Turning Dust to Gold

Developers have hit the IPO market with a vengeance, offering equity worth some Rs 15,000 crore. Not all stocks will be winners.

Parsvnath's Jain: The company's IPO was oversubscribed nearly 62 times

When I started out 23 years ago, I did not know anything about capital markets," says Pradeep Jain, 41, Chairman, Parsvnath Developers. Jain can no longer claim the same ignorance. His company raised Rs 1,000 crore from the equity markets in November, getting over-subscribed nearly 62 times. Jain, a devout Sai Baba follower-the caller tune on his mobile is a hymn in the praise of Baba-is more than happy. "I had expected a very good response, but this is phenomenal. The market has given far more than my expectations."

Happily for Jain, the market is in a mood to give and give by the fistful to any real estate company. It is the India story again. And catching this trend, a clutch of companies is formulating plans to raise funds for their expansion plans through the capital markets (see The IPO Bandwagon). This slew of offerings is expected to improve the market capitalisation of the sector on the Indian exchanges. At present, real estate market capitalisation in India is far lower than those in comparable economies. Although real estate accounts for 5-6 per cent of India's gross domestic product, it contributes only around 1 per cent to India's stock market capitalisation. Contrast this with Hong Kong and Singapore where real estate market capitalisation to total market capitalisation is as high as 10 and 12 per cent.

Reasons are not far to seek. Until recently, large developers chose to remain unlisted and the listed companies had low free floats. And the sector and the handful listed stocks remained ignored. Regulatory changes over the last two years, however, have transformed the scenario. Listed stocks zoomed to stratospheric levels. Unitech, for example, rose a dizzy 2,000 per cent in market capitalisation in the first six months of the current financial alone when compared to the same period last year.

INDIAN REALTY ON AIM
London's stock exchange for small companies takes a fancy to Indian developers.

Ishaan Real Estate, a real estate company incorporated independently in the isle of Man, raised £207 million (inclusive of greenshoe option) by listing on London's Alternative Investment Market (AIM) last fortnight. The funds were raised through a book-built issue, which was open only to institutional investors. Fidelity, Henderson, Templeton and Alliance were among those who invested in Ishaan. Post-listing, however, retail investors too can trade in the shares.

What does Ishaan do? It is focussed on real estate investments in India, and more than two-thirds of the money raised will go towards buying 40 per cent stakes in eight identified properties being built by Mumbai-based K. Raheja Corp. in south and west India to build an initial investment portfolio. Initially, the remaining stakes in these eight special purpose vehicles will be retained by K. Raheja Corp., and a company managed by Ravi and Neel Raheja will provide investment advice to Ishaan. The rest of the IPO proceeds would be invested in other projects over the next 12-18 months. Ishaan, which is aiming at a 20 per cent IRR, is exploring a unique structure since it aims to provide capital appreciation of its portfolio as an upside to its investors. In line with foreign investment regulations in Indian realty, Ishaan's portfolio will consist of green field projects, which will start yielding returns only after a period of three to seven years. At that point, dividends could be distributed or reinvested in more real estate.

What about Valuations?

That brings up the essential questions about valuations of these companies. As more companies go public, analysts and investors are debating the merits of valuing them either on net asset value or price-to-earnings basis. However, more of the analysts seem to be gravitating towards the NAV-based valuation. Any metric to value real estate companies would be based on land bank values and the final real estate product prices. And several factors ranging from government policies to economic growth and urbanisation could impact these final prices. The valuation process can further be refined based on whether the developer intends to sell the developed property or plans to hold it back for lease rentals.

In both cases, estimates of the final sale price or the rentals determine the value of the land. So, if there are flaws in determining demand, supply and price situation with regard to a specific property, the value of the land also gets similarly affected. The key, then, to valuations is the land bank and its proposed use by the developer. Given the hype about the sector, disclosures are far from what would be adequate. Macquarie Research in a recent report on the Indian property sector points out: "We have seen examples of land bank schedules in company presentations being what we would term 'highly optimistic'. It is essential to dig deeper via local inspections, discussions with agents and further consultation with management."

Taking a call on the price of a property that is to be developed so many years later is a tough one. As more developers intend to go public, details of their land bank are becoming available. Given the lack of sufficient stock in the market and the huge investor interest, Indian real estate stocks are trading at premium to their NAVs-a situation which is different from the overseas markets where realty stocks trade at a discount. "I don't understand these valuations. They seem to be slightly overstretched. Discount rates of 15 to 17 per cent on cash flows simply do not match the development risk that the investors are taking," says Landmark Holdings' Gaurav Dalmia.

Going Overseas

The overseas markets also have caught on. In a follow-up of Ishaan Real Estate Plc getting listed on Alternate Investment Market (aim) in London, several others are also planning to do the same. Not all believe aim to be a good long-term funding option. Companies planning to list on the exchange don't need to file financial reports with the exchange or regulators, as they would need to do in the us or India. This is in line with their smaller nature and growth potential of companies wanting to list there. There are no prerequisites of previous trading records or minimum market capitalisation. However, as Kishore Gotety of ICICI Ventures says, "Much will depend on the first few assets getting listed. These companies will have to deliver on the promises they are making."

Public equity may well be long-term capital, but on the flip side, it puts pressure on quarterly earnings, which is against the nature of the real estate business. But as the market gets used to real estate sector performance, valuations will refine themselves. Also, as the market progresses, new and innovative funding structures will emerge. Though India is yet to allow Real Estate Investment Trusts, some companies such as the Bangalore-based Embassy Group are believed to be exploring getting a REIT-like structure listed on the Singapore Stock Exchanges. Jitu Virwani, the founder and MD of Embassy Developers, which has over 11 million sq. ft under its fold, couldn't be reached for comment.

Meanwhile, India is likely to allow another listed instrument soon. The

Securities and Exchange Board of India (SEBI) is expected to come out with guidelines on Real Estate Mutual Funds by the end of the year. So, one way or another, capital will find its way into the market-as long as the sector continues to boom