CRISIL's rating methodology for commercial mortgagebacked securitisation

Executive summary

Funding requirement for commercial real estate in the country is shooting up as a growing economy fuels demand. The banking sector cannot meet this huge need and more diversified sources of funding are needed for a healthy growth of the market.

CRISIL believes commercial mortgage-backed securitisation (CMBS) can be a good alternative funding tool for the developer. In a CMBS transaction, revenue from lease rentals is used to service interest on the debt contracted by the issuer.

CRISIL believes revenue stability is primarily exposed to risks of vacancy, pricing and counter-party credit, and accordingly analyses and factors these in its rating analysis. Factors such as customer and geographical profile, not to forget safeguards such as liquidity adequacy in form of debt service reserve account (DSRA) put in place to mitigate the risks are also considered.

Further, in a typical CMBS transaction, the principal component is not repaid through periodic lease rental payments; it is expected to be repaid by refinancing by the end of indicative maturity date (*explained in subsequent sections*). CRISIL believes the refinancing ability of the issuer is primarily dependent on the value of the property compared with the principal amount. CRISIL factors these aspects while assessing a CMBS transaction.

Scope

This document details a CMBS transaction and how it functions in the Indian context. It also analyses the key risks with respect to CMBS and articulates CRISIL's framework for analysis of these risks.

What is a commercial property?

A commercial property refers to a building or land intended to be used for economic benefit. It includes retail centres, office premises, restaurants, hotels, and warehouses. Globally, even multi-family dwelling units (apartments or condominiums) are classified as commercial properties.

What is a CMBS?

CMBS is a financial instrument secured by receivables from commercial real estate. It is a popular fundraising source for developers and banks worldwide. A CMBS instrument is created by pooling together one or more commercial mortgages, and securitising the lease rentals.

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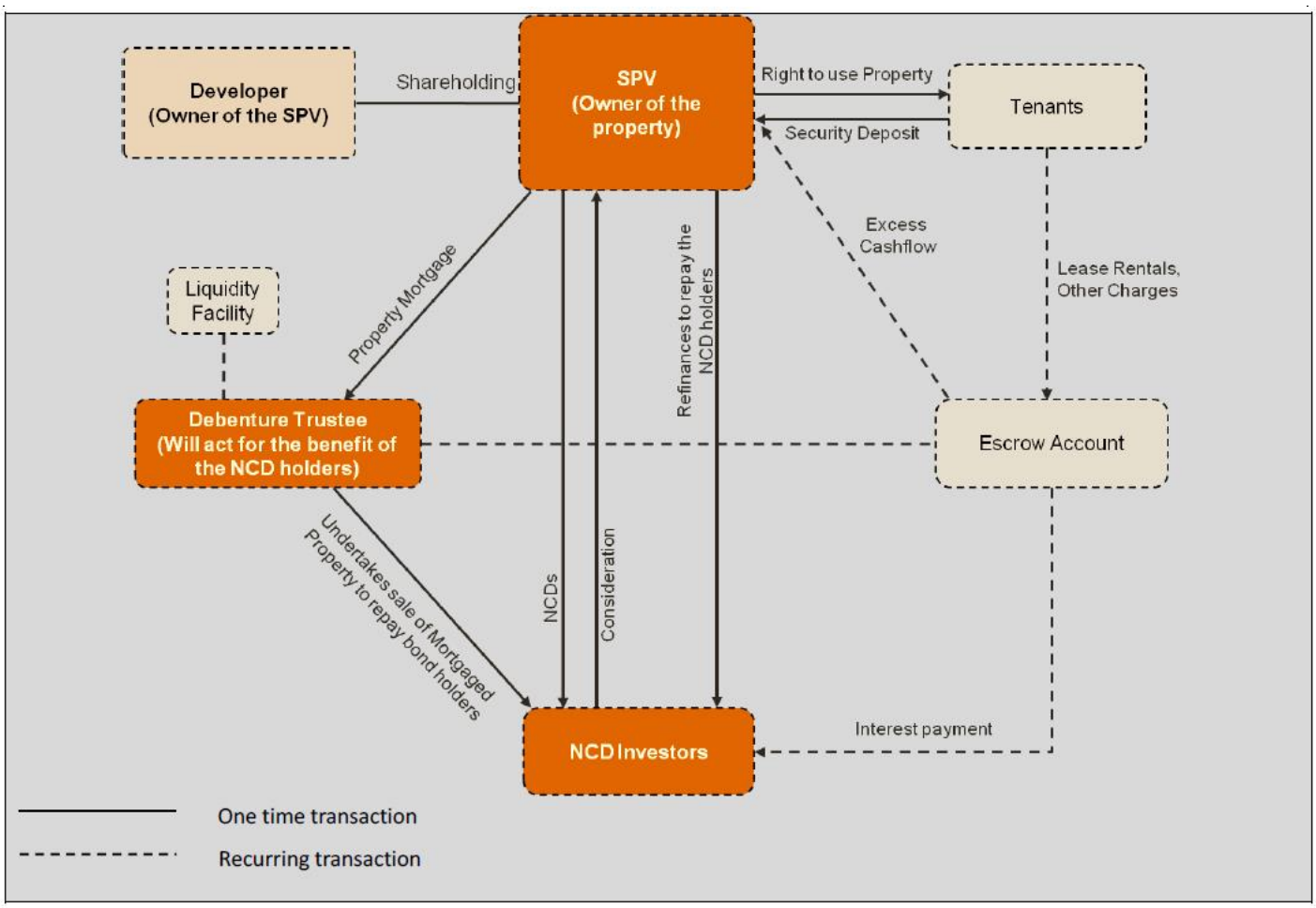
How a CMBS transaction works

