CRISIL Ratings

CRISIL Ratings criteria for REITs and InvITs

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Criteria contacts

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

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

Chaitali Nehulkar
Director
Rating Criteria and Product Development
chaitali.nehulkar@crisil.com

Vanshika Agarwal
Rating Analyst
Rating Criteria and Product Development
vanshika.agarwal@crisil.com

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

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Executive summary

An investment trust is a vehicle created to primarily invest in revenue-generating real estate or infrastructure assets. These entities are 'trusts' by definition, and their 'units' (shares), after the initial offer, are to be listed on exchanges (except for privately placed ones) and regulated by the Securities and Exchange Board of India (SEBI). The units are traded based on their net asset value. These entities have a pass-through structure and are therefore required to distribute most of their earnings to unit holders. As per SEBI's regulatory requirement, if the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, a credit rating must be obtained from a registered credit rating agency for any further borrowing.

Given the regulatory oversight of these entities (*refer to Box 1*), investment trusts have a number of structural aspects that are credit positive when compared with direct credit to real estate and infrastructure assets. These structural aspects include limits on investment in under-construction assets, cap on aggregate gearing, listing requirements, ensuring minimum sponsor holding in the investment trust, ensuring minimum controlling stake in the special purpose vehicle (SPV), independent valuation of the assets, trustee-monitored transparency, and compliance and disclosure requirements. Investment trusts also have flexibility in holding the assets either directly or through an SPV or an intermediate holding company, though investment through an SPV has been observed to be the preferred option.

For rating the debt raised by investment trusts and the SPVs which are a part of the trust, CRISIL Ratings assesses the quality of the trust's asset portfolio, the extent of cash flow coverage, impact of cash flow subordination, diversification benefits, leverage, financial flexibility, and management risks.

Scope

This article[1] deals with CRISIL Ratings' methodology for rating debt in investment trusts and in its underlying SPVs. The rating is an opinion on the ability of the trust and its underlying SPVs to make timely payment on its debt obligations. CRISIL Ratings does not rate the units of these trusts. The units are akin to shares of a company and derive their value from the value of underlying assets. Given that units of investment trusts are like equity, CRISIL Ratings does not rate these units on a credit rating scale.

Salient features of investment trusts

SEBI notified regulations for investment trusts on September 26, 2014 – specifically, real estate investment trusts (REITs) and infrastructure investment trusts (InvITs) – which have undergone modification since then. The objective of REITs and InvITs is to enable sponsors to monetise revenue-generating real estate and infrastructure assets while providing an avenue to investors or unit holders to invest in these assets without actually owning them. REITs and InvITs enjoy favourable tax treatment, including exemption from dividend distribution tax. Figure 1 depicts the indicative structure of a REIT or InvIT. The key structural and regulatory aspects of REITs and InvITs, as per SEBI guidelines, are outlined in Box 1.

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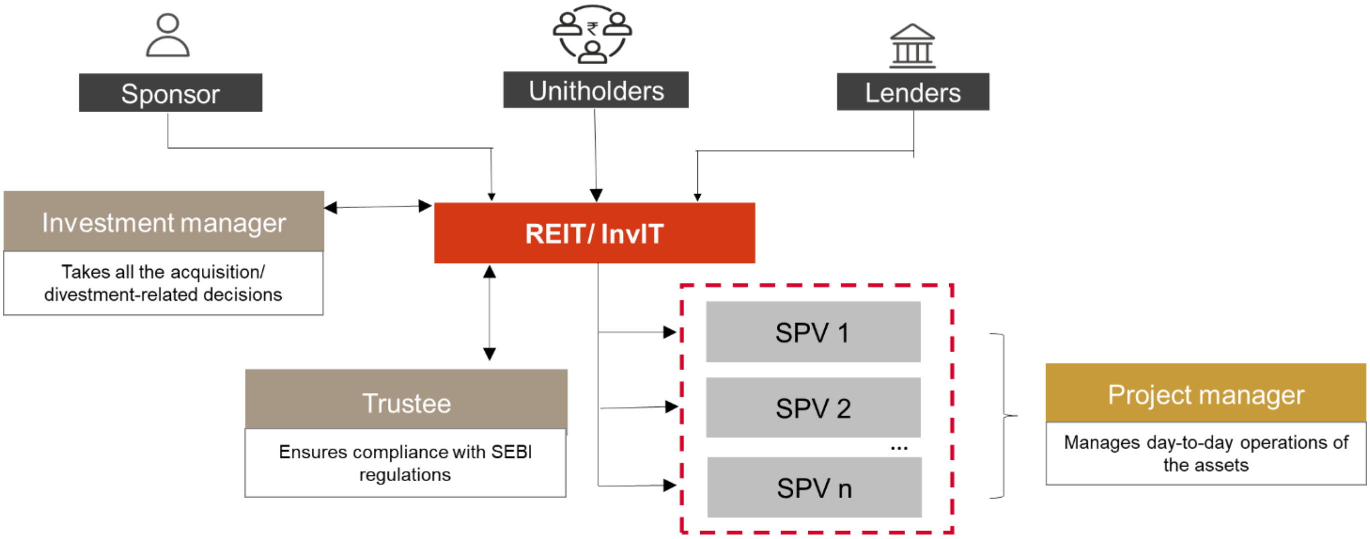
[1] *Link to previous criteria: https://www.crisilratings.com/content/dam/crisil/criteria_methodology/criteria-research/archive/crisils-rating-criteria-for-reits-and-invits-aug2022.pdf*

