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INDUSTRY OUTLOOK

REAL ESTATE INDUSTRY OF INDIA: OUTLOOK AND CHALLENGES

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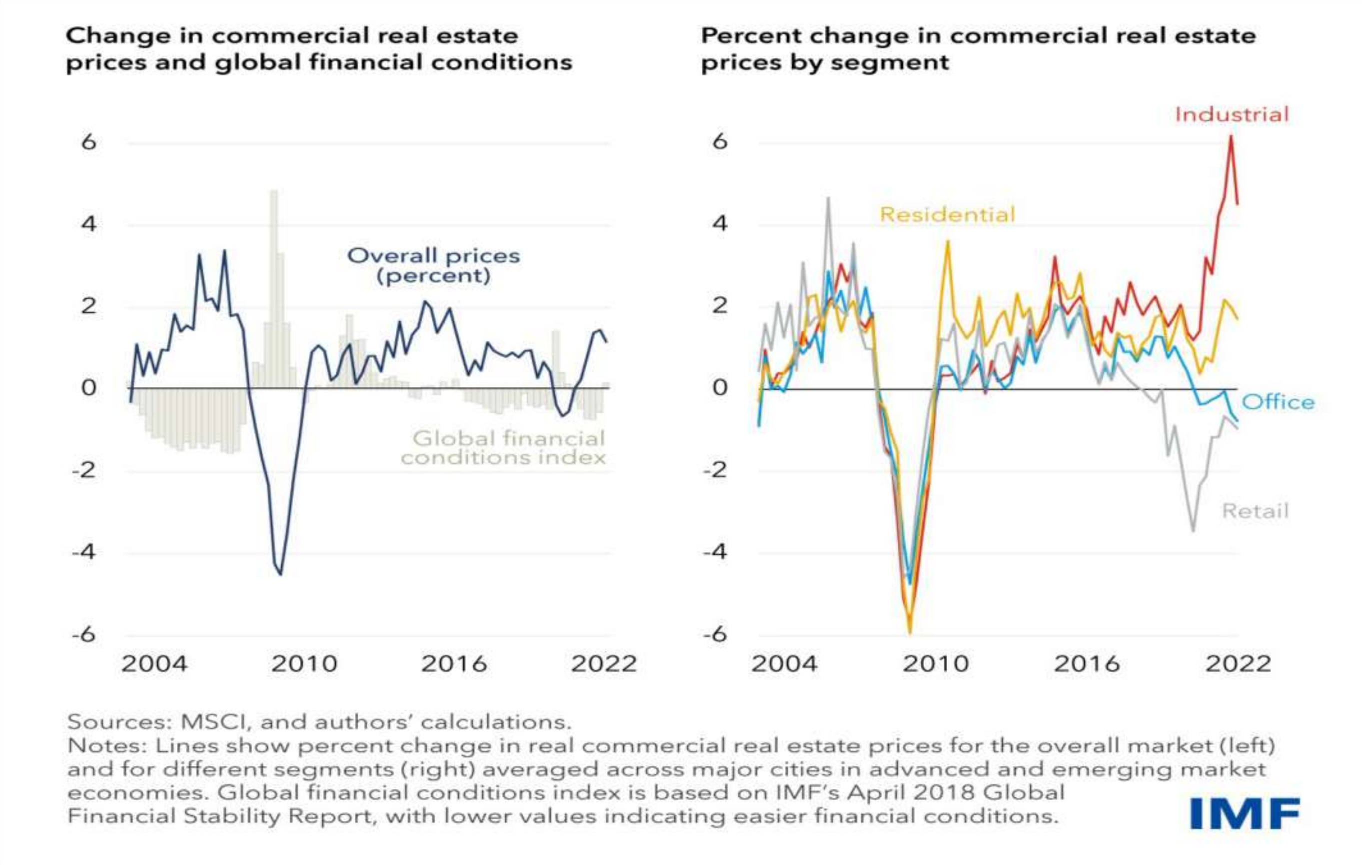
Global Setting

The IMF substantiates the thesis that financial conditions significantly influence prices in different parts of the market.[1] A granular examination of the commercial real estate sector shows that prices of industrial and residential properties have surged globally since end 2020, but the worst-affected retail and office segments are on the stabilization path. With tightening financial conditions and Central Banks across countries in an aggressive rate hiking spree, the industrial and residential segments have taken a hit and the prices retail and office property have moved southwards because of infections, work from home, e-commerce and increased teleworking.

