



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. In CRE, two key financial strategies are used for property transactions. The Outright Sale model involves selling a property (land, building, or commercial space) for a one-time payment. This traditional approach allows the seller to receive full payment and end their involvement with the property.

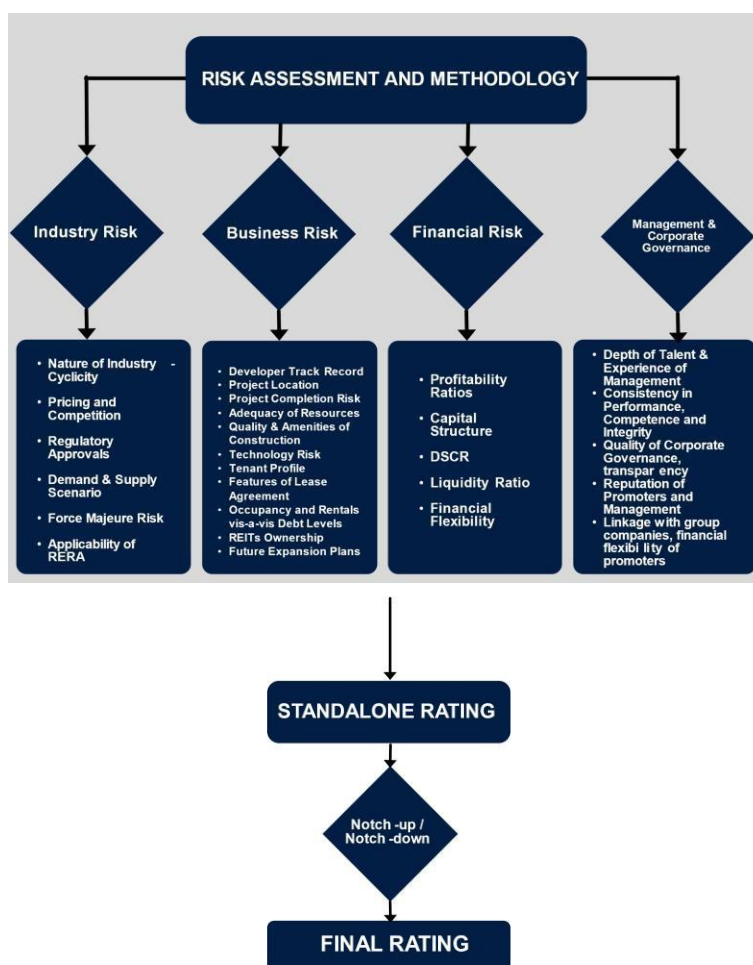
The sale price is usually based on factors like location, market trends, demand, and the property's condition. Developers may also collect advances from the buyer in this model. CRE entities generally avail debt, which is backed by expected rentals to be received in the future from these properties to 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 toward debt servicing. Rental income primarily depends on a property's quality, location, tenant mix, occupancy level, and lease agreements and renewal clauses.

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 the 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 Methodology

BWR factors in the various quantitative and qualitative risks that commercial developers are exposed to while assessing the risks in these projects/entities. The key risks that entail CRE projects are the various credit/default risks, macroeconomic risks, industry/regulatory, business risks, financial risks, and management risks. The risks and how they are integrated into the rating framework are elaborated on in detail below.



The aforesaid parameters are assessed to analyse the credit risk profile to arrive at the standalone rating of the entity. Furthermore, the rating can be notched up/down based on the group or promoter's support to the rated entity to arrive at the final rating.

A. Industry Risk

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

- **Nature of Industry – Cyclicity:** 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, leading to higher occupancy rates and rental income. Conversely, during economic downturns, demand can weaken, resulting in increased vacancies and downward pressure on rental rates.
- **Pricing and Competition:** Managing pricing in a competitive commercial real estate market requires understanding both internal factors (development costs, location, and property quality) and external market conditions (competition, demand, and regulatory factors). Pricing in the CRE market is influenced by supply and demand dynamics, economic conditions, and investor sentiment. Developers must stay attuned to market trends and pricing fluctuations. Overpricing or underpricing can affect the attractiveness of a property to potential tenants or buyers, impacting occupancy rates and rental income. Accurate market assessments are essential for pricing strategies.

- **Regulatory Approvals:** Commercial 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.
- **Demand & Supply Scenario:** Demand and supply within the commercial 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. Evaluate the balance between demand for commercial spaces and the available supply in the market. Oversupply or lack of demand can adversely affect rental income and occupancy rates.
- **Force Majeure Risk:** Force majeure risks arise from events that are beyond the control of the developer, such as natural disasters (earthquakes, floods, hurricanes), pandemics, political unrest, wars, or government interventions. These are an inherent part of commercial real estate projects, and developers must take a proactive approach to managing it. By implementing robust contractual safeguards, maintaining insurance coverage, building financial resilience, and planning for potential disruptions, developers can better navigate the uncertainty caused by unforeseeable events.
- **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 commercial 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 can be analysed through a commercial space /property having significant renting space by focusing on its ability to generate 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 (REIT) are some of the key drivers for assessing the revenue generation. Business risk in commercial real estate developments is influenced by various factors that can affect a project's success. BWR takes into account the following key elements when evaluating risk in these projects to gain a comprehensive understanding of the potential challenges.

