IS THE REAL ESTATE BOOM A BUBBLE READY TO BURST?

An Interview with Mr. Ravindra Pai, Managing Director, Century Real Estate

The Indian economy is in an interesting stage right now. On one end of the spectrum, signs are pointing towards an economic surge. The Sensex hit an all-time high only a few months ago. The RBI seems to be making all the right moves to curb inflation and bring stability to the rupee and analysts can be frequently heard commentating that finally it's a "trading market". This means the economy is picking up, the share market is ripe for investments and therefore investors and traders can take advantage of the opportunities being presented to earn profits.

However, a quick way to see whether a country's economy is improving is to simply look at its real estate prices. If real estate sales fall, then real estate prices eventually fall in tandem. This then reduces the value of all homeowners, whether they are looking to actively sell or not. The result is that there is a reduction in home loans granted to those same homeowners. Finally, this reduces consumer spending which results in reduced GDP.

So all in all, real estate prices or sales are a great indicator of a country's economy.

With the Sensex hitting new highs and RBI Governor Raghuram Rajan promising all sorts of ground-breaking changes to propel the economy (on 6th November, the RBI unleashed a far reaching set of new rules that will allow foreign banks to enter India's protected domestic environment), you would expect real estate prices to be surging upward. And yet, this is not what is happening.

The RBI has been consistently raising the repo rate, which is the rate that banks are charged to borrow from the RBI- in recent months. These past few days, major banks such as State Bank of India and HDFC Bank raised the rates to obtain loans to purchase houses, and the trend is unlikely to stop as the RBI is expected to continue raising rates to fight inflation.

This all translates to bad news for the real estate market. Home-owners will have a more difficult time obtaining loans to purchase houses. Already, cities such as Mumbai are facing a downturn in the real estate market, despite the mass public perhaps not being aware about it. In a candid discussion with Mr. Ravindra Pai, the Managing Director of Century Real Estate, Tejas@IIMB team tried to understand if the boom in the real estate is only a bubble ready to burst and if housing would be more affordable in the future.

ON CENTURY REAL ESTATE & ITS PLANS

Tejas: Brief us about your current and upcoming projects?

Ravindra Pai (RP): We currently have 14 residential projects under construction, totaling to about 1.7 million square feet. We propose to launch five projects in this financial year, which will add another 2.3mn sq ft. These include apartments in the mid-range and high range as well as luxury villas within gated communities. Currently, our commercial portfolio is not very large, but we are hoping that in the coming years this forms 30% of our overall portfolio.

In the hospitality space, our partnership continues with Royal Orchid Hotel, with a 130 room Business Hotel in Bangalore CBD and also City View, which is a mixed development and houses "The Four Seasons, Bengaluru", a 230 room, seven star Hotel along with 100 units of branded residences.

Our residential portfolio by the end of this financial year will be totaling 4 million sq ft. Our total portfolio of development will be 9.6 million sq ft spread over the next five years.

Tejas: Are you seeing some slowdown in your projects?

RP: While there is some resistance in the high end and luxury segments, the demand for apartments in the range of Rs 50 lakhs to Rs 80 lakhs is very robust. The commercial offtake has been slow, as companies are going slow on their expansion plan which has in turn affected absorption of commercial real estate.

Tejas: What is your land bank?

RP: We currently own a land bank in excess of 3000 acres, which is under various stages of development.

Tejas: Are you in talks with other PE firms for Projects?

RP: We are in discussion with various PE firms for project level participation.

Tejas: Brief us about your MOU with IIM, Bangalore?

RP: Century Real Estate and the Indian Institute of Management, Bangalore have signed a MoU on May 17th (2013) for setting up the IIMB-Century Real Estate Research Initiative, a first of its kind in the country.

The IIMB-Century Real Estate Research Initiative will focus on collecting data and conducting scientific, cross-disciplinary research on the Indian Real Estate sector that will be published in leading academic and practitioner journals. In addition, the Research Initiative will seek to provide guidance and policy prescriptions to government and industry stakeholders on major issues relating to the Real Estate sector. There is a tearing need for such an initiative in the Real Estate space that will focus on research, act as an interface between the industry and the policy makers and eventually churn out quality human resource for this sector.

ON THE REAL ESTATE BUBBLE

Tejas: Metropolitan cities in India are fast becoming a hub of industrial parks, high rises, residential complexes, sprawling malls and huge commercial complexes, which are gradually but steadily transforming their skyline. If you are commuting on the busy and packed streets of Delhi, Mumbai, Bangalore, Hyderabad, Kolkata or any other tier I city, you will come across brightly colored cranes, rubble, construction and hordes of workers scurrying up and down the towering skyscrapers. This surely urges you to contemplate on the explosion of real estate sector in India. Is it a mirage? How real is the influx of investments by speculative and long-term profit makers? Are the commitments by oversized private equity firms, overseas investors and domestic financial institutions adding to the hype and frenzy created in the concrete world of real estate?
RP: Astute watchers in the property sector feel that the bubble is not as big as it seems. According to my experience, there are certain factors which are failing to add the right tempering to the real estate markets in India. It is quite evident that the funds brought in by the foreign investors are only a small percentage of the promised amounts. Price resistance from real estate purchasers and the soaring prices of land are cutting deeply into the investor's margins, making real estate ventures less lucrative than expected. Bureaucratic lethargy coupled with red tape, opaqueness in regulations and the absence of insurance title prove to be other concerns for real estate investors.

