



Rating Criteria – Rating of Real Estate - Residential Projects

Executive Summary

The residential real estate segment refers to the construction and selling of projects (high-rise apartments, flats, villas, plots, and so on) exclusively used for residential purposes and demonstrates a developer's ability to execute projects in a timely and cost-effective manner. It mainly includes residential and/or high-rise apartments, independent houses, land/plot development, affordable housing, and/or luxurious housing segments.

Residential real estate properties/entities generally avail debt for the construction of the project, which is partially funded through expected sale proceeds from the units sold and through equity infusion by the promoter. The sales proceeds are deposited into a designated escrow account with a well-structured ring-fencing through the escrow mechanism towards project completion and are used for debt servicing. Cash flow in real estate projects from sold units to customers depends on a certain percentage completion of the project at various stages, whereas the funding risk remains from unsold units.

The real estate sector is one of the largest employers, after the agriculture and textile industries, and plays a significant role in contributing to the country's economy. The sector has achieved greater transparency and accountability after the introduction of the Real Estate Regulation and Development Act, 2016 (RERA), and various other regulatory initiatives. The sector has witnessed many structural changes and liberalization in terms of policy changes like – allowing FDI, simplifying the investment process by reducing the need for permissions and licenses for starting any large construction project, RERA regulations rendering the developer liable for structural defects arising within five years of handing over possession, are in favor of buyers.

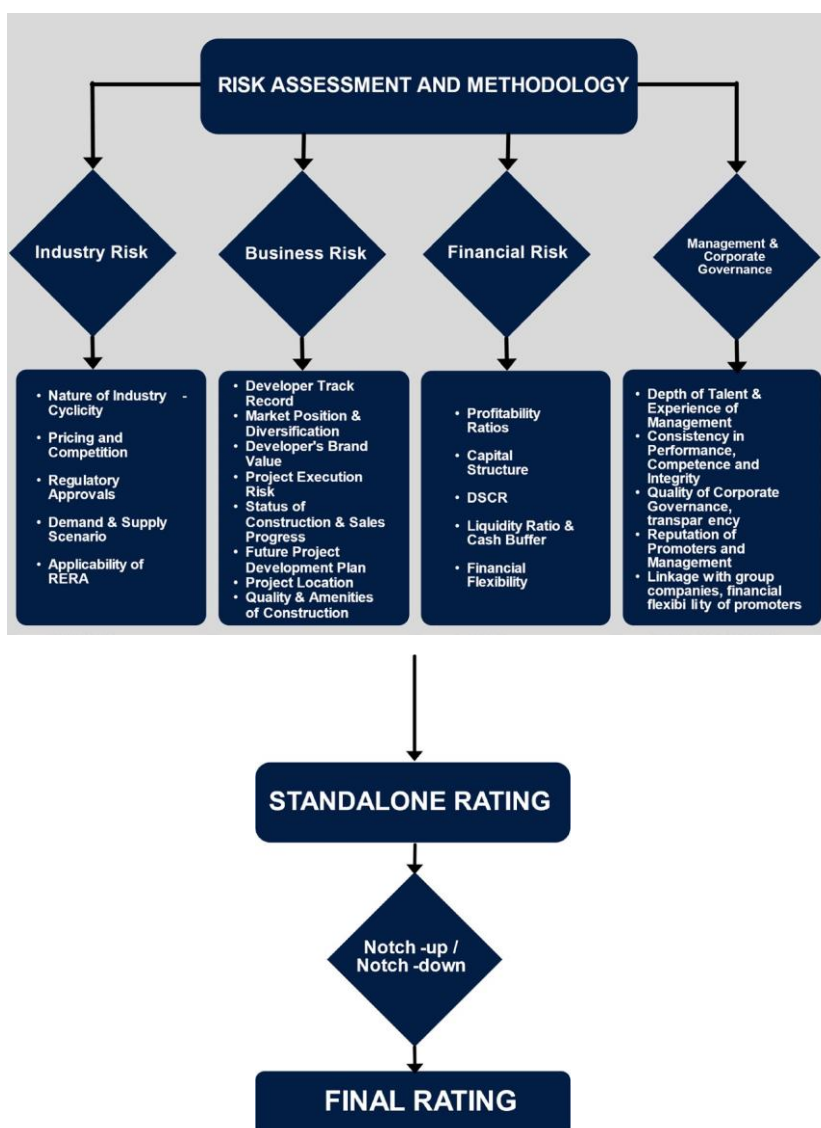
Similarly, the Insolvency and Bankruptcy Code (effective from July 2018) provides the status of financial creditors to home buyers, which has improved the level of transparency in the sector and has increased regulatory oversight manifold. One of the key features of RERA mandates the promoter to deposit 70% of customer advances into an escrow account, the proceeds of which can be utilised only towards the completion of the same project. The escrow amount deposited shall be used only for the project concerned, allowing the promoter to withdraw from the account only to cover the construction cost of the project, in proportion to the extent of completion of the project.

