INDIAN REAL ESTATE INDUSTRY – ON THE WAY TO RECOVERY

Dr. Sujit Kumar Jha
Assistant Professor,
Department Of Commerce,
Nagendra Jha Mahila College, Laheriasarai

Abstract : **After a rough phase that lasted for over a year, the Indian real estate industry is now on the path to recovery, driven by price corrections, softening of interest rates, the launch of affordable housing and improved liquidity. Developers had adopted a two pronged approach to survive the slowdown in the industry. First, they worked on improving their balance sheets and liquidity position, and second, they focused on developing self-funded projects such as affordable housing. These strategies are now bearing fruit and are helping in the recovery of the industry with a revival of demand in the residential sub-segment.**

IndexTerms - **Sub-segment, Real-Estate, Industry, Recovery.**

Introduction :

In the past few months, the residential real estate segment has witnessed a revival in demand, primarily due to improved affordability. Several developers have launched new project in the affordable housing sub-segment, which have received an encouraging response. The following factors have resulted in this recovery of demand in the residential segment.

- **Lower interest rates:** The continuous decline in the REPO and reverse REPO rates of the RBI has helped to bring down home loan rates. Current home loan rates are 125-125 bps lower than the peak rates witnessed in FY08, which encourages end users to avail of home loans.
- **Decline in property prices:** Property price have declined by 15-20% since their peak levels. Even new project have been launched at lower prices (25-30% less than earlier). This has resulted in an increase in property registrations in most micro-markets.
- **Launch of small-sized affordable apartments:** Developers have reduced the size of apartments to make them more affordable for customers and attract a larger number of buyers. One-bedroom flats and studio apartments have also been launched, and additional features such as swimming pools and club facilities are no longer part of many upcoming projects. Frills have been done away with in most projects, with developers

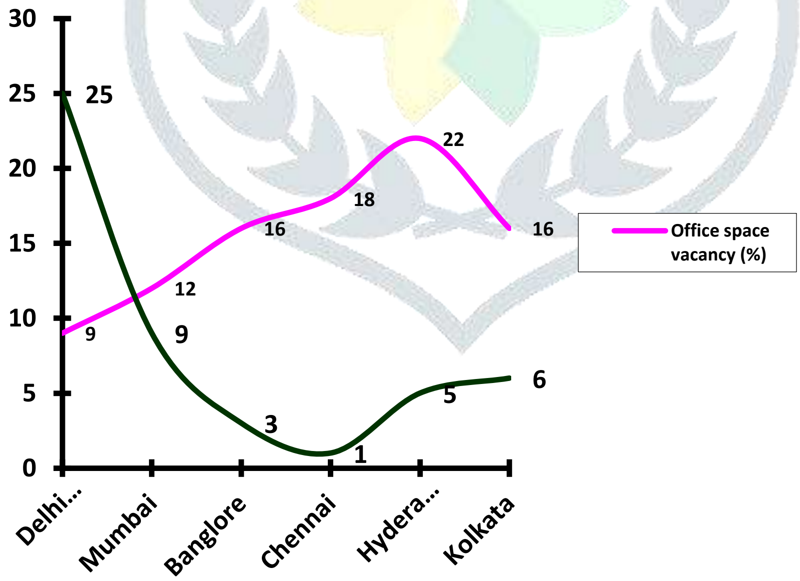
having become cost conscious and using their discretion while determining the material to be used/facilities to be provided.

2. Commercial, retail and hospitality segments still struggling

Due to the global economic slowdown, demand from the IT/ITES industry, has declined significantly, since these companies have reduced their recruitment of employee's. The demand from multinationals has also declined, since most players have deferred their expansion plans in the country. This has resulted in low absorption and high vacancy levels, with most micro markets facing the risk of oversupply.

In the aftermath of the global economic slowdown, most retailers have deferred their expansion plan in India, since the slowdown in demand has resulted in a decline in their revenues and profitability. This has resulted in an oversupply of mail space in the country (close to 300 operational malls at the beginning of 2009) and led to a decline in rentals in most micro-markets. Many developers have delayed or cancelled their mall projects in an attempt to bridge the demand-supply gap.

