PhillipCapital

Real Estate

Tipping point: Perils and triumphs ahead

24 May 2019

INDIA | SECTOR & INITIATING

Indian real estate sector has realigned itself on a growth path. We believe Real estate players with access to liquidity coupled with strong brand leverage and superior execution capabilities (delivery + product placement) will be in a position to indulge in volume play and demonstrate good portfolio mix vs. others. We like the segment due to:

1) **Real estate Industry at five-year best affordability:** Our analysis of four major markets suggests that we are at the best affordability point over the past five years. On an average the affordability matrix has improved by 50 to 100 units across the top four markets.
2) **Inventory overhang down; demand slightly outstrips supply:** Industry saw this trend reversal with inventory overhang coming down to 44 from 46 over Q1CY18 to Q1CY19.
3) **Transition to end-user-led demand from investor-led earlier:** As sharp gains for investors in real estate ceased, Investor led demand has fallen to 13% in CY18 from 34% in CY15.
4) **Residential segment has started consolidating in a meaningful way as many players face liquidity scarcity:** Share of top-25 players went up to 20% in CY18 from 12% in CY15

On the basis of pre-sales, execution capabilities, project pipeline, project addition, product placement our top picks are **PHNX**, **SOBHA**, followed by **OBER**. We like **GPL** for its renewed and recalibrated focus, strong project addition, and pre sales, but its recent rally captures its near-term potential.

Phoenix Mills (BUY): We like **PHNX** for its diversified presence across retail, residential, commercial and hospitality. Strong mall execution capabilities and a upcoming portfolio in retail and commercial (4.6 and 2.1 mn sq. ft. respectively) over FY19-FY23 provides better earnings visibility. Over FY19-21 we expect the revenue CAGR at 10%.

Sobha Ltd (BUY): We like **SOBHA** for: (1) Its strong execution capabilities and pre-sales trend, (2) Focus on diversifying itself into other cities (3) Entry into affordable housing under PMAY (4) Large client base of salaried class (5) Revenue visibility of Rs 25bn over the next 30 months in contractual and manufacturing verticals and (5) Strong growth in cash flow at CAGR of 11% over FY19-21.

Oberoi Realty (BUY): We like **OBER** for its niche focus and placement in luxury segment in MMR. Its 'outright buy' model for its land parcels, coupled with high realizations has led to higher margins than peers. OBER has diversified into commercial, retail, and hospitality segments by capitalizing on past success in these asset classes. It is planning to launch an affordable luxury project soon which will aid sales momentum. We expect strong growth in OBER's revenue CAGR at 15% over FY19-21.

Godrej Properties (NEUTRAL) GPL with its strong brand name, execution, pre-sales, and robust project pipeline – is better placed then most of its peers to capitalise on the opportunities in the Indian RE sector. For this, GPL is in the process of realigning its business by increasing its stake in projects, adopting margin accretive models, and ramping up its execution speed. We expect bookings and cash flow CAGR of 22% and 13% respectively over FY19-21.

Key risks: Ramping up of supply, unsustainable debt levels: Demand currently outstrips supply marginally, leading to reducing inventory levels. If near-term supply ramps up fast, it may lead to a halt in the recovery. Total debt at a systemic level for the sector is alarming and if it is not resolved soon, the sector may plunge into an abyss.

Companies

Phoenix Mills

Reco	**BUY**
CMP, Rs	616
Target Price, Rs	800

Sobha Ltd.

Reco	**BUY**
CMP, Rs	506
Target Price, Rs	620

Oberoi Realty

Reco	**BUY**
CMP, Rs	537
Target Price, Rs	660

Godrej Properties

Reco	**NEUTRAL**
CMP, Rs	847
Target Price, Rs	820

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Executive Summary

Residential Segment: On a Revival Path

Residential segment trudging towards recovery: Over the past 4-5 quarters (Q1CY18 onwards) the industry has seen a trend reversal. With demand outstripping supply, overall inventory levels have started declining, albeit at a very slow pace. We believe that the cycle for price correction is over and prices will stabilize at current levels.

End-user-driven market at five-year best affordability: Our analysis of four major markets suggests that we are at the best affordability point over the past five years. As the sector transits towards being end-user driven, demand for quality houses will rise – providing an opportunity for players.

Mid-ticket sized and affordable housing (including PMAY) will drive the sector: Our analysis of various micro-markets suggests that at a pan-India level, the share of budget housing sales has risen to 86% from 66% over CY16-18. Because of end-users taking the centre stage in driving the sector, there will be a rise in demand for such units which will drive the sector. PMAY will prove to be a major booster for the sector, especially the CLSS scheme.

Residential segment: Transition from pricing play to volume play: We do not expect pricing power returning to the sector over the next 3-5 years because of the substantial inventory overhang. To drive growth, real-estate players will have to look towards volumes – i.e., construct more, sell more. As the industry consolidates, larger players with strong liquidity and cash flows will be able to monetize development opportunities.

The much talked about consolidation has arrived: Analysis of top-25 developers across major cities suggest that their market share has increased by 5-9% over the past three years, implying that the sector is in the process of systemic consolidation due to multiple factors such as implementation of RERA and increasing liquidity scarcity

Execution capability/strong brand presence to drive premiumization and valuations:
Good execution capabilities will be a key for survival and growth in residential real estate. These will drive valuations ahead, unlike land bank in the past. Developers who are better at execution will continue to see good pre-sales, command a premium, and coupled with a strong brand name, it will also be able to drive luxury projects growth.

The real estate industry is one of the most important pillars of the Indian economy. It contributes 6-8% to India's Gross Domestic Product and is second (after IT) in terms of employment generation

All eyes on cash flows now: With implementation of IND AS 115 accounting standards, cash flows become a more important parameter than ever before, as the profit and loss statement and balance sheet lose their ability to show an accurate picture. Cash-flow generation will drive valuation of companies, as these would be an obvious reflection of their good execution capability.

RERA – Still just a paper tiger; right direction though: RERA is an exemplary reform, but while it was rolled out more than a year ago, several states have been lax in terms of implementation. This is because of issues ranging from disinterest of state governments to lobbying by a powerful developer community. We have analysed the status of RERA implementation in all states and believe that implementation in its intended form (such as in Maharashtra and Madhya Pradesh) is a necessary pain for the revival of the sector.

Rising debt and scarce liquidity – smoke before the fire?
Liquidity scarcity after demonetization, RERA, and the NBFC liquidity crisis led to either a complete halt in lending or more cautious lending. As the cost of funding increased for NBFCs, borrowing rates for developers also rose by 100-150bps, which increased the developers' debt burden and led to a rise in overall systemic debt to real estate. We believe this is already at alarming levels and if the liquidity scarcity does not abate soon, it poses a major systemic risk, which could lead to stalling of projects and even bankruptcy filings by certain players.

Commercial and Retail Segment: Growth story continues

Commercial and retail segment: Insulated from most headwinds: RERA affects only buyers of real estate and not lessees. GST is applicable only to the sale of under-construction properties. Most commercial and retail properties have been outside the gamut of RERA and GST. While the liquidity scarcity has affected these segments, they haven't been dented to the extent that residential segment has. This is because they have access to Lease Rental Discounting (LRD) loans, which majority of lenders (including banks) are comfortable providing.

Commercial segment: Annuity play continues to remain strong, driving the sector: With the scarcity of Grade-A commercial spaces across various markets, their demand has been far higher than supply. This has led to very low vacancy levels – pan India c.12% – which has led to better rent realisations over the past 8-12 quarters. Over the short term, this trend will continue on weak supply and improving demand due to a strong macroeconomic environment.

GICs/co-working spaces to fill the IT slowdown void; will drive commercial sector: The IT sector's revenue has slowed down and it is undergoing a paradigm shift in its hiring patterns, which has translated into slower hiring and, in turn, space leased by the sector. This could have led to a slowdown in the commercial segment (as IT has been a key driver), but currently GICs (global in-house captives) and co-working spaces have stepped up to fill the void. Demand should stabilize at current levels and demand growth from co-working spaces will slow down as these go through consolidation.

REITs: A possible game changer: The first REIT in India has gone live and garnered good response. If it performs well, it will cause a paradigm shift in the sector. REITs will be key drivers for the commercial segment, as these will provide an exit opportunity for investors, ensuring continued investor interest in the sector.

Retail segment (malls): Demand for quality mall spaces to continue: Indian mall spaces pose a huge opportunity, if developers get the execution right. Malls saw a growth frenzy from 2000 to 2012 (21% CAGR) and a slowdown from 2012 to 2016. This segment began reviving from 2017, and currently vacancy level stands are c.12.5% overall and in low single digits for Grade-A mall spaces. With healthy rental growth (7% CAGR), thin supply of Grade-A spaces supply, and huge demand for these spaces, they will continue to do well. The success of a mall depends on its execution. Mall developers need to continuously work with their lessees to ensure that they perform well, which helps malls garner consistently high footfalls.

Is e-commerce a threat? Not in the near to medium term at least: Over the last few years e-commerce has been giving tough competition to the brick and mortar retail segment. This has increased the perception of ecommerce as a threat to malls. However, we believe Grade-A malls will continue to see low-single-digit vacancy and consistent rise in rentals because people will always want to touch and feel or test products in stores before buying them. Mall shopping also provides instant gratification – which barrier e-commerce hasn't been able to overcome. However, as a precautionary measure, malls must adopt an omni-channel retail model to become 'One Stop Shops'.

Private equity: Proving to be a saviour: With NBFCs retreating from their lending spree, the sector seems on the brink of severe liquidity crisis. We believe that private-equity (PE) players have the capability to step up and fill the shoes of NBFCs. Over past three years. PE players have pumped in more than US$ 23bninto Indian real estate. Going by this healthy trend and taking into account NBFCs' withdrawal, it seems like PE players will step up and take this opportunity to drive the sector.

2021-22 will be a pivotal point for the sector: A new wave of supply across commercial, residential and retail segments is to hit the markets around 2021-22 and if the macroeconomic environment and government impetus do not remain in favour, demand may not rise enough. This could send the residential segment into a tailspin, halting the growth chariots of commercial and retail segments.

Real Estate Sector: Comparative Snapshot

Our preferred pecking order: Sobha, Oberoi, Godrej Properties*

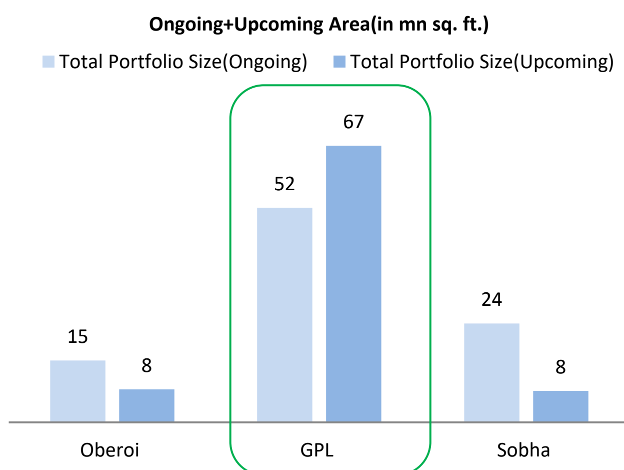
Rank Matrix

Parameter	OBER	GPL	SOBHA
Operational Parameters			
Business Model Robustness	Good	Excellent	Average
New Launches	Average	Good	Excellent
Pre-Booking	Good	Excellent	Excellent
Inventory Overhang	Average	Good	Excellent
Overall portfolio stability in near term	Excellent	Average	Good
Affordability of units	Average	Excellent	Good
Location Diversification	Average	Excellent	Good
Execution	Excellent	Average	Good
Liquidity Access	Good	Excellent	Average
Execution Alignment going forward	Good	Excellent	Average
Overall Sales Velocity	Average	Excellent	Good
Short term growth prospects	Average	Excellent	Good
Medium term growth prospects	Excellent	Good	Average
Land Bank	Good	Excellent	Excellent
Focus on Affordable housing	Average	Average	Excellent
Use of Subvention schemes to drive sales (Excellent =least used)	Average	Good	Excellent
Financial Parameters			
EBITDA and PAT margins	Excellent	Average	Good
Cash flows	Average	Good	Excellent
Interest cover	Excellent	Average	Good
Valuation			
Discount to NAV	Good	Average	Good
Overall Ranking	2nd	3rd	1st

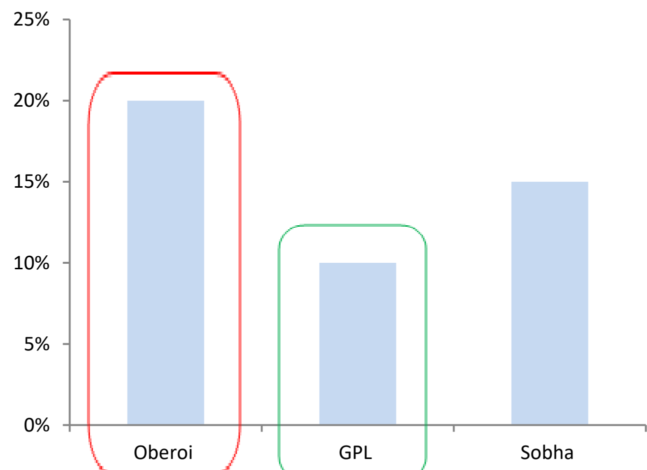
*We like GPL for its renewed outlook, but due to the recent rally in the stock there isn't much upside potential left near term. We will revisit our Neutral rating once we have more clarity on its upcoming project, the status of its exit from select markets, and/or improvement in price levels.

