CRISIL
Ratings

Rating criteria for real estate developers

June 2023

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Executive summary

Real estate firms can be broadly classified as special purpose vehicles (SPVs) incorporated to execute a single project, or as developers[1] that execute several projects. These projects may be housed under one or more firms and have some degree of cash flow fungibility among themselves.

This article explains the methodology adopted to assess the credit quality of developers.

CRISIL Ratings' assessment of the credit quality of real estate developers focuses on four key risks – business, financial, project and management risks. While the overall risk assessment framework is similar to that of manufacturing entities, some factors that are analysed as part of this risk assessment differ given the nuances of the real estate sector.

Business risk assessment comprises an analysis of the market position and operational efficiency of the developer. Market position determines the developer's ability to sustain competitive advantage, and is assessed through its development track record and brand equity. These parameters are supplemented by diversification in the developer's portfolio in terms of type of projects, geography, and market share in relevant micro markets. Operational efficiency indicates the ability to execute projects in a timely and cost-effective manner. This is evaluated by analysing the progress in ongoing projects, the extent to which these projects are sold, and whether the portfolio has a healthy mix of projects in different stages of completion. For operational commercial projects, vacancy rates, tenant profile, and customer concentration are also taken into account.

For developers with a significant share of under-construction commercial projects that are built for the purpose of leasing, project risk is a key component because of the implementation and funding risks. Further, such projects usually tie up lease agreements only towards the end of the construction period. The analysis also takes into account the degree of project completion and the post-completion risk.

CRISIL Ratings evaluates the financial risk by assessing the leverage, cash flow position, and financial flexibility of the developer.

Leverage of a real estate developer is measured by the amount of debt taken vis-à-vis the project costs. The degree of leverage helps estimate not only the ability to meet future repayment obligation, but also the headroom to borrow further. CRISIL Ratings separately analyses debt taken for residential and sale model commercial projects, and that taken against lease rentals expected from commercial projects, given the difference in stability of cash flow.

Residential real estate projects generate cash flow through sale of units during the project implementation stage. Hence, CRISIL Ratings uses cash debt service coverage ratio (CDSCR) – a modified version of debt service coverage ratio (DSCR) – across projects to evaluate the financial position of the developer.

However, operational projects – where lease rentals are the primary source of debt repayment – are gauged using the DSCR, as outlined in "CRISIL Ratings' criteria for rating debt backed by lease rentals of commercial properties".

To assess the liquidity profile and financial flexibility of the developer, CRISIL Ratings evaluates multiple sources such as the ability to raise funds against lease rentals and land bank, cash and unutilised bank lines, refinancing potential, and the ability to tap capital and money markets.

Management risk evaluation of developers is very important. The management's reputation plays a key role in ensuring business stability. In this regard, CRISIL Ratings evaluates management's competence, integrity, and risk appetite.

[1] The terms developers and real estate developers are used interchangeably in this document

The four rating parameters – business, project, financial, and management risks – are combined to arrive at the standalone rating of the developer. This rating can be notched up in case of external support by a stronger parent or group to arrive at the final rating.[2]

Scope

This article discusses the typical risks that real estate developers are exposed to, and the methodology to assess their credit quality. The criteria are applicable to real estate developers who execute multiple real estate projects, which may be housed in different legal entities, but have some degree of cash flow fungibility among themselves.