Debilities and disruptive effects of the commercial real estate market can endanger financial stability because of the inter-linkages and inter-dependencies of this sector with the broader macro-economy necessitating greater caution and effective macro-prudential policy to mitigate systemic risks.

Figure 1: Emerging Headwinds: Global growth in commercial Real Estate Prices has slowed down as financial conditions have tightened.



Source: IMF

Indian Perspective

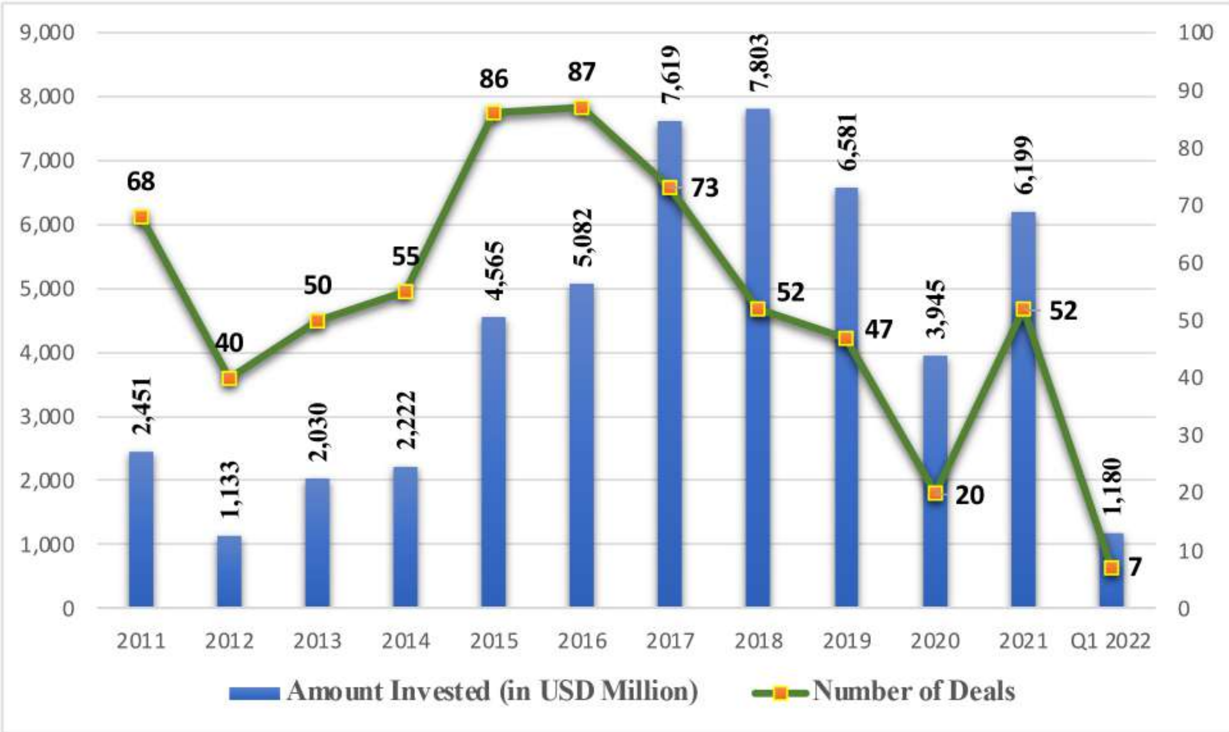
The real estate sector is showing a strong growth trajectory and it is expected to contribute 13 per cent to country's GDP by 2025. The market size of the real estate industry in India was valued at around US$ 120 billion in 2017 and is poised to reach US$ 815 billion by 2024 and 1 trillion by 2030. The sector is recovering from the slump of the debilitating Covid-19 pandemic and is now reaching the pre-pandemic levels. In the last few months, the real estate sector is constantly evolving with innovative solutions across residential, commercial, and retail projects.[2] The Indian real estate market is expected to exhibit a CAGR of 9.60 per cent during 2022-2027.[3]

The real estate sector encompasses a variety of segments, such as, residential, office, commercial, or retail real estate depending upon the purpose of the building. The real estate sector has significantly contributed to economic development of the country. With the growing population, the demand for housing is on the rise in urban space of the country.

