



Lease Rental Discounting (LRD)

PREAMBLE

The increasing prices of real estate and a propensity towards maintaining asset-light business models have been the twin drivers of preference for 'leased' real estate properties as opposed to outright purchase of properties. The trend is more pronounced, especially in certain sectors like Organised Retail, IT & IT-enabled services. The lease option converts 'capex' into 'opex', thereby obviating the need for raising long-term resources to support the growth plans of the corporates. The realtors, especially those operating in the malls and office space segment, have also reoriented their business models to meet the changing requirements of their clients. From the realtor's (lessor or asset owner) standpoint, a sale results in a one-time cash flow, whereas a lease model results in a stream of lease rental inflows, and the realtor gets to capture the capital appreciation (upside), especially in a rising real estate market.

Usually, the process starts with the real estate developer availing a construction loan to develop a property. While the construction is still in progress, the developer initiates talks with potential lessees for the property. Once the property is ready for possession, the construction loan is replaced by a lease rental discounting loan (LRD Loan) based on the agreements signed with the lessees. After adjusting the LRD loan against the outstanding construction loan, any surplus is available to the realtor for investment in his other ventures. The LRD transactions usually have an escrow mechanism under which rental inflows are required to be deposited in a designated account, and the debt obligations are recovered from the said account after allowing permissible debits like property taxes/ operating expenses, as per the agreed arrangement. Thus, from a credit monitoring standpoint, the LRD structures are far more amenable to monitoring by the lender vis-à-vis other credit facilities. The lending banker is usually secured by the hypothecation of the underlying rent receivables and mortgage of the property.

Against the above backdrop, the rating methodology for evaluating LRD based structures should factor these above nuances which differentiate these structures from plain vanilla balance sheet-based loan products. Acuite believes that the following factors need to be considered while rating an LRD transaction:

I. BUSINESS RISK ASSESSMENT

A. Counterparty Risk:

The profile of the lessees (counterparties) is a key factor to be considered in any LRD structure. The higher the credit quality of the counterparty, the lower is the risk (Probability of Default) to the lender. The assessment of counterparty profile is relatively straightforward in case of a single lessee situation; however in case of multiple lessees (i.e., in case of malls/ large commercial complexes), the assessment becomes slightly complex. In case of a mall, typically there would be 3-4 anchor clients, such as a multiplex, reputed multi-brand retail players, etc., generally, provide long-term stability to the rental stream. Due to their large area requirements and their ability to attract large client footfalls, these anchors enjoy concessional pricing vis-à-vis the other multiple smaller lessees occupying smaller areas. The anchor clients are relatively stable vis-à-vis smaller lessees who may witness a churn

based on market-wide and unit-specific factors. In a multiple lessee situation, the top 5/10 clients (in terms of revenues) can be evaluated to gauge the overall clientele profile and also the extent of client concentration risk. While excessive dependence on 2-3 clients for rental revenues may be perceived to be risky, it has to be evaluated from the credit profile of these clients and the expected stability of the revenues from these clients.

B. Revenue Stability, Early Exit Risk and Renegotiation Risk:

From a lending perspective, the steady revenue stream associated with the LRD transactions differentiates them from other project-based term loans. In order to assess the revenue stability, Acuite seeks details of the agreement with existing clients, such as start date and end date of the lease agreement, area occupied, rental to be paid, security deposit, step-up provisions, etc. Usually, the lease agreements for retail space are initially entered for tenures from 3-5 years with renewal clauses. The revenue stability could be impacted on account factors like non-renewal of agreements, sharp decline in the credit quality of existing clients and unanticipated early exits. All lease agreements usually have clauses which stipulate an initial lock-in and early exit clauses which provide the lessee to seek an exit prior to the expiry of the regular lease term. Since early exits cause a disruption in the revenue streams of the lessor, as a partial risk mitigation, the lessees are required to pay rentals for three months/ six months in case they exercise this option. The security deposits placed by the lessees can also be adjusted against such payments. The key risk to the lessor (borrower) in case of early exits by an existing lessee is of identifying a suitable alternative lessee to minimise the impact on revenue streams. These risks are accentuated in an economic downturn when more clients may opt for early exits due to challenging business conditions, and it may be difficult to find alternative lessees, thereby impacting the overall occupancy levels of the property.

