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This rating methodology updates and supersedes ICRA's earlier methodology document on this subject, published in July 2023. While this revised version incorporates a few modifications to provide more clarity on a few aspects, ICRA's overall approach to rating hotel entities remains materially similar.

Overview

The travel and tourism industry accounts for 6-7% of the Indian gross domestic product (GDP) and a large share of employment in the country. The hotel industry in India is highly fragmented across numerous players— independent hotels, home-grown hotel chains and global hotel majors. Almost all the major global hotel entities are present in India—predominantly through the management contract route.

To achieve consistency across product offerings, the Ministry of Tourism had formulated criteria for classification of operational hotels. Accordingly, hotels are classified into various star hotel categories – 5-Star Deluxe, 5-Star, 4-Star, 3-Star, 2-Star and 1-Star, or into heritage hotel categories – Heritage Grand, Heritage Classic and Heritage Basic. Against a scenario where a bulk of the industry's branded supply was concentrated in the higher price points, over the last few years, several branded mid-scale properties have been launched – either through conversion of non-branded properties or construction of new hotels.

Demand for hotel rooms in India comes from both domestic and foreign tourists, for both business and leisure purposes. Given the diverse geographies and the requirements across the country, the demand drivers in each state vary and accordingly the hotel offering also varies. For instance, while some of the hotels target only business travellers, others target leisure travellers, and the rest have features to attract both. Besides the revenues from room occupancy, meetings, incentives, conferences and exhibitions (MICE), banqueting/weddings, restaurants and other allied services also add to the industry revenues.

From a predominantly foreign tourist market, the Indian market over the past decade has slowly matured into a much larger domestic tourist market, with increasing leisure trips and MICE. Compared to the volatility witnessed in foreign tourist arrivals (FTAs), domestic tourist visits (DTV) have generally witnessed a steady growth over the past decade. As a result, the hotels have increased investments in distribution channels, promotion campaigns and amenities targeted at the demographic of domestic travellers.

With increasing incidence of mobile and internet bookings, entities have invested in upgrading their online presence through their own websites and through listings on aggregator websites like online travel agents (OTAs). Own websites as well as direct bookings are the most cost-efficient sources of drawing traveller business because of the high margins charged by third-party booking aggregators as well as distributors.

Rating Methodology

This rating methodology describes ICRA's approach to assessing the hotel entities in terms of (1) their exposure to industry risks, (2) their operating and business positions, and (3) their financial position, including the ability to generate cash flows from operations and the adequacy of the same to service contractual debt servicing obligations. For analytical convenience, the key factors are grouped under the following broad heads — Industry Risk Assessment, Business Risk Assessment, Financial Risk Assessment, other elements of credit risk assessment, Management Quality, Assessment of Environmental, Social and Governance (ESG) Risks and Parentage. This document does not include an exhaustive discussion of all the rating factors that ICRA's analysis considers but provides an overall perspective of the considerations that are usually the most important.

ICRA's portfolio of rated hotel entities consists of several large multi-hotel entities (including some of them with strong parentage), smaller single-hotel entities and under-construction hotel entities. ICRA's risk analysis framework for hotel entities can be broadly divided into the following factors –

Industry risk assessment

- Demand risk
- Supply risk
- Competitive intensity
- Cyclicalities

Business risk assessment

Operational Hotels

- Scale
- Competitive position and brand strength
 - RevPAR premium
- Diversification
 - Geographic diversification
 - Segment diversification

Under-construction Hotels

- Project cost and viability
- Funding risk
- Construction risk and experience

Financial Risk Assessment

- Earnings and profitability
- Leverage and coverage indicators
- Cash flows and liquidity

Other Elements of Credit Risk Assessment

- Financial flexibility
- Foreign currency-related risks
- Tenure mismatches, and risks relating to interest rates and refinancing

- Contingent liabilities/ Off-balance sheet exposures
- Event risks
- Diversification

Management Quality Assessment

Assessment of Environmental, Social and Governance (ESG) Risks

- Environmental (E) and social (S) risks
- Governance practices

Parentage

Industry Risk Assessment

Demand-supply dynamics for hotel rooms in the addressable market have a strong bearing on the performance of hotel entities. Demand dynamics tend to be cyclical and a function of the underlying economic cycle. Risk aversion, financing ability and market-specific demand dynamics have a bearing on new supply. Further, the sector also witnesses risks arising from lumpy supply additions undertaken in response to market-specific demand dynamics.

Demand risk

Growth in demand for hotel rooms bears a strong correlation with the domestic and global economic growth and sentiments, the latter because of foreign tourist arrivals (FTAs). While leisure travel is purely discretionary and a function of the disposable income and consumer confidence, business travel is generally more stable but is prone to witnessing pruning by corporates during periods of downturn. Consequently, monitoring of leading indicators such as underlying economic trends, currency movements (a depreciated Indian currency may make India attractive for inbound travellers and limit outbound leisure travel, encouraging domestic holidays), travel costs and consumer sentiments are vital to forecasting demand for hotel stays. Factors such as high penetration of low-cost airlines, more airports, improved road connectivity and industrial activity also play a pivotal role in driving demand.