Operational Parameters

Total portfolio size*



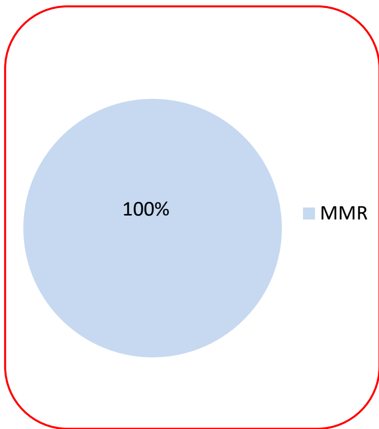
Premiumisation

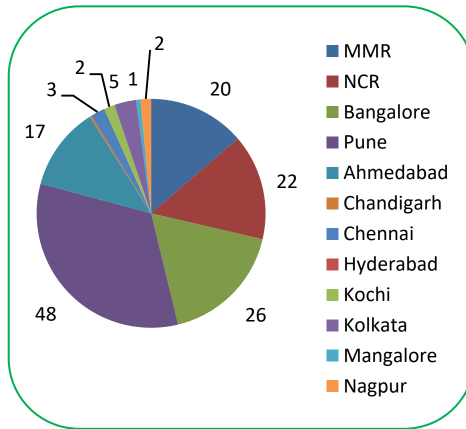


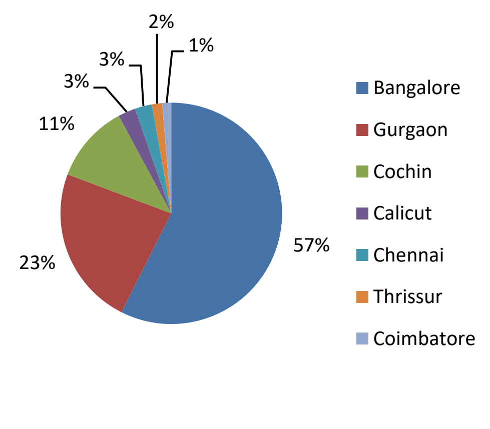
*Total ongoing projects include projects with pending inventory

Source: Company, PhillipCapital India Research

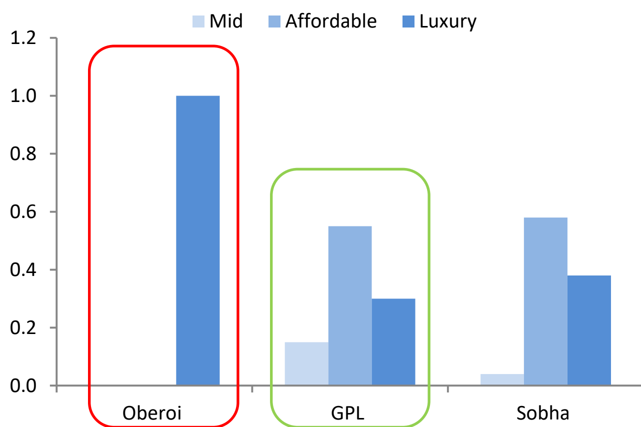
Location Mix : Oberoi | **GPL** | **Sobha**



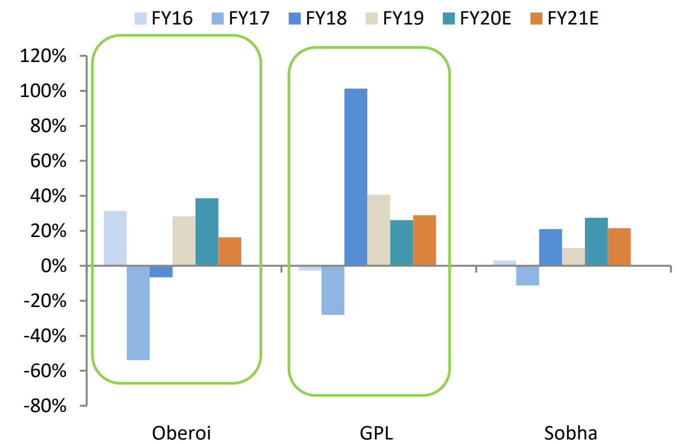




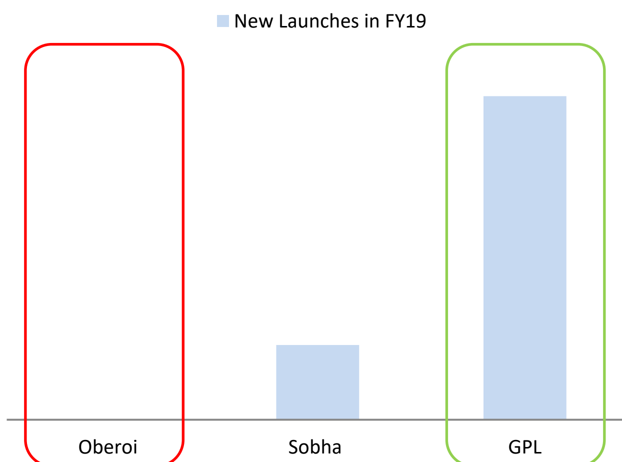
Ticket-size mix



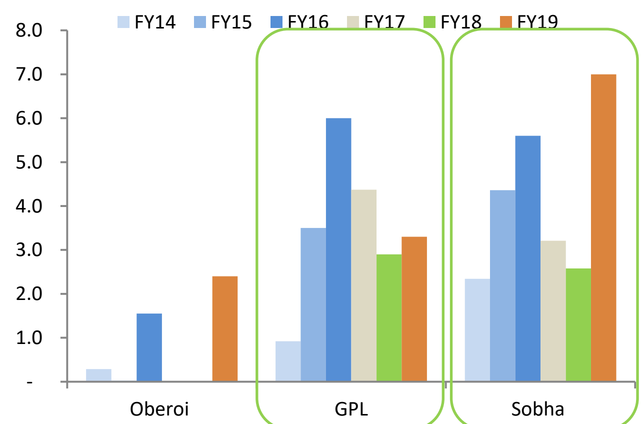
Booking track record



Launch track record

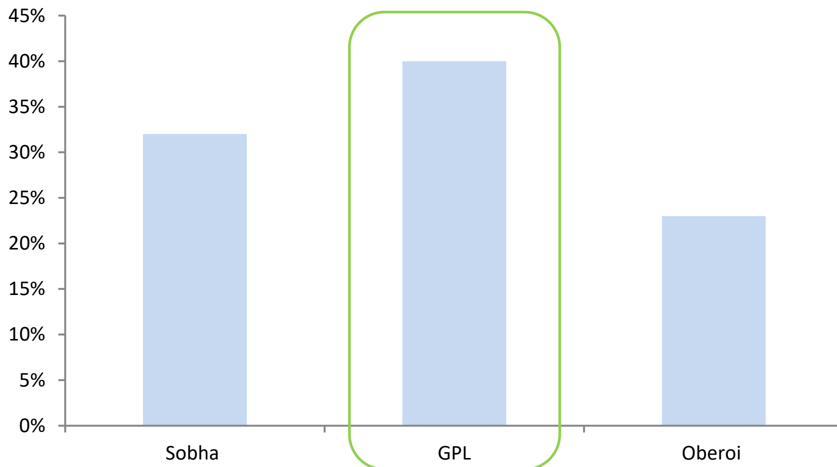


Delivery track record



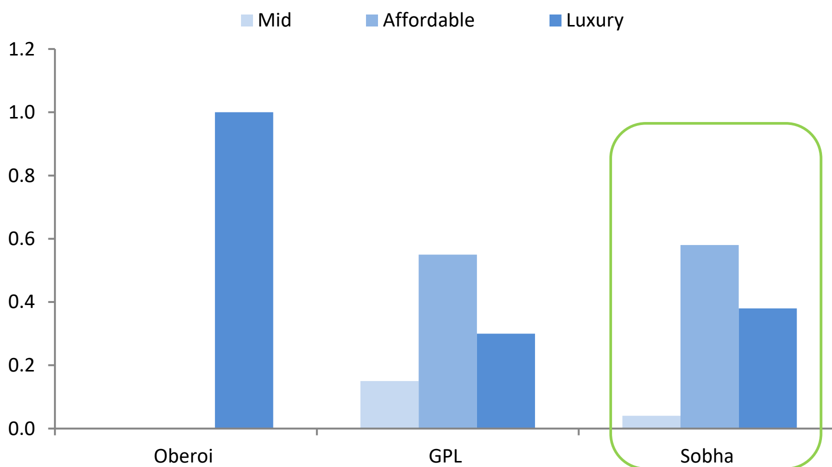
Source: Company, PhillipCapital India Research

Launch sales track record

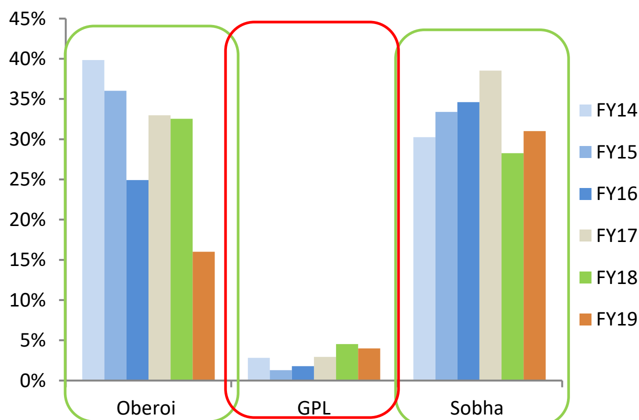


Financial Performance

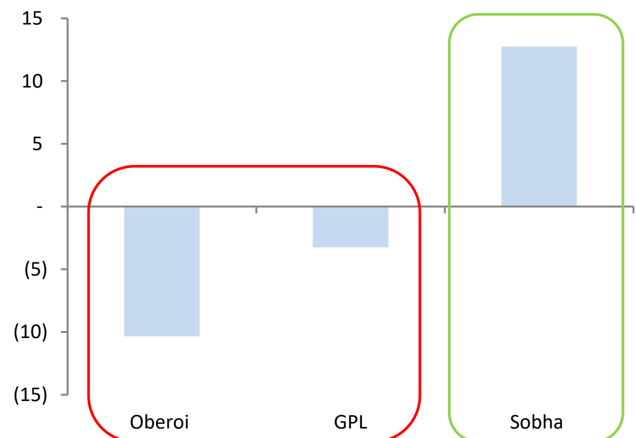
Real-estate revenue



Revenue from other verticals

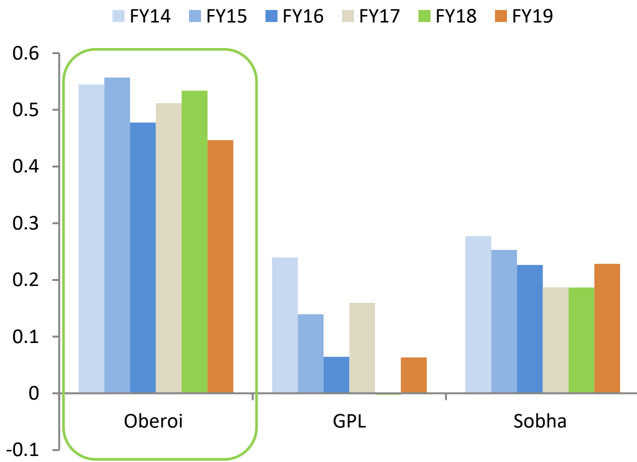


Cumulative last five-years operating cash flow

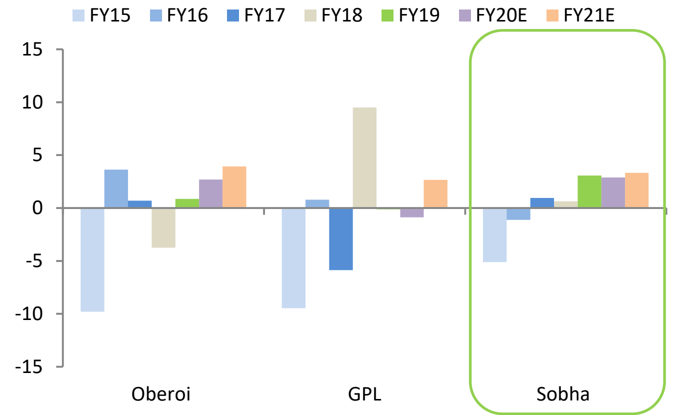


Source: Company PhillipCapital India Research

EBITDA margins

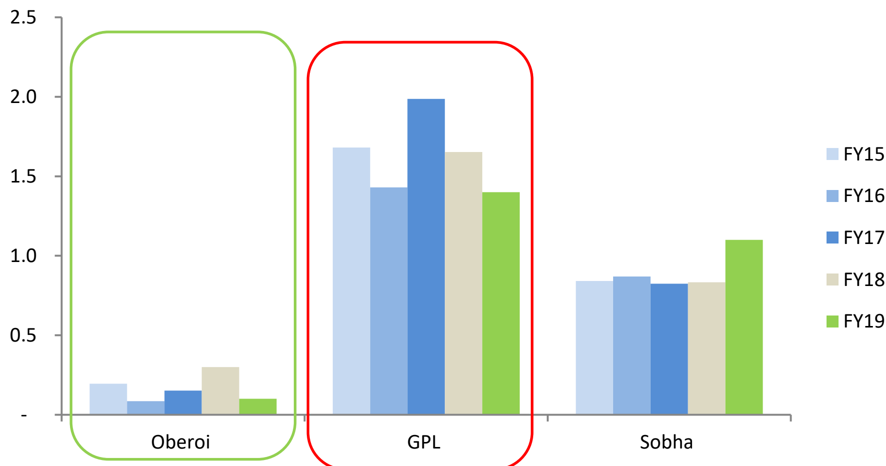


FCF



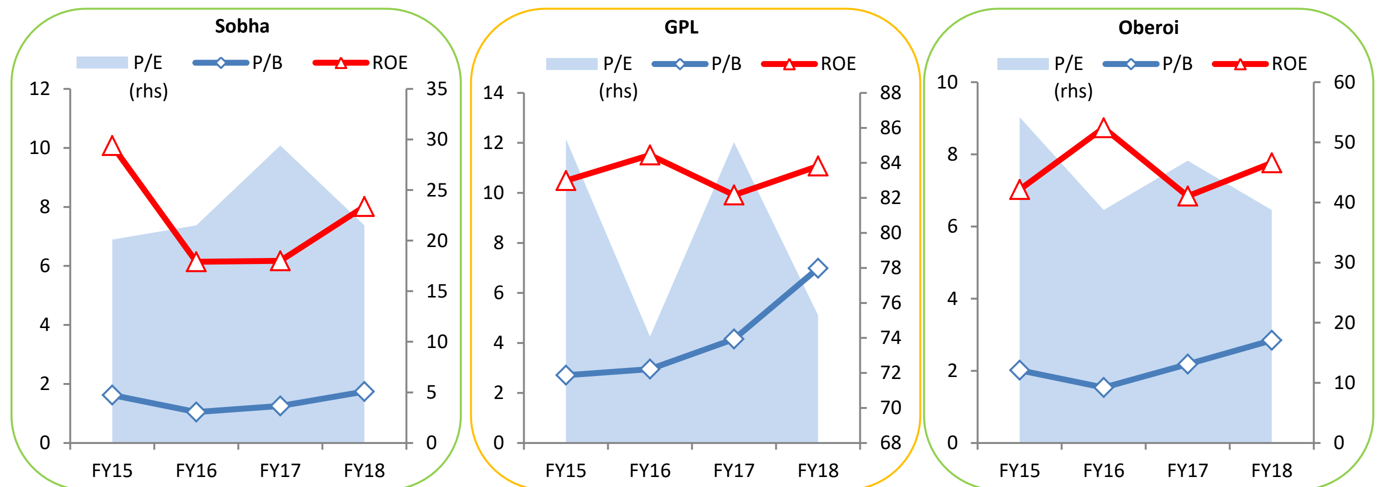
Source: Company PhillipCapital India Research

