Demonetisation: Credit Negative for Real Estate Sector

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Recent demonetisation of high value currency notes, with a key objective to curb circulation of black money, is expected to have far reaching consequences on the real estate sector in India.

Real estate demand has been lacklustre over the last 3-4 years due to several factors. Demonetisation is expected to further dampen demand and negatively impact prices in the sector, in part supported by the presence of the parallel economy.

Lower liquidity likely to impact demand, construction progress and secondary market transactions

Demand is expected to decline, especially in markets and segments with a higher share of cash transactions. Demonetisation will lead to lower liquidity at the hands of potential buyers, thereby negatively impacting demand. The unaccounted-for money which was earlier routed to real estate would now not be available. Further, buyers of under-construction properties who have to pay instalments / stage payments to builders as per contractual Builder Buyer Agreements may have lower liquidity thereby leading to lower collections by developers. The routing of black money into real estate sector which was creating demand and supporting property prices is largely going to dry up.

Projects in early stages of construction are mostly dependent on customer advances for construction progress and for debt servicing. Projects are typically funded by way of capital from promoters, customer advances and debt, with customer advances usually forming a large part of this funding pattern. On account of tight liquidity in the hands of the buyers, as discussed earlier, the demonetisation will lead to lower cash collections in the form of customer advances, with potential impact on project progress as well as debt servicing. Small and marginal developers are likely to be impacted more than larger developers who have access to multiple financing sources. The problem may be compounded if banks and financial institutions do not step ahead to support the sector and lend it the required liquidity.

There is presence of a large secondary market in the real estate sector. Many purchases of the under-construction properties generally happen at the initial launch stages or at early stages of construction. Such

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buyers have only enough cash flows to pay the first few instalments, and plan to sell in the secondary market, much before full completion of the projects. Such speculators usually expect to gain from the likely price

appreciation in projects as they near completion. Buyers with this intent are already struggling due to the prolonged slowdown in the property market and a stagnant or falling price situation and are likely to further suffer due to the demonetisation move. This is because the prices in the secondary market are still supported by a high component of black money, which will no longer be available. The secondary market transactions built on a speculative view will clearly be significantly lower.

Expected decline in prices

The lower demand scenario and the decrease in the cash component in real estate transactions will lead to a decline in the real estate prices.

The real estate sector witnessed the phenomena of selling an existing property and buying another from the proceeds of the sale of the existing property. The proceeds from the sale at prevailing prices were used to buy a new property. The property prices were often supported by such transactions (sell one and buy another) as it had a nullifying impact despite an overheated property market. Such transactions also entailed two components – one, the legitimate part on which the stamp duty was payable and the other one which was the 'cash' component, on which no taxes / stamp duty was paid. The latter component usually constituted around 35% - 40% of the transaction value. Going forward, it is expected that the 'cash' component will not be a part of the transaction. This will have two implications. One, the price support from the 'cash' component will not be there, and prices will drop. Two, post tax receipt with the seller would be lower as taxes will be payable on the entire transaction value (vis-à-vis on 60% - 65% of the transaction value earlier). The seller with lower proceeds would have a lower price to offer for his subsequent purchases.

On the supply side, developers are already grappling with the problem of slow sales leading to mounting inventory levels in all major micro markets. With negative impact on demand and growing uncertainty post demonetisation, there can be further postponement of the buying decisions leading to increase in inventory levels further. This could lead to price drop by the developers / sellers to drive up sales. In this context, expected launch of new projects may also be on the lower side. The over-supply situation would likely continue in the medium term.

Lower land deals in the short to medium term

The cash component is high at the land acquisition and at the early launch stages of the projects. These transactions will have to enter the formal system. However, in the interim, it is expected that there will be fewer such land deals. With these transactions entering the formal system, there will be higher transaction costs that would have to be borne by the developers. This would impact the profitability margins of the developers, as increase in the real estate prices would not be possible.

Further, in the last couple of years, many developers resorted to sale of non-core assets to improve their liquidity position. This primarily entailed sale of land parcels in which typically the use of black money was rampant. Going forward, the number of such land deals may be lower on account of lower cash availability. This can have an adverse impact on developers that had plans of liquidating their land holdings.

Conclusion

Reduced prices, lower demand and difficulty in monetizing land may lead to cash flow mismatches for the developers, which may lead to stressed liquidity of developers and delay the ongoing projects. These problems will persist in the medium term. Overall, the property prices are headed for a drop by atleast 10-15% as a result of the demonetisation move. The impact on the high-end housing segment can be more as the involvement of cash transactions in this segment is higher.

In the long run, a large part of the unaccounted money which is now expected to be infused back into the formal system would lead to demand from genuine buyers or end users in the market. The increased liquidity in the banking system would lead to lower interest rates which will encourage genuine buyers to invest in property.

In the long term, the demonetization along with implementation of Real Estate Regulation Act and single-window clearance system will be positive for the sector leading to higher transparency and investors' confidence.

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