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Reinvention of Indian Realty

Building Blocks of Change

Whitepaper

Reinvention of Indian Realty: Building Blocks of Change

Regulatory interventions witnessed by the Real Estate sector over the last 18 months have brought a paradigm shift in the sector. The interventions started on the night of 8th November 2016, when the Government of India demonetized 80% of the in-circulation currency overnight. This was followed by the implementation of the Real Estate (Regulation & Development) Act in May 2017 and the Goods and Services Tax (GST) Act in July 2017.

The triple dose of regulations in a span of 8 months has had a dampening effect on the industry. The sales volume has been at all-time low post the 2008 crisis and has questioned the sustainability of business models of smaller developers. In this uncertainty and pain, there is a positive ray of hope -hope of transparency and increased scope for organized players. The industry which was earlier synonymous with a lack of transparency, lack of corporate governance, apathy to consumer interests, black money, profiteering and fraud has pivoted itself and is gradually coming to terms with the new way of doing business.

The wave of these regulatory disruptions coupled with the changing demand dynamics have ushered in a wave of consolidation favoring larger, disciplined developers. Recent years have also witnessed an increased impetus from large corporate houses such as Godrej, Tata, Aditya Birla and L&T among others.

The transparency and consolidation has further led to a significant enhancement in investor confidence and stakeholder assurance. In such a scenario, the role of financial institutions, especially non-banking financial companies (NBFCs) is of increasing importance.

Complementing traditional sources of capital, NBFCs can rescue the sector from a financial crisis. This whitepaper analyses the impact of the slew of regulatory reforms on the realty sector. It deciphers the role of the developer community in the context of a business environment that demands greater responsibility, transparency and professionalism. Simultaneously, we look at opportunities for innovation, investment trends and the onus on non-traditional institutional financiers in the framework.

When the Real Estate (Regulation and Development) (RERA) Bill, 2016 was tabled in the Rajya Sabha in March 2016, the Minister of Housing & Urban Poverty Alleviation then, M. Venkaiah Naidu stated, “Over the years the sector has acquired a degree of notoriety which needs to be addressed to enable enhanced flow of investments1.” He acknowledged that purging and regulating India’s real estate sector was of utmost importance.

An imperative partner in India’s development narrative, the sector contributes 9 percent to the national gross domestic product (GDP)[2] and is the second-largest employer in the country[3].

The RERA Act, 2016 was implemented in May 2017. This was preceded by demonetization in November 2016 and followed by the implementation of the Goods and Services Tax (GST) Act in July 2017.

In less than a year, India’s real estate sector witnessed three watershed moments. Other important reforms during the past few years include the Amendment Bill to the Land Acquisition, Resettlement and Rehabilitation Act passed in 2015 and the Benami Transactions (Prohibition) Amendment Act, 2016.

Not only has the government focused on purging the sector of its negativity, it has also brought in investment-friendly guidelines in the areas of REITs, relaxation of foreign investment in AIF, pass through status of AIF. The said changes shall provide much-needed liquidity and free up the invested capital of developers, banks and

