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CRISIL Webinar Takeaways

ViewCube

September 2019

Real estate

Realty check

Slowdown woes linger as demand dries up

Price correction on the anvil

ViewCube is a compilation of sector views expressed during CRISIL's webinars.

These include CRISIL's own views, that of stakeholders, and those emanating from a poll done during the webinar.

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Contents

Our view

The ongoing liquidity crisis in the non-banking financial company (NBFC) segment and jitters from implementation of the Real Estate (Regulation and Development) Act, 2016, have taken a toll on smaller residential developers. Collections have diminished on-year due to low incremental sales and construction slowdown because of lack of funds.

The ticket size of residential projects has been shrinking as developers have been launching units at 7-15% reduction in prices with lower average area per house, led by both market needs and the government's impetus to affordable housing. End-users have been gravitating towards well-established players with a track record of completing and delivering projects on time. For smaller players though, improvement hinges on resolution of the recent NBFC liquidity issues. While large established players with relatively healthy balance sheets and a sizeable operational commercial portfolio to lean on are seeing double-digit growth in collections and sales, smaller ones have been left smarting by the twin blows.

The strong performance of the commercial real estate segment downplays the stress seen in the real estate sector. Unlike the tepid residential demand, the commercial portfolio is seeing steady lease rentals and healthy demand. Indeed, even as investor interest in the residential segment has been fading due to limited property price appreciation and inability to monetise the assets, commercial real estate is becoming a hub for new investments. This has helped cushion the blow for developers who need to refinance their debt and take on more debt for construction. Larger developers with a portfolio of commercial assets have been able to manage their liquidity better and are expected to continue to do so in a market where raising capital is becoming challenging.

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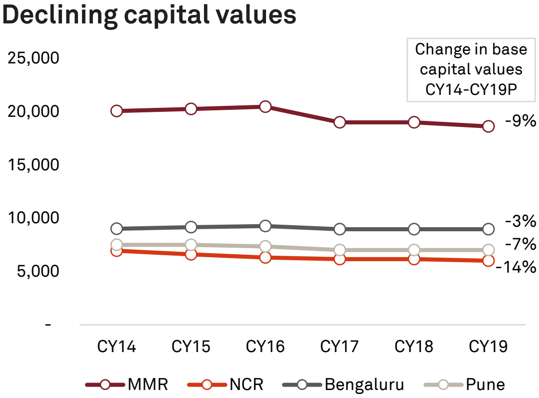
Real estate demand has bottomed out, but significant demand unlikely

Our assessment of the real estate scenario in four key cities of India (Mumbai Metropolitan Region (MMR), National Capital Region (NCR), Bengaluru and Pune) indicates that demand for new homes has bottomed out and is likely to stabilise. Over the last 6-7 years, demand has declined at a compound annual growth rate (CAGR) of 7%, both on account of city-level as well as sector-level factors. However, affordability has improved because of reduced capital values and more launches in lower ticket sizes. Over the next 3 years, demand is set to grow at a slow pace of 3%. Concerns related to income growth, preference for rental options and low confidence in under-construction projects is likely to keep demand range-bound. Bengaluru is likely to fare relatively better than the rest of the cities. Results of some of the listed developers in the city indicate a favourable trend in area sold in fiscal 2019 compared with the previous years.

Base price correction looms, can draw in buyers

Price correction will drive individual participation gradually. In this context, we see that developers are pushing for volume sales, but prices have remained under pressure. The base price is expected to correct by 7-15% across MMR, NCR, Bengaluru and Pune, as shown in the following chart.

Declining capital values



Note: Absolute numbers for NCR are the lowest, weighed down by low prices in the micro markets of Noida, Greater Noida, Faridabad, Ghaziabad.

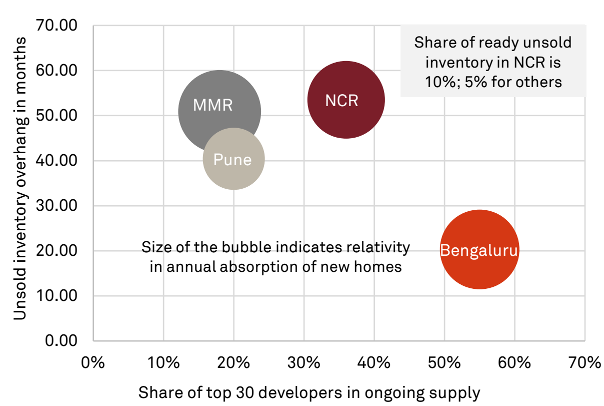
In addition to the correction in base price, developers are offering discounts such as inclusion of stamp duty registration, waiver of Goods and Services Tax. Freebies and add-ons are also being offered, leading to overall savings of 10-30% for end-users. The price correction, coupled with focus on lower ticket sizes, will improve affordability and give impetus to demand.

