

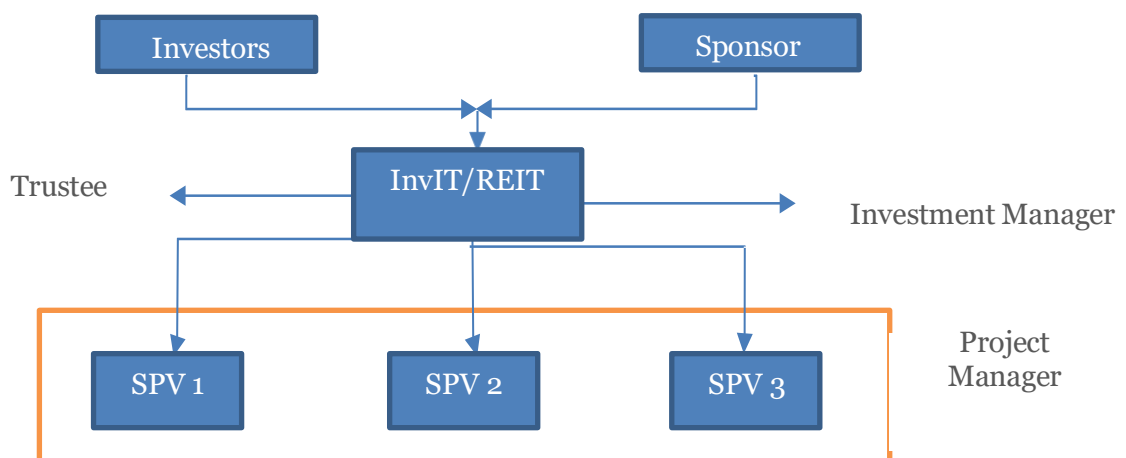


Rating Criteria for InvITs and REITs

Executive Summary:

An InvIT (Infrastructure Investment Trust) is a pooled investment vehicle that owns, operates, and manages infrastructure assets, providing investors with an opportunity to invest in income-generating infrastructure projects. An Investment trusts are investment vehicles to invest in revenue generating Infrastructure or Real Estate projects. The trusts issue units subscribed by the investors. These trusts have a pass-through structure and are required to distribute most of their earnings to unit holders. The trusts have a leverage restriction of 49% on the NAV (Net Asset Value) or up to 70%, subject to certain conditions. There is also a limit of investment in under-construction projects at 10% of the total assets for InvITs and 20% for REITs. REITs are either publicly listed or privately listed, and a "listed REIT" means a REIT whose units are listed on a recognized stock exchange.

Structure of an InvIT/REIT



The credit rating of an InvIT/REIT is an opinion on its ability to service the external debt availed by the InvIT/REIT and by its portfolio of SPVs (Special Purpose Vehicles). It is not a view on the rating of individual SPVs in its portfolio. It is not a view on the potential return to the unit holders. The InvIT/REIT can issue fresh units at any time and also acquire new assets in its portfolio. An InvIT/REIT receives interest and principal from the SPVs it has extended loans to and also dividends from the SPVs. These cash flows are used to make debt payments, and 90% of the net distributable cash flows are distributed to the unit holders.

Scope of Criteria

Brickwork Ratings' (BWR's) rating for InvITs/REITs focuses on the assessment of the business risk, financial risk and management quality of the InvIT/REIT and the underlying SPVs. Since the InvIT/REIT is dependent on the underlying assets in the SPVs, the assessment revolves around the credit quality of these projects and cash flows that they generate. The credit risk profile of the underlying projects is assessed using criteria relevant to the sectors that these projects are in.

Risk Assessment and Framework

The ability of the InvIT/REIT to meet its obligations is assessed based on the following key parameters, categorized into Business, Financial and Management risks.

A. Business Risk

The InvIT/REIT is an investment vehicle; thus, its risk is derived from the underlying assets in the SPVs it holds. This is assessed using the models applicable to the segment in which the underlying infrastructure projects like Toll roads, Annuity roads, Hybrid Annuity roads, Thermal power, Solar power, Wind power, Airports, and Ports, as well as real estate projects such as Malls and Offices. To assess the business risk in an InvIT/REIT, a review of the underlying projects is conducted, focusing on the following key aspects:

- **Revenue risk**

An InvIT/REIT debt repayment is mostly reliant on the excess revenue from the underlying projects. A number of elements are carefully considered in order to evaluate this risks, including Price and demand- The price strategy used to maintain competitiveness and the market demand for the project's services, Competitiveness- The market position of the project and its capacity to contend with comparable products, Long-term contracts- The dependability and stability of long-term agreements that produce steady income, Input availability- The ongoing availability of the resources and inputs required for efficient operations, Reasonability of Projections: The viability and precision of revenue estimates, guaranteeing that they are reasonable and attainable.