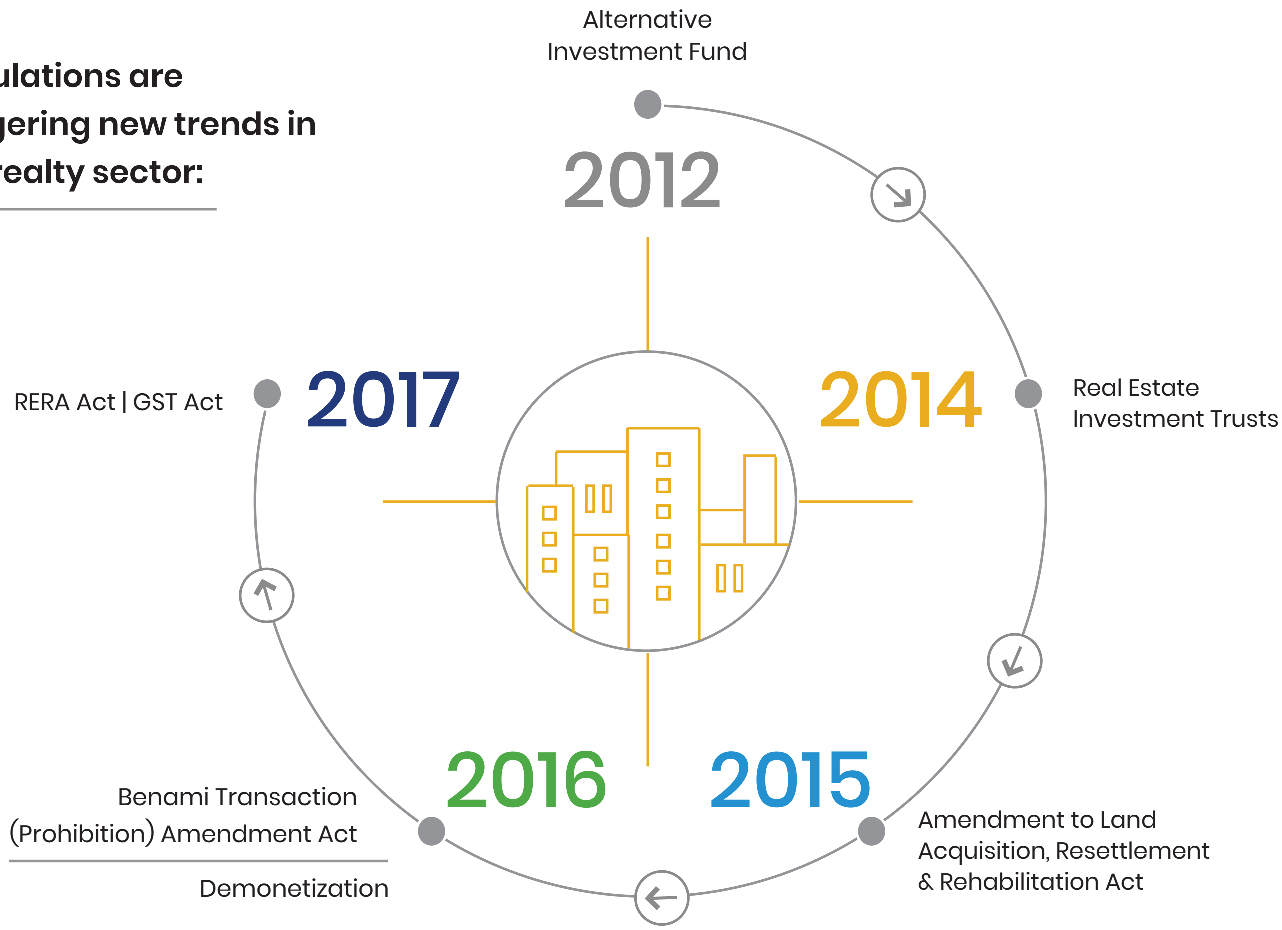
NBFCs that can again be utilized in the growth of the sector. Collectively, these reforms have the power to combat the infamy associated with the sector, thereby enhancing its attractiveness as an investment destination and augmenting outlays.

Triggering New Trends in the Realty Sector

The regulations have provided the realty sector much-needed credibility and therefore an unprecedented image uplift. Real Estate Investment Trusts and Alternative Investment Funds have helped enhance investments in the sector while ensuring protection of investor money.

They also signify the will of the policymakers to work for the benefit of the sector and protect the interests of the entire ecosystem.

Regulations are triggering new trends in the realty sector:



Impact of Regulatory Amendments

Enhanced levels of stakeholder confidence, viz. investor community, customers etc

Compulsory compliance promotes credibility of the construction industry

Accountability + Transparency + Professionalism from developers

High stakes level the field for serious, long-term players

Investments from Corporate players with deep pockets

Consolidation with small and mid-level players

Enabling enhanced flow of investments

Innovation in investment instruments such as REITs, slum rehabilitation and redevelopment etc

Enhanced participation by private financiers / NBFCs

Together We are Stronger

Compulsory compliance shall weed out inefficiencies in the system. Increased entry barriers have ensured that only skilled, well- capitalized and strong brands can survive the new business environment.

Consequently, smaller and fly-by-night players are winding up. Some of them are aligning (through consolidation) with larger reputed companies by way of joint ventures, joint development and in some cases, development management. Larger developers are following an asset-light strategy to increase their national presence and at times pursuing opportunistic acquisitions of land assets.

The new trends are clearly demarcating the territories of landowners and developers. It is a move away from the traditional tendency of every landowner to become a developer.

The overcrowded realty industry will thus become an association of select players who operate with transparency, deliver with efficiency and practice professionalism.

Corporate Players Expanding their Stake in the Sector

Following the implementation of regulatory disruptions such as RERA and GST, there has been a marked increase in non-performing assets (NPAs) among developers.
With this development, lenders are looking for governance-oriented companies who will help them monetize these assets.

