Real estate

Better late than never; switch to safer bets

Key points

- **Separating the wheat from the chaff:** Keeping the tough macro conditions in mind, we have analysed real estate companies on the parameters like debt-equity situation, inventory levels, ability to generate free cash flow and sustainable return on equity. The exercise is aimed at accessing the risk profile of various companies and their ability to tide over tough conditions.
- **Safety commands a premium in tough times:** In the current tough conditions, it is safer to stick to companies with positive free cash flow, controlled inventory levels, strong RoEs, superior quality of management and the ability to re-leverage their balance sheet to exploit opportunities thrown up by distressed conditions. Based on our analysis, the three companies that are strategically better placed than peers are Oberoi Realty (net positive cash on books with better than industry volume sales even in tough environment; weak Q3 results to generate some weakness which can be an opportunity to accumulate), Phoenix Mills (huge cash inflows from flagship property at Parel, Mumbai and other market city projects begin to add to cash inflows) and Mahindra Lifespaces (low debt level with regular cash inflows from operational SEZ projects in Chennai and Jaipur).
- **In a sticky spot—exit on rallies:** Contrary to above mentioned stocks, there are host of real estate companies that are struggling with huge debt on the books and the unfavourable demand environment is further complicating the situation. Some of these candidates that can be exited on rallies are the erstwhile favourite of the last bull run DLF, Uniteh and HDIL (all three facing serious debt and cash flow issues). However, the real estate sector has high beta to market movement and have a tendency to give sharp rebounds which can provide an exit at relatively better levels.

The avoid list: stress is showing

DLF—worsening balance sheet: In H1FY2012, DLF's free cash flows deteriorated to a negative Rs1,132 crore putting more pressure on the balance sheet. Its net debt rose by Rs1,624 crore to Rs26,078 crore. Also the net profit declined by 12% year on year (YoY) in H1FY2012 while the sales bookings declined by 18%. Further, Crisil downgraded the ratings of DLF's various borrowings and raised concerns over its high debt. Over the last month, there has been some progress on the non-core assets sales front for DLF. The company has received the initial payment to the tune of Rs140 crore of the total sale value of ~Rs500 crore from the sale of the Noida information technology (IT) park to IDFC. It has also bought out a 26% stake in its hotel joint venture (DLF Hotels & Hospitality) from Hilton. It sold 67% stake in the Pune SEZ to Blackstone for Rs543 crore. We believe that the stake sale of the Noida IT park and the Pune SEZ are already factored in the valuations. Though the value accretion from the stake sales is positive but it is not material enough to be a stock trigger. We believe that the progress on the Aman Resorts sale will be widely watched and be sentimentally positive but the pick-up in the new launches in H2FY2012 will be the key trigger.

HDIL—weakening TDR market and rising working capital days: The sales of transfer of development rights (TDR) for HDIL were muted in H1FY2012. In H1FY2012, its net profit fell by 17% YoY and margins took a hit due to lower TDR sales. Even receivables are getting strained due to the lower collection despite revenue recognition. HDIl has to repay ~Rs1,200 crore debt in a year's time and the lower cash collection will force the company to go for debt restructuring. Further, with additional 0.33 floor space index (FSI) granted in Mumbai suburbs, the demand for TDR will be subdued going ahead and hence the TDR prices will remain soft. The weak TDR market along with the uncertainty surrounding the company's airport project and poor receivables is putting stress on its balance sheet. The inventory levels have also shot up to more than 2,000 days.

Unitech—slower execution and weak margins: In H1FY2012, Unitech's net profit fell by 46% YoY on account of a sharp contraction in the operating profit margin (OPM). This contraction was due to the booking of revenue on legacy projects (pre-2009 launch) that will take another five to six quarters given the current pace of delivery. Its inventory days have shot up to almost 3,000 days. However, the company is trying to reduce its debt burden. Its net debt-equity now stands at 0.4x as compared to 0.5x in FY2011. The delay in the execution of projects and the pending legacy projects along with the uncertainty related to the telecommunications scam probe will continue to be an overhang on the stock.

