Ratings

CRISIL
An S&P Global Company

Rating criteria for real estate special purpose vehicles

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Executive summary

Many real estate entities are constituted as special purpose vehicles (SPVs) to execute specific projects. The SPV structure allows lenders to ring-fence cash flow through an escrow mechanism, and delink the risks of one project from another.

CRISIL's assessment of the credit quality of real estate SPVs focuses on project risk, financial risk, and management assessment. The rating of an SPV may be notched up in case of parent support.

Project risk covers demand, funding, and implementation risks. Demand risk assessment covers the demand-supply situation in the micro market, the market position of the developer, and how well the product offering aligns with customer preferences. Funding risk factors in the proportion of funds tied up through customer advances, equity, and debt, and the composition of customer advances (whether from actual users or investors). Implementation risk considers the track record of the developer, status of project approvals, and construction progress in the project.

Financial risk is based on financial position and liquidity. Cash inflow in real estate projects is through sale during the project implementation stage, in contrast to manufacturing/EPC projects, where it is through asset utilisation after project completion. To capture these nuances, CRISIL uses the cash buffer ratio (CBR), a modification of the debt service coverage ratio (DSCR), to evaluate the financial position of SPVs. In addition to evaluating sources of liquidity, CRISIL also evaluates the ring-fencing of cash flow through an escrow mechanism, particularly the discipline in retaining project cash flow in the SPV.

The SPV's management is assessed for integrity, competence, and appetite for risk.

Scope of the criteria

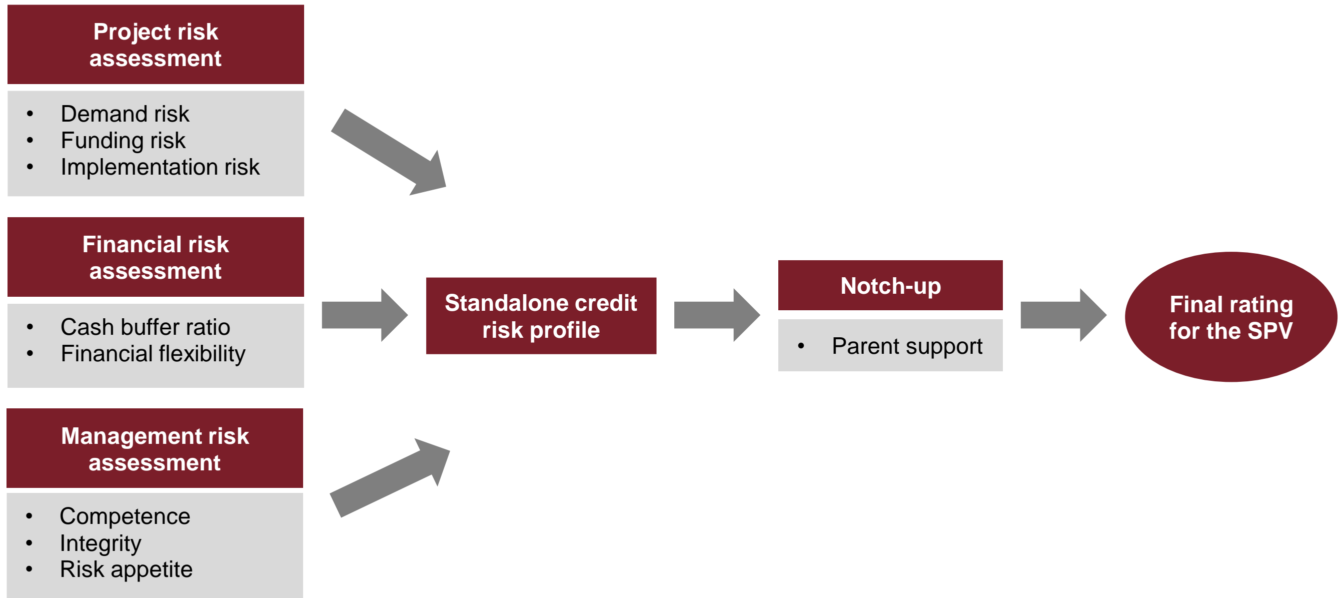
This criteria document discusses the typical risks that real estate SPVs face, and CRISIL's rating methodology to assess their credit quality. These SPVs typically execute a single project, and their cash flow is largely ring-fenced. For credit quality assessment of entities which develop several projects, please refer CRISIL's criteria for real estate developers. Additionally, the criteria is applicable for SPVs engaged in development and sale of real estate units. For projects where debt is backed by lease rentals, please refer CRISIL's criteria for commercial mortgage-backed securities.

