Rating criteria for real estate developers

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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 firm or more firms, but they have some degree of cash flow fungibility between themselves. This article explains the methodology adopted to assess the credit quality of developers. For ratings of real estate SPVs, please refer to “Rating Criteria for Real Estate SPVs” on www.crisil.com.

CRISIL’s 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, the 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 developer’s market position and operational efficiency. Market position determines the developer’s ability to sustain its 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 the relevant micro-markets. Operational efficiency indicates the developer’s ability to execute projects in a timely and cost-effective manner. CRISIL evaluates operational efficiency by analysing the progress in ongoing projects, the extent to which these projects are sold, and whether the firm’s portfolio has a healthy mix of projects at different stages of completion. For operational commercial projects, CRISIL also evaluates the vacancy rates, tenant profile, and customer concentration.

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

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

A real estate developer’s leverage is measured by looking at the amount of debt taken vis-à-vis the project costs. The degree of leverage not only helps estimate the extent of future debt payments, but also the headroom to borrow further. CRISIL separately analyses debt taken for residential and sale model commercial projects, and that against lease rentals expected from commercial projects, given difference in stability.

Residential real estate projects generate cash flow through sale of units during the project implementation stage. Hence, in order to capture these nuances, CRISIL uses cash debt service coverage ratio (CDSCR) - a modified version of debt service coverage ratio (DSCR) - across projects to evaluate the developer’s financial position.

However, CRISIL analyses operational projects where lease rentals are the primary source of debt repayment using DSCR, as outlined in “CRISIL’s criteria for rating debt backed by lease rentals of commercial properties”\(^2\).

For assessing the developer’s liquidity profile and financial flexibility, CRISIL evaluates multiple sources such as ability to raise funds against lease rentals and land bank, cash and unutilised bank lines, besides 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

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\(^1\) The terms developers and real estate developers are used interchangeably in this document

ensuring business stability. In this regard, CRISIL evaluates management’s competence, integrity, and risk appetite. 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.  

Scope

This article discusses the typical risks that real estate developers are exposed to, and CRISIL’s rating methodology to assess their credit quality. The criteria is applicable to real estate developers engaged in execution of multiple real estate projects, which may be housed in different legal entities, but have some degree of cash flow fungibility amongst themselves. This stands in contrast to real estate SPVs where analysis is done at the project level. The impact of Real Estate (Regulation and Development) Act, 2016 is detailed below:

Box 1: Real Estate (Regulation and Development) Act, 2016

The Indian real estate sector is marked with information asymmetry and limited bargaining power of customers. With a view to resolve these issues, the Real Estate Act was ratified by the Parliament. Its key provisions are:

- Mandatory registration of projects with Real Estate Regulatory Authority (RERA), prior to which the developer cannot market the project
- Developers are required to declare details about the project and submit relevant documents on the RERA portal
- Developers are required to deposit 70% of customer advances in an escrow account, proceeds of which can be used only for the project for which advances were sought
- Adherence to the project plan and compensation to customers in case of delays

This act is expected to boost transparency in the sector and empower customers.

The impact of RERA on the fungibility of cash flows between multiple projects of the same developer is not expected to be severe, especially if land cost is counted towards project cost incurred, and surplus from one project may still be used to fund cash flow mismatch of another project.

Methodology

CRISIL uses the framework highlighted in the following diagram for assessing the credit quality of real estate developers

3 For accessing the previous published document on ‘Rating criteria for real estate developers’, kindly refer to the following link: https://crisil.com/content/dam/crisil/criteria_methodology/real-estate/archive/CRISILs-Rating-criteria-for-Real-Estate-Developers.pdf
### Chart 1: Framework for rating real estate developers

<table>
<thead>
<tr>
<th>Business risk assessment</th>
<th>Operating efficiency</th>
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<tr>
<td>• Track record</td>
<td>• Construction and sales progress</td>
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<tr>
<td>• Diversification</td>
<td>• Status of operational projects</td>
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<td>• Brand equity</td>
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<td>• Market share</td>
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<table>
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<tr>
<th>Financial risk assessment</th>
<th>Leverage</th>
<th>Cash flow analysis</th>
<th>Financial flexibility</th>
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<tbody>
<tr>
<td></td>
<td>For residential and sale model commercial portion</td>
<td>For operational lease rental backed commercial portion</td>
<td></td>
</tr>
<tr>
<td>• Extent of debt used to fund project and related costs</td>
<td>• Cash debt service coverage ratio (CDSCR)</td>
<td>• Liquidity sources – cash, bank lines</td>
<td>• Refinancing sources</td>
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<th>Project risk assessment</th>
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<tr>
<td>• Chiefly for under-construction commercial projects built for the purpose of leasing</td>
<td></td>
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<tr>
<td>• Includes implementation risk, funding risk and post-completion risk</td>
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<table>
<thead>
<tr>
<th>Management risk assessment</th>
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<tr>
<td>• Competence (based on execution track record)</td>
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<tr>
<td>• Integrity (transparency, adherence to regulations)</td>
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<td>• Risk appetite (growth plans)</td>
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### Business risk assessment

