Liquidity Crunch in Residential Real Estate Industry

Dr. Haresh Barot

Assistant Professor

Institute of Forensic Science, Gujarat Forensic Sciences University, Gandhinagar, Gujarat, India – 382006

barotharesh@yahoo.com

Abstract

In line with liberalization of economy and increase in business opportunities, real estate industry in India expected rising demand for housing and commercial space. Real estate industry playing crucial role in overall development of a country’s infrastructure. The Indian real estate sector has traditionally been dominated by a number of small regional players with relatively low levels of expertise and financial resources. Historically, the sector has not benefited from institutional capital; instead, it has traditionally tapped high net-worth individuals and other informal sources of financing, which led to issues of liquidity. Informal financing; available for short to medium term throws industry in uncertainty of development. The present paper is an effort to study the liquidity crisis confronted by residential real estate industry in India.

Key words: Liquidity Crunch, Downturn, Real Estate Industry

Introduction

Real estate sector plays significant role in development of any country. In India, real estate sector contributed 8.5% to GDP in the year 2014. Broadly, the sector can be classified into three segments - Residential, Commercial and Retail. In case of residential space, demand is determined by a combination of factors like property prices, interest rates, economic scenario determining the income levels etc. while commercial as well as retail space is directly related to the prevailing macroeconomic environment. In India, the real estate sector is highly scrappy and capital oriented. It has still to receive the tag of industry but it has close linkages with the economy of country.

In real estate sector the liquid financial position of the developer is highly affected on account of any adverse changes in the macro economic factors due to longer lock in period. The real estate sector will remain disturbed due to slow rate of approvals of projects, regulatory changes, inflation and decline in demand. New investments projects launched across India slumped by about 58% in the financial year ended March 2013 to Rs.43151 crore from Rs.101368 crore during the same period a year ago, according to Centre for Monitoring Indian Economy (CMIE).

Developers are also facing difficulty in getting adequate resource of funding the project. In India, the resources mainly consists internal accruals, customer advances and debt. Internal funds are limited in nature and for short to medium term which impact cash flow of project. Customer advances may not be available to fund the project in the initial stages. Thus, debt becomes the principal source of funding for the project.

In debt funding, the exposure of banks drives declining trend. Bank loans to real estate sector have increased only by around 06% in financial year 2014 against financial year 2013 whereas, the same increased by around 14% in financial year 2012 against financial year 2011 indicating the cautious outlook of the banks towards the sector. Since these orthodox source of finance have been dried up, developers approach non-banking financial companies (NBFCs) for short-term debt and private equity (PE) funds. However, due to lack of good returns, NBFCs and PE investors are also diminishing the investment from the sector.

Above discussion reveals that the real estate industry facing financial problem in the sector, which drives the sector towards bearish inclinations. It is also reflected by credit ratings for real estate players rated by Credit Analysis & Research Limited (CARE). CARE has analysed the performance of real estate sector from different perspectives such as review of the sector, Government policies, assessment of the management, the business model, Project-specific analysis, debt profile and financial flexibility of the company. It concluded that sluggish demand, higher construction cost, delays in project and rising interest expenses have lessened earning and return of real estate developers.

Indian Residential Real Estate Industry

The growth of residential real estate industry is tremendous during past few years. Demand for residential houses increased notably but the supply of houses could not pace up with demand thereby leading to a sharp rise in residential asset values. Generally, residential real estate industry can be divided into four phases.

Phase I (2001-2005) was a steady growth phase in Indian economy leading to stabilizing residential real estate prices and growing urbanization and nuclear families.

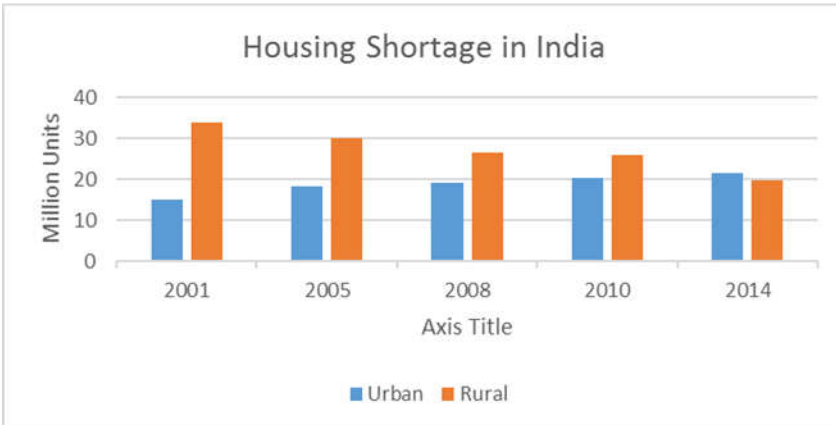
Phase II (2006-2008) was known as high growth phase where high demand for residential real estate led to doubling of housing prices. Rapid urbanization, rising incomes, sixth pay commission declaration let to high rise in middle income group income, low interest rates and tax benefits were the main reasons for rapid increase in demand.