This is giving corporate developers with deep pockets ample opportunities. Consequently, traditional, large-scale players such as Godrej Properties, L&T Realty and Tata Housing are expanding their portfolio aggressively.

Simultaneously, new players such as Aditya Birla Group, Max India and Hero Realty who have entered the market in the past few years, are also looking for opportunities to make their presence felt.

Sales on the basis of construction progress

The rules of doing business are undergoing changes.
From being a working capital management cycle, the sector has moved to a project-based approach.
Consumers bitten by non-delivery as well as sub-standard product configuration are patiently sitting on the fence, awaiting projects to reach completion and actually following the concept of Caveat Emptor ("buyer beware"). Gone are the days of project sell outs on launch with builders investing only a few crores to deliver a project of million sq. ft.

The RERA Act has tightened the noose with developers going for financial closure and getting ready to sell completed projects on time.

Bold Moves, Profitable Returns

On the back of the slew of regulatory reforms and the promise of high returns, investors are also looking at bold options such as slum rehabilitation and redevelopment. For example, the Mumbai Redevelopment Fund launched by Piramal Fund Management is dedicated to investing only in redevelopment of slums and tenanted properties in Mumbai[5].

The fund manager follows a strategy of late stage entry, project redevelopment, i.e. once the slum dwellers accept a proposal and the land is reasonably cleared post-70 percent clearance). Further, it partners with developers who have a strong business record and are known to follow appropriate business practices.

> The overcrowded realty industry will now become an association of select players who operate with transparency, deliver with efficiency, and practice professionalism.

Analysing Reform Impact on Sector Performance

Ready, Steady, Grow

The impact of these reforms is already visible on the performance of the sector (refer chart I). Over the last year, the performance of the BSE Realty index has been remarkably positive6. The NHB Residex has also demonstrated an upswing over the last few years – reflecting a positive attitude among buyers.

Following demonetization, the index registered a low of 1297 points in November 2016. However, its recovery gained traction in the two quarters following the implementation of the RERA Act and then the GST Act.

Between November 2016, when it touched a low of 1162.6 points and January 2018 when it touched a high of 2827.55 points, the index has registered an increase of 143 percent7. Of course, these figures are nowhere close to the 13,000+ points breached by the index before the great financial crisis of 2008. The NHB Residex across the metropolitan cities has registered an average increase of 23% between June 2013 and June 2017 .

Clearly, there has been a steady progress of the sector reinforced by the slew of regulations.
And the trend is here to stay.