Safer options: better positioned to tide over tough times

Oberoi Realty—debt-free balance sheet and good sales volume: Amidst such weak market scenario Oberoi Realty stands tall with a debt-free balance sheet and strong cash balance of Rs1,190 crore. In H1FY2012, it had reported a 24% growth in its net profit while the other companies had reported a decline in their earnings. We believe it is best placed in the sector to leverage its balance sheet to acquire new land banks and execute the existing land bank. It recently bought out the 50% stake from ICICI Ventures in its Worli project where it already holds the balance 50% stake. Even its execution is on track as its inventory levels are very much in control.

Phoenix Mills—safe annuity model: Phoenix Mills recently commenced operations at three of its market city malls in tier-I cities and will commence the fourth one in Q1FY2013. Its High Street Phoenix mall in Mumbai is already a cash cow. Thus its rental income will jump sharply in FY2013. The execution risk is very low as only the Chennai mall and Shangri-la are left to be operational and both will commence operations in FY2013. Similarly, the leasing risk is low as the market city malls are all pre-leased at more than 60%. Further, it is converting its special purpose vehicle (SPV) debts into a self-liquidating lease rental discounting model on commencement of operations. This would alleviate the concern over the high term loans in the books.

Mahindra Lifespaces—low debt levels and strong execution: Even Mahindra Lifespaces has low debt in its books with a net debt-equity of 0.3x. In H1FY2012, it also reported a 24% growth in its net profit led by strong execution of its ongoing projects. Along with Oberoi Realty Mahindra Lifespaces is conveniently placed in terms of leveraging its balance sheet for acquisition of new land banks and execution of the existing land bank.

Valuation

The sector has continuously underperformed over the last one to two years, making the valuations very attractive. However, one still needs to be selective and cautious as the real estate market will take time to revive. Though the interest rates seem to have peaked out and the interest burden of the companies and the liquidity situation might ease in FY2013, but the demand will revive once the developers resort to price cuts and the overall economy recovers. In Mumbai, the demand is expected to pick up as the chief minister of Mumbai has accepted the changes proposed by the municipal commissioner which would result in an increase in the approval of new projects that have been stalled for the past year. This will increase the supply in the market which, in turn, will reduce the property prices. Lower property prices could boost volumes and act as a trigger for the Mumbai-based developers. Thus, we recommend switching from DLF, HDIL and Unitech to safer bets like Oberoi Realty and Mahindra Lifespaces on account of the latter's strong balance sheet and ability to re-leverage in this down cycle even when the others are struggling to reduce their debt positions. We also like Phoenix Mills given its assured revenues on account of its revenue-yielding asset model.

Valuation

Company	Price	EPS (Rs)		Book value (Rs)		P/E (x)		P/BV (x)	
	(Rs)	FY12	FY13	FY12	FY13	FY12	FY13	FY12	FY13
DLF	174.8	9.7	11.7	157.7	166.5	18.0	14.9	1.1	1.0
HDIL	56.8	19.6	24.0	245.8	266.2	2.9	2.4	0.2	0.2
Oberoi Realty	208.7	16.4	23.9	116.1	138.0	12.7	8.7	1.8	1.5
Phoenix	189.0	8.5	10.6	125.7	134.9	22.4	17.8	1.5	1.4
Mahindra Life	253.3	31.9	44.2	295.1	337.8	7.9	5.7	0.9	0.7
Unitech	20.1	2.2	2.8	46.3	49.0	9.1	7.3	0.4	0.4

