Institutional Equity Research

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Real Estate Sector

The gloom after the boom!

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Sensex	16,371
Nifty	4,942

Real estate sector to slow down

In the past two weeks, we have visited three independent property consultants (IPCs), one real estate private equity fund and one international real estate bank in order to understand the current real estate scenario. The key takeaways from our meetings are as follows:

- The significant increase in property prices and rentals in the past two years is likely to slow down demand across regions.
- The incremental rise in property prices is higher than the hike in salaries. The average increase in salaries is approximately 20-25% Y-o-Y whereas the prices of property have increased by 40-50% Y-o-Y. Moreover, the increase in interest rates by 250 bps over the past four years has increased the EMIs manifold. Given the massive development plans of the listed and unlisted players, we believe a price correction of 15-20% could bring back the buyers who are adopting a wait-and-watch policy at present.
- Historically, the stock market and the real estate market have moved in tandem. Any decline in the capital markets percolates down to the real estate market with a lag of 1-2 months. With the recent decline in the stock market, more supply is expected from speculators and investors in the short term as they dispose off their properties in order to mitigate their capital market losses.
- The builders with massive development plans are likely to postpone their plans due to the slowdown in demand. This could lead to construction delays, which would increase the working capital requirements, stretch their balance sheets and affect their NAVs.
- A slowdown in demand for residential projects will also affect the developers who had relied on cash flows from residential projects and invested in malls, hotel projects and land acquisitions for high-end townships and second homes on the outskirts of metros.
- The significant increase in lease rentals, the current global meltdown and the non-extension of STPI benefits in the recent budget are likely to affect the demand in the commercial segment from the IT/ITES sector as IT companies will prefer relocation to SEZs whenever possible. The IT/ITES segment accounts for 70% of the total commercial demand. Moreover, a slowdown in the IT/ITES sector is expected to impact the residential demand in metros like Bangalore, Chennai and Pune.
- The real estate sector is expected to slow down in the short term due to a decrease in liquidity, an increase in funding spreads, the lack of exit routes for investors through REITs, IPOs or secondary sales and an increase in the costs of development.

Residential segment

Mumbai region: To an extent, Mumbai is protected from witnessing a sharp correction in the prices of property because the speculator/investor base in the city is smaller than in the other regions. Moreover, the migration of people from the other cities continues to propel demand. However, prices in Mumbai have increased manifold in the past two years and the demand is expected to slow down with falling affordability levels. The builders are already witnessing a slowdown in demand and are finding it difficult to sell at the current prices. This could result in a price correction in the suburbs, Thane and Navi Mumbai.

The smaller speculator/investor base in Mumbai compared to the other regions will protect from a sharp correction in prices

According to one of the consultants, in Central Mumbai, Rs 15,000- Rs 20,000 per sq ft should be an inflexion point. In the suburbs, the volumes have declined. The smaller developers may feel the heat resulting in a decline in prices.

The recent announcement by the state finance minister in the state budget to increase the FSI from 1 to 1.33 in Mumbai would not impact the supply much as the cap on FSI at 2 remains intact. The developers will benefit in areas where the premium to be paid to the government for the extra FSI is lower than the Transfer Development Rights (TDR) prices, as this would lower the TDR rates.

Other regions: Each major market has seen a price rise of 40-50% in the past two years. In Kolkata, prices have increased to Rs 4,000-5,000 per sq ft compared to Rs 2,000-3,000 per sq ft. Similarly, in Gurgaon, the prices have skyrocketed to Rs 10,000 per sq ft in some areas. With the capital markets correcting sharply and a global meltdown leading to a slowdown in the IT/ITES sector, the demand in the residential market is expected to come down across all the regions.

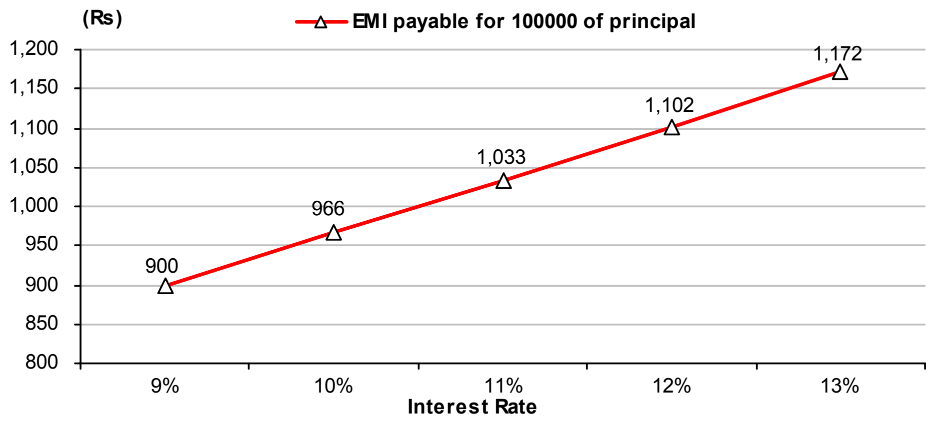
DLF has sold flats in Chennai at Rs 2,700 per sq ft, which is less than the existing price of Rs 4,000

In the NCR region, the demand could shift from Gurgaon to Faridabad as prices in the former are around Rs 4,500-10,000 per sq ft, whereas prices in Faridabad are around Rs 2,300-2,500 per sq ft.

