

India Property Overview

Real Estate Squeeze : Latitude Nowhere

Real estate is a cyclical industry, with typical boom-bust scenarios, prevalent in most of the global cities. India is today in a corrective phase of the property cycle, where the over response of the opportunities afforded by high returns has now been replaced by somewhat rapid withdrawal of interest from buyers as well as investors. Property markets in India are today subject to not one, but several cyclical influences of different periodicity. Corporate sector is facing a demand downturn, financial sector is confronted with liquidity (confidence) crisis and capital market has seen depressed sentiments. These have combined to produce a property cycle where weak demand, excess supply and credit contraction are converging. What we examine in this section is the cause and the adjustment mechanism of the prevalent property cycle and the broad numbers exhibited by the segments of Indian real estate.

The boom that was...

Last 3 years performance of real estate saw a fluctuation that could be called exceptional, on the upturn of the cycle. The supply of Grade A stock, both in commercial and residential segments, of all major markets increased by more than 100 percent in this period. Similarly price (rents for commercial and capital values for residential) increased by an average of 70-80 percent in select markets in 2004-07, with some markets outperforming others. It is important to note here that the financial sector too had a role to play in this cycle. Emergence of new financing methods (from Private Equity route) provided a substitute for traditional banking finance and helped infuse capital into the property sector. Also, the access to public equity markets (both domestic and international) helped expansion plans of developers, apart from improving

information transparency and market discipline. These additions made it possible for property risk to be spread through capital markets to a wider array of investors.

However, on the flip side, integration with financial sector made property cycle coincide with the capital market cycle, which amplified the swings and added another source of volatility into the system. Also, while all the big developers doubled (sometimes quadrupled) their scale of operations, they could not proportionately increase their execution and management capabilities. Lots of inefficiencies got built into the system during the boom phase. Most developers saw their debt levels soar to unreasonable levels. The exuberance of boom time resulted in many realtors purchasing land at prices that make their project unviable in the new environment. While all this might be normal in any other industry cycle, in Indian real estate it has happened at a much faster pace and with many new (small) players.

The correction is here.....

The above boom cycle, today, has been surely reversed. Last 8-10 months have seen a correction in the market, where the rentals and capital values witnessed moderation by 15-30 percent. Today, developers are facing big challenge on liquidity front, end users are gripped in uncertainties on the price front (therefore postponing their decisions) and investors have seen rapid changes on the valuations and are not willing to commit additional capital. Overall, there seems to be a considerable mismatch of supply and demand of real estate product and related expectations. This could be attributed to the fact that the developer's reluctance to adjust price levels (even though the demand

has shifted) and lot of supply still getting constructed (though nearly 50 percent of the construction has been put on hold or postponed). Such behavior could be attributed to few underlying characteristics of the industry: long planning and construction periods for the projects (it takes on average 20 months for a project to be completed in India) and inherent demand uncertainty (it is theoretically challenging to accurately model future realty demand). Moreover, the high cost of adjustment (sunk cost of fit outs and leasing costs) ensures that the market takes time to adjust to supply-demand mismatch in real estate market.

As a result of the above mismatch what we are witnessing today is a severe liquidity crunch. The lenders and investors, who were earlier vying for putting capital, are now keener to consolidate. At the same time, the uncertainty in the real economy, has forced everyone to postpone their transaction related activities. The speed of this double whammy, making capital even scarcer, has caught people unprepared; and we expect to see consolidation and realignment in this sector to last for the next few quarters.

Growth changes direction

The correction in real estate changed the shape of the sector and added new dimensions to its segments. The positive growth of stock and rent has vanished and the only parameter showing growth is vacancy. In this section we take a closer look at the key statistics and emerging trends of two important segments (commercial and residential) of real estate, at a pan-India level.

Commercial Market Update

2008 saw confluence of multiple trends. Record 65 million sq ft of

Grade A space was added in the year, that was 33% of the stock that had been built till 2007. At the same time, absorption of 2008 was reported lower than the one achieved in 2007. As a result, the average vacancies across seven cities increased and today stands at 15%.

Year 2009 is expected to see substantial downsizing of supply (by developers)

Figure 1: Office Rentals

City	Rental Fall (2008)*
Mumbai	-10%
Delhi NCR	-12%
Bangalore	-30%
Hyderabad	-8%
Chennai	-23%
Kolkata	-3%

* Across all micro markets

and absorption (by occupiers). As per DTZ estimates, out of 220 million sq ft of announced new supply (in seven cities), only 95 million sq ft is likely to materialize by 2010. Commercial rents exhibited changing trajectory in 2008. As vacancy rose, the fall in rents (relatively and in percentage terms)

was expected. The decline was more precipitous in over supplied markets of Bangalore and Chennai. What is even more interesting (Figure 1) is the fact that the Central Business Districts (CBDs) reported least fall followed by Secondary Business Districts (SBDs) and Peripheral Business Districts (PBDs). Moreover, as can be seen from Figure 2, CBD rentals across major cities reached their peak in January 2008 and by the end of 2008 had seen the least fall compared to other areas. SBD regions, though, remained stable, and saw a sharp fall in the last quarter of 2008. PBD regions showed continuous fall throughout last year, and witnessed maximum fall last year.

Residential Market Update

Residential real estate also saw correction in last 8-10 months, with some markets experiencing a fall of over 20%. The fall in residential, has been somewhat different from the commercial real estate downturn. One, the residential market started stagnating in the last quarter of 2007 and remained stagnant during the first six months of 2008. Secondly, the fall in transaction volume is much sharper in residential segment, as owners are unwilling to sell their units at reduced prices. Further, developers have started offering discounts or attractive schemes to improve their absorption levels. The uncertain economic environment, along with increasing unaffordability

(mortgage rates are still at high levels) is keeping new buyers at bay.

Mid income housing has gained prominence over the past year, with developers opting to build more projects in this segment. Even the format of developments preferred by the developers has shifted from bigger to smaller units. Further, payment schedules have shifted from construction linked to time linked plans.

While high interest rates and high quoted prices of residential units led to a fall in demand for outright purchases, it led to an increase in demand for rented residential units. Subsequently, rental values across micro markets have witnessed varying degrees of upward movement, especially in the mid-income segment.

Outlook

The above changes in the character and environment of Indian real estate sector over last few years, along the property curve, are likely to be instrumental in explaining its future. We perceive the property market correction and consolidation to create a more mature industry, equipped with improved planning and management techniques. Moreover, the manner and alacrity, in which the stakeholders of the sector conduct and consolidate themselves in the present economic scenario, amongst other things, would determine the time taken by the sector to get back on track. The effort made by the government by infusing liquidity into the system and decreasing mortgage rates could accelerate the revival process. Important to note is that over the last one month the market has shown initial signs of return of confidence. Investors and end users are evaluating property options looking for bargains in the slowdown.

Figure 2: Office rental movement, across cities, in 2008