Scope of Criteria

This document provides a brief analysis of the attributes considered by Brickwork Ratings (BWR) in rating real estate entities/developers. The scope of this document is to capture important aspects of various risks associated with the creditworthiness of real estate entities while arriving at the rating of a real estate project/developer/entity. This is also applicable to developers implementing multiple projects. A brief summary of the effect of these attributes on the overall credit quality of the entity/developers is highlighted, which would help ascertain the debt servicing capability of the entity as against the generation of cash flow from the project.

Risk Assessment and Methodology

BWR factors in the various quantitative and qualitative risks residential developers are exposed to, while assessing the credit risk profile of these entities/developers. The key risks that real estate entities may face while executing a real estate project are business risks, industry risk, financial risks and risks related to management quality. These risks are assessed to arrive at the credit rating profile of the real estate entities/developers. The risks and the way in which they are incorporated in the rating framework are discussed in detail below.



The aforesaid parameters are assessed to analyse the credit risk profile of the entity/developers to arrive at the standalone rating of the entity. Furthermore, the rating can be notched up/down based on the group support to the rated entity to arrive at the final rating (refer to the Group support Rating criteria on the website).

A. Industry Risk

Residential real estate is highly fragmented and is characterised by the presence of large and unorganised small developers. When evaluating the industry risk for residential real estate projects, BWR examines the following factors to identify potential challenges and uncertainties:

Nature of Industry – Cyclicity: The industry is cyclical in nature and has a direct correlation with public spending and the macro-economic environment which can reduce buyer demand. Changes in interest rates have a direct impact on mortgage loans, affecting buyers' purchasing power. When interest rates are low, it encourages home buying, whereas higher rates can slow down the market as borrowing costs increase. Thus, interest rates often move in tandem with the economic cycle.

Pricing and Competition: Real estate markets are prone to both systematic and unsystematic risks that stem from various intertwined macroeconomic factors, which together create long and short real estate market cycles. These cycles cause capital values and rentals from the owned property to vary over time. Real estate developers who can better predict these variations and have sufficient cash buffers have an edge over their competitors. Moreover, a huge mismatch between demand and supply gives rise to a pricing risk, which could reduce developers' bargaining power.

Regulatory Approvals: 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 acquisition, the clearance of land titles and changes in land use, NoCs for construction, changes in requirements for regulatory approvals, building by-laws, zoning designations, approvals from concerning departments (such as fire, safety and environmental protection), completion-cum-occupancy certificates and local regulations. Residential real estate 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. SRA (Slum Rehabilitation Authority) Tenancy status is crucial in residential projects, especially for slum redevelopment schemes. The goal is to relocate slum dwellers into better housing while safeguarding their rights and improving their living conditions. Under the SRA, tenants in slums or unauthorized structures are granted rights based on their tenancy status, which formalizes their recognition as tenants. This status is essential for determining eligibility for redevelopment benefits. Additionally, with growing concerns over global warming and environmental degradation, environmental risks have taken on added meaning.

Demand & Supply Scenario: Demand and supply within the real estate industry vary based on geography, including project location and proximity to various amenities such as schools, hospitals and the marketplace, along with the expectation of stability in future income or/and capital price appreciation.

Applicability of RERA: Real Estate Regulatory Act (RERA) is a regulatory framework that impacts developers, buyers, and stakeholders in residential real estate. Its applicability reduces several risks in residential real estate projects by promoting transparency, financial accountability, consumer protection, and clear legal frameworks. It helps ensure that projects are completed on time, meet quality standards, and protect the rights of buyers, which in turn reduces overall industry risk.

B. Business risk

Business risk in residential real estate projects is multifaceted, involving factors such as market conditions, project costs, financing, competition, and legal/regulatory considerations. BWR considers

the following aspects while evaluating business risk in residential real estate:

Developer Track Record: The business risk for a residential property can be assessed by focusing on the developer's ability to generate stable cash flows during project implementation through the sale of units and expected property value appreciation in future. It generally depends on the quality of property, pricing, ability to attract customers, location, access to transportation and proximity to markets. The real estate sector is highly fragmented in nature, where a large number of small players have captured a significant market share. The project operational efficiency, construction status of the project and sales booking progress, funding tie-ups, and maintaining cost and time overrun as per estimates are also the key drivers for stable cash flow generation. BWR assesses the type and quantum of land bank available with the developer.

