Real Estate Sector | Staring down a US$100Bn+ capital gap

In this short note, we lay down the historical perspective, anatomy of the present and a future outlook of the massive capital gap left behind by the ailing NBFCs

Background

Real Estate (RE) is a critical sector, both from an economic and social point of view. It contributes ~10% to GDP and is a significant source of mass employment, directly and indirectly. More importantly, from a social point of view, various estimates (Census of India, MoSPI, RBI & NHB) peg the annual housing demand (rural + urban) at 10MM+ homes per annum, driven by long-term demographics trends, urbanization and nuclearization.

But the sector is also a capital guzzler, often with wild swings in availability of the same. In our estimate, capital need of the housing sector alone is US$100Bn+ over the next 7 to 10 years. Coupled with demand from other real estate asset classes (office, warehousing, retail, hospitality, etc.), total need is almost US$130Bn.

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The US$100Bn+ Math

The math is simple and derived only from institutionally focused / addressable segments of the total demand. Significant portion of this demand (by numbers) is in low income category (INR 20 lacs or lower) with limited institutional focus. But, even the more focused segments (mid-income and higher) have an annual requirement of ~1MM+ housing units.

Physical Addressable Demand[1][2]		
Total Annual Housing Demand	MM Units	10MM+
Annual Housing demand (20 lacs or higher value)	MM Units	1.1
Average unit size (salable area)	sf	1,000
Annual demand	MM sf	1,100
Addressable Segment[3]	%	40%
Addressable Demand	**MM sf**	**440**

Capital Need for Addressable Demand		
Addressable Demand	MM sf	440
Typical Cost (Land + Construction)[1]	Rs/sf	4,500
Total Annual Capital Need [3]	US$Bn	26
Financed through Internal Accruals	40%	11
Capital Requirement per Annum	60%	16
Capital required over a 7 year cycle	**US$Bn**	**111**

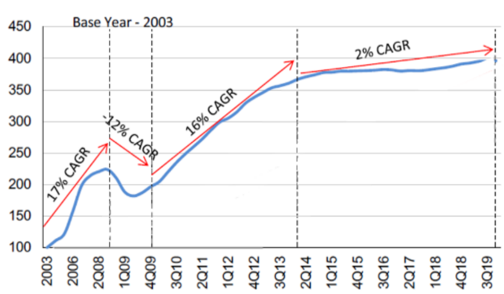
Note: The above is a framework to help visualize the scale of capital need vs. a precise estimation of capital demand

[1]Average over 7 years [2]Source: CLSA India Property Report (Jan 2018) [3]Represent organized/institutionally investable portion of the industry [4]Fx Rate: Rs.75/US$

The above estimation is based on the future need and does not provide for the solutions required on existing wholesale RE exposures held by NBFC / HFCs.

The Last Decade: Ups and Downs

The RE sector opened for foreign investment in 2005 and was soon flushed with capital, given the exuberant pre-GFC environment. Post GFC (late 2008), while the physical markets took a hit, the drop was short-lived. Residential markets re-bounded handsomely clocking a ~15%+ price CAGR for close to five years before starting to cool off in 2014[1].

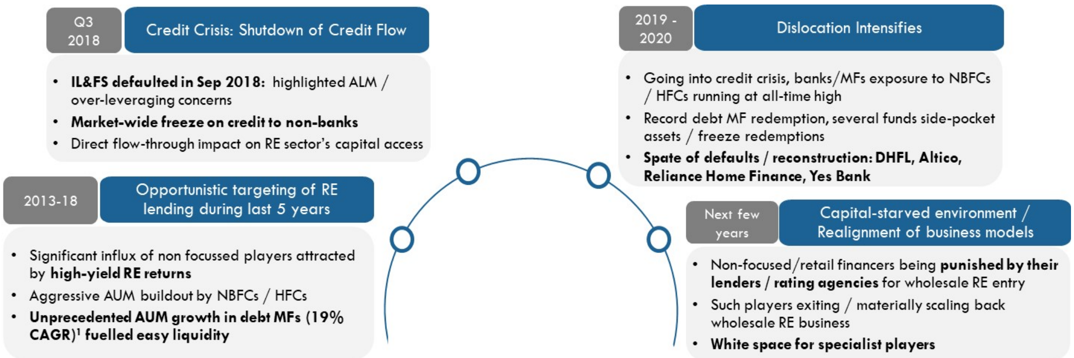


[1] Source: Morgan Stanley Research – COVID 19 Impact (Apr 2020)

However, during the same period, capital availability was severely restricted pushing returns to 20%+ for debt like investments.

This attracted new players, initially those with real-estate investing / lending expertise. But by 2013 / 2014, high-yields lured non-focused / retail lenders into wholesale RE lending business. Between 2013 and 2018, NBFCs / HFCs accounted for 75%+ of the AUM growth in wholesale RE debt. Cheap and easy liquidity for NBFCs / HFCs also aided this buildout. During the same 2013 – 2018 period, debt mutual funds grew their AUM by US$100Bn and accounted for 80% of subscription to NBFCs' Commercial Paper (CPs).

