ICRA

RATING METHODOLOGY - LEASE RENTAL DISCOUNTING (LRD)

May 2022

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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in August 2019. While this revised version incorporates a few modifications, ICRA's overall approach to rating the debt, backed by lease rentals, remains materially similar. Also, a section has been added to provide a broad perspective on how environmental, social and governance (ESG) risks are incorporated by ICRA in its credit assessments.

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Overview

Lease Rental Discounting (LRD) loan is a term loan availed against the future expected rentals from a commercial (office space) or a retail (mall / shops) or a warehouse/ industrial property. The loan is availed by the lessor, based on the discounted value of future rentals and the underlying property value. Generally, entities convert the construction loan availed at the time of project development into LRD loans, post the completion of construction, tying up of lease agreements and commencement of rentals. On most occasions, the lender has the first right over the rentals through maintenance of an escrow[1] account and an appropriate cash flow waterfall mechanism. While in some cases the LRD loans are used purely to substitute the high-cost construction loans, most often the real estate entities leverage their commercial or retail assets to raise LRD loans in excess of the construction loans. These surplus funds are typically used for the repayment of other expensive term loans, to fund construction of other commercial or retail properties and other general corporate purposes.

As the inflows, mainly the rent receivable (parking charges, cafeteria charges, maintenance charges etc. being the other revenue sources), as well as the outflows - mainly debt servicing, taxes and operating and maintenance (O&M) expenses, are largely stable in nature, the rating analysis is focused on the adequacy of the inflows to meet the outflows as well as the sustenance of revenue-generating capacity of the said property.

While evaluating entities with multiple LRD loans, each loan is assessed separately if the cash flows from the allocated assets are escrowed. If the surplus from the escrowed cash flows is available with the company for any discretionary deployment, a consolidated analysis of all the assets as well as loans, including construction finance loan, is undertaken to evaluate the company's credit profile. As the entities involved in commercial real estate operations are likely to routinely have a mix of construction finance (CF) loans for under-construction assets and LRD loans for completed assets, the presence of CF loans will also have a bearing on the credit assessment of the LRD loans as the CF loans entail higher business and financial risk.

[1] *Escrow mechanism: An arrangement made between the lender and the borrower, whereby the hypothecated rentals are deposited in a separate bank account, operated in a manner that is mutually agreed upon.*

For evaluating CF loans taken for under-construction projects, ICRA analyses the project's execution, regulatory and funding risks, as typically done for project debt, apart from analysing the revenue-generating ability of the project, which in turn depends on the factors as detailed in this note. The objective is to ascertain the project's ability to generate future lease income, their adequacy in relation to the debt repayments - in most cases by refinancing through LRD loans. The ability to complete timely refinance of the CF loans, as well as the time available in case of any delay in refinancing is also assessed.

Credit Risk Assessment Framework

This rating methodology explains ICRA's approach to assessing the business and financial risk profiles of entities which primarily have (or are likely to have) debt backed by future lease rental discounting. It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing the quantitative and qualitative risks that are likely to affect rating outcomes in this sector. The list of rating drivers covered in this methodology is not exhaustive by itself but provides an overall perspective on the rating considerations that are usually considered most important. For analytical convenience, the key factors are grouped under the following broad heads—Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, Debt Structure and Other factors.

Credit Risk Categorisation

Industry Risk	Business Risk	Financial Risk	Debt Structure	Other factors
» Demand-supply outlook	» Scale and operational track record of assets » Track record of sponsor/promoter group » Asset competitive position » Asset diversification » Occupancy and market risk » Lease renewal risk » Tenant profile and diversity	» Cash flows and Leverage » Coverage » Liquidity	» Structural factors » Amortisation structure, refinancing and financial flexibility » Covenant Package	» Sponsor Profile » ESG Risks