These apart, there are specific demand drivers for each city such as economic growth and the ability to attract future investments, its popularity as a leisure destination, theme-driven businesses like medical/religious tourism and event-driven demand such as from sports, concerts, religious attractions, etc. Overlaid on these demand drivers are event risks such as terrorist attacks, natural calamities and health scares, which could lead to travel advisories against a country/destination, severely hampering demand in such periods.

Supply risk

Supply of hotel rooms depends on the existing/under-construction inventory, estimated future potential for rooms stemming from either the economic or leisure potential of the destination, availability of land at requisite locations, the cost of raising capital, liquidity and the prevalent policies and Government guidelines, which determine the ease of development. ICRA monitors segment-wise supply (present and future) at the geographic level to ascertain demand-supply gaps. Surplus supply leads to lower pricing power, as more properties compete for the available demand.

Competitive intensity

Despite the sizeable capital requirements and the barriers to entry, competition in the Indian hotel industry is high with numerous players, both homegrown and global majors vying for a foothold across the country. This intense competition from existing rooms, coupled with new inventory being constantly added, often caps pricing power, constraining margins. In the larger cities, competition can be lower if land availability is constrained and hotel supply addition is low.

Cyclical

The Indian hotel industry is highly cyclical and seasonal with strong linkages to the domestic and global economy and is prone to sharp upcycles and deep downcycles. A favourable geopolitical and economic environment encourages discretionary travel spending. However, travel advisories by countries and weakness in the global economy, slows down travel. The industry was one of the most affected sectors during the Covid-19 pandemic but recovered sharply over the past three years. High capital intensity and relatively high fixed costs result in significant weakening in profitability and cash flows during downcycles. Given the relatively high fixed costs, a marginal decline in revenues can lead to a sharp contraction in profits and cash flows available for debt servicing. Employee costs and heat, light and power (HLP) are the main operating and fixed costs for hotels. Consumables, on the other hand, have a high variable component (linked to food and beverage (F&B) income and occupancy).

Business Risk Assessment

OPERATIONAL HOTELS

Scale

The scale of operations (as measured by room inventory and overall revenues) is an important parameter while assigning a credit rating. It is evaluated in relation to other peers in the hotel industry. A large scale is often a reflection of a strong market position, diversified presence, financial flexibility, and is also a driver of operational efficiency.

Competitive position and brand strength

Other than scale, ICRA evaluates the sources of competitive advantages, which can enable a company to differentiate itself, such as operational track record and vintage of operational properties, locational advantage, brand strength and global tie-ups to name a few. Stabilised properties could have advantages in the form of repeat customers while those with locational advantages will be able to generate higher ARR. An established brand also ensures visibility among travellers – both domestic and foreign. Therefore, management contract/franchise agreement with reputed brands provides hotels the access to a wider set of customers and helps with occupancy. Further, hotels under the umbrella of established brands have higher pricing power stemming from various factors, including their service quality. ICRA considers the presence of a strong brand to be a credit positive.

RevPAR premium

The RevPAR premium of a hotel is viewed as a proxy to its market position. For the various properties that comprise a hotel entity, ICRA analyses (1) the ARR and occupancy trends, (2) the property's RevPAR premium compared to its competitive set, and (3) the market potential for increasing RevPAR, based on the upcoming supply and inherent demand potential of the location. The ARR is driven by factors such as location of the properties, demand-supply dynamics, brand strength, and price segment of the hotel, among others.

ICRA analyses the guest profile mix (foreign, domestic, business, leisure, walk-ins, FITs - free and independent traveller, airline crews, and Government business) to determine concentration on a particular set of guests. While the airline crew tie-ups and long-stay guests ensure base occupancies, low rates often compromise the ARR. However, during downcycles, base occupancies allow the operator to manage daily ARR to maximise RevPAR.

Business models

Hotels operate under three main business models, namely:

- Owned/Leased
- Franchisee
- Management Contracts

Owned/Leased

An owned model entails heavy investments by the owner in constructing the hotel and subsequently running it either under an owned brand or a soft branding arrangement with large global or Indian chains. Owners willing to handle the day-to-day operations under their own brand and at the same time wanting to gain access to a larger distribution network, enter soft branding tie-ups.

The high investment by the owner is often funded by significant borrowings, leading to a leveraged capital structure. Considering the large funding requirements, the ability to scale-up under this model is critical, although several entities, to avoid the sizeable upfront construction cost and to set up property in shorter lead time resort to taking properties on long-term leases. However, the lease model will result in higher lease payment obligations.

