



# JULY 2012

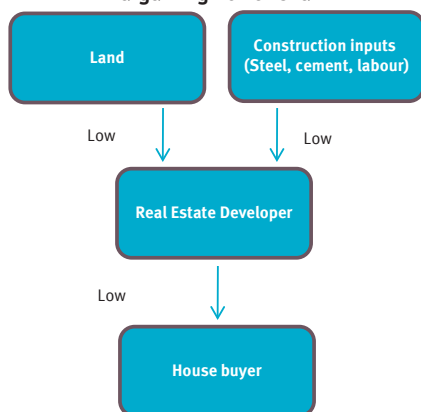
## E&R @ GLANCE

ECONOMY &amp; REALTY

### Knight Frank

The disconnect between the demand and price of real estate over the last few years has raised serious questions on the position of the real estate developer. There is a direct relationship between the demand and price of any product or service. However, the equation does not seem to hold true in the case of the Indian residential market. Such a scenario calls for a deeper analysis of the industry with an objective to understand the real reasons of such an anomaly.

#### Bargaining Power Chain



WHILE THERE HAS BEEN A LOT OF DEBATE ABOUT THE STANDOFF BETWEEN HOUSE BUYER AND DEVELOPER, A LITTLE HAS BEEN DISCUSSED ABOUT THE RELATIONSHIP OF THE DEVELOPER WITH THE SUPPLIERS OF FACTOR INPUTS

While there has been a lot of debate about the standoff between house buyer and developer, a little has been discussed about

the relationship of the developer with the suppliers of factor inputs. In an attempt to throw light on this relationship we need to delve deeper into the dynamics of the upstream channel of real estate development. The real estate industry is very fragmented and localized in nature, with the individual developer having little influence over the input prices. It does not have any industry status and in contrast to industries like FMCG, automobile, organised retail and telecom, it operates largely as an unorganized sector.

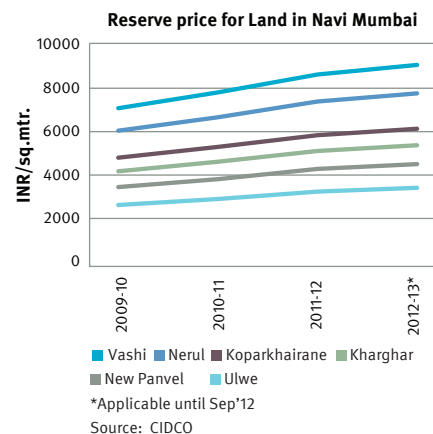
Real estate in India is structured in a manner that the bargaining power recedes as you go lower in the process chain. Land and construction cost are the two largest cost components involved in a real estate project. Hence, the price of these components has a significant bearing on the end product price ultimately charged to the buyer.

Land is perhaps the most significant input for property development constituting almost one-third of the property price in most cases and as high as two-third in some pockets of cities like Mumbai and Delhi. Land is a state subject and as a consequence its development potential is determined by the local governing body implying different Floor Space Index (FSI) and land usage norms within the same city.

While land is considered as an investment in common parlance, it is working capital for a real estate developer. This interpretation highlights the significance of replenishment of the portion of working capital that is sold as developed property. Obviously, the current market price of land and not the developer's historic cost will determine this replacement cost. Hence, the argument of cheap historical land cost to justify the expectation for a lower house price does not command merit.

WHILE LAND IS CONSIDERED AS AN INVESTMENT IN COMMON PARLANCE, IT IS WORKING CAPITAL FOR A REAL ESTATE DEVELOPER. THIS INTERPRETATION HIGHLIGHTS THE SIGNIFICANCE OF REPLENISHMENT OF THE PORTION OF WORKING CAPITAL THAT IS SOLD AS DEVELOPED PROPERTY.

The price of land is derived on the basis of the end product price of the most economically feasible developments like residential, office, retail, hospitality or industrial. However, although land price is derived as a residual value, the fact is land prices continue to remain high. Private land parcel is not alone in the race to exploit the highest possible price; government land is also auctioned with a motive to achieve this.





## PRIVATE LAND PARCEL IS NOT ALONE IN THE RACE TO EXPLOIT THE HIGHEST POSSIBLE PRICE; GOVERNMENT LAND IS ALSO AUCTIONED WITH A MOTIVE TO ACHIEVE THIS.

Analysis of land allotment policy of some of the major land aggregators provides interesting insights. City and Industrial Development Corporation of Maharashtra Ltd. (CIDCO), a Government of Maharashtra undertaking, is responsible for city planning and development of Navi Mumbai. The agency takes charge of the land in its territory and then auctions plotted land parcels with a prescribed land usage. CIDCO follows the 'Present Worth' method for fixing the reserve price of land. Although the reserve price is based on the cost of the land and associated development cost without profit, the fact is that the reserve price has been going up every subsequent year for the period under consideration. Notwithstanding the economic slump, the reserve prices of land in Navi Mumbai have been increased by almost 30% in three years since 2009-10. The auction mode of sale confers the land parcel to the highest bidder, as a result the winning bid in the last few years has been anywhere between two to three times its reserve price.