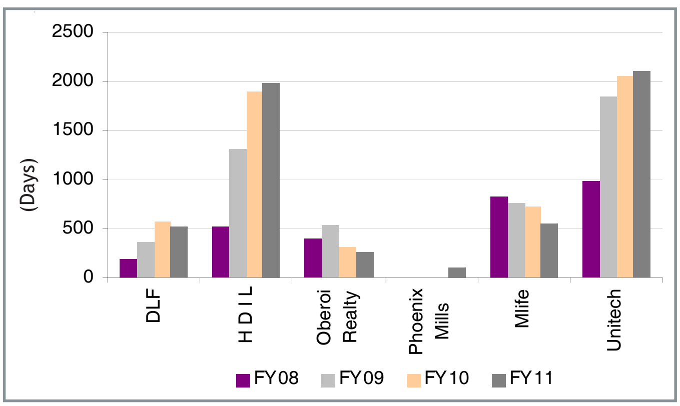
The story in detail

Declining sales and rising inventory levels affecting free cash flows—Oberoi Realty, Mahindra Lifespaces and Phoenix Mills best placed

High debt and falling sales are two issues that are plaguing the Indian real estate industry. As the economy recovered in 2009, sales were expected to recover in 2010. However, the recovery remained elusive as high property prices kept buyers at bay. Meanwhile, construction cost inflated and rising interest cost started to squeeze the earnings of the real estate companies. This affected the earnings in the last two financial years and in H1FY2012.

On the other hand, the falling sales resulted in rising inventory levels leading to working capital pressure. With developers still reluctant to reduce prices and interest rates remaining high, volumes are expected to remain weak over the next few quarters. This will translate into higher inventory levels and affect the cash flows of the real estate companies. Weak cash flows will put more pressure on the financials of these companies, thereby reducing their ability to reduce their debts.

Rising inventory days except for Phoenix, Oberoi and Mahindra Lifespaces



Real estate companies are actively considering ways to generate cash and thus are looking to generate money by selling land or divesting stakes in non-core businesses. For now, that seems the only way to get out of a debt trap.

Among the real estate companies, Oberoi Realty has the best inventory level while Mahindra Lifespaces saw its inventory level improving over the last two to three years. Mahindra Lifespaces' inventory levels are high due to the slow progress of its two integrated business centres at Chennai and Jaipur. Otherwise, its inventory days in FY2011 at the stand-alone level stood at 292 days.

Phoenix Mills has almost zero inventory level as it follows an annuity model wherein it rents out mall spaces to retailers.

...resulted in high negative free cash for the industry—Oberoi being only cash positive

(Rs cr)

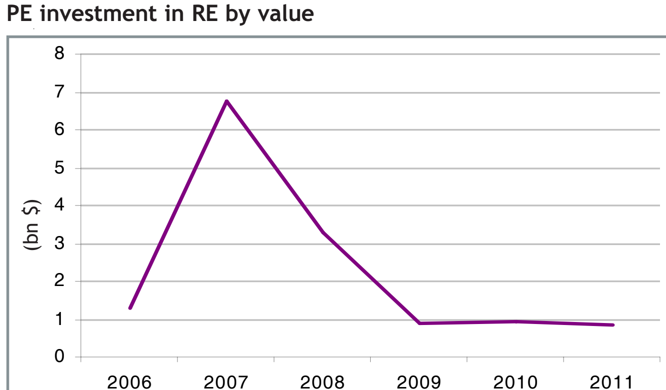
Consolidated FCF	FY08	FY09	FY10	FY11	H1FY12
DLF	-8592	-4781	-6840	-352	-1132
HDIL	-3885	-1248	-1298	-2522	-174
Oberoi Realty	47	-92	307	60	-137
Phoenix Mills	-684	-434	-165	-308	NA
Mahindra Life	-396	-411	-337	-371	NA
Unitech	-3600	-1935	-1260	-823	144

$3bn of PE exits on cards in CY2012—will put further pressure on cash flows

Most private equity real estate fund managers have either hit the exit phase already or are readying themselves to exit investments to repay investors in their funds. According to real estate consultancy Jones Lang LaSalle (JLL), in 2012 such funds are expected to sell assets worth around $2.5 billion. It forecasts that realised returns for these funds will continue to be low given the negative market sentiment and weak economy. As a result, fresh investments by real estate private equity (PE) firms are expected to be under $1 billion in 2012.

