ICRA

RATING METHODOLOGY – REAL ESTATE INVESTMENT TRUSTS (REITs) November 2022

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This rating methodology describes ICRA's approach to assessing the credit risk of Real Estate Investment Trusts (REITs), and supersedes ICRA's earlier methodology document on this subject, published in December 2019. While this revised version incorporates a few modifications related to financial parameters evaluated, ICRA's overall approach to rating REITs 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.

This rating methodology aims to help issuers, investors and other market participants understand ICRA's approach to analyse risks that are likely to affect rating outcomes. This document does not include an exhaustive discussion of all the rating factors that our analysis considers but provides an overall perspective of the considerations that are usually the most important.

Overview

REITs act as vehicles for owning and operating revenue generating real estate assets and distributing cash flows from them to the unit-holders. Structured like a mutual fund, REITs utilise the pooled capital of an investor base to deploy across various income-producing real estate assets such as office space, shopping malls, hotels, resorts, self-storage facilities and warehouses.

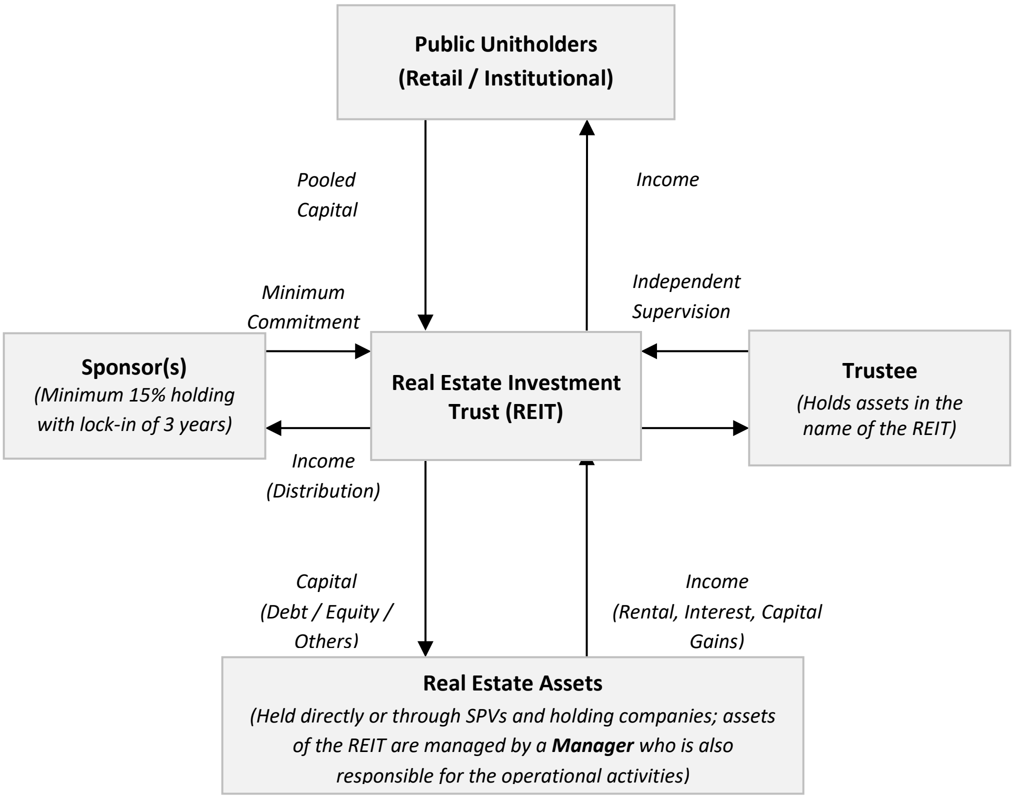
The Securities and Exchange Board of India (SEBI) notified the regulations for establishing REITs in September 2014 through the SEBI (Real Estate Investment Trusts) Regulations, 2014. The regulations were further modified through various amendments thereafter to provide a further impetus to the launch of REITs in India. The first REIT was listed in India in April 2019.