Franchisee

Under the franchisee model, the owner-operator enters into a brand franchisee agreement with established hotel chains for use of the latter's brand name and the global distribution system (GDS), in return for a fixed franchisee fee. Franchisee hotels benefit from enhanced visibility and typically garner higher occupancies right from the initial phase. However, like the owner-operator model, capital investments in the franchisee model are also high, constraining scalability.

Management Contract

Under the management contract route, the ownership and management of the hotel is often independent. The owner invests funds to build the hotel and enters into a management contract with a major operator - such as Indian Hotels Company Limited, Hilton Hotels & Resorts, Marriott Hotels, Accor S.A and Starwood Hotels & Resorts Worldwide Inc., among others for managing the hotel. In such an arrangement, the manager-operator typically appoints the key management at the hotels, oversees the day-to-day operations and decides the overall strategy, in return earning a share of the revenues and the gross operating profit (GOP) as incentive fees.

The business model determines the performance, quantum of investments, ability to scale-up/diversify and the consequent capital structure; and has a bearing on the credit profile of the entity. Over the years, a few successful hotel entities have evolved and scaled up from independent properties to established strong brands and a large portfolio of hotel assets. These entities are now monetising their brands and management capabilities and focusing on asset-light expansions by growing their managed hotel portfolios. Operational synergies arise from a wider portfolio of hotels, strong loyalty programmes which draw demand and a wide distribution network. Access to sophisticated product pricing software enables dynamic management of RevPAR through occupancies or ARR depending on demand. For a hotel manager (with a strong brand), its ability to enter into franchisee agreements or management contracts with independent hotel owners allows for a faster scale-up with limited capital investments and operating expenses.

Diversification

Geographic diversification

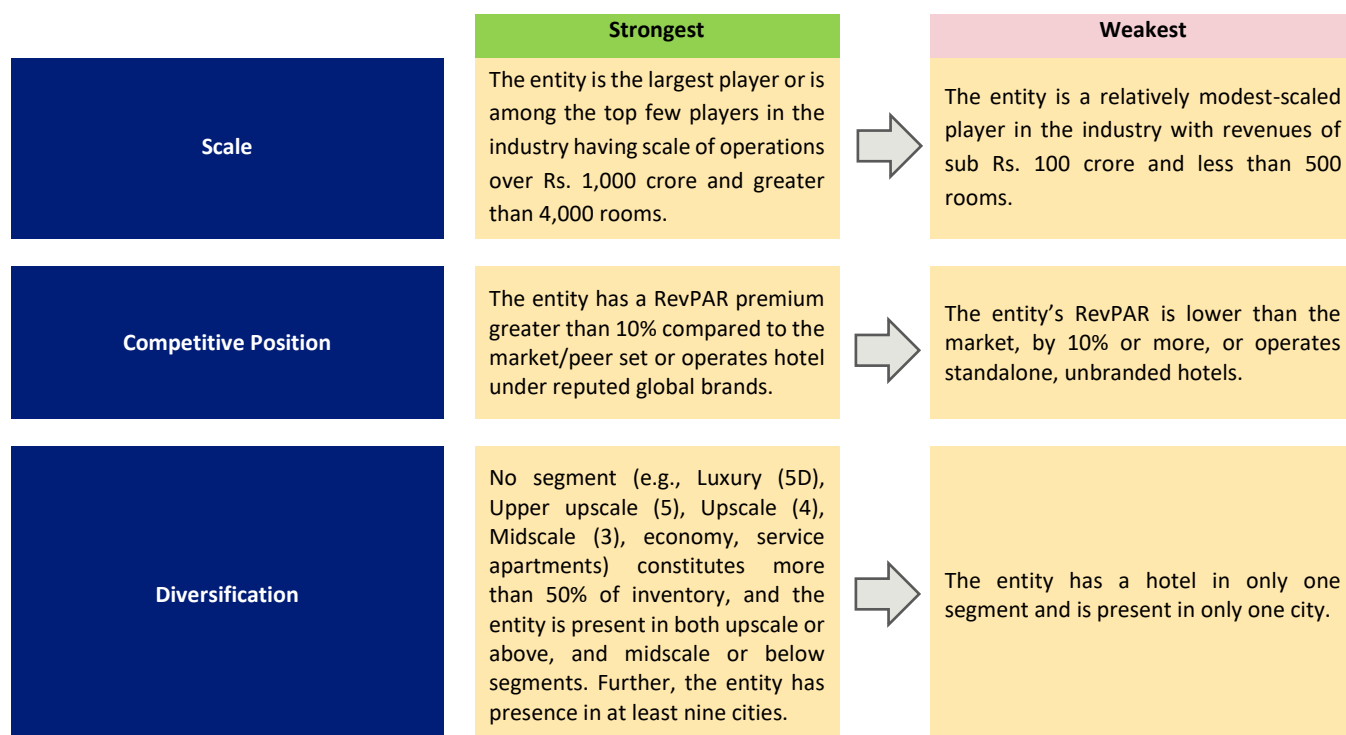
The geographic diversification in any entity's portfolio has a favourable bearing on the rating as this, to an extent, insulates the company from any city-specific demand and supply risks. It also helps cater to a wider range of consumers. Further, an entity with presence across different locations which cover both business and leisure, will be better diversified compared to those with hotels only in business or leisure destinations.