Ticket sizes have reduced in the last three years

Over the last 2-3 years, the overall area of new houses launched has been reducing to make houses affordable, given the government's thrust on affordable housing. In the case of MMR, only 20% of new launches in the last 3 years were at a ticket size of more than Rs 1 crore, while houses launched before 2017 show 40% units priced at more than Rs 1 crore. All the four cities assessed have a similar trend. In MMR, there is a preference for ticket size of less than Rs 1 crore, while in the case of the rest of the cities, there is a preference for ticket size of less than Rs 75 lakh.

Inventory overhang continues to be a major concern in NCR and MMR

Supply - Inventory overhang and market consolidation



Note: Unsold inventory includes both under-construction and ready-to-move in properties

As evident from the chart above, Bengaluru continues to highlight a trait of an organised market (top 30 developers accounting for more than 50% share) and least amount of unsold inventory. On the other hand, MMR and Pune have low share of top developers in overall under-construction projects due to the fragmented nature of the markets. The unsold inventory in MMR is high, mainly because of premium projects, which have a high contribution in total supply. In the case of NCR, unsold inventory is elevated because of reduced participation of investors and end-users on account of low confidence in the properties under construction.

Small developers feel the strain; large developers resort to alternative modes of funding

CRISIL believes that small developers with residential portfolio and no access to alternative modes of funding will face challenges in refinancing, given that the cost of borrowing has gone up significantly. In some of the cases where absorption has remained low, the financial viability of such projects remains questionable.

Small developers and landowners came under pressure post the implementation of the Real Estate (Regulation and Development) Act, 2016, (RERA) and GST, and the situation got aggravated after access to funding stopped because of liquidity issues at non-banking financial companies (NBFCs) since the second half of fiscal 2019. But, this has opened up opportunities for large players.

Large players with stronger balance sheets and access to bank funding are leveraging their position to purchase assets at distressed values. This also allows them to have joint development (JD), joint ventures (JV) and development management (DM) modes of operation while expanding in their current geographies. Some of the top developers have also tapped into alternate sources such as leveraging of lease rentals.

Low vacancy supporting escalation in commercial lease rentals in some micro markets

In the commercial segment, the trend is by and large favourable across cities. Vacancy levels for Grade-A offices are in a low-to-moderate range across cities. This will work in favour of commercial lease rentals, which, we believe, are likely to escalate by 5-10% per annum over the next 2-3 years.

Commercial real estate scenario across top 4 cities

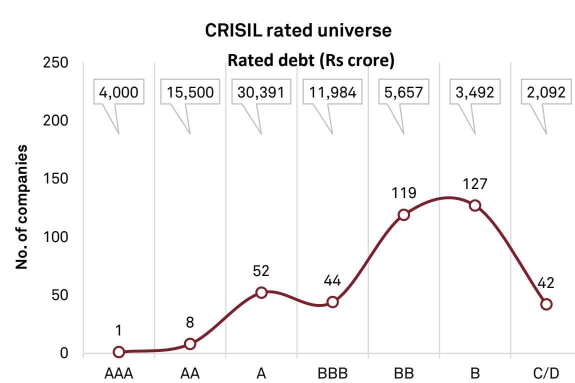
For Grade-A offices	Unit	Bengaluru	NCR	MMR	Pune
Estimated supply addition in 2019-2021	MSF	15-17	15-17	8-10	7-9
Estimated demand in 2019-2021	MSF	16-18	12-14	10-12	7-9
Existing office stock	MSF	130-135	100-105	85-87	47-49
Prevailing vacancy	%	5-10%	25-30%	15-20%	5-10%
Estimated lease escalation per year (for next 3 years)	%	7-10%	3-5%	3-5%	3-7%

Although supply addition seems to be outpacing demand in the NCR market, leaving out the Noida and Greater Noida micro markets, the rest of the locations have moderate level of inventory.