Investment in India's Real Estate Industry

Foreign private equity investors are the major contributor to the sector. About 97 per cent of the total equity investments in the Indian real estates were made directly by the foreign private equity investors. Private equity investments in real estates moved close to pre-Covid levels in 2021 as investor sentiments improved remarkably. The private equity investment increased to US$ 6.2 billion with an increase of 57 per cent in 2021 amid the slump of the Covid-19 pandemic. The number of deals also picked up from 20 in 2020 to 52 in 2021 (See Figure 1). [4]

Figure 2: Private Equity Investments in Real Estates (US$ million) moved close to pre-Covid levels in 2021 as investor sentiments improved remarkably



Source: Investments in Real Estate, Knight Frank

There is a strong case for accelerating economic growth, broadening the process of economic development and making it more equitable. This is also a compelling need to accelerate the process of ease and cost of doing business by structural transformation. The second quarter (Q2) of 2022 proved to be a strong quarter supported by the robust recovery and pent-up demand. Despite the inflationary trend in the economy and back-to-back Repo Rate hikes by the Reserve Bank of India (RBI), there were positive results showing Indian real estate industry's return to normalcy from the Covid-19 induced slump. CBRE, an American real estate services and investment firm, reported that the real estate sector in India is enthused by the robust recovery performance, which exceeded the expectation in the first half (H1) of 2022. The capital inflow in H1 2022 stood at $3.4 billion constituting a rise of 42 per cent on a half-yearly basis and 4 per cent year-on-year (y-o-y) basis.

On a quarterly basis, the capital inflows in Q2 2022 stood at $2 billion, an increase of 47 per cent over Q1 2022 with a cumulative share of about 90 per cent.[5] The private equity investments in Indian real estate sector reduced by 68.3 per cent (y-o-y basis) to $1.1 billion in Q1 2022 because of factors, such as, the impact of Omicron virus and heightened global turbulence in the wake of the Russia-Ukraine war. But now the real sector is recovering with the robust recovery of Indian economy. With the Indian economy surpassing the United Kingdom to become the world's fifth largest economy, sustained macroeconomic prospects are good over the long haul with a salubrious impact on the real estate industry.

The remarkable recovery of the Indian real estate sector to the pre-pandemic levels stimulated by the hybrid mode of work, return of migrated skilled labourers moved back to their native places during pandemic period to satellite cities, has further fuelled demand for Grade-A commercial spaces in these cities as well. The sector is the second largest employment generator and the third largest sector in terms of FDI inflows, the Indian real estate industry is resilient and agile now to fulfil the evolving requirements of end-users and potential homebuyers.

During 2021, office sector accounted for largest share with 46 per cent of the total private equity investments followed by warehousing (21 per cent), residential (19 per cent), and retail (13 per cent) (See Table 1).

Table 1: Share of Investment by Asset Class

(In per cent)