Phase III (2009-2010) observed considerable slowdown and part recovery in demand because of the global economic downturn, which led to a decline in affordability and tight liquidity.

Phase IV (2011-2016) expected to remain in consolidation phase after slowdown. Demand is expected to remain strong witnessing modest rise. This period is expected to witness substantial supply of housing especially in urban areas.

Housing Shortage in India in Real Estate Sector

Chart – I – Housing Shortage in India



Even though the rapid growth during last 10 years, extensive shortage of rural house is prevailing in India. According to CRISIL Research, housing shortage in India is estimated at 78.7 million units at the end of Phase II. The overall housing shortage in India is likely to decline to 75.5 million units by the end of Phase IV.

Research Methodology

The Survey Measures

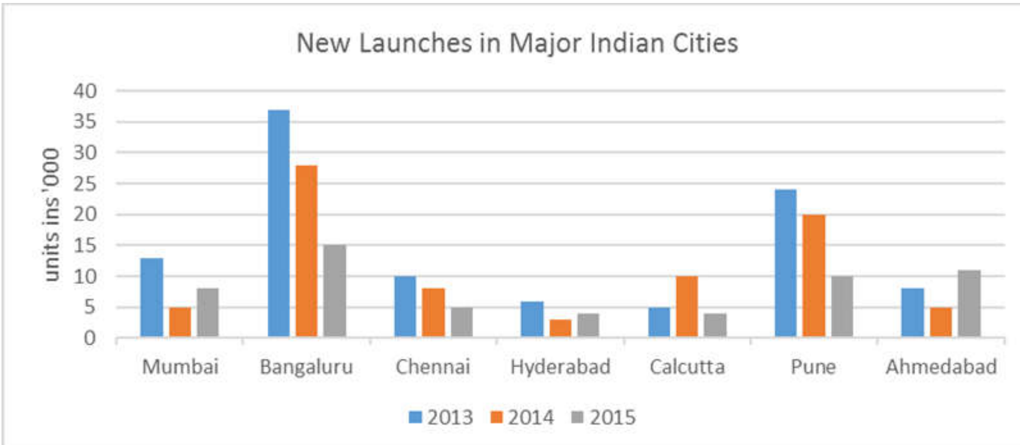
Present paper reported to analyse the liquidity crunch prevailing in residential real estate industry. Researcher has collected and analysed data pertaining to real estate industry from various secondary sources. The data collected for the study covers major cities of India such as Mumbai, Hyderabad, Pune, Chennai, Calcutta, Bangalore and Ahmedabad. The scope of research is limited to study the situation prevailing in Residential Real Estate Industry only.

Data Analysis and Findings

The Indian real estate sector remains in the grip of a downturn owing to slow purchases from homebuyers and low absorption across all asset classes, leaving developers struggling with unsold inventory.

New Launches across Major Indian Cities in Real Estate Sector

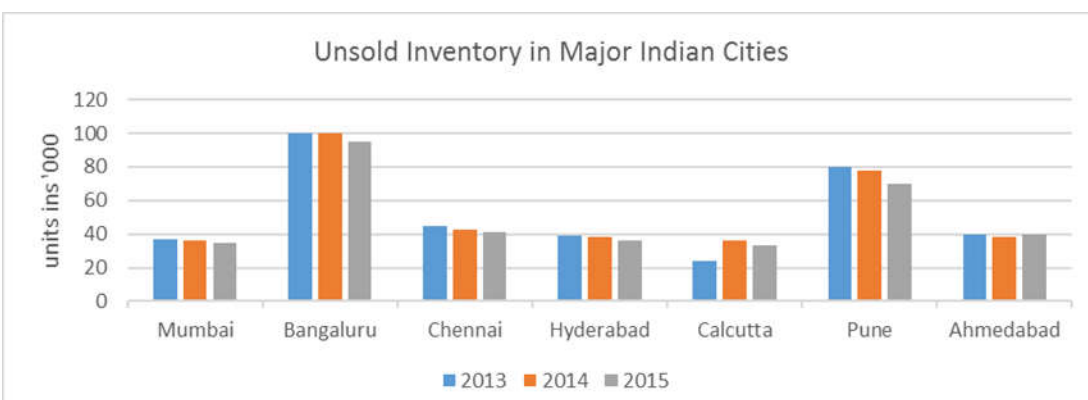
Chart II - New Launches across Major Indian Cities