Industry Risk Assessment

Demand-Supply Outlook

ICRA also notes that the demand-supply dynamics, typical lease terms and stability of cash flows can vary depending on the operating segment of the property (i.e., office, industrial or retail space). Cash flows from office properties are usually seen to be more stable and predictable, given the longer lease terms, stickiness in lease renewals, fixed rate agreements and relatively lower vulnerability to general macro-economic trends. On the other hand, leases in the retail segment are subject to various additional risks such as variable rent rates (due to revenue share arrangements), shorter lease terms, risks of diminishing property attractiveness because of competition and variability in footfalls and shopping spends. The divergent trends have also been established during the waves of the Covid-19 pandemic, which have impacted the two segments in different ways. In the industrial warehousing assets, there are Built-to-Suit (BTS) properties where there is more certainty of cash flows with long tenures (with lock-ins) and better renewal rates.

The other factors such as growth of the industry segment of the lessor, which depends on the macro-economic conditions or dynamics of the specific industry are analysed. Further, risk of substitution from new developments in the vicinity or even new geographies which can be influenced by the incentives or policies of the various state governments or the Central Government is also factored in.

Industry Risk Factors

[Indicative Metrics]

	Strongest	Weakest
Demand-supply outlook	Favourable demand-supply outlook for the micro-market, characterised by a combination of any of the following factors: (i) overall vacancy rates in the micro-market are very low, less than 5%, (ii) limited supply pipeline for projects, (iii) location is a preferred destination for major corporations / tenants, (iv) marginal leasing rates have grown steeply in recent years, say more than 10% YoY	Negative demand-supply outlook for the micro-market, characterized by a combination of any of the following factors: (i) overall vacancy rates in the micro-market are very high, more than 15%, (ii) large supply addition expected in near term, (iii) location is losing out to other micro-markets as preferred destination for major corporations / tenants, (iv) incremental leasing in the location has happened at declining lease rates in recent years

Business Risk Assessment

○ Scale and operational track record of assets

While analysing entities operating in the commercial leasing segment, scale is evaluated through the total area available for leasing, including the properties under development. A larger scale is normally indicative of better financial flexibility, access to capital, track record and ability to attract marquee clients, which typically have a requirement for large areas. A property with established operating track record and consistently high occupancy levels maintained in the past is seen favourably. The past trends in renewal of lease agreements by tenants, rental movement vis-a-vis market rates and success in quickly replacing the vacating tenants can be ascertained through the trends in volatility or growth of rental income and profits and it also helps establish the property's operating track record.

○ Track record of sponsor/promoter group

The track record of sponsor/promoter group in the commercial leasing business is taken into consideration while analysing the entities in this segment. The ability to attract pre-leasing commitments during the construction stage can mitigate market risks to a large extent; in this context, developers with established track record, strong relationships with key tenants and large scale are better placed to conclude such leasing tie-ups. A long track record in the business indicates better experience and helps in implementing better strategy, resulting in mitigating vacancy, interest rates and refinancing risks.

○ Asset competitive position

- **Asset Location:** The location of a property is a critical parameter for attracting tenants and for healthy occupancy levels. Proximity to key business districts and airports and connectivity with the major residential areas and presence of effective transportation options increase the attractiveness of a property.
- **Asset condition**: Property specifications and quality of construction are also key drivers for high occupancy. Some of the key building specifications which drive the leasing decision of tenants include floor plate area, ceiling height, layout flexibility, power-backup, air-conditioning, ventilation, etc. A well-maintained property is likely to result in higher occupancy. Besides, the presence of recreational facilities and food and beverage options within the complex, adequate vehicle parking slots, security arrangement, availability of transport infrastructure and other initiatives like

management of various promotional events enhance the appeal of the property. These factors improve the bargaining power of lessors and are considered favourably by ICRA during its rating exercise.

- **Rental competitiveness**: The competitive rentals allow the property to attract and retain tenants and thereby result in high occupancy rates. A property where the average rent rates are lower than the market rates is less vulnerable to risks of renegotiation of rates or non-renewal of leases as they expire. A combination of high occupancy and competitive / sustainable rentals is likely to result in stable revenues.
- **Suitability of asset to diversified tenant profile:** Grade A office space is suitable for occupancy by any company with standard investments in fitouts / interiors and is better placed, compared to a building that has small floorplates and a location that is suitable for occupancy by tenants only in some specific sectors.
- **Other attributes:** The demand-supply outlook for the micro-market where the property is located has a direct bearing on occupancy levels and rentals, thereby making it an important consideration from the rating perspective. While estimating demand for the property, ICRA takes into account various factors such as the key industries that have driven demand in the market and the trends in incremental supply and absorption of space, vacancy and rent rates.