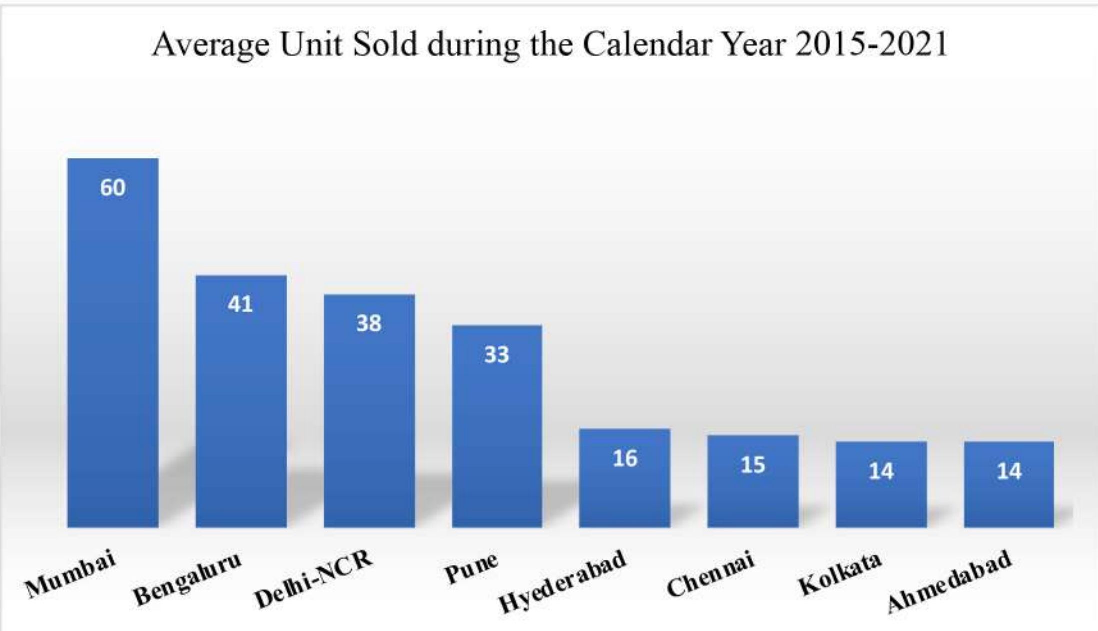
Asset Class	2015	2021	Q1 2022
Residential	57	0	6
Office	25	46	62
Mix	12	19	0
Warehousing	5	21	10
Retail	1	13	21

Source: Investments in Real Estate, Knight Frank

Amongst the cities, Bengaluru received largest investments in the year 2021 with 38.5 per cent of the total private equity investments made in the same year followed by Mumbai (12.4 per cent). According to a recently released report by Knight Frank, Bengaluru was the second largest residential market in India while Mumbai topped the list. The market demand has been stagnating at 45,000-60,000 units over the last seven-to-eight years in Bengaluru. Residential real estate market in Bengaluru is on the edge of a strong demand cycle due to strong hiring in the IT sector and rising count of global captives, salary appraisals for IT employees, and best-in-class affordability. The city is also the largest commercial market by annual absorption (12msf) and office stock (186msf).

Residential Segment Outlook

With economic activity gaining traction and a majority of the workforce returning to offices, the demand for the residential segment is moving northwards. It is expected that the prospective homebuyers will prefer to live in a comprehensive lifestyle ecosystem with bigger homes marked by better amenities in an idyllic location. Therefore, the year 2022 is going to be a year of real estate dominated by residential segment where the millennial homebuyers chose to invest more in real estate than before. In terms of average unit sold in cities, Mumbai with 60,000 units topped in the residential segment followed by Bengaluru (41,000), Delhi-NCR (38,000), Pune (33,000), and Hyderabad (16,000) (See Figure 3).



