CRISIL's rating criteria for REITs and InvITs

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Executive summary

An investment trust is a vehicle created to primarily invest in revenue-generating real estate or infrastructure assets. These entities are 'trusts' by definition, and their 'units' (shares), after the initial offer, are to be listed on exchanges (except for privately placed ones) and regulated by the Securities and Exchange Board of India (SEBI). The units are traded based on their net asset value). These entities have a pass-through structure and are therefore required to distribute most of their earnings to unit holders. As per SEBI's regulatory requirement, if the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, a credit rating has to be obtained from a registered credit rating agency for any further borrowing.

Given the regulatory oversight of these entities (*refer to Box 1*), investment trusts have a number of aspects that lend a relatively positive bias to the creditors compared with direct credit to real estate and infrastructure assets. These aspects include limits on under-construction assets, cap on aggregate gearing, listing requirements, ensuring minimum sponsor holding in the investment trust, ensuring minimum controlling stake in the special purpose vehicle (SPV), independent valuation of the assets, trustee-monitored transparency, and compliance and disclosure requirements. Investment trusts also have flexibility in holding the assets either directly or through an SPV or an intermediate holding company.

For rating the debt raised by investment trusts, CRISIL assesses the quality of the trust's asset portfolio, the extent of cash flow coverage, leverage, and financial flexibility and management risks.

Scope

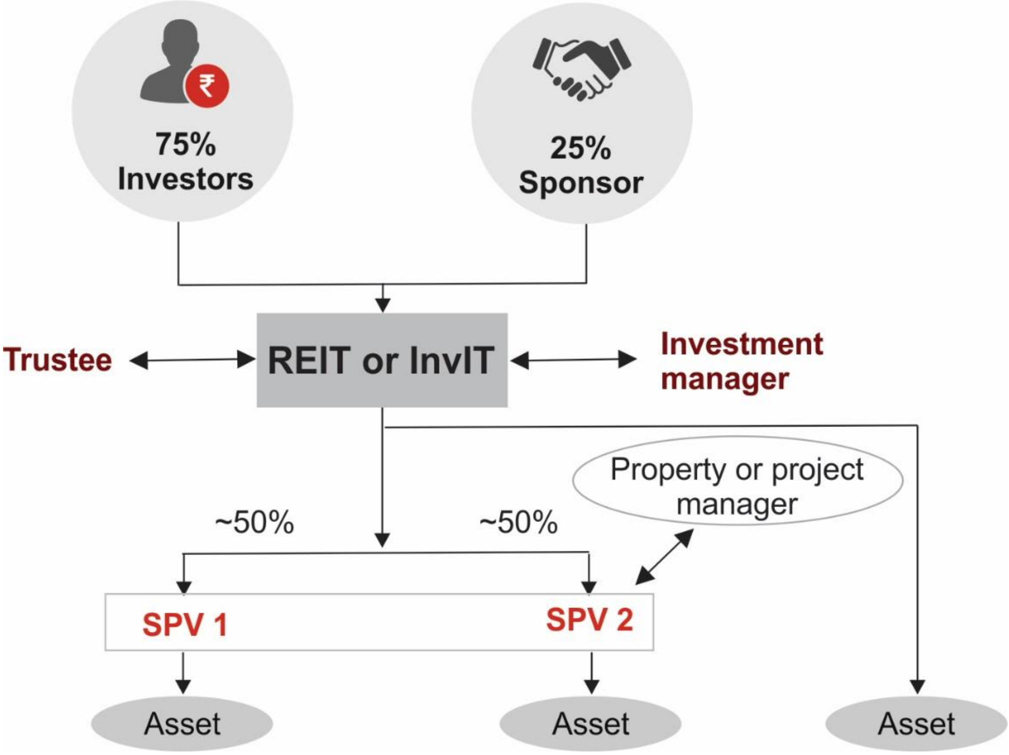
This criteria[1] document deals with CRISIL's methodology for rating debt in investment trusts. The rating is an opinion on the ability of the trust to make timely payment on its debt obligations. CRISIL does not rate the units of these trusts. The units are akin to shares of a company and derive their value from the value of underlying assets. Given that units of investment trusts are like equity, CRISIL does not rate these units on a credit rating scale.