  In addition to the existing supply in any particular region, the ongoing and planned development in the vicinity is a key factor in determining the expected occupancy levels and lease rentals. The demand-supply situation is very critical in determining the likelihood of the lessor being able to let out any un-leased portion in the project as well as the probability of attracting new tenants, should any vacancy arise.

Asset diversification

Asset diversification is measured through the number of different assets owned by the entity and the markets they are located in, as well as the share of revenues contributed by the largest assets of the company. A more diversified portfolio will enable the company to withstand any temporary dip in operating metrics for any individual asset. A single asset entity would remain susceptible to any adverse changes in the demand supply scenario in the micro market.

Occupancy and market risk

Occupancy level and average rent rates are the two main variables that determine the level of cash inflows or net operating income (NOI)[2]. The high occupancy levels provide certainty on revenues and mitigates market risk.

ICRA also considers the form of shell lease such as warm shell or bare shell and whether any investment has been made by the tenant towards fit-outs / interiors in the property. Facilities let out on a fully fitted basis with no investment made by the tenants entail larger vacancy risk in comparison to the facilities wherein the tenants have made substantial investments towards fit-outs and interiors. However, the lock-in terms in lease agreements, which ensure minimal lease terms until capital cost for fit-outs are recovered, can mitigate this risk to an extent.

Market risk in under construction projects is evaluated through the extent of the area which has been tied up through letters of intent or agreements to lease. In addition, the rent rates in such concluded pre-leasing agreements are evaluated with respect to the base case assumptions in the financing plan and suitable adjustments made to the projected cash flows.

Assessment of lease renewal risk

ICRA evaluates the salient features of the lease agreements which typically include lease tenure expiry schedule, lock-in expiry schedules, security deposits collected from the tenants, rent revision schedules, rent-free period, renewal options available to lessee and common area maintenance charges.

While assessing the lease renewal risk ICRA looks into the ratio of weighted average lease expiry (WALE) to the weighted average debt maturity. The lease tenure is generally for a period of five to 15 years, the lock-in period ranges between three to five years. Lease tenures covering the entire loan tenure mitigate the vacancy risk during the loan tenure and thus ensure stable cash flows over the entire period of the debt repayment obligations. On the contrary, a high proportion of lease expiry in the near future or before the maturity of the loan increases the vacancy risk, thereby resulting in the likelihood of cash flow

[2] *Net operating income (NOI) is defined as lease rental income and maintenance income less maintenance, property tax, insurance and any other direct expenses associated with the property*

mismatch for timely debt servicing. Besides, short notice periods and termination clauses, which are in favour of the tenants, further intensify the vacancy risk. However, the letter of intent (LoI) from existing or new tenants for occupying the property, if any, reduces such a risk.

ICRA also takes note of escalation clauses, if any, which might result in higher rentals going forward. However, vacancy risk is enhanced in case such escalations result in an imbalance between the properties' rentals and the prevailing market rates, thus as a sensitivity in such scenarios ICRA also assesses the entity's ability to service debt in case no escalations in rental are implemented.

- **Tenant profile and diversity**

Strong credit profile of the tenants in conjunction with the commitment demonstrated in the past towards timely rental payments mitigates the chances of delays in receipt of rentals. Besides, ICRA also takes into account the client concentration prevailing for the property. The higher the degree of concentration, larger would be the reduction in occupancy ratio and debt coverage ratio, should the tenant vacate after expiry of the lock-in period. A diversified and reputed client profile reduces the dependence of cash flow on a few tenants, thus mitigating the risk of a delay in rental receipt from any of the tenants.

