CRISIL Ratings

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

July 2024

Criteria contacts

Somasekhar Vemuri
Senior Director, Regulatory Affairs and Operations
and Chief Criteria Officer
somasekhar.vemuri@crisil.com

Ramesh Karunakaran
Senior Director
Rating Criteria and Product Development
ramesh.karunakaran@crisil.com

Naveen Vaidyanathan
Director
Rating Criteria and Product Development
naveen.vaidyanathan@crisil.com

Vishal Krishna
Senior Rating Analyst
Rating Criteria and Product Development
vishal.krishna@crisil.com

Raman Tripathi
Rating Analyst
Rating Criteria and Product Development
raman.tripathi@crisil.com

In case of any feedback or queries, you may write to us at criteria.feedback@crisil.com

Executive summary

Entities owning operational commercial real estate properties generally contract debt backed by expected rentals to refinance 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 the excess cash flow after 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 meet debt obligation.

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

Scope of criteria

This article[1] details the 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 the 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.

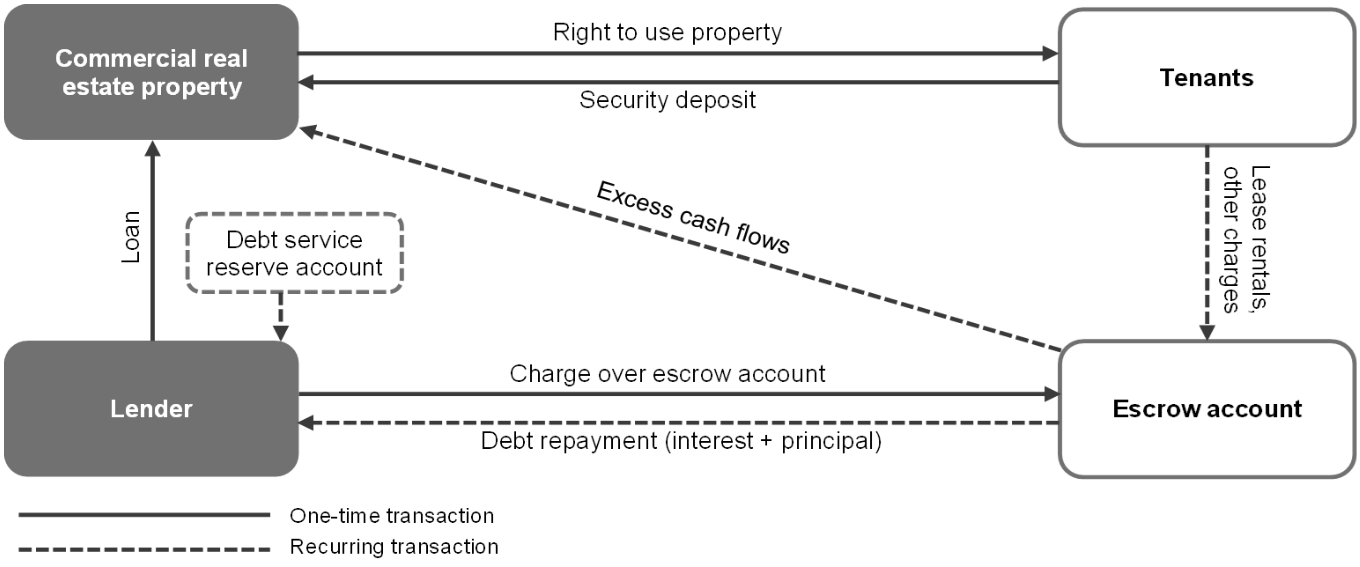
Such projects can also securitise the lease rental receivables and raise funds through commercial mortgage-backed securities (CMBS). The CMBS transactions are structurally different from typical lease rental-backed debt, and do not fall under the purview of this article. For more details on CMBS transactions, 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 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-june2023.pdf

Chart 1: Typical structure of debt backed by lease rentals



Following are the steps in a 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 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 maintains a debt service reserve account (DSRA), which provides liquidity support equivalent to debt 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 debt obligation

Rating methodology

The rating on debt backed by lease rentals is driven by debt service coverage ratio (DSCR) or loan-to-value (LTV)[2]. The rating based on DSCR or LTV is then modified for business risk parameters such as quality and location of the property, micro-market and city-wise dynamics, tenant quality and concentration, vacancy level and contract renewals, and quality of property management. Project risk shall be assessed for the under-construction commercial real estate for 'lease', and the debt servicing pertaining to this shall be suitably factored into the DSCR assessment. Management risk is also factored into the assessment. The following are the major parameters considered for arriving at the rating:

[2] LTV may be assessed as a key driver for real estate investment trusts (REITs) and structures like REITs

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

- DSCR
- LTV, where applicable
- Refinancing and liquidity risks

Management risk

- Integrity
- Competence
- Risk appetite

Project risk

- Implementation risk
- Funding risk
- Demand risk

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 (for instance, luxury 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, and 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 a micro-market would affect the pricing power and occupancy levels of the property. The property will be able to attract tenants 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 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 a property's ability 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 customers can adversely impact the timeliness of debt repayment in case a client delays paying rent or vacates the occupied space.

Vacancy levels and contract renewals

Vacancy levels may be high during 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. The contracts typically contain a lock-in period, on expiry of which the tenant may choose to renew the contract.

CRISIL Ratings assesses weighted average lease expirable (WALE) on first (lock-in period) and ultimate basis (expiry of the contract) to understand cash flow visibility and stability.

CRISIL Ratings assesses if 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 during which the management can 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: since malls 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, are 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, 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 and minimise vacancy risk. Proximity to a client's factory location, major consumption hubs/markets, national and state highways and ports and airports is considered advantageous.

A well-maintained, high-quality warehouse attracts a reputed clientele. Built-to-suit (BTS) way of leasing facilitates opportunity for automation and system integration, thereby attracting premium clients who minimise 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 to debt obligation (including scheduled principal and interest payments). The average DSCR over the tenure of the debt is used as the primary driver to assess the financial risk 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 debt obligation for certain months. 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.

Real estate investment trusts (REITs) and structures similar to REITs hold multiple commercial assets, resulting in a staggered debt structure, which can result in ballooning repayments at various points of time. Given the quality of assets and contractual nature of cash flows, more often than not, REITs are expected to refinance these ballooning repayments.

Hence, for REITs and similar structures, CRISIL Ratings may assess LTV as one of the key drivers.

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

Management risk

The management quality of the property developer 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, presence of professional management teams to oversee daily operations, 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.

Project risk

In addition to debt backed by lease rentals, a commercial property may contract construction loans to fund 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 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 servicing the construction loan.

CRISIL Ratings assesses project risk for under-construction assets based on the following parameters:

- Implementation risks around securing approvals, land free of encumbrance, and technical complexity
- Funding risk related to obtaining funds necessary to complete the project
- Demand risk related to getting suitable lessees for the project

Other considerations

There may be instances of a commercial real estate entity holding multiple properties, in which case it may avail of several loans backed by lease rentals of different properties. 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 obligation. CRISIL Ratings may, in such 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 debt 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.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited, an S&P Global Company)

CRISIL Ratings pioneered the concept of credit rating in India in 1987. With a tradition of independence, analytical rigour and innovation, we set the standards in the credit rating business. We rate the entire range of debt instruments, such as, bank loans, certificates of deposit, commercial paper, non-convertible / convertible / partially convertible bonds and debentures, perpetual bonds, bank hybrid capital instruments, asset-backed and mortgage-backed securities, partial guarantees and other structured debt instruments. We have rated over 33,000 large and mid-scale corporates and financial institutions. We have also instituted several innovations in India in the rating business, including rating municipal bonds, partially guaranteed instruments and infrastructure investment trusts (InvITs).

CRISIL Ratings Limited ("CRISIL Ratings") is a wholly owned subsidiary of CRISIL Limited ("CRISIL"). CRISIL Ratings Limited is registered in India as a credit rating agency with the Securities and Exchange Board of India ("SEBI").

For more information, visit www.crisilratings.com

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 through businesses that operate from India, the US, the UK, Argentina, Poland, China, Hong Kong, UAE and Singapore.

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.

For more information, visit www.crisil.com

Connect with us: LINKEDIN | TWITTER | YOUTUBE | FACEBOOK | INSTAGRAM

CRISIL Privacy

CRISIL respects your privacy. We may use your personal information, such as your name, location, contact number and email id to fulfil your request, service your account and to provide you with additional information from CRISIL. For further information on CRISIL's privacy policy please visit www.crisil.com/privacy.