The new launch ratio witnessed downturn across all major cities except in case of Ahmedabad and Hyderabad for last three years. Year 2015 witnessed almost 50 percent decline in new launches across all the major cities compare to 2013. Bengaluru and Pune faces highest declining in new launches, but compare to other cities it has highest launches also during the year 2015. The sluggish demand led to the unsold inventories and in turn resulting in the fall of newly launched units.

Unsold Inventory of Residential Houses in Major Indian Cities

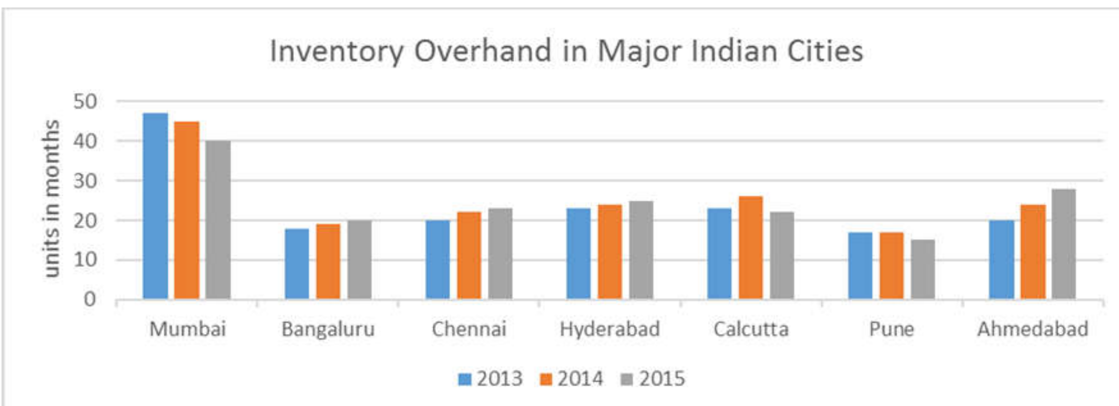
Chart III - Unsold Inventory in Major Indian Cities



Above table reveals that the unsold inventory of residential houses face stagnant phase. Analyses reveals that, the fall in new launches does not correlate to the similar fall in unsold inventory. It can be said that the amount of unsold inventory increased with respect to new launches since 2013 to 2015. Bangalore and Pune holds the highest unsold inventory. Majority of the cities witnessed a minor decrease in unsold inventory in 2015 barring Ahmedabad, which witnessed a marginal increase in inventory.

Inventory Overhang in Residential Sector

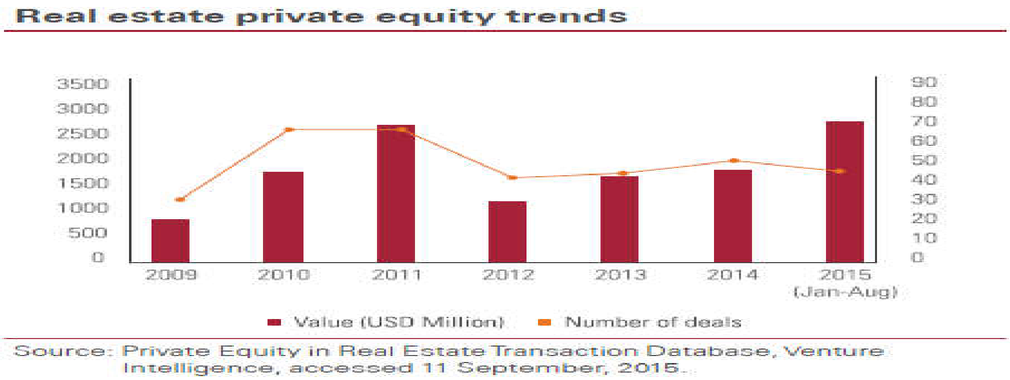
Chart IV - Inventory Overhang



The inventory overhang in major Indian cities is in the range of 15 to 55 months, owing to low sales velocity. Pune has the lowest overhang with 16 months, followed by Bengaluru at 20 months, and Chennai at 22 months in the same time period. Mumbai has the highest overhang period at 40 months followed by Ahmedabad at 24 months. Overall in Bangalore, Chennai, Hyderabad and in Ahmedabad, the overhang inventory shows increasing trend while in Mumbai, Calcutta and Pune the trend seems to be declining during 2013 to 2015.