A diagrammatic representation of CMBS (where a firm is securitising the lease rentals from its commercial property) is shown below:



Steps in a typical CMBS transaction:

The properties whose lease rentals are to be securitised are housed in a special purpose vehicle (SPV). The SPV houses only the designated property and doesn't usually undertake any future development, capital expenditure or any other business activity.

- Debt is contracted by the SPV by issuing CMBS. This debt is secured by a mortgage on the specified property.
- The cash flow waterfall of the lease rentals is as follows:
  - Net lease rentals (charges such as maintenance costs, tax deducted at source, service tax, income and property tax are deducted from the gross rentals to arrive at the net rentals available to service debt) are paid into a designated escrow account.
  - Debt servicing is done out of net lease rentals on a periodic basis, and the residual cash flows then flow back to the borrower.

- Principal repayment on the loan is typically in the form of a bullet payment at the end of the tenure.

- A debenture trustee is appointed to act as an agent of the CMBS debt holders, with a fiduciary duty to protect the interest of investors.
- The SPV normally acts as the property manager for the securitisation transaction.
- The lease rentals are deposited in a specified escrow account charged with the SPV. The SPV uses these deposits in accordance with the waterfall mechanism acknowledged in the agreement. The debenture trustee will intervene only when the terms of the agreement are violated in a way detrimental to the CMBS debt holders.
- The debt instrument has two key dates - indicative maturity date and legal final maturity date. The indicative maturity is the date by which the principal is expected to be repaid (primarily through refinancing).
- On or before the 'indicative maturity date', if the issuer is not able to refinance the debt, there are embedded structural features which empower the debenture trustee to take steps and ensure repayment by the 'legal final maturity date'.
- If the CMBS debt holders are not repaid in full by the 'legal final maturity date', it constitutes an event of default on the CMBS debt.
- The debenture trustee has the right to sell the underlying property and ensure repayment of the CMBS debt. Since this process can take time, the terms of the instrument provide a tail period between 'indicative maturity date' and 'legal final maturity date'. The tail period depends on the estimated time it is likely to take for completing the sale, and realising the proceeds. Thus, the 'legal final maturity date', by which the investors have to be repaid through sale of property, is set at a date some time after the 'indicative maturity date'.
  - Since sale of property by enforcing the mortgage may not be the most economically efficient mechanism, CMBS transactions have typically adopted an additional structural mechanism that allows sale of the SPV. Here, the developer pledges its entire shareholding in the SPV, which houses the underlying commercial properties, to the debenture trustee. Thus, the debenture trustee can raise funds by sale of the SPV and repay the investors on or before the 'legal final maturity date'.

Thus, to summarise, in a typical CMBS transaction:

- Lease rentals from the property are used to pay interest on the CMBS transaction.
- The principal is normally repaid by the end of the indicative maturity date.
- Lease rentals alone are normally not sufficient to repay principal.
- Thus, all or almost all of the principal repayment is through refinance.
- If the issuer is unable to redeem the principal payment by the indicative maturity date, the Debenture Trustee is empowered to realise the funds through sale of property or SPV, as the case may be, and repay the debt holders by the legal final maturity date.

Risk analysis for CMBS transactions

CRISIL has developed a detailed framework for analysing the risks in CMBS transactions. CRISIL's analytical framework comprises a detailed analysis of the following primary risk factors:

- **Revenue risk:** The revenue source in a CMBS transaction is primarily the lease rentals. Any reduction in the lease rentals reduces the cushion between lease rentals and the interest obligations, posing a risk to servicing of the debt instrument. The lease rentals could reduce on account of any of the following factors:
  - **Vacancy risk:** Lease tenures in India are typically very short (about three years). If the CMBS transaction tenure is longer than the lease tenure, then the leases have to be renewed. Vacancy risk arises when such renewals are not done in a timely manner. Tenants may decide to vacate the property either mid-way or at the end of the lease tenure. Also, while evaluating the vacancy risk, the property's current vacancy levels along with the micro-market vacancy profile is taken into consideration. The nature of the property viz., retail or office, is also a factor while assessing the vacancy risk of a property.

