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 segment. 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 also 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. In terms of generating employment and contributing to the country's GDP, the sector ranks second globally. Over the past few years, the industry has shown a growth rate of 30% each year. However, real estate, once a booming sector in the Indian economy, has been experiencing a slowdown since the last few years. The sector, which was not regulated much earlier, has lately been heading towards greater transparency and accountability after the introduction of the Real Estate Regulation and Development Act, 2016 (RERA), and various other regulatory initiatives. The real estate sector was hit again by the subsequent rollout of GST in July 2017. The liquidity crisis in the NBFC sector, which led to the curtailment of lending, too has added to the plight of this beleaguered sector.

To provide relief to developers with unfinished projects and ensure the timely delivery of homes to buyers, the Government of India had (in July 2020) opened doors to foreign investment in the sector, by allowing a 100% Foreign Direct Investment (FDI). Several liberalisation policies have also simplified the investment process by reducing the need for permissions and licenses for starting any large construction project. As stated above, some regulations, such as RERA, rendering the developer liable for structural defects arising within five years of handing over possession, are in the favour 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 completion of the same project. The escrow amount deposited shall be used only for the concerned project, 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.

The residential real estate sector has faced a multitude of challenges in recent years, primarily stagnant absorption rates and low consumer demand. However, with the onset of the coronavirus pandemic, the residential real estate market saw an opportunity for revival with respect to historically low rates of interest by the RBI, low mortgage rates and boost to affordable housing in the Union Budget, among others. With people spending the majority of their time indoors, the need to "own a home" was exacerbated during the pandemic due to the uncertainties of living in a rented apartment. With the extended work-from-home and online education culture, there is an increased need for larger homes, especially for families with working spouses. The following trends have been observed in the sector during the current year:

1. Mid-range and affordable housing to continue to drive sales
2. An increase in demand from millennials for digitally enabled homes and homes with a work-from-home-supportive infrastructure
3. A higher number of joint ventures to mitigate execution risks
4. Increased demand from the NRI population
5. Increased home buying from the final/end user rather than investors

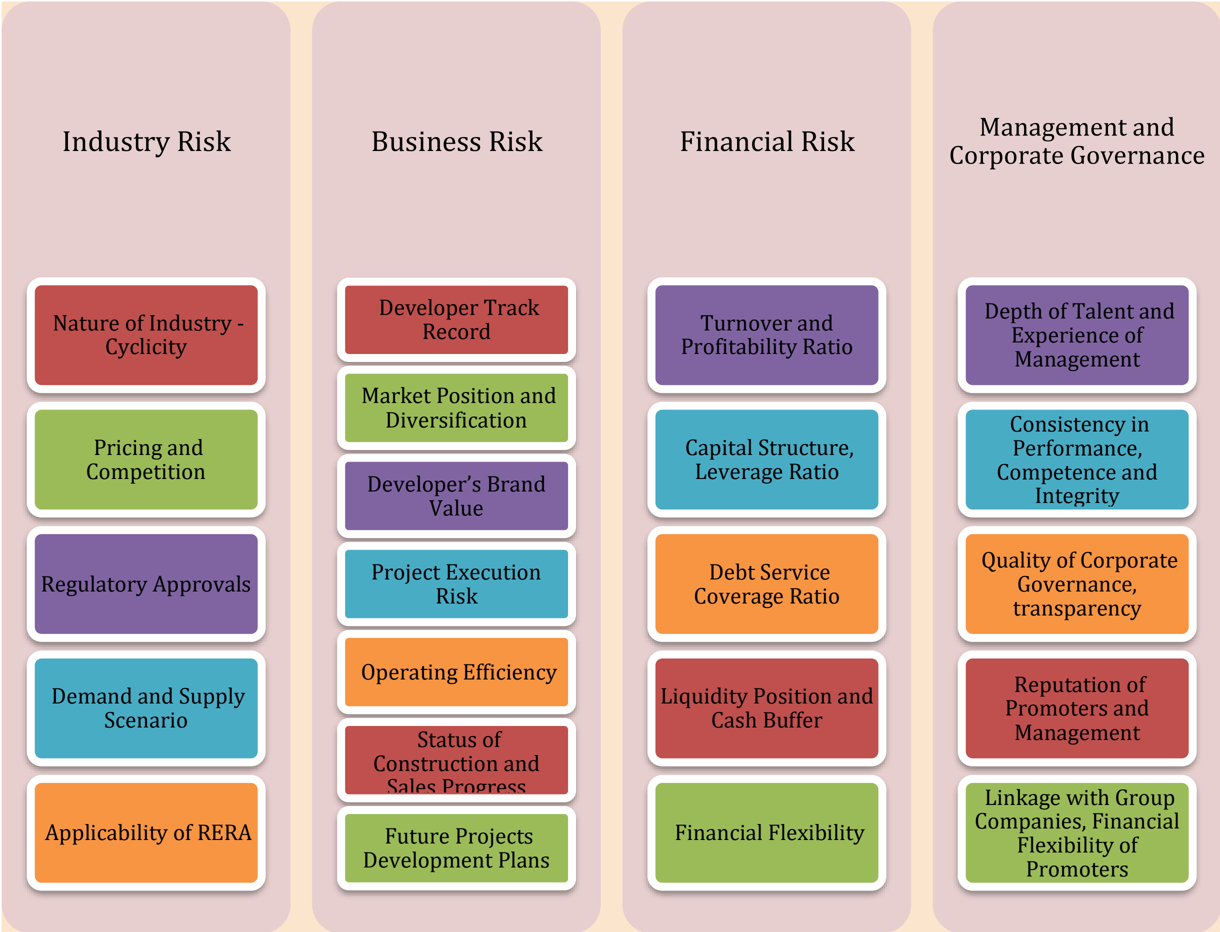
While real estate and construction remained the most impacted sectors in India in H1FY21, there was some buoyancy during H2FY21, with economic activity reviving. Factors such as a reduction in the stamp duty in Maharashtra, lower interest rates, pent-up demand and a halt in launches provided some relief to the real estate sector. That said, the green shoots that had started becoming visible turned out to be short-lived as the second wave of the pandemic hit the nation unawares. Owing to the accelerated vaccine programme adopted by the government, the situation is now improving, and hopefully the problems inflicted by the pandemic should subside soon.