Figure 1: Indicative[2] structure of investment trust



Box 1: Salient features of SEBI guidelines on REITs and InvITs

Guidelines for listed REITs and InvITs

A. Structure of investment trust

- Investment trusts are to hold assets either directly or through SPVs. Trusts can invest in two-level SPV structures through a holding company (holdco), subject to mandatory guidelines on distribution of cash.
- There is a mandatory sponsor holding of not less than 25% of the total units of the REIT after initial offer on a post-issue basis (the minimum sponsor holding specified in this clause shall be held for a period of at least three years from the date of listing of such units). In the case of InvITs, mandatory sponsor holding is 15% for a period of at least three years from the date of listing of such units.
- REITs can invest up to 20% in under-construction assets, while public listed InvITs can invest up to 10% in under-construction assets. Private listed and unlisted trusts are found to have flexibility in terms of investment allowed in under-construction projects. However, they tend to predefine their strategy to help stakeholders calibrate their investment decision.
- Investment trusts are to hold controlling interest and not less than 50% equity share capital or interest in the SPVs (except in the case of public-private partnership projects where such holding is disallowed by the government or regulatory provisions)
- SPVs are to hold not less than 80% of assets (90% in case of InvITs) directly in properties (infrastructure projects for InvITs).

[2] *Sponsor holding mentioned above is indicative*

- SPVs should not engage in any activities other than those pertaining and incidental to the underlying projects

B. Stipulations to ensure transparency

- A full valuation shall be conducted by an independent valuer not less than once in every financial year; a half yearly valuation of the assets shall be conducted by the valuer for the half-year ending September 30 for incorporating any key changes in the previous six months

C. Distribution requirements

- Not less than 90% of net distributable cash flow of the SPV is to be disbursed to the investment trust in proportion to its holding in the SPV subject to applicable provisions in the Companies Act, 2013, or the Limited Liability Partnership Act, 2008
- Not less than 90% of net distributable cash flow of the investment trust is to be distributed to unit holders

D. Leverage restrictions

- The aggregate consolidated borrowing and deferred payment of the investment trust net of cash and cash equivalents is typically restricted to 49% of the value of the investment trust assets
- InvITs are allowed to increase their leverage from 49% to 70% if they satisfy the following conditions:
  - Approval from unit holders
  - Credit rating of ‘AAA’ post increasing leverage to 70%
  - Minimum track record of six continuous distributions
  - Capital released is used in acquiring new infrastructure assets
- If the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, for any further borrowing, a credit rating is to be obtained from a registered credit rating agency

E. Responsibilities of the Investment Manager

The investment manager is basically responsible for:

- Undertaking investment and financing decisions on behalf of the InvIT
- Oversee activities of the project manager with respect to compliance with SEBI regulations and project management agreement
- In consultation with trustee, appoint the valuer, auditor, registrar, etc and other required entities
- Ensure transparency to the unit holders, board, trustee, and stock exchanges in all assets related decisions
- Undertaking or initiating activities related to the general functioning of the InvIT (such as unitholder meetings, unitholder grievance remedy, issuance of capital by an InvIT)

F. Responsibilities of Sponsor

- Sponsor sets up the InvIT/ REIT and appoints the trustee of the trust
- Shall transfer all the shareholding of the underlying SPVs to the trust prior to the allotment of units of REIT/InvIT except for the minimum investment requirement by sponsor as per applicable guidelines.

CRISIL Ratings' methodology for rating investment trusts

The investment trusts have been constituted to attract retail investors, and other investors who typically expect a high cash flow yield. To cater to the investor needs, investment trusts distribute most of the cash flows generated from the underlying real estate or infrastructure assets. Therefore, while the principles of rating debt in investment trusts are essentially similar to those in corporates, special focus is on the quality of underlying assets and cash flow coverage.

While the rating approach broadly remains the same for both REITs and InvITs, CRISIL Ratings will assess the credit risk profile of the underlying assets by applying specific criteria relevant to real estate and infrastructure respectively. For instance, to evaluate the transmission assets, CRISIL Ratings shall apply the “Criteria for Rating Power transmission projects”, and for roads it shall be “Rating Criteria for Toll Road Projects”.

Credit risk profile: Investment trusts vis-à-vis SPVs

Debt can be raised by both the investment trust and the underlying SPVs. The credit risk profile of the debt residing in the SPVs can be different from that in the investment trust.

