

This methodology document stands superseded. Refer to ICRA's website [www.icra.in](http://www.icra.in) to view the updated methodology document on this subject.



## ICRA Rating Feature

# Rating Methodology for Real Estate Entities

This rating methodology explains ICRA's approach to analysing the credit risk profile of real estate entities (REEs)<sup>1</sup>. The objective of the rating methodology is to provide a reference tool that can be used to evaluate the credit profiles of companies involved in real estate development. It aims to help issuers, investors and other interested market participants understand ICRA's approach to analysing quantitative and qualitative risk characteristics that are likely to affect rating outcomes. This methodology does not include an exhaustive treatment of all factors that are reflected in the ratings but enables the reader to understand the rating considerations that are usually the most important.

The current note discusses ICRA's approach in rating real estate entities, where the primary business model is to construct and sell built-up area in the residential segment or the commercial segment. While the rating approach is broadly similar for both the segments, ICRA notes that there could be differences in the demand-supply dynamics and sales/collection cycles of the two.

For projects in the commercial segment (including retail), which are intended to be held for leasing, ICRA analyses the projects' ability to generate adequate lease income to cover the debt repayments. The factors considered for the analysis therein are described in detail in the note on "Rating Methodology for Debt Backed by Lease Rentals".

ICRA's rating approach in this sector draws upon its general corporate credit rating methodology with key rating factors grouped under four broad heads – Industry Risk, Business Risk, Financial Position, and Management Quality. However, appropriate emphasis has been laid on the relevant rating factors that take into account the features that are specific to the real estate industry, including its execution and cash collection cycle, funding mix, the terms of typical debt sanctions and general industry practices.

## Industry Risk Analysis

### Industry Structure and Cyclicity

The industry is also characterised by the presence of many large as well as small unorganised developers. Nonetheless, the recent regulatory developments, particularly the Real Estate Regulation and Development Act of 2016 (RERA Act), have resulted in consolidation of the industry, in turn benefiting larger developers. The funding mix for the real estate sector, especially the residential segment, involved significant contribution from customer advances. To that extent, there is high dependence on sales during the construction stage to ensure adequate funding for the construction.

The real estate industry is cyclical in nature and has positive correlation with the macro-economic environment. Some of the key drivers of the industry are the state of the economy reflected in the growth rate of the manufacturing and the services sectors, employment levels, increase in the proportion of gainfully employed workers in the total population and the extent of rise in disposable income. The purchase of a residential real estate unit is considered to be an investment by many customers and the buying decisions are influenced by factors such as expectations of future income stability and capital price appreciation, affordability, apart from various personal preferences. Moreover, the demand-supply trends within the real estate industry may vary in different geographies and product segments. Given that the typical

<sup>1</sup> This rating methodology updates and supersedes ICRA's earlier methodology note on the sector, published in March 2017. While this revised version incorporates a few modifications, ICRA's overall approach to rating issuers in the sector remains materially similar.

implementation period for a real estate project can range from three years to six years, the cyclicity in the industry trends may significantly impact a project's performance.

### **Legal and Regulatory Risk**

Real estate projects are subject to significant regulatory risk on account of the various approvals that are required from government bodies for the construction and sale of buildings. In addition, the legal status of the title of the underlying land for the project can also be subject to litigation and poses a major risk to developers and buyers in real estate projects.

The regulatory oversight on the real estate sector has increased manifold with the passing of the RERA Act, which emphasises on adherence to contractual obligations and regulatory guidelines. Developers who have a strong track record of adhering to regulatory stipulations and contractual obligations will be better placed to operate under the new framework. Thus, the introduction of the RERA Act is expected to gradually result in consolidation of the industry, which hitherto has been characterised by a fragmented structure with presence of large unorganised segment and intense competition.

