RESEARCH

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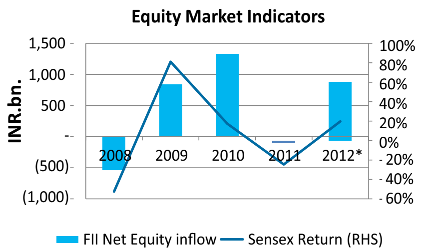
Knight Frank

Light at the end of the tunnel?

Over the last quarter, the government announced a slew of reforms and initiated measures to rein discomforting fiscal deficit. This winter session of the parliament remains a crucial platform if the announced measures have to fructify. Crucial on two counts, first the importance of the pending bills which range from attracting foreign investment in sectors like retail, insurance and pension to curtailing the nuisance of corruption, and secondly the timing of this session amidst the faltering economic growth. Notwithstanding this significance, the opening two days of the parliament's winter session were disturbing. We hope that the remaining days are utilized in a manner that puts the government and bureaucratic machinery in motion.

WHILE THE MACRO ECONOMIC DATA STILL LAGS BEHIND, THERE ARE EARLY INDICATORS THAT SUGGEST IMPROVEMENT IN SENTIMENT

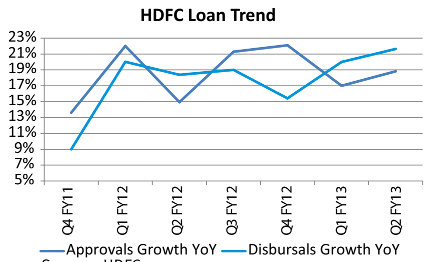
While the macro economic data still lags behind, there are early indicators that suggest improvement in sentiment. Even the finance ministry and the central bank have hinted at shifting gears of priority from taming inflation to boosting economic growth by the next quarter. In relation to bank loans for the real estate sector, the finance minister has moved from an earlier hawkish stance in his message to banks about coaxing real estate developers for reducing prices, to a dovish stand of easing lending norms to the ailing housing sector. Similarly, the central bank is easing its stance in a bid to salvage the economic growth. The central bank has been cautious not only because of the high inflationary pressure but also due to the rising amount of bad loans in the system. It initiated measures to ease pressure of high interest rate by bringing down the repo rate in April'12. However, it is currently responding to slowing economic growth only by lowering of the CRR and the SLR while hinting towards reducing key policy rates early next year. While lower reserve ratios have increased liquidity in the banking system to some



Source: CMIE *Until Oct 2012

extent and banks have also responded by lowering interest rates, indication for cut in key policy rates by the next quarter is certainly a positive signal.

The data from the equity market also indicates an improvement in sentiment. The asset class has witnessed net FII inflows of ₹941 bn in the initial 10 months of 2012, which is the second highest in the last 5 years. In comparison, the last year had witnessed net FII outflows of ₹34 bn. The asset class has thus provided a return of almost 20% in this latest period. Further, the housing loan data from HDFC indicates an improvement in the latest quarter. Loan approvals in Q2 FY13 have witnessed a growth of 19% in comparison to the 15% witnessed in the same period last year. Loan disbursals have also witnessed a growth of 22% in comparison to 18% in the previous year.



Source: HDFC

IN RELATION TO BANK LOANS FOR THE REAL ESTATE SECTOR, THE FINANCE MINISTER HAS MOVED FROM AN EARLIER HAWKISH STANCE IN HIS MESSAGE TO BANKS ABOUT COAXING REAL ESTATE DEVELOPERS FOR REDUCING PRICES, TO A DOVISH STAND OF EASING LENDING NORMS TO THE AILING HOUSING SECTOR

We at Knight Frank, on a continuous basis track the performance of the top-25 listed real estate companies based on their market capitalization. This set of companies pertinently represents the performance of the Indian real estate sector. This time we have taken the stock of their performance with the latest financial results for the quarter ending 30th September 2012 (Q2FY13).

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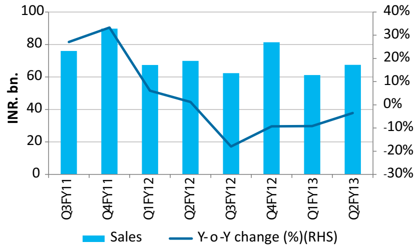
Revenue Trend of Top 25 Real Estate Companies

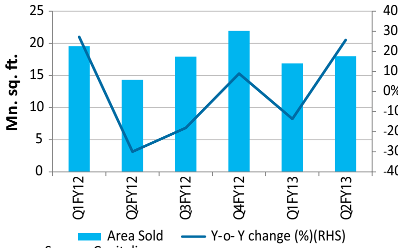


The top-25 companies cumulatively reported revenues of ₹67.44bn in Q2FY13, a decline of 4% on a Y-o-Y basis, another lacklustre quarter highlighting the slump in the real estate sector. However, closer examination of the revenue growth trend over the last eight quarters (Q3FY11 –Q2FY13) offers an interesting insight. The slide in the sales momentum of the industry witnessed until Q3FY12 has come to a halt now. This can be inferred from the revenue growth trend in the last three quarters, which has improved in each of the successive periods. While the revenue declined by 18% in Q3FY12 and 9% in each of Q4 FY12 and Q1FY13, the margin of decline in Q2FY13 was lower at 4%. This has happened on account of change in focus of developers on residential real estate which even in this tough economic environment fares better in comparison to commercial real estate. Largely bought for consumption, the demand for the residential real estate reacts positively even with the slightest improvement in sentiment. However, this is not the case with the commercial real estate sector, which is mainly bought for facilitating business operations; a decision based on economic rationale.