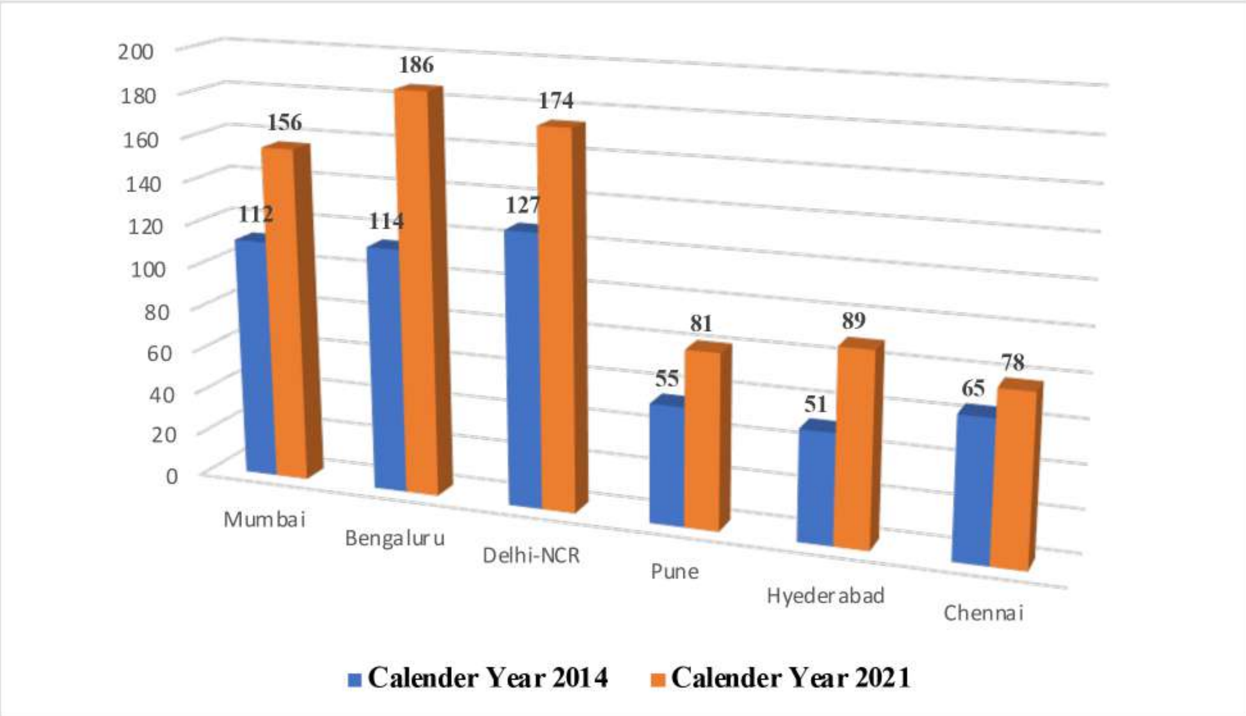
Source: Motilal Oswal

Office (Commercial) Segment Outlook

The office segment of the Indian real estate remained the most preferred choice of the private equity investors. With robust economic growth led by recovery of various sectors, the office segment of the Indian real estate industry surged by 57 per cent (y-o-y) in 2021. The Indian real estate industry received a total of US $6.2 billion in investments across four segments: office, residential, warehouse and retail.[6] The economy is in the reviving phase and is overcoming the disruptive effects of the Covid-19 pandemic. The office segment is expected to attract most of the investment because of the positive return to office post pandemic experience.

In India, Bengaluru has been the most attractive commercial (office) destination with 186 deals in 2021 followed by Delhi-NCR (174), Mumbai (156), and Hyderabad (89) (See Figure 4).

Figure 4: Comparative Analysis of Office Stock in 2014 and 2021



Source: Knight Frank

During the period April to June 2022, the institutional investments in Indian real estate fell by 27 per cent to US$ 966 million due to global economic and geopolitical headwinds. However, it was US$ 1,329 million in the similar period a year ago. The institutional investment in the office segment of Indian real estate rose from US$ 231 million in April-June 2021 to US$ 652 million in April-June 2022.[7]

Institutional Initiatives

Despite the skyrocketing housing prices, mortgage and property rates, the residential market in India is expected to sustain demand momentum. Other spoilers such as the demonetisation, regulatory changes, GST, and COVID-19 have negatively impacted the growth momentum of the industry. But the Real Estate Regulatory Authority (RERA) under the Real Estate (Regulation & Development) Act, 2016 has been continuously trying to improve buying sentiment among the homebuyers.