Amid funding crunch and slow demand in the residential segment, large developers having a portfolio of yield-generating commercial assets are better positioned to benefit from favourable trends on commercial assets. Over the last 3 years, ~70% of the almost Rs 750 billion of private equity investment that the sector has seen has been parked in the commercial and retail portfolio.

Rating distribution mirrors the inherent risks in the sector

Rating distribution of real estate segment in FY19



Above data excludes ratings classified as 'issuer not-cooperating'

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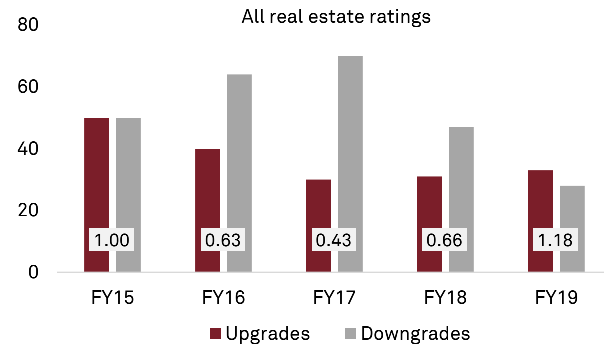
The rating distribution is seen leaning towards lower categories, indicative of the inherent risk in the sector. The median rating for the sector is at B+, which is defined as having high risk of default regarding timely servicing of financial obligations. Additionally, with a quarter of the total rating downgrades being directly to a D, the stress in the sector is evident. CRISIL's credit ratio also mirrors the trends witnessed in the sector, as evident below.

CRISIL's credit ratio of real estate portfolio



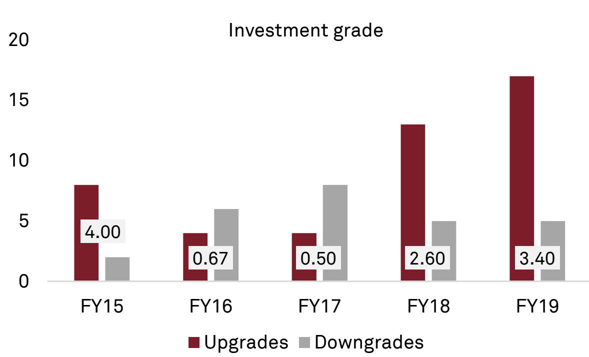
Credit ratio has been on a downhill trend since 2016

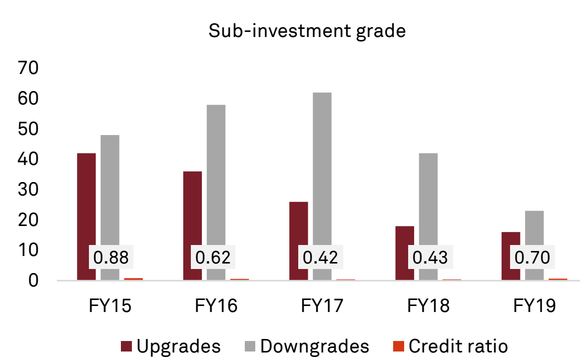
CRISIL rates over 700 companies in the sector, which includes residential developers, commercial real estate developers, special purpose vehicles (SPVs) and diversified developers who have a portfolio of both commercial and residential assets. Credit ratio is the ratio of number of upgrades to the number of downgrades during a particular period. For the real estate sector, the credit ratio has remained below one from fiscal 2016 to fiscal 2018, meaning there were more downgrades than upgrades in the portfolio.

Splitting the credit ratio, we see that the stress is much higher in the residential segment, while the commercial portfolio is healthy. The uptick in the overall credit ratio witnessed in 2019 as seen in the chart above, is due to the strong performance in the commercial real estate segment.

Another split (refer chart below) shows that the credit ratios of the investment grade portfolio has been consistently above one time for the past few years, while credit ratio of sub-investment grade portfolio is under pressure. This means that the larger, disciplined players are faring much better, even in the subdued environment, while the smaller players with leveraged balance sheets are facing headwinds due to low demand, funding issues and compliance with RERA.