    Customer concentration also forms a factor while assessing vacancy risk in specific property. A highly diversified customer base would tend to lessen the adverse impact of vacancy risk, whereas higher customer concentration increases the adverse impact of vacancy risk.
  - **Pricing risk:** Movement of the market rates of lease rentals is also taken into consideration while evaluating the revenue risk. Typically, the lease rentals rates are negotiated at the time of lease renewal. Thus a reduction in market lease rental rates during this time poses a revenue risk for the transaction.
  - **Counterparty credit risk:** This arises when the existing tenant delays payment of lease rental obligations. CRISIL factors in the credit risk profile of the tenants into its evaluation of a CMBS transaction.
  - **Diversity of properties:** Real estate market is significantly impacted by local/regional conditions. CRISIL believes sufficient geographical diversification mitigates risk pertaining to local/regional conditions. Accordingly, CRISIL takes into account portfolio diversification while evaluating a CMBS transaction.

  CRISIL evaluates whether the debt service coverage ratio (DSCR) provided by expected lease rentals in relation to the debt service on the CMBS over the life of the instrument are commensurate with the rating assigned. In a typical CMBS transaction, revenue from the lease rentals is used to service interest on the debt contracted by the SPV - thus the DSCR cover in a CMBS transaction primarily represents an interest service coverage ratio. CRISIL considers the average DSCR over the life of the instrument for its rating analysis; the cash flows available for debt service comprise net lease rentals[1], while the debt service comprises interest payments and scheduled principal repayments (if any). After factoring these risks into the DSCR calculations, the average DSCR levels for assigning **CRISIL AAA(SO)** rating should be in the range of 2.1-2.2 times, whereas the same stands at 1.8-2 times corresponding to **CRISIL AA(SO)** rating category. Also, the confidence on

[1] Charges such as maintenance costs, tax deducted at source, service tax, income and property tax are deducted from the gross rentals to arrive at the net rentals available to service debt.

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

- **Refinancing risk:** Property price is the second key risk element in a CMBS transaction. Since the principal amount due on the CMBS is to be serviced through refinancing or sale of property, property price trends also assume importance. CRISIL will carry out a detailed analysis of the historical movement of property prices to evaluate coverage (called loan-to-value) for the transaction. The average loan-to-value, or LTV, is 40% for CRISIL AAA(SO) rating and 50% for CRISIL AA(SO) rating.

- **Liquidity risk:** The third key variable in a CMBS transaction is the time gap between the two maturity dates. This time has to be long enough to enable the sale of property to take place, so that the CMBS is fully redeemed before the legal final maturity. CRISIL will assess these risk factors primarily from the point of view of the prevalent regulatory and legal systems. CRISIL believes the minimum required time period between indicative maturity date and legal final maturity date is 2 years for a CMBS transaction rated in CRISIL AA(SO) rating category and around 3 years for CRISIL AAA(SO). For this purpose, CRISIL will assess the nature of the mortgage, the impact of bankruptcy on the developer (if he continues to be the owner of the property), clear title, any risk of litigation by the developer, etc.

- **Parent credit risk:** CRISIL believes the developer's financial strength is a critical factor while refinancing the underlying debt, or even for smooth enforcement of security and sale of property. CRISIL believes that if the developer is in financial distress or in bankruptcy, then the developer or the liquidator might create legal impediments, potentially elongating the time required to accomplish the sale of property to repay the debt holders. Hence, CRISIL requires the developer credit quality at a specified minimum level while assigning a CMBS's rating at a certain level. For instance, for assigning a rating of **CRISIL AAA(SO)** to a CMBS debt with a total tenure of seven years, the minimum rating of the developer should be in the **Moderate Safety** rating category on CRISIL's scale.

These are the primary risk factors in a CMBS transaction. CRISIL will also analyse other risk factors, including other developer- and property-specific risks before rating a CMBS transaction.

Conclusion

Globally, CMBS is a very popular form of financing real estate development. CRISIL believes it will prove an effective tool in India, too. Development of the CMBS market will pave the way for orderly growth of the commercial real estate market.

About CRISIL Limited

CRISIL is a global analytical company providing ratings, research, and risk and policy advisory services. We are India's leading ratings agency. We are also the foremost provider of high-end research to the world's largest banks and leading corporations.

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 over 95,000 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 and microfinance institutions. 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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