

## RATING METHODOLOGY – REALTY (LEASE RENTAL DISCOUNTING)

May 2024



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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in May 2022. While this revised version incorporates a few modifications, ICRA's overall approach to rating the debt backed by lease rentals remains materially similar.

### 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 or a data centre. The loan is availed by the lessor, based on the discounted value of future rentals. 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<sup>1</sup> 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.

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. In other words, while the individual assets with LRD loans might have a healthy credit profile, the rating might still be constrained because of the presence of other debt on the balance sheet (such as CF) of the entity by virtue of cross-default linkages or bankruptcy risk.

<sup>1</sup> 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 risk, regulatory risk and funding risk, 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 rental income and their adequacy in relation to the debt repayments.

## 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 the 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.

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 quality and diversification	» Stability of cash flows » Leverage and debt service coverage metrics » Liquidity	» Structural factors » Amortisation structure, refinancing and financial flexibility » Covenant Package	» Sponsor Profile » ESG Risks

## Industry Risk Assessment

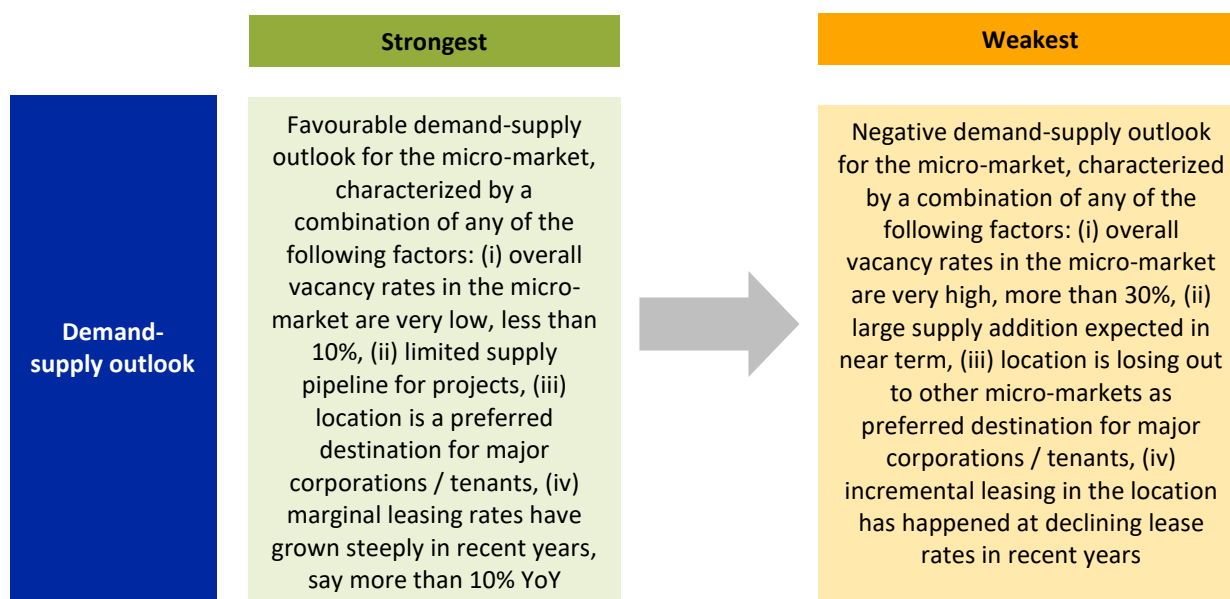
### Demand-Supply Outlook

The demand-supply analysis is undertaken at the level of the property’s micro-market as the local factors related to the prevailing vacancy levels for the available stock in the micro-market, expected demand growth and extent of supply additions expected in the near to medium term drive the lease rentals and the occupancy levels.

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 and data centers are usually seen to be more stable and predictable, given the longer lease tenures, 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 tenures, risks of diminishing property attractiveness because of competition and vulnerability to the variability in the macro-economic environment which drives footfalls as well as shopping spends. In the industrial warehousing assets, Built-to Suit (BTS) properties typically have more certainty of cash flows with long tenures (with lock-ins) and better renewal rates.

## Industry Risk Factors

[Indicative Metrics]



## 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 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 helps in establishing 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 largely mitigate market risks; 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 in mitigating vacancy, interest rates and refinancing risks.

### Asset competitive position

While assessing the competitive position of the asset, ICRA considers various factors such as location and condition of the asset, rental competitiveness, suitability of asset to a diversified tenant profile. The location of a property is a critical parameter for attracting tenants and to maintain healthy occupancy levels. Proximity to key business districts, connectivity with the major residential areas and presence of effective transportation options increases the attractiveness of the property. For asset condition - property specifications, age and physical condition of the asset are considered. In addition to the above factors, 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. For suitability to diversified tenant profile - Grade A office space with standard investments in fit outs /interiors 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. In addition, 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.