- **Credit risk profile - investment trusts:** This is generally derived from the aggregate credit risk profiles of the trust and the SPVs.

  CRISIL Ratings consolidates the financials of all SPVs and the trust[3] and arrives at the rating for consolidated group. In most cases, the SPV rating is equated to the rating of this consolidated group on account of -

  – Operation of REIT/InvIT as a group that exercises cash flow fungibility and articulates support for debt servicing for various SPVs, if required

  – Common management in the form of investment manager, taking strategic decisions for the entire group

  – Debt covenants around consolidated entity, presence of debt instruments specifying the cross-default clause

However, in a few cases, depending on the relative cash flow subordination/prioritisation within the group, SPV rating might be differentiated from the rating of the trust. CRISIL Ratings will assess the overall debt levels, the debt split between the trust and the SPV level and presence of restrictive covenants, if any, to arrive at the final rating. In

[3] *The approach is similar to that of the homogeneous groups*

case of presence of significant restrictive covenants, the diversification benefits may be limited and will reflect in the rating.

- **Credit risk profile – SPVs:** Credit profile of the SPVs will depend on the available cash flow coverage in the SPVs as well as at the consolidated level. As stated earlier, in the case of full cash flow fungibility, the rating of the SPVs will generally be similar to the trust rating. However, in case of restricted cashflows, the ratings on the SPVs and the trust could differ.

Overall Risk Assessment Framework:

For rating debt in investment trusts, CRISIL Ratings focuses on the following aspects:

- **Quality of asset portfolio or business risk profile:** Quality of assets determines the quality of underlying cash flows and is, therefore, the key determinant of the trust's business risk profile.

- **Coverage, leverage, and liquidity**: CRISIL Ratings evaluates the debt service coverage ratio for the debt, both at the consolidated trust level and at the SPVs based on the cash flows generated from the underlying assets. Typically, there is fungibility of cash flows amongst the trust and the SPV and hence CRISIL Ratings uses consolidated DSCR approach. However, the individual SPV DSCRs and debt covenants are also analysed to assess the impact of cashflow prioritization.

  Leverage is assessed by looking at total outstanding debt against asset value / cash flow potential. The same is also evaluated in relation to the underlying asset class and therefore the volatility associated with the cash flows from the asset. Any headroom available will indicate financial flexibility for the group.

  For liquidity analysis of REITs and InvITs, the availability of DSRA and its sufficiency to cover seasonality/ counterparty delays/ cyclicality is assessed. Adequacy/provision for maintenance is also looked at.

- **Counterparty risk:** In case of an asset class that involves counterparties, CRISIL Ratings assesses the credit profile of the counterparty and its payment track record. The presence of offsets, if any, in the form of liquidity buffers to counter any delay in payments are also factored into the assessment.

- **Refinancing risk:** At times REIT/InvIT or the underlying SPVs raise debt of lower tenure (say, 3-5 years) when compared to the underlying asset life of over 20 years or more. This results in significant refinancing risk. Given the long asset life of most of the underlying assets, refinancing is generally possible. The ability to refinance is assessed by taking into account the strength of the future cash flows to support the debt. In addition, CRISIL Ratings understands the refinance plan from the management. The refinancing plan is required to be credible and one that enables the issuer to meet the obligations well in time. The plan is tracked closely for the timely progress and adherence to the same. Failure to demonstrate a credible refinancing plan as one moves closer to the bond/term debt maturity could lead to downside rating pressure. In such a situation, CRISIL Ratings may take appropriate rating action.

- **Management risk:** Investment manager takes strategic decisions in terms of asset acquisition, divestment of assets, determines policies around leverage levels and oversees activities of project manager with respect to operation of assets etc. CRISIL Ratings therefore evaluates the investment manager based on 3 major parameters: integrity, competence, and risk appetite. CRISIL Ratings also evaluates sponsor in case sponsor's expertise is being leveraged in managing the REIT/InvIT.

- **Project risk** is evaluated basis the asset specific criteria.
- **Diversification benefit** accrues in case of presence of multiple assets / asset classes where their performance has low correlation and there exists fungibility of cash flows amongst these assets. Such a benefit, if it exists, enhances the combined credit profile of the REIT/InvIT.

Conclusion

REITs and InvITs are vehicles that invest primarily in real estate and infrastructure assets, respectively. CRISIL Ratings rates the debt raised by investment trusts based on the quality of the underlying assets, debt coverage, leverage, liquidity, diversification benefit, refinancing risk and management expertise. Generally, consolidation approach is used to rate the REIT/InvIT as a whole and ratings of all SPVs are equated to the rating of the consolidated entity. However, presence of cash flow subordination/prioritization, if any, could lead to SPV rating being different from the rating of the consolidated group.

About CRISIL Ratings Limited (A subsidiary of CRISIL Limited)

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).

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For more information, visit www.crisilratings.com

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