals from government bodies, which could be tedious and long drawn. Regulatory risks affect real estate directly in terms of land usage, the clearance of land titles, changes in requirements for regulatory approvals, building codes, zoning designations, fire approvals, financial regulatory reforms and environmental regulations. CRE projects require approvals and clearances from various government authorities, and delays in obtaining such approvals may stall the progress of the project, leading to time and cost overruns. Additionally, with growing concerns over global warming and environmental degradation, environmental risks have taken on added meaning. Increased awareness and action on the environmental implications of buildings may lead to the implementation of new policies, which can affect the value of existing buildings that do not comply with the new standards, due to stringent laws applicable at a later stage.

B. Business risk

Business risk can be analysed through a commercial space /property having significant renting space by focusing on its ability to generate a stable cash flow and sustained revenue in future. It generally depends on the property's quality, ability to attract tenants, especially established retail chains, location, access to transportation and proximity to residential areas. Occupancy levels, the renewal of lease rental agreements and ownership held by a Real Estate Investment Trust (REITs) are some of the key drivers for assessing the revenue generation. Furthermore, emphasis is laid on a developer's execution track record, brand name and market presence in the respective market, number of projects delivered, the scale of projects being currently undertaken, and the quality of the projects. The assessment of CRE entails default risks by tenants, implying a delay or inability to pay the lease rentals on time or meet a financial obligation. Late payments by tenants may hamper the stability of cash flows. The situation may worsen if the tenant goes out of business and moves out of the rented space, which results in a decreased occupancy level and increased chances of default. To analyse such risks, BWR assesses the tenant mix of developers, track record of payments by tenants, and cushion in cash flows to meet such exigencies including the preparedness of the issuer to replace the tenant exiting. The value of CRE properties depends on their accessibility, neighbourhood, industries, offices in the vicinity and the heterogeneity of tenants. A property in a prime location buzzing with business opportunities and proximity to residential areas further increases its attractiveness. Construction risk faced by the developer can be either related to a new development or the renovation/maintenance of an existing property. This could lead to delays in expected rental incomes, the timeline of completion getting stretched and the cost of construction being more than expected. Such risks may end up impacting the margins of the project/entity. CRE spaces with a single tenant are exposed to the highest risk on account of a lack of diversification and thus, limited ability to withstand any economic cycle. In such cases where projects under construction account for a lion's share of the developer's portfolio, the overall credit profile gets exposed to the inherent risks of funding, implementation and timely finalisation of tenants at expected rates.

C. Financial risk

Risk is an inevitable part of investing in CRE or a CRE developer exposed to various risks, including debt from various lenders, and credit and liquidity risks. Financial risk is driven by the adequacy of rental income received as against its debt servicing requirements. Commercial properties, being highly expensive, suffer from the risk of liquidity, which involves the risk of renting-out property, availability of tenants or low occupancy levels, and the selling price of the property being much lesser than the market value in the case of very low occupancy or rentals. BWR assesses the DSCR of the property, signifying the debt servicing ability over the tenor of the debt. Furthermore, credit risk, that is the risk of non-payments by tenants, looms over developers as late payments impact their expected cash flows negatively. The risk profile of a developer is also directly proportional to the amount of leverage employed as part of the capital and the interest rate that the availed debt carries. This gives way to debt risks, which are related to the ability of the entity to pay its financial obligations on time. Unforeseen circumstances such as a change in the overall economic scenario or a policy change by the government could affect the cash flows of the developer in the form of rent received and affect its credit capacity negatively. A conservatively leveraged property would be in a better position to handle such a risk. BWR assesses the proportion of debt and equity employed as part of the capital by the developer. These risks can be summarised as under:

1. **Profitability Ratio:** Includes risks related to the operating margin, revenue growth and return on capital employed
2. **Capital Structure, Leverage Ratio:** Helps ascertain the level of debt held by contractors to gauge their ability to pay-off their fixed-interest obligations
3. **Debt Service Coverage Ratio**: DSCR of the property/entity signifies cash flow availability as against the debt servicing requirements over the tenor of the debt
4. **Turnover and Liquidity Ratio:** Includes risks related to payment to/from debtors/creditors and liquidity; a developer's liquidity levels are reflected from its cash balances, unutilised bank limits, investment in liquid assets, availability of bank credits and other intermediaries
5. **Financial Flexibility:** Group/promoter's ability to raise funds in case need arises on a short-term basis and ability to refinance its debt with ease

D. Management & Corporate Governance

In the absence of the right management, even properties that tick all the boxes in terms of location, price and tenant mix can prove to be unprofitable. The management helps establish relations with tenants and is responsible for making decisions about lease agreements. Poor management can result in high vacancy rates, a low level of liquidity and high operating expenses, all of which reduce the returns on investment. Apart from experience, BWR captures the ability of the management to adapt itself to changes in the external environment with respect to technological advancements, risk appetite and risk mitigation plans, policies on leveraging, demand-supply scenario and track record of the execution of CRE projects, among others. Furthermore, the history of litigations and regulatory actions will be seen negatively.

Conclusion

BWR analyses each parameter after measuring the impact of the above-mentioned risks and attributes, along with financial projections over the life of the facility to arrive at the overall assessment of the credit quality of a developer or entity. While the methodology comprises a comprehensive analysis of various risks associated with the regulatory aspects, financial risk, industry, operational and business risk, the project profile and competitive position, the final rating is assigned based on the overall credit assessment of commercial developers.

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