FINANCIAL ANALYSIS OF THE REAL ESTATE COMPANIES

March 2014
High interest rate regime and high real estate prices coupled with uncertain job prospects deterred end-users from committing themselves to real estate investments of their life. Based on the sales volume, the market-share of South India based companies has gained the most during the past eight quarters. Characterised by affordably priced residential properties across the city and being an end-user driven market, collectively Bengaluru and Chennai city witnessed the highest growth in their market share from 16% in Q4FY12 to 33% in Q3FY14. While North India based companies, continue to dominate the Indian realty market in terms of sales volume, its share continuously fell from 75% in Q4FY12 to 51% in the latest quarter. Major Northern India based real estate companies have been trapped by huge debt, compelling them to change their strategy. They went slow on new launches and instead of frenzied launches as in the past, concentrated on completion of launched projects and sold non-core assets in order to deleverage their balance sheet. These changes in business strategy adversely impacted the overall share of the dominant real estate region. The West India based realty companies regained lost ground from the lows of Q4FY12. Increased launches of the affordable projects in the peripheral markets of Mumbai as well as Pune helped boost the region’s market share.

**All India Analysis**

Sales volume is one of the best indicators to ascertain the demand for any sector. Hence, tracing the growth of real estate companies sales volumes, we monitor a set of 15 out of the top-25 companies, that consistently disseminate sales volume details on a quarterly basis. For the quarter Q3FY14, sales volume declined by 43% Y-o-Y to 11.80 mn.sq.ft. thereby exhibiting low demand for real estate across India. Over the past eight quarters, sales volume almost halved from 21.85 mn.sq.ft. to 11.80 mn.sq.ft. High interest rate regime and high real estate prices coupled with uncertain job prospects deterred end-users from committing themselves to the largest buy
Delay in approvals, high cost of funds and slow uptick in the sales volume dried up the liquidity for the cash-starved real estate companies which in turn log jammed the construction activity across India.

It has been observed that aggregate revenues for the top-25 realty companies peak in the fourth quarter of every financial year. Further, in Q3FY14, these realty companies cumulatively reported revenues of ₹8 bn, a 1% increase on a Y-o-Y basis, thereby highlighting the slow uptick in the primary real estate market. Twelve companies out of the top-25 realty companies reported a positive sales growth in the current quarter. While the volume growth speaks about the demand for the sector, sales or revenue growth speaks about the project’s construction (completeness) stage. Based on the Indian accounting standards all the real estate companies are bound to report their revenues along with their associated cost after reaching a certain threshold of construction. Revenue is recognised in the income statement to the tune of construction completed in a particular period. By this logic revenue growth can be construed as a progress in the construction activity. It can be inferred from the last eight quarter’s revenues that the construction activity has been hampered across India. Delay in approvals, high cost of funds and slow uptick in the sales volume dried up the liquidity for the cash-starved real estate companies which in turn log jammed the construction activity across India.

Operating profit has been consistently clocking a quarterly run-rate of ₹28-29 bn, since Q4FY12. This feat could be achieved primarily on account of continuous price rise across India. Residential property prices across major cities have witnessed a double digit growth rate during Q4FY12 to Q3FY14. Despite steady operating profit levels, the operating profit margin (OPM) for the top-25 real estate companies has contracted by 900 basis point (bps) from 50% in Q3FY13 to 41% in Q3FY14. This decline in operating profit can be attributed to rise in input cost. The building construction cost index comprising major construction material like cement, iron and steel, labour, building bricks, paints, plywood, etc. has increased by 6.3% during the last one year.

Source: Company data, Knight Frank Research

FIGURE 3
All India - Revenue Trend

Source: Company data, Knight Frank Research

FIGURE 4
Price Index

Source: Knight Frank Research

FIGURE 5
All India - Operating Profitability

Source: Company data, Knight Frank Research

FIGURE 6
All India - Net Profit Trend

Source: Company data, Knight Frank Research
The past eight quarters have been quite volatile as far as the net profit and net profit margin are concerned. The cash starved realty sector continued leveraging its balance sheet in order to complete the ongoing projects, which led to a constant rise in gross debt. A tightened monetary policy by the central bank (RBI) increased the policy rates which in turn pushed up the base rate for scheduled commercial banks. Rise in the gross debt levels coupled with the increase in cost of funds were a double whammy on the real estate companies adversely impacting the net profits. Net profits registered a fall of 41% during the last eight quarters, while the net profit margins during the same period plummeted from 13.6% to 9.7%.

Real estate is a regional game and India being a vast country, regional dynamics are starkly different from the national dynamics. Hence it is imperative to delve deeper into individual regions. As per the primary markets these companies cater to, we have grouped these companies between north, west and south for our study.

Northern India Based Real Estate Companies Analysis

Northern India based real estate companies are represented by seven companies in our set of 25 real estate companies, of which four companies disseminate sales volume data on a regular basis.