Among the institutional initiatives, the implementation of Real Estate (Regulation & Development) Act, 2016 and initiating the process of digitisation of land registries has helped in raising the transparency level northwards in the real estate industry. India is among the top ten most improved countries in the 2022 edition of Jones Lang LaSalle's LaSalle's Global Real Estate Transparency Index (GRETI). India now stands at the cusp of entering the 'Transparent' category.[8] India's improvement in its composite transparency score between 2020 and 2022 was higher than some of the top ten transparent markets like the UK, Australia, Canada, Ireland, Sweden, New Zealand, Belgium, and Japan.

Recently, the Monetary Policy Committee (MPC) of the Reserve Bank of India (RBI), in its policy review, decided to permit the rural cooperative banks (RCBs) to finance residential real estate projects. The RBI has doubled the limit on housing loans from cooperative banks also permitted Rural Cooperative Banks (RCB) to finance residential real estate projects to support affordable housing and inclusive growth.[9][10] This would bring UCBs on par with scheduled commercial banks (SCBs), which already provide such services.

Industry Risks/Challenges

In the light of the fact that real estate prices were flat for about five years, pent-up demand and a sharp rise in input prices because of soaring inflation, there is not much chance of real estate prices coming down in the near future. The rising costs of living and home loans may affect the affordability of homebuyers in coming days. The sector is recovering after the COVID-induced lockdowns in 2020, but now the sector is again facing serious macroeconomic challenges. The current headwinds characterized by spiralling inflation, repeated Repo Rate hikes by the RBI are hurting the sentiments of the real estate market again. The recovery of the sector from the COVID-19 slump can be witnessed from the improved demand situation in the first half of the fiscal year 2021. [11]

Further, sales in the residential segment surged by 60 per cent in the first half of the fiscal year 2022. There was an uptick of 51 per cent in housing sales in the calendar year 2021. The rising cost of living and further the costlier home loans are the major concerns for real estate of India, which significantly reduces the affordability of the homebuyers. Increase in the housing prices due the surge in commodity prices and required input materials for the construction of homes also cause concern for the real estate industry of India.

The Real Estate Sentiment Index Q2 (April-June 2022), developed by Knight Frank-NAREDCO, for the real estate sector dropped in April-June period of 2022 from the previous quarter's all-time high of 68 to 62 in Q2 2022 mainly due to the perceived impact of the two consecutive repo rate hikes in May and June 2022.[12] The index is based on the survey of supply-side stakeholders like developers, investors, and financial institutions. The US Federal Reserve's back-to-back hikes in repo rate to tame inflation after over three years since 2018 showing impact on emerging markets like India as foreign institutional investors (FIIs) are likely pulling out capital resulting in capital market erosion. This has led to another problem for Indian real estate industry. Since October 2021, FIIs have sold over ₹2 lakh crore of Indian equities from Indian market.

It has also to be realized that a sustained rise in the real estate sector with supportive bank lending is fraught with serious macroeconomic risks as succinctly brought out in an important Paper. In an incisive analysis [13] by Itay Goldstein, et al, it has been demonstrated "during the 1988–2006 real estate boom, and documented that banks that are active in strong housing markets increase mortgage lending and decrease commercial lending. As a result, firms that borrow from these banks have significantly lower investment. Specifically, for a one-standard-deviation increase in house prices in areas, where a bank has branches, it reduced lending growth to firms that borrow from that bank by 42%, and total investment by the affected firms fell by 21%".

While most banks are impacted by the crowding-out effect, this crowding-out effect was particularly discernible in case of banks "that are more constrained to begin with".

"Crowding-out" effect implies that increasing sector spending reduces spending in the private sector. The government is effectively taking a progressively higher percentage of all savings currently usable for investment; eventually, when the interest rate gets high enough, only the government is able to afford the cost of borrowing–private firms are then "crowded out" of the market. If a government wants to increase spending, it can finance the higher spending by increasing taxes, which reduces the disposable income of consumers and firms and consequently lower consumer spending. Another way is to increase borrowing from the private sector by selling bonds to the private sector (private individuals, pension funds, or investment trusts) through the Central Bank, i.e., open market operations and thus the private sector is unable to these funds to invest in the private sector–the "crowding out effect."