Summary of the Salient Business Risk Factors

[Indicative Metrics]

	Strongest	Weakest
Scale and Track Record	1. Leasable area of property For office space> 10 million sq.ft For warehousing/retail > 2 million sq.ft 2.Operational track record of property for more than 10 years 3. Track record of sponsor/promoter group of more than 15 years.	1. Leasable area of property For office space < 1 million sq.ft For warehousing/retail < 0.25 million sq.ft 2. Operational track record of property for less than 5 years 3. Track record of sponsor/promoter group of less than 2 years.
Asset Competitive Position	1. Building is less than 3 years old and meets all the latest specifications for a Grade A building with adequate parking, power back-up, etc. 2.Building located in prime micro market abutting the major transport networks. 3. The weighted average rent rate for the asset is at least 20% lower than the prevailing market rate (not due to inherent drawbacks in the building) and ability to achieve the market rent has been demonstrated through recent leasing transaction(s) in the property. 4. Grade A space which is suitable for occupancy by any company with standard investments in fitouts / interiors.	1. Building is more than 20 years old or has poor maintenance / upkeep; it would not be able to charge rents close to the market rates if it were to be leased out to a new tenant. 2. Asset is located in non-prime micro-market where demand potential is not yet established. 3. The weighted average rent rate for the asset is at least 20% higher than the prevailing market rate and there have been instance(s) of sustained vacancies / new leasing at lower rent rates / inability to enforce escalation clauses. 4. Occupancy is linked to specific requirements of current tenant(s) and ability to find replacement tenants may be limited due to asset specifications / location / profile
Asset Diversification	1. Top 3 projects constitute less than 40% of the total area (including area under development). 2. Presence in at least 5 distinct micro-markets (where each market has at least 10% of the total portfolio)	1. Single asset company 2. Single micro-market

	Strongest	Weakest
Occupancy and Market Risk	For completed projects: (Vacant area + Area where termination notice received) < 5% of completed portfolio For under development projects: Area under letter of intent / agreement to lease / hard option / lease agreement > 80% of under-construction portfolio	For completed projects: (Vacant area + Area where termination notice received) >30% of completed portfolio For under development projects: Area under letter of intent / agreement to lease / hard option / lease agreement < 20% of under-construction portfolio
Lease renewal risk	Ratio of WALE/Weighted average debt maturity >=1.0 times	Ratio of WALE/Weighted average debt maturity <=0.25 times
Tenant profile and Concentration	% of Income from Top 5 Tenants < 20% of Total Income and strong tenant profile	% of Income from Top 5 Tenants is more than 80% of Total Income and weak tenant profile

Financial Risk Assessment

Cash flows and Coverage

For estimating the cash flow adequacy, ICRA computes the cash flows available for debt servicing (CFADS) by deducting expenses such as salaries, power and fuel, repairs and maintenance, management expenses, property taxes, income taxes etc and other working capital adjustments from gross revenue. Besides, the lessor might receive income from some other sources such as fit-out rentals, common area maintenance (CAM), parking, cafeteria, advertisements etc. These revenues, if recurring, as demonstrated by historical trends, are also added to the gross revenues.

The CFADS is then divided by the debt repayment obligations to arrive at the DSCR – a higher DSCR ensures better cash flow adequacy. Depending on the specifics of the transaction, ICRA carries out various sensitivities on key variables such as interest rates, rentals, operating costs and occupancy levels to determine the base case / stress case cash debt service coverage ratio (DSCR). The DSCR is evaluated on an annual basis as well as on a cumulative basis over the loan tenure. The five-year average DSCR is also looked into as there is more clarity and certainty of cash flows in the near to medium term.

Occupancy level and average rent rates are the two main variables that determine the level of cash inflows in an LRD transaction. Vacancy impacts the regular rental inflows while also resulting in outflows related to the redemption of security deposits, given initially by the outgoing tenants. In this context, the extent of tenant diversification is a critical factor as a higher tenant concentration would imply a larger adverse impact on DSCR if any of the larger tenants were to terminate their leases.

