CRISIL Ratings

Rating criteria for debt backed by lease rentals of commercial real estate properties

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Executive summary

Entities owning operational commercial real estate properties generally avail debt backed by expected rentals of these properties to refinance existing construction loans at lower interest rates, or to fund additional projects. This debt can be in the form of lease rental discounting (LRD) loans or dropline overdraft facilities.

The rentals and other income generated by the property are typically deposited into a designated escrow account charged with the lender. The lender uses these deposits in accordance with a well-defined waterfall mechanism that prioritises debt repayment. Only excess cash flow post debt servicing is routed back to the borrower.

While rating debt backed by lease rentals, the quality of the property and its location, the tenant mix and concentration, vacancy levels, and contract renewals are assessed to gauge the ability of the property to generate rental revenue. The net rentals, after accounting for operating and tax expenses, are then compared with the debt service requirement to assess the ability of the property to make timely debt repayment.

The quality of the management of the property developer/manager is also factored into the rating, as reputed managements typically have better ability to attract and retain tenants, mould themselves according to changing competitive scenarios, and negotiate favourable terms with tenants and lenders.

Scope of criteria

This article[1] details CRISIL Ratings' methodology for rating debt backed by lease rentals generated by operational commercial real estate projects, including office spaces, retail malls and warehouses. The document also covers CRISIL Ratings' approach to financial ratios used for analysing these entities, including adjustments, if any, carried out to the reported metrics in the financial statements.

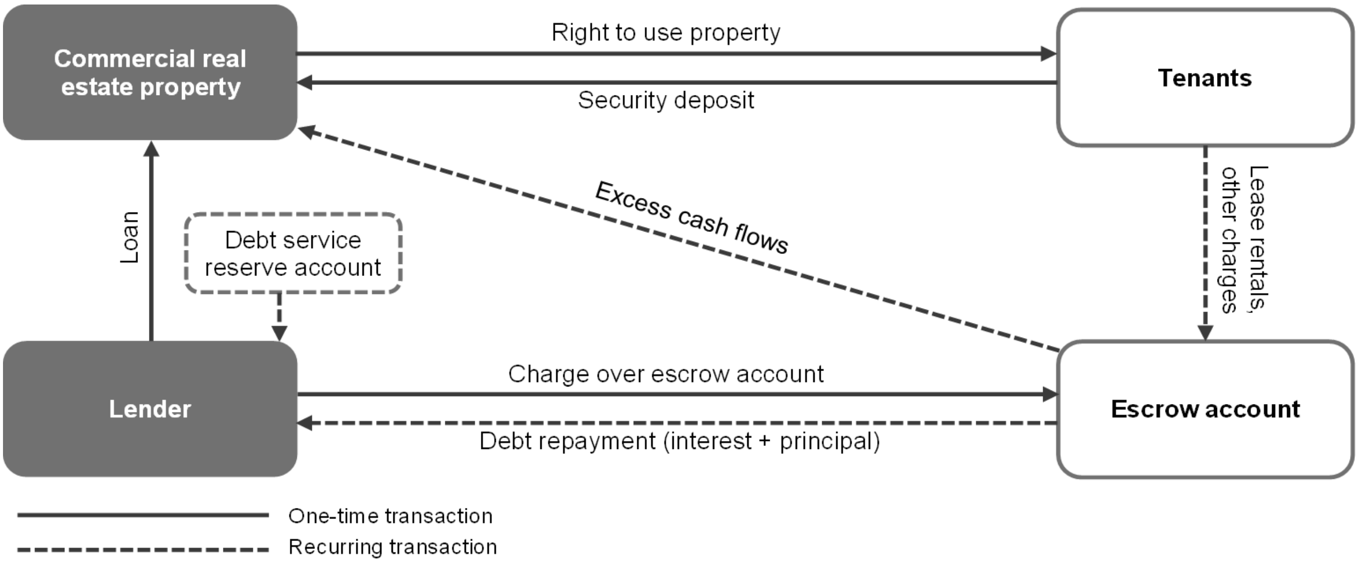
Such projects can also securitise the lease rental receivables and raise funds through commercial mortgage-backed securities (CMBS). CMBS transactions are structurally different from typical lease rental-backed debt, and do not fall under the purview of this article. For more details on CMBS transactions, please refer to "CRISIL Ratings' methodology for commercial mortgage-backed securitisation", available on www.crisilratings.com.

Salient features of debt backed by lease rentals

Such debt is typically structured with an escrow mechanism, wherein lease rentals and other charges, governed by lease agreements, are deposited into an escrow account maintained by the lender, who controls the cash outflows as per a well-defined waterfall mechanism (Chart 1).