Pune is the only region which is likely to be insulated from the slowdown due to its geographical aspects. As it is a circular region, major areas are equidistant from the centre of Pune. Over the past 2-3 years, with rising prices, the demand has shifted from crowded areas to the less-crowded ones.

In Chennai, we have already seen a price correction as DLF has sold flats at Rs 2,700 per sq ft, at less than the existing price of Rs 4,000.

Increase in EMI

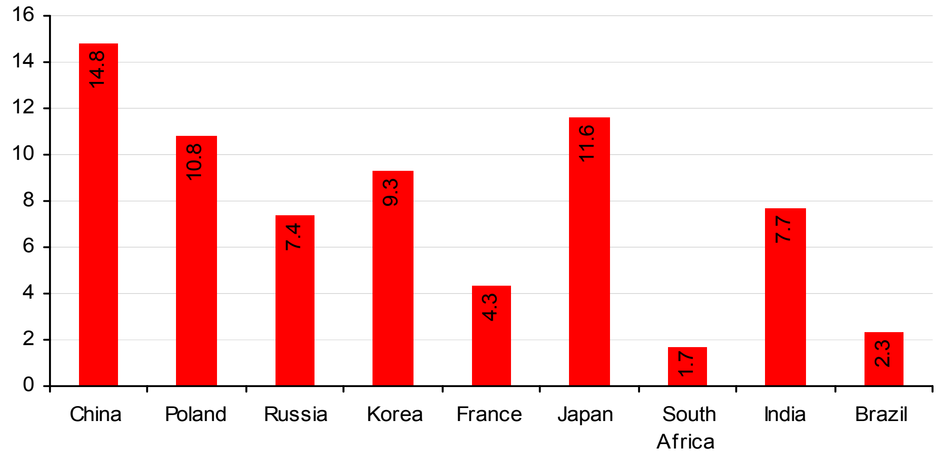


Source: Religare Research,
* We have assumed monthly rest and the tenure is 20 years

An increase of 1% in interest rates leads to an increase of 6-7% in EMI

We have computed the impact of a rise in interest rates on the housing loan amount. An increase of 1% in interest rates leads to an increase of 6-7% in EMI. For new houses, the rising interest rate reduces the maximum amount an individual can borrow and also reduces the ability to go for bigger houses.

Affordability Ratio



Source: Crisil Research, world Bank Report 2005

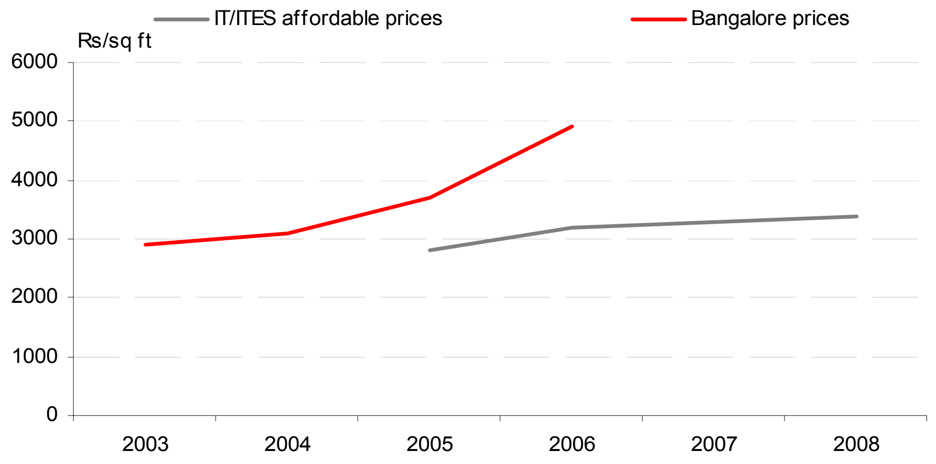
As per the World Bank report,the affordability ratio of 7.7 indicates that the Indian housing prices are unaffordable

According to the World Bank, the affordability ratio for India was 7.7 in 2005. The affordability ratio is defined as the ratio of median house prices to median incomes. Typically, an area is said to be affordable if the ratio is less than 3, moderately unaffordable if the ratio is between 3 and 4, and severely unaffordable if the ratio is greater than 4. Hence as per the World Bank report, the Indian housing prices are severely unaffordable.