Goldstein stressed "smaller banks are more financially constrained" than others because "when a bank is more financially constrained, it can't raise deposits as easily as others". Accordingly, when such banks channel their resources into mortgages, their commercial and industrial (C&I) lending will decline. Reduced investment was marked by more capital constrained firms than others or that borrowed from more-constrained banks leading to the conclusion "commercial loans were crowded out by banks responding to profitable opportunities in mortgage lending" instead of changes in demand for those loans. "The results suggest that housing prices appreciations have negative spillovers to the real economy, which were overlooked thus far".

The authors substantiated the thesis that C&I loan profitability of banks is sensitive to increases in housing prices. The authors averred "as housing prices increase, banks cut more C&I loans, and so the loans they continue to extend have higher average profitability… We show that while both commercial lending and mortgage lending profitability increase in response to increasing housing prices, mortgage lending profitability increases more, supporting the basic claim that housing price increases make lending opportunities in the housing market more lucrative and trigger the crowding out of C&I loans."

The paper highlighted "much has been written about the negative real effects of asset price crashes … [but] much less is known about the real effects of the boom phase in asset prices". Hence this paper breaks fresh ground by empirically documenting the role of bank lending during an asset price boom. Similarly, The Economist [14] maintained "high and rising property prices can have damaging economic effects, by crowding out productive investment and leading to a misallocation of capital".

Goldstein justifiably maintained "during the [2008] financial crisis, C&I lending was hurt". "Now, we show that it was hurt during the housing boom as well. It's a bit of a lose-lose with all these booms and busts in housing — C&I lending is the one that is always getting hurt." The empirical analysis covered data on more than 750 lenders linked to 120 bank holding companies (BHCs). Significantly, it studied differences across banks in their exposure to the real estate market by using the location of banks' deposit branches to proxy for the location of mortgage activity, "since banks are more likely to do mortgage lending if there is larger price appreciation in the areas where they have branches."

It then compared the behavior of banks that are more exposed with that of banks that are less exposed to housing price booms, and explored the implications for firms related to them. In a subsequent Paper,[15] these authors found that as the Federal Reserve bought mortgage-backed securities and Treasury securities as part of its "quantitative easing" policy, banks that benefitted from those purchases increased mortgage origination and reduced commercial lending, with the result that firms that borrowed from these banks decreased investment.

The discussion clearly brings out, as ably done by Goldstein, "there is damage in housing booms beyond what was previously recognized". Goldstein stressed "people typically think that everything is good during a housing boom. But [our research shows that] even during a housing boom, there are some damages because resources are pulled away from other parts of the economy — the real economy in particular — and moved into housing." Policymakers tend to focus on measures that are geared "to help and stimulate the housing market". "Maybe they should not worry as much about the housing market, but rather think more about the real economy." With rising mortgage rates post the during the COVID pandemic, the U.S. housing market is suggestive of some debilities and frailties. Goldstein pointed out "whenever house prices start going down, there is this attempt to try to stimulate the housing market and prevent housing prices from going down too much". "One wants to be cautious with that, because if you focus too much on the housing market, you might divert resources away from the real economy".

The Way Forward

Project delays, default and hidden cost of housing and rising interest rates are some of the major challenges faced by a prospective homebuyer. It is a difficult task for a homebuyer to close a deal with timely possession, a defect-free home and hassle-free procedures. The decision of the RBI through its Monetary Policy Statement to raise the existing limits on individual housing loans by cooperative banks is a welcome move. The housing prices have significantly increased over the years and the revision on existing limits on individual housing loans was timely in providing some relief to the housing loan borrowers. The housing market is going through severe structural changes and is now at the start of an upcycle. The level of transparency has always been a concern in the real estate industry. To improve the buyers' sentiments, amendments in the Real Estate Regulatory Authority (RERA) under the Real Estate (Regulation & Development) Act, 2016 must be done when required.

During the pandemic, Maharashtra government had slashed the stamp duty which helped in reviving the sales in the housing market. The state government should take measures to protect the interest of the stakeholder in the real estate industry as a strategic institutional initiative to position this sector with significant multiplier effects and macro-economic linkages on a sound and sustainable footing.

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