Rating Methodology for Real Estate Companies*

Introduction

The real estate industry is characterized by high volatility and cyclicality, with its performance having a strong correlation with the macro-economic environment. Some of the key drivers of the industry are the state of the economy (as reflected by GDP growth), employment growth, extent of rise in disposable incomes, and increase in the proportion of gainfully employed workers in the total population. In Indonesia, real estate contributes around 3.0% of GDP and amounted to IDR 256.4 trillion in 2014, rising from IDR 244.2 trillion in 2013. The sector has recorded a compounded annual growth rate of 6.7% during 2010-2014.

The real estate sector has three main segments: residential, commercial, and retail. Increasing population, reducing household size, low interest rates and a high rate of property appreciation will drive demand in the residential segment. In the commercial segment, the growth in manufacturing and services sectors are the usual demand drivers, in that they require commercial space to expand their facilities. These include the information technology/information technology enabled services (IT/ITES) sector, outsourcing companies, automotive, bank and tourism sector. Demand in the retail segment is largely driven by the growth of the organized market for real estate.

As has been witnessed in the recent past, real estate business is highly cyclical, which in turn also results in high variability in the credit risk profile of the industry players. ICRA Indonesia's rating methodology for the real estate companies involves an assessment of the business risks, financial risks and management quality. The factors that are specifically evaluated while assessing the credit quality of a real estate company are given below.

Business and Competitive Position

Track Record

ICRA Indonesia evaluates the track record of a real estate development company to understand its market positioning and its ability to deliver efficiently and within the contracted time. The key points analysed to assess the company's track record are:

- Years of presence in the real estate sector
- Type of projects developed viz. residential housing complex, commercial office space, Special Economic Zones (SEZ), malls, hotel and integrated townships
- Numbers and mix of projects developed in the past and also the total area (size) developed
- Presence in regional market or diversified across national market
- Quality and safety standards maintained in the past projects reckoned by customer feedbacks and physical verification
- Extent of timeliness in project completion in the past
- Major clientele in case of commercial projects and firm customer base
- Bookings/occupancy in developed projects
- Brand equity enjoyed by the company, as reflected by the premium earned over market rate.

The process also involves visit to some of the projects, so as to gain a first-hand idea of the quality and safety standards maintained and the timeliness of work executed in the past.

Execution Capability

This factor is critical keeping in view the fact that development plans of most real estate players are usually aggressive compared to the area developed in the past. Moreover, many of the real estate players could also be diversifying into new areas - for instance from residential space enter into commercial space, or vice-a-versa. In order to assess this risk, besides evaluating the company‘s past projects in terms of size, quality, safety standards, infrastructure, timeliness, cost, and after-sales service; ICRA Indonesia evaluates company‘s project management systems and its adequacy of resources.

Project Management Systems: The internal planning and project management and monitoring systems as well as construction techniques adopted can significantly affect the progress at the worksites. The management information system practiced at site, project monitoring at regular intervals and engagement of project management consultant are critical in adherence to time schedule and cost estimate in case of large size projects. The safety standards adopted and the level of standardisation and modernisation of work flow process serve to enhance the quality levels.

Adequacy of Resources: ICRA Indonesia analyses the sufficiency of manpower and machinery employed by the company. An assessment is also made of the external agencies --architects, structural engineers, civil contractor, and project management consultants, among others-- employed by the company. A real estate company with backward integration facilities like in-house construction, design and architect team, etc is viewed favourably, and so is its adherence to the agreed quality levels and timelines in past projects.

Market Risks

In evaluating the market risks that a real estate company faces, ICRA Indonesia assesses the saleability of its projects and its market strength. The company‘s market share, brand value, and bookings in past as well as ongoing projects reflect its market strength. The saleability of the company‘s ongoing and upcoming project is assessed by the project‘s type, location, price, amenities on offer, and target customers. Market risk associated with each project is also assessed in relation to its present stage of development/construction, bookings and advances from customers. Besides, marketing strategy adopted by the company has a direct bearing on the saleability and the brand of the company. Factors that mitigate market risks for a real estate company include diversity of project portfolio in terms of geography, product, price points and clientele.

Moreover, ability of the developer to market its product is dependent on overall demand-supply scenario. Thus ICRA Indonesia assesses the current and projected demand-supply gap in cities/towns wherein developers operations are concentrated. As residential, commercial, and retail are three distinct segments; some of the segment specific criterion are:

Residential: In the case of residential segment, the extent of market risk is evaluated in relation to the anticipated sale levels and sale rates. A widespread channel network (dealers and property agents) also aids in targeting a wider customer base and reduces the market risk to an extent.

Moreover for each of the launched projects, ICRA Indonesia assesses the proportion of booked space to total area offered. A lower proportion of booked space increases the market risk for the project and can also lead to a delay in project execution as residential projects are largely financed from customer advances. This apart, ICRA Indonesia evaluates proportion of end users (measured in terms of bookings backed by bank borrowings) to investors in a project as high percentage of end users eliminates booking cancellation risk to an extent and ensures higher collection efficiency over the project execution period.