Salient features of investment trusts

SEBI notified regulations for investment trusts on September 26, 2014 – specifically, real estate investment trusts (REITs) and infrastructure investment trusts (InvITs) – which were subsequently amended twice; first on September 23, 2016, and later on April 22, 2019. REITs and InvITs allow sponsors to monetise revenue-generating real estate and infrastructure assets while enabling investors or unit holders to invest in these assets without actually owning them. REITs and InvITs enjoy favourable tax treatment, including exemption from dividend distribution tax and relaxation of capital gains tax. Figure 1 depicts the indicative structure of a REIT or InvIT. The key structural and regulatory aspects of REITs and InvITs, as per SEBI guidelines, are outlined in Box 1.

[1] *Link to previous criteria: https://www.crisil.com/content/dam/crisil/criteria_methodology/criteria-research/archive/CRISILs%20rating%20criteria%20for%20REITs%20and%20InVITs.pdf*

Figure 1: Indicative[2] structure of investment trust



Box 1: Salient features on SEBI guidelines on REITs and InvITs

Guidelines for listed REITs and InvITs

A. Structure of an investment trust

- Investment trusts are to hold assets either directly or through SPVs. The trusts can invest in two-level SPV structures through a holding company (holdco), subject to sufficient shareholding in the holdco and the underlying SPV and other safeguards such as right to appoint majority directors in the SPVs and mandatory guidelines on distribution of cash.
- There is a mandatory sponsor holding of not less than 25% of the total units of the REIT after initial offer on a post-issue basis (the minimum sponsor holding specified in this clause shall be held for a period of at least three years from the date of listing of such units). The sponsors shall together hold not less than 15% of the outstanding units of the listed REIT at all time and an individual sponsor shall not hold less than 5% of the outstanding listed REIT units. In the case of InvITs, mandatory sponsor holding is 15% for a period of at least three years from the date of listing of such units. There is no limit on the number of sponsors both in the case of REIT and InvIT.
- For determining the allotment in an initial offer by publicly offered InvITs/REITs, the following guidelines shall be applicable:
    1. The value of each allotment lot shall not be less than Rs 1 lakh for InvITs and Rs 50,000 for REITs, where each lot shall consist of 100 units.

[2] *Sponsor holding mentioned above is indicative*

2. Allotment to any investor shall be made in the multiples of a lot.

- For follow-on offer by publicly offered InvITs/REITs, the following guidelines shall be applicable:
  1. Minimum allotment shall be of such number of lots, the value of which is not less than Rs 1 lakh for InvITs and Rs 50,000 for REITs, where each lot shall consist of such number of units as in its trading lot.
  2. Allotment to any investor shall be made in multiples of a lot.
- REITs can invest up to 20% in under-construction assets, while InvITs (through public issue) can invest up to 10% in under-construction assets.
- Investment trusts are to hold controlling interest and not less than 50% equity share capital or interest in the SPVs (except in the case of public-private partnership projects where such holding is disallowed by the government or regulatory provisions)
- SPVs are to hold not less than 80% of assets (90% in case of InvITs) directly in properties (infrastructure projects for InvITs) and not invest in other SPVs
- SPVs should not engage in any activities other than those pertaining and incidental to the underlying projects

B. Stipulations to ensure transparency

- The trustee is to hold assets for the benefit of unit holders, oversee activities, and ensure compliance with respect to reporting and disclosure requirements
- A full valuation shall be conducted by an independent valuer not less than once in every financial year; a half yearly valuation of the assets shall be conducted by the valuer for the half-year ending September 30 for incorporating any key changes in the previous six months
- All related-party transactions are to be on an arm's-length basis

C. Distribution requirements

- Not less than 90% of net distributable cash flow of the SPV is to be disbursed to the investment trust in proportion to its holding in the SPV subject to applicable provisions in the Companies Act, 2013, or the Limited Liability Partnership Act, 2008
- Not less than 90% of net distributable cash flow of the investment trust is to be distributed to unit holders

D. Leverage restrictions

- If the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, for any further borrowing, a credit rating is to be obtained from a registered credit rating agency
- The aggregate consolidated borrowing and deferred payment of the investment trust net of cash and cash equivalents is typically restricted to 49% of the value of the investment trust assets
- InvITs will be allowed to increase their leverage from 49% to 70% if they satisfy the following conditions:
  – Approval from unit holders
  – Credit rating of 'AAA' post increasing leverage to 70%

– Minimum track record of six continuous distributions
– Capital released is used in acquiring new infrastructure assets

Guidelines for private placement of units of InvITs (not listed on stock exchanges)