Vacancy Levels across Cities (FY98)



Graph - 1

As developers shifted their focus to self-funded projects due to the liquidity crunch, they deferred and even cancelled hospitality projects that have higher gestation periods. This has resulted in the widening of the demand-supply gap in hotel rooms in the country. However, the RBI has proposed the exclusion of hotels and hospitals run by developers form the ambit of commercial real estate exposure, for the purpose of bank lending. This is expected to ease lending for the development of hotels and help to increase the number of hotel rooms in the country.

Financing of SEZ project is also expected to case, since the government has allowed access to ECBs for SEZ development under the approval route. The proceeds can, however, only be used for infrastructure facilities in an SEZ and not for integrated township and commercial real estate development within the SEZ.

3. Land deals reviving but primarily in local markets.

Enhanced financing options and improved liquidity have revived developers' interest in acquiring land parcels at strategic locations. Large developers have begun buying land, especially in their local markets and other key cities, which have all the required approvals, primarily through auctions.

Table - 1

Developer	Land (acres)	Deal size	Location
DLF	350	17,500	Gurgaon, NCR
IBREL	4	13,760	Nariman Point, Mumbai
Hiranandani	135	8,000	Bangalore, Chennai and Hyderabad

4. Real Estate IPOs making a comeback

After shying away from capital markets for over a year, many real estate companies have again announced their plans to tap capital markets for funds. Around 15 companies, including Emaar-MGF, Godrej Properties, Lodha Developers and Oberoi Constructions, plan to issue their IPOs during the course of the year.

OVERVIEW OF FUNDING PATTERNS IN INDIAN REAL ESTATE

During the golden period for the estate sector beginning 2005, banks showed great enthusiasm in providing debt to the real estate sector. The period between 2004 to 2009, saw debt capital flowing into the real estate sector increase form INR 55,770 million in 2004 to INR 9,15,750 million in 2009 (Reserve Bank of India), representing a CAGR of 75% During

FY2008-09, the Reserve Bank of India brought in change to its provisioning norms for lending to the real estate sector by bringing in an increase from 100% to 150% thereby reducing the overall capacity of banks to lend to the sector. Although this provisioning norm was revised once again in FY2009-10, reducing it back to 100%, banks have seemingly reached the ceiling for exposure to commercial real estate. A positive indication reflected in the recent circular issued in September 2009, suggesting the exclusion of hotels, educations institutions and hospital form the definition of commercial real estate by RBI, is expected to increase the level of credit provided for such projects.

1. **Funding Trends across Various Real Estate Asset Classes**

    a) **Residential:** Funding residential projects has always been a priority for bank because of the social objective of providing housing for all. In most residential projects, bank look at funding one-third of the project cost through debt. The rest of the project is generally funded through equity and advance form customers. The typical tenure of lending by banks for such projects is three years.

    b) **Commercial Complexes/Malls:** In their effort to garner higher spreads on their interest income, bank had been looking for opportunities that could fund such high spreads. Commercial real estate was the only sector that could absorb these high interest costs on paper. Thus, the eagerness of bank of fund these projects resulted in huge over supply of commercial complexes and malls across the country. This oversupply has now led to the slowing of lending to these projects. Some corporate organizations, which still want to fund such projects, are resorting to the option of formulating their corporate balance sheets in the form of guarantees to raise debt for their projects.

    c) **Hospitality:** Many hotel projects had taken off with the influx of business and leisure travelers between 2004 and 2007. During this period banks were willing to provide debt to these projects at a 70:30 debt equity ratio. This ratio has seen a decline to 55:45 due to reducing occupancy and rentals. Today, banks are selective in lending to hotel projects and are looking for incentives that were offered to hotel projects being set up in the NCR region due to the Common Wealth Games (for projects that could come up before 2010.)