Commercial: In the case of commercial segment, the extent of market risk is evaluated in relation to the anticipated occupancy levels and lease rentals. High quality of construction/maintenance, adequate power back-up, reliable data connectivity and energy saving initiatives are some of the features which improve the marketability of the project. Moreover, ICRA Indonesia studies the lease agreements to assess the term of lease, lock-in period, renewal term, escalation clause and termination clauses. The quality of tenant profile is also assessed to estimate the likely collection risk over the period of lease agreement.

Retail: The marketability of retail project besides the location of the project and quality of construction is determined by initiatives taken by the developer to enhance the customer footfall. Some of these initiatives include tying-up with reputed anchor tenants, ensuring good tenant-mix to attract wider customer base, provision of adequate parking facility, tie-up with entertainment and food service providers and organizing promotional activities on a regular basis. Further as in case of commercial projects, ICRA Indonesia studies the lease agreements to assess the term of lease, lock-in period, renewal term, escalation clause and termination clauses. The quality of tenant profile, primarily anchor tenant and other major occupants, and leased space and rentals contracted with them is also taken into account.

Legal and Regulatory Compliance

In assessing a real estate company's adherence to the relevant legal and regulatory compliance, ICRA Indonesia looks at various aspects, including: authenticity of title (external legal opinion is sought on this, if required); and status of title (whether clear and without encumbrance). High importance is given to the status of regulatory approvals (building plan permit, environmental clearance, airport authority approval, fire approval, etc.) for the on-going projects as often delays in obtaining the requisite approvals/sanctions results in project execution delay. Further, the sale agreement between the developer and the buyer is also examined, especially the clauses relating to commitment on delivery (time), penalty in case of delay, transfer of title, schedule of payment, and management of property.

Land bank

Other than the on-going projects, ICRA Indonesia also assesses the quality of the land bank that is available with the company for future development. The key parameters considered include the location of the land bank i.e. its proximity to the city centre, availability of the infrastructure in the surrounding area, zoning of the land bank (i.e. agricultural or developable) and status of the approvals for the development. Further, the assessment of land bank is done on the basis of its ownership:

> *i) Land owned by the company itself and through its subsidiaries* – examined for clear title of land.
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> *ii) Land for which joint development agreement has been entered* – examine the agreement between the landowner and the developer and the irrevocable power of attorney granted by the former to the latter.
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> *iii) Land which is partly paid and where the memorandum of understanding or agreement to sell has been made* - the capability of the company to pay the balance payments for acquiring the land is taken into consideration.

ICRA Indonesia, thus, evaluates the land policy with regard to investment in land bank or development of the property for future growth. This also measures the development potential, financial flexibility as well as commitments emanating from the land bank. Other factors which carry importance while assessing the land bank is its cost as the developers who would have acquired land at relatively lower costs will have higher flexibility in pricing the final products.

Financial Profile and Cash Flow Adequacy

The financial risk analysis of a real estate company involves analysis of the following:

1. Profitability and Sustainability of Cash Flows
2. Leverage and Capital Structure
3. Liquidity and Financial Flexibility
4. Adequacy of Future Cash Flows

Profitability and Sustainability of Cash Flows*:* In assessing sustainability of cash flows and profitability of operations of a real estate company, ICRA Indonesia looks at various aspects, including diversity of revenue streams, scope for revenue growth and operational efficiency. A company that has revenues coming in from diverse projects in terms of location, type and price points may be expected to have relatively sustainable and smoother cash flows. Confirmed revenue streams in the form of lease rentals and management income from commercial projects provides steady source of cash flows. As for revenue growth potential, the factors assessed include the number of ongoing and planned projects, the area already sold out, expected realisations and the expected appreciation in property prices along with the market risks involved. Profitability is assessed in the light of the real estate company‘s cost of operations, land cost, brand equity, and the expected realisation.

Leverage and Capital Structure: A real estate company usually requires capital in large tranches both before and during every stage of development. Usually, this capital requirement is met largely by a mix of debt and equity. While evaluating a real estate company‘s capital structure, ICRA Indonesia assesses whether the company‘s debt-equity ratio is in line with the underlying business risks and with that of other companies of similar size and with similar project portfolios. ICRA Indonesia analyses the adequacy of the debt coverage ratios and the matching of the company‘s future cash flows (under various sensitivity scenarios) with its debt servicing obligations.