Segment diversification

Apart from the business models, larger hotel chains often operate across various segments: Luxury, Upscale, Upper-Upscale, Midscale and Economy¹. Segment diversification helps capture a wider traveller base and any down-trading in traffic during economic downturns, thereby helping the entities to maintain occupancies. This enables better absorption of fixed costs and prevents a sharp deterioration in profitability and cash flows during downturns, which is viewed as a credit positive. While the upscale brands typically generate higher margins during upcycles, the economy brands exhibit relatively better stability in performance across cycles, in general. The Covid-19 pandemic has been an exception though with upscale brands recovering faster.

¹ ICRA considers Luxury, Upscale and Upper-Upscale as the premium segment (4-Star and above). Midscale is considered as 3-Star, while Economy is below the 3-Star category.

Summary of the Salient Business Risk Factors



UNDER-CONSTRUCTION HOTELS AND PROJECT RISK

While rating under-construction hotels, ICRA also evaluates the following risks.

Project cost and viability

While analysing an under-construction greenfield hotel project, ICRA analyses project-specific risks such as potential delays in construction and cost escalations, which could impact the viability of the project. Per room investment in the hotel (with and without land) forms a key metric to benchmark a property vis-à-vis other upcoming projects and existing hotels in respective star category. The role of the future hotel operator is also critical to the project cost, as they mandate certain minimum safety standards and designs, which have a bearing on the cost per key. ICRA also analyses the regulatory approvals required, as these could also have a bearing on costs and commencement of operations.

Investment in the hotel is evaluated with respect to the potential ARR (at time of launch) and potential for MICE and F&B income, considering the market and its positioning, compared to the peers. The location/category of the hotel determines the customer mix (business or leisure) the property is likely to attract, and the price points it can command.

Funding risk

The mode of project financing plays a key role in determining the credit risks associated with the project, as projects burdened with high leverage struggle to service their debt in the initial years of operation, given the gradual ramp-up in operational performance. A judicious mix of debt and equity is required to tide over the initial stabilisation period. Apart from the mix, ICRA also considers the cost of debt, the tenure of the instrument and the structure of the debt (moratorium during the construction period, buffer between commencement of operations and repayments). A debt amortisation structure, which provides for ballooning repayments, could help match cash flows generated by the project with debt servicing requirements, given the long gestation period of the new hotels. Additionally, the promoter's ability to mobilise equity and fund shortfalls during the initial years of operations, if required, and any cost overruns/ future renovation expenses are some parameters considered for arriving at the rating.

Construction risk and experience

It is important to have an experienced design and construction team supported by reputed ancillary support service providers for kitchen equipment; heating, ventilating, and air conditioning (HVAC); furniture and interiors, as they play a key role in ensuring timely completion of projects within the budgeted costs. A typical greenfield project takes three to five years for execution and runs the risk of facing delays in commencing operations because of delays in receipt of regulatory approvals and consequent cost escalations. The gestation period of a new hotel, depending on its launch period (during the industry cycle), could widely range from five to ten years.

Financial Risk Assessment

ICRA analyses the long period past financial performance trends and estimates future financial performance to assess the financial risk exposure of an entity. The financial metrics provide a useful reference not only to evaluate the performance trends of an entity over a given period, but also enable a comparison with its peers. The company's future capital expenditure and investment plans, be it for setting up of a new hotel or buying existing properties, are considered along with the mode of funding to forecast the company's future debt-servicing capability. Also, it is important for hotels to invest in regular renovations/upgradations to keep the property in line with evolving customer expectations and competition, although most stabilised properties can fund their renovation through own funds. The various financial metrics assessed by ICRA could be divided into three categories — earnings and profitability, leverage and coverage, and cash flows and liquidity. This document provides a summary of why ICRA considers these ratios to be important. For a more detailed description, readers may refer to the document titled, "Rating Approach - *Financial Ratio Analysis*" published on ICRA's website. Depending on the uncertainty around how the various credit drivers could evolve in the future, ICRA also carries out sensitivity analysis to assess the impact of the key variables on the various financial metrics.