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 generation of cash flow from the project.

Risk Assessment and Rating Criteria

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 risk, 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 promoter's support to the rated entity to arrive at the final rating.

A. Industry Risk

Residential real estate is highly fragmented and is characterised by the presence of large and unorganised small developers. The industry is cyclical in nature and has a direct correlation with public spending and the macro-economic environment. Moreover, demand and supply within the real estate industry vary based on the 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. 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. Additionally, with growing concerns over global warming and environmental degradation, environmental risks have taken on added meaning.

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.

B. Business risk

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. Furthermore, 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. Furthermore, emphasis is laid on the developer's execution track record, brand value/reputation, experience in real estate project development, number of projects delivered, scale of projects being currently undertaken, quality of the projects and diversification into various geographies and product segments. Since land is the primary component for any real estate project, BWR assesses the type and quantum of land bank available with the developer. 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 the timely infusion of funds as well as demand from prospective buyers.

Apart from being prone to general market and demand-supply risks, residential developers face construction risks, and legal and regulatory risks, stemming from the possibility of a government agency with jurisdiction over a project not allowing for 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. Financial risk is driven by funding risk, which usually involves equity, debt and customer advances, from which a majority of funding comes. The said 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 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. Turnover and Profitability Ratio: These include risks related to operating margin, revenue growth, return on capital employed. A stable and diverse stream of revenues provides a steady source of cash flows and gives it a protective cover against any uncertainties. A higher return on capital employed further strengthens the ability of the entity to service debt obligations.
2. Capital Structure, and Leverage Ratio: 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 determine 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 an additional borrowing in case 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.
3. Debt Service Coverage Ratio: 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.
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 material 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 from 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 a cash flow, and a debt service reserve account is seen positively.
5. Financial Flexibility: The group/promoter's ability to raise funds in case 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.

D. Management & Corporate Governance

A strong, dedicated and highly experienced board of directors helps the organisation achieve its profitability and operating efficiency targets and also helps improve the financials of the company. 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. 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 the comprehensive analysis of various risks associated with project implementation, regulatory aspects, financial risk, industry, operational and business risk, 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.

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