In addition to rental / occupancy sensitivity, analysis is also done on the impact of variation in interest rates on the DSCR ratio – the debt coverage ratios should remain consistent with that of the rating category under moderate stress on the interest rates, given the long tenure of such loans and the possibility of interest rate movements over the tenure.

Ratio	Computation
Cumulative DSCR	Sum of CFADS from the calculation date to the maturity of the rated instrument, divided by the sum of debt servicing obligation (principal plus interest) on the rated debt instrument during the tenure of the instrument
Average DSCR for next 5 years	Simple average DSCR for the next five years

Assessment of Coverage
[Indicative Metrics]

	Strongest	Weakest
Cumulative DSCR	>1.75x	<=1.05x

	Strongest	Weakest
Average DSCR for next 5 years	>1.60x	<=1.05x

Leverage

ICRA assess the leverage ratio as the ratio of the debt to the net operating income (NOI). However, suitable adjustments are made to the debt[3] and NOI[4] to account for the impact of under-construction assets (referred to as Adjusted Debt and Adjusted NOI henceforth). If the existing leverage levels are lower, it implies that the company has headroom for raising top-up LRD loans or for extending maturities on loans to improve coverage ratios. On the other hand, high leverage levels can result in weak coverage ratios or high refinancing risk in case of back-ended repayment structures. A high leverage ratio also makes the entity more vulnerable to any decline in operational parameters such as occupancy or rent rates and provides lower cushion to absorb such adverse variations. Issuers with a higher proportion of completed assets or lower reliance on construction finance are better placed to absorb the risks associated with ongoing capital expenditure.

[Indicative Metrics]

	Strongest	Weakest
Total portfolio (incl under-construction)	Adjusted Debt / Adjusted NOI is < 4x	Adjusted Debt / Adjusted NOI is > 9x

Liquidity Analysis

Liquidity is the measure of an entity's ability to meet its short-term cash obligations from various internal or external resources. Internal resources include cash flows from operations, unencumbered cash and cash equivalents on balance sheet and cash inflows expected from the monetisation of physical and financial assets. External resources include undrawn lines of credit or equity capital. The short- term obligations include both the committed as well as the contingent claims on an entity's cash, including the debt servicing obligations, working capital requirements, capital expenditure and other investment outlays and other outflows. The higher the cushion available between the resources available (especially internal resources) and the obligations, better the liquidity profile of an entity. Liquidity is generally assessed in conjunction with the vulnerability of an entity to timely refinancing / renewal of short-term sources of funding. ICRA evaluates the transaction documents to ascertain the availability of debt service reserve account (DSRA[5]) prior to the default, to ensure timely debt servicing, if DSRA can be assessed before the due date of debt servicing, it is considered for liquidity assessment

Foreign Currency-Related Risks

Foreign currency risk for an entity is measured by considering its un-hedged foreign currency debt. ICRA's analytical focus is on assessing the magnitude of such exposure, relative to the entity's profits.

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[3] *Adjusted debt will be the sum of current LRD and CF debt outstanding and pending cost to complete for under-construction assets less committed equity, committed security deposits and cash balances earmarked for capex.*

[4] *Adjusted NOI - NOI from developed assets + Expected income from under-development assets.*

[5] *DSRA: Debt Service Reserve Account is a liquidity support in the form of deposit equal to a given number of months of projected debt service obligations. The lender has rights to use these funds in case there are delays in debt repayment by the borrower.*

Debt Structure

While the financial risk assessment considers the capacity of the properties to generate adequate cash flows and the stability of those cash flows, the debt structure analysis considers the payment waterfall ranking and the structural features, amortisation structure and the associated refinance risks, and the covenant package.

Structural factors

ICRA considers the robustness of escrow and cash flow waterfall mechanism. Presence of escrow mechanism and ring fencing of cash flows to prevent any leakage of funds are some of the structural considerations.

The following factors in LRD transactions, can enhance the credit profile –

(i) Ring-fencing of cash flows,
(ii) Sufficient time gap between the remittance of the lease rentals and the scheduled repayment obligation, and
(iii) Availability of liquidity support mechanisms.