### **Asset diversification**

Asset diversification is measured through the number of different assets owned by the entity and the markets they are 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 or sudden vacancy by one or more large tenants.

### **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)<sup>2</sup>. The high occupancy levels provide certainty on revenues and mitigates market risk. Location of property, quality and vintage of the asset, rental competitiveness are some of the key drivers of the occupancy.

ICRA also considers the form of shell lease such as warm shell or 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 can mitigate this risk to an extent.

Market risk for completed projects is evaluated through the proportion of vacant area and the leased area for which the termination notice has been received with respect to the total area. Market risk for under construction projects is evaluated through the extent of the area which has been tied up through letter of intent or agreements to lease.

### **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 considers the ratio of weighted average lease expiry of total lease tenor (WALE) to the weighted average debt tenor. The lease tenor is generally for a period of five to 15 years, the lock-in period ranges between three to five years. Lease tenors covering the entire loan tenor mitigate the vacancy risk during the loan tenor and thus ensure stable cash flows over the entire period of the debt repayment obligations. On the contrary, a high proportion of lease expiries before the maturity of the loan increases the vacancy risk, thereby resulting in the likelihood of cash flow mismatch for timely debt servicing.

### **Tenant quality and diversification**

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 deterioration in the occupancy ratio and debt coverage ratio, should the tenant vacate after the 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.

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<sup>2</sup> 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.

## Summary of the Salient Business Risk Factors

[Indicative Metrics]

	Strongest	Weakest
<b>Scale and Track Record</b>	<ol style="list-style-type: none"> <li>1. Leasable area of property For office space &gt; 10 million sq.ft For warehousing/retail &gt; 2 million sq.ft</li> <li>2. Operational track record of property for more than 12 years</li> <li>3. Track record of sponsor/promoter group of more than 15 years.</li> </ol>	<ol style="list-style-type: none"> <li>1. Leasable area of property For office space &lt; 1 million sq.ft For warehousing/retail &lt; 0.25 million sq.ft</li> <li>2. Operational track record of property for less than 2 years</li> <li>3. Track record of sponsor/promoter group of less than 2 years.</li> </ol>
<b>Asset competitive position</b>	<ol style="list-style-type: none"> <li>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.</li> <li>2. Building located in prime micro market abutting the major transport networks.</li> <li>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.</li> <li>4. Grade A space which is suitable for occupancy by any company with standard investments in fitouts / interiors.</li> </ol>	<ol style="list-style-type: none"> <li>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.</li> <li>2. Asset is located in non-prime micro-market where demand potential is not yet established.</li> <li>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.</li> <li>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</li> </ol>
<b>Asset diversification</b>	<ol style="list-style-type: none"> <li>1. Top 3 projects constitute less than 40% of the total area (including area under development).</li> <li>2. Presence in at least 5 distinct micro-markets (where each market has at least 10% of the total portfolio)</li> </ol>	<ol style="list-style-type: none"> <li>1. Single asset company</li> <li>2. Single micro-market</li> </ol>

	Strongest		Weakest
<b>Occupancy and Market Risk</b>	<p><u>For completed projects:</u> (Vacant area + Area where termination notice received) &lt; 5% of completed portfolio</p> <p><u>For under development projects:</u> Area under letter of intent / agreement to lease / hard option / lease agreement &gt; 80% of under-construction portfolio</p>	➔	<p><u>For completed projects:</u> (Vacant area + Area where termination notice received) &gt;30% of completed portfolio</p> <p><u>For under development projects:</u> Area under letter of intent / agreement to lease / hard option / lease agreement &lt; 20% of under-construction portfolio</p>
<b>Lease renewal risk</b>	Ratio of WALE/Weighted average debt maturity $\geq 1.0$ times	➔	Ratio of WALE/Weighted average debt maturity $\leq 0.25$ times
<b>Tenant profile and Concentration</b>	% 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

### Stability of cash flows

For assessing the future cash flows, ICRA considers parameters such as the past track record of cash 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 and cost structure. Here emphasis is laid on the predictability of net cash inflows after deducting expenses such as salaries, power and fuel, repairs and maintenance, management expenses, property taxes, income taxes etc. For projects with short operational track record, the projections are drawn based on base case estimates of parameters such as the occupancy and the rent rates 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<sup>3</sup> and NOI<sup>4</sup> to account for the impact of under-construction assets. If the existing leverage levels are lower, it implies that the company has headroom for raising top-up LRD loans. 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. Entities with a higher proportion of completed assets are better placed to absorb the risks associated with ongoing capital expenditure.