Chart I: BSE Realty Index – 3 Years Performance

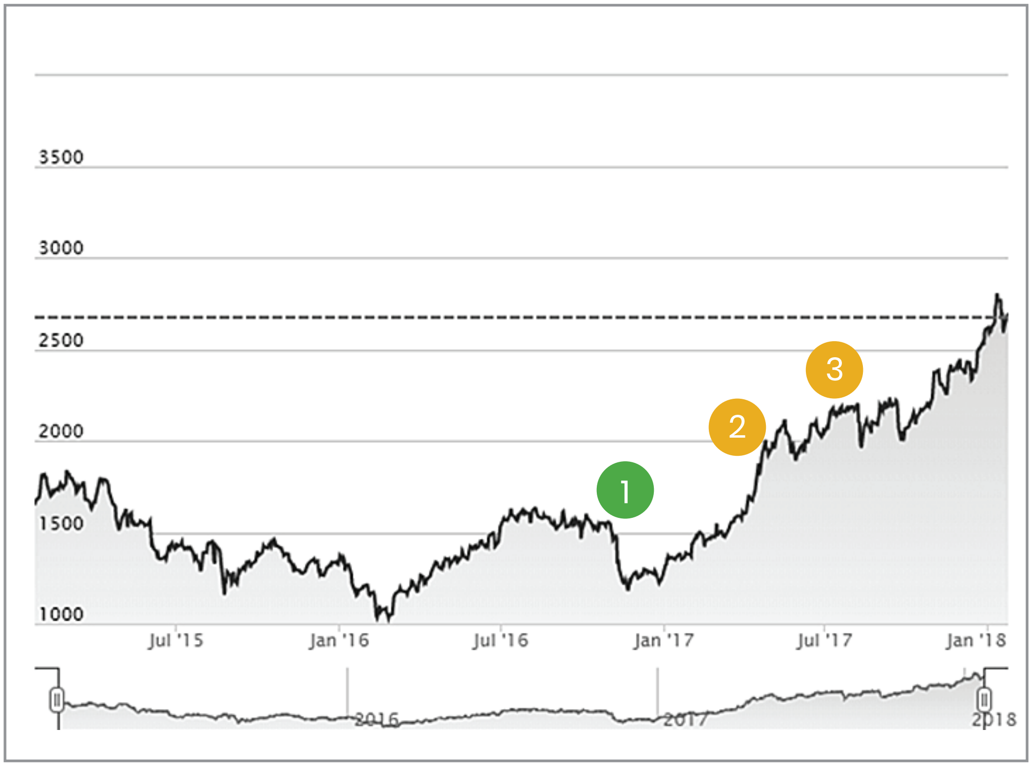
2016

1 Demonetization

2017

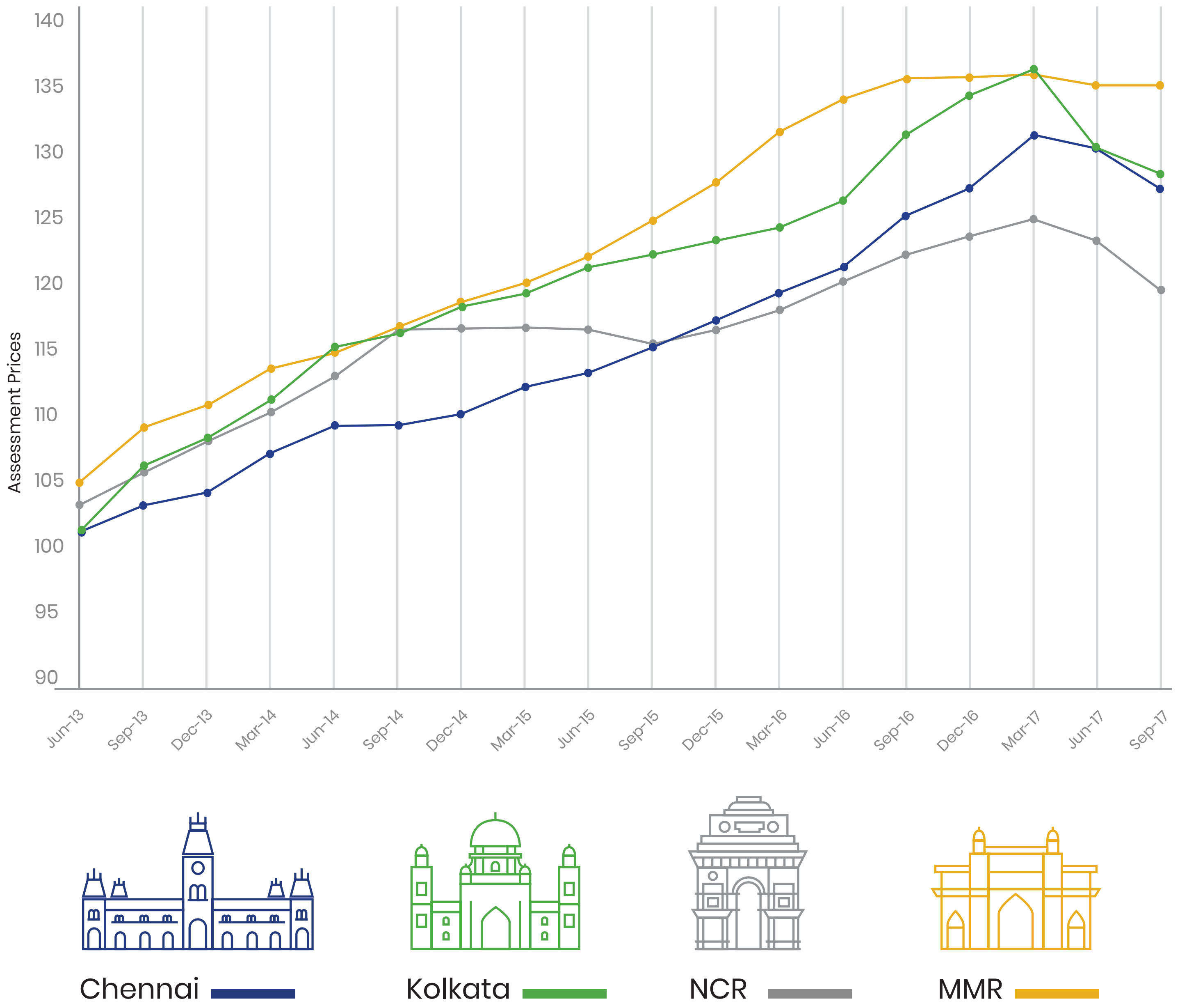
2 RERA Act

3 GST Act



[1] https://residex.nhbonline.org.in/

Chart II: Housing Price Index of Major Indian Cities (QI13 – Q217)



