ECONOMIC
RESEARCH

ECONOMY & REALTY AT A GLANCE

August 2013

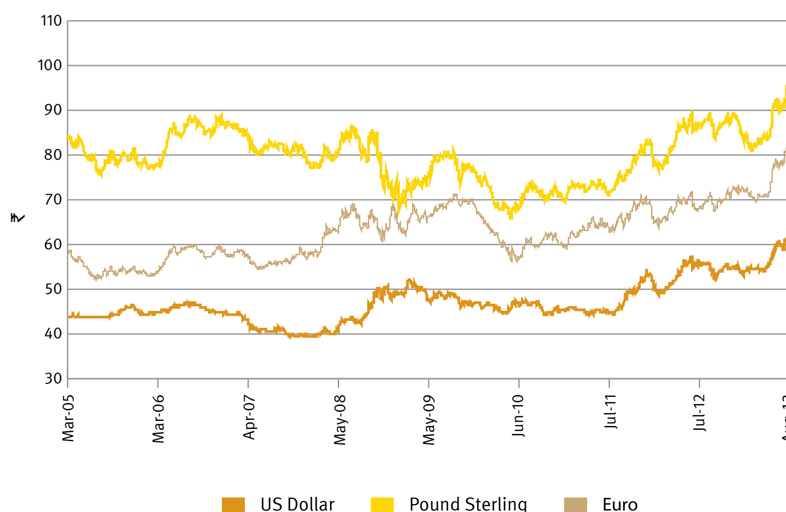
REAL ESTATE UNDER STRESS

The crumbling Indian rupee reflects the weakening Indian economy. At an exchange rate of ₹68 against the US dollar, the Indian currency touched its life time low this month. In the last three months (28th May 2013– 28th August 2013), the Indian rupee has depreciated against major global currencies like the US dollar, euro and pound sterling by 23%, 27% and 26% respectively. Notwithstanding the arduous efforts of the Reserve Bank of India (RBI) and the Government of India (GOI) to salvage the falling rupee, its downward march continues. Hopefully, the policymakers will realise that the international financial markets are bigger than anything else as far as price discovery is concerned.

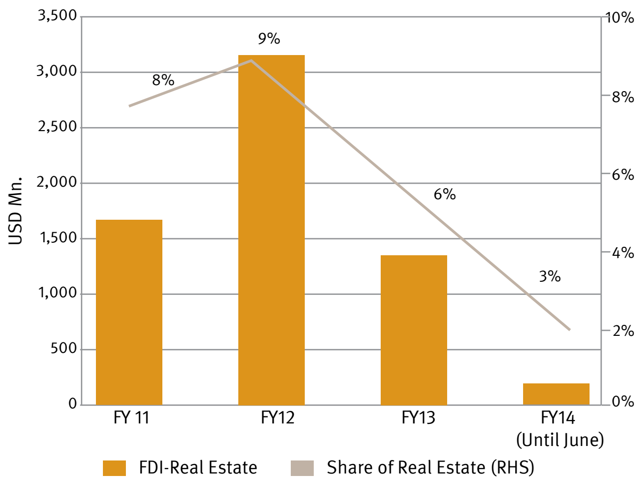
India is not alone as far as the erosion in domestic currency value is concerned. A slew of other developing economies like Brazil, Indonesia and South Africa have also witnessed depreciation in currency value. During the last three months, the Brazilian real, Indonesian rupiah, South African rand and Russian ruble have depreciated against the US dollar by 16%, 11%, 8% and 5% respectively. However, the cause for concern with respect to India is the high twin deficit problem amidst faltering economic growth. At 5% GDP growth in FY13, the Indian economy grew at the slowest pace during the last decade. At 4.8% of GDP, the current account deficit is at a multi decade high point. A fiscal deficit of 5.06% of GDP is anything but comforting. Besides, policy inconsistency and apathy towards the sentiments of the international as well as domestic business community have aggravated the agony.

Hopefully, the policy makers will realise that relaxing FDI restrictions alone will not attract foreign investment

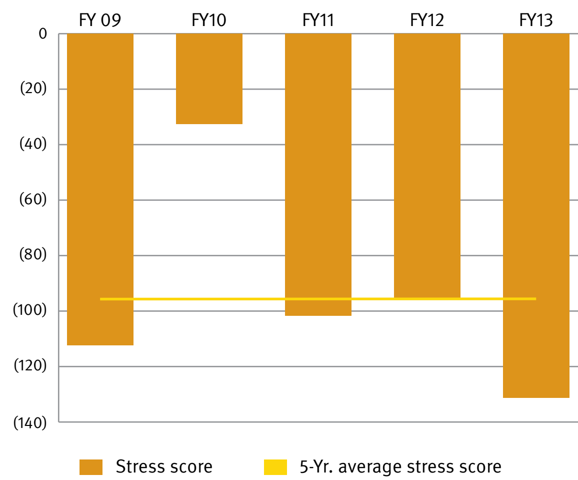
Rupee losing ground against major currencies



