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Why Real Estate is Getting Riskier

Thinking of investing in real estate to diversify your portfolio? Think again

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The first quarter of this financial year promises to be a difficult one for the real estate sector. Many of the big players in metropolitan cities have had to borrow funds to pay their installments on loans due to banks by the end of March 2011. In smaller cities and towns, the situation is not getting any better.

Realtors who had overestimated actual end user demand for housing, and had received advances from speculators and investors are coming under pressure to deliver promised projects to enable them to cash in on their investments. Projects are not moving because of lack of cash, and banks are not falling over themselves to lend money to the sector any longer – especially as the RBI has restricted such flows and has asked banks to be wary of lending out too much money to real estate companies.

What does all this mean? And how are these indications going to affect the person who wants to invest in real estate?

First, potential investors should now be very, very wary of where they invest in. In the absence of a real estate regulatory body in place (even though the government has been promising one for six years now), the old dictum of caveat emptor, or buyer beware is more relevant today than ever before.

Developers are facing a double whammy this year. Even if their projects come up, the support of infrastructure promised by government agencies – power, water, sewage, and above all, road and transport connectivity – is just not happening on time, so projects may be finished, painted and polished, but may not be livable. The high cost of borrowing money is also hitting developers – and with banks becoming wary of extending credit to the sector, many developers are now looking towards private equity and similar sources of finance, many of which are more expensive than bank funds. Apart from expenses, many financiers are also more careful about the money they lend out.

With developers sputtering, money getting costly, projects lying under-developed and a crackdown on cash, the real estate investor needs to be very careful

Secondly, the return on investment ratios are dropping fast – even in large cities where one would expect rents to be higher, returns are pitifully poor. While it is true that most people feel that low rentals are compensated with an increase in capital value over the years, this mind set is fast changing, mainly because real estate is now part of the portfolio of investments which a person makes, and not just a house to live in and draw rent from. Today, there's a growing number of people which looks upon real estate as an investment, and not much more.

Three, the cost of money is going up. The posted results of the dozen odd big players in the real estate industry this financial year show that they have debt burdens totaling about ₹90,000 crore this year. With the RBI monitoring monetary policy aggressively, money is becoming dearer. To get around that, many players are borrowing from private equity funds to pay banks. That is adding to costs. With the overall increase in interest rates through the economy, we have a dangerous mixture waiting to blow up.

Four, many large developers have borrowed too much. According to a Bloomberg study, most large developers have debts which are at least 10 times the cash-on-books figures declared by them at the end of the accounting year, with one large developer having borrowed 24 times its cash reserves. The old theory that large land banks would help them bail out of any debt trap is now history – the RBI has mandated that all banks which lend money to developers shall insist on a monitored escrow account for each specific project to ensure that the money borrowed for a particular project is not diverted for any other purpose than the development of that project.

Five, while the RBI has tightened money flows by increasing interest rates and the CRR, the recent policy announcement of increasing the limit for affordable housing loans from ₹20 lakh to ₹25 lakh shall further force developers to move towards projects for the aam aadmi, instead of banking on the high end products they have been presently concentrating on.

Lastly, big developers have moved back again to selling land rather than built space – thereby disposing off land banks which have been a unproductive burden on their balance sheets. Will these plots that are being sold get adequate infrastructure? Will they be developed further? These are open questions, especially in the absence of a strong consumer protection body to push for timely development.

There's another important issue involved: the recognition that a lot of black money, including from politicians, is sunk in real estate. Whether it's the apex court that wants speedy investigation of black money trails, or the 2G scam, there is evidence of real estate companies messing with political big wigs.

Today, government investigating agencies and regulators are working on systems, incorporating many databases, to track down property undervaluation and track suspicious transactions.

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The author is an architect