## ALTHOUGH THE RESERVE PRICE FOR CIDCO LAND IS BASED ON THE COST OF THE LAND AND ASSOCIATED DEVELOPMENT COST WITHOUT PROFIT, THE FACT IS THAT THE RESERVE PRICE HAS BEEN GOING UP EVERY SUBSEQUENT YEAR

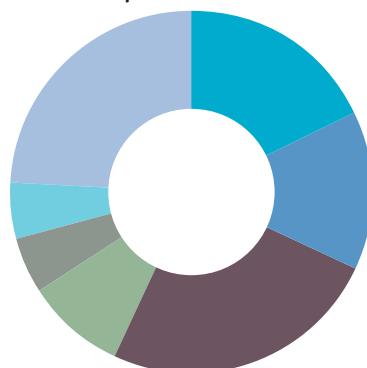
Another case under consideration is land sale policy of Rail Land Development Authority (RLDA) which is in charge of approx. 43,000 hectares of vacant land of Indian Railways

that is not required for operational purposes. A significant portion of this vacant land lies in urban centres. As a policy, RLDA develops the vacant railway land for commercial use for the purpose of generating revenue and allots land at the best achievable price through a bidding process. This leaves no scope for availability of rail land at a discount to market price.

These instances highlight the controlled environment for supply of land over which developers have little influence and hence they can be considered as price takers.

Construction of a real estate project involves the use of a wide range of factor inputs starting from steel, cement, bricks, labour, wood, pipes, paint and others. However, around 57% of the total construction cost is contributed by three major input items namely steel, cement and labour. At any point in time during the construction period, a developer has to keep a strict control on the prices of these three items as even a small escalation in their price can have a significant impact on the price of the project.

Break-up of Construction Cost



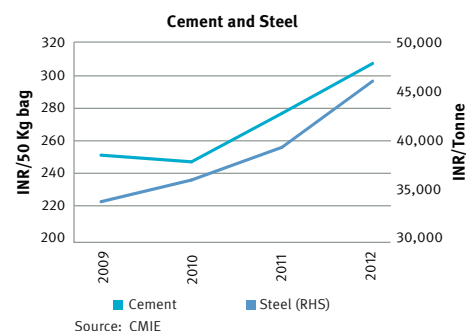
- Steel - 18%
- Cement - 14%
- Labour - 25%
- Building bricks - 9%
- Paints - 5%
- Wood & plywood - 5%
- Others - 24%

Source: Knight Frank Research

A real estate developer is a price taker in most of the input items used in construction and has no significant influence on their price movement. Steel and cement, which constitute one-third of the total construction cost, are produced by around 520 and 140 manufacturers respectively. In contrast to this, there are more than 6,000 developers

across India relying on these manufacturers for their purchases leaving a developer with little bargaining power. Additionally, since 2009, the cost of steel and cement has moved up by 35% and 24% respectively. While steel has moved up from INR 34,000 per tonne to INR 46,000 per tonne, cement price has increased from INR 250 per bag to INR 310 per bag.

## A REAL ESTATE DEVELOPER IS A PRICE TAKER IN MOST OF THE INPUT ITEMS USED IN CONSTRUCTION AND HAS NO SIGNIFICANT INFLUENCE ON THEIR PRICE MOVEMENT



In case of labour, various job guarantee schemes launched by the government in the last few years have reduced the supply of migrant workers. Central government schemes like the Mahatma Gandhi National Rural Employment Guarantee Act (MGNREGA) which provides 100 days job guarantee has adversely impacted the supply of migrant workers to construction sites in urban centres. Additionally, the minimum wage rate has also been increasing since the launch of the scheme. This in effect has reduced the bargaining power of the developer in the labour market.

As a result of this, the developer is left with two choices- either absorb the increased cost and compromise profitability or increase end product price. Since, an individual house buyer constitutes a very small component of a real estate project and is placed at the lowest end of the bargaining power chain, he ends up taking all the brunt of increase in input cost.



The industry structure clearly highlights that isolating the developer and solely holding them responsible for inflated property price is not justified. Since input materials like steel and cement operate in a free market mode, the focus comes back to the dynamics of land market. While all the stakeholders have a role to play, the government has a pivotal role by not only being a regulator but also the largest supplier of land. It should introduce clear and transparent policies for release of government land at an affordable price, increase the development potential of urban land with adequate infrastructure and enhance connectivity to distant suburbs through Mass Rapid Transport System (MRTS). Legislative bills with a potential to reform the real estate industry such as the Real Estate Regulatory Bill, Land Titling Bill and Land Acquisition, Rehabilitation and Resettlement Bills should be implemented on a fast track basis for a sustainable real estate environment.

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