- **Operational metrics of underlying projects, operational track record of projects**

When evaluating the reliability of future cash flows for an InvIT/REIT, the operational performance of underlying projects is crucial. While only 10% projects in InvITs and 20% projects in REITs can be in the construction phase, the operational track record of the operational projects can vary substantially and is a key determinant of the stability of future cash flows. The following are important variables that affect operational risk:

The operational projects' performance history, which sheds light on the cash flows' dependability and consistency, Input tie-ups partnerships or agreements for obtaining resources that are essential to sustaining ongoing operations, the stability of cash flows may be impacted by price volatility, which is defined as variations in input costs or revenues. Additionally, tie-ups for inputs and price volatility constitute an important element of the project's ability to generate sufficient and stable cash flows, Reserves and Maintenance-To guarantee the projects' long-term performance and operational health, it is imperative to have the capacity to execute routine maintenance and set aside funds for significant repairs.

BWR also evaluates the ring-fencing of cash flows for each SPV within the InvIT framework, ensuring that cash flows are allocated in accordance with the waterfall mechanism outlined in the ESCROW agreement. Both the InvIT and SPV ESCROW accounts are managed by lending banks, which oversee the monitoring and management of the cash flows.

- **Diversity of projects**

The safety of an InvIT/REIT depends on the diversity of its projects. Instead of depending on one or a small number of large, focused initiatives, it is essential to combine the cash flows from multiple unconnected projects in order to lower risk. The structure derives its safety from the pooling of cash flows from all projects to meet the debt obligations. Therefore, to guarantee low correlation among receivables, money should be invested in a range of unconnected projects across various counterparties, asset kinds, and geographical locations.

- **Credit quality of projects and Average quality of counterparties in projects**

Diversification is key, but an InvIT or REIT's stability also depends on the credit quality of each project and the dependability of its counterparties. Individual projects are assessed for various safeguards in place to ensure that operations will be in line with the projections and that there are not stumbling blocks that could derail cash flows. These would involve the assessment of their contracts, pricing adequacy, competition, counterparties, operations team and track-record, among others.

- **Event risk**

The projects could be vulnerable to unfavourable events that could lead to a disruption in cash flows. An assessment of possible events in the different projects is carried out, and safeguards in contracts to compensate in the case of such an event are analysed. Specifically, force majeure clauses, termination payments in contracts and any insurance covers and the adequacy of these are assessed.

- **Regulatory risk**

The regulatory framework brings necessary stability in the operating environment for projects. Regulatory changes and their expected impact are assessed. In addition, any intervention in pricing by the regulator can have a negative or positive impact on the projects. Sectors with over regulation could be constrained in their assessment.

B. Financial Risk

The financials of individual projects are assessed to see the surplus available to make debt payments. In order to determine the total surplus at a pooled level and make sure there are enough funds available to cover the InvIT/REIT's debt obligations, the consolidated financials are also examined.

- **Average DSCR:**

The Average Debt Service Coverage Ratio (DSCR) is a financial metric that evaluates an InvIT/REIT's ability to meet its debt obligations using its project cash flows over time. It is calculated by averaging the ratio of net operating income (or cash flows) to the debt service obligations. A higher average DSCR indicates that the InvIT/REIT has a greater ability to cover its debt payments reliably under normal circumstances. The actual leverage within this permissible limit is assessed to gauge the ability to raise funds at the appropriate time. The ability to get long-tenure funds is key to keeping the DSCR under control to absorb any volatility in cash flows.

- **Stressed DSCR:**

The Stressed DSCR is a more conservative financial metric that assesses the InvIT/REIT's capacity to service its debt under more challenging conditions. It considers scenarios where cash flows may be lower than expected due to operational or financial difficulties, such as economic downturns or market volatility. This metric ensures that the entity has the ability to maintain debt payments even during periods of financial stress, providing a more cautious view of the business's financial health.

- **Leverage Ratio:**

The amount of debt that an InvIT or REIT can take on in proportion to its equity is known as leverage. InvIT/REIT have a leverage limit of 49%, but it can be extendable to 70% if the company has a AAA rating, has made at least six consecutive distributions, using the funds for the acquisition of

infrastructure projects and subject to getting the unit holders’ approval. While operational projects are expected to have more stable and predictable cash flows, there could be stressed periods of lower cash flows, and hence, a stress DSCR is also assessed.

