RESEARCH

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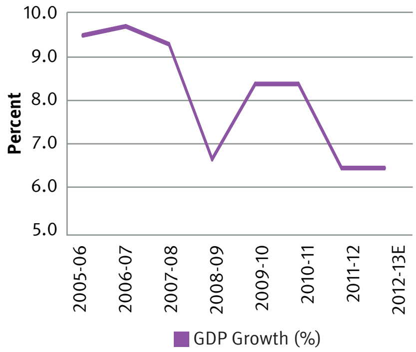
Knight Frank

The slipping economic growth rate and high inflation are the biggest concerns facing the Indian economy at present. While these should be addressed on topmost priority, allegations on the government over corruption in coal allocation has put a logjam in clearing reformist policies on land acquisition, housing regulation, retail FDI and others.

Indian Economy in the doldrums?

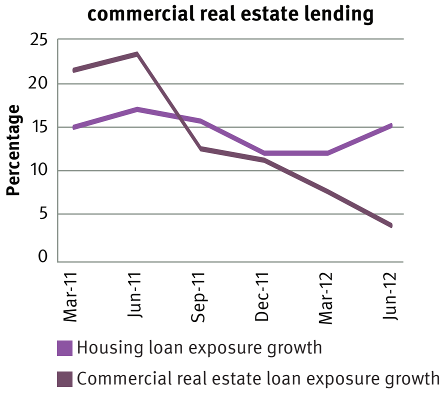


Source: CMIE, RBI

The global financial crisis in 2008-2009 had a repercussion on the Indian economy and the GDP growth rate slipped from over 9% during FY06-FY08 to 6.7% in FY09. While the economic situation improved in FY10 &FY11, with 6.5% in FY12 the scenario has actually worsened in comparison to the period of global financial crisis. Appalling is the fact that the country's central bank does not expect any meaningful improvement in the situation even for the current financial year. At an estimated growth rate of 6.5%, it expects the situation to remain bleak even in FY13. While one may take comfort in accepting the sub 7% growth rate as the new normal, the fact is this decline has come with its fair share of agony on the economic well being of the citizens.

Since demand for property is a derived demand, the overall economic situation has a bearing on the real estate sector. The lower growth had a significant impact on demand for commercial and residential property during the last year. While the initial signal was decline in absorption, it is fewer project launches now. Adding to the agony is the finance minister's admonishment of banks to pressurize developers to cut property prices in wake of high credit exposure to the industry. As per the June'12 RBI data, the outstanding bank credit to the real estate sector is Rs.5,313 bn. 78% of this exposure is towards the housing loan segment and the remaining 22% is to the real estate developers. An evident trend is the decline in banking sector's exposure towards commercial real estate lending. The growth has come down from 23.2% in June'11 to just 4% in June'12. Amidst this waning interest of the banking sector, one thing is clear that although the instructions from the finance minister may not have a bearing on loan accounts that are regular, restructuring cases in the sector will become pretty difficult.

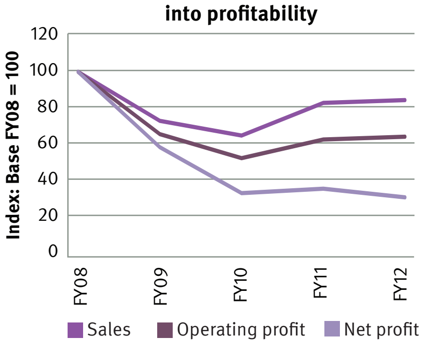
Bank's waning interest towards commercial real estate lending



Source: CMIE, RBI

The disconnect between the state of economy and property price movement in principal metros made it imperative to study the factors that have a larger bearing on prices. By identifying holding capacity of developers as a determining factor and quantifying it by calculating the stress score we arrive at reasons for this disconnect. We have conducted our analysis with the latest annual financial numbers for FY12. Since, real estate is a highly fragmented industry with a significantly large proportion of the turnover being contributed by small developers operating as unorganized players, we base our analysis on a set of listed companies that have reported the relevant financial data. This set comprising 12 listed companies contributes over 50% of turnover of all the listed companies in the sector.