Net debt/equity



Source: Company PhillipCapital India Research

Valuations



Source: Company PhillipCapital India Research

***Note: We are not using FY19 valuation ratios for comparison as implementation of IND AS 115 has led to these ratios indicating misleading P/E,P/B and ROE ratios. We do not recommend using valuation ratios as a metric to gauge the performance of Real Estate firms going forward**

Peer valuations

	CMP	Mcap	EV	Revenue (Rs bn)			EBITDA Margin			PAT Margin			OCF (x)			P/E (x)			EV/EBITDA (x)			ROE (%)			D/E (x)		
	Rs	Rs bn	Rs mn	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e	FY19	FY20e	FY21e
SOBHA IN Equity	507	47	70	34	42	48	20%	22%	22%	9%	7%	7%	1.3	2	5.0	16	19	16	14	10	9	8	12	12	1.1	1.2	1.3
GPL IN Equity	847	197	218	28	20	14	6%	8%	30%	9%	10%	15%	3.3	(0)	-5.0	77	96	93	61	53	11	11	13	14	1.4	1.4	1.4
OBER IN Equity	533	201	198	26	37	35	45%	38%	41%	32%	27%	29%	0.3	13	7.0	24	24	19	14	12	8	10	11	10	0.2	0.2	0.1
DLFU IN Equity	180	391	510	84	82	71	28%	38%	39%	16%	28%	28%	53.1	-	-	29	16	18	20	16	18	15	6	5	0.4	0.4	0.4
PEPL IN Equity	260	98	175	55	59	59	20%	26%	28%	7%	8%	9%	5.4	-	-	27	21	19	16	12	11	8	9	10	1.5	1.5	1.5
HUDCO IN Equity	41	81	432	41	56	62	80%	86%	88%	20%	22%	24%	(78.3)	-	-	10	7	6	15	4	5.0	8	10	-	3.6	3.6	3.6
SRIN IN Equity	488	69	73	9	13	16	48%	43%	44%	28%	27%	28%	(2.2)	-	-	27	18	14	17	13	10	9	12	13	0.2	0.2	0.2
BRGD IN Equity	242	33	63	30	30	29	19%	28%	31%	8%	9%	10%	(1.6)	-	-	14	12	12	12	7	7	7	11	10	1.4	1.4	1.4
MLIFE IN Equity	382	20	19	6	6	7	4%	6%	11%	20%	22%	23%	1	-	-	16	14	14	70	52	26	6	7	7	0.1	0.1	0.1
KPDL IN Equity	222	17	22	14	15	15	22%	26%	26%	9%	12%	11%	1.3	-	-	14	10	10	10	6	5	13	16	13	0.6	0.6	0.6
PURVA IN Equity	72	17	27	14	-	-	22%	-	-	6%	-	-	0.4	-	-	18	-	-	13	-	-	4	-	-	0.3	0.3	0.3
ASFI IN Equity	107	12	11	3	-	-	12%	-	-	4%	-	-	(0.6)	-	-	85	-	-	-	-	-	-	-	-	0.2	0.2	0.2

Source: Bloomberg, PhillipCapital India Research

Peer valuations

	CMP	Mcap	Revenue			EBITDA Margin			PAT Margin			P/E			EV/EBITDA			ROE		
	Rs	Rs mn	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E	FY18	FY19E	FY20E
PHNX IN Equity	619	92	15	18	24	50%	51%	51%	16%	16%	18%	37.8	30.3	21.7	16.5	15.0	13.4	9.7	10.1	12.0
NSE IN Equity	480	35	3	3	4	69%	63%	66%	56%	47%	45%	19.5	21.7	18.5	17.1	15.9	12.3	19.2	14.5	15.6

Source: Bloomberg, PhillipCapital India Research

CHAPTER 1:
Road Ahead

Residential: Tipping demand-supply scales backed by fundamental changes

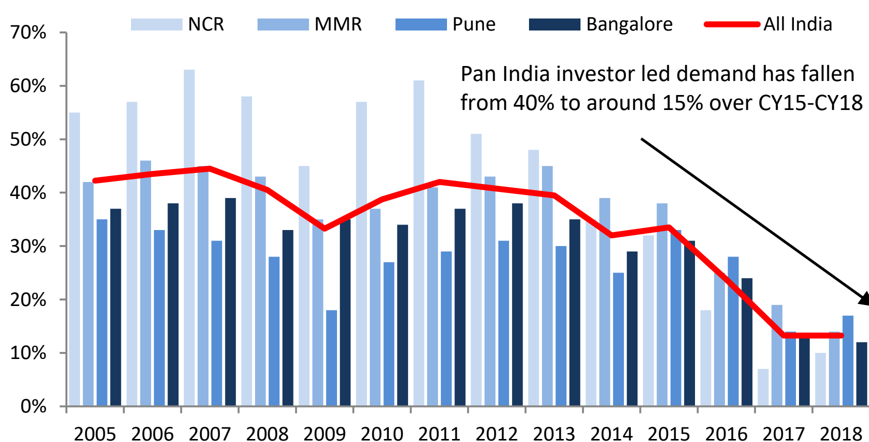
The series of regulatory and business environment changes (GST, RERA, demonetization, NBFC liquidity crisis) didn't just disrupt the Indian residential real-estate sector, but changed its very dynamics. Here is what we see in the future of residential real estate.

Transition to end-user-led demand from investor-led earlier

Since the bull run of the early 2000s, the boom in the housing sector was due to investor-led demand. When the sector was hit by the 2008 sub-prime crisis, investor-led demand fell and the second major jerk was the Euro-zone crisis. Since then investor led demand has been tumbling.

Since the year 2013, the Indian residential market's volumes have been falling, breaching new lows in terms of supply and sales every successive year

Investor-led demand as a % of total demand



Source: PropEquity, PhillipCapital India Research

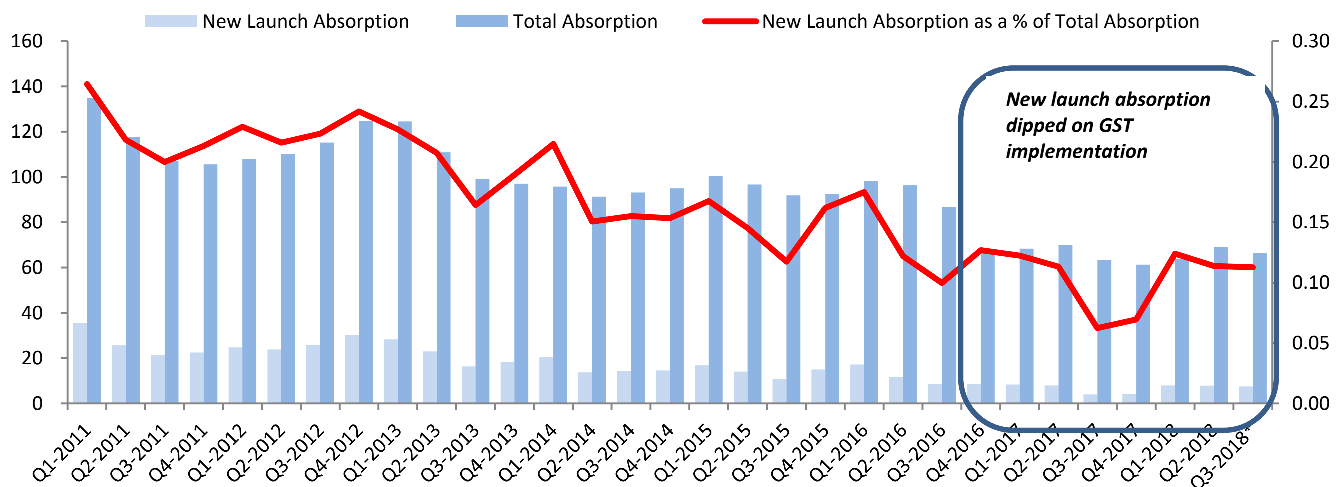
Over the last few years, the market has shifted from being an investor driven one to an end-user market. Here are some reasons why:

- **Used to making quick money:** Investors tasted success, making a quick buck in real estate from 2000 to 2008. They became frustrated in the slowdown between 2009 and 2016 because of slower returns and when the price correction phase began these panicked investors started liquidating their properties leading to a further tumbling of prices, adding to the inventory overhang in the market.
- **Demonetisation:** Developers faced a cash crunch and didn't have money to fund projects. They started to sell at lower prices, but buyers also faced liquidity issues. As a result, demand began falling rapidly. Investors joined the race to offload investments amid spiralling prices. This led to a significant price correction, making investors wary of this investment category.
- **Lifestyle projects:** In the bullish phase, developers focused on launching *lifestyle* projects, targeted at premium customers. In these, major buyers were investors, not end-users. Such premium projects are still seeing a price correction – this has put off investors even more.
- **RERA:** When it was implemented, it wasn't a structural deterrent for the investor community. However, it did have some effect. Usually investors used to buy flats from builders without registering the flat (trust factor) and therefore saved 5-9% (varying from state to state) on stamp duty and registration charges – an additional gain. RERA laws require (in certain states) developers to register a unit if they collect more than 10% of the total consideration, which has wiped out that additional gain for investors in already thinning margins.
- **GST:** GST is applicable on under construction units, not completed ones. This meant that investors who registered the flats they purchased had to pay an additional 12%, serving as a deterrent.

Indian real estate became quite un-lucrative as an investment category – yielding lower returns than government yield or even negative returns in certain cases. Due to GST charges, end-users started preferring completed projects and avoiding under-construction ones. Investors, who never had an impetus to buy completed projects, stayed away from real estate as an asset class altogether.

The following graph shows that the share of new launch absorption (under construction flats) has been consistently declining over the years, especially after Q1 2017, though it revived in the past three quarters (Q1-Q3 CY18) – but that has been because of subvention schemes used by developers.

New launch absorption analysis



Source: Knight Frank, PhillipCapital India Research

This transition from investor-led demand to end-user-led demand will lead to an effective price discovery in the sector and provide stability in the demand-supply dynamics of the sector.

Affordability: Our analysis shows that it is at its five-year best

Since the beginning of India's Housing Boom (2000-2013), owning a house has been a dream for people. However, many found buying a house out of reach. This seems to have changed. Apart from the low-ticket-sized units, affordable houses under PMAY will be key drivers of the sector. The CLSS scheme will particularly contribute to the overall sales of mid-segment housing – increasingly, tier-1 developers are either developing or considering developing under the PMAY scheme.

Assumptions: 350 sq. ft. carpet size, 15-year loan tenure, 25% down payment, interest rate as per HDFC's pan-India rates, and price of the house based on historical per square feet rates in respective cities

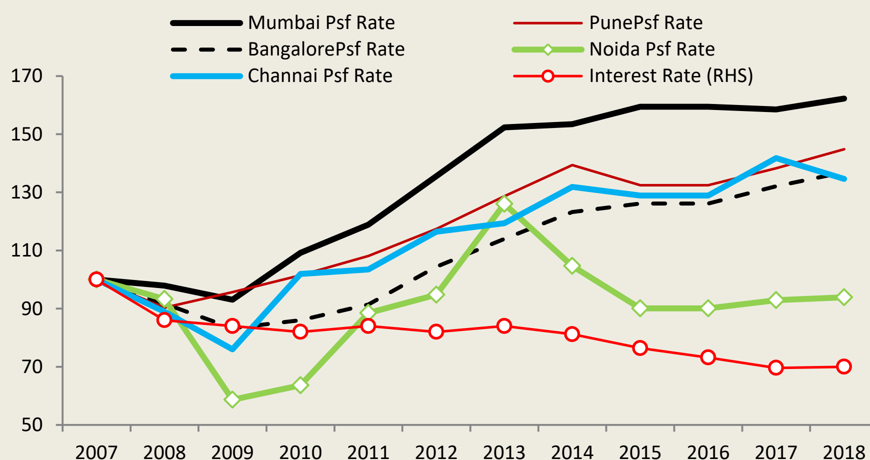
Affordability analysis: Low-ticket-size units and PMAY will be key drivers

Best in five-year affordability is based on stagnated/corrected housing prices, increasing income, benign interest rates, and PMAY (especially CLSS). Our analysis shows that over 2013-18 affordability in various cities improved. The increasing gap between the normalized GDP per capita and house prices is an indicator of income outstripping price growth – which in turn indicates improved affordability.