Moreover, amendments to the Insolvency and Bankruptcy Code, with effect from July 2018, provide homebuyers the status of financial creditors, thereby granting them the right to initiate insolvency proceedings against developers who have not fulfilled their commitments under sale agreements. Post the amendment, there have been many instances of insolvency proceedings initiated by customers against developers who have delayed handover of residential units. Admission of such claims under the insolvency framework may adversely impact the debt servicing ability of the company as its operations will be taken over by the insolvency professional, who may impose a standstill on debt servicing even where cash flows are available. In scenarios where the claims are settled prior to admission by the authority, such developments may adversely impact the developer's reputation and market standing, apart from the financial damages. ICRA assesses the risk of such claims by homebuyers by looking at the project commencement dates and contracted handover dates to identify delayed projects which may be vulnerable. In addition, the past track of complying with regulations and delivery as per scheduled timelines and promised quality is viewed positively. ICRA believes that such risks are higher in projects launched prior to the implementation of RERA Act due to the structural changes that the new regulations have brought about in the operations and strategies of real estate developers.

### **Business Risk Assessment**

The key rating factors evaluated under Business Risk include the REEs' past track record in the industry, market standing and execution capabilities. These have a direct bearing on the REEs' ability to execute, market and finance their portfolio of ongoing and planned projects. In addition, there are risk factors that are specific to the projects being developed by the REEs and need to be analysed separately. While assessing REEs, ICRA evaluates each project in the portfolio on an individual basis. However, given that there can be significant cash flow fungibility across projects, an evaluation of the project portfolio on an aggregate basis becomes critical even when these are taken up in multiple entities promoted by the REE. A description of the factors assessed under Business Risk is given below.

#### **Track Record**

While evaluating an REE, ICRA lays emphasis on the developer's execution track record in terms of years of presence in the real estate sector, types of projects developed, geographic diversification, number and area of projects delivered, and quality and timeliness in the past projects. A developer's long presence in the sector is looked at in conjunction with the scale and type of development over the years. During the rating exercise, ICRA analysts typically visit some of the completed and ongoing projects and obtain feedback from execution agencies and channel partners to develop qualitative judgment about the developers' execution track record, reputation and adherence to commitments under sale agreements. An REE with a successful track record of developing large-sized projects with the required quality and within timelines is looked at favourably as such a track record enhances its market position as well as brand equity, and increases the pricing power of the developer. The track record is also examined in relation to the type and scale of projects being currently undertaken vis-à-vis projects executed in the past. A limited track record in the industry can

be mitigated to some extent by ICRA's expectations of continued support to the REE by a strong promoter group and/or strong systems and processes put in place to manage the business risks.

### **Systems and Management Capability**

While analysis of the track record of an REE provides some insights into its historical project management capabilities, further evaluation of its current systems and processes is done to assess its ability to deliver the ongoing projects within the committed timelines, specifications and quality. In case the development plans of the REEs are relatively more aggressive in relation to the area developed by them in the past, the same could test their ability to scale-up the execution capabilities commensurately. For instance, many real estate players tend to diversify into new geographies and segments – from residential space to commercial space and vice versa, or from low-rise to high-rise buildings, or from apartment projects to mixed-use integrated townships. While assessing the project management capability of an REE, ICRA looks at the internal planning, management information systems and project monitoring systems.

### **Market Standing**

ICRA believes there is a positive correlation between the market position of a real estate player and its ability to attract customers/brokers, engage with key lenders/investors, and get projects approved for home loans from banks/housing finance companies. Therefore, while assessing the fundamental strength of an REE, ICRA evaluates the market position of the entity on the basis of the qualitative and quantitative determinants of relative market strength, such as market share, brand equity, track record of sales/bookings, and velocity of sales. The brand equity enjoyed by the REE is reflected by the premium earned over the market rate and customer preference for the REE's projects over similar competing projects. The REE's market position is also assessed through its execution track record (as described earlier), bookings/occupancies in developed projects, after-sales service and general customer feedback. With a large share of the funding mix in real estate projects is met through customer advances (typically 50-70%), a superior market position can translate into relatively faster sales and hence, reduced funding risks for the project.

