CARE Ratings Credit Outlook on Real Estate

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Background

The real estate sector has seen tremendous growth prospects, over the last 10-15 years. The increased business and consequent employment opportunities led to heavy migration to Metros and Tier-I cities which in turn increased the demand for all the segments of real estate. Further, the emergence of the services sector, especially IT/ITES, reduced the Real Estate sector's reliance on manufacturing segment.

Besides increased opportunities, the real estate cycle reduced over the period. The sector saw sustained rise in the asset prices since 2000-01 till 2007-08. The upward trend commenced with the emergence of the information technology industry and was supported by sustained high GDP levels. However, the real estate cycle appears to be shortened as witnessed in post 2008 downturn. The asset prices started northward journey from beginning of 2010, just in about 2 years time period from the June 2008 crash. However, the rise in the prices was quick and sharp. Further, the prices, after peaking the 2007 levels, are feeling the pressure due to slump in demand which had been low for about 8-10 months; again, the rally did not last for 1.5-2 years.

Current Issue

The sector which posted quick and sharp recovery, post June 2008 downturn, is now facing issues such as subdued demand mainly due to substantial increase in the asset prices, reduction in the affordability affected due to double whammy of sustained high level of inflation and consequent increase in interest rates causing higher EMIs and delays in the projects due to increased time lag in getting approvals. The availability of sand (mainly Mumbai) as well as labour shortage brought the execution of existing projects to a standstill and 2G and Adarsh scam led to delay in the approvals which halted launch of new projects.

On the pricing front, the skyrocketed land values are holding the prices high. Besides, the developers are experiencing the cost pressure due to increase in the prices of cement and steel bars which increased by about 20% and 26%, respectively, in July 2010 to November 2011 period. The shortage of labour partially caused by Government's various employment schemes is keeping labour cost high. Further, the consistent rise in the interest rates led to higher cost of borrowings for the developers.

Besides dwindling demand causing cash flow shortfall, the sector experienced funding crunch wherein banks, the major source of funding to the sector, stayed away from the sector as a result of the loan scams. Furthermore, the uncertainty in the equity markets curtailed the developer's access to the capital markets. Surprisingly, though the demand reduced drastically, with Mumbai recording about unsold inventory of about 44 months, the prices have not cooled off.

Probable remedy

In the real estate sector, especially, maintaining adequate liquidity acts as a boon in the downturn. The sector has witnessed the benefits of volumes which enhances the cash flow visibility and brings in much relief to the sector. However, with reduced profitability. The factors which can tame the issues of the sector and bring in cash flow stability would come primarily from 2 sources; increase in the affordability of the buyers and deleveraging of the land banks and sale of non-core assets.

The affordability is the function of the EMIs – dependent on the interest rates, the income levels and the real estate prices. The first two factors are the outcome of the macroeconomic movement which cannot be controlled in a short term. However, the correction in the asset prices, which are sustained at a higher level, would provide much needed relief to the sector by driving in the required volumes and easing out the cash flow pressure.

The deleveraging of the land banks as well as non-core assets would cause a fundamental shift in the balance sheets of the real estate developers by way of reduction in the debt levels (the sale proceeds are assumed to be utilised towards reduction in debt levels). Though sale of land banks and non-core assets would ease out the cash flow pressure, the same is a long drawn process and may not help in short term.

Credit Outlook

The credit outlook for the industry remains negative until the cash flows are streamlined. However, the credit outlook for certain completed rent yielding projects is stable mainly due to the sustained cash flow visibility through firm lease tie ups.

The prices are expected to correct mainly due to sustained low sale transactions, high inventory levels (excluding few pockets like Mumbai where the ready inventory is low) and the funding shortfall with the developers.

The improvement in demand is the major catalyst for the industry. Though the RBI has faintly hinted at reduction in the interest rates with the cut in the CRR by 50 basis points, the affordability is not expected to improve immediately. As a result, the correction in the prices is viewed as the major factor which can drive in the volumes.

The sector is expected to continue feel the funding crunch, though the gearing levels are down compared to the pre-FY09 levels, mainly due to limited fund raising options. Besides, the inflow from the private equity as well as NBFCs, are coming at a very high cost. Hence, the ability of the developers to manage the funding shortfall by way of stable cash flows and maintain adequate liquidity would determine the credit quality going ahead.

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