Currently, affordability is the best in the last five years because of:

1. Supply outstripping demand led to historically highest inventory-overhang levels, which led to a correction in prices and a seizing of the extraordinary growth in housing prices. Our analysis shows prices corrected, stabilised, but will not grow.
2. Benign interest rate regime: Home-loan rates have come down from above 12.5% in 2007 to a historical low of 8.5% in 2018. This has brought down the overall cost of a house
3. India's GDP is seeing good growth. People's disposable incomes are also rising fast. Growth in income has outstripped housing price growth over the last five years – improving affordability.

Per sq. ft. rate across cities; interest rate movement

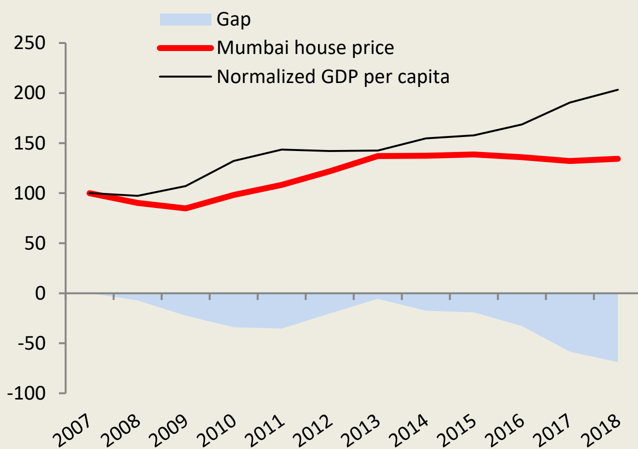


Source: Knight Frank, PhillipCapital India Research, HDFC Bank

Improving affordability suggests that there are chances of revival in demand from end-users, as many fence sitters should/would consider buying a house

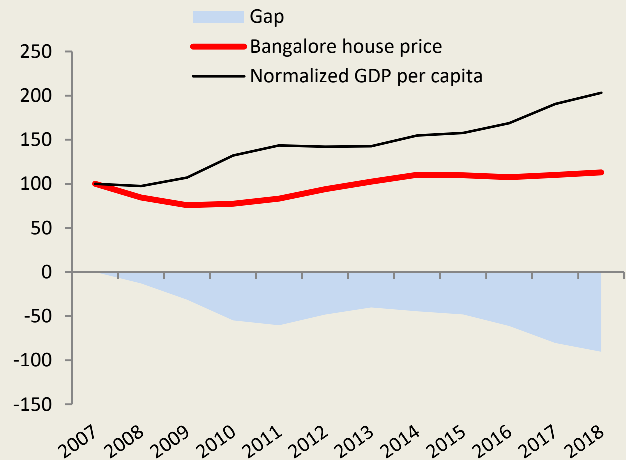
We have plotted affordability indices across various cities below; they show that affordability has been at its best in past five years

Mumbai affordability analysis



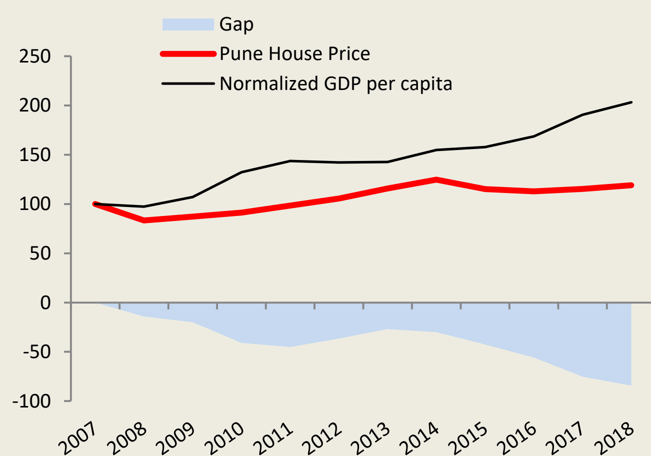
In Mumbai prices have remained flattish or grown slowly; despite headwinds they haven't fallen. As income levels have grown at a steady pace, affordability has improved vs. 5 years ago, but to a lesser extent vs. other cities

Bangalore affordability analysis



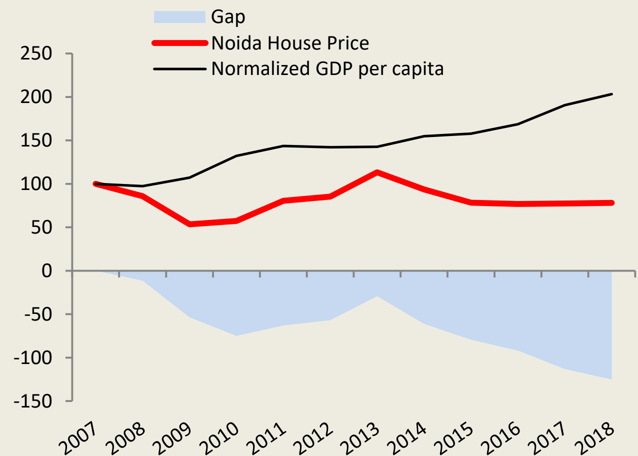
In Bangalore, prices have remained flattish or corrected a bit. Hence, affordability has improved

Pune affordability analysis



In Pune, prices have corrected considerably. Affordability has improved to a good extent

Noida affordability analysis



In Noida, prices have corrected significantly; affordability has overall improved to a great extent

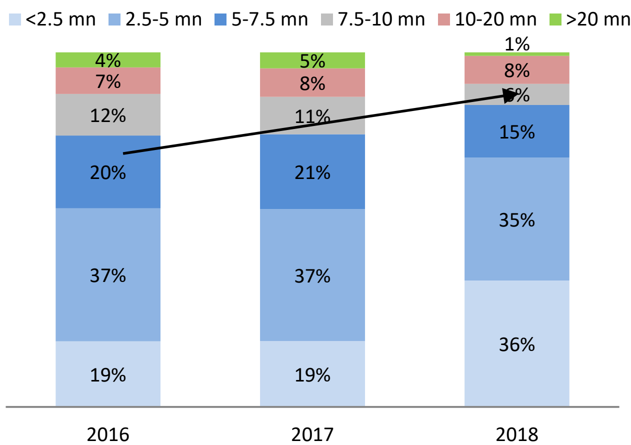
Source: Phillip Capital Research

Our ground research suggests that affordable housing (both – under CLSS and those that have low ticket sizes) ranging from Rs 3.5mn to Rs 15mn (depending upon the micro market) shall be key drivers for the sector. With demand shifting to end users from investors, over the last two years, the contribution of low-ticket-size flats has risen significantly.

Note: Affordability analysis stated above DOES NOT take into account CLSS interest subsidy; if subsidy is considered, affordability would improve even more

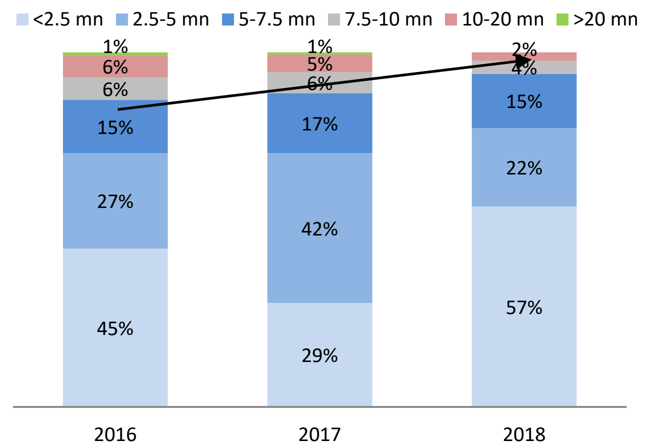
The share of affordable houses in key cities

PAN-India



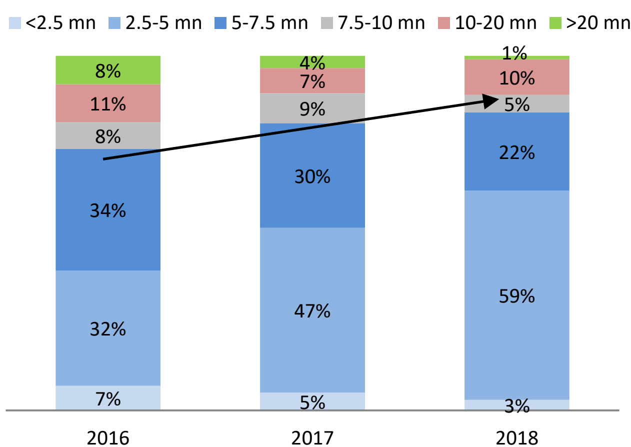
The share of low (<Rs 2.5mn), mid-sized (Rs 2.5-5.0mn) and mid-to-high(Rs 5.0-7.5mn) sized units over the last two years has risen substantially – to 86% from 66%

Ahmedabad



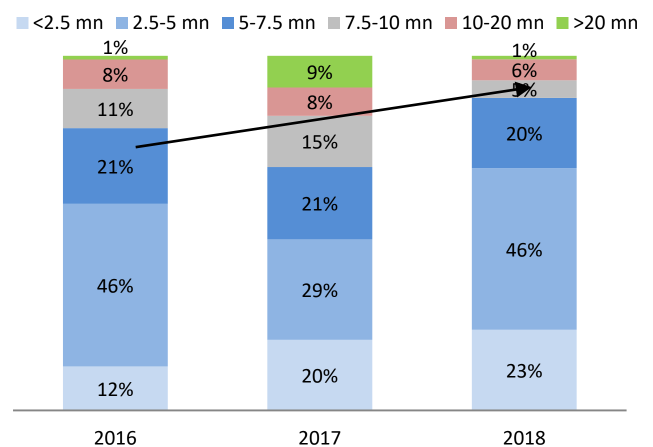
The share of low ticket sized units (<Rs 2.5mn) in Ahmedabad over the last two years has increased substantially – to 57% from 29%

Bangalore



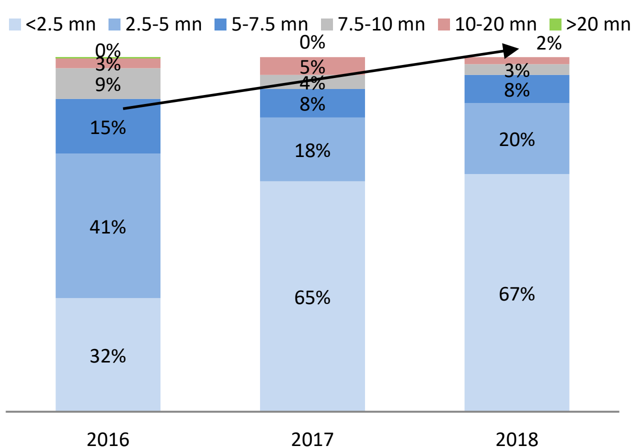
The share of low (<Rs 2.5mn), mid-sized (Rs 2.5-5.0mn) and mid-to-high (Rs 5.0-7.5mn) sized units in Bangalore went up to 82% from 73% over the last two years

Chennai



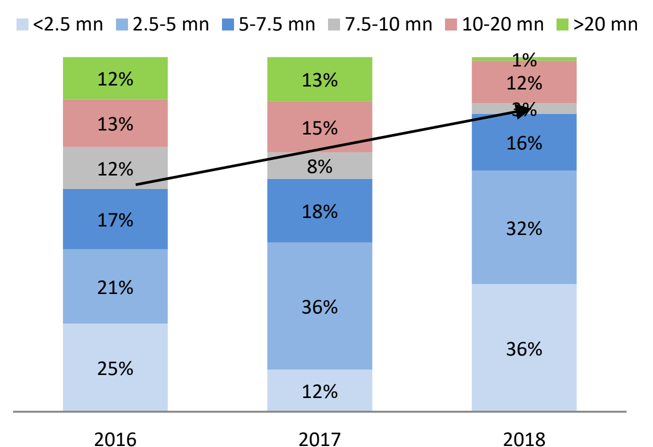
The share of low (<Rs 2.5mn), mid-sized (Rs 2.5-5.0mn) and mid-to-high (Rs 5.0-7.5mn) sized units in Chennai over the last two years increased to 89% from 79%

Kolkata



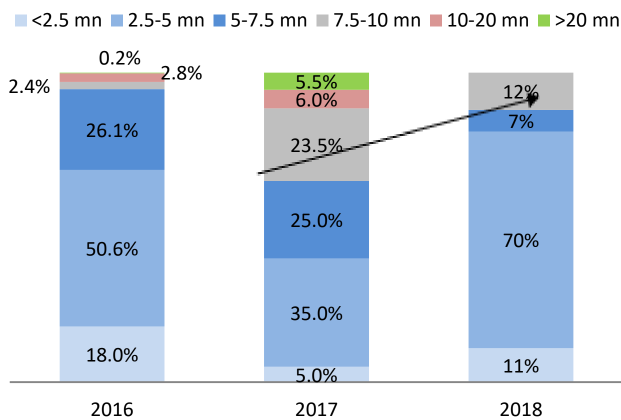
The share of low ticket sized units (<Rs 2.5mn) in Kolkata over the last two years has increased to 87% from 73%