Ring-fencing of the cash flows is established through escrow accounts which are generally controlled by the lender, whereby the receipts into the account are allowed to be used by the company only after meeting its debt repayment obligations for the month. In the absence of an escrow mechanism, there is higher reliance on the company maintaining financial discipline and prioritising debt repayments over other cash outflows.

Typical waterfall mechanism

The priority of cash waterfall from the respective designated escrow would be as follows:

1. Statutory dues/Regulatory payments
2. Debt (Principal + Interest) servicing of the loan sanctioned by lender
3. Replenishment of DSRA, if required
4. General operating, administration and maintenance expenses
5. Balance to be transferred to current account of borrower

A reasonable time gap between the rental payment due dates and debt servicing due date provides a cushion in case of minor delays in rent remittance due to any operational issues at the lessee's end. Moreover, maintenance of DSRA provides liquidity support for debt repayment in case of a temporary delay in rental receipts or short-term vacancy.

ICRA evaluates the probability of intra-group transactions, which might result in cash outflows from the subject company to other group entities in case of absence of escrow, thus resulting in a lower cushion available for debt servicing. Besides, ICRA takes into account the past credit culture of the rated entity, which is primarily done through evaluation of its track record of servicing of debt repayment obligations.

Amortisation Structure, Refinancing Risks and Financial Flexibility

Sometimes, in addition to the monthly instalments, the loan might also require a large bullet repayment at the end of the tenure. This generally is the case when either the LRD term is very short, or the property is overleveraged, i.e. it entails higher debt than what the monthly inflows can service and hence requires a lump sum payment towards the back-ended tenure of the loan. In such cases the refinancing capacity of the underlying asset and the ability of the management to raise funds in a timely manner, become vital rating considerations. While assigning the ratings, the focus is mainly on the cash flow adequacy for debt servicing; however, to assess refinancing ability in scenarios where there is an expected requirement of refinancing, adequacy of security available for lenders and the property's estimated market value are considered by ICRA.

A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing ones in quick time and whenever required. Financial flexibility could arise from factors such as an entity's large scale of operations with strong financials, large unencumbered cash flows, unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group. Further, entities with strong leverage metrics are in a better position for refinancing the debt.

ICRA also assesses the presence of cross-default clauses in loan agreements to evaluate the possibility of a default on non-LRD loan, triggering an acceleration in payment of the LRD loan and hence precipitating in a default situation. ICRA also assesses the likelihood of the exercise of the put/call options and evaluates the leverage when the options are exercised.

Assessment of Refinancing risk
[Indicative Metrics]

	Weak	Adequate	Comfortable
Share of LRD debt in overall external debt	<=60%	60-80%	>=80%

Covenant package

ICRA draws comfort from the restrictive debt covenants, which include prohibitions/tests on additional indebtedness or liens, restrictions on the acquisition and sale of assets, limitations on mergers and consolidations, limitations on investments (permitted investments), change of control/ownership, especially if the sponsors are important to the project.

	Positive	Neutral	Negative
Structural Features	1) Lender administered cash flow waterfall with well-defined payment priorities 2) Dividend lock-up / restricted payment triggers with both backward and forward-looking tests 3) Trapping surpluses early and cash sweep mechanism 4) Immediate replenishment of debt service reserves (if dipped into) from subsequent operating cashflows 5) Sufficient time gap between the remittance of the lease rentals and the scheduled repayment obligation	1) Lender administered cash flow waterfall with well-defined payment priorities 2) Dividend lock-up / restricted payment triggers; covenant testing is not forward looking 3) Immediate replenishment of debt service reserves (if dipped into) from subsequent operating cashflows 4) All promoted debt instruments remaining sub-ordinated to senior secure debt and payments subject to consent of external lenders	1) No Escrow account 2) Lack of presence or lack of adherence to the specified cash flow waterfall 3) Weak/no dividend lock up triggers 4) Debt service reserves with no replenishment 5) No cash flow sub-ordination of promoter debt and payment track record of recurring payments on promoter debt instruments
Amortisation Structure	1)Fully amortising with step-up repayments structure in line with expected rental inflows 2) No debt acceleration triggers	1) Amortising debt structure with no more than 25% of the current debt to be unamortised at the end of tenure	1) Highly concentrated maturities with large bullet repayments 2) Cross default or debt acceleration triggers 3) Put options during debt tenure
Covenant Package	1) Prohibitions/tests on additional indebtedness (including financial assistance) or liens, restrictions on the acquisition and sale of assets; limitations on mergers and consolidations; limitations on investments (permitted investments)	1) Prohibitions/tests on additional indebtedness (including financial assistance) or liens, restrictions on the acquisition and sale of assets; limitations on mergers and consolidations; limitations on	1) Additional indebtedness (including financial assistance) or liens is permitted; no restrictions on investments (permitted investments)