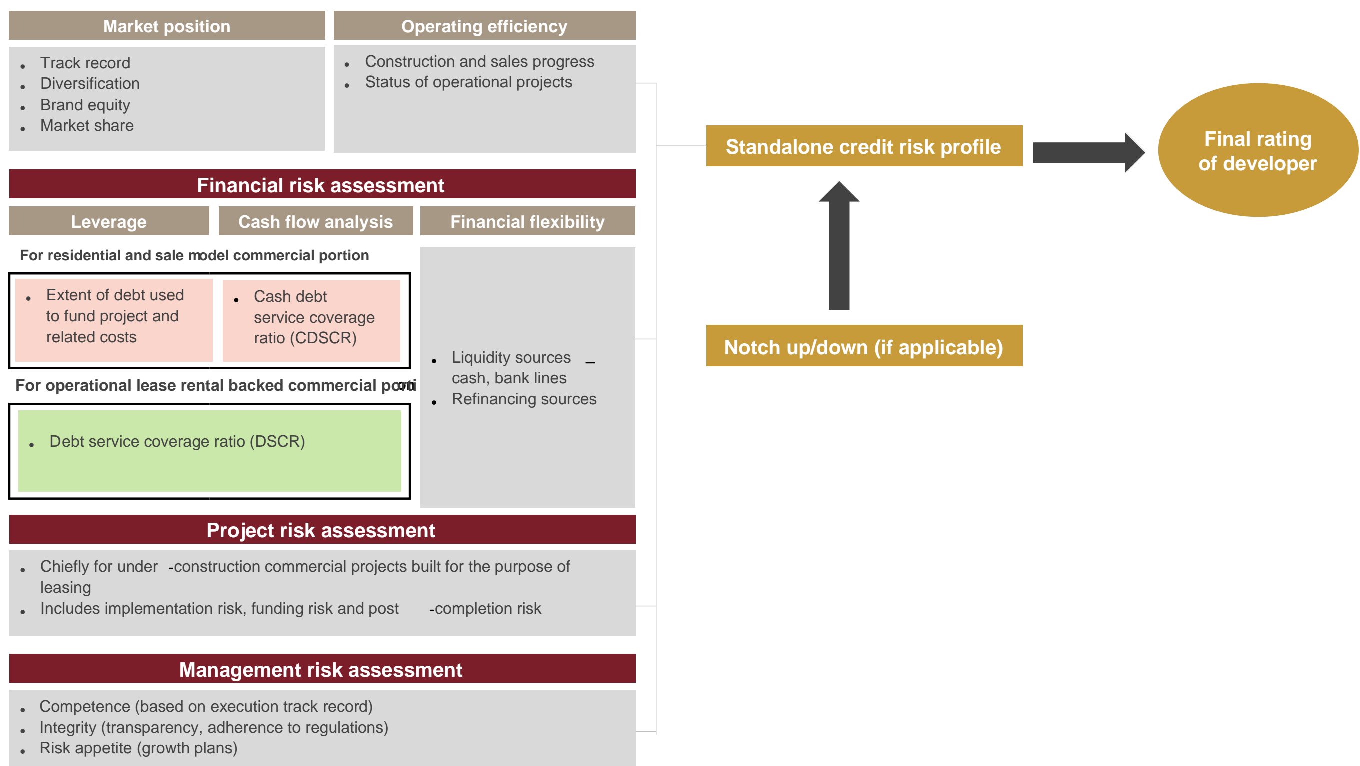
The analysis for project-specific SPVs is done at the project level. Approach for the same is also captured briefly in the document.

The document also covers CRISIL Ratings' approach to financial ratios used for analysing these entities, including adjustments carried out to the reported metrics in the financial statements.

Methodology

Chart 1 highlights the framework used for assessing the credit quality of real estate developers.

Chart 1: Framework for rating real estate developers



[2] For accessing the previous published criteria, kindly refer to the following link: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/real-estate/Criteria-for-rating-debt-backed-by-lease-rentals-of-commercial-real-estate-properties-may2022.pdf

Business risk assessment

Business risk assessment evaluates risks inherent in the environment the firm operates in.

The real estate sector is marked by a high degree of fragmentation, given a large number of small regional players with small market share. Thus, assessing the ability of a firm to sell profitably and in a sustainable manner amid competitive pressure becomes crucial.

This is captured in the market position through factors such as development track record and brand equity of the developer; and supplemented by the extent of diversification (in terms of operating segments and geography), and consequent cash flow stability and share in the relevant micro market.