Out of the PE investments of $13 billion that have been made in the Indian real estate sector so far, about $3 billion has been pulled out with an average return of only 1.2 times, much lower than the expectation of the investors. In the last two years, funds were under pressure from their own government authorities to liquidate as their investment period was coming to an end. Also, the negative sentiment and uncertain economy have yielded low returns. As per JLL, 67% of the exits till date have been through promoter buy-backs. Thus, looking at this trend, we believe that the likely exits over the next two years will also be largely via this route. This will pose significant cash flow pressures for the realty industry as the falling sales are already dampening the cash flows. Thus, the funding pressure in the industry will continue for next one to two years.

PE investment in RE by value



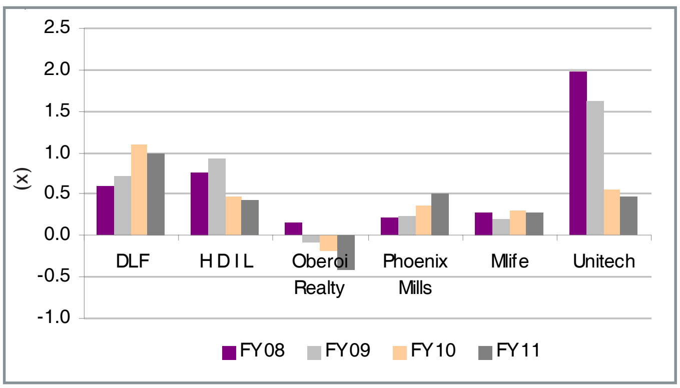
Ability to re-leverage plays important role in down cycle; Oberoi and Mahindra Lifespaces best placed

The rising working capital pressure and the negative free cash flow are resulting in higher debt burdens. Though Unitech and HDIL have been able to reduce their debts over the last year but the interest outgo hasn't come down because of the growing borrowing rates. Further, HDIL has been able to reduce its debt only marginally against the ~Rs1,200 crore debt to be repaid in a year's time. Its low receivables will force the company to go for debt restructuring. A number of realty companies are also trying to reduce their debts by selling non-core assets. DLF plans to raise Rs6,000-7,000 crore via this route. Unitech too is looking at reducing its debt further by selling its SEZs and IT parks. There will be a lot more developers coming out and selling non-core assets.

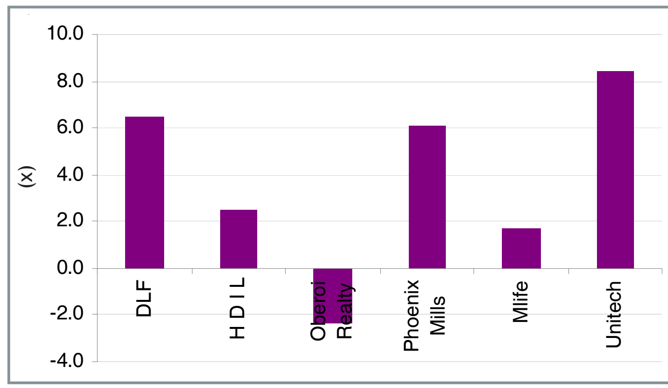
Oberoi Realty is best placed among the whole real estate pack with zero debt in its books. This enables the company to leverage its balance sheet even under tough market conditions. Similarly Mahindra Lifespaces has zero debt in its stand-alone books while at the consolidated level its net debt-equity ratio stands at 0.3x mainly due to the debt taken for its integrated business centres.

Phoenix Mills' debt-equity ratio stands at 0.5x due to the debt taken for the construction of the Shangri-La hotel and four market city malls that are being built by it. However, now three malls are operational and another one will be operational by the next year along with Shangri-La hotel. Further, the company is converting its SPV debt into a self-liquidating lease rental discounting model once the remaining projects commence operation.