Business risk assessment entails evaluation of risks associated in the environment where the firm operates. The real estate sector is marked by high degree of fragmentation, given a large number of small regional players with a small market share. In such an environment, the assessment of a firm’s ability to sell profitably and in a sustainable manner becomes crucial. This is captured in the market position of developers 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 flows are generated through sales proceeds and lease rentals. Sales proceeds are realised based on milestones. 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 as well as cash flow generating stage are critical indicators of 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

Market position captures the ability of a firm to maintain competitive advantage – i.e. to sell real estate units profitably

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4 The term ‘sell’ should be read as ‘lease’ for commercial projects that are usually leased out
in a sustainable manner. It indicates the developer’s ability to sell the real estate inventory over time and command premium in the respective market segments.

These factors are captured through the following:

1. **Development track record:** Real estate projects carry a 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 a real estate project.

**Chart 2: Real estate value chain**

![Real estate value chain chart](image)

**Chart 3: Regulatory regime for real estate projects**

![Regulatory regime chart](image)
Given these complexities, real estate projects are prone to delays. Hence, buyers can derive confidence from a real estate developer's development track record, including timely completion of projects. This is an important factor in ensuring the salability of projects during the construction stage.

For assessing the development track record, CRISIL takes into account the following factors:

- **Area developed (in sq ft) and time or cost overruns in these projects.** This highlights the project execution skills such as whether the developer has capabilities to execute projects of varying complexity.

- **Project pipeline in the medium term,** evaluated in conjunction with the projects that the developer has executed in the past. An aggressive expansion plan would require commensurate scale-up in execution capabilities, too.

- **Years of experience in the given micro-market,** as it indicates the reputation of a developer and the fact that the developer has experienced 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 viewed favourably than those with significant exposure to one or two projects. CRISIL evaluates diversification 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 flows. Commercial projects generate cash flows 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 flows, 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 with presence in multiple geographies will, therefore, be better protected against slumps than the one with full exposure to a single geography, irrespective of the type of properties.

4. **Market share:** The real estate segment is typically fragmented. Therefore, market share in the relevant micro-market is looked at instead of the industry as a whole.

**Operational efficiency**

Operational efficiency captures the developer's ability to execute projects in a timely manner at a competitive cost and manage project level cash flows. This is important because it not only impacts a developer's existing profitability, but for a developer facing time and cost overruns in several projects, it impacts reputation and, consequently, the future salability. This can spiral into weakening profitability as highlighted in the chart below:
CRISIL assesses a developer’s operational efficiency based on the following factors:

1. **Construction and sales progress of residential and sale model commercial projects**: Real estate projects tend to have a higher implementation risk during the initial stages, which reduces as it nears completion. This is for two reasons: customer advances (which may fund 50-70% of project cost) being linked to project milestones and significant number of approvals required 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 margins, adversely impacting 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 evaluates the following:

- Construction progress in ongoing projects
- Sales booking progress in ongoing projects
- Proportion of projects for which funding has been completely tied up, i.e. construction cost is completely covered by available funding

CRISIL 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 analyses the 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

CRISIL evaluates the financial risk associated with the developer 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 looks at the extent of debt funding at an aggregate level of the developer’s 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.

**Cash flow analysis**

As already mentioned, CRISIL uses CDSCR to 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 evaluates these ratios at an overall portfolio level to assess the financial position of the developer.

For residential and sale model commercial part of the developer’s portfolio, CDSCR is used to determine the cash flow adequacy. CDSCR provides some cushion over principal and interest payments, of expected collections less expected expenses to be incurred. While computing CDSCR, CRISIL 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. CRISIL computes the adequacy of such committed collections in meeting expenses of ongoing projects. CRISIL also evaluates the extent of future sales needed to meet the residual portion of expenses not met by committed cash flows 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 analyses the cash flow using DSCR, as outlined in “CRISIL’s criteria for rating debt backed by lease rentals of commercial properties”.

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

**Financial flexibility**

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

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• 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

Management risk assessment

CRISIL’s 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 evaluates competence in executing similar sized real estate projects and whether sufficient project execution capabilities exist if the developer is scaling up in the medium term. The risk appetite of 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.

Conclusion

CRISIL’s methodology for assessing the credit quality of real estate developers takes into account 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 flows and their liquidity position. These risks, combined with the management risk, are evaluated to arrive at the standalone rating of the developer. In addition, CRISIL 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 CRISIL’s website.
About CRISIL Limited
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