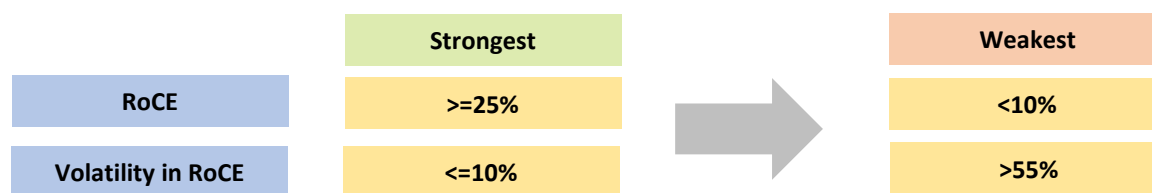
Earnings and Profitability

Operating in a highly cyclical industry and exposed to discretionary spends, hotels witness significant variation in profit margins through an economic cycle. Hotel revenues are highly cyclical, in view of the demand-driven price-elastic business model as well as the lumpy supply-side dynamics. ICRA also factors in the inherent seasonality in the hotel industry, which witnesses subdued performance in the first two quarters and subsequent pick-up in demand over the second half of the fiscal as the peak travel season starts.

Profitability metrics are a measure of an entity's efficiency and return on investments. Given the need for most businesses to invest regularly in physical assets, marketing and human capital to sustain or improve their competitive position, and the high capital cost and long gestation period of the properties, the RoCE for the industry has been relatively low even during upcycles in the last 10 years. However, despite the low profitability, hotels have been able to attract capital, given healthy growth prospects on account of the favourable demographic profile and overall long-term potential of the sector.

Validation of Business Risk through Profitability Metrics

[Indicative Metrics²]

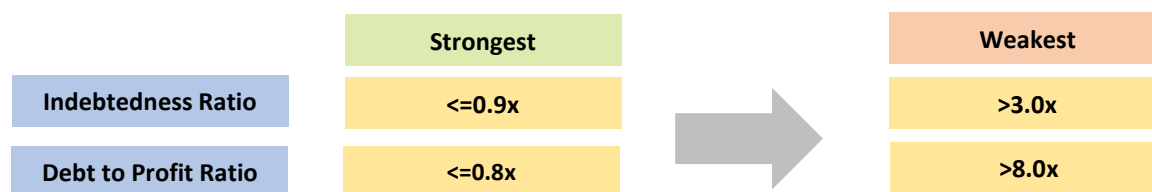


Leverage and Coverage indicators

Financial leverage is a measure of an entity’s dependence on borrowed funds. Lower the dependence on borrowings, the lower (better) the leverage. When an entity borrows, it is obliged to pay both interest as well as principal to the lenders as per a defined schedule. This increases the fixed cost burden on the borrowing entity and in the limiting case, increases the default risk. While high leverage may mean high risk from a credit perspective, it is an often-adopted course by shareholder-oriented managements, given that high leverage, in good times, leads to high returns on equity capital. An entity’s financial leverage could thus be a function of its management’s financial policy and risk tolerance, besides being a point-in-time reflection of an entity’s business and financial choices. An entity with lower leverage is better equipped to withstand volatility in cash flow generation in situations of economic downturn, competitive challenges, unexpected costs, changing consumer preferences, or regulatory changes. The financial leverage of an entity depends on its business model, as the asset owner funding their capex through borrowed funds will be highly leveraged compared to entities expanding through asset-light mode of expansion with relatively lower capex requirements. While the leverage in the initial years for the asset owners is typically high, coverage metrics are usually supported by a longer tenure of loans with higher moratorium and/or ballooning repayments.

Assessment of Leverage

[Indicative Metrics]

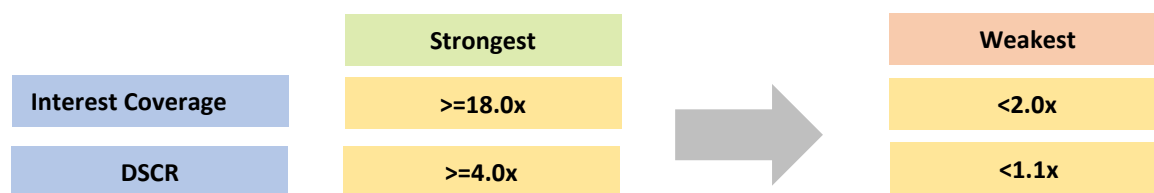


Apart from the capital structure, ICRA also pays attention to the coverage indicators, including interest coverage, debt service coverage, operating profit and net cash accruals relative to total debt, while evaluating the financial health of a hotel entity. The more robust an entity’s performance is during downcycles, the better it is from a credit evaluation perspective. The debt repayment structure is also important, given the gestation period for ramping-up the operations and the seasonal nature of the business with most of the revenues in the second half of the year.

² The indicative financial metrics mentioned here and elsewhere in the document are intended to provide a broad overview to the readers regarding what ICRA generally considers as ‘relatively strong’ or ‘relatively weak’ metrics. It is, however, possible that an entity has relatively weaker metrics on one or more financial parameters, but its credit risk is assessed to be low because of other mitigating factors, including (but not limited to) stronger metrics on other financial parameters, a healthy business risk profile, strong financial flexibility or a strong promoter group that is willing to extend distress support to it.

