Real Estate Sector

22 March 2019

CII Conference Update

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High Stress Continues In Residential Segment

Based on our interaction with industry experts at the Confederation of Indian Industry (CII) conference held recently, we maintain our pessimistic view on the residential real estate segment as first enunciated in our report: 'Eerie Calm Before The Storm' dated 7 September 2017. The key takeaways are as follows: 1) Stress in the residential segment expected to continue for two to three years. 2) Residential sales are just half of the amount spent on construction in CY2018. 3) NBFC crisis has added to the stress in the residential segment. 4) Major shift on the part of developers towards affordable housing. 5) Consolidation taking place in the residential segment. 6) Commercial segment (office space) is strong, but shows signs of peaking.

Our view on the residential segment: 1) The worst is yet to come. 2) Expect a further decline in prices followed by U-shaped recovery. 3) Sales volume has increased, but substantially below peak level.

We retain our Sell rating on Sobha with a target price of Rs376 (based on FY21E NAV). However, we have Buy rating on Nesco with a target price of Rs764 (based on FY21E NAV), Phoenix Mills with a target price of Rs791 (based on FY21E NAV), Brigade Enterprises with a target price of Rs290 (based on FY21E NAV) and on Prestige Estates Projects with a target price of Rs256 (based on FY20E NAV).

Highest stress on builders since the past 25 years – sales weak but spending is high on construction: Mr. Puri (Chairman Anarock) is of the opinion that builders are facing maximum stress since the past 25 years. In FY14, residential sales were twice the amount spent on construction, but in CY18 residential sales amount to less than half of what is spent on construction. Further, statistics show that while the eight-year CAGR on investment in the residential segment is only 4.8%, the commercial segment posted eight-year investment CAGR of 18%. Therefore, it can be surmised that investors - who formed a large percentage of the buyers - are out of the residential segment.

NBFC crisis accentuates stress on the residential segment: Experts at the conference stated that in the past four years, while banks had slowed lending to the residential segment, NBFC lending increased by 4x - 5x. After the IL&FS crisis, lending to the residential segment has been reduced by NBFCs, which led to an increase in cash flow stress of real estate companies.

Developers shifting their focus to affordable housing: Sharp slowdown in sales has primarily been witnessed in the premium residential segment because of the affordability factor. Consequently, developers have shifted their focus to affordable housing by offering apartments of a lower ticket size by reducing the size of apartments and also reduction in rates. As per RERA authority, 80% of the new launches in the past two years were apartments having a carpet area of around 600sqft. However, the growth in affordable housing has been limited because of high land costs, lack of infrastructure in some areas and a high premium to government agencies.

Consolidation in the residential segment has already started: With high cash flow stress faced by many developers, there is rising evidence that consolidation in the residential segment has begun. We expect the consolidation to gain pace with a further slowdown in funding because of the NBFC crisis.

Commercial segment strong, but shows evidence of peaking: Experts were of the opinion that the commercial segment continues to be strong and is expected to remain so for the next few years. However, there are rising indications of oversupply coming into the market based on ongoing construction and launches planned, which is expected to lead to the peaking of the segment.

We maintain our negative view on the residential segment: Weak sales together with rising cost pressure have been compounded by negative impact of the NBFC crisis. With a sharp slowdown in financing, we expect an equally sharp increase in consolidation and also a steep decline in residential prices in the next one year. We expect the residential segment to witness U-shaped recovery. Likely further decline in residential prices together with rising costs will add to the pressure on stock valuation. We have a negative view on the residential segment and therefore assigned Sell rating to Sobha with a target price of Rs376. However, we are bullish on the commercial segment and selectively on retail and therefore have Buy ratings on Nesco with a target price of Rs764, Phoenix Mills with a target price of Rs791, Brigade Enterprises with a target price of Rs290 and on Prestige Estates Projects with a target price of Rs256.

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