Real Estate Investment Private Equity Trends

Chart V – Real Estate Private Equity Trends

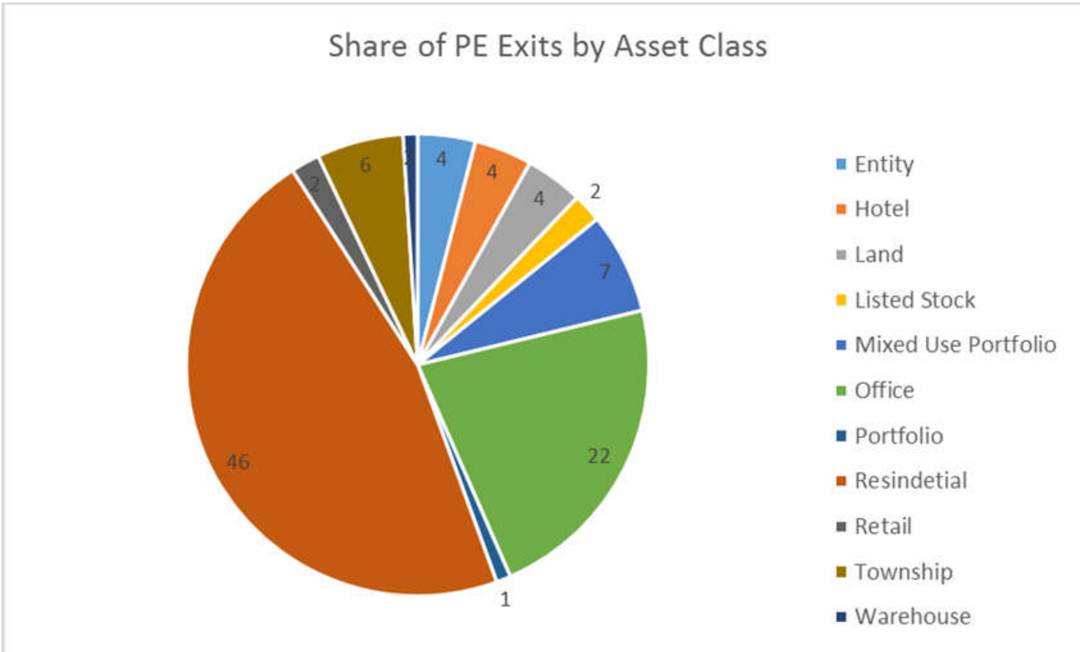


Prior to 2008, the major source of financing real estate sector was private lending by High Net-worth Investors, banks and cash-flows through project sales. However, post global economic slowdown in 2008, the financial crisis has drastically changed the quantity and source of availability of finance in the sector. Slowdown in sales has lessened financing from internal accruals and substantially increased the dependence of developers on external capital for funding new projects and repaying existing liabilities.

The NBFC and private equity funding channels have continued to gain importance ever since with bank credit to real estate sector declining from 10 per cent in financial year 2010 to 8.1 per cent in financial year 2015. The share of NBFCs and PEs is increased since 2010 except in 2012. Developers accessed financial resources from it for either to complete projects or refinance existing debt. The share of debt structured deals has increased significantly over the years and peaked in 2014. However, in the first eight months of 2015, the share of debt structured deals fell to 57 percent.

Exits in Private Equity Real Estate in India

Chart – VI - Exits in Private Equity Real Estate in India



It can be seen from the above table that PE investors have rolled back investment from residential sector followed by commercial office segment. Residential sector witnessed highest 46 percent exist from the projects during 2010 to 2015 followed by 22 percent by commercial office during same period. It hits the financial position of the developers that hinders the completion time of project. It also leads to serious liquidity issues in the sector.