The following table outlines the metrics along with their respective formulas:

Average DSCR	$(\text{Net Operating income or cash flows})/\text{Debt Services}$
Stressed DSCR	$(\text{Stressed Net Operating Income or cash flows})/\text{Debt Services}$
Leverage Ratio	$(\text{Total Debt}/\text{Total Capital}) * 100$

- **Stability of cash flows**

Average DSCR provides a view on the overall quality of the projects. However, volatility in specific periods could lead to a different credit profile for the InvIT/REIT. A portfolio of projects with more stable cash flows that has also been demonstrated over time improves the credit profile of the InvIT/REIT. While the segment to which the projects belong defines a large part of the stability, with transmission projects and annuity projects having more stable and predictable cash flows and wind/solar power projects and toll roads having a lower stability in cash flows, predictability is better established with a track record of operations of a few years for the project.

- **Project profitability**

The IRR generated from the projects shows the strength of the surplus project cash flows through the tenor of the InvIT/REIT and is a determinant of the attractiveness of the projects and their ability to attract investors looking for a predictable long-term return on the investment.

- **Refinance, Interest Rate and Foreign Exchange risk**

The potential financial risks related to the ability to refinance debt, interest rate fluctuations, and currency exchange rate changes are referred to as refinance, interest rate, and foreign exchange risks. An InvIT/REIT's performance and financial stability may be greatly impacted by these risks. Structuring of the assets and liabilities is important, given the long tenor of the projects and debt taken by the InvIT/REIT. Clauses and flexibility related to refinancing, if required, due to a tenor mismatch or ballooning cash flow structure, need to be assessed. Additionally, any unhedged interest rate and forex risk can be a credit dampener, given the uncertainty that may exist in such long tenors.

- **Financial Flexibility and Liquidity Ratio**

For evaluating the financial stability and risk management prowess of InvITs/REIT, financial flexibility and liquidity ratio are crucial metrics. The ability of an InvIT or REIT to modify its capital structure, get more funding, or change financial commitments in response to shifting market conditions, economic shocks, or refinancing. A highly flexible company reduces the risk of refinancing, interest rate changes, and foreign exchange fluctuations by making it easier to borrow capital or restructure debt when needed. Liquidity mismatches can be pronounced between cash inflows and debt pay-outs. It will be key to assess the liquidity smoothening measures adopted by the trust, including DSRA availability, undrawn credit lines from reliable sources and the ability to raise short-term funds, if required. The mechanism for the creation of reserves for major maintenance and timing of dividend pay-outs will additionally be assessed.

C. Management Risk

Management Risk in InvITs and REITs refers to the possible influence that management choices, skill, and honesty may have on the investment's performance. The quality of the projects in the portfolio is greatly influenced by the sponsor's profile, even though an InvIT/REIT is set up to be independent of its sponsor. The sponsor is frequently also in charge of operations and maintenance (O&M), which may be impacted by their personal characteristics. The management's strategy for choosing, financing, and running projects is crucial to guaranteeing the effective expansion of the InvIT/REIT portfolio and lowering risk. Furthermore, the management's risk appetite, or willingness to assume risk, can affect the possible returns but also leaves the InvIT/REIT vulnerable to changes in the market. Effective project execution and preserving investor faith depend heavily on the management team's competence, which is demonstrated by their knowledge, abilities, and moral principles. Management's tactics for project selection, funding, operations, and future investment plans are discussed in order to evaluate the risk appetite and competency and determine their capacity for long-term success.

A discussion is held with the management on the strategy of project selection, funding, operations of projects, and future investment and funding strategies to assess the risk appetite and competence to achieve success.

Conclusion: To sum up, the evaluation of InvIT/REIT entails examining each metric by assessing the influence of important risks like business risk, financial flexibility, liquidity, and management competence, in addition to long-term financial projections. The technique includes a thorough examination of the entity's market position, project profile, and operational skills in addition to a number of hazards, such as refinance risk, interest rate risk, and forex risk. The final assessment is based on the overall credit quality assessment, which takes into account how well the InvIT/REIT can control these risks while guaranteeing investors steady returns and sustainable growth.

The previous version of this document can be found in

<https://www.brickworkratings.com/download/Criteria-InVIT-REIT%20v1.1.pdf>

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