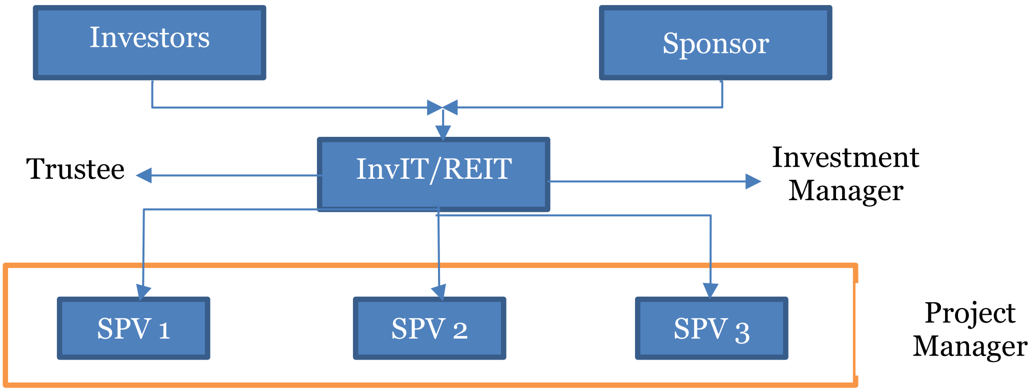
Rating Criteria for InvITs and REITs

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.

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. 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 its debt payments, and 90% of the net distributable cash flows are distributed to the unit holders.

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. The ability of the InvIT/REIT to meet its obligations is assessed based on the following key parameters:

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 projects are, such as, Toll roads, Annuity roads, Hybrid Annuity roads, Thermal power, Solar power, Wind power, Airports, Ports, Malls and Offices. To assess the risk in the InvIT/REIT, an assessment of the underlying projects is undertaken in the following aspects.

- **Revenue risk**

Debt repayment is dependent on the revenue surplus from the underlying projects. An assessment of demand and pricing, competitiveness, long-term contracts, the availability of inputs for continuous operations and the reasonability of projections is undertaken.

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

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. Additionally, tie-ups for inputs and price volatility constitute an important element of the project's ability to generate sufficient and stable cash flows. The ability to undertake regular and major maintenance and setting aside reserves for the same are also critical parameters considered.

- **Diversity of projects**

Since InvITs/REITs are dependent on the cashflows from the underlying projects, and they are structured to be considered much safer than individual projects, the structure cannot be depended on a single or a few large, concentrated projects. The structure derives its safety from the pooling of cash flows from all projects to meet the debt obligations. Hence, the funds need to be invested in a variety of unrelated projects across geographies, counterparties and types of assets to ensure low correlation among receivables.

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

While diversity in projects is important, the quality of each project is equally important. 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.

Financial Risk

The financials of individual projects are assessed to see the surplus available to make debt payments. Financials at a consolidated level are also assessed to assess the surplus available on a pooled basis to meet the debt repayments of the InvIT/REIT.

- **Average DSCR, stressed DSCR and leverage**

Leverage for InvITs/REITs is restricted to 49%, extendable to 70% on getting a AAA rating, having a track record of at least six distributions on a continuous basis, using the funds for the acquisition of infrastructure projects and subject to getting the unit holders' approval. 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. 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.

- **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 forex risk**

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**

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.

Profile of sponsor, management Strategy, risk appetite, competence and integrity

While the provisions of an InvIT/REIT make it independent of the sponsor, the profile of the sponsor is key in determining the quality of projects that the InvIT/REIT carries in its portfolio. Moreover, in most instances, the sponsor is likely to be the provider of O&M, which may be impacted by the profile of the sponsor.

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.

regulations applicable in Europe and also the USA).

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