

Real Estate Sector

26 June 2019

Residential sub-sector continues to be under pressure; maintain bearish view on realty stocks

We reiterate our bearish view on the real estate sector (see our first report: [Eerie Calm Before The Storm](#) dated 7 September 2017).

Our recent interaction with real estate expert in Mumbai has led us to maintain our bearish view on the residential real estate environment. The key points were: 1) Slowdown in the residential sector to last for 2-3 years. 2) Sales volume continues to be weak. 3) Prices have already declined 20-25% from peak and the drop in prices will continue. 4) Broker margins have risen to 2-5% from 1% historically, indicating desperation of builders. 5) Expect many developers to declare bankruptcy.

We reiterate our Sell rating on pure residential real estate stock- Sobha with a target price (TP) of Rs376 (based on FY21E NAV).

Residential real estate to remain weak for next 2-3 years: In our interactions with a real estate expert recently, we observed continued pessimism about the residential business. The expert said that the weakness in the residential sector is expected to prevail for the next three years with gradual recovery seen from the fourth year. As per the expert, many builders are expected to be driven out of business or declare bankruptcy due to tight conditions- slow sales together with difficult cash flow conditions. As an example, he stated that a few years ago many builders were very keen to develop and sell redevelopment projects. But now most builders are avoiding redevelopment projects due to weak buyer sentiment, price declines and increasing cash flow problems (due to difficulty in getting loans).

Volumes have risen but still remain very weak: The expert mentioned that while the sales volumes have increased they still remain extremely weak and more focused towards completed projects of reputed developers.

Price decline to continue: Prices have declined by ~20-25% from the peak in the past two years. The market is expected to remain weak for another three years with gradual price declines. Prices are expected to decline by another 20-25%, implying that prices would decline by ~50% from the peak levels. This is the impact of weak buyer demand along with distressed cash flows of the developers. The combined impact of weak market, distressed cash flows and recent regulatory changes (like the bankruptcy act, buyer activism, RERA) is expected to lead to distressed selling in the market.

Desperation of developers - broker commissions rise sharply: Our discussion with the realty expert indicated that the broker commissions have risen from the traditional 1% of the value of apartment to current 2-5% of the value of the apartment. Some developers are offering up to 10% of the price of the apartment.

We maintain our negative view on the residential space: Weak sales and rising cost pressure may be compounded by the negative news flow arising from the implementation of RERA and the Insolvency & Bankruptcy Code. Expectation of further decline in residential real estate prices along with rising costs will add to the pressure on valuations. We have a negative view on the sector and therefore assign Sell rating to pure residential plays like Sobha with a TP of Rs376.

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Exhibit 1: Sobha (Since IC - Till Date)

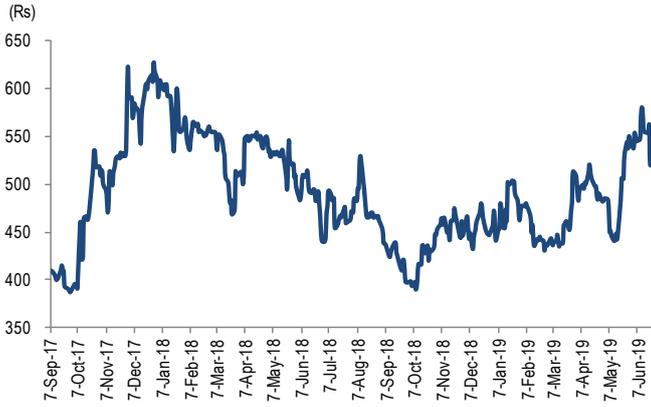


Exhibit 2: Sobha (1 Year)



Source: Nirmal Bang Institutional Equities Research

Exhibit 3: BSE Realty Index (Since IC -Till Date)

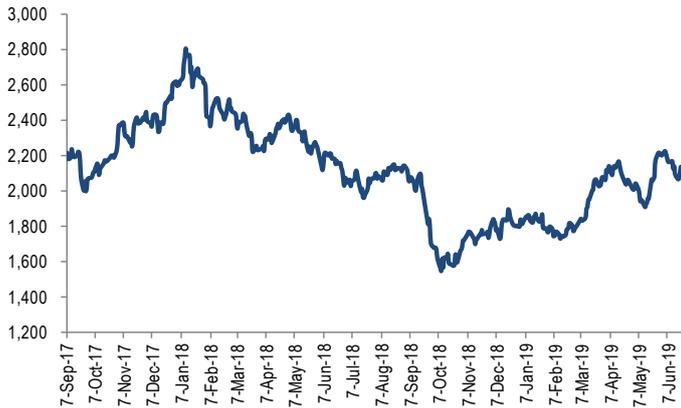


Exhibit 4: BSE Realty Index (1 Year)



Source: Nirmal Bang Institutional Equities Research

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Stock Ratings Absolute Returns

BUY > 15%

ACCUMULATE -5% to 15%

SELL < -5%

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