### **Funding Risk**

The funding mix for real estate projects usually involves equity, debt and customer advances with the latter generally forming the largest share of the mix. ICRA evaluates the adequacy of the committed cash flows as the sum of the balance collections from the sold area and undrawn credit lines divided by the balance cost to be incurred to complete the project and the debt sanctioned. A lower ratio implies that there will be high dependence on either fresh sales (market risk) or promoter contribution (sponsor risk) to bridge the funding gap.

In the case of residential projects, it is also important to consider the profile of the customers from whom the receivables are to be realised – typically collections from end customers who fund purchases with home loans are seen to be prompt and less vulnerable to market conditions and price movements in the project. A high percentage of end users lowers booking cancellation risk to an extent and ensures higher collection efficiency over the project execution period. If required, the list of buyers is taken along with the payments due as per construction progress and amounts received to evaluate the customer's commitment towards the project.

In this context, the collection efficiency or the ratio of the amounts received against the demands raised to the customers is an important parameter to evaluate. In addition, the ratio of customer advances received to the total value of sale agreements should be commensurate with the current stage of construction and the corresponding billing milestone as per the payment schedule. The impact of any deferred payment schemes offered by the REE to boost sales is also considered while evaluating the funding risk.

For commercial real estate projects, the payment milestones could be more spread out, resulting in lumpiness in collections and potential cash flow mismatches. Hence, the specific payment terms for the sale agreements need to be evaluated to estimate the funding risks.

Since projects in the initial stage can be dependent on debt funding, especially given the increasing preference among homebuyers for completed inventory, the status of financial closure, conditions precedent for debt disbursement and adequacy of equity margin funding for debt disbursement are considered.

### Market Risk in Ongoing Projects

The saleability of the REEs' ongoing and upcoming residential projects is assessed by the projects' type, location, price, amenities on offer, competition from nearby projects and target customers. The saleability of commercial projects is evaluated through parameters such as expected demand for office/retail space in the location, price competitiveness (vis-à-vis other sale projects or leased area) and suitability of construction specifications for the target customer segment (for eg. adequate parking, power back-up, etc). Market risk associated with each project is also assessed in relation to its present stage of development/construction, level of bookings (percentage of total area sold) and velocity of sales over the project tenure. Projects where the sales proportion is significantly high and sales velocity has been strong in the recent years are perceived to have lower market risk.

Factors that mitigate market risks for an REE include diversity of project portfolio in terms of geography, product, price points and clientele, and presence of strong marketing channels. In ICRA's experience, the market risks associated with commercial real estate properties tend to be higher on account of the narrower target customer segment and larger ticket size per transaction. Developers that have strong track record of selling commercial space through strata sales and demonstrated ability to tie-up leasing for the space under development are better placed to absorb the market risks associated with such projects.

For each of the launched projects, ICRA assesses the proportion of booked space to the total area offered. A lower proportion of booked space increases the market risk for the project and can lead to a delay in project execution as the projects are largely financed from customer advances. The sales volume and pricing trend since the launch of the project are also analysed to understand the market response and are used to draw inferences on future sales which will determine the projected cash flows. The break-even sales volume required to bridge the funding gap, if any, in the project is also determined and the adequacy of the current sales velocity to achieve this break-even sales volume is assessed. The years of unsold inventory (calculated as area pending to be sold divided by average sales in trailing 12 months) is evaluated in relation to the general industry trends as well as the pending project implementation period (in case of a single project SPV).