Additionally, real estate cash flow is generated through sales proceeds and lease rentals. Sales proceeds are realised based on milestones, while lease rentals start flowing in only when the project is completed. Hence, timely completion of a project within budgeted costs and healthy balance between projects in the under-construction stage and the cash flow generating stage are critical indicators of the overall operational efficiency of developers.

When assessing commercial real estate developers, parameters such as vacancy rates, tenant profile, and customer concentration are also considered.

The components of business risk are detailed below:

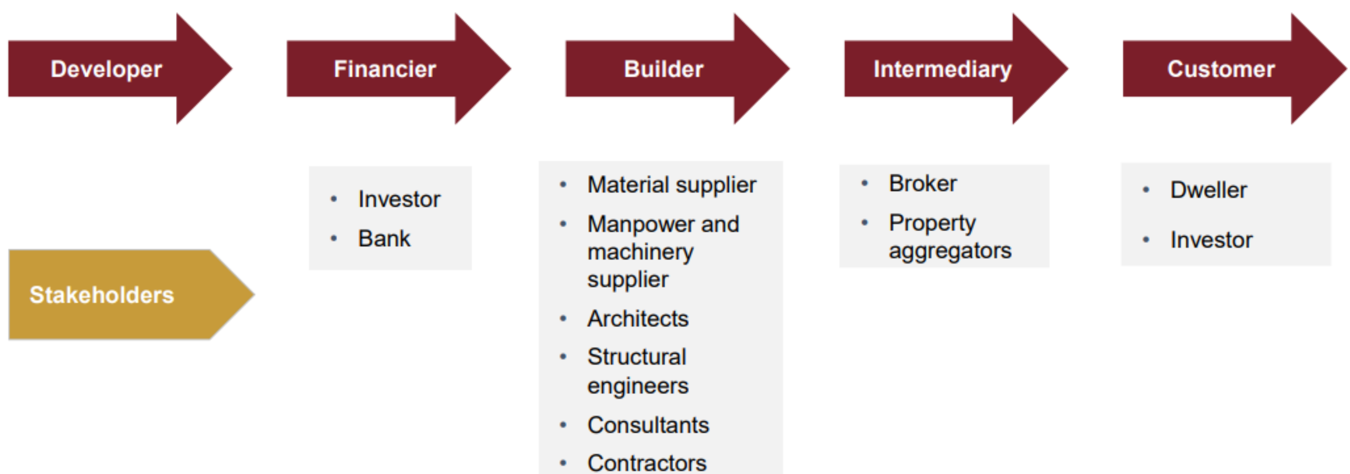
Market position

This captures the ability of a firm to maintain competitive advantage – i.e. to sell[3] real estate units profitably in a sustainable manner. It indicates the ability of a developer to sell the real estate inventory over time and command premium in the respective market segments.

These factors are assessed through the following:

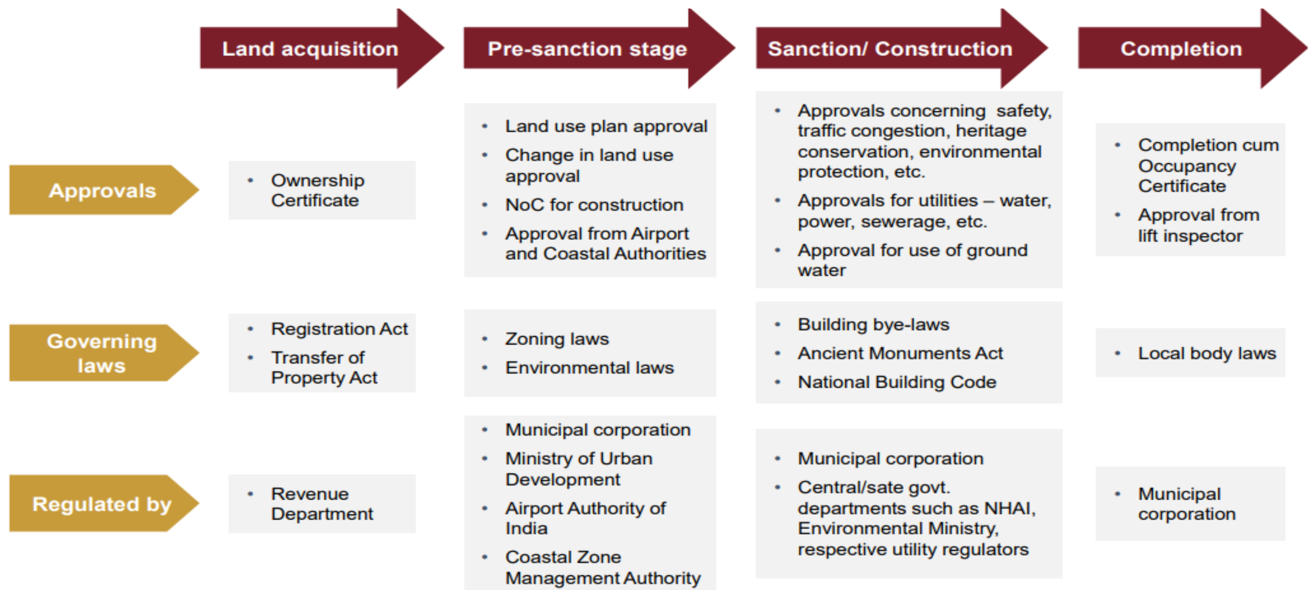
1. **Development track record:** Real estate projects carry significant implementation risk as they involve coordination with several stakeholders and require liaising with multiple government authorities to successfully execute the project. Charts 2 and 3 indicate the diversity of stakeholders and breadth of approvals required to execute such projects.

Chart 2: Real estate value chain



[3] The term 'sell' should be read as 'lease' for commercial projects that are usually leased out

Chart 3: Regulatory regime for real estate projects



Given these complexities, real estate projects are prone to delays. Hence, buyers can derive confidence from the development track record, including timely completion of projects, of a real estate developer. This is important to ensure saleability of projects during the construction stage.

Factors taken into account for assessing the development track record of a real estate developer are as follows:

- Area developed (in square feet) and time or cost overruns in these projects. This evaluates the ability of the developer to execute projects of varying complexity
- Projects executed in the past are evaluated along with those in the pipeline. An aggressive expansion plan requires commensurate scale-up in execution capabilities
- Years of experience in the given micro market as it indicates the reputation of a developer in handling multiple business cycles

2. **Brand equity:** Developers with strong market reputation tend to have better capability to withstand cyclical downturns and ensure higher degree of business stability. This allows them to sell projects or lease inventory even when the industry outlook is tepid.
3. **Extent of diversification:** Developers with a well-diversified portfolio of projects are preferred over those with exposure to just 1-2 projects. Diversification is gauged in terms of:
    - Type of projects (residential or commercial)

      Commercial real estate projects have a consistent revenue stream in lease rentals, whereas revenue from residential real estate projects can be lumpy. However, this advantage is partially offset by the timing of cash flow. Commercial projects generate cash flow after project completion, whereas sale proceeds from residential projects start pouring in during the construction phase. Hence, developers with a well-diversified mix of projects across residential and commercial space are likely to have higher stability in cash flow, allowing them to withstand downturn in a particular segment.

