Industry Outlook and Credit Rating Perspective in Real Estate SECTOR

Real estate sector plays an important role in the Indian economy; contributing around 6.5% to GDP in the year 2012. The sector is one of the largest employers after agriculture and textile and has numerous allied industries linked with it. Broadly, the sector can be classified into three segments - Residential, Commercial and Retail. In case of residential space, demand is determined by a combination of factors like property prices, interest rates, economic scenario determining the income levels etc whereas the demand for commercial as well as retail space is directly related to the prevailing macroeconomic environment.

> *"Real Estate- important role in Indian economy but highly fragmented and yet to receive industry status"*

The real estate in India is highly fragmented, capital intensive in nature and is yet to receive an Industry status. Further, the sector has close linkages with the economy and therefore is highly cyclical in nature. A typical real estate project has a gestation period of three to four years and any adverse change in the macroeconomic factors in the interim period can affect the cash flows of the developer.

The real estate sector continued to remain fragile in FY13 as the industry is facing the headwinds such as slow rate of approvals, recent regulatory changes in key micro market – Mumbai (pertaining to development control rules), inflation impacting cost structure, declining demand due to increasing prices, etc. New investments projects added in the real estate sector across India slumped by about 58% in the financial year ended March 2013 to Rs.43,151 crore from Rs.1,01,368 crore during the same period a year ago, according to Centre for Monitoring Indian Economy (CMIE).

> *"Slowdown in sector due to macro challenges accompanied by pressure on funding projects"*

Developers are even facing lack of adequate sources for funding the project, which is done through a mix of internal accruals, customer advances, and debt. Funds from internal accruals are likely to be limited in nature in short to medium term due to current sluggish demand in real estate sector, impacting the cash flows from ongoing projects. Customer advances, the other source of funding, may not be available to fund the project in the initial stages. Thus, debt becomes the principal source of funding for the project. The total exposure of banks calculated as percentage increase in lending towards the real estate sector has also followed a declining trend. Bank loans to real estate sector have increased only by around 12% in FY12 against FY11 whereas, the same increased by around 23% in FY11 against FY10 indicating the cautious outlook of the banks towards the sector.

To add to this, foreign investors have also become cautious in investing due to continued weakness in the Indian rupee in an uncertain macroeconomic environment. The rupee has weakened 6.27% against the US dollar in the last fiscal. As per RBI's data, FDI flows to India in real estate activities in FY12 (provisional) has been USD 340 million vis-à-vis USD 444 million in FY11 (provisional). Since these traditional sources of finance have dried up, developers approach non-banking financial companies (NBFCs) for short-term debt and private equity (PE) funds. However, funds from NBFCs and PE investors are also fading away as the returns have been on the lower side and many PE investors are struggling to exit at decent returns.

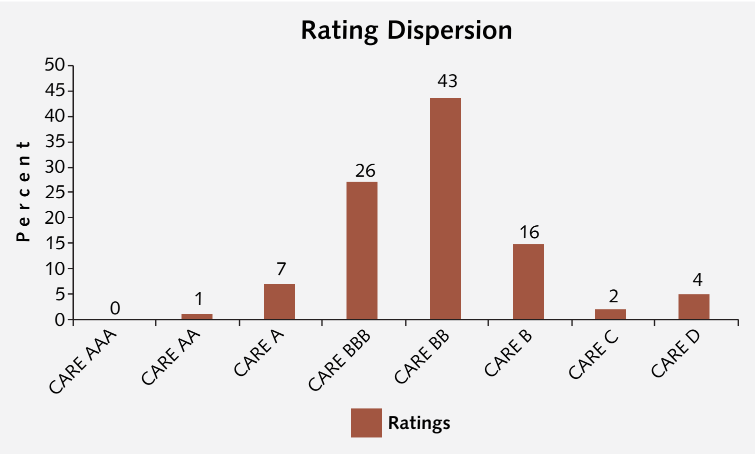
All the above-mentioned factors have resulted in liquidity crunch in the sector. The same can also be reflected from the latest dispersion of credit ratings for real estate players rated by Credit Analysis & Research Limited (CARE).

CARE's view- Assessing the credit profile of real estate developers

While assessing the credit profile of a real estate entity, CARE begins with review of the sector and the Government policies, followed by assessment of the management and the business model adopted. Project-specific analysis is carried out to determine the funding, execution and marketing risk while financial parameters are analysed to understand the debt profile and determine financial flexibility of the company. Greater emphasis is placed on cash flow analysis to determine liquidity and cash flow adequacy to meet the funding requirements as well as debt obligations of the entity.

CARE has observed that primarily subdued demand, increasing construction cost, rising interest expense, and delays in project approvals have dented the earnings and return ratios of real estate developers in India. Moreover, drying funding sources have impacted the liquidity profile. As a result, the credit ratings of real estate developers were impacted in FY13 and in such a scenario, many entities in the real estate sector fell in CARE BB [Double B] category.

CARE's rating dispersion in the real estate sector as on June 30, 2013, is presented in the graph shown below



CARE Rating- Dispersion of ratings in the real estate sector

More than 50% of total outstanding ratings at the end of June 2013 in the real estate sector were below investment grade. During FY13, around 30% of the outstanding ratings were downgraded, and only 11% were upgraded. The sector has also some established and organized players with strong credit profile. Out of total portfolio of companies rated by CARE 34% belong to investment grade rating.

Outlook

> *Anticipated turnaround and aggressive marketing by developers likely to enable developers to manage cash flows smoothly*

CARE believes that GDP growth has bottomed out and gradual recovery is expected most likely from H2FY14. Further, inflation (wholesale price index) is showing signs of cooling down as it stood at 4.70% for the month of May 2013, as compared to 4.89% for the month of April 2013 (5.96% March, 2013) and 7.55% during May 2012. In this backdrop and if it continues to move around the RBI's target of 5%, CARE expects RBI to soften the repo rate during the course of FY14 with a view to boost business confidence and create a more favourable investment climate resulting in availability of funds. Moreover, with improving growth in the employment, household incomes are also likely to improve. Decline in interest rates and improvement in employment outlook will improve affordability and provide the much-needed stimulus to demand in the real estate sector. Combination of the above factors and aggressive marketing and pricing of inventory will help the real estate players to stride on smoother ground and manage cash flows in the coming period.

Contact: **Mukesh Chhatani**
Manager- Corporate Ratings
Tel: 022-67543436
mukesh.chhatani@careratings.com

Varsha Sonthalia
Analyst – Corporate Ratings
Tel: 022-67543576
varsha.bagaria@careratings.com