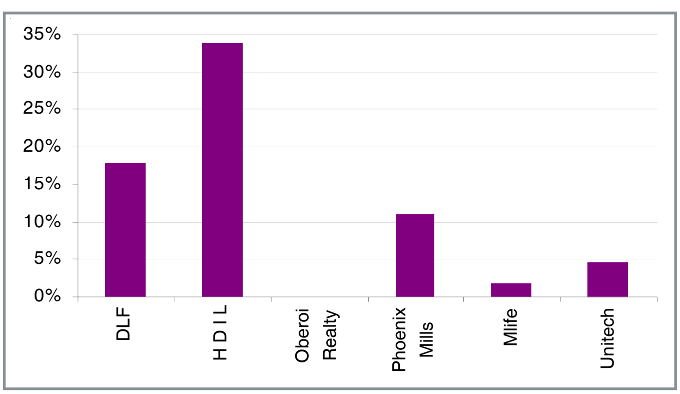
Net debt:equity across players



Net debt/EBITDA comfortable for Oberoi and Mahindra Life



Interest cost as % of sales



Raising funds under the current tough market situation is becoming difficult day by day. Banks and financial institutions have tightened their norms for lending to real estate players and borrowing from private sources at exorbitant rates is the only short-term solution. Raising funds from even the equity market or PE players is getting difficult. Thus, in such a scenario, only those developers that boast of a strong and healthy balance sheet will be able to mobilise funds.

RoE slips for most to single digits, Oberoi in a comfortable zone

The RoE had deteriorated for all developers in FY2009 when the markets had slumped and the volumes had fallen drastically. Since then the companies have not been able to revive their RoE. In fact, the RoE has fallen even further with the volumes continuing to be low across the market and the interest burden remaining high, affecting the profitability. For most of them, the RoE now stands in single digits.

RoE (%)	FY08	FY09	FY10	FY11
DLF	73	21	7	6
HDIL	64	20	10	10
Oberoi Realty	29	19	29	20
Phoenix	5	4	4	5
Mahindra Life	7	7	7	10
Unitech	58	27	8	5

However, Oberoi Realty is in a better position with its RoE in double digits. Phoenix Mills generates a low RoE due to its annuity based model.

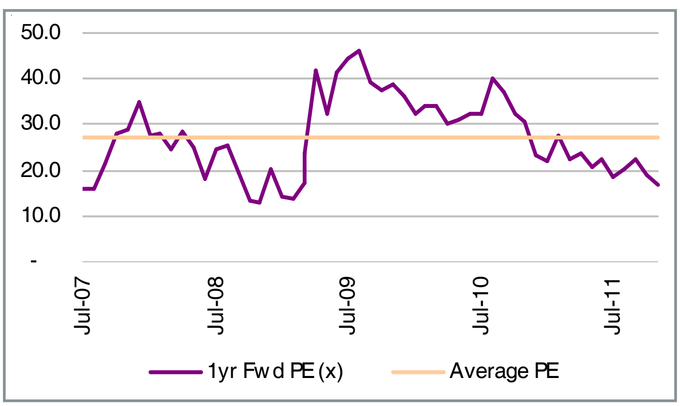
PAT growth (%)	FY08	FY09	FY10	FY11
DLF	733	-43	-62	-11
HDIL	158	-44	-28	46
Oberoi Realty	268	-15	87	13
Phoenix	310	26	17	40
Mahindra Life	226	10	11	51
Unitech	27	-27	-45	-10