Tejas: Reflect on the investor sentiments?
RP: According to reports by Cushman and Wakefield, there has been a 15 per cent drop in the valuation of private equity deals in the first nine months of 2012. Investors are putting their money in residential deals rather than commercial ones. PE players are showing an increasing preference towards the metros rather than class II cities in the hope of better liquidity and higher returns. Investors are looking towards projects which have all approvals and licences in place and are expected to have short cycles. The assurance of quick and stable returns is guiding their purchase and investment decisions. They are also having a greater say in the prices of projects. This is decreasing the scope for automatic price correction or defining of prices by the developers.

Tejas: What do you make of the current scenario in the real-estate market?
RP: The current situation is raising fears of an overheated economy and real estate bubble. This has inspired the central banks to initiate a lender cutback on the amounts sanctioned for real estate loans. The act has caused an upward escalation in the rates of interest and lowered the attractiveness of home financing for consumers. As a result, the cost of home and office rentals along with their purchase price has ended up touching unprecedented heights.

Tejas: So where does this scenario leave the investors and property purchasers?

RP: A majority of Indian real estate companies are privately held and do not disclose their financial health to investors and buyers. The inability to read the right signals in the absence of readily available information on products such as retail outlets, industrial property, residential apartments and offices is causing grave concerns in the minds of the investors. Rumors related to the misfiring of a large deal or reports of distress sales by prominent property developers is further adding to the confusion in investor sentiments.

Tejas: What determines these unprecedented prices in the Indian markets?

RP: The prices of property in the Indian markets are being stoked by the following factors:

- Numerous speculative deals taking place in the hope of making faster and better gains
- The rising cost of construction with respect to raw material, labor and other costs
- An unexpected hike in the excise prices
- Increase in service tax rates
- The escalation in land prices

Tejas: Would you agree that the real estate situation in our country is really just a bubble ready to burst?

RP: Usually, before a bubble "bursts", price rises begin to slowly drop. This is currently being evidenced across the country. The National Housing Bank's Residex, which tracks housing prices across 26 prominent cities in India, showed that in the April-June period, 22 cities saw a fall in prices compared to the previous quarter. Mumbai and Delhi saw prices drop by 0.5 per cent and 1.5 per cent, respectively. While properties in Chennai dropped by 2.3 per cent and properties in Kolkata dropped by 4.1 per cent.

When looking at nominal numbers, which is not comparing to the previous quarter when adjusted for inflation, out of the 15 largest cities in India, house prices actually fell in 11 out of the 15 cities in the second quarter of 2013. This is absolutely alarming. For example, Kolkata saw a dramatic -12.9 per cent drop in prices when adjusted for inflation, and Surat saw a -11.5 per cent drop in prices when adjusted for inflation. The most alarming fact is that builders, in order to not cause a panic among homeowners and the public, try their best to not drop prices even if it leads to higher vacancy rates.

As real estate prices boomed in 2011 and through early 2012, builders began building away. Yet by the end of 2012 it became evident that homes were not selling at the price points that builders had previously anticipated.

As of right now, 11.09 million homes in urban areas across India are lying vacant. New home sales in Delhi NCR fell by 13 per cent, Mumbai by 12 per cent, 15 per cent in Pune, and 7 per cent in Chennai during Q3 in comparison to Q2.

One example of a builder facing the housing dilemma is the Orbit Grand property in Mumbai, built by Orbit Corporation which is one of the country's most prominent builders. This building project was to house at least 35 floors of elegant apartments, yet after completion of 10 floors construction work had to be stopped. Similar instances can be heard from all over India.

There has been the willingness of developers to hold growing inventories of unsold apartments, shops and offices without offering price discounts. The volume of real estate transactions has slumped in India as developers have refused to offer discounts for fear of starting a market rout.

If builders drop prices, investors will undoubtedly begin to panic, and a self-fulfilling prophecy will unwind.

Tejas: What would cause the bubble to "burst"?
RP: As of now, builders are already stopping work on projects, as evidenced by the Orbit Grand example. Eventually, as demand does not meet the supply of apartments and builders begin defaulting, buyers begin losing interest in purchasing new homes (as evidenced by the plunge in new home sales in Delhi NCR). For now sellers are refusing to cut prices out of fear of causing panic; but eventually they will have no choice but to cut prices. At that point, the bubble bursts and prices can drop dramatically and immediately.

