



MISSING IN ACTION

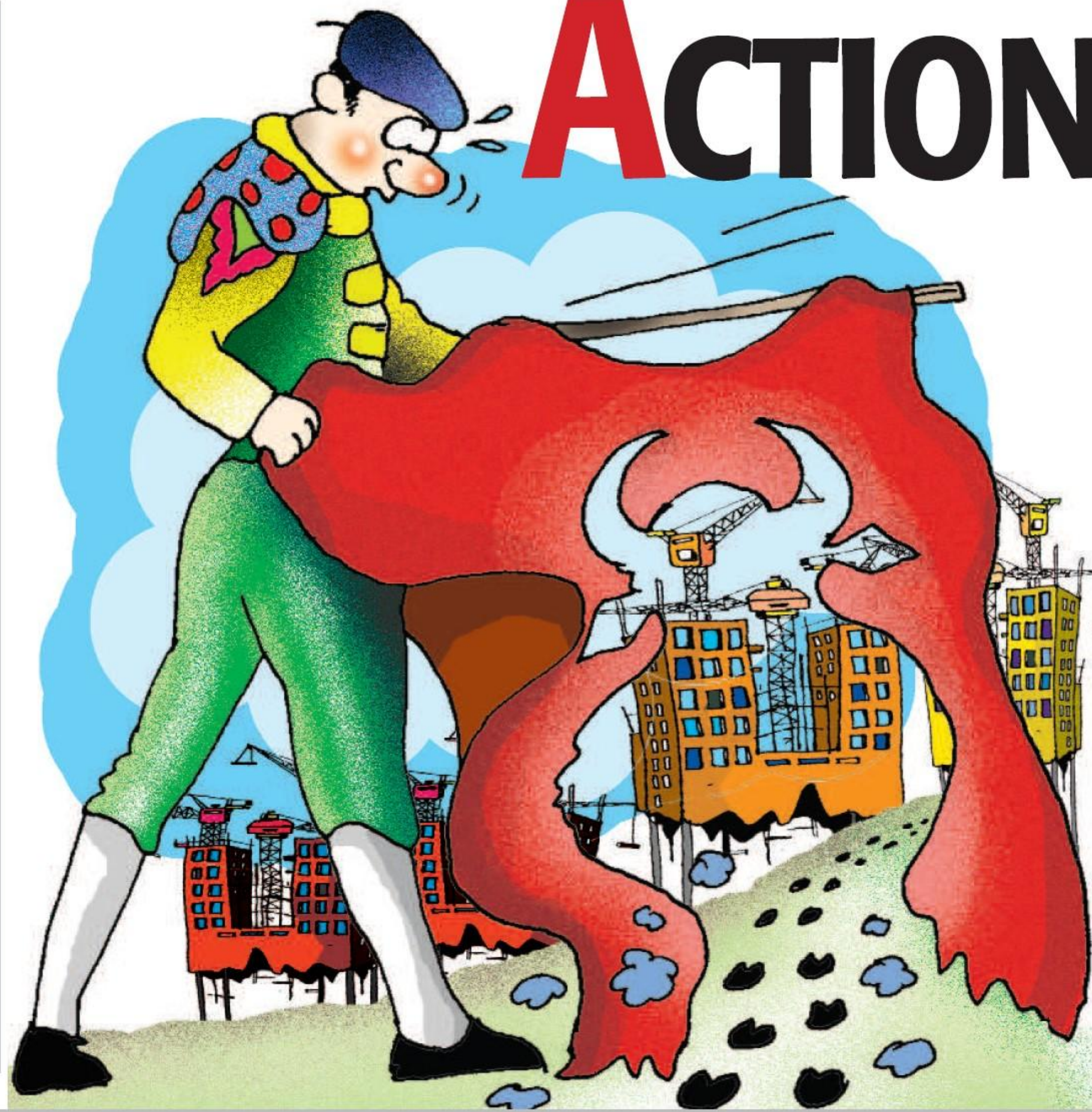


ILLUSTRATION: SALAM

A 'wild child' in corporate governance norms, the realty sector's performance, of late, has not been quite up to the mark. What has triggered the correction is a surge in borrowing costs and higher prices. The alleged involvement of some of the companies in a wave of scams has only fed to the negative sentiment. **Shikha Sharma and Kiran Kabtta Somvanshi** of **ET Intelligence Group** analyse the dynamics of the Indian real estate sector

INDIAN realty stocks that looked all set to fly on the wings of rising demand amid easier access to bank loans and higher purchasing power have been beaten down once again in the recent market correction.