Assessment of Coverage

[Indicative Metrics]

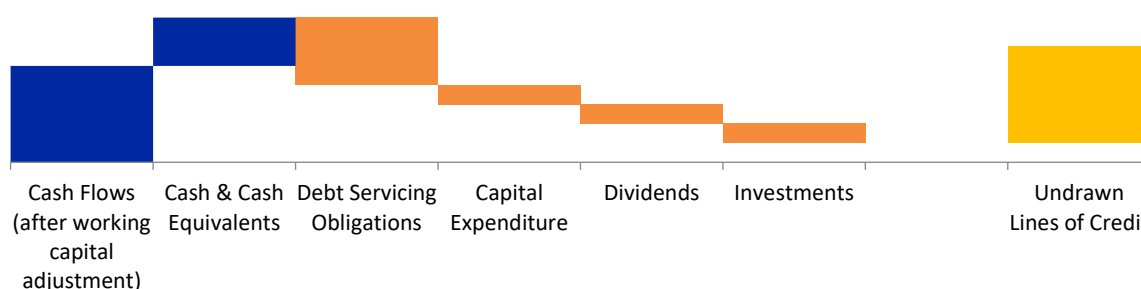


The reinvestment requirements in the industry — for renovation or expansion — remain high. The entity’s ability to capitalise on periods of healthy profitability to generate adequate cash flows and fund expansions without affecting the capital structure, could help the company tide over downcycles comfortably. ICRA assesses the entity’s ability to cover all its operating expenses and invest in future expansions while managing its capital structure and debt-servicing capability to arrive at the rating.

Liquidity and cash flows

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 as well as 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, dividend and share buyback-related outflows, besides the sudden demand arising from crystallisation of discrete events such as unfavourable outcome of an ongoing litigation. The higher the cushion available between the resources available (especially internal resources) and the obligations, the 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. Depending upon the circumstances, an entity that has a relatively modest liquidity profile, but a strong refinancing ability may not be viewed too unfavourably. ICRA also notes that the liquidity available with an entity may be for a temporary period and, hence, an entity’s overall policy towards maintaining adequate liquidity (given the trade-off between returns and liquidity) is accorded due importance in the analytical approach³.

Liquidity snapshot over any defined period



It is cash that is required to service the obligations. A cash flow statement represents the sources from which cash is generated and its deployment. Analysed here are the trends in an entity’s funds flow from operations, cash consumed to fund the working capital, the retained cash flows after paying out dividends or carrying out share buybacks, and the free cash flows after meeting debt repayment obligations and capital expenditure needs. The cash flow analysis helps in understanding the external funding requirements that an entity has, to meet its maturing obligations. Given the nature of business, wherein payments are received on an upfront basis from customers, and there is minimal requirement for extending credit, except for the institutional

³ For more details on how ICRA assesses liquidity, readers may refer to the document titled, “Liquidity Analysis of Entities in the Non-Financial Sector” published on ICRA’s website

customers, the working capital requirements for the sector are usually low. Additionally, the inventory holding is also limited to food & beverages and other hotel supplies.

Other Elements of Credit Risk Assessment

Consolidated Financial Analysis

When entities have subsidiaries/joint ventures/associates, it is necessary to analyse their consolidated and group-level financial indicators. Various parameters such as capital structure, debt coverage indicators and future funding requirements are assessed at a consolidated level or on limited consolidation basis, which provides a better picture of the company's financial risk profile.

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 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 (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.

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.

Foreign currency-related risks

Foreign currency risks/liabilities for hotel entities primarily arises from acquisition and operation of overseas hotels, borrowings in foreign currency, import of foreign currency-denominated fixed assets. This apart, currency movements also have a bearing on demand – a weaker currency drives inbound travel, limits outbound travel and vice-versa. The assessment is done by considering the materiality of the net foreign exchange earnings or expenditure in relation to the total revenues. Foreign currency risk for an entity is measured by considering its unhedged net liabilities [= foreign currency receivables – foreign currency payables – foreign currency debt]. ICRA's analytical focus is on assessing the magnitude of such exposure relative to the entity's profits.

Tenure mismatches and risks relating to interest rates and refinancing

Large dependence on short-term borrowings to fund long-term investments can expose an entity to significant re-financing risks, especially during periods of tight liquidity. ICRA evaluates the extent of such mismatches and the mitigating factors therein. One source of mitigation could be the existence of adequate buffers of liquid assets/committed bank lines to meet short-term obligations. Another source of mitigation could be the entity's strong financial flexibility to be able to garner fresh funds at a short notice or a potent ability to refinance. Further, ICRA evaluates the extent to which an entity might be impacted by movement in interest rates.

Contingent Liabilities/ Off-Balance Sheet Exposures

ICRA reviews the contingent liabilities and off-balance sheet exposures as disclosed by the entity in its Annual Report and evaluates the likelihood of their devolvement and the financial implications of the same.