Source: RBI



Source: GOI



Source: Capitaline, Knight Frank Research

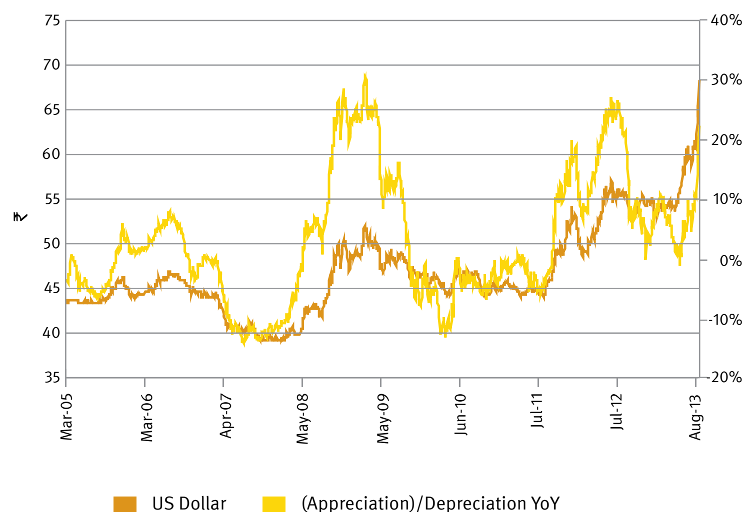
Hopefully, the policy makers will realise that relaxing FDI restrictions alone will not attract foreign investment. A congenial business environment promoting transparency and policy consistency is a greater prerequisite.

Besides the imbalance on the fiscal and the current account which exposes the country to a risk of sovereign ratings down grade, high inflation continues to be a worry. While wholesale inflation inched-up marginally to 5.8% in July'13 as against 4.9% in June'13, consumer inflation continued to remain stubborn at 9.6% as of July'13 in comparison to 9.9% in June'13.

Increased marginal standing facility and bank rate have brushed aside the hopes of lower interest rate regime in the near term impacting corporates and households alike

Further, crude prices hovering over USD 110/barrel and the recently approved food security bill by the Indian parliament will add to the economic strain. To combat the problem of high inflation and weak currency, the Reserve Bank of India (RBI) has thwarted its earlier path of reducing the interest rates. In fact, after lowering the key policy rate (repo) on four occasions since May'12, the RBI took an unprecedented step in July'13 by increasing the bank rate and marginal standing facility rate by 200 bps to 10.25%. This has effectively increased the interest rates in the economy and brushed aside the hopes of lower interest rate regime in the near term. The higher cost of borrowings will impact corporates and households alike. Sectors like real estate which form a derived demand from corporate expansion and household affordability will continue to be under stress for an extended period.

A higher 'stress score' number indicates an improving situation and a lower number implies a worsening situation



Source: RBI

Hence, to understand the stress level of the sector we ran the 'stress test' module. The module calculates 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 and interest obligation. A higher number indicates an improving situation and a lower number implies a worsening situation.

Since the 'stress score' is calculated on the cash-flow basis, the test has been conducted only on 11 out of the 25 listed real estate companies, that have filed their annual reports till FY13. These 11 companies cumulatively account for 58% of the total sales of the listed space.

Launches and absorption of residential projects in the top seven cities plummeted by 37% and 23% respectively during the past two years (FY11-FY13)

Huge liquidity, post opening up of the real estate sector for FDI in 2005, sky rocketed realty prices across India. This made developers believe that real estate values and sales volume will ceaselessly increase. Hence, they leveraged their balance sheet to deliberate their ambitious expansion plans. Therefore, even though the business profits (operating margins) were as high as 55% in FY09, the 'stress score' was quite alarming at -113.

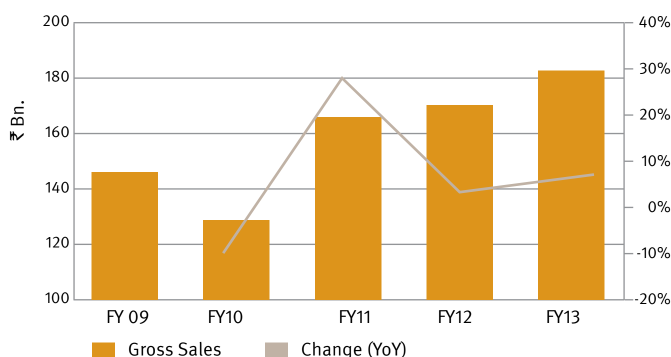
In FY10, the realty sector felt the brunt of the global turmoil. The fundamentals of the real estate sector imploded - sales, operating profit and net profit all declined by 11%, 21% and 43% respectively. Despite such an awful performance, the sector managed to escape liquidation primarily due to one-time debt restructuring relief package offered by the central bank. Hence, the 'stress score' for the sector recuperated to -32.