In the past one year, Bombay Stock Exchange's Realty Index has been a stark underperformer, losing half of its value when benchmark Sensex managed to churn out a 2% return. The price-to-earnings ratio of the realty index corrected from its peak of 59 in January, 2010, to a modest 19 in March 2011. But factors such as a rise in borrowing costs and peaking asset prices — that are weighing down the residential home segment — have stopped investors from bottom fishing in the stocks.

Already considered a wild child in corporate governance norms, the sector was also hit by revelations of some firms being allegedly tainted by scams that fed into the negative sentiment. On the valuations side, the sector is attractive as the price-to-book value currently is at the same level as it was when both realty and stock markets had crashed in 2008, despite better fundamentals. On the flip side, increasing interest rates will hit realty firms that have high debt on books and those whose demand is typically affected by higher borrowing costs for end consumers. But the impact will not be uniform on all builders with varied exposure to residential, commercial, and retail sectors.

So, is it a good time to buy into the sector? **ET Intelligence Group** looks at the sector dynamics and its impact on the players.

FUNDAMENTALS OF THE SECTOR

The real estate market can be broadly divided into three sectors — residential, commercial, and retail. Residential housing is the biggest driver of demand in the sector. In commercial realty business, nearly two-thirds demand come from office space and the rest from leased retail space. The demand for office space in the country has improved on the back of growth in information technology and banking sectors, which account for a big chunk of demand in the category.

The Indian realty market went through a downturn following the global economic meltdown in 2008. A squeeze on credit flow and slowdown in demand as job growth in the country came to a standstill led to a sharp fall in asset prices and many new projects were held back. This also pushed up inventory or vacant and unsold space across cities, resulting in high working capital pressure for the real estate companies.

But in mid-2009, signs of revival in domestic economy, correction in asset prices, and lower interest rates led to a pick-up in realty demand. The aggregate inventory nearly halved from mid 2009 to the quarter ended March 2010, according to a Credit Suisse report. As a result, residential property prices hit all-time highs in major markets. Going forward, Indian property prices are seen moderating as an increase in borrowing costs and record high asset prices will dissuade residential home buyers from buying new properties in coming quarters, say analysts and industry experts.

However, the expected fall in demand for residential housing is likely to be offset by the recovery seen in commercial realty segment over the past six months. The overall revival in economy and improving business sentiment is prompting companies to expand operations and set up new branches, thus leading to a rise in demand for commercial property. Realty firms that derive a major chunk of their

revenue from commercial property space have witnessed a significant rise in volumes and could be less impacted by the expected slower growth in housing demand. However, the commercial retail leasing market in India still remains under pressure as lack of government reforms in allowing foreign retailers to set up shop in the country has restricted volume growth.

FINANCIAL PERFORMANCE AND STOCK SELECTION

While smaller realty firms are solely residential housing developers whose fortunes are directly linked to any change in property prices, interest rates, and absorption, the integrated players whose businesses are spread evenly between commercial and residential housing are less risk prone in a growing economy.

DLF, Unitech, and Anant Raj Industries derive a significant chunk of revenue from commercial leasing, besides residential properties. As a result, they have more recurring rental incomes that support operating cash flows and their revenues are not just dependent on launch of a new housing project. On the flip side, these companies generally have high debt due to huge asset class, which makes them prone to high risks during a downturn.

Among companies that primarily depend on residential properties, Godrej Properties — unlike most other realty firms — has an asset-light business model with most of its portfolio skewed towards joint development projects. The company is partly insulated from high costs of purchasing land that eats into margins as interest rates go up, but its business is affected by a slowdown in demand either due to rising cost of home loans or unaffordable property prices.