d) **Slum Rehabilitation:** The main challenge in a slum rehabilitation project is the rehabilitation of slum dwellers. Almost all slum-rehab projects are in Mumbai, there are political overtones in their rehabilitation and it is extremely difficult for banks to assess the risks in such projects until such time when the hurdle of rehabilitation is crosses, banks are willing to fund the remaining project (residential and commercial) on a 60:40 debt equity ratio due to the high project margins.

e) **Hospitals:** Hospitals have been removed from the definition of commercial real estate. Therefore, such projects are finding favour with banks and are able to get debt funding with an equity ratio of 67:33. Banks are also willing to lend up to a door-to-door tenure of 9 to 11 years for hospital projects.

f) **School:** School has also been taken out of the definition of commercial real estate. Therefore, banks are willing to lend to them, not just because school do not have the problem of exposure but also because they feel they are contributing to a social cause. The general debt equity ratio use to finance schools is 50:50.

g) **Warehousing:** Banks are enthusiastic about funding warehousing projects. However, long gestation period and low rentals make it difficult for banks to fund these projects at a debt equity ratio greater than 50:50. Banks are generally unwilling to take a position for projects that may span over seven year.

Changes in terms for bank funding from 2004 to 2009 under different real estate sub-sectors:

Particulars	2004					Current Scenario				
	Commercial complexes	Hospital	Hotel	Residential project	Schools	Commercial complexes	Hospital	Hotel	Residential project	Schools
Debt: equity ratio	60:40 including land funding	70:30 including land funding	70:30 including land funding	50:50 including land funding	66:34 including land funding	Funding not available	60:40 excluding land funding	60:40 excluding land funding	33:67 excluding land funding	66:34 excluding land funding
Interest rate	Sub-PLR around 11%	Sub-PLR around 11%	Sub-PLR around 11%	Sub-PLR around 10-11%	Sub-PLR around 10-11%	-	PLR + 1-2%	PLR +1%	PLR + 1-2%	PLR +1%
Security	Fixed assets	Fixed assets	Fixed assets	Fixed assets	Fixed assets	-	Fixed assets + collaterals + guarantee	F.assets + collaterals + guarantee	Fixed assets + collaterals + guarantee	Fixed assets + collaterals + guarantee
Tenure	Up to 11 years	Up to 13 years	Up to 10 years	Up to 5 years	Up to 7 years	-	Up to 9 years	Up to 8 years	Up to 3 years	Up to 5-7 years

2. Available sources for funding

Banks-PSU's and private sector	➢ Banks and in particular public sector banks continue to be the biggest providers of debt to the real estate sector. ➢ Banks do not usually finance acquisition of land in a real estate project. Since there is an RBI regulation against this.

Hedge Funds	➢ Hedge Funds based outside India, are not allowed to lend to real estate projects in India. ➢ Hedge Funds typically bring in money into real estate projects through a convertible structure but with a fixed yield, although such investments cannot strictly be termed as debt. ➢ The yield expectations of these funds when lending to real estate ventures are generally in the region of 25 to 30%.
Mutual Funds	➢ In the past, Mutual Funds were able to provide funding at the corporate level to corporate organizations for various ventures for a period of one to two years against a rating form a rating agency. ➢ With the slowdown in real estate activity and reduction in demand, real estate companies have seen their credit rating taking a beating, Therefore, this avenue of funding is practically absent now.
Insurance Companies	➢ Insurance companies generally invest in instruments of debt and do not provided loans directly. These debt instruments need to be rated. ➢ With the credit ratings of all real estate companies plummeting, insurance companies do not consider them secure investments.

Fixed Deposits	➢ Companies are allowed to borrow up to one third of their net worth through fixed deposits. ➢ Increasingly several corporate organizations are resorting to borrowing through fixed deposits.

3. Restructuring policy for real estate projects

The difficulties faced by the real estate sector due to the sudden and significant reduction in demand resulted in the RBI taking the initiative to extend special treatment to commercial real estate exposures by allowing loans to be restricted (up to 30 June 2009.) This has enabled real estate players to stagger their repayments to banks. Therefore' reducing their outflow of cash in these difficult times. This is one of the main reasons for the recovery of the real estate market.

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