For accessing the previous published document on 'Rating criteria for real estate SPVs', kindly refer to the following link:
https://crisil.com/content/dam/crisil/criteria_methodology/real-estate/archive/CRISILs-Rating-criteria-for-Real-Estate-SPVs.pdf

Methodology

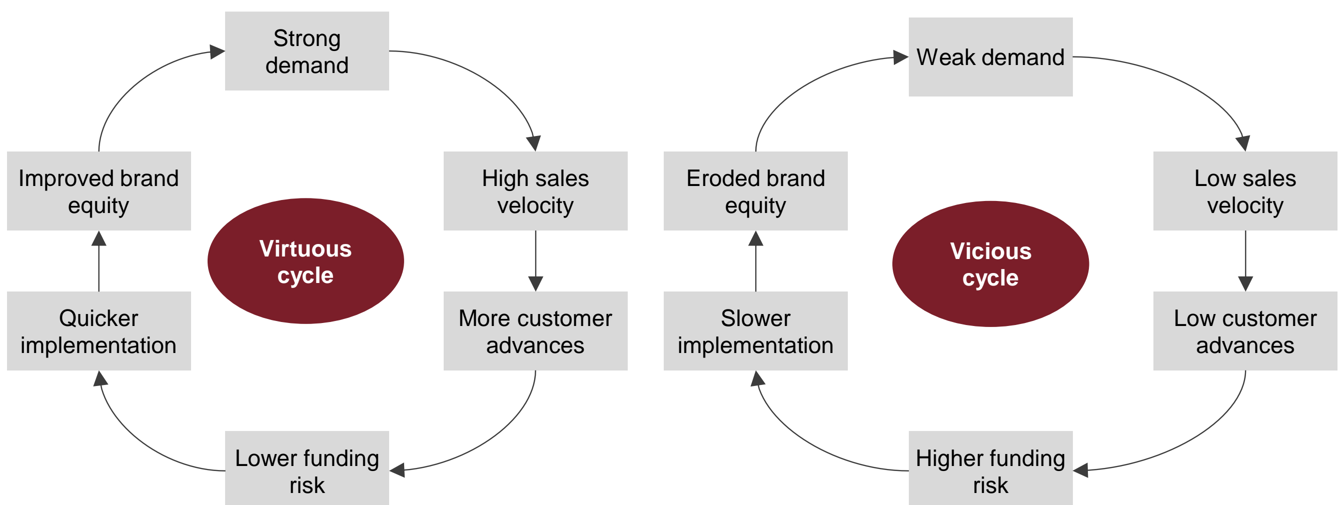
The diagram below demonstrates the framework CRISIL uses for assessing the credit quality of real estate SPVs.

Framework for rating real estate SPVs



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 on the basis of milestones, time and cost overruns could hit funding (customer advances may slow down) and demand (slow execution could deter new buyers). Therefore, the evaluation of project risk for real estate projects covers demand risk, funding risk, and implementation risk. These parameters are strongly inter-linked *(see chart below)*.



Demand risk

Typically, real estate projects rely considerably on customer advances (50-70% of project cost). Therefore, demand assumes high significance. CRISIL assesses demand risk through the following parameters:

- **Demand-supply gap in the micro market:** CRISIL estimates the demand for new dwelling units for the next three years, and compares it with inventory and current project pipeline. If supply significantly outpaces demand, it reduces the bargaining power of SPVs, and may lead to subdued sales or pressure on pricing.
- **Market position:** Developers' long track record of timely execution and sound construction quality leads to strong brand equity, creating demand for their projects even amid tepid industry outlook. CRISIL considers factors such as the premium that a developer can charge, market share in the concerned micro-market, and brand perception among chief stakeholders (customers, financiers, real estate brokers) to assess market position.
- **Product-customer mix:** For real estate projects to take off, the product should be closely aligned to customer preferences. Disparity between the two — for instance, a luxury project in an area with a need for mainly economy housing units — will result in low demand.
- **Pricing:** CRISIL compares size (unit area in square feet [sq ft]) and pricing (Rs per sq ft) with other projects in the micro market to determine whether the value proposition of the project is in line with the discount offered or the premium charged by the developer. For example, a developer with limited track record may have to offer a discount to push sales, while a developer with a strong track record may be able to charge a premium without impacting ability to sell.

Funding risk

To ensure that the project is completed on time, availability of funding is critical. CRISIL evaluates the funding risk by calculating the extent of funding tie-up—that is, the proportion of construction cost covered by the funding available. If a large proportion of project cost is covered by available funding, the funding risk is low, and vice versa. Real estate projects are funded through debt, equity, and customer advances.

Analysis of customer advances is important, as this source covers 50-70% of project cost. Factors such as percentage of units sold and customer advances received are critical. Customer advances are usually staggered, depending on construction progress. Delay in availability of customer advances may impact funding for the project. The composition of customers is also important—buyers backed by home loans or end-users are stable sources of funding. On the other hand, projects that have investors as primary customers face the risk of delay in receipt of advances because of market factors such as slowdown.

Debt entails interest, and hence is costly. Local market practices are also considered while assessing funding risk. For instance, in some parts of the country, customers are reluctant to commit money unless the project achieves a high level of completion, in which case, SPVs may contract substantial debt for funding the project.

