In a state of despair

Bloomberg

Plagued by high input costs, the real estate sector is going through a rough patch for not being able to pass on the costs to consumers and because of the land acquisition Bill

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WILL Mumbai ever be Shanghai, Delhi another Paris, Bangalore an answer to Silicon Valley? If you ask these questions to a few, you might get confident and swift replies, mostly 'Yes, of course.'

However, millions of outsiders who are drawn to these mega-cities come across a common basic problem that still requires an answer. This is the problem of affordable housing. For real estate developers, a lack of solution to this has become a matter of concern, a threat to their business viability. But for those who have been holding realty stocks for long, all seems to be lost already.

Realty stocks have lost over 90 per cent of their market value since the 2007 peaks. This year alone, real estate stocks have seen up to 32 per cent drop and if we go by what analysts say, the sector will take a considerable time to come out of the woods. There is a simple economic phenomenon that price for a normal good rises with rise in demand.

However, there is also something called 'law of demand', which states that demand falls with rise in prices. At present, there is a mismatch between property demand and prices.

The development cost of projects has been rising due to higher cost of inputs. Consumer sentiment, on the other hand, has been weak as banks are reluctant to reduce home loan rates due to elevated policy rates and risk of default associated with home loans. This has made it difficult for real estate developers to pass on the cost to consumers, and hence their margins are taking a hit.

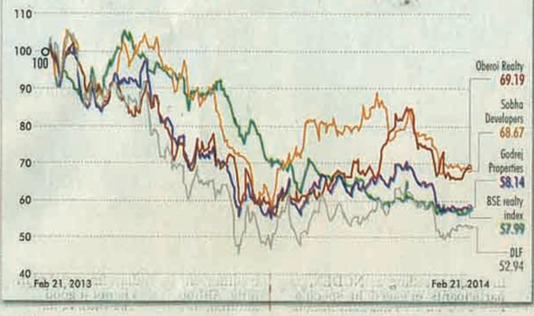
"Real estate developers are struggling with weak cash flows and slow approvals. They are stressed," said Lalit Kumar Jain chairman of CREDAI, who is also CMD at Kumar Urban Development.

Jain said construction cost has gone up by 40 per cent in the past two years, which excluded the rise in cost of acquiring land.

He does not see any significant reduction in debt level of real estate firms in the near future mainly due to their inability to generate free cash flows. In addition, he sees sales remaining weak at least till the general election.

There have been marginal 15-25 basis points cuts in home loan rates by lenders such as SBI, HDFC and ICICI Bank in the past two months. However, sentiment is so weak that these marginal cuts hardly matter.

Real estate stocks vs BSE realty index



Pinaki Paul

"Due to three years of rising interest rates, consumer sentiment has been shaken. The rise in interest cost has hit the top line of India Inc, which has also hurt the income levels of middle class. Since real estate is probably the single largest investment for middle class families, the decision requires confidence, which is lacking due to high EMI rates. Things do not change overnight," said Bikram Sen CEO at Arthveda Fund Management, the PE arm of Dewan Housing Finance.

"Having said this, we believe GDP growth has bottomed out. While we do not see demand improving in the whole of 2014, sentiment may start improving if we see good monsoon and a new government at the Centre with majority seats. We are positive on real estate sector on a long-term basis," Sen said.

Data available with database Capitaline showed that a total of 13 real estate firms from the BSE realty index have reported 41 per cent YoY fall in net profit to Rs 578.57 crore for the December quarter. The average profit margin declined to 18 per cent in the third quarter from 21.40 per cent in the year-ago quarter.

Among the major players, the net profit of DLF halved to Rs 145 crore. Anant Raj, Unitech, HDIL, Sobha Developers and Prestige Estates saw their net profit falling between 13 per cent and 80 per cent. Net sales, in the meanwhile, grew by a modest 4.30 per cent YoY at Rs 5,430 crore for these 13 firms during the quarter.

Motilal Oswal, in a note on third quarter earnings review, said," New launches in festive season disappointed, with Bangalore developers and Unitech now being among a few that are likely to cross FY13 launch volume in FY14. Presales velocity weakened QoQ with general slowdown in momentum. Prestige Estates, Indiabulls Realty and DLF (due to a low base) stand out on YoY growth in 9MFY14 presales. There was no major surprise in commercial leasing either, which was flat for Prestige Estates and DLF."

The brokerage pointed out that weak collections and higher construction spending led to further reduction in cash surplus for Oberoi, while Prestige Estates, Sobha, Indiabulls Realty and Godrej witnessed marginal to moderate increase in leverage on negative free cash flow to equity (FCFE).

FCFE is a mean to calculate the equity available to shareholders after accounting for the expenses to continue operations and future capital needs for growth.

DLF has recently sold Aman Resorts; along with the final settlement with DDA on the Dwarka Convention Centre project, the firm's net debt has gone down to Rs 17,400 crore.

"Given the muted environment, sales bookings and operational cash flows will be key to maintaining debt at lower level. We cut our sales bookings estimate by 28 per cent for FY14 and 14 per cent for FY15 due to an extremely tepid NCR market. While stock performance will largely hinge on pickup in sales bookings, the stock trades at an attractive 37 per cent discount to NAV," said Aashiesh Agarwaal of Edelweiss Securities.

On Unitech, Saurabh Kumar of JP Morgan in a note said that pre-sales for 9MFY14 have dropped to the lowest levels since 2009 and the company seems to be struggling to accelerate the pace of legacy deliveries.

"We think Unitech's stock price at 0.3x P/B (with key land parcels at historical rates in BPS) materially understates its land assets. However, given potential cash mismatch in the business, the value may not crystallise. A few large asset sales (UCP/Hotels) will be required to unlock this value," it said.

On Oberoi Realty, Tejas Sheth of Emkay Global, said, "The value of Cash, Commerz-1, Westin and Commerz-2 (projects in Goregaon) is equal to 35 per cent of the current m-cap and 28 per cent of our estimated NAV. Fall in Mumbai housing prices by more than 25 per cent would add to the downside risk to our target price. Any slowdown in the Mumbai housing space would exemplify the Oberoi brand and the balance sheet strength in the minds of consumers," Sheth says in a note. Oberoi Realty has recently got approval for its Mulund project, which could be launched within three to six months. The firm is seen to officially launch projects such as Oasis in Q4FY14 and Splendor Prisma in Q2FY15.

In the meantime, Sobha Developers has reduced its sales volume guidance to 3.8 million sq ft in FY14E against its initial guidance of 4.2 million sq ft. Experts see launches in low ticket size projects and ramps up in free cash flow as being key to the stock.

As far as regulations are concerned, industry watchers believe the recent Land Acquisition Bill has made acquisition process more complex and time-consuming. They cited clauses regarding sharing of future incremental gains from land transactions with land owners, obtaining mandatory consent of 80 per cent of the owners and different resettlement procedures as the key irritants.

Anuj Puri, chairman and country head at Jones Lang LaSalle India said, "The Land Acquisition Bill continues to remain a cause of concern for the real estate community because of issues such as inflated land cost and the complexity involved in resettlement of original inhabitants. These issues, which came to light in the version that was released in late 2013, still need to be addressed."

Overall, the near-term management outlook has deteriorated moderately and is expected to improve in 2HFY15 after the general election. The focus is seen to remain on streamlining cash flows and ontime launch and execution. ▪

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