CRISIL's credit ratio of real estate portfolio – split between investment and sub-investment grades

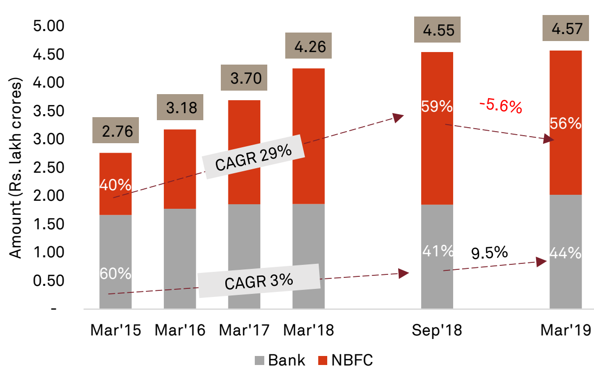




Lending by NBFCs off highs; banks have filled in part of the void

The real estate sector relies heavily on banks and NBFCs for funding, while some portion of the overall requirement has also been met by private equity and other alternative investment sources. Incremental debt from banks, who were the largest source of funding in fiscal 2015, has dried up in the last few years with lending largely restricted to refinancing and commercial segments. NBFCs supported players during this time, increasing their share in developer loans from 40% in March 2015 to 59% by September 2018. The tightening of liquidity for NBFCs since then has had a bearing on the real estate sector. That said, lending from banks has inched up to bridge part of the gap. However, the stress in NBFCs will delay the execution of projects, thereby impacting developers' economic benefits. End-users are already gravitating towards completed or near-completion projects increasing the fund requirements for developers. Moreover, with RERA, delays in project implementation can jeopardise economic benefits for developers.

Trend in developer debts – funding dried up in second half of FY19



Conclusion

CRISIL believes large players with strong brands, healthy balance sheets and a commercial portfolio to lean on will continue to strengthen their position, gain market share and find ease in refinancing.

Liquidity options such as leveraging of lease rentals, equity infusion and private equity investments will fulfill funding requirements over the near term. Opting for real estate investment trust (REIT) could be another way to help developers deleverage and the success of the first REIT has set the tempo for this option. The liquidity issues of NBFCs are not expected to go away in the near term and many small players who are dependent on them are not expected to survive this cycle.

The sector is expected to consolidate, with large developers increasingly opting for JVs and JDs with larger, established names to benefit from their processes and financial flexibility. Monetisation of projects will dominate fund-raising in the interim.

Their view

Views excerpted from a panel discussion during the CRISIL webinar on the real estate sector. The webinar was attended by 311 external participants representing 147 organisations.

The panelists were:

Vinod Rohira
Managing Director - Commercial Real Estate and REIT
K. Raheja Corp

Balaji Raghavan
Managing Partner and Chief Investment Officer - Real Estate
IIFL Asset Management

Dev Santani
Head - Special Opportunities and Credit - India
Brookfield Asset Management

Some gain...

On the lucrativeness of real estate in India vis-à-vis other markets

India is fundamentally growing faster than the rest of the world. It has a reassuring gross domestic product (GDP) story and a large population – which offers a great opportunity in terms of returns. However, the country does face challenges: (a) a dynamic environment with change being the only constant - RERA, Goods and Services Tax (GST), Bankruptcy Code; and (b) operating and regulatory challenges. The rules for investment and taxation have changed a few times. It is not simple to bring in money to India.

On developers focusing on commercial vis-à-vis residential

A lot of developers are being encouraged to convert land slotted for residential to commercial real estate if the dynamics of the micro market and all the other logistics allow demand to shift. The perennial challenge is that the cash-and-carry business model and the lease-and-hold business model suit two different profiles. First-time developers typically run for lower strata because there is benign demand in commercial real estate. The easiest way is to build something on the drawing board, start some work on it and then sell; this will not be without mistakes though. Commercial demand is driven primarily by high-end technology companies. But the question is: what kind of real estate or micro-environment is suitable for their kind of tech jobs? The product is evolving and has been changing every 4-5 years. You might be in the right location but you may not get the right chemistry in detail. Here's a macro perspective: Bengaluru continues to absorb 8-10 million square feet, Hyderabad 5-6 million square feet, Pune 5-6 million square feet, Chennai 3-4 million square feet, Mumbai CBD 2-3 million square feet, and tech jobs 2-3 million square feet. Strong demand is expected in these cities over the next 12-18 months. In fiscal 2023, you may see some supply increase in Hyderabad and Chennai. But in terms of the micro perspective, there will constantly be a problem and first-timers are going to enter. In terms of micro markets, increase in supply is on the drawing board and how much of that will get completed within the timeframe promised will also drive the supply-demand mismatch.