HDIL, the leading slum developer, derives close to half its business by selling transfer development rights (TDR), where a portion of land can be sold by a company undertaking redevelopment projects. So, any movement in TDR price determines its revenue on a sequential basis.

As all realty companies are not comparable on the same plank due to different revenue models and risks, investors need to pick their stock based on some other parameters that are comparable to par.

While selecting a stock, an investor could thus consider the operating cash flow of the company as it is not impacted by any revenue recognition schemes and gives the cash position, which is critical for realty firms exposed to high debt. Potential investors should also watch out for disclosure standards of companies, as it is necessary to make informed decisions. For instance, firms disclosing their total debt besides project launches and sales every quarter allow better understanding of financial performance and management. Another critical aspect that must be looked into by a potential investor in the stock is execution track record. Moreover, while deciding on the valuation, it is advisable to look at the price-to-book value ratio and the return-on-equity as the sector is highly leveraged.

OUTLOOK

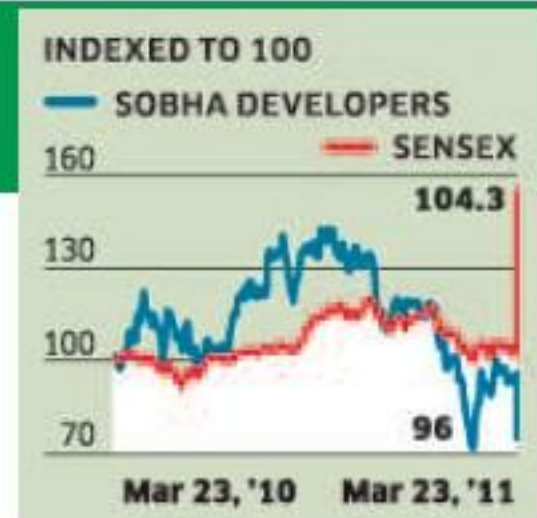
Demand outlook for the sector looks stable with a negative bias amid subdued volume growth in the residential property space, revival in commercial leasing market, and likely reforms in the retail sector. While the fundamentals as well as financial parameters make the sector attractive, investors should look at selective buying.

Here are the prospects of six leading realty companies in the country.

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SOBHA DEVELOPERS

Sobha Developers has benefited from the low-cost land bank and continued strength in the Bangalore real estate market. The company is looking at reducing debt on the back of land sales and strong operating cash flows. Margins are likely to sustain with the company's focus on luxury and super luxury projects. The company acts as a contractor for other non-real estate companies like Infosys that



acts as a balancing factor towards de-risking their business model. The company is expanding in other cities like Gurgaon, NCR, Chennai, and Mysore. Successful expansion in northern regions remains a concern.

HDIL

HDIL, the leading transfer development rights (TDR) player stock, has seen lack of interest despite strong financial results for the quarter ended December. Unlike most realty firms, whose revenue is linked to project launches or commercial rentals, HDIL derives close to half its revenue from TDR. HDIL looks attractive due to its strategy of diversifying into the residential market with discounts of 15-20% to other projects in the same



geographical area. So, investors with reasonable appetite can take exposure for the long term, but keep tabs on its quarterly numbers for any unexpected event, which could impact its profitability.

OBEROI REALTY

Oberoi is one of the largest Mumbai-based realty companies with 93% land bank based out of the state. It's the only company in this sector which has negative debt with robust revenue and cash flow visibility. The company's remarkable performance is linked with its strategy of sales linked to sales of the projects, which results in better cash flows. Its strategy of rationalising prices according to demand scenario has helped the



company report a superior margin and profitability over the past three years. With a better execution history and strong financial position, the company is well-placed to reap the benefits of growing demand.