MMR



The share of low (<Rs 2.5mn), mid-sized (Rs 2.5-5.0mn) and mid-to-high (Rs 5.0-7.5mn) sized units in MMR over the last two years has risen substantially – to 84% from 63%

Pune



The share of low (<Rs 2.5mn) and mid-sized (Rs 2.5-5.0mn) units in Pune over the last two years has risen substantially – to 81% from 68%

Source: Knight Frank, PhillipCapital India Research, HDFC Bank

The residential segment will consolidate

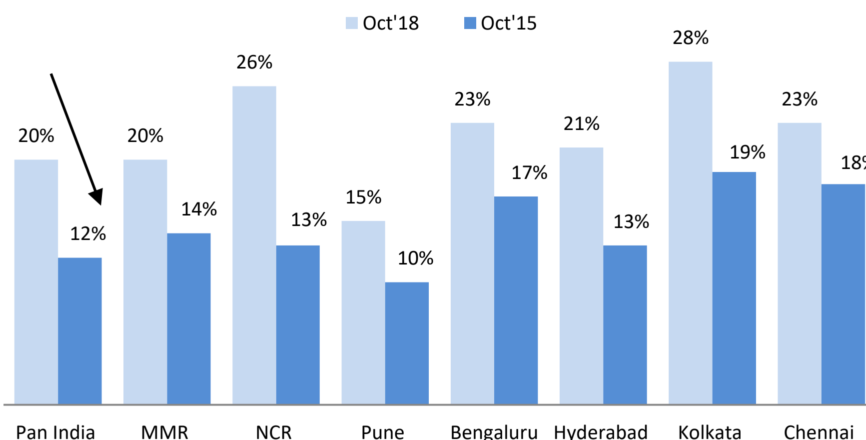
We believe that the sector is about to undergo a systemic consolidation due to multiple factors:

Access to capital has become scarce

In the pre-demonization era, the sector was predominantly cash-driven. Demonetization, the NBFC crisis, and to a certain extent the Benami Act have seriously sucked out liquidity from the sector, leading to stalled projects. In addition, as per RERA, out of every 100 rupees received, 70 have to be put in an escrow account and the developer can remove the amount from the account only up to the extent of the expense incurred/percentage completion, that too after approvals from the CA/architect/chief engineer. This particular clause has also led to liquidity scarcity for developers, which coupled with the current liquidity situation in the market, aggravates the overall liquidity issue – leading to more stalled projects. This is driving consolidation because – **only the deep pocketed will survive.**

Like the developed markets, the Indian market will also transform and over the coming year, land-owners turned developers and small-time developers will find it relatively very difficult to survive.

City-wise share of top-25 players



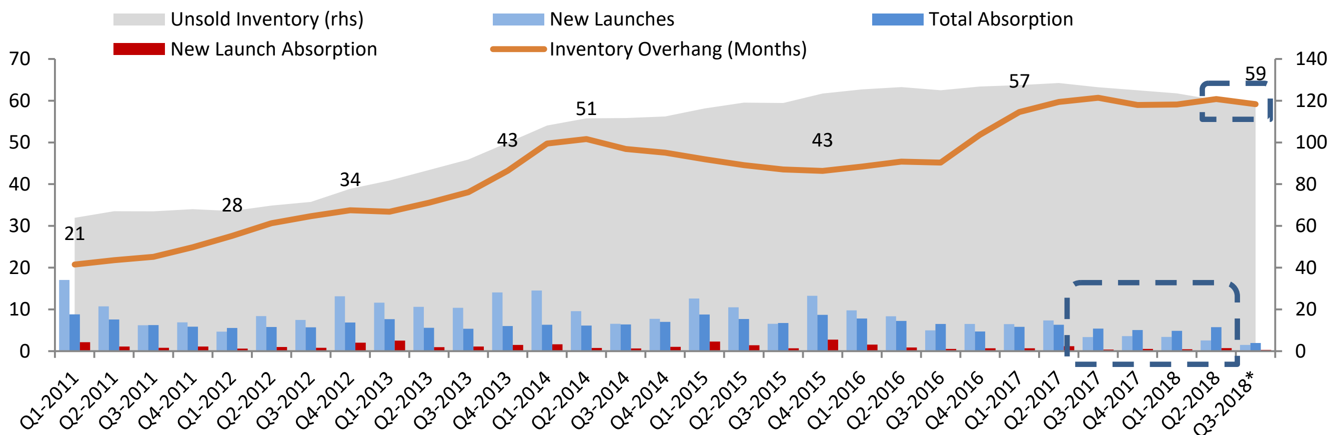
Share of top-25 developers over the last three years at a pan-India level has increased to 20% from 12%, indicating consolidation at a systemic level

Source: PropEquity, PhillipCapital India Research

Inventory overhang down; demand slightly outstrips supply

After years of a bulging inventory overhang, in the last three quarters (Q1-Q3 CY18) it has steadied. After more than a decade, after 2017, the industry saw a trend reversal in demand-supply dynamics (demand outstripping supply). This is because while there has been a steady decline in supply, demand seems to be reviving, albeit slowly. Demand has been higher than supply for a couple of quarters – at a pan-India level and in majority of the micro-markets.

India market trend



Source: Knight Frank, PhillipCapital India Research

The residential segment will be a volume play, not a pricing play

As the industry dynamics change – from investor-led demand to end-user led demand – we do not expect overall demand to reach previous highs, despite demand being higher than supply. This is because of the still substantial inventory overhang, which will prevent pricing power returning to the sector over the short to medium term (3-5 years).

To drive growth, real-estate players will have to look towards volumes – i.e., construct more, sell more. As the industry consolidates, larger players with strong liquidity and cash flows will be able to monetise development opportunities.

For volume play, many developers have taken the following steps:

- **Using subvention schemes to boost sales**: Providing flexible payment facility to buyers by allowing them to book a unit by paying a small percentage (10-25%) and paying the rest at their convenience (during the construction phase or near/on completion).
- **Using pre-cast technology**: Many large developers (Sobha, Godrej Properties) have started using pre-cast technology to expedite construction and deliver faster. This serves multiple purposes– it crunches the construction timeline (typically by a year or more), enhances the quality of construction, and also leads to freeing up of working capital at a faster rate, allowing developers to re-employ money in a new projects. This trend should be evident in 3-4 years in the execution pace of these developers.

Execution capabilities will drive sales, premiumization, multiples

Going forward, '*In Time – In Fit' (timely and good quality)* delivery will be the cornerstone of buyers' decisions. Therefore, a developer's execution capabilities (timeline and quality) will take centre-stage. Developers that are able to excel in these two parameters will see exceptional sales velocity, albeit without significant pricing power; though we expect such players to be able to drive premiumization to a certain extent even within the prevailing bearishness of the sector.

Developers that regain the trust of consumers will see sales growth and improvement in margins – which will translate into their stocks trading at better multiples

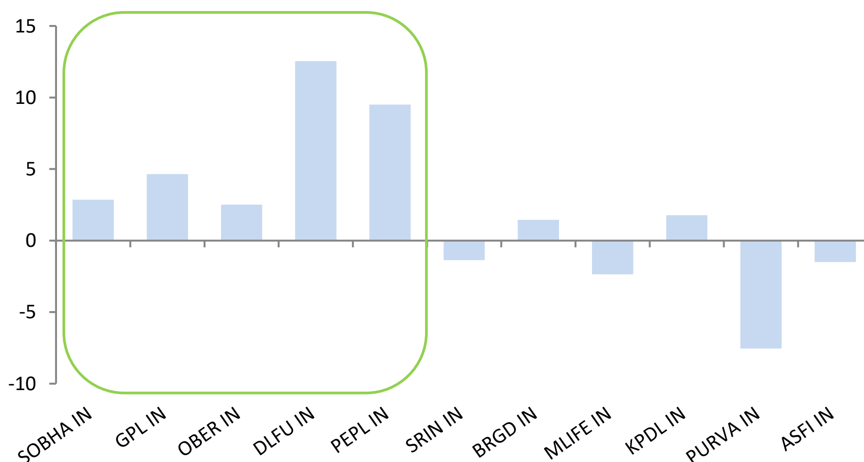
In order to achieve better and faster execution, certain large players have started employing pre-cast technology, which helps to improve the quality of the building delivered and also shrinks project timelines. Players who have strong execution capabilities will regain the trust of home-buyers (the developer community has broken buyers' trust due to past actions). This regained trust will drive future sales of projects – word-of-mouth publicity is often a big driver of real-estate sales.

Cash flow will be a key indicator of performance

In the past, even some of the largest players in the industry have struggled to generate a positive cash flow. However, with the implementation of IND AS 115 diminishing the importance of the P&L and balance sheet, the focus will shift to cash flows. Firms that generate positive operational cash flows will keep growing and fetching better valuations.

We expect valuations of many listed companies to be driven by execution capabilities, not by land banks (as was the case in the past)

Cumulative operating cash flow over FY16-18



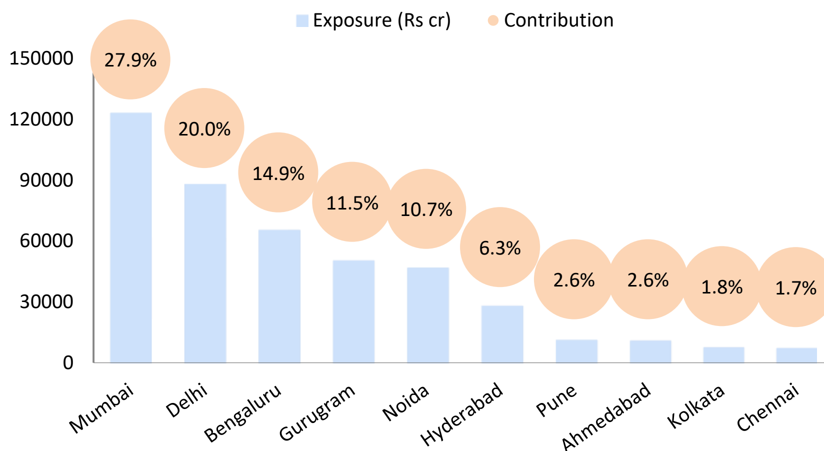
Source: Bloomberg

Firms like Sobha, Godrej, Oberoi, DLF and Prestige have been generating positive operating cash flow on a ccumulative basis over FY16-18, indicating healthy performance

Resolution of mounting debt

In the sector, debt has risen to alarming levels, NBFCs are being cautious about disbursements, and overall costs of funds are rising. We believe that the sector can face some serious issues if the debt levels climb any further and projects are stalled, it will create a domino effect. Only government intervention seems like a possible resolution. Currently, the government is making an effort to deliver projects of defaulting developers by appointing co-developers (PSUs) such as HUDCO and NBCC.

Top-10 cities by borrowings



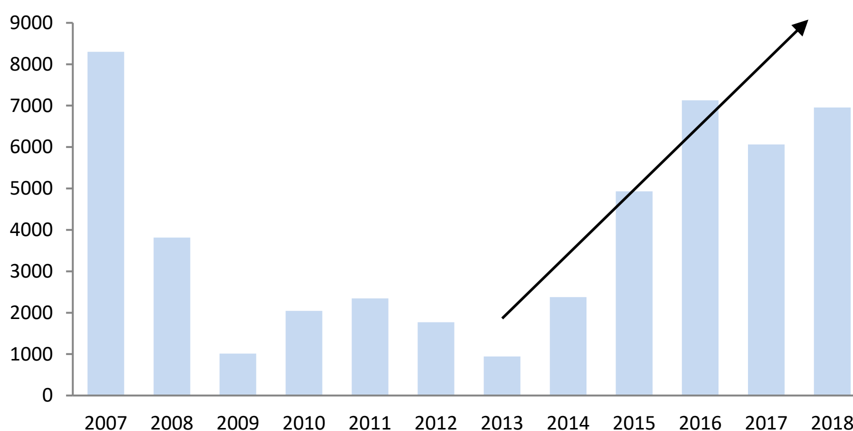
Source: CRE Matrix

Need for new liquidity providers: Private equity may step up

With NBFCs retreating from their lending spree, the sector seems on the brink of severe liquidity crisis. We believe that private-equity (PE) players have the capability to step up and fill the shoes of NBFCs. Over past three years. PE players have pumped in more than US$ 23bn into Indian real estate.

Going by this healthy trend and taking into account NBFCs' withdrawal from the scene, it seems like PE players will step up and take this opportunity to drive the sector. Some of the largest players of the industry (Godrej Properties, DLF, Phoenix Mills) already have PE investments from some of the largest global players (APG, GIC, CPPIB).

PE investment in India real estate (USD mn) has grown 6x over CY13-18



Source: Knight Frank, PhillipCapital India Research

Typically PE players are forerunners of investments into any sector; growth in equity typically follows. We see strong PE inflows as a positive sign for the sector

Commercial space: Demand Supply dynamics fairly balanced for now

Low supply is keeping the commercial segment strong – but it's coming

Currently, the commercial segment is performing well because of the low pace of supply and very low vacancies in Grade-A office spaces, creating a shortage for them. Our research shows that because of rising rental yields, demand, the interest shown by private equity players, low interest rates, and a growing economy – supply over CY19-22 is going to ramp up at a tremendous pace. We expect 170mn sq. ft. to hit the market in the next four years.

The demand journey: IT → ecommerce → co-working spaces and GICs

In the past the Indian IT sector was the key demand driver for the commercial spaces, over CY17-18 the Indian IT industry has slowed down hiring due to the slowdown in the IT sector and fundamental changes in its hiring pattern. Earlier contacts of these IT firms with clients were on a fixed headcount basis, which are now migrating to fixed-price no-headcount basis, which reduced in surplus or 'forced' over-recruitment by IT players leading to slowdown in leasing by the IT players.