	Positive	Neutral	Negative
	2) Limits on change of control/ownership, especially if the sponsors are important to the project 3) Absence of debt acceleration due to breach of covenants or covenants which have sufficient cushion with respect to the existing metrics	investments (permitted investments)	

Other Elements of Credit Risk Assessment

Sponsor Risk Assessment

All debt ratings necessarily incorporate an assessment of the quality of the entity's management, as well as the strengths / weaknesses arising from the entity being a part of a Group. Also, of importance are the entity's likely cash outflows arising from the possible need to support other Group entities, in case the entity is amongst the stronger ones within the Group. Usually, a detailed discussion is held with the entity's management to understand its business objectives, plans, strategies and views on past performance, besides the outlook on the entity's industry. Some of the other points assessed are:

- Experience of the promoter / management in developing and leasing commercial properties
- Commitment of the promoter / management to the line of business i.e. importance of the property in relation to its overall real estate asset portfolio and other business activities
- Promoter's / management's risk-taking appetite, leveraging strategy, ability to mitigate vacancy, interest rate and refinancing risks
- Risks posed by other business segments of the company
- Entity's plans on new projects, acquisitions, expansion, etc.
- Strength of the other entities belonging to the same group as the entity and the ability and willingness of the promoters / group to support the entity through measures such as capital infusion, if required
- ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity. Support here means financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period, advances etc in times of credit or liquidity stress on the entity.

Assessment of Environmental, Social and Governance (ESG) Risks

The assessment of ESG risks by ICRA involves a broad range of considerations that pertain to the sustainability of an entity with focus on aspects that can have a material impact on its credit quality. While the E&S risks tend to be both sector-related as well as entity-specific and could be driven by external factors such as regulations or demographic changes, the G risks are largely entity-driven. The impact of the E&S risks on an entity's credit profile tends to be asymmetric. If the ESG risks are material but unmitigated, these generally translate into pulling down the rating, but generally the ratings are not pushed up even when the ESG context is favourable.

Environment (E) and Social (S) Risks

As this methodology highlights, while undertaking credit assessment of entities, ICRA seeks to incorporate all relevant credit considerations into its rating decisions, while taking a forward-looking view on the risks and the mitigating elements. The relevant credit considerations include (sometimes overtly, sometimes covertly) the E&S factors that could affect the rated entity/ transaction. While ICRA's analytical approach does not explicitly disaggregate these risks to assess their impact on the rating, these risks are often assessed broadly. Further, it is not always feasible to fully or precisely disaggregate the sub-components of E&S risks in credit analysis since these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time horizon over which they are expected to crystallise differs widely across sectors and entities. In some cases, while the E&S risks could be material, but their effect on the credit profile may be muted because of other fundamental strengths of the entity. In other cases, the adverse impact of the E&S risks is expected to play out in the distant future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the distant future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating the E&S risks, ICRA's objective is only to assess the direct and indirect risks that an entity faces and how it already is or is intending to mitigate the impact of such risks on its credit profile. As an example, ICRA only assesses whether an entity is exposed to physical climate risks or carbon transition risks such as those arising from changes in regulations or other environmental and social risks; and seeks to understand the various mitigation and adaptation approaches that the entity is implementing to mollify these risks. Notwithstanding the above, as an example, it is possible that even if an entity A has a higher carbon footprint than entity B, it does not materially affect ICRA's credit opinion on entity A. This is because ICRA's credit opinion on an entity considers a wide gamut of credit-relevant factors and the E&S factors are only one among those.