Debt servicing track record

The debt servicing track record of the company forms an important rating consideration. Any history of past delays or defaults in meeting interest and principal repayment obligations reduces the comfort level with respect to the company's future debt servicing capability and willingness. Nevertheless, the reason behind past defaults is also analysed, which could also be due to adverse demand situations in the underlying industry. The company's ability to honour its debt obligations during the period of cyclical stress is also factored in.

Accounting quality

ICRA reviews the accounting policies, notes to accounts, auditors' comments and other disclosures that are parts of the Annual Report of a rated entity. Any deviations from the standard accounting practices are evaluated and the financial statements are adjusted, where feasible, to reflect the impact of such deviations. Significant deviations may be indicative of weak corporate governance practices in the entity.

Event Risks

ICRA recognises the possibility of events such as unrelated diversification, mergers and acquisitions, business restructuring, asset sales and spin-offs, litigations, equity infusion and refinancing, which could have a material impact on the credit profile of an entity. Incorporating the impact of such discrete events in the credit rating, from the beginning, is often difficult. Depending on whether and when such events occur, the rating opinion could be substantially different. To take rating decisions in such cases, ICRA applies its analytical judgement based on the rated entity's track record, the credibility of the management and the experience of having seen similar situations play out in other entities. However, given the nature of such events, it is possible that the rating may undergo a material change later, upon the occurrence of the event.

Diversification

Mixed-use properties which earn revenues not only from the hotel but also from leased-out commercial space, office space and residences are often viewed favourably as they diversify the revenue base and are relatively stable earnings-wise compared to hotels during downcycles. The contribution to the overall revenue pie, would, however, depend on other specifics like location of the property and ability to lease out space.

Management Quality Assessment

As a part of its process, ICRA undertakes discussions with the rated entity's management to understand its views on past performance as well as its future plans and strategies, besides the outlook on the industry. Some of the points assessed are:

- » Experience of the promoter/ management in the industry
- » Risk appetite of the promoter/ management and risk mitigation plans
- » Policies on leveraging, managing interest rate and currency risks
- » Management's plans on new projects, acquisitions and expansions

Periodic interactions with the management help in ascertaining the shifts, if any, in their financial policies.

Assessment of Environmental, Social and Governance (ESG) Risks

Environmental (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 mitigants. 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 as these considerations often tend to overlap.

That said, the materiality of the E&S risks and the time 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 future, and hence these considerations do not necessarily weigh on the rating today—with the expectation that when these risks manifest in the future, the rated entity by then would possibly adapt itself by realigning its business model.

While evaluating 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. Hotel entities are exposed to natural disasters (such as hurricanes and floods) and extreme weather conditions, which could interrupt operations or damage properties. However, the availability of insurance for most hotels helps in these circumstances and may not be a material driver of credit, especially when there is property diversification. For hotels with fewer properties, the impact on occupancy could be relatively higher. Overall, the hotel industry has relatively low environmental risk.

Further, it would need to adapt to evolving social fabric (including changing consumer preferences and social trends) from time to time such as digitisation and preference for branded hotels and rely heavily on human capital. The Covid-19 pandemic is an example of social risk, given its substantial implications on health and safety. Travel advisories from various corporate/Government organisations on account of any geopolitical or other developments could also impact the sector. Hotel entities are also vulnerable to data security and data privacy issues. Hence, there is moderate exposure to social risk.

Governance Practices

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.

Parentage

While the credit rating of an entity is a function of its standalone credit profile, in certain cases, the entity's credit quality can also be driven by the relationship with its parent or the promoter group (henceforth referred to as the parent). If the parent's credit profile is relatively stronger than the rated entity, ICRA assesses the ability and the likelihood of the parent extending

extraordinary support to the entity. Support here means financial support from the parent expected to be available to the entity in the form of loans, equity, extended credit period, advances, etc., in times of credit or liquidity stress on the entity. Support here does not mean operational support in the form of new business opportunities, technology sharing, distribution network sharing and so on, as these aspects are factored in the standalone credit profile assessment itself. It may be noted that promoters in their individual capacity, or private equity firms/ other financial investors are generally not treated as parents for assessing the likelihood of extraordinary financial support coming in. If the parent's credit profile is relatively weaker than the rated entity, the entity's rating may be lower than what its standalone credit profile assessment would have merited, given the possibility that the entity may at some point of time be bound to extend financial support to its weaker parent, possibly to the detriment of its own credit profile⁴.

Considering the troughs the hotel industry faces and the relatively long gestation cycle for new properties, promoters with strong financial resources can provide a significant credit uplift. This is critical, more so, in the Indian context where the tenure of borrowing could fall short of the much longer gestation period and life of a typical hotel asset.