Earlier the demand growth for commercial spaces was aided by the rise in demand from e-commerce players (over CY15-16) which has now died down

Co-working spaces and GICs emerge

The void left by ecommerce has begun to be filled by co-working space players and GICs (Global In-House Captives), which are growing at a fast pace.

We believe that demand led by co-working spaces is unsustainable, as the competition in the co-working spaces grows, the consolidation in the co-working industry might take place leading to slowdown in demand by them.

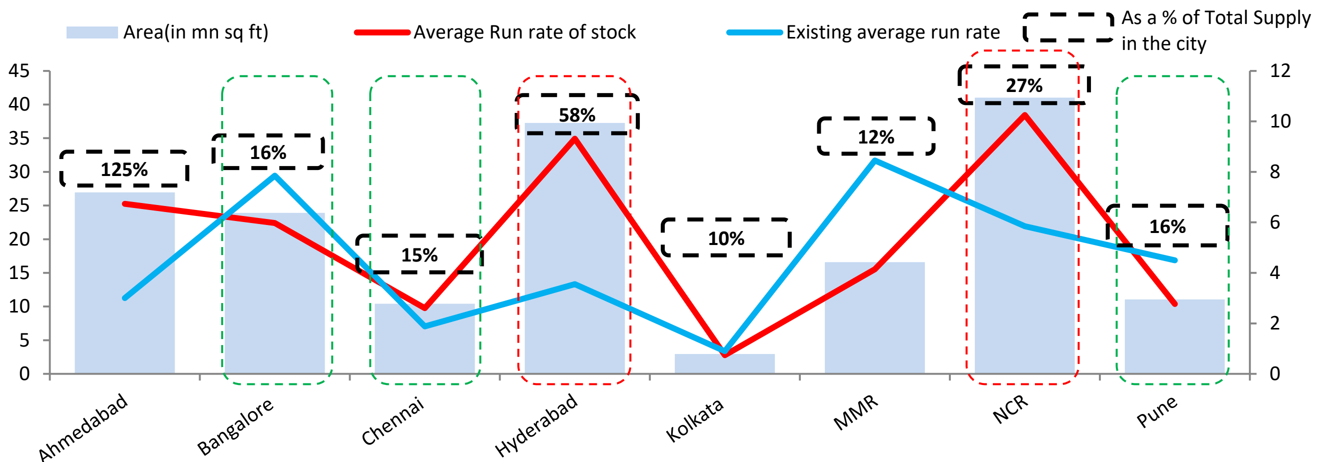
Private Equity investors – possible saviours

As the commercial segment is a capital intensive one, liquidity availability remains a key. The segment has an easy access to funding – debt (in form of LRDs) as well as equity (with increasing infusion from Private Equity players). The strong trend of Private Equity investment Over the past decade, private equity players have kept the sector's wheels turning, augmenting their liquidity needs. From 2008 to 2018, these players have pumped in c.Rs 613bn into the Indian commercial segment. We expect the trend to continue which shall aid the growth of the commercial segment and keep a check on overall debt levels.

The supply rates in Ahmedabad, Hyderabad, MMR, and NCR look alarming – these cities have quite a bit of total supplying coming in ahead – at 125%, 58%, 12%, and 27% of existing total supply Over the next 3-4 years. Ahmedabad has high vacancy rates and with huge supply coming in. It could see a significant slowdown if demand does not keep up pace. While addition of supply is relatively low in MMR (vs. historical pace) it raises some concerns because of an already high inventory. Even so, we believe that this lower supply pace and steady demand will help the city to improve its rental yields and vacancy levels over the medium term. NCR and Hyderabad micro markets both are in imminent danger of slowdown – however, in Hyderabad, demand will increase along with a huge supply coming in; NCR has no such cushion and the situation may deteriorate

Bangalore, Chennai, and Pune will remain in a sweet spot and enjoy low vacancy levels and better rental yields, but both face the threat of a further slowdown in the IT sector.

Upcoming commercial supply in various cities



Source: Cushman Wakefield, PhillipCapital India Research

Ahmedabad, Bangalore, Hyderabad, and NCR to see a huge influx. Ahmedabad and NCR markets may see a slowdown

It all hinges on demand keeping up pace; REIT could boost sentiment

- The commercial segment is faring really well due to demand being higher than supply, it being insulated from the impact of RERA and GST, and being relatively unscathed by demonetization and the NBFC crisis with liquidity available in the form of LRDs and private equity investments.
- India's first REIT is here – if it is successful, it will bolster investor confidence and lead to adequate liquidity in the market.
- In the short term, we expect the trend of pre-leasing to continue in the key micro-markets.

Over CY22-23, India is likely to see strong supply of commercial spaces especially in key cities – we believe that if demand keeps up pace, then this segment will remain strong. Players will keep enjoying high rental yields and low vacancy. If demand falters, the commercial segment could turn bearish in the medium term.

Retail space: Superior execution remains key

Insulated from the worst of recent changes and events

- Most malls operate on an annuity model– so they are outside the gamut of RERA and GST (as they aren't being sold).
- The retail segment faced the brunt of demonetization, but events such as the NBFC liquidity crisis haven't dented the retail segment much because of the easy availability of credit in the form of LRDs (Lease Rental Discounting).

Seeing high interest from private equity players

- This is because retail annuity assets provide a higher rental growth (6-7% p.a.) and higher yield (due to base rent + revenue share above a certain sales threshold) than rental growth in commercial assets (which is typically 5% p.a.)
- They also provide (at least Grade A spaces do) a relatively better visibility in terms of rate hikes
- Various players such as Blackstone, CPPIB, GIC, Xander Group, and APG have invested Rs 186bn in Indian retail assets over the last five years – which bolsters our confidence in this segment's future.

More healthy (Grade A) supply coming online

- We expect a more healthy supply of mall spaces coming in from FY19 to FY23.
- Our research suggests that there is a demand for Grade A superior quality mall spaces in India
- The execution of the mall will decide its fate. Based on our calculation, some malls in India may close due to poor execution, but at least in near to medium term we do not expect e-commerce to significantly disrupt Grade A malls' business
- Grade A malls will continue to command higher rentals and will have lower vacancies.

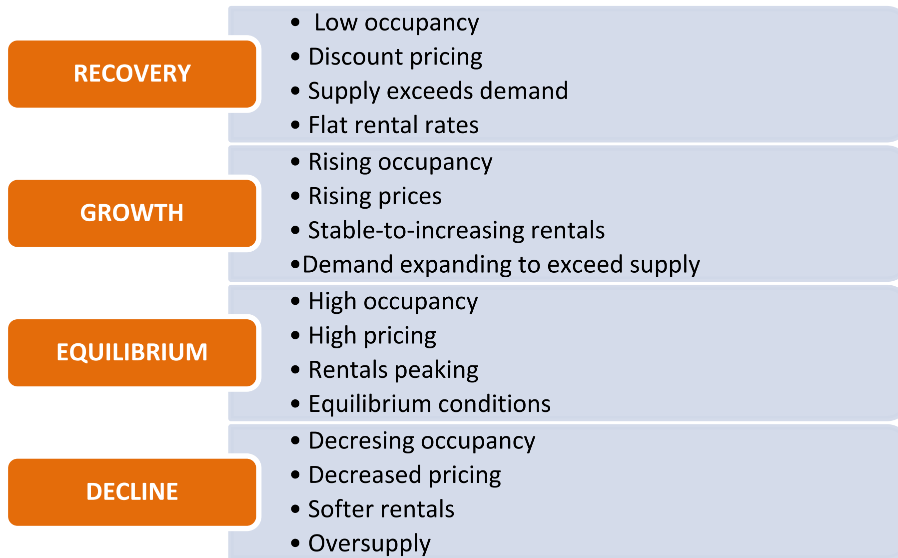
Retail propellers: Insulation from RERA and GST, easy access to liquidity in the form of LRDs, interest from private equity players

CHAPTER 2:
Residential: A patchy ride so far

The four 'eras' in Indian real-estate

Globally, the real estate sector is cyclical with a typically long cycle of more than five years, so is the Indian real-estate sector. While the residential real-estate segment has already been through *growth*, *equilibrium*, and *decline* phases and seems to be currently in the *recovery* phase, commercial and retail segments are in the *growth* stage.

The four stages of the real-estate cycle



Source: PhillipCapital India Research

The four 'eras' in Indian real-estate

We have slotted the journey of the Indian real estate sector into four eras:

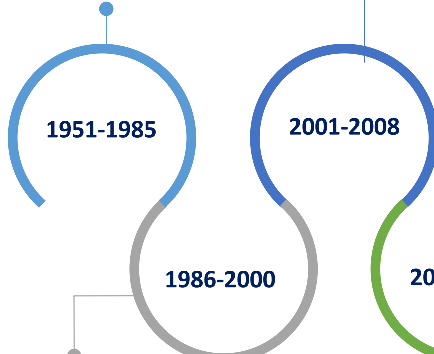
1. Pre 2000 – a government regulated and dominated period
2. 2001 to 2008 – the advent of private players and the bull run
3. 2008 to 2016 – entering into a bearish phase
4. Post 2016 – A new dawn

We have discussed the first three briefly below in this section. However, due to the business environment and regulatory reforms that the sector experienced after 2016, we have carved out the fourth as a separate subsequent section

Tracing the evolution of Indian real estate

Real estate: The rollercoaster ride so far

After Independence, for almost 50 years, the sector was led by the government. In this period, major focus was on rapid planning of urban areas. The era marked the setup of HUDCO, planning of houses for poor, controlling urban settlements, and development of small and medium towns.



Sector took off in 2001 as bank exposure towards the sector increased rapidly. In 2005, the advent of allowance of 100% FDI in the sector led to a growth frenzy. Annual price appreciation was 10-30%. Advent of HFCs added fuel to fire. Tangible nature of assets and legislative comfort obtained from SARFAESI act propelled lending.

2001-2008

2008-2016

2016 – RERA and demonetization

IN March 2016, GOI passed a landmark reform -- RERA – which created a safety net for buyers and penalized developers severely for non-adherence to deliverables. A major move was mandatory creation of an escrow account for each project. This leash on funds followed by demonetization led to a further slump in the sector.

2017-2018 GST and NBFC liquidity crunch

With the sector already in troubled waters, NBFCs came to the rescue. The relief didn't last long as October 2018 brought a widespread NBFC liquidity crunch. Meanwhile, GST proved to be a last nail in the coffin.

This decade marked a departure. Major responsibility of housing construction shifted to the private sector. NHB* was set up and UBSP** was launched. These measures and focus on urban sheltering in 1992-97 led to emphasis on the role of the private sector as a development partner.

Subprime crisis in 2008 changed sentiment of the almighty real estate sector that had been growing rapidly for a decade. After a slump in 2008, the market recovered temporarily only to hit the ground again in 2013 when prices fell sharply. With some major real estate players defaulting, the RBI intervened by increasing base rates and instructing banks to release loan amounts in phases linked to construction, putting a leash on financing. This opened the doors for NBFC players in the sector. Since 2013, price realizations have been flattish.

***NHB:** National Housing Board ****UBSP:** Urban Basic Services for poor

Source: PhillipCapital India Research

Pre-2000 – a government regulated and dominated period

- Up to the 1990s, the government's strategy towards the sector was strictly limited to government-led housing development. The demand was mainly driven by basic need for housing.
- 'Liberalization' of 1991 helped the sector in many ways. A growing population and more importantly the shift towards urbanization played a major role in increasing demand. The rate of urbanization increased from 25.7% in 1991 to 31.2% in 2011. This increased the demand.
- This period marked a shift in the government's focus towards the sector – it allowed more private players.
- The government's focus also shifted towards urban-housing schemes. HUDCO already existed and the National Housing Bank (NHB) and Urban Basic Services for Poor (UBSP) were started to provide a boost to the sector.

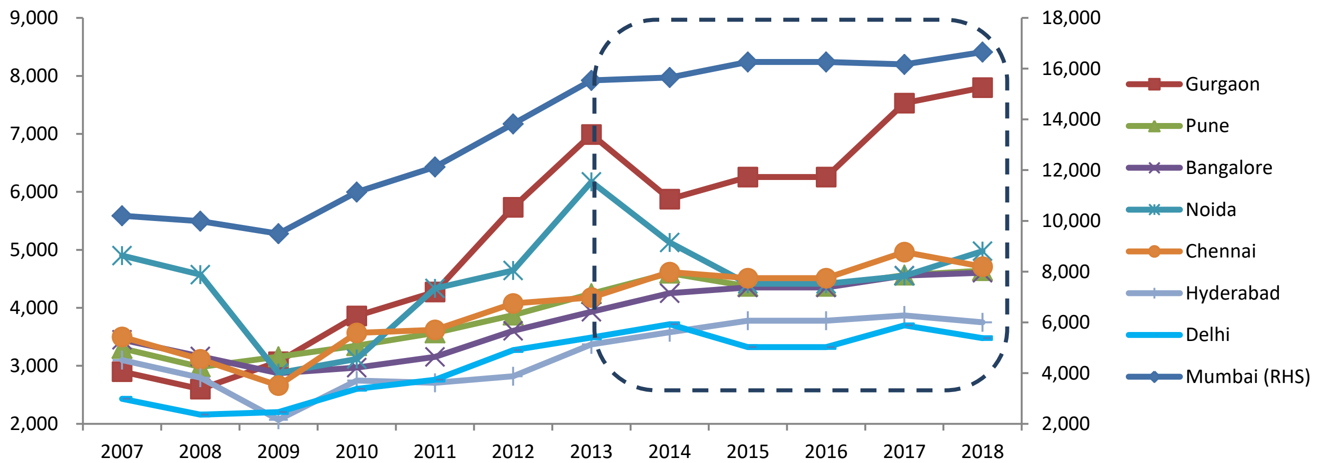
2001-08 – the advent of private players and the bull run

- In 2001, private players began entering Indian real estate in a meaningful way.
- Banks started lending aggressively to real-estate companies. Their retail loan portfolios (including housing and real estate advances) expanded at a scorching 22-41% in 2001-02 and accounted for c.27% of the incremental non-food credit in 2007-08.
- As per RBI's Annual Policy Statement for 2007-08, incremental growth in the loans to commercial real estate and housing clocked astounding rates of 84% in 2006 and 29% in 2007. Soon, NBFC players and HFCs plunged in, creating almost a frenzy of sorts. The real-estate asset class, which was delivering 10-30% annual returns, captured the imagination of the Indian population.
- Massive demand for housing and office spaces (by investors and end-users) led to a rapid growth in supply, absorption, and prices.
- 100% FDI was approved for the sector in 2005, which ensured inflow of liquidity.

