The paradox of residential real estate prices

Sales have been low for a while, but this has not brought down prices. Here's why

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The Indian real estate sector, especially the residential segment, defies the normal demand-supply mechanism that determines prices. A report titled 2014 Outlook: Real Estate Sector by India Ratings and Research Pvt. Ltd, the Fitch group's research arm, said that prices of residential units have risen continuously since financial year (FY) 2009 and considering that the end-user affordability is on the decline, this is a paradox. The report further added that "residential demand has been hit by the continuous rise in prices and persistent negative sentiments". The total area sold in sq. ft terms decreased in the first half of FY14 and this is expected to continue in the first half of FY15 as well.

Unlike other asset classes such as equity or gold, which witness cycles of price appreciation and depreciation concurrent with various domestic and global economic, political and socioeconomic events, real estate prices tends to be "sticky"—after attaining a certain level, they tend to remain there or increase ultimately. There are, however, pockets across the country that may have seen slight correction. "There is a common thread across segments in the real estate sector: the project off-take has slowed and there is enough inventory, but prices have not come down," said Lalit Kant, head-real estate, Arthveda Fund Management Pvt. Ltd. He further added that if projects are slowing down, to bring in more liquidity, prices should fall. However, since this is not happening, it means that either developers are able to sustain themselves without sales increasing or bring in liquidity from other sources—both from on-shore and off-shore financing.

Let's examine some of the reasons that are contributing to this phenomenon.

Market dynamics

Real estate is a preferred choice for investment in many parts of the world. "Despite various software, training and codes, nobody has been able to crack equity across the world," said Sanjay Dutt, executive managing director-South Asia, Cushman & Wakefield India Pvt. Ltd. According to him, real estate is a local and tangible asset, and the principal does not get eroded. Also, the certainty of returns makes the sector behave differently. Apart from that, in India there is an emotional connect of having your "own home".

Most retail customers hold real estate for the long term, maybe for a future goal. "It is held as a hedge in the long term," said Sunil Agarwal, adjunct professor at RICS School of Built Environment and managing director, Black Olive Ventures Pty. Ltd.

Other investment instruments either give negative or low inflation-adjusted returns. Gold, though volatile and risky, is the other asset class which retail customers are comfortable with. This again is due to various social factors.

Apart from those who buy a house to live in it, there is another set of participants in the residential space—investors. They typically look at real estate as another asset class and look to get returns as they would with other asset classes. The India Ratings report said: "Builders, perhaps expecting a greater participation from this segment rather than from end-users, prefer to gradually increase prices, satisfying the return expectation of investors."

Parallel economy

Though it is difficult to explain and establish the rationale, said Dutt, but globally there is a parallel economy that finds its way into real estate. As the sector is not transparent, it is a destination for black money investments.

Agarwal seconds this view. "These are mostly high net worth individuals," he added. The parallel economy generally uses cash to park its money in the sector. Since capital gains are taxed at a high rate and stamp duty is also high, some investors use cash as a medium of investment to save on these.

"In fact, developers give discount to HNIs but not to retail customers. This does not come to the notice of retail investors," said Dutt. Typically, such big investors are reluctant to withdraw their investment as real estate is considered a safe haven.

“Developers do not play with their own money and deep-pocketed financiers will not force a repayment schedule,” said Kant. This is another factor that keeps prices of residential projects from reducing.

Developers’ cost matrix

A real estate project has to cross various barriers before it reaches the execution stage. “A developer goes through a harrowing time at various stages of development—buying land that has no litigations, adequate manpower and various clearances are some of these,” said Agarwal.

Typically, a project is sold at a margin of 20-25%. Developers incur 30-40% as land cost and another 30-40% as construction cost depending upon the location of the project. “Since 60% of the cost is received by the developer, there is no rush to reduce prices in case of low sales,” added Agarwal.

This portion of the cost—land and construction—is often taken care of by the money coming through the parallel economy. “Since the short-term need of the developer is met, it can go ahead with construction and debt finance,” said Dutt. Since developers already make some profit by this stage of the project, or reach break-even, they tend to keep the prices high.

Banks, too, look for safe avenues with good developers. If banks stop construction lending, there are very few other opportunities to invest in. “Other sectors such as telecom and auto are limited,” said Dutt. This keeps project financing on track for developers. Though there are rising non-performing assets with banks and there is pressure from the Reserve Bank of India to lighten books, “if banks move in Sarfaesi, other loans may go under as well,” said Kant. (Through the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, or Sarfaesi, financial institutions can auction residential and commercial properties if borrowers have not made repayments.)

The theory is that once prices are pulled down, there could be a freefall. And, of course, no developer or investor will want that to happen.

Is it sustainable?

Agarwal, however, believes that projects where the margins are more than 25-30% will see a correction soon. “These would typically be luxury projects (that cost `8,000 per sq. ft or above). Some pockets, such as south Delhi, have seen a correction,” he added. However, projects in the mid-segment, `4,000 per sq. ft level, may not see a fall as margins here are lower.

“Prices are also inflated from the market and political sentiment angles. If these change, prices will change accordingly,” said Dutt, but added that the changes won’t be radical.

Some of the investors may not pull out their money for another 5-10 years, and so the prices will remain stable. However, factoring in inflation of, say, 6-8% in the long run, the real cost will reduce if not the per sq. ft rate.