Thus prefer Oberoi Realty, Phoenix Mills and Mahindra Lifespaces

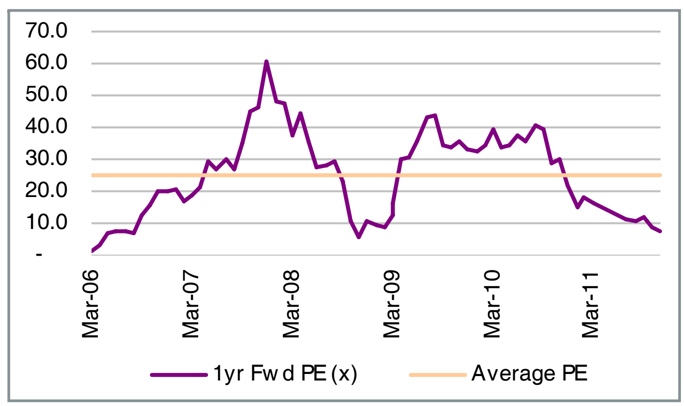
The sector has continuously underperformed over the last one to two years, making the valuations very attractive. However, one still needs to be selective and cautious as the real estate market will take time to revive. Though the interest rates seem to have peaked out and the interest burden of the companies and the liquidity situation might ease in FY2013, but the demand will revive once the developers resort to price cuts and the overall economy recovers. In Mumbai, the demand is expected to pick up as the chief minister of Mumbai has accepted the changes proposed by the municipal commissioner which would result in an increase in the approval of new projects that have been stalled for the past year. This will increase the supply in the market which, in turn, will reduce the property prices. Lower property prices could boost volumes and act as a trigger for the Mumbai-based developers.

Thus, we recommend switching from DLF, HDIL and Unitech to safer bets like Oberoi Realty and Mahindra Lifespaces on account of the latter's strong balance sheet and ability to re-leverage in this down cycle even when the others are struggling to reduce their debt positions. We also like Phoenix Mills given its assured revenues on account of its revenue-yielding asset model.

