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Keynote Address

How to Mange Turbulences in Real Estate Business

Deepak Parekh

Good morning, Ladies and Gentlemen:

Thank you for inviting me here today. Let me start by saying that my personal assessment is that we are still not out of the woods and I do foresee some more pain in the real estate market in India. This is a view that I have held for a while now and have been fairly vocal about. Now despite these trying times, we cannot go on lamenting about the real estate market. Every crisis in its own way brings out new opportunities, new insights and new lessons.

Patience is the first step to immunize against sudden changes in the real estate market. Such cycles are inevitable and will continue to come and go. I do not think we need to be too concerned about a slowdown in the real estate market – a long, overdue adjustment was needed and this, to some extent has already happened. But there is pain because the adjustment is not gradual, but like a shock wire packed with an alarmingly negative sentiment. For the past three years, the Indian real estate sector was touted as being 'sizzling red hot'. Subsequently some things went wrong – the real estate market grew too fast for its own good, some developers went hopelessly haywire on land deals resulting in prices spiraling uncontrollably and investors began demanding unrealistic returns. When these investors retracted, many developers were left scrambling for resources, prices fell, confidence was shaken and the rest of the story is familiar to all. So who is bearing the pain?

- Investors, who now have to deal with valuations that have been beaten down to pulp;
- Certain developers who find themselves cash-strapped for having committed to buying land at exorbitant prices with no takers for their projects;
- And finally, there is pain for those lenders who carelessly doled out funds to developers without understanding the ground realties.

Unfortunately, there is no instant relief for this pain. My advice once again is patience – investors need not panic and resort to distress selling but must have a long – term perspective on the real estate market. Yes, it is true that high rewards do not come without taking risks. But indiscriminately chasing high returns invariably results in agonising losses. Realty stocks were completely overvalued – some by close to 50 to 60% at the time of their IPOs, so what one is seeing is more in line of a correction. There is an understanding that real estate companies cannot be valued on the basis of their land banks, but on projects that are actually being executed.

For those developers caught in a cash bind, they need to realise that their absurdly high margins cannot sustain. There are certain developers who have refused to relent on prices, despite a slowdown on sales and curbs on their funding sources. It is unfortunate to see this ostrich like approach where these developers would prefer to put themselves on the brink or pay exorbitant interest rates rather than lower their prices and tide over their financial crunch. Another breed of developers that I have come across openly proclaim that they are willing to stop construction, thereby orchestrating a shortage which will automatically push up prices. Developers need to guard against the dangers of excessive borrowing. Leverage works like a double-edged sword – in the good times it magnifies returns, but on a downturn, it can eat you alive. If you live off too much of borrowed money, even the best risk management systems cannot save you.

The second lesson and a tough one, is the importance of being rational in an irrational market. One's behaviour in a bull market is often a reflection of how one behaves in a bear market. The key point is that one's basic business policies and practices should not be compromised or vary with market cycles. The subprime crisis is a case in point. As long as house prices kept increasing and interest rates kept coming down, lenders became so lax that even an appraisal of a borrower was considered almost unnecessary. In India too, the overkill that happened on retail lending is now having its repercussions in terms of increased non-performing assets. Ultimately, there is no substitute for prudent lending, irrespective of whether the market is going through a boom or bust phase.

The third lesson is the need to guard against 'overexuberant development'. Identifying genuine demand is critical and one should not be swayed by heard mentality. With the real estate boom came 'mall mania'. The oversupply of mall plans was very apparent but the overestimation of the spending power of the average Indian was way off mark. Malls increasingly became the place to 'hang out' or eat and therefore most retailers with paltry sales were unable to sustain rentals that rocketed as high as Rs. 300 to 600 per sq. ft. today, the top eight cities in India are already witnessing a 20% vacancy across 40 million sq. ft. of operational malls and I suspect there will be more vacancies coming around. So, while abandoned mall plans are scrambling to be converted into office space, certain cities are already seeing an oversupply of commercial space, especially in light of the slowdown in the IT and BPO sectors. It is critical to be able to assess genuine demand. For instance, the more nimble developers have already been able to shift to other opportunities such as affordable housing, which is a clear departure from their earlier focus on the high-end luxury homes segment.