### Construction Risk

The stage of construction of each of the ongoing projects is evaluated from the perspective of an REE's ability to complete the project in a timely manner and with all committed specifications. Any delays in project execution can negatively impact collections from customers (which are generally linked to construction milestones) and saleability of projects, leading to a vicious cycle of lower funding availability that further constrains execution progress. For evaluating construction risks, ICRA compares the physical and financial progress on the projects vis-à-vis the initial targets including the completion date as per RERA registration. Other factors which are considered include complexity of the construction activities involved in the projects and the track record of the contractors engaged. Also, the scale of the upcoming projects is seen in relation with the current scale of operations of the REE. Further, the systems and resources of the REE are assessed with respect to its ability to manage any increase in scale in the upcoming project portfolio. The track record of the external agencies — architects, structural engineers, civil contractors, and project management consultants, among others — engaged by the developer are also assessed.

Adherence to the legal and regulatory processes is assessed by ICRA to understand any deviation, which could have a bearing on an REE's ability to execute a project in a timely manner. The key areas of assessment include an REE's clear title over the property and availability of regulatory approvals (such as building plan sanction, commencement certificate, occupancy certificate, environmental clearance, airport authority approval, fire authority approval, RERA registration, etc). High importance is given to the status of the regulatory approvals for the ongoing projects as delays in obtaining the requisite approvals/sanctions often result in project execution delay. Any violations of the provisions of the RERA Act, including delays in handover of the projects, may also invite monetary penalties of up to 10% of the project cost.

## Diversification

ICRA looks at the developer's presence across multiple assets, geographical markets and product segments and the consequent cash flow generating capability from each market/segment. A diversified product mix, while allowing a developer to address a wider customer market, also reduces its reliance on a single segment/project. ICRA, while making the assessment, also looks at the developer's geographical presence as that helps the latter to mitigate the risks to its portfolio from exposure to a single region as well as enables it to leverage on growth opportunities in other regions. Diversification reduces an REE's exposure to demand volatility and competition in any particular segment/location. Operational cash flows/leveraging in projects that are performing well can be a source of cash flows to support relatively weak ongoing projects. However, such diversification is viewed in conjunction with an REE's execution capability, management bandwidth and feasibility for such diversification. In addition, restrictive covenants in debt sanction on usage of project surpluses (through strong ring-fencing or mandatory prepayment) may also impact the assumption of fungibility and hence the terms of the debt sanction are suitably factored in.

Moreover, the RERA Act of 2016 imposes a cash flow ring-fencing mechanism, with 70% of the collections to be received in the project escrow account and withdrawals permitted on the basis of the cost incurred on the project. The impact of such regulatory constraints on the fungibility of cash flows across projects is also evaluated by estimating the amount of cash from each project that will be required to be maintained in the separate RERA accounts through the projected period. In ICRA's experience, REEs that have been maintaining adequate financial discipline in terms of utilisation of customer advances have not been significantly impacted by the RERA separate account requirement, since these generally are eligible to withdraw most of the collections into this account by maintaining commensurate construction progress. Overall, a diversified project portfolio tends to support the financial flexibility of REEs and aids these to raise capital from other sources like private equity (PE).

Many REEs are present across multiple business segments such as residential, commercial, retail and hospitality. Within commercial real estate, developers can follow the for-sale model or held-for-leasing model. In such cases, ICRA analyses the business model, financial profile and cash flow position of each segment separately to understand the inherent risks and determine the impact of each segment on the overall credit profile of an REE. For instance, an REE which owns a portfolio of completed and leased commercial real estate with moderate leverage levels would be assessed for good financial flexibility, which can be a credit positive for the same. On the other hand, a portfolio of projects in commercial real estate/hospitality segments in the nascent stage could constrain an REE's free cash flows.

While analysing the various segments, ICRA uses the specific rating methodologies applicable for those segments – viz, Rating Methodology for Debt Backed by Lease Rentals, Rating Methodology for Hotel Industry. In the case of commercial real estate developments intended to be sold, the subject rating methodology is applied since the cash flow cycle closely matches that of a residential real estate project.