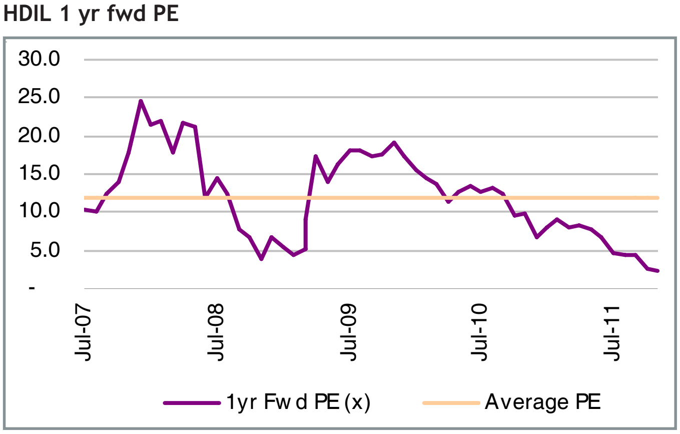
DLF- 1 yr fwd PE



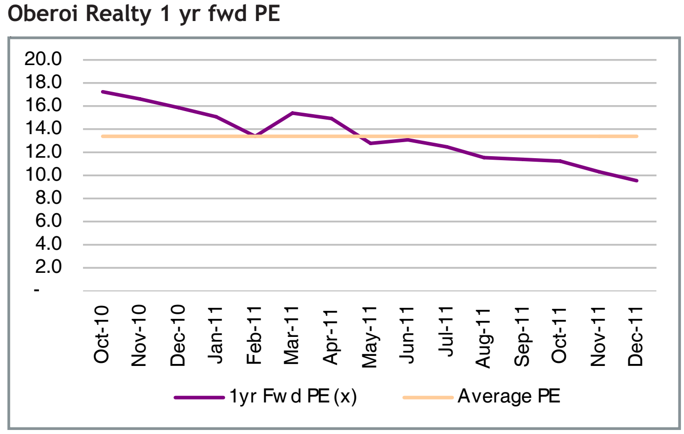
Unitech- 1 yr fwd PE



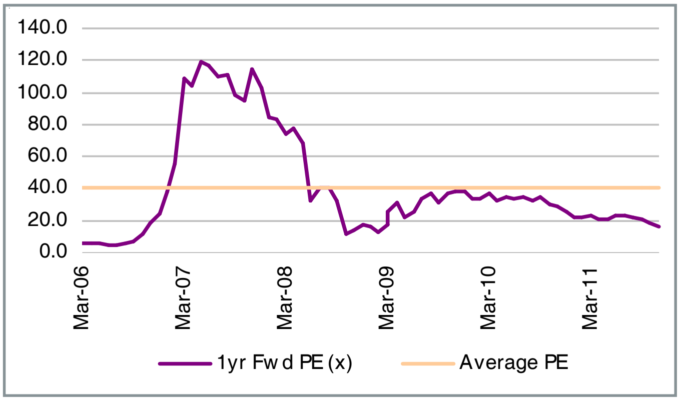
HDIL 1 yr fwd PE



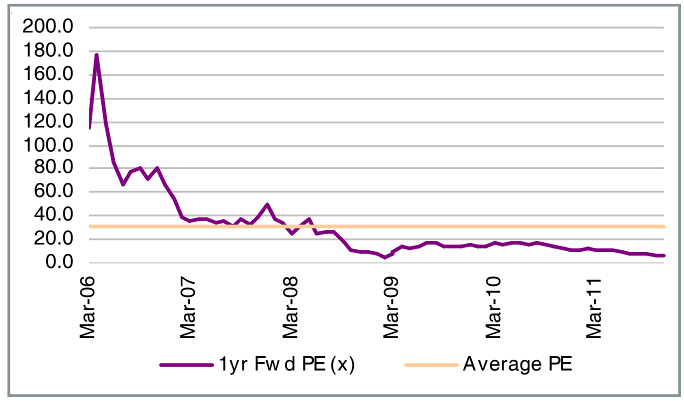
Oberoi Realty 1 yr fwd PE



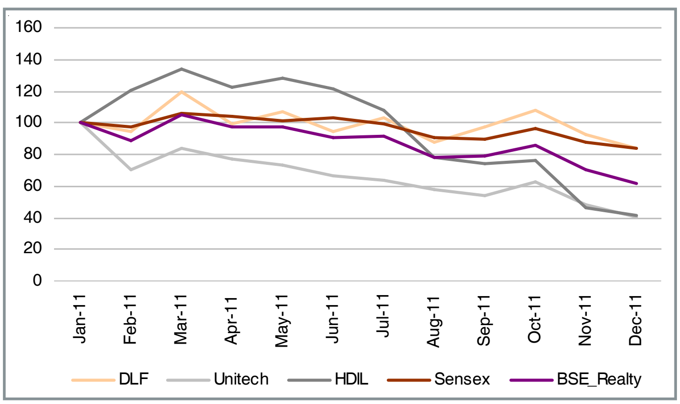
Phoenix Mills 1 yr fwd PE



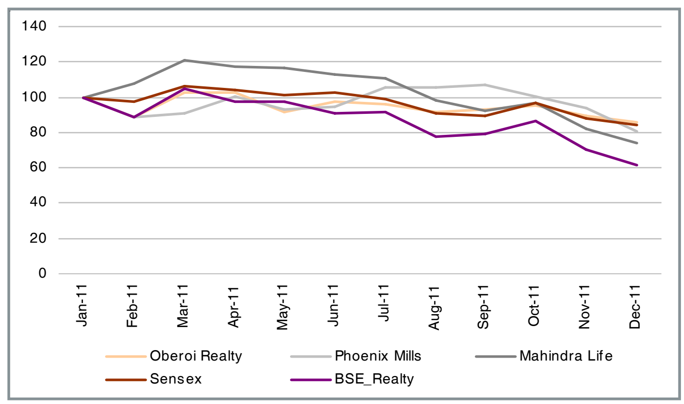
Mahindra Life 1 yr fwd PE



One year price performance vs Sensex, BSE Realty



One year price performance vs Sensex, BSE Realty



Sharekhan Limited, its analyst or dependant(s) of the analyst might be holding or having a postition in the companies mentioned in the article.