According to the chart below, the prices in Bangalore have gone beyond the affordability of a typical IT/ITES sector employee. It shows that in Bangalore, even at the prevailing prices of 2006 and taking into account salary levels in 2008 for an employee, it is unaffordable to purchase a house.

Prices in Bangalore have gone beyond the affordability of a typical IT/ITES sector employee

Affordability Ratio



Source: Crisil Research

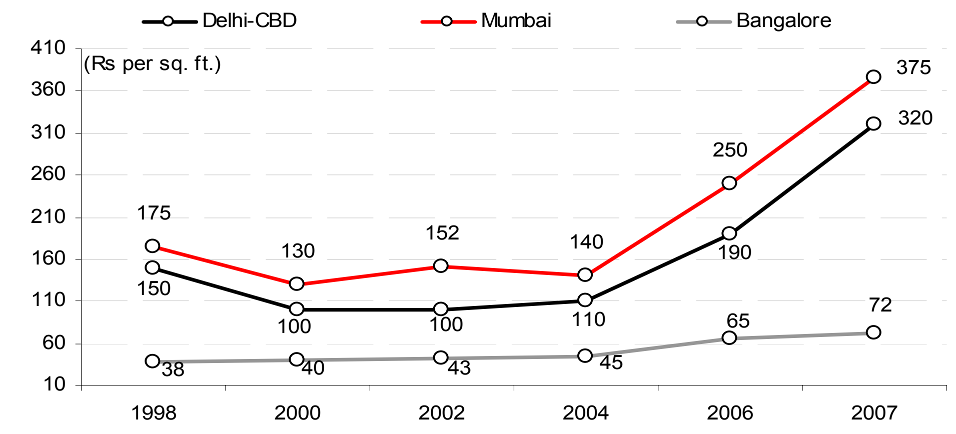
Commercial segment

70% of commercial demand comes from the IT/ITES sector

In the commercial segment, around 70% of the demand comes from the IT/ITES sector. The global meltdown and the lower-than-expected recruitments in the IT/ITES segment could result in a lower demand for the commercial space.

Moreover, the lease rentals have seen a sharp increase in the past 2-3 years across India. This, coupled with an increase in the salary levels, is affecting the profitability of many IT companies that are the major demand drivers of the commercial space. In order to curtail costs, many companies have started to shift to Tier II and Tier III cities.

Trends in Rentals



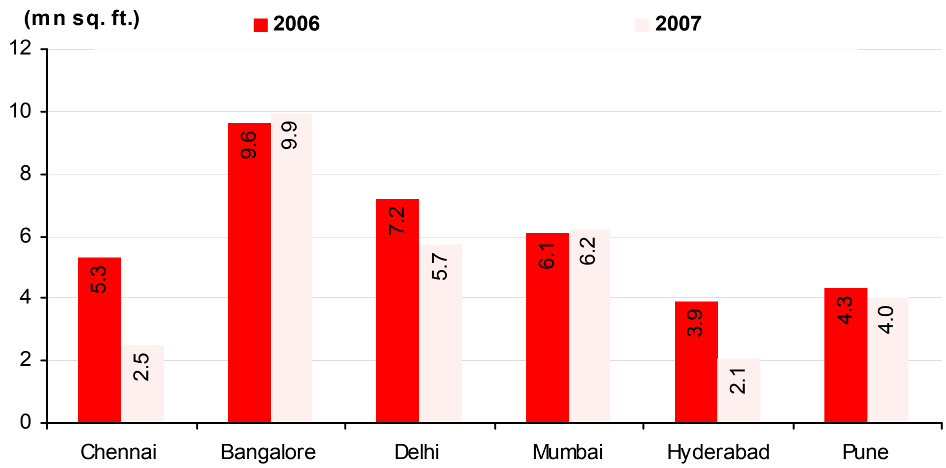
Source: DTZ

In the commercial space, the real estate developers have aggressive development plans in the next 3-4 years. Hence, an oversupply situation is expected in the market.

Greater the oversupply situation, the longer would be the absorption time frame

Greater the oversupply situation, the longer would be the absorption time frame. Also, in case of large projects (like SEZs), an oversupply will result in a longer gestation period. As can be seen from the chart below, the absorption levels have not increased much and have declined in some cities.