## Future Expansion Plans, including Land Bank

ICRA's rating approach also evaluates the future project launch plans of the REEs and the ability to tie-up land, funding and regulatory approvals for the same. ICRA assesses the quality of the land bank that is available with an REE for future development. The key parameters considered include the location of the land bank, i.e. its proximity to the city centre, any other location-specific advantage, availability of the infrastructure in the surrounding area, zoning of the land bank and status of the approvals for development. Other factors which are important while assessing the land bank are its historical cost as the developers that would have acquired land at relatively lower costs would have had a higher flexibility in pricing the final products.

ICRA also evaluates the land aggregation strategy with regard to the current and planned investment in land bank for future growth, as this could be a key determinant of the overall cash flows and leverage levels of an REE. A business model that focuses on joint development agreements (JDA) for land tie-ups can lower the upfront capital requirements and minimise large outflows on land purchase. Large surplus cash balances in projected cash flows are discussed with the management to gauge the planned utilisation of these cash balances. Such surpluses could lead to the intentional slowdown in sales by the management in anticipation

of better sales realisations in future or could be utilised for land purchases. Accordingly, the assumptions related to future sales velocity and land acquisition (including any deferred land payments in ongoing projects) in the cash flow model are modified to arrive at realistic cash balances. Amounts payable as internal/external development charges for land (as applicable in certain states) are treated as committed outflows and can pose a risk to the financial profile of an REE in case of inadequate collections from the associated project.

## Management Quality

In evaluating the management quality of REEs, ICRA's approach is broadly the same as detailed in the document "Corporate Credit Rating Methodology", available on ICRA's website. Specific factors relating to an REE that are evaluated include the management information systems and level of transparency as reflected in its sale agreements, quality of accounts, accounting disclosures, and corporate governance practices. The discipline exhibited by the management to maintain project level cash flows without diversion and/or commingling of funds is also viewed favourably. Further, an REE with strong corporate governance practises and good execution track record would find it easier to enter into JDA with the landowners at favourable terms.

ICRA also assesses the strengths/weaknesses arising from the issuer being a part of a Group. Expected funding support from Group entities can be a credit positive, whereas large funding commitments at the Group level can be a constraint on the rating for individual entities in the Group, which may have relatively stronger business profiles. Discussions are held with the REEs' management to understand their business objectives, plans and strategies, their risk appetite, dependence on debt funds, and their views on past performance, besides the industry outlook. The focus is particularly on the management's strategy towards future developments plans, land acquisition and diversification.

## Financial Risk Assessment

The various financial metrics assessed by ICRA could be divided into four categories viz., Profitability, Leverage, Coverage and Liquidity. This document provides a brief summary of how ICRA evaluates these metrics for real estate entities. For a more detailed description, readers may refer to the note titled, "Approach for Financial Ratio Analysis" published on ICRA's website. ICRA uses direct cash flow statements to evaluate the past performances as well as to estimate the debt servicing capability under various projected scenarios. The various parameters assessed under the Business Risk, Management Quality and Financial Position form the inputs for the projected cash flow statements. A description of the factors assessed under Financial Position is given below.

### Scale and Diversity of Cash Flows

In assessing the sustainability of cash flows of a real estate company, ICRA looks at various aspects, including scale, diversity of cash flow streams and scope of growth. An REE that has revenues coming in from diverse projects in terms of location, type and price points may be expected to have relatively sustainable and smoother cash flows. Stable revenue streams in the form of lease rentals and diversification into commercial projects also provide steady cash flow source. As for growth potential, the factors assessed include the number of ongoing and planned projects, the area already sold out, expected realisations and the anticipated appreciation in property prices along with the market risks involved. A higher scale of cash flow generation is seen to be correlated with enhanced market position, financial flexibility, higher economies of scale and access to lower cost capital.