About REITs

The REITs are collective investment vehicles that enable developers of real estate assets (generally held under various special purpose vehicles or SPVs) to monetise their assets by pooling multiple assets under a single entity (trust). A REIT could own the underlying assets directly or through special purposes vehicles (SPVs), with intermediate holding companies also permitted (subject to certain regulations). As per the REIT regulations, a REIT is to be incorporated as a "trust" under the Indian Trusts Act, 1882, and registered with SEBI. The units in the trust are to be listed on stock exchanges. The parties in a REIT are the sponsor (or the promoter), the trustee and the manager(s). The key features of REITs are mandatory distribution of 90% of net distributable cash flows (NDCF)[1] to the unit investors, a leverage restriction of 49% on the total REIT asset value[2], and a limit of investment in assets (other than operational rent-generating assets projects) at 20% of the value of REITs' assets. The REIT sponsor is responsible for setting it up and appointing the trustee. The sponsor should hold a minimum 15% of the units issued by the REIT with a lock-in period of three years from the date of issuance. Credit rating is mandatory for REITs if the aggregate consolidated borrowings and deferred payment obligations of the REIT (including that of holding company, and the SPVs) net of cash and cash equivalents exceed 25% of the value of the REIT assets.

A graphical representation of a REIT structure along with the various stakeholders is shown below.

Exhibit 1: Graphical Representation of a REIT Structure in India



1 The calculation of NDCF is to be defined in offer document or placement memorandum of the REIT. Generally, NDCF is calculated as PAT + Depreciation + loss/gain on sale of assets – capex - Repayment of external debt (principal) /redeemable preference shares/ debentures etc. (adjusted for other non-cash expenses/income and working capital changes).
2 Market value as determined by an independent valuer

What does the credit rating of REITs address?

A REIT's credit rating is an opinion on its ability to service its debt obligations in a timely manner. This entails an assessment of the operational and financial risk profile of the REIT's portfolio of assets on a consolidated basis. The analysis takes into account the external debt availed or proposed to be availed at the consolidated REIT structure. A REIT's credit rating is not a reflection of the credit worthiness of the individual SPVs of the REIT, pricing of the units issued by REIT or its market performance and potential returns to the unit holders.

ICRA's credit assessment of a REIT is based on a consolidation of the business and financial risk profile of the REIT and that of its SPVs. Accordingly, the rating of a REIT benefits by virtue of asset diversification and the associated cash flow diversification. Moreover, the REIT regulations impose certain conditions on the operational and financial profile of a REIT, which supports taking a consolidated view of the entity. These include mandatory distribution of available free cash flows at the SPV level and regulation of the minimum holding by the REIT in its SPVs. In addition, certain regulations have a favourable impact on the rating such as cap on the under-construction areas in the portfolio, limits on permissible leverage levels as well as enhanced disclosure norms, which are enforced by an independent trustee. Though the rating for the REIT is assigned on the basis of a consolidated approach, the benefit of liquidity at the SPV level in the form of encumbered cash is not given to the assessment of the REIT's credit profile since such liquidity will be restricted to the individual SPV.

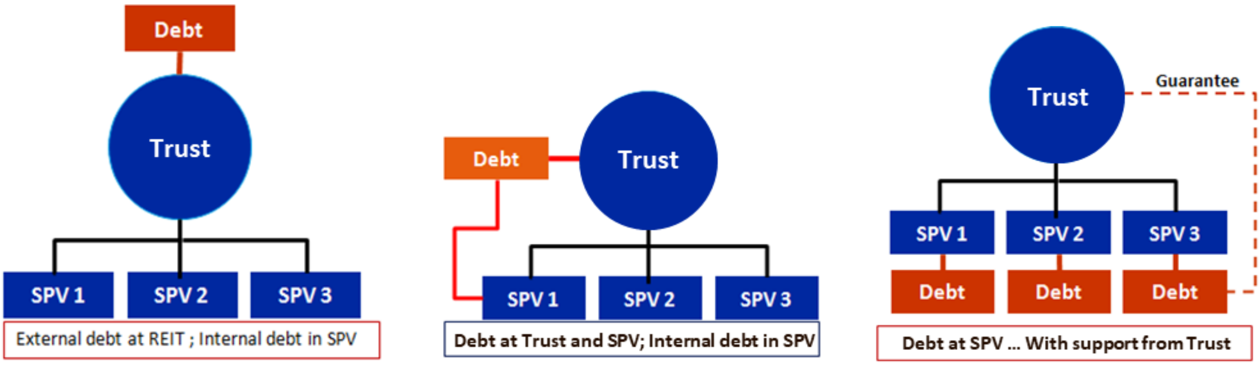
Salient features of REIT regulations which govern their operations

The business and financial risk profile of REITs are governed by the REIT regulations, which were initially notified in September 2014 and modified through multiple amendments over the subsequent years. A brief description of the key features of the REIT regulations that impact their credit profile is given below.