Market Position & Diversification: The ability to target the right demographic (e.g., luxury buyers, first-time homebuyers, renters) can influence demand. A developer that caters to a niche market, such as affordable housing, may be more insulated from market downturns compared to those focused on high-end properties. The developer's ability to stand out in a competitive landscape, whether through unique design, pricing strategies, or additional amenities, can mitigate business risk. Developers with projects in different locations are less vulnerable to downturns in specific markets. For example, if one area faces a slowdown due to economic challenges or oversupply, a developer with properties across various cities or regions can still capitalize on demand in other markets.

Developer's Brand Value: The developer's reputation in the market can significantly influence the success of a project. Negative perceptions regarding the quality of previous developments or a history of delays can affect buyer interest. Failing to deliver projects on time, within budget, or to the promised specifications can lead to customer dissatisfaction, legal disputes, and a tarnished reputation, which can hurt future business prospects.

Project Execution Risk: Residential real estate entails default risks emanating from a shortfall in cash flow on account of lower sales or cost and time overruns, implying a likely delay or the inability to pay financial obligations on time. Late payments by customers or a delay in project execution may hamper the stability of cash flows. To analyse such risks, BWR assesses the project's dependency on customer advances, developers' ability to raise funds or refinance their debt obligations on or before the due date (if need be), regulatory approval status, completion stage of the project, and developer credit profile and past track record. Any overrun in terms of time and cost would impact on the timely infusion of funds as well as demand from prospective buyers.

Projects that are designed to be scalable or phased over time offer developers the ability to adjust based on market conditions. For instance, a phased approach allows developers to proceed with construction in stages, reducing the risk of overbuilding or being stuck with unsold inventory in a downturn. The diversity in future project types (e.g., affordable housing, luxury developments, mixed-use projects) can reduce reliance on a single market segment. This diversification spreads business risk across different sectors, making the developer more adaptable to market shifts. Furthermore, the location of a residential project plays a crucial role in its potential success. Areas with strong economic growth, expanding employment opportunities, and population growth typically offer higher demand for housing, reducing business risk.

Quality & Amenities of Construction: Residential developers also face construction risks, and legal and regulatory risks, stemming from the possibility of a government agency with jurisdiction over a project not allowing approvals to carry out the construction process. BWR assesses the list of applicable approvals required for the execution of the project. Project completion risks encompassing technical, execution and operational risks further impact the timely and smooth completion of projects. Due to increasing competition and the presence of a large number of small and independent developers, the availability of resources is another challenge for developers with respect to the training and development of their employees. In cases where projects under construction account for a lion's share of the developer's portfolio, the overall credit profile gets exposed to inherent risks of funding, implementation and timely finalisation of tenants at expected rates.

C. Financial risk

Financial risk is inevitable for a real estate developer exposed to debt from various lenders, credit, and operational and liquidity risks. The risk is driven by funding risk, which usually involves equity, debt and customer advances, from which a majority of funding comes. Financial risk is assessed by the adequacy of defined cash flow and the collection of advances from sold units as against the completion of the project and its debt servicing requirements.

BWR assesses the project's DSCR, signifying cash flow availability as against the debt servicing requirements over the tenor of the debt. Furthermore, credit risk, that is the risk of the non-receipt of customer advances or the ability to sell the entire project, looms over developers as delays in the receipt of advances may 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 entity's ability 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 developer's cash flows. Setting up large projects requires huge sums of funding and real estate projects, mostly having long gestation periods, are exposed to several financial risks during their construction and operating period. In general, it is observed that cash flows are likely to be fungible across projects unless there are specific covenants in the sanctioned terms that restrict such cash flow movements. BWR assesses the following ratios to determine the extent of financial risks the developer is exposed to:

- 1. Profitability Ratio:** These include risks related to operating margin, PAT margin, revenue growth, and return on capital employed. A stable and diverse stream of revenues provides a steady source of cash flow and gives it protective cover against any uncertainties. A higher return on capital employed further strengthens the ability of the entity to service debt obligations.