2008-16 – the bearish phase, or the post-subprime-crisis era

- The sector got its first jolt in years in late 2008, with the coming of the Sub-Prime Crisis. In Q4 2018 and Q1 2019, absorption levels fell to an all-time low since the start of the property market boom. Project executions slowed down in order to sustain market dynamics. The market was able to revive by early 2010, but due to the increasing pace of new supply and delayed execution of older projects, inventory levels spiked dramatically in 2010-11.
- The industry showed some signs of stability by 2012, but they proved short lived. After 2013 the sector went into a complete bearish phase, with the new inventory supply rate dipping to a third of the rate seen in 2010.
- Since 2001, banks had lent a sizeable portion of their credit to the real-estate sector. This trend continued right up to 2012, by which time bank lending comprised 70% of the total money being lent to the real-estate sector.
- In 2013, some developers filed for bankruptcy leading to large NPAs for banks. Hence, the RBI put a leash on bank lending to real estate by capping the limits and increasing the base rate. However, HFCs stepped in to fill the gap. In 2010, lending by HFCs was 20% of the total lending to the sector, which jumped to 40% by 2015. Before 2016, the role of NBFCs in the construction financing was limited. In fact, NBFCs gained prominence in the real-estate sector only after 2016.
- The Eurozone crisis pushed the sector into a cyclical downtrend with the inventory overhang spiking (from 21 months early 2013 to 35 months in 2015) due to lack of demand. This led to a flattish price trend across cities from 2013 till 2016.

Price trend after 2008 – prices have corrected/flattened over 2012-18

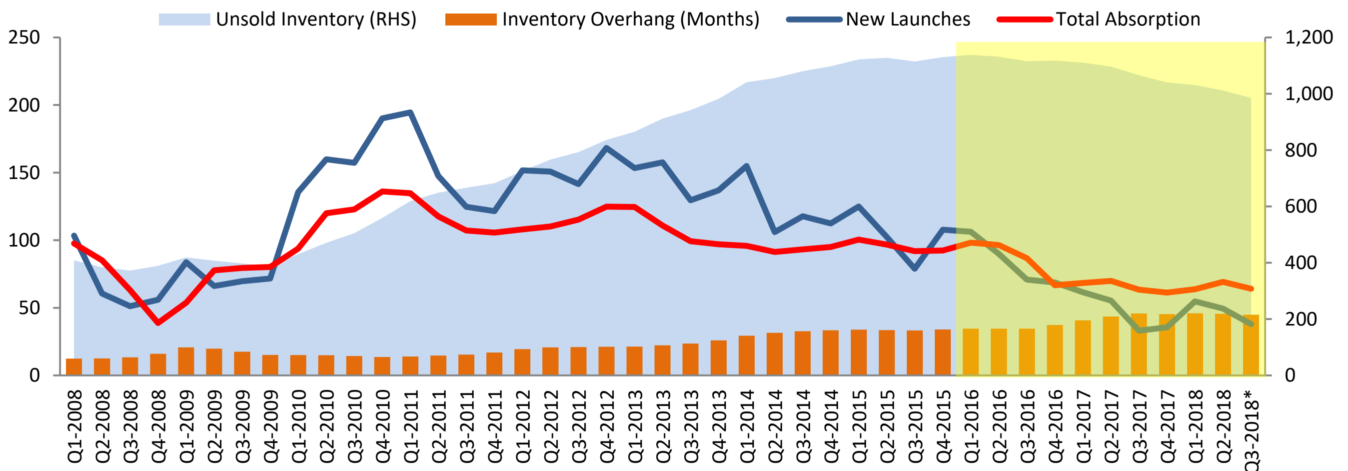


Source: PhillipCapital India Research

Post 2016 – a new dawn

After 2016, the sector underwent tremendous changes – economic, regulatory, and business. In this section, we discuss these changes and their implications on the sector.

India residential real estate trends – before and after 2016. After 2016, supply fell sharply while demand fell and stabilised, leading to decline in inventory levels, and preventing inventory overhang from worsening



Source: PhillipCapital India Research

Demonetization – A necessary evil

Demonetisation (November 8, 2016) was a cataclysmic event for Indian real estate. However, even before this event, the sector was struggling, facing stagnant sales growth among other challenges.

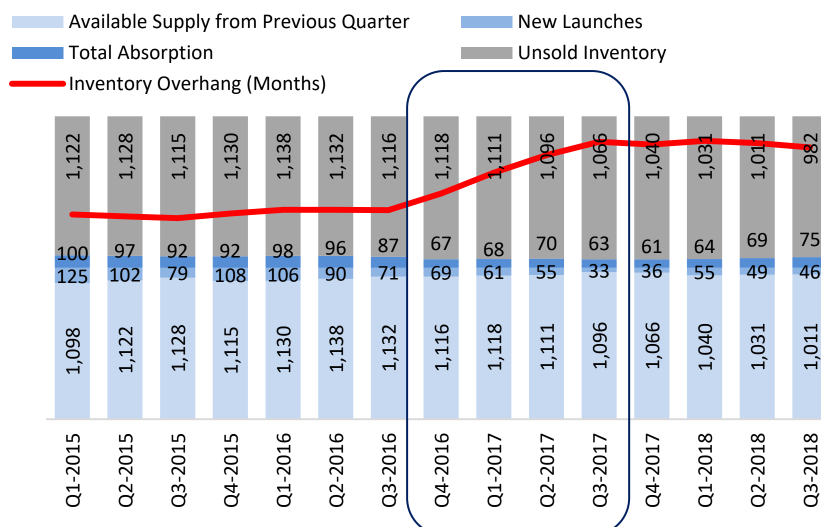
Here are a few of the changes in residential real estate before and after demonetization:

Demonetisation effect: Dip in demand followed by supply; inventory overhang deteriorated

	Pre demonetisation	Post demonetisation
Inventory	• Inventory overhang* was at 35 months	• Inventory overhang kept increasing to touch 46 months in Q2 2018. • Seems to have stabilised now • Dropped for the first time in Q3 CY18 to 45 months
New launches	• New launches were at an average 100mn sq. ft. in Q1-Q3 CY16	• New launches dipped to 69mn sq. ft. in Q4 CY16 • Finally seem to have stabilised at 46mn sq. ft. in Q3 CY18
Absorbtion	• Absorption in Q3 CY16 was 87mn sq. ft.	• Absorption tumbled to 61mn sq. ft. in Q4 CY17 • Has improved in the last three quarters to 75mn sq. ft.
Others	• Was an extensive cash-driven market • Popular channel for cash transactions among buyers and investors. • Payments made to the construction workers and contractors were in cash.	• Majority of the liquidity was sucked out. • Became extremely difficult for developers, investors, and buyers to transact in cash

Note: * At a pan-India level, considering top seven cities – MMR, NCR, Bangalore, Pune, Kolkata, Hyderabad and Chennai, which effectively represents around 60% of the Indian real-estate market.

Effect of demonetisation on Indian real estate



Source: PhillipCapital India Research

Inventory levels deteriorated sharply over Q4 CY16 to Q3 CY17

Increasing inventory overhang has started stabilising over Q1-Q3 CY18, indicating possible beginnings of a sector revival

Amendment of the Benami Properties Act in 2016

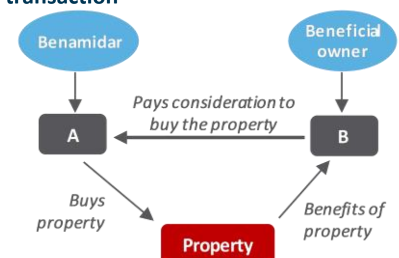
India has a history of rampant money laundering through moveable and immovable properties and real estate is one of the major sectors for the generation and investment of unaccounted money also known as *black money* in India. To curb this, the government had introduced the Benami Properties Act in 1988, but the law was plagued with loopholes. As a result, it amended the law in 2016 and tightened the net against people breaking the rules.

The key implication of the Benami Properties Act will be lower demand and liquidity

The Benami Properties Amendment Act:

- Tried to give a comprehensive definition of *benami* transactions clearly.
- Provided for the establishment of adjudicating authorities, setting up of an appellate tribunal, and the power of the central government to designate one or more Courts of Session as 'Special Courts' for speedy and smooth trial of offences punishable under the new act.
- Provided for attachment, adjudication, confiscation, and vesting of *benami* property – and prescribed penalties and punishments for offences punishable under the new act.

An example of a typical benami transaction



Source: Benami Properties Act, PhillipCapital India Research

The act aims to ensure that black money transactions are curbed and that all real estate transactions are conducted in the name of the actual owner, where the consideration is paid from his/her known sources. This act aims to curb tax evasion and avoidance too.

GST – A landmark tax reform

GST Era I: July 1 2017 to March 31 2019

Previously, multiple taxes were applicable on the sector (service tax, VAT) – now there is a single tax – GST

The aim was to fill the government kitty, but it also (unintentionally) curbed the pricing bubble created by investors

Old Tax Regime		New Tax Regime					
		Scenario 1 Under construction property		Scenario 2 Under construction property -- For homes purchased under credit-linked subsidy scheme		Scenario 3 OC received property	
VAT(1% to 4%)*	2%	GST	12%	GST	8%*	GST	0%
Service Tax	4.50%	Service Tax	NA	Service Tax	NA	Service Tax	NA
Registration charges	1%	Registration charges	1%	Registration charges	1%	Registration charges	1%
Stamp duty	5%	Stamp duty	5%	Stamp duty	5%	Stamp duty	5%

** The homes purchased under the Credit-Linked Subsidy Scheme (CLSS) attracts 12% GST rate. The applicable effective rate will be 8% after cutting the 1/3rd amount towards the cost of land.*
Note: VAT, registration charges, stamp duty charges vary from state to state. VAT was not applicable on completed or ready to sale properties. Under the erstwhile indirect tax regime, cenvat credit on inputs used for the construction of a building or a civil structure or any part thereof was also restricted.

The impact on buyers

Higher tax implication dissuaded people from buying 'under construction' properties. A significant (c.50%) hike in total effective tax outgo proved negative for homebuyers in new projects. However, GST also helped to transform the industry towards a consumer-driven market from an investor driven one.

Pre GST	Post GST
• Buyers had to pay VAT, service tax, registration charges and stamp duty on purchase of properties under construction • VAT, registration charges, and stamp duty were state levies, so prices of properties varied from state to state • Developers had to pay various duties like central sales tax (CST), custom duty, OCTROI, etc., for which credit was not available • Total effective tax outgo (including stamp duty and registration fees) from a buyer's side was anywhere from 12.5-16.0% • No input tax credit available on construction materials such as cement and steel	• A single tax rate of 12% is applicable on properties under construction across India • GST is not applicable on completed or ready to sale properties continuing the trend of no tax on completed projects • Stamp duty and registration charges continue to remain state subject and vary from state to state. They are still applicable on both completed properties and under-construction properties (same as earlier) • Total effective tax outgo (including stamp duty and registration fees) from a buyer's side increased to 18-20% • Had input tax credit facility

Source: PhillipCapital India Research

GST Era II: April 2019 onwards – silver linings

The Interim Budget 2019 came to the rescue of the flagging real-estate sector (somewhat) when the government announced setting up a Group of Ministers (GoM) to re-consider GST rates for the sector. On February 24, 2019, the GST council slashed GST rates by 7% to 5% (for normal projects from 12% earlier) and 1% (under PMAY from 8% earlier) but without tax credit. This move, which came into effect from April 1, 2019, is welcome, and directionally a positive change, but brings headwinds.

The move's intention, which is to bring down home prices, might not play out as planned because developers' margins are already thin due to high cost of borrowing, sluggish sales, and stable prices. They might not be able to absorb the differential tax loss (due to loss of input cost credit) and may want to pass it on to buyers by raising home prices – which effectively nullifies the entire essence of the move. However, this move in effect brought parity with the pre-GST tax regime, i.e., effective total tax outgo of 11-12% (including stamp duty and registration) and withdrawal of the input tax benefit (it didn't exist pre-GST). There are other ways in which developers could tackle this – some may decide to absorb the differential loss partially by trying to reduce their cost (switching to unorganized, non-branded players for construction material) in anticipation of higher sales. Some (mostly large) developers might even manage to sell these units at existing wholesome MRPs, with claims of absorbing losses themselves.

Overall, we expect many developers to absorb the differential tax loss, which should lead to a revival in demand for under-construction projects (possibly even investor-led demand), but we do not expect sector dynamics to change significantly. Basically, we don't anticipate investor-led demand reviving over the short to medium term; end-users will continue to drive demand. This transition will lead to effective price discovery in the sector and provide stability to demand-supply dynamics.