On affordable housing

At a macro level, the affordable housing segment is attractive. However, opportunity always comes with caveats. One has to be careful about where this product is being delivered because there have been instances where just by labeling something as affordable or cheap, one launches a project or acquires a land. However, it is not saleable because of lack of physical and social infrastructure. Demand has always been robust in the segment even though infrastructure is poor. If you look at any mortgage player across the country, the average ticket size of any loan indicates where the demand resides, so majority of the demand obviously resides in this segment. Some of the larger players have been getting into this segment. Since land prices are high in some of the cities that require this kind of housing, the opportunity to deliver affordable housing becomes a limitation. If one has to reduce the cost of land and go beyond city limits, then the infrastructure becomes a challenge. Owing to such challenges, larger players seem to have stayed away from this segment and are focusing on the mid-segment instead. But, eventually, infrastructure and growth catch up and cities do grow. It is safe to conclude that the opportunity exists and like in all segments, one has to be prudent.

On attractiveness of new segments – warehousing, logistics parks or retail

The logistics segment has shown a lot of promise. A unified regime of the GST opens up the market to wherever the consumer is. If it is retrofitted to assets of an older industrial set, it can still be viable, but if you are buying fresh land and looking for infra and building assets to a world-class level for warehousing, then the rental expectation needs to be higher. It is moving up, but it will take time to reach reasonable returns. Retail has seen a choppy ride for the past few years, but a serious amount of consolidation has already taken place in that market. Quality retail space will be back and there is demand for it.

On REITs

A REIT is the most stable available alternative currently; most of the organised money in real estate has considered REIT as a possible exit. REIT changes the perspective of how one sees commercial real estate as the focus shifts from the tangible to the intangible in terms of governance, compliance, and credibility. REIT has great potential because the interest rate regime is easing and with a minimum guaranteed yield as part of the offering, it offers an opportunity to invest. Secondly, many high networth individuals have looked at commercial real estate as an investment vehicle, but it is very difficult to manage individual assets. REIT makes it easier. Initially, people were cautious and wanted to see how the first REIT worked out, but now there is confidence in the market. A few more are slated over the next 2-3 quarters. A word of caution: right players need to choose REIT to establish it as a prudent product than a mere investment opportunity.

… But more pain

On the NBFC crisis

The NBFC crisis and tight funding have left the small and the medium-sized players in a lurch. With a focus on quality, limited bank capital is chasing only the top five developers in each city. There have been situations where the developer achieved financial closure but disbursements were not made by NBFCs which left the developer and the project stranded. Unfortunately, government intervention seems to have been ruled out to smoothen the stress in the NBFC space.

The developers have to increasingly focus on either selling some of their prime assets, focus on finishing a small part of their project using customer receipts, and try to minimise external dependency. Smaller developers are looking at their yield-bearing or hotel assets or even some other businesses unrelated to real estate to generate liquidity and complete their projects.

The liquidity crisis is today's reality. Most NBFCs were funding real estate mainly at the time of land acquisition. The financial sector is structured in such a manner that regulations permit banks and housing finance companies only to do working capital and construction financing. Therefore, anything which requires capital prior to that was so far being catered to either by private equity or NBFCs or structured debt. That source of capital has now dried up and is likely to remain so in the medium and long term. The Reserve Bank of India (RBI) has a set of norms, but these are tough to meet. The headwinds faced by NBFCs and the aversion of lenders to lend to them if they have large real estate exposures would seriously impede future lending. These changes, which started 6-8 months ago, are here to stay. Resultantly, the way in which capital will be raised going forward will also change substantially.

On price correction

Price correction is happening and will continue wherever required. Every market is different and every micro market within it is different. Places such as the MMR or the NCR have different demographics. We have been seeing stagnancy or correction over the past five years. Places where the end unit price is still not falling within the affordable range of that particular micro market even after the price correction will continue to follow the trend. A stark example of that might be the central region of MMR – Mumbai Central, where a large number of end units are priced above Rs 5 crore or so and resultantly buyers are limited. Even after a price correction, are there buyers for that size? Only price correction will not boost the market. Different projects and different micro markets will need a different formula.