Between 2013-2018, high yields and capital market liquidity attracted several non-focused / retail lenders to wholesale RE lending. Sep'18 IL&FS default brought this to a grinding halt



All of this came to a grinding halt when IL&FS defaulted in Sep, 2018. Credit access to several NBFCs / HFCs froze. Since then, several other institutions have defaulted highlighting asset-quality and asset-liability issues.

Current Situation

For large part of the RE sector, the pendulum has swung from one extreme to the other - from easy & abundant liquidity to practically no capital.

Non-specialized players are exiting this space or scaling back. Focused incumbents are also on the backfoot due to non-availability of growth debt capital. Banks are unlikely to fill the gap due to (1) limited underwriting focus on wholesale RE (2) regulatory restrictions and (3) higher capital allocation requirement due to higher-risk weightage mandated by RBI.

As several of these incumbents change their business models or downsize due to asset / liability side issues, part of the ~US$50Bn+ existing exposure sitting with NBFC / HFCs needs to find a new home. Since the onset of credit crises with IL&FS default in Sep 2018, foreign investors have invested / are in discussions to invest ~US$2.0Bn towards such exposure[2] . And there is still a long way to go.

Investor	NBFC/HFC	Rs. Crores
Closed / Under Closure Deals		
Oaktree Capital	DHFL	1,375
Goldman Sachs	Piramal Capital	700
SSG Capital	Altico	2,750
Oaktree Capital	Indiabulls	2,200
SSG Capital / Farallon	Edelweiss	1,500
Sub-Total		**8,525**
Under Discussion Deals		
SSG Capital / Apollo	IIFL	1,500
Apollo	Piramal Capital	3,700
Sub-Total		**5,200**
Total		**13,725**

Source: Media Reports and Industry sources

This capital vacuum is intensifying consolidation in the sector, which was already underway post RERA, GST and De-monetization. About 263K units (250MM sf+) across projects are either on hold or delayed due to financing and liquidity related challenges[3]. Even

[2] *Source: Media Reports and Industry sources*

[3] *Source: JP Morgan Asia Pacific Equity Research – India Real Estate May 2020 report*

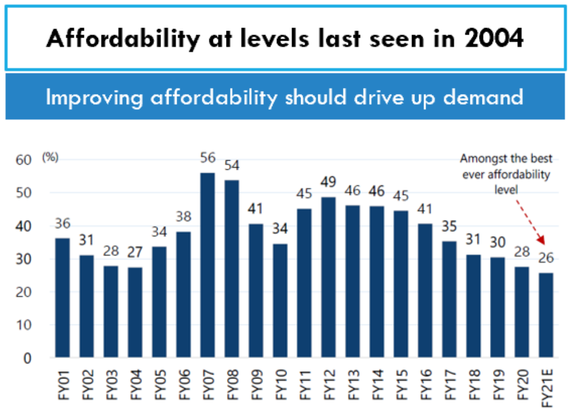
fundamentally strong projects are finding it difficult to access capital and for many, yields have spiked to 20% +/- for senior debt type capital.

The real estate sector continues to remain capital starved while being in a build-out phase driven by strong macro fundamentals

View on the Future

The demand for housing in India is structural, driven by demographic and social trends. Further, COVID induced disruption has put a premium on home ownership. Cyclically, last 7 years were characterized by several disruptive events (demonetization, RERA, GST, NBFC credit crises and finally COVID). We believe that this down cycle is bottoming.

Affordability is at levels last seen in 2004[4] , driven by 15-year low mortgage rates and benign property prices where growth has trailed inflation for the last seven years. Add to that discounts being offered by developers, stamp duty reduction in certain markets and other recent reforms, the overall package has become compelling for the buyer. Recent sale performance (significantly up y-o-y) and near-term expert projections provides an early evidence to the aforementioned view.



On one hand, where we expect start of a new demand cycle, supply is likely to moderate. To begin with, tight liquidity conditions constrain capital required for new starts. This is further exacerbated by increased working capital requirement due to RERA imposed discipline and shift in consumer buying preference to late stage projects. Overall, we expect these trends and accelerating sector consolidation to lead to significant supply discipline, both in terms of quality and quantity.

In our opinion, the solution to current capital woes ultimately lies in continuous sectoral reforms (state level regulatory and procedural reforms rather than fiscal incentives) and restart of domestic credit flows to the sector

Conclusion

In our opinion, the solution to current capital woes ultimately lies in continuous sectoral reforms (state level regulatory and procedural reforms rather than fiscal incentives) and restart of domestic credit flows to the sector. No other source of capital can plug the massive needs of the sector. Domestic institutions however remain fearful and are unlikely to come back in a hurry.

In the meanwhile, it is yet not clear who will step in to fill the massive gap left by these retreating incumbents. In this, we see an urgent need and an opportunity. And the current vintage feels truly unique and rare.

[4] *Source: Jefferies Equity Research: India Property – From Chaos to Order (May 2020)*

Founded in July 2018, Certus Capital is an independent, team owned platform. Certus partners institutional investors and family offices to invest in real estate opportunities in India. For more information, please contact us on contactus@certus.co.in or visit us at https://certuscapital.in

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