UNITECH

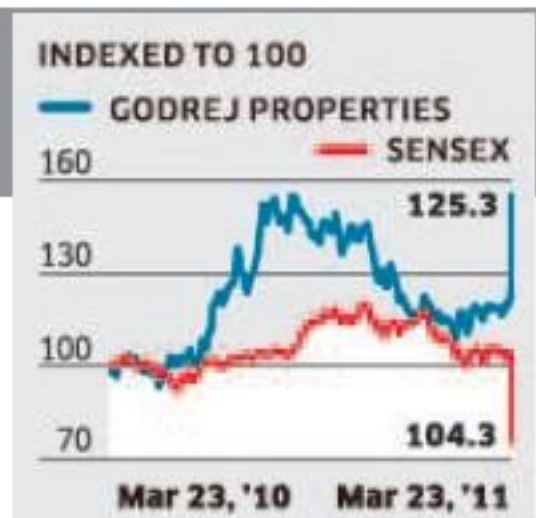
One of the largest residential realty companies, Unitech has been predominantly present in the NCR. It has posted decline in new sales bookings, and its pre-sales and project execution trends have stagnated for the past few quarters. After deciding to curtail new launches to match with execution bandwidth in Q2 FY11, the company has now reversed its strategy to one of aggressive new launches. The stock's price has fallen 60% in the past four months as the market has factored in lower



pre-sales and removed the telecom business from the company's valuations. While the company is depending on new launches to increase its sales, peaking property prices and rising interest rates are dampening the demand for residential real estate.

GODREJ PROPERTIES

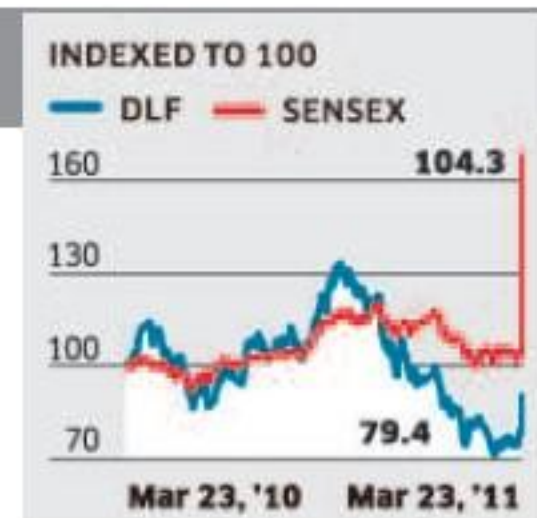
Godrej Properties has advantages like a strong pedigree of Godrej Group, clear land title and an asset light model. The company has half of its land bank in the fast-growing state of Gujarat. It has also signed an MoU with Godrej Group to jointly develop the 185 acres of land owned by the latter. There is, however, no progress on that. Moreover, most of the company's projects are at the pre-development planning stage. An in-



crease in construction costs and a rise in interest rates may impact project development in FY12. Even though, it looks attractive in terms of its business strategy, the company's valuations look expensive. Investors can wait before taking an exposure in the stock.

DLF

The leading realty player has posted a double-digit growth in the topline for the Dec-2010 quarter. The improvement in the commercial lending helped the company as it earns over half of its revenue from this segment. However, increase in debt due to consolidation of land has lowered its net profit. With the target of 12 mln sq ft for FY 2011, DLF has only been able to sell 6.5 msf in the past nine months. This is expected to impact the topline growth in the coming quarter. To



counter this, DLF plans to maintain a strategy to protect operating margins and take price increases in line with costs. Investors can adopt a wait-and-watch policy in the medium term to assess the downside in bottom line in the coming quarter due to high interest cost.

A Snapshot of the Fundamentals of Real Estate Companies

Realty Company Figures

(₹ CRORE)	DLF	Unitech	HDIL	Sobha Developers	Oberoi Realty	Godrej Properties ^
Net sales(%)	41.2	-3.8	7.7	-1.6	49.4	1.5
PAT(%)	-4.1	-19.6	1.5	-5.0	80.3	43.2
Debt/ Ebdita	5.5	6.8	3.2	5.5	-	3.1
Debt/ Equity	0.7	1.2	0.7	1.2	-	1.2
ROE (%)	6.9	6.5	8.1	8.1	25.1	15.2
P/E	23.1	16.8	7.6	13.6	12.8	35.1
CMP* (Rs)	234.2	40.5	161.4	275.2	235.3	644.5
M-cap* (Rs in crore)	39,748	10,588	6,698	2,699	7,721	4,501

Note: Net Sales and PAT have been calculated as CAGR of last three fiscals; ^Standalone figures; *As on Mar 25, 2011; Oberoi Realty P/E is Annualised