Real Estate: Challenges Ahead amid Coronavirus scare

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Overview of the Indian Real Estate Sector

The Indian Real Estate sector is one of the largest employment generators only second to agriculture and has a multiplier effect on various allied industries. The Real Estate sector in India can be primarily categorised into 1) Residential Housing & Commercial Sales and 2) Commercial leasing which shall comprise of sub sectors such as office space leasing, mall space leasing and industrial leasing. The year 2019 was a mixed bag for the industry having attracted investments worth around USD 5bn and around 66% of these investments were in the commercial real estate market which witnessed healthy increase in volumes of around 27% on y-o-y basis. The healthy demand has been from private equity investors scouting for stable rent yielding assets.

The residential housing segment has been witnessing sluggishness in demand and lower absorption in the past few years owing to structural reforms such as RERA, demonization and GST as the developers took time to re-align to the changing market dynamics and regulations. Further, economic slowdown, NBFC crisis, low buyer sentiments too led to stagnant demand in the residential segment.

Impact on the Residential Housing Segment

1. In view of the nationwide lockdown, the construction activity has come to halt as supply chains for obtaining construction material have been disrupted and labour workforce have migrated to home states altering into agriculture labour in search of alternative sources of livelihoods. Besides, non-availability of transport has added to the woes of the industry. As a result, it should also be noted that resource mobilisation in terms of availability of building material, labour etc. at the site will take time owing to lag effect as a result of supply chain disruption. This along with delay in approvals will lead to slowdown in construction activity.

2. In 2020, post lockdown, the residential housing segment is expected to see muted demand as buyers may choose to postpone

their purchases as they shall become more risk averse in the medium term. As a result, sales & collection is expected to get impacted adversely. As a result, post lockdown, developers may choose to reschedule their new launches and wait for the sentiments to improve. Thus, going forward with lower collections anticipated, especially in Q1FY2021, the construction progress for projects with high dependence on customer advances may get hampered in the short to medium term.

3. In the wake of COVID-19 situation, price points are expected to soften for developers "desperate to sell". However, this would again depend upon location and type/ segment of individual projects and the builder's financial flexibility which will be demonstrated in its ability to hold on to the inventory in such times. Luxury projects which have shown lower sales growth are likely to be impacted more.
4. Slowdown in the construction activity may result in weakened cash-flows for the companies in the short term. Consequently, companies with higher financial flexibility, stronger liquidity or having projects nearing completion or having longer moratorium period or having cash strap mechanism i.e. repayments linked to sales are better placed to tide over the uncertain market environment. However, in the long term, it would depend upon developer's ability to improve collections.
5. Disbursement of new loans/ refinancing risks have increased as housing finance companies, NBFCs and banks become more selective and tighten their disbursements criteria to developers. A large portion of funding requirements of the sector (customer advances) is met by NBFCs or HFCs who would also be highly selective in fresh disbursements. The uncertainty and slowdown in economic activity would have severe impact on new loans/ refinance to developers.

Impact on the Commercial Real Estate Segment

1. Commercial Real Estate comprising office space leasing which was one of the booming sectors having attracted majority of funds from the private equity players in the past; is now expected to experience slowdown largely in the co working space owing to surge in "Work From Home" option by various industry players as they would look to optimise their cost and potential change in user habits as majority of demand is driven by the IT/ITES industry. As a result, rentals are expected to soften/ stabilise in the co-working space owing to lower demand. Further, the surge in office rentals exhibited in the past is expected to taper down and remain steady owing to the fact that MNCs begin to appreciate the benefits of work from home.
2. FDI within the commercial real estate segment is expected to be on hold owing to limited new leasing activity and majority of investments coming from countries such as USA, Singapore, Hong Kong and China where the economic activities are at standstill as they are still confronting with the turbulence brought in by the presence of the pandemic.

3. In the wake of COVID-19 situation, rentals for operating malls are expected to soften owing to various multiplex operators and large anchor tenants having force majeure clauses in their agreements, if any, covering waiver of rentals during closure of operations. Further, majority of old agreements may be re-negotiated between the tenants and landlords wherein the tenants will be seeking either for waiver or deferment of rentals or even shifting to a revenue sharing model as even after the lockdown is lifted, the footfalls in malls may take some time to revive. Thus, entities operating retailing malls will see an impact on its cash flows in the short term and companies with higher financial flexibility, stronger liquidity or assets with low debt are better placed to tide over the uncertain market environment. Going forward, over the medium term, the lease rentals may see some correction for mall space leasing while the lease rentals is expected to remain firm for office space leasing and commercial warehousing.
4. E-commerce which has been the driving force behind commercial warehousing demand is expected to slow down due to national lockdown in the short term. However, with majority of ecommerce players or commercial warehousing activity largely driven by demand from foreign clients is expected to increase as the clients look to shift their base from China to alternative places like India, Vietnam etc. Thus it augurs well for companies operating warehousing leasing in the long term.

Mitigants

1. MahaRERA have extended the period of validity for registration of all registered projects where completion date, revised completion date or extended completion date expires on or after March 15, 2020 by three months. The extension has also been provided for all statutory compliances. This is expected to provide some respite for the on-going projects.
2. RBI’s three month moratorium on term loan repayments and interest on working capital till May 31 2020 is expected to provide some relief to the developers. In the present circumstances, developers except a few ones who are well placed in terms of liquidity or having greater financial flexibility, are expected to avail the facility as these developers may have either chosen to conserve cash owing to uncertainty prevailing.
3. As cash flows of various developers or commercial asset owners are expected to weaken on the back of lower collections, developers/landlords having longer moratorium period or having cushion in terms of collections vis-à-vis expenditures/repayments to be met or developers having inbuilt cash strap mechanism (i.e. repayments linked to sales) are expected to do relatively well in terms of servicing of debt obligations as compared to companies having leveraged assets or offices/malls thereby not having flexibility to raise funds if needed.

4. In the present scenario, the government is set to move an ordinance to suspend fresh insolvency action against companies for six months by lenders or creditors. As a result, financial creditors including home buyers in residential real estate projects cannot initiate insolvency action against the developers.

Outlook

CARE continues to have Negative outlook for Real Estate sector. The sector was as it is facing lower sales and collections on the back of subdued demand is further expected to witness slowdown in construction activity and weakened cash flows due to pessimistic sentiments of the buyers. This would mean the projects getting delayed and cash flow mismatch in the short term forcing the developers to raise funds through tapping the refinancing route which would mean higher cost for the developers. Our discussion with several developers has led to a conclusion that developers with lower leverage will be able to sustain these tough times with ease as compared to developers having high leverage who do not have financial flexibility to raise funds. In CARE's opinion the credit quality is expected to weaken and post lockdown, revival of the segment will take more time.

On the commercial real estate segment, CARE believes outlook to remain fairly stable. In CARE's opinion, though mall leasing activity is expected to see some impact in the short term owing to weaker cash flows as compared to office or warehousing leasing activity having robust rentals; yet comfort can be derived from the fact that majority of companies operating malls have financial flexibility in terms of liquidity or enjoy parentage of a larger business group or has lower loan to value ratio which increases its ability to raise funds if needed. Furthermore, CARE believes that the office space and warehousing leasing activity to recover faster as compared to other real estate asset classes.

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