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By Prasanna Deshpande Jan 25 2012

Rough terrain ahead

Real estate sector has been facing troubled times since 2008 and the underlying concerns are showing no signs of subsiding

Year 2012 hasn't heralded a new era for real estate sector. The going has been tough for most players, while investors seem to be less optimistic about the industry's immediate prospects, especially in commercial and retail segments.

Once the darling of investor fraternity before the onset of 2008 global economic meltdown, the real estate sector has since been on slippery ground. Industry analysts and experts believe that the sector would continue to face a fall in demand in 2012 as well, with most of the underlying concerns still showing no signs of subsiding.

Analysts feel it would take some more time for the sector to come out of the woods as sluggish demand, rising construction costs and higher equated monthly installments (EMI) because of significantly higher interest rates are the key concerns that will continue to haunt the sector.

Slowing GDP and job losses may lead to postponement of purchase decisions, further affecting residential demand. Rating agency Fitch in its recent report stated that outlook for the country's real estate sector remains negative in 2012 due to weak overall demand and higher construction costs, which are likely to continue to squeeze margins.

Hemant Kanawala, head (equities) of Kotak Mahindra Old Mutual Life Insurance, told FC Build that the sector continues to suffer from high debt and slowdown in demand in commercial and retail sector. "Although residential demand is good in many geographies and prices are firm, there can be correction in demand due to slowdown in the economy. Hence outlook remains cautious at the start of year."

The weak fundamentals of the sector were well reflected in the share prices of several top-notch realty companies in 2011, which under-performed the benchmark Sensex. Last year, shares of HDIL crashed 72 per cent and Unitech 71 per cent, while Indiabulls Real Estate and DLF plunged 66 per cent and 38 per cent, respectively. During 2011, the sector barometer BSE Realty index declined 52 per cent, while benchmark Sensex ended 25 per cent lower.

Bikram Sen, CEO of Arthveda Fund Management, a DHFL group company, said, "Whether stock prices bounce back or remain low is a function of the prices relative to the underlying intrinsic value, which in turn is a function of the fundamentals driving the business. Whenever the intrinsic value is sufficient to justify the current prices or is higher than that, the stocks do bounce back eventually."

In its attempt to keep a check on headline inflation, the Reserve Bank of India raised key policy rates 13 times since March 2010, which pushed up bank interest rates and had far-reaching impact on home loan seekers. With home loan rates turning dearer, demand for housing loans moderated leading to fewer sales at the developers' end.

"The RBI has continued to increase policy interest rates in 2011. Home loans with step-up interest rates (floating loans with fixed rates initially) were also discontinued by home loan lenders, due to pressure from the RBI. Both these factors have led to an increase in EMIs," the Fitch report said.

However, Kanawala says there is expectation of RBI cutting policy rates from April onwards. This should ease interest cost pressure for highly geared companies and also help revive demand for property at the margin. Hence earnings can get some respite from reduction in interest cost.

Realty players will have to balance between volume and prices. They should cut rates to boost volumes, which will help improve cash flow in their business and reduce debt, said Kanawala.

Even as demand for residential homes continues to remain sedate, the commercial segment has not seen any major pick up either due to supply glut.

Sunil Mantri, chairman, Mantri Realty, said there is excess supply in the commercial segment by around 30 to 40 per cent annually and it will take at least two years for the existing stock to get exhausted. “Absorption in the commercial space is low as IT and retail sectors are going through a tough phase,” says Mantri.

Hariprakash Pandey, vice president - finance, HDIL, agrees. “The commercial segment has over supply situation with a muted a growth and it would take the next couple of years to exhaust the existing capacity. Lease rentals for commercial space are likely to remain muted given the higher supply. However, since developers are now shelving plans of constructing commercial real estate and in many cases converting them into residential projects, in the long-term once the demand revives there will be shortage of commercial space which will drive prices upwards.”

Mantri, on his part, is bullish about the residential segment. He said at the moment overall residential demand has slowed down due to high interest rates and as consumers are expecting price correction. The actual demand still remains and if the interest rates on housing loan decline, the positive sentiment of consumers will once again return.

Liquidity pressures: With fund raising becoming more and more difficult, dependence on operational cash flows to fund growth and service debt will increase. Foreign direct investment and private equity funding has dwindled and a weak equity market no longer makes IPOs a viable funding option. All this, together with the banks’ cautious approach, limit fund raising options.

Analysts believe that developers of commercial properties, which have stable rentals as a significant portion of total revenues, will have stable credit profiles but the outlook for the industry as a whole is negative.

Besides, rising construction costs and higher inventory levels, most companies continue to sit on a huge pile of debt although steps to reduce them by offloading non-core business has been gaining ground.

Some real estate companies reduced their gearing levels in 2011-12 by selling non-core assets, like land parcels and IT Parks. Overall, gearing of large real estate companies has decreased by about 20 per cent from the post-crisis peak of around 0.89 times, the Fitch report said.

Realty companies are looking at all instruments: Equity, debt, and convertibles. It depends on specific terms and conditions, investment mandates and risk appetite of the investors, and the relative bargaining power of the parties involved in a deal, said Sen.

It is possible that certain cities where the prices of real estate have become delinked from the fundamental buying power of the households in that city could correct. However, whether this will happen in any particular timeframe is not a call we would like to take. But it is getting more and more likely in markets where there is huge oversupply compared to the demand and the prices are delinked from the income levels.

They are trying to deleverage by selling off non-core assets and businesses, said Sen.

Outlook: Improvement in demand, either due to a decrease in interest rates or the launch of new projects at affordable prices, would have the potential to improve cash flows to real estate companies and change the outlook to stable.

HDIL's Hariprakash Pandey said the performance of real estate sector would depend on overall economic scenario and this calendar year everyone is focusing on consolidation including developers.

Pandey also said he is bullish on the residential segment as interest rates are expected to fall in the next couple of months. “In the next six months definitely residential demand will be back.”

(With inputs from Jharna Mazumdar)