THE SLIDE IN THE SALES MOMENTUM OF THE INDUSTRY WITNESSED UNTIL Q3FY12 HAS COME TO A HALT NOW. THIS CAN BE INFERRED FROM THE REVENUE GROWTH TREND IN THE LAST THREE QUARTERS, WHICH HAS IMPROVED IN EACH OF THE SUCCESSIVE PERIODS

Further, to track the growth in the sales volumes, we analysed data for a set of 14 companies out of the top-25 companies that have consistently disseminated information on a quarterly basis. On a cumulative basis, this set of 14 companies has made sales of 18 mn.sq.ft. in Q2 FY13, which is a growth of 25.6% in comparison to the same period last year. The same period last year (Q2 FY12) witnessed sales decline by 30%. The sales volume data, indicator for the depth of the market, signals Sep'12 quarter was much better in comparison to the same period last year. While the residential demand in major metros was the primary reason behind this uptick, improvement in state of project approvals in some western markets also helped the cause. On the backdrop of improved sentiment many developers accelerated residential project launches.

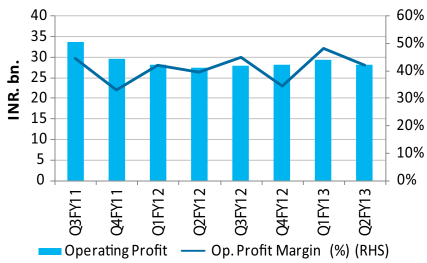
Sales Volume Trend of 14 Real Estate Companies



Source: Capitaline

On the operating profit front Q2 FY13 recorded growth of 2.7% in comparison to the same period last year. Q2 in the previous financial year had witnessed a de-growth of 8.2%. Input cost including material and labour stabilised, which subsequently led to improvement in the profitability at the operating level. Operating profit margin stood at 41.9% in Q2FY13, an increase of 256 basis

Operating Profitability of Top 25 Real Estate Companies

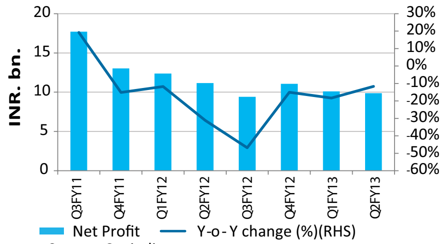


Source: Capitaline

points (bps) compared to the same quarter last year.

However, profitability continues to remain a concern in the wake of high cost of funding. The net profit for this set of top-25 real estate companies has consistently declined in the last seven quarters, from ₹13.03bn in Q4FY11 to ₹9.87bn in Q2FY13.In hey days of 2009-10, this set had reported net profit margins as high as 25-30%. However, high interest charges led by double digit funding cost had a cascading impact on the net profit margins. The net profit margin deteriorated by 135bps to 14.6% in Q2FY13 vis-à-vis 16% in the same quarter last year. With the central bank's indication for a cut in interest rates, the situation would improve in the ensuing two quarters.

Net Profit Trend of Top 25 Real Estate Companies



Source: Capitaline

THE HOUSING LOAN DATA FROM HDFC INDICATES AN IMPROVEMENT IN THE LATEST QUARTER. LOAN APPROVALS IN Q2 FY13 HAVE WITNESSED A GROWTH OF 19% IN COMPARISON TO THE 15% WITNESSED IN THE SAME PERIOD LAST YEAR

Even while the real estate industry faces a tough macro-economic environment, the analysis indicates an improvement in sale momentum. While commercial real estate continues to witness a slump, focus on residential segment has been the primary reason for this improvement. Even though end-users in the residential segment by and large are still in a wait-and-watch mode in anticipation of price correction, the inherent demand for housing in the country continues to salvage the industry. While high interest cost has impacted the profitability of the industry and also the affordability of the

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consumers, RBI's indication of a cut in policy rate in the ensuing two quarters would ameliorate the situation. Lower interest cost would benefit the developers and end users alike.

After a long period of inaction, the government has now changed its modus operandi and turned reformist. It has introduced major pending bills for FDI in retail, pension and insurance in the parliament. Going forward, implementation of these policy measureswill determine the economic direction of the country and have an impact on the sentiments of house buyers as well as commercial real estate consumers.

GOING FORWARD, IMPLEMENTATION OF THESE POLICY MEASURESWILL DETERMINE THE ECONOMIC DIRECTION OF THE COUNTRY AND HAVE AN IMPACT ON THE SENTIMENTS OF HOUSE BUYERS AS WELL AS COMMERCIAL REAL ESTATE CONSUMERS

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