[1]. For the previous version of this article, please refer to the link below:
https://www.crisilratings.com/content/dam/crisil/criteria_methodology/real-estate/archive/Criteria-for-rating-debt-backed-by-lease-rentals-of-commercial-real-estate-properties-Sep2021.pdf

Chart 1: Typical structure of debt backed by lease rentals



Following are the steps in a typical debt transaction backed by lease rentals:

- The lender advances a loan to the commercial real estate property (borrower) based on expected rentals
- Future rentals are generally governed by contractual lease agreements with lock-in periods as well as periodic rent escalation clauses
- The lease rentals and other charges – such as common area maintenance (CAM), parking, and revenue share – are deposited in an escrow account
  - The lender has first charge over the escrow account
- The amount collected in the escrow account is used by the lender in accordance with the waterfall mechanism
- Any excess cash flow from this account after debt repayment is paid back to the borrower
- The borrower typically maintains a debt service reserve account (DSRA), which provides liquidity support equivalent to debt servicing obligation for a certain number of months
  - The lender can dip into the DSRA in case the amount deposited in the escrow account is not adequate to meet the debt obligation

Rating methodology

CRISIL Ratings' methodology for rating debt backed by lease rentals is driven by the ability of the property to generate sufficient revenue, mainly lease rentals, to meet debt-servicing obligation. The following are the major parameters considered for arriving at the rating:

Chart 2: Parameters considered while rating debt backed by lease rentals

Business risk

- Quality of the property and its location
- Micro-market dynamics
- Tenant quality and concentration
- Vacancy levels and contract renewals

Financial risk

- Debt service coverage ratio (DSCR)
- Liquidity
- Refinancing and interest rate risk

Management risk

- Integrity
- Competence
- Risk appetite

Business risk

The business risk analysis of a property focuses on its ability to generate and sustain future revenue, which is driven by occupancy levels and average lease rental rates. The key parameters assessed to gauge the business risk in commercial properties are:

Quality of the property and its location

These have significant bearing on the ability to attract tenants and maintain healthy occupancy levels. Location in a well-established commercial centre, availability of transportation facilities, and proximity to residential areas increase the attractiveness of a property. In case of retail malls, the target population of the mall (say, luxury segment or mid-market segment) vis-à-vis the demographic profile of the catchment area is also a key driver of occupancy levels.

Property-specific characteristics such as size, layout, construction quality, safety features, facilities offered (including parking spaces, power back-up, recreational facilities, and food and beverage outlets), also influence the occupancy levels of a property. A well-maintained, high-quality property in a prime location will be able to attract and retain quality tenants and command a premium.

Micro-market dynamics

The demand-supply scenario in the micro-market would affect the pricing power and occupancy levels of the property. The property will be able to attract tenants to fill vacant spaces and negotiate higher rental rates in case of strong demand in the micro-market. However, if demand is weak and there is oversupply, the property may be forced to lower the rental rates or lose tenants to other similar properties in the vicinity.

While analysing micro-market dynamics, CRISIL Ratings takes a forward-looking view on the demand for leased spaces, and the existing as well as upcoming commercial properties that can cater to the demand.

Tenant quality and concentration

CRISIL Ratings analyses the credit quality of the tenants and the track record of timely rental payments to evaluate the ability of the property to generate lease rentals as per the contractual terms with tenants.

Client concentration is also considered in the analysis as high dependence on a few clients for most of rental revenue could adversely impact the timeliness of debt repayment if there is a delay in rental payment by a client, or if a client vacates the occupied space, leading to high vacancy levels.

Vacancy levels and contract renewals

There may be high vacancy levels in times of oversupply or economic downturns, which could also lead to a drop in rental rates.

Therefore, CRISIL Ratings assesses the current vacancy levels of a property in conjunction with its track record in leasing vacant spaces, the micro-market demand-supply scenario, and renewal of lease contracts with existing tenants.

Lease contracts with longer tenures enhance the stability of cash flows from tenants. The contracts typically contain a lock-in period, on expiry of which the tenant may choose to renew the contract.

CRISIL Ratings assesses whether a tenant is likely to renew the contract based on the investments made in fit-outs and interior works, its track record of renewals, current lease rental rates vis-à-vis market rates, supply of comparable commercial properties in the vicinity, and the quality of property maintenance.

If a tenant wishes to vacate the leased space during the tenure of a contract, there is usually a notice period, which provides time to the management to replace the outgoing tenant with a new one.

CRISIL Ratings assesses the adequacy of the notice period to ensure effective tenant replacement in case of termination of contracts.

In case of retail malls, the track record of churning tenants is also assessed; as malls usually have revenue share agreements with tenants, they tend to push out non-performing tenants to effectively manage revenue and footfalls.

CRISIL Ratings also analyses the rental rates at which the new leases are signed vis-à-vis the existing rental rates to gauge whether the property can command a premium.

LRD credit raised by warehouses

Apart from commercial office space and retail malls, warehouses as an underlying asset class for LRD loans is showing significant growth. This asset class has certain distinct features. Apart from the existing LRD criteria, CRISIL Ratings assesses the following key parameters to gauge the business risk for this asset class -

CRISIL Ratings evaluates the quality of the property based on its construction quality, location, cubic space available and amenities. The location of the warehouse is a prime factor as warehouses equipped with better approachability and vicinity command a premium over other warehouses and minimise vacancy risk. Proximity to factory location of the client, major consumption hubs/markets, national and state highways and ports and airports is considered advantageous.