Conditions on Investment in Assets	• Not less than 80% of the value of the REIT assets shall be in completed and rent generating real estate properties; hotels, hospitals and convention centres which form a part of the composite real estate projects, are also permitted real estate assets • Not more than 20% of REIT assets shall be in the form of other permitted assets, which include under-construction properties • A REIT shall invest in at least two projects, with one project attributing to not more than 60% of the value of REIT assets
Distribution of Cash Flows	• REITs and SPVs shall distribute not less than 90% of net distributable cash flows to its unitholders / REIT, at least once every six months • An intermediate holding company shall distribute 100% of the cash flows received from underlying SPVs and at least 90% of the cash flows generated by it on its own • If any property or shares are sold by the REIT / SPV / intermediate holding company, it shall distribute at least 90% of the sale proceeds, unless the REIT proposes to reinvest the sale proceeds into another property within a period of one year
Debt	• A REIT can raise debt (net of cash) up to a maximum of 49% of the value of its assets on consolidated basis; further an external credit rating would be required in the event the consolidated debt and deferred payments exceeds 25% of the asset value

Source: SEBI

Debt could be raised by the REIT at any of these levels / combinations



As permitted under the regulations, the REIT can raise external debt either at the trust level or at the SPV level. The consolidated debt is required to be capped at 49% of the value of the REITs' assets. The debt raised at the SPV level could be guaranteed by the REIT, if the cash flows at the SPV level are expected to be inadequate or volatile. In a few cases, even if the SPVs' cash flows are adequate, the REIT can guarantee the debt at the SPV for credit enhancement purposes. The REIT can also invest in the SPVs and intermediate holding companies through debt instruments.

ICRA's Credit Risk Assessment Framework

For analytical convenience, this document describes ICRA's methodology for rating REITs under broad sections viz., Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment and Management Quality & Corporate Governance Assessment and other elements of credit risk assessment.

Industry Risk Assessment

- Demand-supply outlook

Business Risk Assessment

- Assessment of individual assets
    - Scale and operational track record of assets
    - Competitive position of assets
    - Occupancy and market risk
    - Lease renewal risk
    - Tenant profile and diversity
    - Project implementation risk
- Portfolio diversity

Financial Risk-Assessment

- Stability of cashflows
- Leverage, liquidity and debt service coverage metrics
- Debt maturity profile and refinancing requirement
- Interest rate and forex risk
- Structural factors

Other Elements of Credit Risk Assessment

- Accounting Quality
- Contingent Liabilities and Off-balance Sheet Exposures

Management Risk

- Stakeholders' profile and track record
- Management quality

Assessment of Environmental, Social and Corporate Governance Risks

Industry Risk Assessment

Demand-Supply Outlook

The demand-supply outlook for a property's micro-market is evaluated based on factors such as the prevailing vacancy levels for the available stock in the micro-market, extent of supply additions expected in the near to medium term, the attractiveness of the location to prospective tenants as well as the growth in marginal leasing rates in the location. While the prevailing vacancy in the micro-market is an indication of existing demand-supply imbalances, the expected supply additions and trajectory of absorption in the location are critical for indicating possible variations to the current operational metrics. Locations which witness high absorption in relation to the supply are characterized by faster growth in leasing rates in new transactions. Such factors are important to consider since it is generally observed that even within a given city, different micro-markets have varying demand-supply outlooks.

ICRA 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.

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

Assessment of individual SPVs

REITs are intended to primarily hold completed and rent-generating assets. Though the REIT regulations permit them to invest in hotels, hospitals and convention centres which are part of the composite real estate project, the majority of the asset portfolio would comprise rent-generating assets such as office parks, retail malls, etc. Hence, the framework for assessing the business risk profile of REIT assets would largely follow from the framework detailed in the methodology titled "Rating Approach – Lease Rental Discounting (LRD)" available on ICRA's website www.icra.in.

The key assessment parameters are summarised below:

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 tenants, which typically have a requirement for a larger area. 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 are reflected in the trends in volatility and growth in rental income and profits.

Track record of sponsor/ promoter group

The track record of the 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 enables handling the tribulations relating to vacancy risk, adverse interest rate movements 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 a diversified tenant profile:** Grade A space is suitable for occupancy by any tenant with standard investments in fitouts/ interiors and is better placed, compared to a building that has smaller 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 drive 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.

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)[3]. 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 by lessor, 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) period 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 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.

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

[3] 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

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.