On alternative methods of funding

Pension funds don't usually take development risks, especially in India. However, hedge funds, private equity funds financiers, etc, will be okay to take the risks for the right amount of returns. Over the past five years, the risk of getting into under-development residential projects in India hasn't been priced correctly. NBFCs getting in at the development stage are effectively taking equity risk for return (albeit in the form of non-convertible debentures). Risks and returns don't seem to match. With some of the bad capital out of the way, yields and financing costs are going to harden. It may not necessarily be all straight high-yield debt but the effective cost of financing for under-construction projects will go up and when that return makes sense for institutional investors, foreign capital will flow in.

Globally, there is no shortage of capital – there are zero and negative interest rates in parts of Europe. So, as long as yields make sense, given the risk involved, there will always be capital available to invest.

There is a lot of interest from stress funds – both from partners and other private equity players looking to enter India. But it takes time for returns to adjust. It takes time for people to see other funds actually get in, make investments and reap rewards. We will see a rush of players not in the next quarter or a couple of quarters, but over the medium term, after success stories play out.

On the impact of IBC and NCLT on the real estate sector

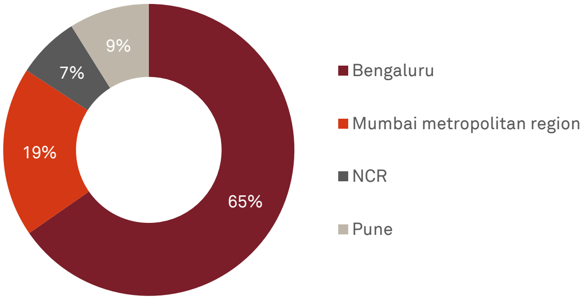
Since the rules of the game keep changing for National Company Law Tribunal (NCLT), the mindset of a lender who currently has a portfolio and needs resolution is to avoid going to these forums. Goals need to be streamlined, by which a secured creditor is recognised in the rightful form and there is a resolution by which the home owner gets homes. However, processes evolve. NBFC and private equity players would not prefer to go to NCLT as they lose control. Various other creditors, such as unsecured creditors and homebuyers, find resolution challenging.

Poll view

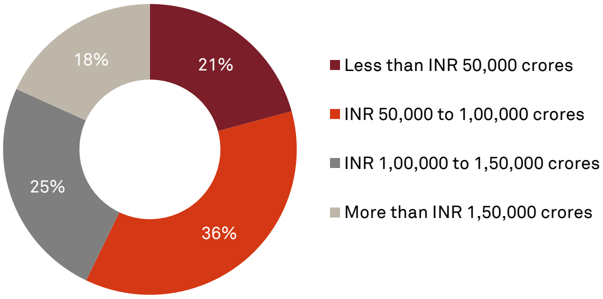
Results of the survey held during the CRISIL webinar on the real estate sector

Based on responses from over 120 participants

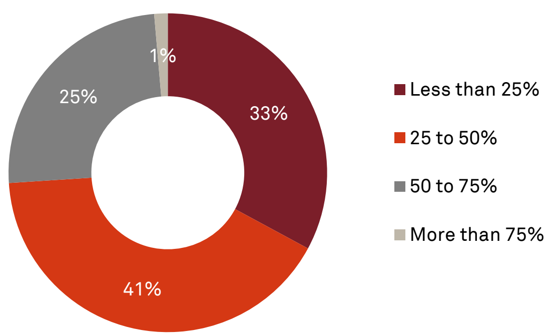
Which city is likely to revive first in residential segment?



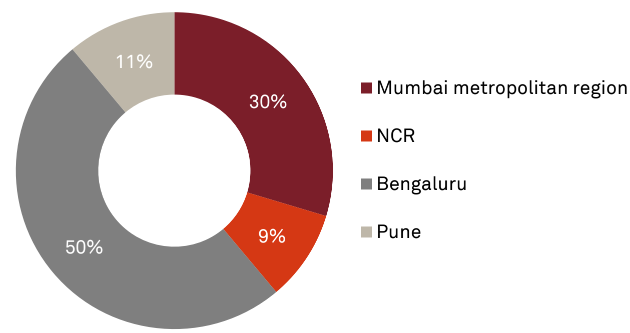
How much potential do you believe REIT will have in unlocking capital in India?