A well-maintained, high-quality warehouse attracts reputed clientele as its tenants. Built to suit (BTS) way of leasing facilitates opportunity for automation and system integration thereby attracting premium clientele. The strong clientele base results in low counterparty risk. Tenants with chain contracts for different locations enjoy better rental negotiations and tend to be sticky. Clients opting for BTS facilities have longer tenures and better renewal rates.

Analysis of the micro-market is also carried out to understand the level of competition and suitably factor in the corresponding vacancy and renewal rates.

Financial risk

The financial risk of the entity is driven by the adequacy of revenue generated to meet debt obligation, and the presence of liquidity to tide over any temporary shortfall in revenue. The key parameters assessed to gauge the financial risk in commercial properties are:

DSCR

Revenue of the property includes lease rentals, and other charges such as CAM and parking, which are collected from tenants. Operating expenses such as CAM and taxes are deducted from revenue to determine the cash flows available for debt servicing. CRISIL Ratings computes the DSCR of a property as the ratio of cash flows available for debt servicing, and the debt servicing obligation (including scheduled principal and interest payments). The average DSCR over the tenure of the debt is used as the primary driver of the financial risk assessment of the property.

While estimating the cash flows over the tenure of the debt, CRISIL Ratings considers its assessment of vacancy rates, rental rates for the property, and the contractual agreements such as rental rate escalations and renewals. CRISIL Ratings also performs scenario analyses to factor in the effect of possible variations in these parameters, as well as interest rates, on the DSCR of the property over the debt tenure.

Confidence on cash flows in the initial years is much higher than in later years; hence, the requisite DSCR levels for the initial years can be relatively lower than the long-term average for a specific rating category.

DSCR = (Lease rentals + CAM + parking charges – operating expenses-taxes) / Scheduled principal and interest payments

Liquidity

Liquidity available with the property is also considered. Commercial properties typically maintain a DSRA, which covers certain months of debt service obligations. The lenders can dip into the DSRA in case there is a shortfall in the revenue collection from tenants. The DSRA helps tide over any temporary liquidity shortfall on account of payment delays by tenants or interim vacancy created due to a tenant terminating its lease contract.

Refinancing risks

Certain lease rental-backed debt transactions, typically of short tenures, may involve a significant proportion of debt to be repaid on maturity, thereby exposing the property to refinancing risks. In such cases, in addition to the DSCR during the tenure of the debt and the presence of liquidity, the ability of the property to refinance debt on maturity is also assessed. Refinancing ability is gauged based on the ratio of debt to market value of the property (loan-to-value ratio), on maturity of the debt.

Loan-to value (LTV) = Debt on maturity/ Market value of property at debt maturity

Management risk

The management quality of the property developer/manger influences the ability to negotiate favourable terms with tenants and lenders, and to attract and retain tenants. The key parameters assessed to gauge the management risk in commercial properties include:

Integrity

The management's relationship with key stakeholders (tenants, lenders, and creditors), track record of timely payment of dues, and adherence to applicable laws and regulations are assessed.

Competence

The track record of the management in operating commercial properties, the presence of professional management teams for administering the day-to-day operations of the property, and proactivity in management and maintenance of the property are considered.

Risk appetite

The expansion plans and financial policy of the management are factored. While assessing the financial policy, CRISIL Ratings considers the policy related to gearing and topping up of existing loans.

Other considerations

In addition to debt backed by lease rentals, a commercial property may contract construction loans for meeting funding requirement for expansion plans. In such cases, the property will also be exposed to project execution risks, which will be factored in the overall rating. The rating on the debt backed by lease rentals may be differentiated from the overall rating by a few notches, in the presence of an escrow with a well-defined waterfall mechanism that prioritises payments on lease rental-backed debt, and only the excess cash flows are available for meeting payments on the construction loan.

There may also be instances of a commercial real estate entity holding multiple properties. It may raise multiple loans backed by lease rentals of different properties. Even in such cases, CRISIL Ratings may differentiate the ratings of individual loans from the overall rating of the entity based on the terms of each debt, specifically the escrow structure and waterfall mechanism.

Most commercial real estate properties are housed as special purpose vehicles with limited recourse to the sponsor. Hence, they are rated on a standalone basis, without factoring any distress support from the sponsors. However, there may be instances where a strong sponsor articulates support for the property, typically for bridging any shortfalls in cash flows for meeting debt repayment. CRISIL Ratings may, in these cases, notch up the standalone rating of the property depending on the extent of support articulated by the sponsor, and the track record in extending such distress support to the property.

Conclusion

CRISIL Ratings rates debt backed by lease rentals of commercial real estate properties based on their business, financial and management risk profiles. The business risk analysis of the property is driven by factors that affect the rental rates and occupancy levels, including the quality and location of the property, the demand-supply scenario of the micro-market, the quality and concentration of the tenants, and past and expected trends in vacancy and renewal rates. The financial risk analysis focuses on the adequacy of cash flows to meet the debt service obligation, liquidity available to tide over temporary shortfalls in cash flows, and ability to refinance debt, if needed. Under management risk, CRISIL Ratings analyses the relationship of the management with stakeholders, its track record of operating and maintaining commercial properties, and financial policy.

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