Project implementation risk

REITs are permitted to have up to 20% of their asset portfolio in the form of under-construction properties. This exposes the REIT to project risk in relation to the ongoing development. ICRA analyses the project's execution risk, regulatory risk and funding risk, as typically done for project stage issuers, for the under-construction asset(s). The focus is on identifying the key risks which could impede the timely commissioning of the asset, evaluating market factors that will impact the operational metrics post commissioning, and estimation of the net free cash flow addition to the REIT from the asset on completion. Projects which are brownfield expansions of existing operational assets are typically seen more favourably from a business perspective because of the track record demonstrated in the operational asset. Likewise, projects that are expected to generate high free cash flows (because of good profitability or limited leverage deployed in construction) are also seen favourably.

Portfolio Diversity

Diversity in the asset portfolio aids the credit profile of the REIT as it can mitigate the risks of cash flow shock in any of the operational assets. ICRA evaluates the diversity of the portfolio, based on the geographical presence of the assets, sectoral profile of the tenants and degree of co-relation between the business risk profile of the assets. Material presence in multiple markets (cities as well as micro-markets) can mitigate the risks of adverse demand-supply scenario in any specific market. Moreover, a wide distribution in the sectoral profile of the tenants (such as IT/ITES, BFSI, manufacturing, etc) can reduce the risks of reduction in demand from any particular sector. Even when the REIT portfolio is diversified with the presence of retail malls, hotels, etc as part of composite projects, the performance of these assets could be linked to some extent to the occupancy in the office parks. In this context, a well diversified asset base spread across multiple geographies with no single asset dominating the cash flows and low receivable concentration from any single counter party is viewed favourably. The REIT regulations mandate certain level of diversification as no project can attribute to more than 60% of the value of the REIT assets.

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.

	Strongest	Weakest
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
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

For financial risk assessment, the cash flows for all underlying SPVs and the Trust are consolidated on account of the cash flow pooling benefit available with the REIT, given the requirement to mandatorily upstream the surplus cash flows from the SPVs. The adequacy of total cash flows at the consolidated level is assessed with respect to the REITs' consolidated expenses and debt servicing obligations. This is the approach followed for analysing SPVs where the external debt at the SPV doesn't have any restrictive covenant on upstreaming of cash flows to REIT.

Stability of cash flows

For assessing the future cash flows, ICRA considers parameters such as the past track record of fund flows from operations, nature of the underlying assets, contractual terms relating to rent rates and their escalations, occupancy levels, market outlook, diversification in tenant profile, cost structure for maintenance services and agreements with tenants for recovery of the same. Here emphasis is laid on the predictability of cash inflows and ability of the manager to exercise better control over operating costs. For projects with short operational track record, the projections are drawn based on base case estimates of occupancy, rent rates, etc, by drawing on the track record of the sponsor and the prevailing market conditions in the project location. ICRA carries out sensitivities on key variables such as interest rates, rentals and occupancy levels, as relevant to analyse the cushion available to tide over any market disruptions etc.

Leverage and debt service coverage metrics

ICRA evaluates leverage as the ratio of the debt to the net operating income (NOI). However, suitable adjustments are made to the debt[4] and NOI[5] 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.

The debt service coverage ratio (DSCR) is the key coverage ratio which is analysed. The DSCR measures the cushion between debt-servicing obligation and cash flows available for debt servicing (CFADS) in any given period. The DSCR is evaluated on an annual basis as well as on a cumulative basis over the loan tenure. In case of amortising debt, the cumulative DSCR and 5-year average DSCR (on a projected basis) are looked into. 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. For cumulative DSCR, in case of amortising debt, CFADS over the loan tenor is the numerator, and the total debt service obligation is the denominator.

In case of unamortising debt, debt service annuity is calculated to arrive at the denominator for the calculation of cumulative DSCR.

Debt Service Annuity refers to the annuity-type payment of interest and principal required to repay outstanding debt over 12 years (typical loan tenure of LRD structure). Debt Service Annuity is calculated using a standard formula that converts total outstanding debt into an annuity payment with no residual value at maturity.

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

Debt Service Annuity is calculated with the following formula:

(Total Debt x Discount Rate[6]) / (1 – (1/(1 + Discount Rate)$^{12\ years}$))

Assessment of Leverage
[Indicative Metrics]

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

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

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[7]) prior to the default, to ensure timely debt servicing. If DSRA can be utilised before the due date of debt servicing, it is considered for liquidity assessment.