Summing Up

ICRA's credit ratings are symbolic representations of its current 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 likely cash flows and the adequacy of such cash flows vis-à-vis the entity's debt-servicing obligations and other funding requirements. ICRA's rating approach also involves an assessment of the entity's management quality and governance practices. In addition to these considerations, an entity's credit rating may also be influenced by its ownership, the nature of linkages with its parent or group entities, degree of financial flexibility, the corporate legal structure, track record of operations and that of debt servicing, and vulnerability (if any) to discrete event risks.

⁴ For more details, readers may refer to the documents titled, "Rating Approach–Implicit Parent or Group Support" and "Rating Approach–Explicit third-party support", available on ICRA's website.

ANNEXURE

Summary of rating factors and an example to illustrate the key building blocks of a credit rating

		Strong			Comfortable			Adequate			Moderate			Weak		
Industry Risk	Industry Position															
	Number of rooms															
Business Risk	Revenues															
	Segment diversification															
	Geographic Diversification															
	Brand															
	RevPAR premium															
Financial Risk	Profitability and Earnings Stability															
	Leverage															
	Coverage															
		Enhance					Support/ Neutral					Hinder				
Do these factors enhance or hinder the credit profile?	Diversification															
	Refinancing Dependence, Liquidity and Financial Flexibility															
	Currency Risk															
	Financial Policy															
	Management, Governance & Reporting															
		Very High				High				Moderate				Low		
Parent Support	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	

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 Committees based on both quantitative and qualitative considerations.

Basic lexicon for hotel entities

- Average Room Rates (ARRs) = Total Annual Room Revenues/Rooms Nights Occupied
- Occupancy=Occupied Room Nights/Available Room nights
- Revenue per Available Room (RevPAR) = ARR*Occupancy
- Food & Beverage (F&B)
- Meeting, Incentives, Conferences and Exhibitions (MICE)
- Gross Operating Profit (GOP) = Operating profit before royalty and some selling expenses

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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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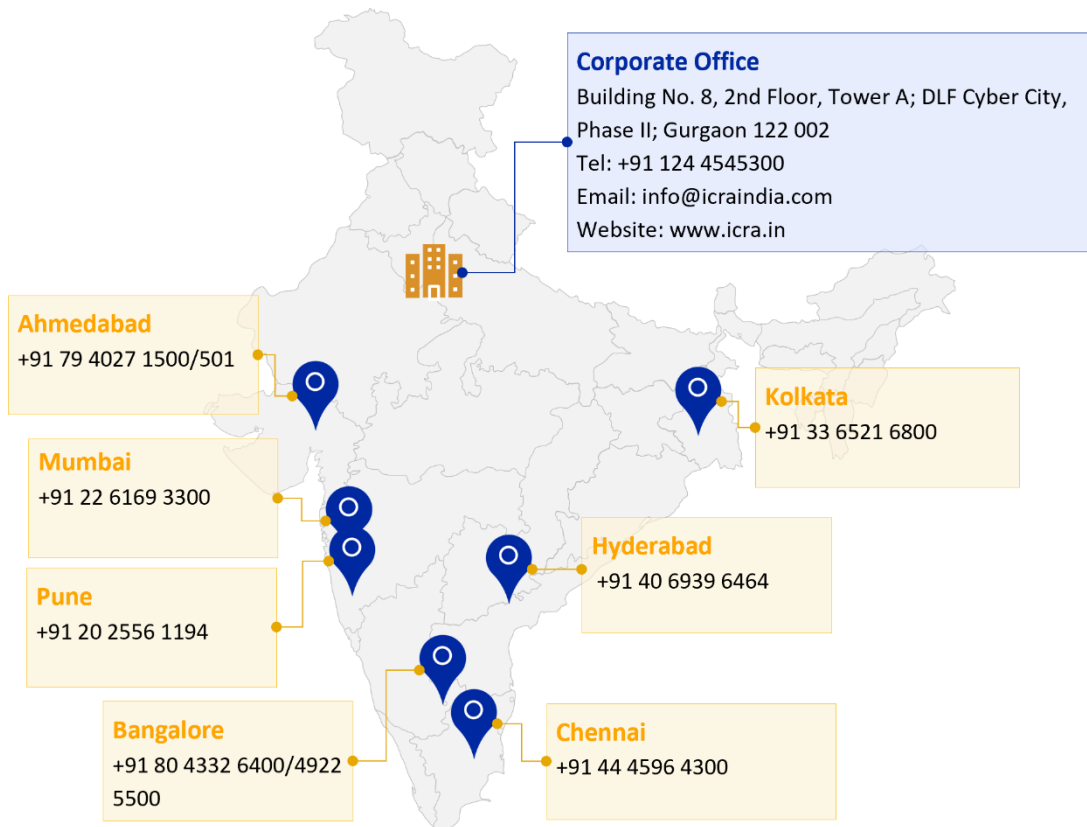
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