- Geography

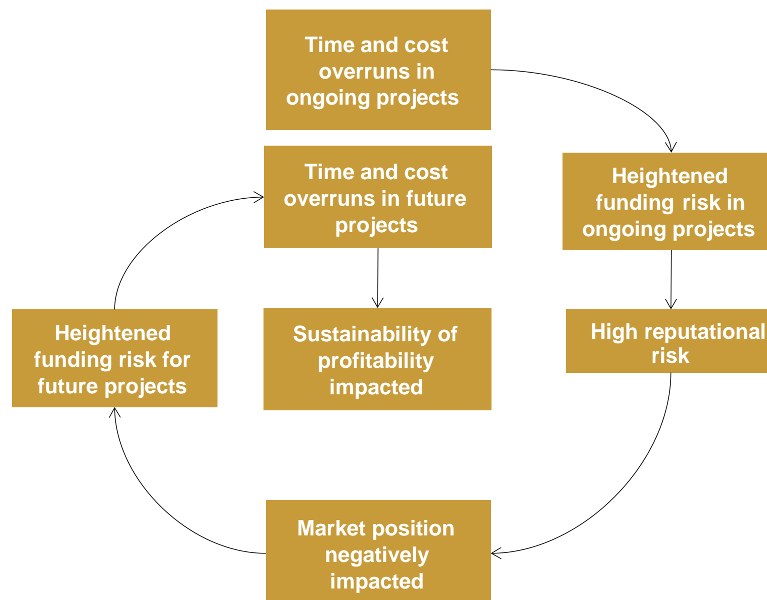
  Geographical diversity becomes important as demand-supply dynamics in real estate tends to be local in nature. A developer operating in multiple geographies will, therefore, be better protected against slumps than the one limited to a single geography, irrespective of the type of properties.

4. **Market share:** As the real estate segment is typically fragmented, market share in the relevant micro market is taken into consideration instead of the industry as a whole.

Operational efficiency

Operational efficiency captures the ability of a developer to execute projects in a timely manner at a competitive cost and manage project-level cash flow. This not only impacts existing profitability, but for a developer facing time and cost overruns in several projects, it also effects reputation and, consequently, future saleability. Chart 4 explains how time and cost overruns constrain profitability.

Chart 4: Impact of time and cost overruns on profitability



CRISIL Ratings assesses operational efficiency based on the following factors:

1. **Construction and sales progress of residential and sale model commercial projects** Implementation risk tends to be higher uring the initial stages of a real estate project and gradually reduces as the project nears completion. This is because customer advances (which may fund 50-70% of project cost) are linked to project milestones and several approvals are necessary for project execution.

   As the project progresses, more customer advances are released, which provides funds for the project. In the absence of sales traction, developers have to rely on bank funding, which puts pressure on the margin, constraining operational efficiency.

These factors necessitate a detailed analysis of portfolio construction progress and whether it is in line with the estimates. Cost or time overruns adversely impact operational efficiency. In this regard, CRISIL Ratings evaluates the following:

- Construction progress in ongoing projects
- Sales booking progress in ongoing projects
- Proportion of projects for which construction cost is completely covered by available funding

CRISIL Ratings also analyses developer portfolios to determine the stage projects are in. A project portfolio skewed towards early-stage projects means the developer is exposed to significant implementation and funding risks. On the flip side, a project portfolio skewed towards near-complete projects ensures stable cash flows in the near term, but compromises on cash flows in the long term. Besides, the developer would have to launch several new projects in a short time to build an inventory to sell, which can lead to a sudden spike in project-related risks and leverage. A steady pipeline of projects across multiple stages is most favourable.

2. **Status of operational commercial and retail projects:** CRISIL Ratings analyses operational projects where lease rentals are the primary sources of debt repayment as outlined in CRISIL's criteria for rating debt backed by lease rentals of commercial properties.

Financial risk assessment

Financial risk is calculated in three broad areas – leverage, cash flow analysis (captures the debt paying ability), and financial flexibility (captures the liquidity and ability to raise funds). These areas are detailed below:

Leverage

CRISIL Ratings considers the extent of debt funding at an aggregate level of the project portfolio vis-à-vis costs. A high leverage indicates not only higher principal and interest payments, but also limited financial headroom for the entity to borrow more in case of funding requirements.

Debt / Total assets = Total Debt / (Inventory + Debtors + Cash)

Cash flow analysis

The cash DSCR or CDSCR helps evaluate financial position of projects where loan repayment is through sale of units and DSCR for projects where lease rentals are the primary source for debt repayment. CRISIL Ratings evaluates these ratios at an overall portfolio level to assess the financial position of the developer.