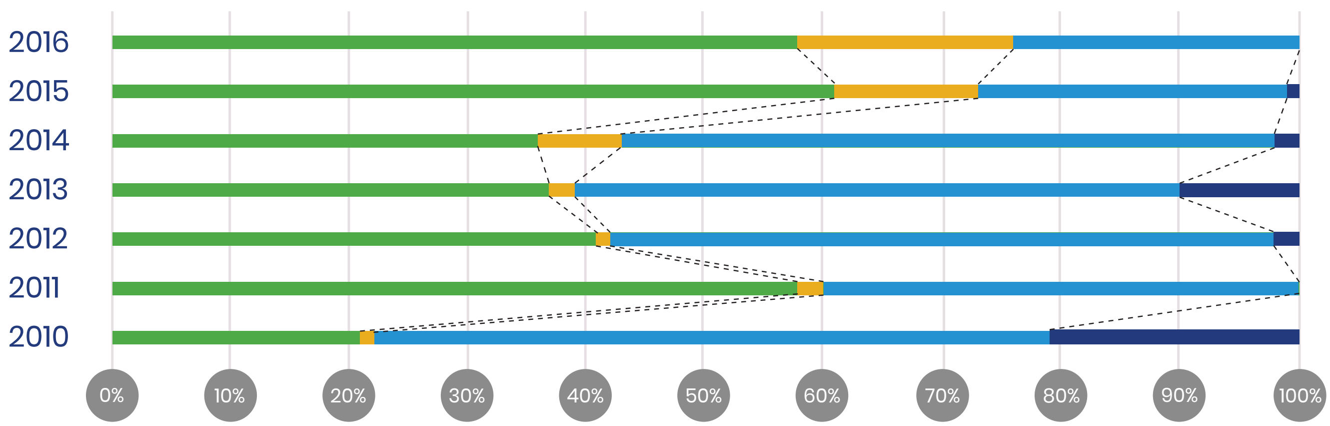
	Jun-13	Sept-13	Dec-13	Mar-14	Jun-14	Sept-14	Dec-14	Mar-15	Jun-15	Sept-15	Dec-15	Mar-16	Jun-16	Sept-16	Dec-16	Mar-17	Jun-17	Sept-17
Chennai	101	103	104	107	109	109	110	112	113	115	117	115	121	125	127	131	130	127
Kolkata	101	106	108	111	115	116	118	119	121	122	123	122	126	131	134	136	130	128
NCR	103	106	108	110	113	116	116	117	116	115	116	115	120	122	123	125	123	119
MMR	105	109	111	113	115	116	118	120	122	125	127	125	134	135	135	136	135	135

Reforms Demand Innovation in Investment Approach

NBFCs are Go-to Lenders for Small and Medium Players

Given the opportunities, it is natural for the realty sector to attract the attention of global and domestic investors. However, it has been assigned a risk weightage of 1.5 times by the Reserve Bank of India (RBI), which deters banks to lend too much credit to the sector[8]. However, it is evident that realty developers are in dire needs of funds – between FY07 and FY16, the debt liability of listed developers has increased by more than three times[9]. Moreover, with many developers opting for debt over equity, the role of private equity players is reducing considerably. Consequently, the contribution of private equities in real estate funding has reduced from 61 per cent in 2015 to 58 percent in 2016. In this scenario, non-banking financial corporations (NBFCs) are bridging the credit gap.

Chart II: NBFC fund flow trends in the real estate sector



	2010	2011	2012	2013	2014	2015	2016
Private Equity	21%	58%	41%	37%	36%	61%	58%
NBFCS	1%	2%	1%	2%	7%	12%	18%
Bank Credit	57%	40%	56%	51%	55%	26%	24%
IPOs	21%	0%	2%	10%	2%	1%	0%

Owing to superior product lines, quicker decision-making abilities, lower costs and robust risk management capabilities, NBFCs are fast becoming popular among developers as substitutes to banks.

Further, government incentives to the affordable-housing sector have gained steam across all regions, thus increasing the demand for housing finance options. For NBFCs, these projects are becoming a lucrative low risk-high investment opportunity. Consequently, their contribution towards the sector funding has increased by 17 times since 2010[10] (Refer chart II).