Liquidity and Financial Flexibility: The company‘s financial flexibility --as reflected by it unutilized bank/credit limits, liquid investments, and the nature of its relationship with banks, financial institutions and other intermediaries-- is assessed. One of the most important criteria for assessing the credit quality of a real estate company is its liquidity position, given that its assets would consist mainly of land and property, both developed and under construction. In a scenario of buoyant market, the liquidity position of a real estate company tends to be good as the volume of transactions higher; however in a subdued market, the reverse holds true. Though unencumbered land base also provides financial flexibility, however based on experience, in ICRA Indonesia‘s opinion in adverse circumstances sale of land can be a difficult and a lengthy process. Besides, the committed land payments towards partly paid land could be a drag to liquidity. A real estate company usually collects upfront advances from the customers which provide liquidity over short to medium term. ICRA Indonesia evaluates the level of dependence on advances from customers and its management in an escrowed manner. In case of ongoing commercial projects, the extent to which debt and equity tie-up in place vis-a-vis the total capital expenditure is determined. ICRA Indonesia, in addition to all these factors, also considers the fund raising capability of the company being rated by assessing its access to the capital markets and banks.

Adequacy of Future Cash Flows: Since the prime objective of the rating exercise is to assess the adequacy of the company‘s debt servicing capability, ICRA Indonesia draws up projections on the likely financial position of the company under various scenarios. These projections are based on the expected operating and financial performance of the company, ICRA Indonesia‘s outlook on the real estate industry, and the company‘s medium/long-term development plans. Sensitivity tests are also performed on certain key drivers, such as selling prices/rentals, bookings/occupancy, and construction schedule. Also of particular importance are the projected capital expenditure and debt repayment obligations of the company over the projection horizon.

Some of the other aspects that are analysed include the following:

- **Cash flow analysis:** Cash is required to service obligations. Cash flows reflect the sources from which cash is generated and its deployment. Analysed here are trends in company‘s Funds Flow from Operations (FFO) after adjusting for working capital changes, the Retained Cash Flows and Free Cash Flows after meeting debt repayments and capital expenditure needs. The cash flow analysis also enables an understanding of the external funding requirement that a company has, to meet its maturing obligations.

- **Tenure mismatches, and risks relating to interest rates and refinancing:** Large dependence on short-term borrowings to fund-long term investments can expose a company to significant re-financing risks, especially during periods of tight liquidity. The existence of adequate buffers of liquid assets/bank lines to meet short-term obligations is viewed positively. Similarly, the extent to which a company would be impacted by movements in interest rates is also evaluated.

- **Accounting quality:** Here, the Accounting Policies, Notes to Accounts, and Auditor‘s Comments are reviewed. Any deviation from the Generally Accepted Accounting Practices is noted and the financial statements of the company are adjusted to reflect the impact of such deviations. A real estate company which follows consistent, transparent and conservative policy on financial accounting is viewed more favourably. Typically, the revenue recognition method followed by the real estate companies varies as there are many variations in real estate sales transactions. ICRA Indonesia notes the revenue recognition method followed by the company with respect to Indonesian General Accepted Accounting Standard (PSAK).

- **Consolidated financials:** Real estate firms usually operate with a host of subsidiaries who acquire the land, etc. Many times, projects are also developed in subsidiaries and the financial arrangements are done at the subsidiary level. Hence ICRA Indonesia in its analysis also looks at company‘s financial credentials on a consolidated basis to assess the group risk. Sensitivities are also carried out to assess the impact of any contingent liability on the risk profile of the developer.

- **Working capital intensity:** The analysis here evaluates the trends in the company‘s key working capital Indicators like Receivables, Inventory and Creditors, again with respect to industry peers. Collection efficiency is also evaluated with respect to receivables and advances from customers.

- **Contingent liabilities/Off-balance sheet exposures:** In this case, the likelihood of devolvement of contingent liabilities/off-balance sheet exposures and the financial implications of the same are evaluated.

- **Debt servicing track record:** The debt servicing track record of a company is an important input for a credit rating exercise. Any delays or defaults in the past in the repayment of principal and/or interest payments reduce the comfort level with respect to the contractor‘s future debt servicing capability and willingness.

Management Quality

All debt ratings necessarily incorporate an assessment of the quality of the company‘s management, as well as the strengths/weaknesses arising from the company‘s being a part of its “group”. Usually, a detailed discussion is held with the management of the company to understand its business objectives, plans and strategies, and views on past performance, besides the outlook on the company‘s industry. Some of the other points assessed are:

- Experience of the promoter/management in the line of business concerned
- Commitment of the promoter/management to the line of business concerned
- Attitude of the promoter/management to risk taking and containment
- The company‘s policies on leveraging, interest risks and currency risks
- The company‘s plans on new projects, land acquisitions, diversification etc.
- Strength of the other companies belonging to the same group as the company
- The ability and willingness of the group to support the company through measures such as capital infusion, if required
- The possible need to support other group entities, in case the company is among the stronger entities within the group.

Summing up

ICRA Indonesia‘s credit ratings are a symbolic representation of its opinion on the relative credit risk associated with the instrument being rated. This opinion is arrived at following a detailed evaluation of the issuer‘s business and financial risks, its management, its competitive strengths, its likely cash flows over the life of the instrument being rated, and the adequacy of such cash flows vis-à-vis its debt servicing obligations.

*Adopted and modified from ICRA Limited’s Rating Methodology for Real Estate Companies