Discussion

Real estate sector started grooming in the early phase of 2005 after relaxation of foreign direct investment norms in the industry. Since last 08 – 09 years, the prices of land rise almost 30% to 100%, which also hikes the prices of residential as well as commercial properties. The developers have grab smart profit by building commercial space and providing housing in cities and towns across the country. But now, some of that has changed. There has been 50% drop in real estate transactions over the last few months, Thirumal Govindraj, Chennai head of CB Richard Ellis, said. In the National Capital Region, Mumbai and Bangalore, prices have slumped by 10-20%.

Further from the above statistics, it is revealed that a fall in the demand for residential property, coupled with a credit crunch, has severely impacted small local developers. Most of them might have to close shop.

On account of slack down the repayment of debt hasn't been easy as cash flows from project sales have remained under strain and developers have been forced to borrow more to repay earlier loans. The top 10 real estate firms by market capitalization had a total net debt of Rs.45723 crore as on 31 March, 2015. With the sector carrying a debt burden of about $24.6 billion in the year to July 2011 compare to $3.8 billion in September 2005, many small and midsized Indian property groups face the risk of default. Major developers are delaying projects, discounting properties and looking to sell big assets. This is one of the worst liquidity crises the sector ever faced, says Dipesh Sohani, an analyst at MF Global.

Conclusion

Real estate sector witnessed emblematic shift in the last decade. From unorganised sector in the past, the sector is progressively converting into the organized sector. However, several issues on the macroeconomic front, including muted growth, rising inflation and falling currency, confine the growth of the industry. Government shall take necessary steps to encourage the investment in the industry. Upmost an infrastructure status must be granted to the sector and the interest rate on retail loans should be brought down to the level of middle income group affordability.

Neeraj Bansal, Partner and Head, Real Estate and Construction, KPMG said, the time required to get housing development related approvals was between 2-4 years. ``Such delays block hefty investments which depending on the project location, range from 20-60 per cent of the total project cost and escalating the same in the range of 10-30 per cent. The government needs to streamline the approval mechanism by introducing single window clearance in the sector.'' A Political stability and focussed efforts by the government are required to strengthen economic revival.

However, several reforms by the Government of India have been initiated or are underway to encourage the development and growth in the sector. Some of them include easing the FDI rules, REIT (Real Estate Investment Trust) establishment, Smart City projects, focus on affordable housing and Housing for all by 2022. All of these reforms and policy announcements along with favourable economic growth prospects are expected to provide an impetus for the speedy revival of the sector.

References:

- KPMG (2015), challenging the tides: Indian Real Estate, https://home.kpmg.com/in/ en/home/insights/2015/10/challengingthetide.html, accessed on 19 November, 2016
- India Economic Survey 2010-15, Ministry of Finance – Government of India.
- Indian Economic Survey 2014-15 – Key Highlights and KPMG in India's analysis, 2015.
- "India Inflation Rate", Trading Economics, website, http:// www. tradingeconomics.Com /India/inflation-cpi, accessed on 15 November 2016.
- Press Information Bureau, http://pib.nic.in/newsite/ PrintRelease.aspx?relid=126841, accessed on 01 December 2016
- India to Lead Global Growth in 2015", World Bank International Business Times website, http://www.ibtimes.co.in/india-lead-global-growth-2015-world-bank-635483, accessed on 01 December 2016.
- Make in India website, http://www.makeinindia.com/ sectors/, accessed on 03 December 2016.
- http://www.sebi.gov.in/cms/sebi_data/attachdocs/1411722678653.pdf, accessed on 04 December 2016
- Real Estate and Housing - A Sensitive Sector or Samvriddhi Sector?, https://www. RBI. org.in/scripts/BS_SpeechesView.aspx? Id=910., 05 December 2016
- http://www.careratings.com/pdf/rating- resources/Industry Outlook and Credit Rating Perspective Real Estate Sector.pdf, accessed on 10 November, 2016
- India Real Estate Overview - Crisil, www.crisil.com/pdf/capitalmarket/Industry-content.pdf, accessed on 03 November, 2016.
- www.jll.co.in/.../reaping-the-returns-decoding-private-equity-real-estate-exits-in-india/ Janes Lang Lassale Survey, accessed on 15 December, 2016.
- http://www.livemint.com/Companies/Is-this-indias-worst-real-estate-nightmare.html, accessed on 12 December, 2016.
- http://economictimes.indiatimes.com/wealth/real-estate/articleshow/55446040.cms, accessed on 05 December, 2016.
- http://www.thehindu.com/business/Industry/realty sector body national real estate development council NAREDCO calls for greater-liquidity-investments-in-housing-in-India/ article 6313499.ece, accessed on 03 November, 2016.