### Profitability

Profitability is impacted by various factors such as the real estate company's cost of operations, land cost, brand equity, and the expected realisations. While the land cost may vary based on location and book value of land is linked to the vintage of purchase and hence cannot be benchmarked across locations, the construction costs for projects with similar specifications are typically comparable. Lower-than-comparable costs may reflect high profitability at initial stages, but could also imply a risk of cost overrun at the later stages and lower eventual profitability. On the other hand, reasons for higher project costs are analysed in

relation to additional features in project specifications, if any. An REE with higher profitability margins and returns on capital has a greater ability to generate internal accruals, attract external capital, and withstand business adversity. Higher profitability margins would also aid an REE to refinance its debt.

### Capital Structure

An REE usually requires capital in large tranches, especially during the land acquisition and approval stage. Usually, a mix of debt and equity largely meets this capital requirement. While evaluating an REE's capital structure, ICRA assesses whether the entity's debt-equity ratio is in line with the underlying business risks and with that of other companies with similar business models and project portfolios. Conservative leverage ratios are viewed favourably as the same reduces the committed outflows via interest and principal repayment.

The funding in the real estate sector also comes as PE, which may assume the form of debt or quasi debt since an REE may be obligated to provide an exit to investors with assured returns. The terms of PE investment are studied to evaluate the nature of repayment obligation which may fall on the REE or its promoters, resulting in refinancing risk. Though such funding will be subordinated to bank construction financing, any promised coupon/amortisation during construction period may impact the REE's liquidity as such investments generally carry high coupons/yields.

ICRA also assesses the leverage in an REE's projects by calculating the ratio of debt financing to the cost incurred on the projects to the extent not financed by customer advances. This ratio should ideally be in line with the proportion of debt and equity funding as per the projects' initial budgets. However, in ICRA's experience it tends to be higher than the initial budgets in projects with good sales velocity and collections, as some of the surplus collections received could be deployed towards other projects/investments for future projects. A ratio that is significantly higher (more than 100%) could indicate that the debt against the current project portfolio is supporting high investments in future growth requirements or other business segments. Similarly, a ratio that is significantly lower could suggest low sales progress or inability to achieve financial closure.

$$\text{Leverage Ratio} = \text{Debt Outstanding} / (\text{Work-in-progress less Customer Advances})$$

Weak sales levels can impact debt funding, given that banks and institutions usually disburse monies in proportion to the equity infusion and customer collections received, and hence delays/inability in bringing in the above could impair the ability of the project to draw down even the sanctioned debt. Adherence to the other operational or financial covenants that are stipulated in the debt sanction terms are also evaluated.

### Project Cash Flow Adequacy and Debt Coverage

ICRA analyses the adequacy of the debt coverage ratios and the matching of an REE's future cash flows (under various sensitivity scenarios) with its debt servicing obligations. ICRA analyses the extent of committed future outflows (on account of construction, debt obligation, etc.) which can be met through committed cash flows from projects, expected cash flows from new sales, undrawn bank lines. The inherent cash flow potential of the projects to meet these committed outflows is assessed through ratios such as Adequacy of Committed Cash Flows and Cash Flow Security Cover. The higher these ratios, the lower would be the expected dependence on refinancing and promoter contribution.

$$\text{Adequacy of Committed Cash Flows} = (\text{Receivables from Sold Area}) / (\text{Pending Cost} + \text{Debt Outstanding})$$

$$\text{Cash Flow Security Cover} = (\text{Receivables} + \text{Value of Stock} - \text{Pending Cost}) / \text{Debt Outstanding}$$

While the above ratios are useful to assess the inherent cash flow cover available in the projects, the ability of an REE to match these future cash outflows with the schedule of inflows is analysed through cash flow projections drawn quarterly/annually. Project-wise cash flow projections are drawn to assess project-wise surplus/deficit. The total funds available in the form of cash flow from operations and debt available for drawdown in each of the projected periods is compared with the scheduled repayments (including collection linked prepayments, if any) and finance cost due. The higher the gap between the available sources of funds and the repayments due, the better will be the ability of an REE to withstand any adverse variations in sales or collections performance as well as lower its dependence on refinancing/promoter contribution.