To show the devastating impact of a real estate bubble, let us look at the BSE Realty Index, which tracks 13 real estate based companies. Since the launch of the Index on 10th July, 2007 the Index has depreciated more than 80 per cent in value, with a huge 80 per cent drop happening just during the calendar year of 2008. The year 2008 is when the bubble occurred. Meanwhile, the Sensex has appreciated 47 per cent from 10th July 2007 till date.

If another bubble were to occur, we could very well witness a similar scenario. The frightening aspect is that all signs are pointing towards the same direction.

ON BUYING / RENTING OF PROPERTY IN 2014

Tejas: India's current economic uncertainty combined with the inflated real estate prices makes the buy or rent decision tougher for a common man. Zero or negative growth in incomes, higher interest rates and a shrinking carpet area for the same money make a strong case for a personal finance drive. In such a scenario, is it financially prudent to buy a house? Can there be an advantage to renting a place to live? Will there be any lifestyle changes that one needs to accommodate?

RP: I enlist some of the most important factors one should consider while arriving at a merit-based decision. While buying a house,

- Amount of down-payment for house loan (20 per cent of cost)
- Time to save for down payment (No. of years)
- EMI on house loan
- Monthly property maintenance charges
- Annual repairs
- Annual property tax
- Income tax savings under sections 80C and 24B.

While renting a house,

- Security deposit
- Monthly rent
- Yearly increase in rent

- Monthly property maintenance charges
- Income tax savings under HRA exemptions

The three factors that are pivotal when deciding on buying a house are: current property price, which determines the EMI to be paid; current monthly rental value, and the current gross income.

Monthly rent or the EMI being paid should not consume most of one's salary which in turn is likely to affect the current lifestyle or future goals. Also, it is not a good financial decision to buy if the rental value is low compared to the EMI to be paid when owning a property. However, one cannot only rely on the rent-to-buy ratio and make the decision to buy without assessing his affordability. Similarly, a decision to buy a house just because one can afford the EMI is not advisable.

Tejas: Which cities would you recommend for buying / renting a new house?
RP: Hyderabad and Ahmadabad are the most affordable markets to buy a house, according to a recent study by ArthaYantra. Delhi and Mumbai clearly stand out as the cities where buying or even renting a house has become incrementally tougher over the years and has gone beyond the reach of the common man.

The minimum salary range to be able to afford a house across all the large 8 cities has also increased compared to 2012. Similarly, the area for the same amount of money has shrunk. This has led to increasing number of people opting to rent a house rather than buying one.

Hyderabad continues to be the most economical choice for both renting and buying across all salary levels. However, in Pune, Bengaluru, Ahmadabad and Kolkata, the salary threshold to buy a house starts after one starts earning more than Rs. 12 Lakhs per annum. These cities today offer a good buying alternative to professionals working in Mumbai or Delhi.

Tejas: What do you make of the Future trends in the industry?
RP: According to me, this is a good time for purchasing real estate intended for long-term investment and end use. The cyclical nature of the markets is expected to push up the residential property rates in the next three years. If the investment horizon is greater than this period then it makes good business sense to invest in property in metros and other fast developing cities. The decision to purchase property in the emerging areas should be backed by a complete analysis of the demand-supply forecasts and infrastructure plans for the region. As far as capital appreciation and rental yields are concerned, mid-range houses are expected to provide better returns than luxury apartments or premium property purchased at discounted prices.

ABOUT THE PERSON:

Ravindra Pai serves as Managing Director of Century Real Estate and has significant experience in the Real Estate Industry. He oversees all activities of the Company starting from sourcing of land to project execution and delivery. He has been at the forefront of reinforcing Century Real Estate as Bangalore’s leading real estate developer. Prior to joining the Company, he has had very successful stints in diverse fields such as software programming, business process migration and sales with very reputed companies such as Tata Infotech and GE Capital. His last assignment was handling sales in South and West India for Oracle. He holds a Masters Degree in Business Administration from the prestigious Indian Institute of Management, Bangalore.

ABOUT THE COMPANY:

Century Real Estate, with its headquarters in Bangalore, India was founded by Dr.P.Dayananda Pai and Mr.P.Satish Pai in the year 1973 with the primary objective of transacting in the simple buying and selling of land. More than 35 years later, the Company has evolved into an integrated, full service real estate development company that has transformed Bangalore’s urban landscape and is credited with several of Bangalore’s landmark developments such as Manipal Centre, Taj Residency, Vijaya Bank Head Quarters and Diamond District to mention only a few. Century Real Estate has the unique distinction of having purchased land on M.G.Road at INR 5 per square feet way back in 1973 where today the quoted prices are in the range of INR 20,000 per square feet.
Regarded as one of the oldest and most respected companies in the Real Estate space in India, the growth of Century Real Estate has practically mirrored the growth of Bangalore as one of Asia’s fastest growing cities. Today, Century Real Estate is the largest owner of real estate in Bangalore with a land bank in excess of 3000 acres representing more than USD 2 billion in asset value and a development portfolio of over 10 million square feet comprising hotels, office buildings, residences, educational institutions and integrated townships spread across South India.