The debt service coverage ratio (DSCR) is among the key coverage ratios analysed. The DSCR measures the cushion between the cash flows available for debt servicing (CFADS) in any given period and the debt-servicing obligations. The DSCR is measured on an annual basis (5-year average on projected basis) as well as on a cumulative basis over the loan tenure. The five-year average DSCR is analysed as there is relatively more clarity and certainty of cash flows in the near to medium term compared with the distant future. For cumulative DSCR, CFADS over the loan tenor is the numerator, and the total debt service obligation is the denominator.

#### Assessment of Leverage

[Indicative Metrics]

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

<sup>3</sup> Debt considered is 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

<sup>4</sup> NOI is the NOI from developed assets + Expected income from under-development assets

**Assessment of Coverage**

[Indicative Metrics]

	Strongest	Weakest
<b>Cumulative DSCR</b>	>1.75x	<=1.05x
	Strongest	Weakest
<b>Average DSCR for next 5 years</b>	>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<sup>5</sup>) 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.

<sup>5</sup> 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 the cash flow waterfall mechanism. The presence of an 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 debt servicing 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 entity only after meeting its debt repayment obligations for the month. In the absence of an escrow mechanism, there might be a higher uncertainty around whether the entity will maintain financial discipline and prioritise debt servicing 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 issues at the lessee's end. Moreover, maintenance of the DSRA provides liquidity support for debt repayment in case of a temporary delay in rental receipts or short-term vacancy.

ICRA evaluates the possibility of intra-group transactions, which might result in cash outflows from the rated entity to other group entities in case of the absence of an 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 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.

### Amortisation Structure and refinancing risks

Sometimes, in addition to the monthly payments, 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 tenor 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, comfortable leverage is considered favourably.

### Assessment of Refinancing risk

[Indicative Metrics]

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

### Financial flexibility

An entity's financial flexibility (or the lack thereof) is reflected in its ability to access the capital or the money markets at short notice, attract diverse and marquee investors and enjoy the confidence of banks, financial institutions, and intermediaries. A strong financial flexibility allows an entity to raise fresh borrowings or refinance existing debt in quick time and whenever required. This flexibility could arise from factors such as an entity's large scale of operations with strong financials, large and unencumbered cash flows (such as rental income, annuity payments in road projects), unencumbered assets and the flexibility to borrow against such assets, or strong parentage or linkages with a strong group. Also, debt/potential NOI<sup>6</sup> is calculated to assess the financial flexibility of the company.

In contrast, among the various measures of an entity's depleting financial flexibility, one relates to a high share of pledged promoter shareholding. A sign such as this may imply that the entity might be persuaded to distribute high dividends or support the promoter group through other means to the detriment of its own credit profile. If the promoters fail to repay their loans (availed by pledging of shares) or top up collateral when required, the lenders could sell the pledged shares. In some cases, this could trigger a change-of-control clause in the rated entity's bond indentures or loan documents and require it to redeem its debt ahead of schedule, creating a liquidity squeeze, besides affecting fresh capital-raising ability. Financial flexibility could also be impacted in cases of adverse industry developments, weakening business profile, or management & governance concerns, which could translate into sharp decline in market capitalisation or spike in bond yields and consequently constrain an entity's ability to raise fresh capital or materially increase its cost of capital.

### 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
<b>Structural Features*</b>	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) Presence of debt service reserves and provision for immediate replenishment,	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) Presence of debt service reserves and provision for immediate replenishment, if	1) No Escrow account 2) Lack of a specified cash flow waterfall 3) Weak/no dividend lock up triggers 4) Debt service reserves with no provision for replenishment 5) No cash flow subordination of promoter debt

<sup>6</sup> Potential NOI is the NOI from operational and under-construction assets, considering its expected peak potential occupancy

	Positive	Neutral	Negative
	if dipped into, from subsequent operating cashflows 5) Sufficient time gap between the remittance of the lease rentals and the scheduled repayment obligation	dipped into, from subsequent operating cashflows 4) All promoter debt instruments remaining sub-ordinated to senior secured debt and payments subject to consent of external lenders	and payment track record of recurring payments on promoter debt instruments
<b>Amortisation Structure</b>	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) Presence of debt acceleration triggers 3) Put options during debt tenure
<b>Covenant Package</b>	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	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)

\*If structural features are well-defined as a part of the contractual terms but they are seen not being adhered to in practice, then such structural features are viewed as being largely redundant.

## 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.
- ICRA assesses the ability and the likelihood of the parent extending extraordinary support to the entity and vice-versa. 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.