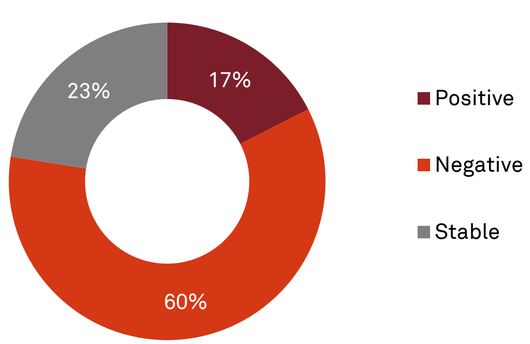
How many of the small residential developers are likely to survive the present liquidity crisis?



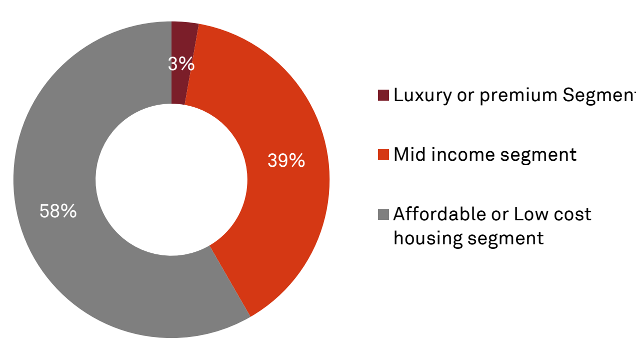
Which is the preferred commercial market?



What is your credit outlook on the real estate sector?



Residential demand will largely come from which segment?



List of CRISIL-rated real estate players

Company name
Embassy Office Parks Reit
Mahindra Lifespace Developers Ltd
Oxygen Business Park Private Ltd
Tata Realty and Infrastructure Ltd
HCY Industrial Parks Private Ltd
Indospace Bommasandra Logistics Park Private Ltd
Godrej Properties Ltd
Classique Associates
DLF Ltd
Gamma Constructions Private Ltd
Kolte-Patil Developers Ltd
Mahindra Bloomdale Developers Ltd
Mahindra World City (Jaipur) Ltd
Phoenix Mills Ltd
Roma Builders Private Ltd
Ruchi Malls Private Ltd
Sobha Ltd
Brigade Enterprises Ltd
Coremind Software Services Private Ltd
Darshita Hi-Rise Private Ltd
Darshita Infrastructure Private Ltd
Debonair Realtors Private Ltd
Devbhumi Realtors Private Ltd
Electronics Technology Parks- Kerala
Greenage Griha Nirman Private Ltd
Harkeshwar Realtors Private Ltd
Island Star Mall Developers Private Ltd
Kolte-Patil I-Ven Townships (Pune) Ltd
Mascot Properties Private Ltd
Mindcomp Properties Private Ltd

Company name
Mindcomp Tech Park Private Ltd
Monotype Grihanirman Private Ltd
Neelanchal Projects LLP
Neelanchal Realtors LLP
Poorna Build-Tech Private Ltd
Poppy Realtors Private Ltd
Quadro Info Technologies Private Ltd
Rajlaxmi Griha Nirman Private Ltd
Rajmata Realtors Private Ltd
S S Developers
S.B.G. Software Private Ltd
Salarpuria Developers Private Ltd
Salarpuria Griha Nirman Private Ltd
Salarpuria Housing Private Ltd
Salarpuria Properties Private Ltd
Salarpuria Real Estates Private Ltd
Sattva Developers Private Ltd
Sattva Housing Private Ltd
Sattva Real Estate Private Ltd
Softzone Tech Park Ltd
SPPL Property Management Private Ltd
Water Edge Builders Private Ltd
Worldwide Realcon Private Ltd
CSJ Infrastructure Private Ltd
E-Lights Techno Park Private Ltd
Indore Treasure Island Private Ltd
Infoparks Kerala
Upal Developers Private Ltd
Vamona Developers Private Ltd

The list includes companies rated in 'A' category or higher. CRISIL Rates around 700 companies in real estate sector in total.

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