Since the last 4-5 years, Northern India based developers focussed on executing on-going projects, reducing debt and divesting non-core assets. They have been quite successful in doing so but at the cost of muted sales volume. Real estate demand in the north, when compared with other regions, has plummeted the most. Eleven quarters lowest sales volume has been recorded in Q3FY14. Sales volume plunged by 57% on a Y-o-Y basis, booking only 5.98 mn.sq. ft. against 14 mn.sq. ft. in Q3FY13. Continuous decline in the region’s sales volume can be attributed to the change in focus of the local developers. From the latest quarterly result, it can be inferred clearly that the focus of majority of this region’s developers is to reduce their debt unlike earlier times when they launched projects in a frenzy, in turn boosting their sales volume. Northern India based developers have refrained themselves from launching too many projects due to the current economic conditions and huge inventory pile up in this region. Hence, the outlook for sales volume remains dim, compelling developers to shift their targeted milestones by at least two to four quarters.

Despite a decrease in sales volume, revenues during the last eight quarters have been steady, registering an average quarterly revenue of ₹39 bn. This is mainly on account of increase in real estate prices. Average residential prices in this region have increased by 21% during last eight quarters. As explained above, companies follow a certain threshold of construction completed to recognise revenues. Low sales volume and increase in revenues clearly speak about developer’s keenness in completing the ongoing projects. Revenues increased by 18% in Q3FY14 to ₹37.90 bn. as compared to ₹32.10 bn. during the same quarter the previous year. Growth of aggregate operating profit as well as net profit for the Northern India based real estate companies on a Y-o-Y basis have declined in almost all the past eight quarters. In the most recent quarter it posted an operating profit of ₹14.46 bn. registering a 7% decline, while during the same period net profits declined by 53%. Operating profits were hit by the increase in input cost and dearth of cheap labour while ballooned interest cost adversely impacted the net profit margins. These had a cascading impact on both operating profit margins (OPM) as well as net profit margins (NPM) as they nosedived during the last one year. OPM fell to 38% in Q3FY14 after registering a 48% margin in Q3FY13, NPM during the corresponding period declined to 6% from 15%.
Western India Based Real Estate Companies Analysis

Western India based real estate companies are represented by thirteen companies in our set of 25 real estate companies, of which six companies disseminate sales volume data on a regular basis. Within the western region, there are two companies that are completely based out of Pune, one has majority of its projects in Gujarat and the rest of them are primarily based out of the Mumbai Metropolitan Region (MMR).

Oversupply, ever escalating prices and continuous delay in approvals hampered the overall sales momentum of the most expensive real estate market of India. Western India based companies collectively booked 1.90 mn sq.ft. during Q3FY14 thereby registering a 36% decline when compared to Q3FY13. Delving further into these numbers, it has been observed that Mumbai based developers have registered the highest decline in sales volume. Unaffordable prices and execution risk hit this region’s developers so hard that unit sales literally came to a grinding halt during this quarter. Launches in the affordable market of Pune and peripheral market of the MMR were the only saviours for this region.

Majority of the projects in the western region are running behind schedule for want of approvals as well as due to the liquidity issues at the developers end. During the last few years, the ban imposed on sand mining, delay in receiving environmental and forest clearances as well as other approvals have hindered construction activity here.
Net profits for the Western India based real estate companies almost halved when compared on a Y-o-Y basis, it reported a net profit of ₹2.51 bn. in Q3FY14 against ₹4.76 bn. in the same quarter the previous year. Increase in cost of funds along with a delay in approvals, ballooned the interest charges thereby deteriorating the profitability of these companies. Subsequently, during the corresponding period net profit margins too declined to 16% from 22%. A delay in project approvals along with rising interest rates is jeopardising the developers. Increase in interest cost directly impacts developer’s cost of servicing debt which puts further strain on their liquidity condition. And secondly increase in interest rate deters customers from buying houses, which in turn again leads to slow uptake of sales thereby impacting the cash flow of the developer. Developers could buy time in 2009-10 to repay their debt, but a similar kind of arrangement is hard to find in the current economic scenario, where there is rise in the bank’s non-performing-assets.

SOUTHERN INDIA BASED REAL ESTATE COMPANIES ANALYSIS

Southern India based real estate companies are represented by five companies in our set of 25 real estate companies. South India based companies are pioneers in disseminating information consistently to all the stake holders, hence we have sales volume data for all the five listed real estate companies. Primarily these companies cater to Bengaluru, Chennai, Hyderabad and Kochi real estate markets. The Southern India real estate market is the most stable when compared to other regions. Despite the continued worsening scenario of the real estate market across India, companies based in this region stand-out as outliers. Affordable prices and end-user driven market were the real estate market here the most sought after affordable option for the middle-income group. The sales volume remained buoyant for South India based real estate companies reporting growth in almost all the past eight quarters. For the current quarter it booked sales to the tune of 3.92 mn.sq.ft. as against 3.76 mn.sq.ft. in Q3FY13, thereby registering a growth of 4%.