Absorption for Grade A Office Space



Source: DTZ

Demand for office space in Mumbai was around 6 mn sq ft in FY07

Atleast 25-30 mn sq ft of development of office space is planned in the next 3 years

Mumbai region: The demand for office space in Mumbai was around 6 mn sq ft in FY07. However, the total supply expected in the next three years in Mumbai is close to 25-30 mn sq ft. Assuming a 25% growth in demand, the supply is expected to exceed demand in the short to medium term. This could possibly result in a decline in lease rentals in the short to medium term.

One of the consultants opined that the lease rentals in the South Mumbai region are not sustainable at Rs 450-500 per sq ft and could decline by 25-30%.The lease rentals in Mumbai have appreciated sharply compared to the other regions. While, in Bangalore, the high-end area has a lease rental of Rs 70-90 per sq ft, in Gurgaon, the rentals are close to Rs 100 sq ft.

The recent auction of three plots - one commercial and two residential properties in the BKC - by MMRDA at Rs 13.22 bn is much lower than the Rs 27.9 bn the authority earned for a similar transaction three months ago. These are clear signs of a slowdown in the commercial segment in Mumbai.

The non-extension of STPI benefits beyond 2009 to result in lower demand for commercial property

Other regions: In the southern regions like Bangalore, Hyderabad and Chennai and in the NCR region, the demand is mainly from IT/ITES companies. However, the global meltdown and the non-extension of STPI benefits beyond 2009 could result in lower demand in the commercial property market. This will majorly impact the players planning to build IT Parks, since with no STPI benefits, the IT companies would shift to IT SEZs. However, as per the SEZ guidelines, the existing operations cannot be relocated to the SEZs.

Retail segment

There is a growing urgency among the real estate developers to venture into the retail segment. In certain towns, this could result in the clustering of retail space.

Typically, in a 500,000 sq ft mall, there are 1-2 anchor tenants occupying around 10-20% of the space, vanilla tenants occupying the 50-60% and the balance being occupied by cinemas and restaurants. Overall, there are only 8-10 anchor tenants and they are unlikely to absorb the entire new retail capacity coming up. A contract for a retail space is for 9 years with an escalation clause every three years.

A large part of the footfalls in the malls does not get converted into sales

With rentals increasing in certain areas and margins shrinking due to competition, the demand is expected to decline especially if sales are also affected by clustering. In the NCR region, this is evident where there are a high number of malls in a small area. The retail rentals have increased by 30% in the past two years. In order to absorb such high rentals, the retailers need to have higher sales. However, a large part of the footfalls in the malls does not get converted into sales. As per the recent press reports, at least two malls in the NCR region are being converted into office space. According to the report, the total malls expected to come up in the next two years are only a little over half of the earlier projected figure of 250.

Also, the anchor tenants and retail companies book space in the malls by paying a token deposit during the construction period. When the mall is ready, they may forego the token amount if the primary catchment is not developed over a certain period.

Before building a mall, there should be a detailed study conducted of the surrounding area and the affordability levels. Unless the mall developers get adequately educated in understanding the running of a successful mall, we expect to see malls remain empty (due to competition and lack of development in the adjoining area) or get converted into commercial spaces.

Conclusion

Overall, the property market's scenario is weak in all the major cities.

Prices and lease rentals could correct at least 15-20%. In the residential segment, buyers are adopting a wait-and-watch policy as they expect prices to fall.

The sector is expected to witness a slowdown due to the decrease in liquidity, an increase in funding spreads, the lack of exit routes for investors by way of REITs, IPOs or secondary sales and an increase in the development costs

However, currently the developers are in a comfortable position from revenues achieved in the recent past and fund-raising through private equity. They have a huge cash balance leading to better financial flexibility and are not keen to offload their inventory. We expect the situation to worsen six months down the line as the current inventory and the planned inventory build up. Alternatively, the developers will delay their execution plans and will not create a situation that will lead to oversupply.

With the majority of players, the REIT's listing got delayed. Now, the only route seems to be through private equity. However, as the market sentiment takes a further plunge, it would be difficult to get money through the private equity route due to the lack of exit routes.

A slowdown in the demand for residential projects will affect the developers who had relied on cash flows from residential projects and invested in malls, hotel projects and land acquisitions for high-end townships/second homes on the outskirts of metro markets.

The sector is expected to witness a slowdown in the short term due to the decrease in liquidity, an increase in funding spreads, the lack of exit routes for investors by way of REITs, IPOs or secondary sales and an increase in the development costs.

Rating definition

Buy	: > 15% returns relative to Sensex	**Accumulate**	: +5 to +15% returns relative to Sensex
Sell	: > (-)15% returns relative to Sensex	**Reduce**	: (-) 5 to (-) 15% returns relative to Sensex
Hold	: Upto + / (-) 5% returns relative to Sensex		

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