Debt maturity profile, refinancing risk and financial flexibility

Ceteris paribus, the tenure of the term debt is a key driver for the debt coverage as entities with longer tenure debt and similar levels of leverage will generally be more comfortably placed compared to entities with shorter tenure debt. Sometimes, in addition to the monthly instalments, the loan might also require a large bullet repayment at the end of the tenure. This

[6] *Discount rate used is the estimated long-term average cost of debt*

[7] *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.*

generally is the case when the debt term is very short. 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 loan-to-value (LTV) ratio – i.e., ratio of consolidated external borrowings (excluding security deposits) to the value of the REIT assets are considered by ICRA. Generally, a conservative LTV is viewed favourably as it provides headroom for drawing additional debt to meet exigencies or fund future growth plans. The REIT regulations impose an upper cap on the permissible LTV in the REIT on a consolidated basis; if a REIT's LTV is to the maximum extent possible, it will reduce its financial flexibility and increase dependence on further equity raising or asset sale in case of large funding requirements towards under-construction projects or acquisitions.

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.

Assessment of Refinancing Risk

[Indicative Metrics]

	Low	Moderate	High
Amortisation structure	Fully amortising with step-up repayments structure in line with expected rental inflows	No more than 25% of the current debt to be unamortising in nature	More than 25% of the current debt is unamortising in nature with highly concentrated maturities with large bullet repayments

Interest rate and forex risks

The foreign currency risk can arise from unhedged liabilities, especially for entities with un-hedged foreign currency borrowings which could pertain to part-funding of the project cost of the underlying assets or refinanced debt at the SPV or the REIT. As there is limited scope for natural hedge, the focus here is on the hedging policy of the issuer to mitigate such risk for net foreign currency exposure. Similarly, the extent to which an issuer would be impacted by movements in interest rates is also evaluated.

Structural factors and debt structure

ICRA considers the robustness of escrow and cash flow waterfall mechanism. The 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 debt facilities backed by lease rental income, 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. Creation of the debt service reserve account (DSRA) to cover debt servicing obligations for some period (either in the form of cash deposits or in the form of a guarantee) provides additional comfort.

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 is typically 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 issue 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 track record and probability of intra-group transactions, which might result in cash outflows from the subject company to other group entities in case of the 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.

ICRA also assesses the presence of cross-default clauses in loan agreements to evaluate the possibility of a default on a subordinate loan triggering an acceleration in payment of the senior loan and hence precipitating a default situation. The likelihood of the exercise of the put/ call options and the leverage when the options are available are also taken into consideration.

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 **6.** No debt acceleration triggers	**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	**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 **6.** Debt acceleration triggers

		to consent of external lenders	7. 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) 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	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. Additional indebtedness (including financial assistance) or liens is permitted; no restrictions on investments (permitted investments)

Other Elements of Credit Risk Assessment

Accounting quality

The financial analysis considers a review of the REIT's accounting quality. Here, the Accounting Policies, Notes to Accounts and Auditors' Comments that are part of the Annual Report are reviewed.

Contingent liabilities/ Off-balance sheet exposures

In this case, the likelihood of devolvement of contingent liabilities / off-balance sheet exposures of the SPVs and the REIT and the financial implications of the same are evaluated.

Management Risk Assessment

Management Quality

All debt ratings incorporate an assessment of the quality of the management, as well as the strengths/weaknesses arising from the sponsor being a part of a 'group'. Usually, a detailed discussion is held with the management to understand its investment objectives, plans and strategies, and views on past performance. Some of the other points assessed are:

- **a.** Investment manager and trustee's experience and track record
- **b.** Project manager's experience and track record
- **c.** Investment process and objectives
- **d.** The issuer's policies on leveraging, rationale for debt raising, balance between leverage and returns, interest risks and currency risks
- **e.** Asset acquisition /asset diversification strategy, assets in pipeline

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 tightening environmental standards impacting operating costs including the 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 sensitivity of tenants towards environmental norms may lower the competitive positioning of assets that are behind the curve 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 also need to contend with 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 shift towards a work-from-home operating model.

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 issuer's business and financial risks, its competitive strengths, its likely cash flows over the life of the instrument being rated and the adequacy of such cash flows vis-à-vis its debt servicing obligations and other funding requirements.

Overall, ICRA has a more favourable opinion on REITs that have diversified and high-quality asset base, stable cash flows and strong counterparties. ICRA also draws comfort from strong DSCR and conservative leverage ratios. Presence of structural features like adequately funded DSRA with restrictive covenants on additional debt and lenders' consent for addition of new assets is a credit positive. The rating is also a function of the operational track record of the assets, the REIT's asset acquisition strategy and experience of investment manager and trustee.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks for REITs

		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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