For residential and sale model commercial projects, CDSCR is used to determine the cash flow adequacy. CDSCR indicates extent of cushion available over principal and interest payments, after netting off expenses from collections.

CDSCR = (Collections – Expenses expected to be met out of internal cash flows)/ (Principal + Interest)

While computing CDSCR, CRISIL Ratings also nets off the expenses expected to be met by debt taken in the future. A high CDSCR indicates better coverage.

However, the quality of such collections is also important. Advances from sales already made represent the steadiest sources of future collections and, hence, are of high quality. Adequacy of such committed collections in meeting expenses of ongoing projects is calculated.

CRISIL Ratings also evaluates the extent of future sales needed to meet the residual portion of expenses not met by committed cash flow and analyses whether sales are reasonable in comparison to historical numbers.

For operational commercial projects where lease rentals are the primary source of debt repayment, CRISIL Ratings analyses the cash flow using DSCR.

CRISIL Ratings also assesses the sensitivity of these ratios to external events such as unanticipated downturn and delays in receiving customer advances.

Financial flexibility

CRISIL Ratings evaluates the various internal and external sources available with the developer as against the cash outflow expected to be incurred in the near to medium term. These sources include:

- Cash, unutilised bank lines
- Ability to raise additional debt of commercial projects
- Ability to raise debt against land bank
- Ability to tap capital/money markets
- Ability to refinance

Project risk

Project risk pertains to under-construction commercial real estate projects expected to be leased out. Following risks are assessed -

- Implementation risk: Pertaining to securing approvals, land free of encumbrance, and technical complexity
- Funding risk: Related to obtaining funds necessary to complete the projects
- Demand risk: To get suitable lessees for the project

Management risk assessment

The evaluation involves assessment of the management in three broad categories: integrity, risk appetite, and competence. In real estate projects, management evaluation further assumes importance on account of the opacity in the sector.

CRISIL Ratings evaluates competence in executing similar-sized real estate projects and whether sufficient project execution capabilities exist if the developer is scaling up over the medium term. Risk appetite of the management is assessed through aggression in land bank acquisition and pricing policy. While the history of litigation or regulatory action reflects negatively on management integrity, professionalism, management information system or MIS, and transparent disclosure practices are given due credit.

Approach for rating real estate SPVs

Real estate SPV is formed for executing a single project and its cash flow is ring fenced. Credit risk assessment for such an SPV encapsulates analysing the business and financial risks that drive the rating.

Project risk assessment: Real estate units may be sold before project completion, and a significant proportion of the project cost may be funded through sales proceeds. As sales proceeds flow in based on milestones, time and cost overruns could hit funding (customer advances may slow down) and demand (slow execution could deter new buyers). Therefore, evaluation of project risk for real estate projects covers demand risk, funding risk, and implementation risk.

Financial risk assessment: CRISIL Ratings assesses leverage levels and carries out cash flow analysis to determine the financial risk profile of the SPV. A typical residential real estate project generates cash flow through sale of real estate units, which begins well before project completion. The gap between construction cost and advances is funded through debt, which acts as an inventory funding mechanism. CRISIL Ratings factors debt contracted during the construction phase as source of inflow (equity and funds extended by the promoters) and calculates the CDSCR as cash surplus before debt maturing during the year and compares it with the interest and principal outgo for that year. The average and minimum CDSCR during the project tenure is calculated for the financial risk assessment.

Management risk is also assessed and appropriately factored into the rating.

Conclusion

The methodology of CRISIL Ratings for assessing the credit quality of real estate developers considers their business strengths and weaknesses, as reflected in the market position and operational efficiency. These factors impact the financial position of the developer, which is assessed through analysis of cash flow and their liquidity position. These risks, combined with the management risk, are evaluated to arrive at the standalone rating of the developer.

CRISIL Ratings may also factor in parent support or external credit enhancements in the form of guarantees.

The criteria for parent/group support and for evaluating guarantee instruments are covered in other articles available on the website of CRISIL Ratings.

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