The real estate segment is exposed to risks of increasing environmental norms impacting operating costs, including higher costs of raw materials such as building materials and cost of compliance with pollution control regulations. Environmental clearances are required for commencement of projects and lack of timely approvals can impact business operations. Impact of changing environmental regulations on licences taken for property development could also create credit risks. For operational commercial real estate properties, increasing awareness of environmental norms may lower the competitive positioning of assets which do not adhere to the prevailing norms on energy and water consumption. The under-construction projects are also exposed to social risks such as inadequate labour availability leading to construction delays. Developers are exposed to accident and safety issues at construction sites. Further, Covid-19 pandemic has been a social risk, which impacted the footfalls in retail assets as well as moderated the absorption of office spaces, due to work from home.

Governance Practices

Corporate governance remains a complex and evolving subject. From a risk perspective, the same is as important as an entity's business strategy. A sound corporate governance structure attempts to make clear the distinction of power and responsibilities between the Board of Directors and the management. The constitution of an entity's Board and the Board of Directors' participation in strategy formulation, besides the entity's adherence to legal and statutory compliance requirements are factored in during credit assessments. ICRA seeks to gain a qualitative understanding of an entity's commitment to following transparent and credible practices by the way its financial statements are reported, their level of disclosures, consistency in communication and the openness about sharing information during the credit rating exercise. Besides, the corporate group structure (whether simple or complex), the rated entity's related party transactions and instances of supporting group entities at the expense of debt holders are assessed.

Summing Up

ICRA's credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the entity's business and financial risks, its competitive strengths, the likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis the debt-servicing obligations. The LRD loans are characterised by relatively superior predictability of underlying rental cash flows, limited operating expenses and ring-fencing of cash flows through maintenance of escrow accounts. The rating analysis is focused on the sustenance of revenue-generating capacity of the underlying property and its adequacy to meet the committed debt-servicing obligations.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks for debt backed by lease rentals

		Strong			Comfortable			Adequate			Moderate			Weak	
Industry Risk	Industry Position														
Business Risk	Scale of assets														
	Track record of Sponsor Group														
	Asset competitive position														
	Asset diversification														
	Lease renewal risk														
	Occupancy & market risk														
	Tenant profile and concentration														
Financial Parameters	Coverage														
	Leverage														
		Enhance					Support/Neutral					Hinder			
Do these factors enhance or hinder the credit profile?	Liquidity, Refinancing dependency and Financial Flexibility														
	Financial Policy														
	Management, Governance & Reporting														
		Very High				High				Moderate				Low	
	Likelihood of Parent Support														
	Rating of Parent	AAA	AA+	AA	AA-	A+	A	A-	BBB+	BBB	BBB-	BB+	BB	BB-	B/ C category
	Final Rating	**AAA**	**AA+**	**AA**	**AA-**	**A+**	**A**	**A-**	**BBB+**	**BBB**	**BBB-**	**BB+**	**BB**	**BB-**	**B/C category**

***Source**: ICRA Research*

The above graphic is only for illustration purpose and does not represent a rating output from a formulaic model. The ratings assigned by ICRA are determined by Rating Committee based on both quantitative and qualitative considerations.

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About ICRA Limited:

ICRA Limited was set up in 1991 by leading financial/investment institutions, commercial banks and financial services companies as an independent and professional investment Information and Credit Rating Agency.

Today, ICRA and its subsidiaries together form the ICRA Group of Companies (Group ICRA). ICRA is a Public Limited Company, with its shares listed on the Bombay Stock Exchange and the National Stock Exchange. The international Credit Rating Agency Moody's Investors Service is ICRA's largest shareholder.

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