The South India based real estate companies offer the only respite in the current tepid environment. Aggregate revenues for the south India based real estate companies exhibited positive growth on a Y-o-Y basis in each of the past eight quarters. Affordable prices consistently lured end-users to this region, sales booked brought in the much needed funds to fuel the construction activity. An increase in sales volume along with increase in revenue implies growth in construction activity. This can be concluded by change in prices in this region, which grew by 10% in Chennal and 17% in Bengaluru during the past eight quarters.

However, unlike sales volume the region could not decouple itself from the rise in input cost. In the last eight quarters, operating profit for the first time has reported a decline in Q3FY14. It has fallen marginally by 5% to ₹4.75 bn. as against ₹4.98 bn. in Q3FY13. Moreover, stable prices and increase in input cost adversely impacted operating profit margins. OPM has declined in each of the last six quarters and now stabilised between 30-33%.

Affordable prices, an end-user driven market and comparatively less leveraged balance sheets led to a relatively better performance by the developers based in South India.
Outlook

Since the last 2-3 months, the Indian economy has witnessed improvement in all the economic parameters be it inflation, IIP, imports, CAD, etc. However, for the second largest populous country, job creation is of utmost importance for it to return to its high GDP growth levels. Job creation primarily depends on the labour intensive manufacturing sector which in turn depends on the investment in this sector. Fresh investments in the economy have been overshadowed by the upcoming general elections despite improved economic conditions.

Economic and political stability are the vital catalysts for revival of the real estate sector in India. In addition, revival of this sector also depends on the regional policies. We believe that post deleveraging of the balance sheet the Northern India based realty companies will re-focus on new project launches. Sales volumes are expected to regain and surpass the earlier highs. Further by virtue of a lighter balance sheet and consistent sales, we expect construction activity to be steady. While for the Western India based realty companies, adoption of the Maharashtra Housing (Regulatory and Development) Act-2012 will have a considerable impact on the way real estate business is carried out in this region. Adherence to this new Act will not only lead to enhanced transparency but also to timely completion/ possession of the projects. Post this Act, we expect construction activity to resume for all the under construction projects. Any rapid increase in the real estate prices in the price conscious Bengaluru and Chennai real estate market will have an adverse impact on the Southern India based realty companies. With relatively less leveraged balance sheets and stable prices we expect South India based realty companies to deliver robust profits at operating as well as net levels.

REGION WISE SYNOPSIS

<table>
<thead>
<tr>
<th>REGION</th>
<th>Q3FY14</th>
<th>Q3FY13</th>
<th>Change YoY</th>
<th>Remarks</th>
</tr>
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<tbody>
<tr>
<td>North India</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volumes</td>
<td>5.98</td>
<td>14%</td>
<td>-57%</td>
<td>Decline in volume due to slow down in new launches</td>
</tr>
<tr>
<td>Revenues</td>
<td>37.90</td>
<td>32.10</td>
<td>18%</td>
<td>Increase in sales due to developers focus on completing the ongoing projects</td>
</tr>
<tr>
<td>Operating profit Margin (%)</td>
<td>38%</td>
<td>48%</td>
<td>-1000bps</td>
<td>OPM hit by the increase in input cost and dearth of cheap labour</td>
</tr>
<tr>
<td>Net Profit Margin (%)</td>
<td>6%</td>
<td>15%</td>
<td>-900bps</td>
<td>Ballooned debt coupled with high cost of debt impacted the net margins</td>
</tr>
<tr>
<td>West India</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volumes</td>
<td>1.90</td>
<td>2.97</td>
<td>-36%</td>
<td>Unaffordable prices and execution risk brought sales literally to a grinding halt</td>
</tr>
<tr>
<td>Revenues</td>
<td>15.66</td>
<td>21.33</td>
<td>-27%</td>
<td>Slow construction activity due to delay in approvals as well as due to developers liquidity issue</td>
</tr>
<tr>
<td>Operating profit Margin (%)</td>
<td>56%</td>
<td>61%</td>
<td>-500bps</td>
<td>Spiraling input cost and high cost of labour adversely impacted profitability</td>
</tr>
<tr>
<td>Net Profit Margin (%)</td>
<td>16%</td>
<td>22%</td>
<td>-600bps</td>
<td>Delay in project approvals along with rising interest rates impacted the profitability</td>
</tr>
<tr>
<td>South India</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volumes</td>
<td>3.92</td>
<td>3.76</td>
<td>4%</td>
<td>Affordable prices and end-user driven market</td>
</tr>
<tr>
<td>Revenues</td>
<td>14.46</td>
<td>13.64</td>
<td>6%</td>
<td>Sales booked brought in the much needed funds to fuel the construction activity, hence increase in revenues</td>
</tr>
<tr>
<td>Operating profit Margin (%)</td>
<td>33%</td>
<td>37%</td>
<td>-400bps</td>
<td>Surge in input cost including cost of labour adversely impacted profitability</td>
</tr>
<tr>
<td>Net Profit Margin (%)</td>
<td>12%</td>
<td>10%</td>
<td>200bps</td>
<td>Relatively less leveraged balance sheet was the saviour</td>
</tr>
</tbody>
</table>
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