

Reality Companies and Retail Investors

Roti Kapada aur Makaan... We have all heard about these basic necessities of life since our childhood. House has symbolized security, stability and progress for the erstwhile nomadic human race... in investment markets, this is recognized as an asset class. Real Estate refers to something related to land, permanent fixtures or building attached to it. In simple language one can term real estate as an immovable property. The boom in real estate market touched the retail investor through investment in Real Estate IPOs, which have flooded the stock exchanges.

The demand for real estate comes from enhanced economic activity as a result of constant growth in GDP over past few years and the optimism that this growth will continue for a few more years. Commercial and housing needs itself in our country is huge. This is due to historical reasons, current size of the population, demographic changes, economic growth and change income levels that we are witnessing. It is estimated that every year for next 25 years or so, about 7 million new small to medium size houses will be needed to take care of demand. When all this young population enters workforce, commercial space is further needed employing them and so on. So there is no debate about the potential of this sector.



Before we make a case for investment in real estate it is important to understand the risk return profile of various asset classes. It is important to note some fundamental differences between other markets and real estate markets. Most large markets have ease of transaction and low costs there of which is not the case with real estate market. The table below shows that there is a probability of high return with comparatively lower risk as compared to stock market. However do not forget that if the real estate company shares are listed on stock exchange then one has to combine the profile of shares as well as real estate investment.

Investment Avenue

	Return	Volatility	Liquidity	Risk
Stock Market	High	High	High	High
Bond	Medium	Medium	High	Low
Bank Deposits	Medium	Low	High	Low
Precious metals	High	Medium	Medium	Low
Real Estates	High	Low	Low	Medium

How does one participate?

Traditionally, mode of investment was simple one-dimensional where you put your money to buy a house, land or property on outright basis. Buying a house involves large cash outflows; sometimes it is as high as entire life's savings. Minimum investment in a house ranges from Rs. 2.5 lacs to 5 lacs to 10 lacs and so on depending on the type of city that you choose for your residence.

Real Estate Funds:

Participating in real estate funds is an alternative. As expertise used by the fund managers diversifies the risk to the investors over many projects and companies. However, such funds have not come in a large way due to the issues associated with the underlying real estate industry itself. The industry is opaque in nature due to legal issues related to transfer of property, title deed, high cost of transfer from one party to another, etc. The industry needs to do all that it can do to address these issues if they want to grow the size of this market rapidly.

This leaves little choice to the investor wishing to participate in this opportunity via organized markets except buying shares. So let us examine this alternative.

On one side there is a demand for housing but this activity has not got the recognition of industry by the Indian Banking Industry as well as financial institutions. The companies in this sector have largely relied on private finance and paid exorbitant interest rates. Large amount of unaccounted money also finds a resting place in this industry since organized sector finds it too risky to lend and thus demands high interest rates.

Several companies have therefore tapped the capital markets to raise funds for development. The real estate market has not however changed its practices to attract low cost capital. Equity is an expensive source of capital. Further the inherent risks in the real estate market are also being passed on to the retail investors by virtue of investing in real estate companies.

When we buy shares of the real estate companies, valuation of these can be a difficult and often treacherous task. Many a companies are traded on potential profitability of these companies discounted for interest-discounted Cash Flow basis leading to extremely high price earnings multiples. Often the risks associated with ownership title, project execution, space salability and factors alike are totally disregarded. This leads to what one calls a bubble and can burst with severe implications. Therefore the underlying risk in real estate market needs to be understood.

The risk factors of real estate companies are as follows:

Land reserves being in third party name is first major risk. There is no legal assurance whether the development valuations will really materialize. The gestation period of the projects are also very long hence keeping a track of which land availability and problems thereon is difficult. Since the land is not in the real estate company name same cannot be offered as collateral for lending from the organized sector. These companies have a debt equity ratio that is very high and interest costs are therefore very high. The sensitivity to interest rate fluctuations is high.

The next risk is again linked to long gestation period. Profits can get lumpy or bunched up when projects near completion. Quarterly results will not be able to give indication about the company performance. Monitoring the company on quarterly basis and reviewing your decision where to stay invested or not is also something, which is difficult. A long-term view on these stocks would be necessary. Investing in short term would not give the real reward on investments. This could also become a major reason for volatility.

Acquisition of land and development rights over immovable properties and title of land are governed by certain statutory and government regulations, which also governs various requirement of transaction document, payment of stamp duty, registration of property

documents. Any change in current regulation by government will have tremendous effect on the companies and their fortunes. Framework for Special economic zone (SEZs), is still in the pipeline, if any change could effect the companies who have got in principle approval for SEZ developments and Slum Rehabilitation Scheme (For Mumbai based company), which is a different model for development of infrastructure in and around Mumbai also faces problems if any amendment is brought by Slum Rehabilitation Authority. Thus the entire development can be in jeopardy if political compulsions make the government change its policies.

Outsourcing has been a boon to India in IT Industry. However the success of outsourcing in real estate development industry is yet to be tested. The real estate company signs a development agreement, gets contractors to do the construction activity and all the equipments used for the same are also outsourced. Hence the Real Estate Company is more in the business of facilitating development rather than itself doing the development. Low wages paid to construction workers, poor living conditions has led to migration of labour from project to project. Assuring quality from untrained labour force is a challenge by itself. Information on the level of competence of the contractors is not easily available. The aspirations of real estate companies are such that development done by them in 50-60 years of company's existence is sought to be done many times over in 1-2 years. This is a big challenge to the management skills of owners of these companies.

Investors are thus advised make a thorough study of each real estate company's prospectus and benchmark the risk against the issues outlined above before buying the shares of such companies. Alternatively, wait for real estate mutual funds to come to market so that expert advice is available for investing in this sector. Either way this is high-risk high return sector. What is your risk appetite; eat only what you can digest..

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