- **Developer Track record:** The business risk factors for commercial real estate put a strong emphasis on a developer's market presence, brand recognition, and execution history. This covers the quantity of projects that have been completed successfully, the size of ongoing projects, and the caliber of those projects. A solid track record lowers overall risk in commercial real estate investments by showcasing the developer's capacity to efficiently manage projects, cut down on delays, and produce excellent results. 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. Developers with a solid market reputation are better positioned to endure cyclical slowdowns and maintain a higher level of business stability. This enables them to sell projects or lease properties, even when the industry's outlook is lackluster. BWR evaluates the tenant composition of developers, the payment history of tenants, and the financial buffer available to

handle such contingencies, including the issuer's readiness to replace any tenant who exits.

- **Project Location:** The value of CRE properties depends on their accessibility, neighborhood, industries, offices in the vicinity and the heterogeneity of tenants. Particularly appealing properties are those that are close to residential areas and in desirable locations with plenty of commercial options.
- **Project Completion Risk:** Project completion risk in commercial real estate refers to the uncertainty and potential issues that may prevent or delay the successful completion of a development project on time, within budget, or to the desired quality. This can include construction delays due to labor shortages or weather, unexpected cost overruns from price fluctuations or design changes, issues with obtaining regulatory approvals, or financing challenges. Additionally, market conditions such as shifts in demand or economic downturns can impact the project's viability and profitability. Proper planning, management, and contingency strategies are essential to mitigate these risks and ensure successful project completion.
- **Adequacy of Resources:** It refers to the availability and sufficient of financial, human, and physical resources needed to successfully finish a project. This includes ensuring there is enough funding to cover construction, operational, and finance costs, as well as sourcing competent labor, experienced management, and necessary materials for timely and quality execution. Lack of resources can affect a project's profitability and marketability by causing delays, cost overruns, or compromised project quality. To prevent shortages and guarantee the project's seamless progress, effective planning, budgeting, and resource allocation are crucial.
- **Quality & Amenities of Construction:** 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.
- **Technology Risk:** In commercial real estate, technology risk refers to possible problems brought on by antiquated or inadequate technology in the building. This could include insufficient cybersecurity safeguards, a lack of smart building capabilities, or inefficient building systems (such as HVAC, lighting, and elevators). Properties that don't use modern facilities may find it difficult to draw in new tenants, incur greater running costs, or be vulnerable to cybersecurity concerns as tenants' demands for modern amenities grow. The future profitability and value of a property may be jeopardized by this technological divide.
- **Tenant Profile:** Because different businesses may need different degrees of technological infrastructure, the tenant profile affects the risk associated with a property. Tech firms, for instance, might insist on high-speed internet, smart office systems, and advanced security, but more conventional tenants might not be as interested in these things. The property may lose prospective tenants and experience vacancy or reduced rent if it is unable to live up to these expectations.
- **Features of Lease Agreement:** Terms pertaining to operational expenses, technology upgrades, and property upkeep are frequently included in lease agreements. Properties with antiquated technologies may find it difficult to draw in high-value tenants or negotiate advantageous lease terms. In order to influence the landlord's capacity to fulfill these obligations and impact on the likelihood of a future lease renewal, tenants may also look for provisions that guarantee frequent technological advancements or appropriate cybersecurity measures.
- **Occupancy and Rentals vis-a-vis Debt Levels:** Occupancy rates and rental income may be

impacted by technology risk, particularly if a property does not adhere to contemporary technical norms. Inadequate technology can lead to higher vacancy rates, which can damage rental income and, ultimately, the property's capacity to pay off debt. Debt repayment may become a serious economic issue if the property is unable to draw in and keep renters.

- **REITs Ownership:** Technology risks are particularly important for Real Estate Investment Trusts (REITs) that own commercial real estate because they can affect the portfolio's overall performance. In order to draw in tenants and guarantee steady returns, REITs must maintain competitive, contemporary properties with cutting-edge technological systems. A lack of technological upgrades could lead to underperformance in REIT's portfolio, affecting its value and dividend distribution to investors.
- **Future Expansion Plans:** Future expansion or redevelopment plans for a property might be hindered by technology risks, particularly if the property needs significant upgrades to remain competitive. Failure to integrate advanced technologies during expansion could reduce the building's attractiveness and long-term marketability. Conversely, strategic technology investments during expansion can enhance future profitability and reduce risks associated with obsolescence.

C. Financial risk

Risk is an inevitable part of investing in CRE or a CRE developer is exposed to various risks, including debt from various lenders, and credit and liquidity risks. The funding can be sourced from the bank, promoter's equity, and client advances.

Financial risk is driven by the adequacy of rental income received as against its debt servicing requirements. Commercial property, being highly expensive, suffers from the risk of liquidity, which involves the risk of renting out the 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-payment 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 flow 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 follows:

- **Profitability Ratio:** These include risks related to the 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	((Revenue in Current Period – Revenue in Previous Period) / (Revenue of Previous Period)) * 100

Operating Margin	Operating Income / Revenue
Return On Capital Employed (ROCE)	EBIT / Average Capital Employed

- **Capital Structure:** Helps ascertain the level of debt held by contractors to gauge their ability to pay off their fixed-interest obligations. Commercial 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.
- **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.

Debt Service Coverage Ratio	$(PAT + Dep. + Int.) / (Int. + Principal Repayment)$
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- **Liquidity Ratio:** Includes risks related to the 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 credit 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	
Current Ratio	Current Assets / Current Liabilities
Cash to Current Liabilities	Cash & Cash Equivalents / Current Liabilities
Total outside liabilities / Tangible net worth	$(Total Debt + Other Outside Liabilities) / Total Tangible Networkth$

- **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

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 vacancies, 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.

The previous version of this document can be found in

https://www.brickworkratings.com/download/Commercial%20Real%20Estate%20Rating%20methodology%20-%20Web%20Version_v1.0-NEW.pdf

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