Sales and operating profit revived for the real estate sector in FY11 and FY12 primarily facilitated by the stimulus package offered in FY10. However, the sector could not skin the massive debt they were carrying in their balance sheet. Its impact could be felt by the quantum of interest the sector paid due to heightened interest cost. The interest cost as a percentage to sales grew from 12% in FY10 to 18% in FY12. This along with the debt repayment obligation exacerbated the 'stress score' to -102 and -95 in FY11 and FY12 respectively. High stress score implies high strain on the sector's ability to honour its debt and interest obligation.

Now in FY13 the situation has worsened further. Launches and absorption of residential projects in the top seven cities plummeted by 37% and 23% respectively during the past two years (FY11-FY13), thereby aggravating the structural problems of the sector. The real estate developers have been caught in a trap of ambitious expansion, decelerating sale, hardening interest rate, and weakening cash flow. Unlike the earlier occasions, the sector now has no bailout package and alternate funding options have also dried-up. Hence, despite operating cash flow (OCF) improving compared to last year, the stress score is at a five year low of -132.

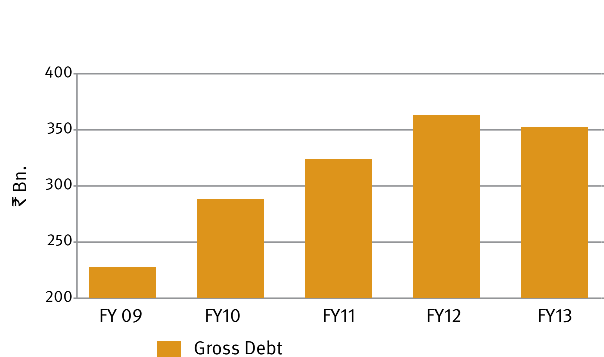
The real estate developers have been caught in a trap of ambitious expansion, decelerating sale, hardening interest rate, and weakening cash flow. As a result the stress score is at a five year low of -132 in FY13

Slowed sales impacting operating cash flows



Source: Capitaline

Realty sector gross debt increased by 55% since FY09



Source: Capitaline

The determinants of real estate industry's 'stress score':

Particulars (₹bn.)	FY09	FY10	FY11	FY12	FY13
Cash Flow from Operations	(3.11)	93.26	30.02	27.66	31.68
Debt serviced (Interest & Principal)	109.62	125.29	132.05	122.86	163.34

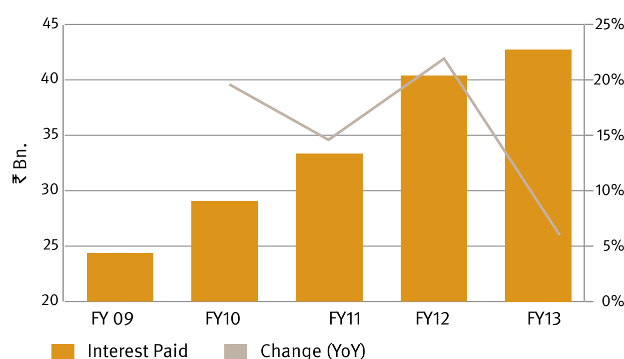
The problems faced by realty companies today are more deep rooted and chances of a revival in their financial health during the current year seem bleak. To add to the woes of the developers funding options have almost dried-up. Banks, one of the largest lenders to the real estate sector, are shying away from lending as they are troubled in their own backyard with increased non-performing assets, tightened monetary policy, currency depreciation and volatile debt markets.

Private Equity Funds, the all-time saviour of the real estate sector have also been seen exiting Indian markets. The capital market does not have any appetite for raising funds; Initial Public Offering (IPO) and Qualified Institutional Placement (QIP) have disappeared from the capital market. Foreign Direct Investment (FDI) in real estate has also declined, its share as a percentage of the total FDI has plummeted from 8% in FY11 to 3% in FY14 (until June). The aftermath of the dried-up fund scenario is also apparent in the market, some real estate companies have defaulted their debt repayments. This seems to be just the beginning of doom for the highly leveraged realty firms.

Chances of a revival in real estate industry's financial health during the current year seem bleak

Run-up to the elections is generally characterized by a period of policy paralysis and we expect the upcoming state elections as well as the general elections in 2014 to have the same impact. Realty firms are now in deep trouble and we expect the sector to witness more pain in the foreseeable future.

Interest paid swelled by 1.76x during FY09-13



Source: Capitaline

Research

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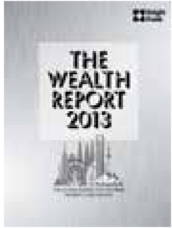

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