From an analytical standpoint, the aspects to be evaluated are, length of association of the lessee, the extent of lessee's investment in fit-outs/ infrastructure at the said property, and the criticality of the said operation to the overall operations of the lessee. Generally, the longer the association, the lower are the chances of early exit by the lessees. Similarly, a significant investment in fit-outs and infrastructure by the lessee will act as a deterrent to early exits. The nature of operations carried out at the leased facility also has a bearing on the decision to seek an early exit. For instance, in case of a highly profitable branch of a retail jeweller or a bank or a branch office of an IT company with a large headcount of highly skilled personnel working out of that office, any change in location could be disruptive to the lessee's operations.

C. Demand Supply Dynamics and Location:

The demand-supply dynamics of the real estate market depend on several factors like level of economic activity in the region, retail spending patterns, current projects in the pipeline, and government policies. Again, within real estate, the dynamics of the retail segment will diverge from the demand for office space. For retail space, the location of a property is a critical factor influencing its revenue profile and ability to maintain optimal occupancy levels. A mall in a central location of a city with developed infrastructure like adequate parking spaces and well connected to

surrounding residential localities will be an attractive option for the retailers. Such a mall may, in fact, command a premium in its rentals in view of the high footfall expectancy and large catchment area in the initial stages of development of the city/ town. However, with the gradual development of the city/ metro in its satellite regions and across the periphery, these properties will face competition from newer properties. In case of office space, key factors influencing demand are connectivity, availability of supporting infrastructure like parking spaces, proximity to government offices and banks, proximity to clients and suppliers, etc. Shifts in pockets of economic and commercial activity could impact the demand for office space in any given region. The demand supply dynamics could also be influenced by a slowdown in the level of economic activity, which could result in lower demand for office space, forcing corporates to go in for rationalisation of headcount, shifting to low-cost locations, outsourcing or streamlining processes by bringing them under one location, etc. A thumb rule to assess the location advantage and demand supply dynamics of the property would be to assess the extent of churn in the clientele and the average occupancy levels over the past 2-3 years.

Acuité notes that technological advancements and the increasing trend of online models both in B2B and B2C segments have made it easy for companies to operate with smaller-sized offices, especially those companies embracing new age practices like flexi-timings and Work From Home (WFH). This trend is expected to result in more 'location agnostic' business models, thereby optimising the overheads.

II. FINANCIAL RISK PROFILE

DEBT SERVICE COVERAGE RATIO (DSCR)

In a standalone LRD-based structure, the inflows will be from lease rentals and recovery of CAM (Common Area Maintenance charges) from clients. The outflows will comprise operating expenses (maintenance and electricity overheads, salaries of operating staff etc.) and interest costs on the LRD loan. Since most of the operating expenses are borne by clients (lessees), the EBITDA margins in an LRD structure are high.

As in case of real estate projects, cash flow-based approach based on comparison of cash inflows (net rentals and allied inflows like parking charges, CAM recoveries) with cash outflows (operating expenses, interest costs and principal repayment obligations) is more appropriate while arriving at the DSCR metric (instead of the P&L approach). In view of the steady cash flows and the escrow mechanism in place, a lower DSCR is acceptable in LRD-based structures.

In case where the borrower has other project-related debt besides the LRD debt, it would be appropriate to calculate the DSCR both at the company level and for the LRD, for a holistic analysis. In such cases, Acuité does not make any distinction between the LRD & Non-LRD debt from a rating perspective. The understanding is that any delays/ delinquencies on non-LRD debt, if not cured in time, could trigger an action from those lenders, impeding the smooth functioning of operations, which in turn could affect the timely servicing of the LRD debt.

Presence of DSRA Mechanism

In certain LRD-based transactions, Debt Service Reserve Account is stipulated which could be a fixed deposit on which the lender has a lien. Typically, it would be comprising debt servicing obligations for a period of say 1-3 months. The DSRA serves as a liquidity buffer. In the event of a shortfall in inflows due to factors like delays in rental payment by some of the lessees, the bank can utilise the amount under DSRA for making good the shortfall in debt servicing obligations. Subsequently, the DSRA will have to be replenished. The presence of a DSRA is a strong positive from a rating standpoint, especially if the DSCR metrics are near unity.

Financial Discipline & Alignment of Repayment

Acuité has observed that despite a moderate to healthy tenant profile, there have been instances of delays observed with Lease Rental backed debt. These delays have largely been attributable to a lack of discipline and/ or limited time cushion between the collection of rentals and the debit of repayment obligations. It is therefore critical to observe the time gap between the collection of rentals and the schedule of debt repayment. An adequate time gap between the collection of rental collection and repayment provides a cushion against minor delays that may occur in the collection of lease rentals.

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