Profitability Ratios	
Revenue Growth	$((\text{Revenue in Current Period} - \text{Revenue in Previous Period}) / (\text{Revenue of Previous Period})) * 100$
Operating Margin	Operating Income / Revenue
Return On Capital Employed (ROCE)	EBIT / Average Capital Employed

- 2. Capital Structure:** Real estate entities, being highly capital-intensive, require a mix of debt, customer advances, and equity. The proportion of debt and adequacy of cash flow determines the ability of the entity to pay off its debt obligations. BWR assesses the extent of debt funding at an aggregate level of the developer; high leverage is an indicator of less headroom for additional borrowing in case the need arises and a higher outgo towards interest and principal. A conservatively leveraged project would be in a better position to handle such a risk.

Capital Structure	
Leverage Ratio	Total Debt / Total Equity
Debt/Equity Ratio	Total Debt / Total Equity
Interest Service Coverage Ratio	EBITDA/Interest & Finance Charges

- 3. Debt Service Coverage Ratio (DSCR):** The DSCR of the property/entity signifies cash flow availability through the sale of units as against the debt servicing requirements over the tenor of the debt. Advances from sales already made provide stable cash flows from future collections.

Debt Service Coverage Ratio	$(PAT + Dep. + Int.) / (Int. + Principal Repayment)$
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- 4. Liquidity Position and Cash Buffer:** With exposure to several macroeconomic risks, it is imperative for the residential real estate developer to have high levels of liquidity to account for any contingency arising out of labour strikes, the non-availability of raw materials, and so on, all of which causes project delays. A higher scale of cash generation at the developer's level defines the scale of operations, diversity of projects, enhanced market position, high economies of scale and access to a low cost of capital. A developer's liquidity levels are reflected in their cash balances, unutilised bank limits, investment in liquid assets, availability of bank credits and other intermediaries. Furthermore, dependency on customer advances and an escrow mechanism towards the maintenance of such cash flow, and a debt service reserve account is seen positively.

Liquidity Ratio & Cash Buffer	
Receivable Days	$(Trade\ Receivables * 365) / Net\ Sales$
Payable Days	$(Trade\ Payables * 365) / Cost\ of\ Goods\ Sold$
Current Ratio	Current Assets / Current Liabilities
Cash to Current Liabilities	Cash & Cash Equivalents / Current Liabilities
Total outside liabilities / Tangible net worth	$(Total\ Debt + Other\ Outside\ Liabilities) / Total\ Tangible\ Networth$

- 5. Financial Flexibility:** The group/promoter's ability to raise funds in case the need arises on a short-term basis and the ability to refinance their debt with ease, shows strong financial flexibility. BWR assesses the fund-raising ability of a developer based on the past track record and overall leverage level. Lower leverage provides higher financial flexibility to a developer. BWR also evaluates all active projects, assessing their equity needs and the availability of resources.

D. Management & Corporate Governance

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets as well as helps improve the financial situation of the entity. In the absence of the right management, even properties that tick all the boxes in terms of the location, price, regulatory approvals and customer mix can prove to be unprofitable. The management helps establish relationships with customers and is responsible for project launches, identifying land parcels for the projects, selling unsold units/inventory of the project, quality of construction and brand reputation. Poor management can result in high unsold rates, delays in regulatory approvals, funding tie-ups, a low liquidity level and high operating expenses, all of which reduce the returns on investment in the project. Apart from experience, BWR captures the management's competence towards acquiring market share and its transparency of public disclosures and risk appetite. BWR also assesses the management's capability to secure partnerships for sanctioning individual housing loans from different banks and financial institutions, as well as obtaining project approvals. Furthermore, a 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/instrument to arrive at the overall assessment of the credit quality of the issuer. The sensitivity analysis of the financial projections provides an understanding of cash flows as against the debt servicing obligations. While the methodology comprises a comprehensive analysis of various risks associated with project implementation, regulatory aspects, financial risk, industry, operational and business risk, and the competitive profile, the final rating is assigned based on the overall credit assessment of the issuer. Due to the long gestation period of residential projects, the financial profile of counterparties and sponsors associated with the project is critically assessed to service debt obligations.

The previous version of this document can be found in

[https://www.brickworkratings.com/download/Criteria-Rating%20Criteria%20%E2%80%93%20Rating%20of%20Real%20Estate%20-%20Residential%20Projects%20Web%20Version v1.0-NEW.pdf](https://www.brickworkratings.com/download/Criteria-Rating%20Criteria%20%E2%80%93%20Rating%20of%20Real%20Estate%20-%20Residential%20Projects%20Web%20Version%20v1.0-NEW.pdf)

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