- The units issued or proposed to be issued through private placement shall not be eligible to be listed on recognised stock exchanges
- Relaxed investor protection and governance norms for privately placed InvITs
  – No restriction on leverage limit; leverage shall be determined by the issuer in consultation with investors
  – No regulatory constraints on investment strategy; for example. no restriction on share of operational projects in the asset mix
  – No regulatory guidelines on distribution of free cash
  – No regulatory requirement regarding public disclosure on performance of the InvIT
- An InvIT raising funds through private placement shall
  – Do so through a placement memorandum;
  – Raise funds only from institutional investors and bodies corporate;
  – Not accept from an investor an investment of less than Rs 1 crore;
  – Not raise funds from more than 20 investors

Privately placed and listed InvIT can choose to convert the InvIT to a privately placed unlisted InvIT if such request has been approved by unit holders and exit been provided to dissenting shareholders. Conversely, InvITs that are privately placed may choose to list their units on stock exchanges, after complying with the requirements as applicable for a listed InvIT.

CRISIL's methodology for rating investment trusts

The principles of rating debt in investment trusts are essentially similar to those in corporates. The key difference lies in the nature of investors in investment trusts. Investors who typically invest in these trusts expect a high cash flow yield. To cater to the investor need, investment trusts distribute most of the cash flows generated from the underlying real estate or infrastructure assets. Therefore, the quality of assets and cash flow coverage are key drivers of rating an investment trust. While the rating approach broadly remains the same for both REITs and InvITs, CRISIL will assess the credit risk profile of the underlying assets by applying specific criteria relevant to real estate and infrastructure, respectively. For instance, to evaluate the transmission assets, CRISIL shall apply the "Criteria for Rating Power transmission projects", and for roads it shall be "Rating Criteria for Toll Road Projects".

For rating debt in investment trusts, CRISIL focuses on the following aspects:

- **Quality of asset portfolio**: Quality of assets determines the quality of underlying cash flow and is, therefore, the key determinant of the trust's business risk profile. Factors that CRISIL considers for its assessment include:
  – Contracts governing future cash flow, tenure of contracts and its permanency, and re-pricing risk of contracts
  – Demand-supply situation that can impact future cash flows

– Credit risk profile of the counterparty (for example, tenant profile in the case of commercial real estate) from where the cash flows originate
– Diversification benefits emanating from multiple customers and geographies

- **Coverage, leverage, and financial flexibility**: CRISIL evaluates the debt service coverage ratio for the debt, both at the trust level and the SPV based on the cash flows generated from the underlying assets. CRISIL also factors financial flexibility in the form of gearing headroom. Gearing in case of an investment trust is measured as aggregate debt, including those in the SPVs, to market value of the assets and any increase in the market value of assets improves the gearing headroom.

Management risk: CRISIL also evaluates the experience of the trustee and investment manager, and stipulation and efficacy of risk management policies.

Credit risk profile: Investment trusts vis-à-vis SPVs

Debt can be raised by both the investment trust and the underlying SPVs. The credit risk profile of the debt residing in the SPVs can be different from that in the investment trust.

- **Credit risk profile - SPVs:** This will depend on the available cash flow coverage in the SPVs. In case the debt in the SPV is exposed to project execution risk, CRISIL will factor the risks related to implementation, funding, demand and pricing risks on the SPVs' cash flows.
- **Credit risk profile - investment trusts:** This is derived from the aggregate credit risk profiles of the SPVs and assets they hold. However, the credit risk profile of the debt in the investment trust can be different from that of the aggregate credit risk profile of the SPVs, based on the following factors:

  a. Repayment profile and other safety mechanisms inbuilt in the profile of the debt residing in the trust

  b. Diversification benefits on account of accessing cash flow from multiple SPVs

  c. Headroom for additional debt based on the value of assets in the SPVs

  d. Subordination of cash flow from the SPVs to the investment trust, depending on

     – Level of external debt in SPVs
     – Any working capital requirement in SPVs
     – Any capital expenditure in SPVs
     – Percentage of shareholding held by the investment trust in SPVs

While arriving at the final credit risk profile of the investment trust and the SPVs, CRISIL will also factor the extent of distress support that may be provided by the investment trust to some of the weaker SPVs.

Conclusion

REITs and InvITs are vehicles that invest primarily in real estate and infrastructure assets, respectively. These investment trusts are governed by regulations with guidelines on listing, distribution of cash flows, transparency and discipline in cash flows, as well as investment management. CRISIL rates the debt raised by investment trusts based on the quality of the underlying assets, cash flow coverage, financial flexibility, and management expertise.

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