Opportunities for NBFCs

Architects of India's New Realty Story

In addition to the regulatory reforms aimed at purging the sector and safeguarding the interest of all stakeholders, schemes such as the Pradhan Mantri AwasYojna (Housing for All), and Smart City projects are providing greater impetus to the sector's growth.

The government has set an ambitious investment target for the infrastructure sector – ~USD 600 billion – over the next five years. Of this, the private sector share is pegged at 50 per cent. Further, the increase in the number of asset reconstruction and sale proceedings as a result of insolvency cases will also give rise to large funding requirements.

The role of NBFCs becomes important in the context of servicing short and medium-term capitalization needs of the sector. With options such as last-mile funding and refinancing advanced projects, the risk exposure of the lending entities also reduces drastically.

Furthermore, their intent is strengthened with de-risking shields such as the Insolvency & Bankruptcy Code in case of default. Additionally, the interest of realty-focused NBFCs is fortified owing to their different approach to investing.

Instead of focusing on the internal rate of return (IRR), NBFCs concentrate on qualitative aspects of the investee developer companies such as corporate governance, capital structure lucidity, asset quality and financial management. The quantitative factors are bound to follow when the developers have stringent control over the aforementioned aspects.

Conclusion

The Dawn of a New Beginning

Strengthened by strong regulatory reforms and a never-seen-before political will to set things right, India's real estate sector is offering investors unprecedented prospects. With banking institutions hesitating to loosen their purse strings to lend to the sector, NBFCs are grabbing the opportunity with both hands.

In the words of the renowned motivational speaker Eric Thomas, "You have to take advantage of the opportunity of a lifetime in the lifetime of the opportunity."

Annexure I: Snapshot and Impact of Recent Regulatory Reforms

In a Snapshot

Regulation	What does it provide for?	Impact on the realty sector	Impact on end-users
The Right to Fair Compensation and Transparency in Land Acquisition, Rehabilitation and Resettlement, 2013 and the Second Amendment Bill, 2015	An Act to ensure, in consultation with institutions of local self-government, a humane, participative, informed and transparent process for land acquisition for industrialisation, development of essential infrastructural facilities and urbanisation, provide just and fair compensation to the affected families and make adequate provisions for such affected persons for their rehabilitation and resettlement[11].	• More surety in the land acquisition process • Rooting out problems relating to unwarranted claims and issues of inadequate compensation	• Provide equitable share of profits
Real Estate (Regulation & Development) (RERA) Act, 2016	An Act to ensure, in consultation with institutions of local self-government, a humane, participative, informed and transparent process for land acquisition for industrialisation, development of essential infrastructural facilities and urbanisation, provide just and fair compensation to the affected families and make adequate provisions for such affected persons for their rehabilitation and resettlement[12].	• First regulator of the Indian realty industry • Compulsory registration of every real estate project • Create a more equitable and fair transaction between the seller and the buyer of properties, especially in the primary market. • Simplifying the purchase of real estate by bringing in better accountability and transparency • Developers are required to park 70 percent of all project receivables into a separate reserve account and use these towards land and construction expenses only • Consolidation of small-scale players and projects	• Accumulating data at a designated repository • Creation of a robust grievance redressal system • Mandated to dispose applications within a maximum period of 60 days • Periodic updating of project status on RERA website • Prescribes a standard model sale agreement between developers and buyers

In a Snapshot (contd.)

Regulation	What does it provide for?	Impact on the realty sector	Impact on end-users
The Benami Transactions (Prohibition) Amendment Act, 2016	An Act to prohibit benami transactions and the right to recover properly held benami and for matters corrected therewith or incidental thereto[13].	• Amending the definition of benami transactions • Establishing adjudicating authorities and setting up an appellate tribunal to deal with benami transactions • Specifying penalties for entering into benami transactions • Clarity in ownership titles will help developers execute JVs more quickly and kick-start projects more efficiently	• Encouraging greater transparency in the ownership of property
The Central Goods & Services Tax Act, 2017	An Act to make a provision for levy and collection of tax on intra-State supply of goods or services or both by the Central Government and for matters connected therewith or incidental thereto[14].	• Higher profit margins for developers • Input credit availability on all the goods and services purchased and spent in the construction of the property. • Reduced cost of logistics • Lower construction cost across all asset classes	• Applies to the overall purchase price.

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[1]http://pib.nic.in/newsite/PrintRelease.aspx?relid=137670
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