High interest cost eating into profitability



Source: Capitaline, Knight Frank Research

THE COMMERCIAL REAL ESTATE LOAN EXPOSURE GROWTH HAS COME DOWN FROM 23.2% IN JUNE'11 TO JUST 4% IN JUNE'12

During the five year period between FY08-FY12, while sales value is down by 15%, the net profit is down almost 67% primarily on account of interest cost going up five fold. Even while property prices rose during this period, the industry has not managed to surpass the FY08 sales value clearly indicating the larger dent on sales volume.

India Research

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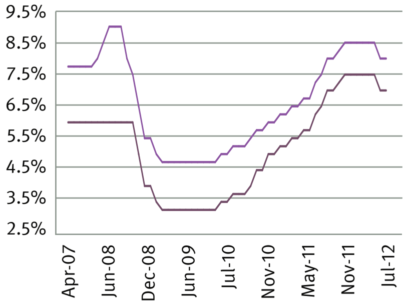
Table: Financial performance of the real estate industry (Rs. bn.)

	FY08	FY09	FY10	FY11	FY12
Sales	214	158	141	179	182
Interest cost	7	15	19	27	35
Net profit	105	63	37	39	34

Source: Knight Frank Research

Low interest rate regime still a distant dream



Source: Source: RBI

Interest rate has been on a rise since beginning of 2010 when RBI started increasing the key policy rates in the wake of high inflation. Since Jan'10, RBI has increased repo rate by 325 basis points, which coupled with stringent lending norms for the real estate sector sent interest rate spiraling for the sector. Between FY10 and FY12 although debt increased by a marginal 0.4%, the interest cost increased by a significant 81%. Increase in project completions during the period also led to higher interest cost recognition during this period. Clearly the momentum of the industry has reduced with profitability taking an even bigger hit.

Delving further, we have calculated the gap between the Operating Cash flow (OCF) and the debt serviced, which includes interest as well as principal repayment in a particular year. This gap referred to as 'Stress score' indicates the ability of business operations to service debt. A higher number indicates a better situation and a lower number implies a worsening situation. Being the worst in FY08, the score improved until FY10 before deteriorating to -118 in FY11. In FY12 the stress score improved to -91.

While we have conducted a threadbare analysis of the financial situation of the real estate industry, the pertinent question is what happens to property prices in the wake of declining property sales. In the short term, factors other than law of demand will have an upper hand in determining the

Table: Cash flow situation of the real estate industry (Rs. bn.)

Particulars	FY08	FY09	FY10	FY11	FY12
Operating Cash flow (OCF)	(75)	(13)	90	19	33
Debt serviced (Interest & principal)	94	122	129	137	124

Source: Knight Frank Research

Improvement in Operating Cash flow will be a critical factor

Source: Capitaline, Knight Frank Research

direction. The industry's ability to service debt will determine the hold on price of new projects. While the Debt Equity ratio at less than one indicates comfortable leverage situation, the ability of operations to service debt has taken a beating. As a result principal repayment and interest is being serviced by sale of assets whether land, TDR or leased out commercial property. In our analysis, the Stress score improved considerably in FY10 mainly on account of slew of new project launches that shored up the operating cash flows considerably to Rs.90 bn. in comparison to an outflow of Rs.13 bn. in the previous year. However, the consumer appetite for new project launches is considerably low in the present scenario.

Table: Stress score for the real estate industry

Particulars	FY08	FY09	FY10	FY11	FY12
Stress score (OCF-Debt Serviced)	(169)	(135)	(39)	(118)	(91)

Source: Knight Frank Research

The industry has witnessed a negative stress score in each of the five years under consideration, which may make it appear as a normal business situation. However, our analysis indicates that a negative score supported with increasing sales momentum is sustainable but not otherwise. In extreme situations prevailing for a short duration, asset sales and alternative financing sources,

A NEGATIVE STRESS SCORE SUPPORTED WITH INCREASING SALES MOMENTUM IS SUSTAINABLE BUT NOT OTHERWISE

akin to equity investments structured as debt, can save the day. However, the inclination of traditional sources like banks and NBFCs as well as alternative sources like private equity and HNIs remains muted at present. Declining property sales coupled with stretched balance sheet will remain a concern in the short term leading to a moderation in property prices in some markets.

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