### 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. 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.

### Accounting quality

Here, the accounting policies, notes to accounts, and auditor's comments are reviewed. Any material deviation from the generally accepted accounting practices is noted and the financial statements of the entity are adjusted to reflect the impact of such deviations.

### Contingent liabilities/ Off-balance sheet exposures

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

## 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 disaggregate the sub-components of E&S risks fully or precisely 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.

The real estate segment is exposed to risks of tightening environmental standards impacting operating costs including the cost of compliance with pollution control regulations, besides the need to align with the tighter energy efficiency standards. 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. 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**

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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 and other funding requirements.

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 (Commercial Office)

		Strong			Comfortable			Adequate			Moderate			Weak		
<b>Industry Risk</b>	Industry Position															
	Scale of assets															
<b>Business Risk</b>	Track record of Sponsor Group															
	Asset competitive position															
	Asset diversification															
	Lease renewal risk															
	Occupancy and market risk															
<b>Financial Parameters</b>	Tenant Concentration															
	Coverage															
	Leverage															
		<b>Enhance</b>					<b>Support/Neutral</b>					<b>Hinder</b>				
<b>Do these factors enhance or hinder the credit profile?</b>	Liquidity, Refinancing dependency and Financial Flexibility															
	Financial Policy															
	Management, Governance & Reporting															
		<b>Very High</b>				<b>High</b>				<b>Moderate</b>				<b>Low</b>		
	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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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.

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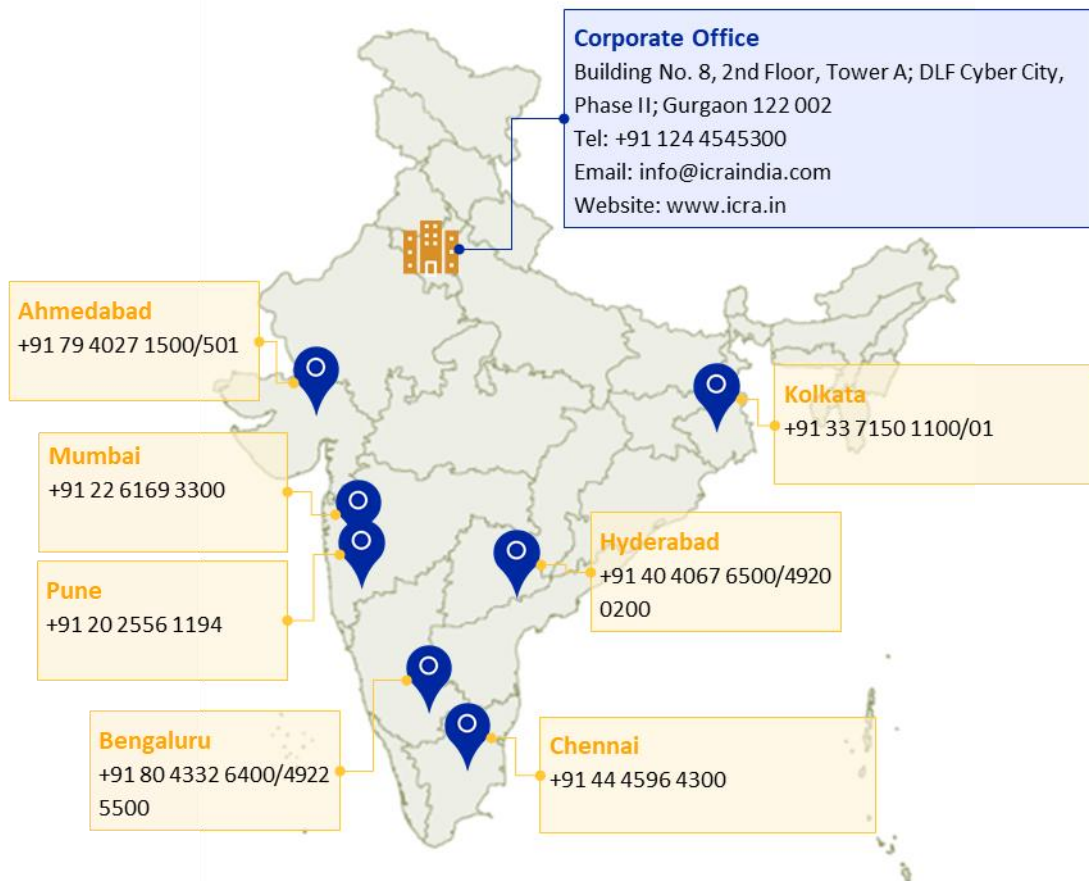
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