To summarise, CRISIL assesses funding risk by:

- Assessing the extent of funding through sales, equity, and debt
- Analysing the customer composition to evaluate the likelihood of timely receipt of advances

Implementation risk

Even for projects with strong demand and funding tied up, delays in implementation may increase project risk. Implementation hurdles may lead to funding constraints (due to customer advances not being released) and demand risk (due to eroded brand equity). Implementation risk is especially critical for real estate projects as they involve co-ordination between several stakeholders *(see diagram below)*.

Additionally, each stage of construction involves liaising with several government authorities.

Hence, assessment of the project management skills of real estate developers is paramount. CRISIL considers the following factors for assessing implementation risk:

- **Implementation track record:** CRISIL assesses developers' track record in terms of the size of projects executed (area developed in sq ft), type of projects (commercial or residential), and geographies and segments catered to. Developers tend to develop expertise specific to certain type of projects and geographies, and undertaking larger projects or entering new geographies or customer segments requires acquisition of new skills. Inability to acquire these skills will weaken the developer's credit risk profile.
- **Construction progress:** CRISIL assesses adherence to timelines and cost structure, and evaluates the status on achievement of key approvals.

Financial risk assessment

CBR

CRISIL uses a cash-flow-based approach to evaluate a real estate SPV's financial position.

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's CBR addresses this very aspect of debt. It factors debt contracted during the construction phase as source of inflow (like promoter's equity and promoter's funds) and calculates the CBR as cash surplus before debt maturing during the year, and compares it with the interest and principal outgo for that year.

CRISIL considers the average and minimum CBR during the project tenure for its financial risk assessment. It also assesses the sensitivity of CBR to events such as unanticipated slowdown in sales or delay in customer advances.

Liquidity assessment

Liquidity available to an SPV from sources such as cash surplus accrued in the past is an important determinant of its financial risk profile. CRISIL evaluates the management philosophy regarding ring fencing of cash flow, and discipline in retaining project cash flow—this is expected to improve post implementation of Real Estate Regulation Act (RERA), 2016, which stipulates that 70% of customer receipts be held in an escrow account and be used only for the project. Further, the ability to raise additional funds, and refinance existing debt, against unsold project inventory also is a positive with respect to liquidity.

Management risk

CRISIL's management evaluation covers competence, integrity, and risk appetite. In real estate projects, management evaluation is important on account of the opacity in the sector. CRISIL evaluates the management's competence in executing real estate projects, aggression in land bank acquisition, project pricing, and reputation of the developer among stakeholders. For details on management risk assessment, please refer to CRISIL's article titled 'Rating Criteria for Manufacturing and Services Sector Companies' available at www.crisil.com.

Impact of the Real Estate Regulatory Act (RERA)

RERA came into force on May 1, 2017. As of December 2018, it has been notified by all but eight state governments, albeit with modifications as per the local market in many states. RERA has brought into force various buyer-friendly reforms, such as improved transparency, promise of timely delivery through introduction of penalties for delays, and making the developer liable for structural defects that arise within five years of handing over possession.

One of the key clauses of RERA is regarding usage of the amount realised from customers. The Act mandates that a promoter shall deposit 70% of the amount realised from the allottees, from time to time, in a separate account to be maintained in a scheduled bank. This is intended to cover the cost of construction and, as per the RERA notified in some states, the land cost. The amount deposited shall be used only for the concerned project. The promoter shall be entitled to withdraw from the account to cover the cost of the project, in proportion to the extent of completion of the project.

Effective implementation of RERA is expected to reduce possible divergence of funds, improve transparency, and increase financial discipline. Over the long run, it is expected to provide a fillip to the credit risk profile of real estate SPVs.

Conclusion

CRISIL's methodology for evaluating the credit quality of a real estate SPV covers demand risk, funding risk, and implementation risk. These risks impact the SPV's financial position, which is captured in CBR. CRISIL also considers liquidity maintained in projects through surplus retention. These risks, combined with management risk, are evaluated to arrive at the standalone rating of the SPV. CRISIL may 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 CRISIL's website.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

About CRISIL Ratings

CRISIL Ratings is India's leading rating agency. We pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we have a leadership position. We have rated/assessed over 100,000 entities, by far the largest number in India. We are a full-service rating agency. We rate the entire range of debt instruments: bank loans, certificates of deposit, commercial paper, non-convertible debentures, bank hybrid capital instruments, asset-backed securities, mortgage-backed securities, perpetual bonds, and partial guarantees. CRISIL sets the standards in every aspect of the credit rating business. We have instituted several innovations in India including rating municipal bonds, partially guaranteed instruments, microfinance institutions and voluntary organizations. We pioneered a globally unique and affordable rating service for Small and Medium Enterprises (SMEs).This has significantly expanded the market for ratings and is improving SMEs' access to affordable finance. We have an active outreach programme with issuers, investors and regulators to maintain a high level of transparency regarding our rating criteria and to disseminate our analytical insights and knowledge.

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