Sila

Indian Real Estate 2021 – The Calm after the Storm?

While writing our bi-annual memo we speak to industry leaders and our teams that are maintaining over 60 million sqft, managing developments of over 5 million sqft across India.

The last memo we put out in April 2020, **Indian Real Estate 2020AC: A Full Reset**, was when we were in the eye of the storm, in complete lockdown. A lot of pundits made forecasts based on very little information at hand. Even now, we don't have full clarity on how this unfolds, but we can see data over the last 6 months to make some calls going into 2021.

Capital, aka Oxygen

$100bn+ is an estimate that some bankers forecast will be needed to fund Indian Real Estate over the next decade. There is no doubt that the NBFC (Non-Banking Financial Corporation) stress has not found a permanent solution, and will need significant Capital over the next couple years. In a sector which was already starved of Capital post the NBFC crisis, the fear during the initial lockdown was that Capital flows would slow down as Developed countries offered better risk-adjusted returns due to the correction. However, with abundant global liquidity, one cannot ignore high growth markets like India.

We did see some large platform deals being announced post-pandemic in the Commercial space, but one can argue that it was just a continuation of the trend of the last few years where Commercial has attracted the bulk of global Capital into Indian Real Estate. There may be one or two more platform deals on the Commercial side with large developers but we believe, in 2021, Capital flows into Indian Real Estate will (and should) move slowly from Commercial to Residential Real Estate.

The 2020 'Distress' Play **-** with the unprecedented liquidity, there is Capital sitting on the side-lines looking for the 'Distress' in Indian Real Estate. The preferred deal structure for suitors has been, buying brownfield assets from a stressed NBFC, giving them a part cash out and moving them to residual charge, expecting a 20+% IRR (Internal Rate of Return). Well …. at scale, that trade does not exist! We have seen many deals fall through over the last few months either on the return expectations of the incoming investor, or for the downside protection they need with respect to existing creditors, receivables.

Our view is that fresh Capital will need to have 16-18% IRR expectations and look at more Greenfield deals which don't have legacy issues; it may be a better idea to look at deals including the additional collateral with the NBFCs, rather than the projects they have already funded, brownfield in nature. For the solutions on stalled projects (definitely needed), that may need someone with more experience than the authors of this article to find an answer, or a mega write down!

The Commercial Trade

As much as we have a vested interest in Commercial (Office) Real Estate coming back next year to 2018, 2019 absorption levels, unfortunately, we believe that is not going to happen. Not even close!

Few Data points:

1. Large tenants are not going back to work until mid-2021, that might be extend depending on the vaccine distribution across India.
2. Large Asset owners with 90%+ occupancy are offering up to 15% discounts to quality tenants on rents in some markets. This pain is exacerbated for those Asset owners with lower occupancy levels, weaker balance sheets.
3. Due to supply/demand metrics, markets like Mumbai and Bangalore will be more resilient than Pune, Chennai, NCR and Hyderabad in 2021.
4. Lastly, conversations we are hearing from large tenants is that they want to take advantage of the lull now to lock-in prime Grade A space, at a good price, with a RCD (Rent Commencement Date) of calendar year 2022. Asset owners, currently on the back foot, are entertaining these discussions in order to ensure that their portfolios are back on track from calendar year 2022.

Next year will be challenging for Commercial real estate but the good news is that after the consolidation and big ticket deals over the couple years, most of the large Asset owners have a low cost of capital, strong balance sheets and will tide over until demand picks up.

The other positive will be the trend that we believe will reverse by mid-2021, Work from Home (WFH). There is a possibility that 10-15% of employees may permanently work from home, but that will be offset with tenants planning to de-densifying office space going forward. A small research exercise we carried out showed that most employees want to get back to work, and that productivity levels had dropped at home, in addition for most millennials, the IT/Commercial parks they worked at were not only their places of work but also their social life. Something that they are eager to get back.

Time to buy a Home!

In our last memo in April 2020, we highlighted that Residential Real Estate is starting to look interesting from supply/demand metrics, unsold inventory numbers and lower costs of capital for buyers. We are optimistic that over the next 12 months, a bottom will be formed in most micro markets.

Few data points:

1. Pricing is rational across most micro markets, and affordability is at early 2000s level.
2. Mortgage rates are at a 10-year low. Additionally, the spread between rental yields and mortgage rates is sub 5% in most markets, something we have not seen in the recent past in India.

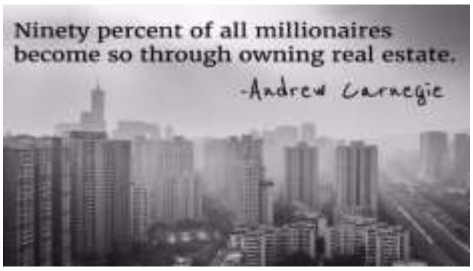
3. Transaction costs in many markets are lower due to the temporary Government reduction in stamp duty.
4. This Festival season was very strong across most markets; in Mumbai region the sales numbers were better than most numbers over the last decade.

In addition to the above are quantifiable metrics, we are seeing demand come in from the negative effect that the lockdown has had on tenants dealing with landlords & societies plus those living in large joint-families. Across most markets, there has a been a surge in enquiries and registrations over the last quarter. Although prices aren't appreciating in a hurry, the plan to sit down with a cheque book and get another 15% off from the developer, might not be on the table in 2021.

Conclusion

When a lay person talks about Real Estate in India, he/she is most likely talking about Residential Real Estate which comprises approximately 75% of Real Estate developed in the country. While the Commercial, Industrial sub asset classes have had a strong few years, other asset classes within Indian Real Estate, specifically Residential, have had a tough run.

According to our research, Commercial, Retail and Hospitality will have a tough 2021, however, Industrial and Residential sectors will help the industry gain some momentum. We also believe that the Government being on the back foot with economic growth, will support the Real Estate sector valuing its importance for the overall economy, and the ancillary benefits a strong Real Estate market provides other sectors.



Stay Safe and wish everyone a Happy New Year!

-Team SILA