In India, housing if priced correctly has an enormous demand and given the huge housing shortage, it is unlikely that there will be any saturation in the market for a long time to come. This is a win- win situation for both, the buyer and developer. The attraction for developers in the affordable housing segment is assured sales and upfront cash flows. While margins may be lower compared to high-end projects, they make up in terms of volume. Further, sales in this segment augurs well since it is an assurance that speculators are out of the market. The riskier, though more profitable projects include slum rehabilitation and it is encouraging to note that more developers are looking at this segment too.

The fourth lesson pertains to the buyer and his psyche. A cardinal rule is that you cannot time the real estate market. Do not sit on the fence – if you find the right house go ahead and buy it. Even interest rates, over a 15-year period will inevitably move up and down.

The other lesson for the borrower is not to overstretch on a loan and maintain a sufficient buffer.

And finally, the last lesson is the compelling need to push through our long-standing, unfinished agenda – namely increasing transparency in the real estate market, simplifying land acquisition procedures, reducing stamp duties, devising a single-window clearance system and reframing development control rules to meet the present requirements and supporting infrastructure. This is also a growing consensus for a real estate regulator as evidenced in the latest E & Y-FICCI real estate report.

So what future beckons the real estate market? The present situation may call for some consolidation within the sector and perhaps the need to create innovative financial instruments that could support financially distressed developers to tide over. As regards capital raising options, while the IPO market may take time to recover, there is sufficient interest from foreign investors to partake in the Indian real estate market through the private equity and FDI route. In the first quarter of the financial year, about 20% of FDI inflows were in housing and real estate. So, long-term prospects of the commercial real estate market continues to remain positive owing to growing opportunities in sectors like healthcare, hospitality, logistics and education. The residential housing market will also continue to show robust growth given the strong demand, favourable demographics, increasing urbanization and rising disposable incomes.

I do believe that the Indian real estate market has been relatively unscathed when compared to many other countries where the housing markets have slumped. In the US, bank losses and write-downs from the yearlong subprime crisis have crossed US$ 500 billion. The US, the very country that sowed the seeds of capitalism, where private enterprise and free market forces govern the system has seen a meltdown. Fannie Mae and Freddie Mac, the two housing finance entities that own or guarantee over US$ 5 trillion of US mortgages have been placed under government conservatorship. Thus the 'too big to fail' entities eventually needed tax payer's money for a bailout.

Even our neighbour, China whose economy we so often look at with envy, has not been spared from the property market crisis. Efforts to cool the Chinese property markets include hard-line measures such as sharp increases in interest rates, vacant land taxes and imposing a mandatory 40% down payment on second home mortgages. Despite this, many Chinese developers are reportedly heading towards bankruptcy. Comparatively India has been more fortunate, having identified early signs of a heating real estate market with the RBI stepping in to take quick corrective measures.

So finally to conclude, I'll leave you with a few thoughts:
Land is the riskiest form of speculative real estate, which is why there are huge swings in land value. The ironic thing about land is that only when there is demand to develop the land does the value increase, thereby yielding huge profits. Similarly, when demand stalls, land can lose value really quickly because there are few other ways to generate that kind of income from land. Sure you can cattle on the land, but you will literally and euphemistically have to wait till the cows come home before you see any sizable return

from the land. But on a more serious note, this has been the root cause of all the problems faced in land acquisition. For instance, in cases where land is purchased from farmers, it is done at fair value, but subsequently when project plans are announced, the value of that land escalates and then the original sellers feel cheated or disgruntled with their compensation. It is difficult to find outright solutions but experience shows that the need of the hour is transparency in such land dealings, clearer land titles and making those losing their land stakeholders in the project. Offering them equity in the project will give them long-term economic benefits, rather than leaving them with fear of being displaced and then subsequently becoming the grist for someone else's battle.

Housing markets across many countries have slumped and foreclosures have increased manifold. Not many imagined that developed countries would be faced with problems of having to de-house families. In India, we need to continue to strive towards the challenge of housing more people. 'Housing for All' is often wielded as political rhetoric, but we must not lose sight of the importance of building a property owing democracy. A civilized society depends on having the greatest possible number of people who have a stake in society. Being a homeowner gives one a secure and direct stake in society; so that is the goal we need to work towards.

Thank you.