Cash flows are also adjusted for the units sold under various marketing schemes such as possession-linked plans, subvention plans, etc. where either the cash inflows are back-ended or interest cost has to be borne by the developer on behalf of the customer. Sensitivity tests are performed on certain key drivers and assumptions, such as selling prices, bookings, construction schedule and sales velocity. These projections are based on the expected operating and financial performance of the issuer, ICRA's outlook on the real estate industry, and the issuer's medium/long-term development plans.

Also, the projected capital expenditure, land acquisition outlay (either committed or proposed), and investment in Group companies are of importance. While preparing the projected cash flows, the impact of any PE funding availed for the projects (which could have terms relating to distribution of surpluses in specified ratio) or cash sweep mechanisms imposed by the lenders are also considered.

### **Liquidity and Financial Flexibility**

The issuer's liquidity and financial flexibility — as reflected by its cash balances, unutilised bank/credit limits, liquid investments, and its relationship with banks, financial institutions and other intermediaries — are also assessed since these can form a vital source of funding in case of any weakness in the operational cash flows from the projects. Though the unencumbered land base is an inherently less liquid asset, it can provide financial flexibility through debt raised against it.

ICRA evaluates the level of dependence on advances from customers and the structural features in place (such as escrow account) for managing such advances. Loan structures which require mandatory prepayment of debt using a specified proportion of the customer collections (that is appropriate for the construction stage) is viewed positively, as are debt service reserve accounts (DSRA). In the projected cash flows, the incremental debt drawdown considered is compared with the debt sanctions already in place to estimate the dependence on fresh debt sanctions. ICRA also considers the fund-raising ability of an REE against its ongoing projects by comparing the leverage levels in these projects to the industry trends. Lower leverage level in projects that are operationally performing well can provide financial flexibility to an REE.

### **Debt-Servicing Track Record**

The debt-servicing track record of an REE is important for a credit rating exercise. Any delays or defaults in the past in the repayment of principal and/or interest payments reduce the comfort level with respect to the developer's future debt servicing capability and willingness.

### **Contingent Liabilities/Off-Balance Sheet Exposures**

Typically, an REE has to provide a bank guarantee to the municipal authorities for its various projects being developed, which form a part of the developer's contingent liabilities. ICRA, in its analysis, determines the possibility of such guarantees being invoked and the pressure that the event would exert on the REE's cash flows.

### **Consolidated Financial Analysis**

In the case of Groups consisting of companies with close financial and operational linkages, various business and financial parameters are assessed at the consolidated/Group level to evaluate the plausible impact on the entity being rated. The impact of regulatory constraints such as the RERA on the fungibility of cash flows across projects is also be evaluated.

### **Accounting Quality**

While assessing the developer's accounting quality, the Accounting Policies, Notes to Accounts, and Auditor's Comments are reviewed. Any deviation from the Generally Accepted Accounting Practices (GAAP) is noted and the financial statements of the issuer are adjusted to reflect the impact of such deviations. A real estate company which follows consistent, transparent and conservative policy on financial accounting is viewed more favourably. Accounting practices like the revenue recognition method (percentage of completion versus completed), valuation of inventory and construction work-in-progress, depreciation methods and asset lives, and treatment of contingent liabilities, are reviewed and compared with the industry practices. As the revenue recognition policies may vary across entities, resulting in diverse financial statements, ICRA's assessment is based more on the adjusted cash flows and related ratios. Since the revenue recognition relies

significantly on the management estimates of the total project cost, the cost estimates are compared with similar projects to determine the possibility of future cost revisions and assess the stability of the profit margins going forward.

## 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. As this note highlights, for real estate companies, the analytical emphasis also includes factors like an REE's ability to execute projects, its market risk arising from the operating environment and its market position, its cash flow position, its land aggregation policy, and its debt-servicing obligation and financial flexibility.

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