Real Estate Sector – Credit Outlook

Contacts

Mahendra Patil

Asst General Manager - Corporate Ratings

Tel- +91- 022- 6754 34443

mahendra.patil@careratings.com

Hita Luhar

Corporate Communication

Tel- +91-22-67543424

hita.luhar@careratings.com

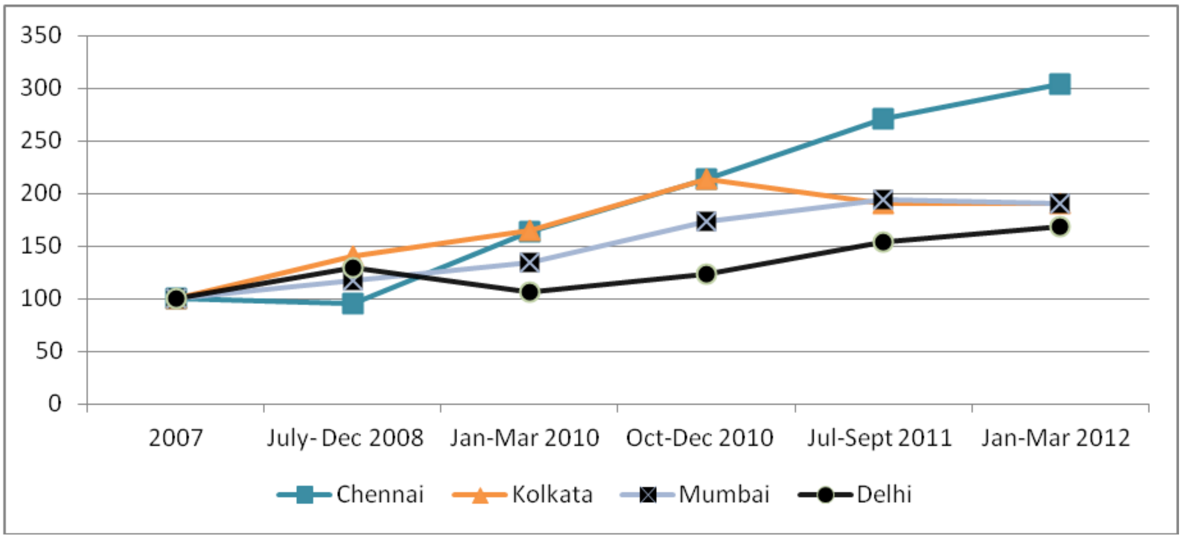
Real estate, while being one of the largest sectors of the economy, is regional and fragmented in nature. With the ongoing economic downturn, the sector is facing issues on many fronts. These include subdued demand, curtailed funding options, rising costs, restricted supply due to delays in approvals, etc thereby resulting in stress on cashflows.

Curtailed demand

The sector has seen low demand for quite some time now primarily due to factors like sustained high level of inflation, which apart from keeping interest rates high, has adversely impacted the buying power and affordability for the consumers. Besides, the ongoing economic uncertainty casts apprehensions on the sustainability of the income levels causing a delay in decision making by the home buyers. On the commercial front as well, the demand is low causing fall in the lease rentals. The companies are taking a cautious approach with pan-India vacancy at about 20%. The uncertain economic scenario is forcing many companies to put the expansion plans on the back burner resulting into lower demand for office space.

Subdued supply

Surprisingly, the curtailed demand has not impacted the price levels which have only increased or remained stable in the past. The NHB residex for Mumbai which was at about 117 in July-December 2008 was hovering at 160 in April – June 2010 and further increased to 190 in January - March 2012. The other metros are posting a similar trend, though at differential pace. The following chart shows movement of index of residential prices in four metros, with a base of 100 in July 2007.



The developers are maintaining a 'wait and watch' policy and holding on to the inventory. At best, there are few developers providing some sweeteners in the form of free parking space and/or waiving the floor rise, however, the prices are being kept at high level. The ever-increasing real estate prices are supported by lack of new launches limiting fresh supply and increased cost of construction. Though the supply is high in few pockets, especially Mumbai, most of the inventory is from under-construction projects. The buyer community increasingly prefers completed or near-completion properties on the backdrop of delayed projects.

On the cost front, the prices of cement and TMT bars have increased by about 24% and 30%, respectively, since January 2011. Increase in the minimum wage rates has increased the cost of labour as well as impacted their availability. Land, forming substantial portion of the project cost, is keeping the price levels high. Also, high interest rates have put developers in a "catch 22" situation with rising interest rates causing increase in EMI for the buyers as well as increasing the cost of borrowing, thereby affecting demand and cost of the project simultaneously.

Lack of approvals

The sector is also marred by slowdown in the approval process and lack of a single window clearance. The requirement of numerous approvals also results in delays and increases the cost of the project. Though the realty sector is one of the largest employers after agriculture and textile, it is yet to get the industry status. The industry status would reduce the perceived risk thereby lowering interest rates as well as moderating the approval processes.

Cash flow challenges

As a result of slowed down demand, the cash-flows have got affected considerably. Slack demand affecting the stage payments, the major source of funding for the under-construction projects (after bank finance for initial construction), is affecting the construction progress as well as constraining the cash-flows. Besides, funding sources have been impacted with the overall gloomy scenario. The private equity funding which had increased post 2008 crisis has slowed down. Though the lending to the sector is not completely dried, funding is mainly available to the rent-earning properties which provide stable returns.

The subdued cash flows coupled with high level of debt, has deteriorated the liquidity position of many developers. Listed companies in the real estate sector have started FY13 (refers to April 2012 to March 2013) with total debt of about Rs.42,000 crore. However, this forms a minute portion of the total borrowings of the real estate sector, primarily due to presence of significant number of small unlisted developers. The cash flow crunch continues to affect the credit profile of many real estate companies. CARE has reviewed about 96 ratings in the real estate sector during September 2011 to June 2012 period out of which about 1/3rd of the ratings were revised downwards and close to 2/3rd of the ratings have been retained.

For the sector, revival in demand would be a major boost as most of the developers are reeling under debt repayment and funding pressure. However, given the high level of prices and uncertain economic scenario, it appears that the developers might not see many transactions materializing in the short-term, unless developers reduce prices.

To ride over the liquidity issues, the developers have been disposing off the surplus land banks and non-core assets. The developers who have abstained from acquiring land at exorbitant prices in the past and have managed the leverage are relatively insulated from the cash-flow mismatches. Besides, the developers with a mixed bag of projects from all segments, including rent-yielding properties, are somewhat insulated from the cash flow mismatches.

The credit outlook for the sector remains stressed until demand picks up, which depends on the improvement in the affordability. However, the affordability is the outcome of prevailing interest rates, income levels as well as asset prices, all of which are currently not in favor of the buying community. As such, it appears that reducing prices would augur well for the industry which would bring in the much-needed volumes and help stabilizing the cash flows.