Whatever the outcome, slashing GST definitely indicates the change in stance of the current government towards the real-estate sector – it is its attempt to revive the ailing sector

We have discussed the tax implication of this transition in this section – click here

New tax regime					
Scenario 1 Under construction property		Scenario 2 Under construction property -- For homes purchased under credit-linked subsidy scheme		Scenario 3 OC received property	
GST	5%	GST	1%*	GST	0%
Service Tax	NA	Service Tax	NA	Service Tax	NA
Registration charges	1%	Registration charges	1%	Registration charges	1%
Stamp duty	5%	Stamp duty	5%	Stamp duty	5%

Source: PhillipCapital India Research, GST council (Government of India)

GST: Impact on stakeholders

- Impact of the allied services such as material suppliers, service suppliers, etc., depends on the increase or decrease in the tax levied on those goods and services. Apart from fly-ash bricks, majority of the input raw materials have seen a reduction in tax rate under the GST regime, a positive for the sector
- The removal of central sales tax of 2% on cross-border transaction has facilitated smoother flow of goods among states

GST rates of the building material

Product	Tax in the previous regime*	Tax as per GST regime
Sand & Fly ash Bricks	6%	12%
Steel	17.5%	18%
Paints	26%	18%
Marble and granite	25%	18%
Cement	30%	28%#

* Tax in Previous Regime is as per erstwhile Maharashtra VAT; # has been under consideration for reduction

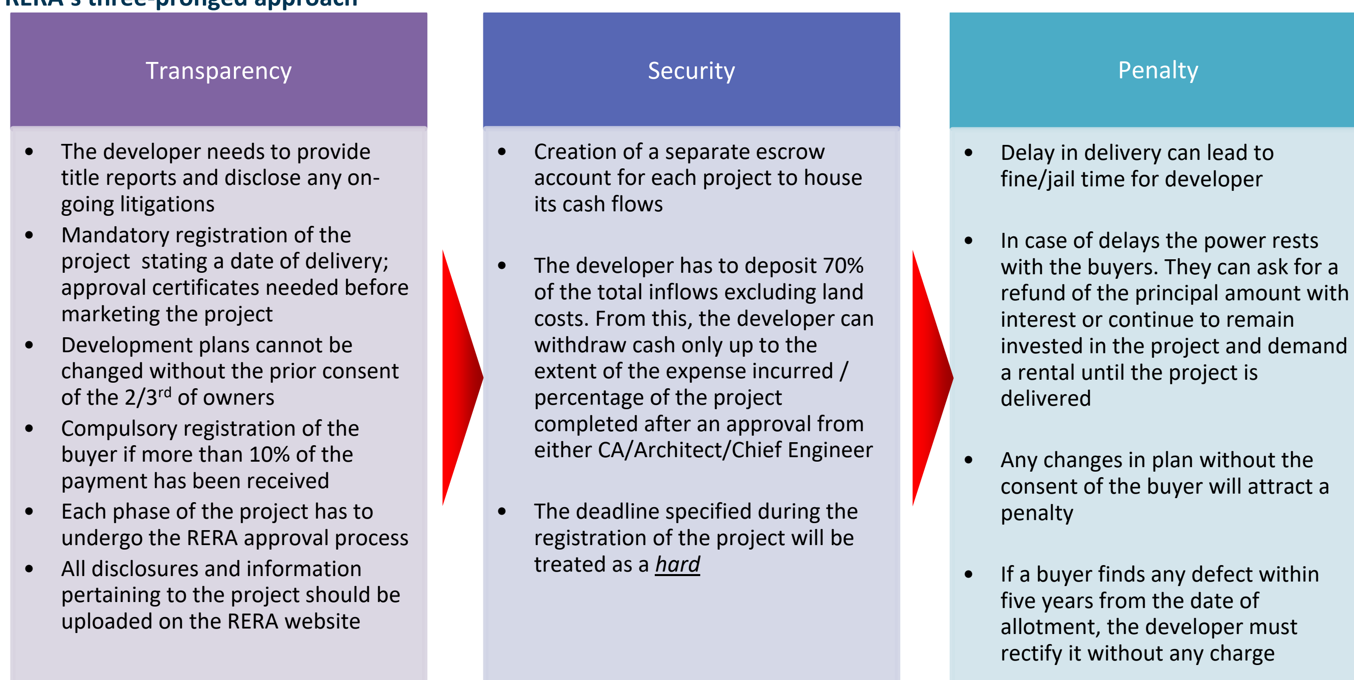
Source: PhillipCapital India Research, GST Council (Government of India)

RERA – Still just a paper tiger; right direction though

RERA Act came into force on May 1, 2016. We see RERA having a three pronged approach – transparency, security (for buyers through norms such as creation of separate escrow accounts for each of the projects), and penalty (on developers for non-adherence).

The Real Estate (Regulation and Development) Act, 2016 seeks to protect homebuyers and help boost investments in the real estate industry. The Act establishes Real Estate Regulatory Authority (RERA) in each state for regulation of the sector and to act as an adjudicating body for speedy dispute resolution

RERA's three-pronged approach



Source: PhillipCapital India Research

Each state has to setup its own RERA authority

Additionally, every state is required to set up a website providing details of all registered projects. All developers who intend to sell their projects have to register them with RERA. However, developers would only be able to register their projects after they receive basic approvals from all regulatory authorities.

RERA to make the sector capital intensive

This is because developers have to keep 70% of the cash inflows of a project in an escrow account. They can withdraw from it only as per expenses incurred – and only after an approval from the developers' chartered account, or architect, or chief engineer. This increases working capital requirements. As developers have to depend on customer advances for financing a project, project IRRs are likely to fall, which means higher equity contribution from developers and an increase in their borrowing.

10% clause for buyer registration clamps down on malpractices

Another move with significant implications is that developers have to register buyers, if they accept more than 10% of the total consideration (this has been implemented by Maharashtra RERA (MAHARERA). This clause will curb rampant malpractice by developers where they allowed large investors into their projects without registering them, thereby avoiding paying stamp duties and registration charges.

Here is our analysis of RERA's impact on project IRR. With RERA implementation, project IRRs have dropped to 20-30% from 30-40% earlier. It reinforces our belief that the developers' working capital requirements will increase under RERA.

RERA – an analysis of the impact on project IRR

Assumptions (INR mn)					
Total consideration of the project	10000	**Cost of land**	2000	**Cost of construction**	4000
Kept in escrow account	30%				

Particulars	Impact analysis (INR mn)					
	Year 1	Year 2	Year 3	Year 4	Year 5	Year 6
Construction progress	5%	10%	25%	25%	20%	15%
Collection schedule	10%	10%	25%	25%	25%	5%
Pre-RERA						
Outflow	-2500	-500	-750	-750	-750	-750
Inflow	1000	1000	2500	2500	2500	500
Net Cash	-1500	500	1750	1750	1750	-250
Cumulative cash flow	-1500	-1000	750	2500	4250	4000
IRR	30% -40%					
Post-RERA						
Outflow	-2500	-500	-750	-750	-750	-750
Inflow	1000	1000	1000	1500	1500	4000
Net cash	-1500	500	250	750	750	3250
Cumulative cash flow	-1500	-1000	-750	0	750	8000
IRR	20%-30%					

Source: PhillipCapital India Research

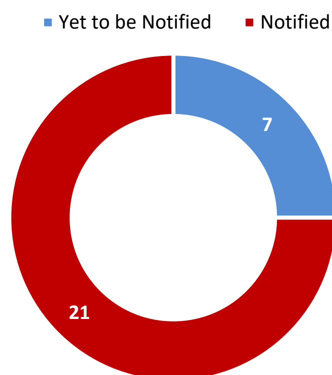
Many a slip between announcement and implementation

RERA is a landmark reform – no doubt. However, the reality is that it lacks execution. Even after a year and a half after being announced, implementation of RERA in many states is not up to the mark. The key issue with RERA is that land is a 'state subject'– so RERA's implementation has been left to states. Due to the political 'swing' towards the developer community, many states are reluctant to implement RERA or are trying to bypass it altogether. For example, West Bengal has enacted its own Act – Housing & Industry Regulation Act (HIRA), even as it has been advised to notify the rules under RERA. Kerala is planning to follow West Bengal.

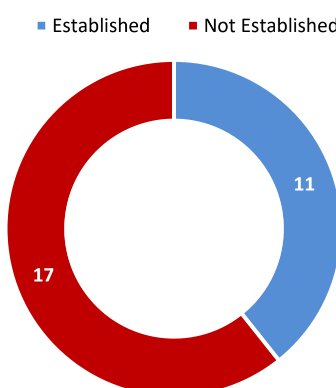
Notification of General Rules of RERA is the preliminary step of RERA implementation; this has not yet happened in 7 north eastern states (barring Assam) and West Bengal, while J&K* has been left out of RERA's gamut.

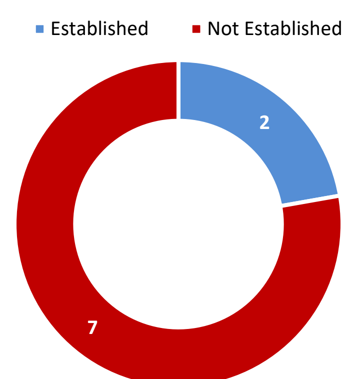
** Recently Jammu & Kashmir has agreed to set up the state RERA authority*

RERA: Status of 'general rules' in the state (excluding J&K)



Permanent regulator establishment status in states





Source: Ministry of Housing and Urban Affairs, PhillipCapital India Research

RERA: On the ground status

STATES	Registration Process	Permanent Appellate Tribunal	On Ground Status
Andhra Pradesh	✓	✗	• Relatively successful in implementing • Missed a key ingredient – state RERA rules do not mention opening a separate escrow account for a project as of now
NE states & Sikkim	✗	✗	• Shown strong inclination for implementation • Have recently agreed to implement norms • We believe it will take at least one year for successful implementation
Bihar	✓	✗	• Failed to garner a serious response from the developer community • Successively extending deadlines because of non-adherence by developers • RERA Bihar has been increasing fines on developers failing to register projects – most recently to Rs 1mn from Rs 400,000 earlier (flat fine for non-compliance) • The increase shows the state government's commitment to implement RERA
Chhattisgarh	✓	✗	• The state RERA authority has been lax in terms of implementation; facing severe opposition from developers • Hasn't been able to monitor adherence to deadlines on registered projects • Hasn't been able to get projects and the real estate consultants registered
Goa	✓	✗	• Struggling to implement RERA • State RERA committee is a one-man authority headed by Sudhir Mahajan • Seeking help from Maharashtra RERA to handle its cases in MAHARERA Appellate tribunal • Complaints in Goa have remained significantly low – maybe due to the state's lax attitude
Gujarat	✓	✗	• Successful implementation on paper with the second-highest number of registrations in India but failed to address buyer grievances according to our feedback • Unsuccessful at implementing Online Development Permission System (ODPS), which led to stalling of project Registration process. This translated into a 10% drop in launches in Ahmadabad
Haryana	✓	✓	• Doing a lot in terms of regulation setup • Planning to take existing completed projects under RERA • But state RERA authority lacks execution capabilities
Himachal Pradesh	✓	✗	• Initiated strong execution of RERA • Should be able to successfully implement it in one year
Jammu and Kashmir	✗	✗	• Recently agreed to and made provision for setting up a state RERA authority
Jharkhand	✓	✗	• Slow on the implementation front
Karnataka	✓	✗	• Despite diluted norms, it hasn't been able to garner favourable response from developers
Kerala	✗	✗	• Planning to set up its own real estate norms like West Bengal instead of adopting RERA
Madhya Pradesh	✓	✓	• **At the forefront of successful RERA implementation**
Maharashtra	✓	✓	• **Has set a benchmark for its exemplary execution of RERA**
Odisha	✓	✗	• Slow implementation, but has garnered support from the developer community
Punjab	✓	✗	• Initially, the state RERA authority was lax about implementation, but in the past couple of months the state has been tightening its grip
Rajasthan	✓	✗	• Very lax in getting developers registered
Tamil Nadu	✓	✓	• Very lax in enforcing implemented RERA norms
Telangana	✓	✗	• Implemented a few months ago • Failed to garner a serious response from the developer and real estate community
Uttrakhand	✓	✗	• Failed to garner a serious response from the developer community
Uttar Pradesh	✓	✓	• Plagued with loopholes which favour local developers
West Bengal	✗	✗	• Enacted its own act – HIRA – which essentially is accommodating of the demands of the developer community, which loses the entire essence of the RERA Act • State has been advised to notify rules under the RERA Act
NCR	✓	✗	• Appointed a regulator recently • Struggling to implement norms
Other Union territories	✓	✓	• Are on a track for successful implementation

Legend: Successfully Implemented | Implemented (Lacks Execution by state) | Struggling to Implement | No signs of state implementing RERA

Source: PhillipCapital India Research

RERA: Some facts and figures in terms of implementation

- As of April 2019, 40,098 projects and 31,129 agents have registered under RERA across the country.
- Permanent regulator is established only in 11 states (excluding J&K) and 2 of 7 UTs.
- Permanent Appellate Tribunal has been established only in three states and three UTs so far (Madhya Pradesh, Tamil Nadu and Maharashtra and Andaman, Dadra and Nagar Haveli, Diu and Daman).
- Interim Appellate Tribunal only in 11 of 28 states.
- Websites are up and running in 17 states and 5 UTs.
- Registration process hasn't started in eight states – north eastern states (barring Assam), West Bengal, Kerala, Lakshadweep; process is still offline in Odisha, Pondicherry, and Assam.
- Six north-eastern states had some issues related to land that belongs to communities and autonomous councils – and the issue is under discussion.
- Jammu and Kashmir does not come under the purview of the Act but the state has recently agreed to implement RERA.

Our on-the-ground research and checks revealed that not only does RERA lacks in terms of 'on-paper' execution, but it also faces several execution challenges. The table below details our research on the status of RERA implementation in each state.

Maharasthra shows how it's done

MAHARERA has set a high benchmark for all the states, even as Uttar Pradesh, Haryana, and Bihar are trying to provide loopholes to the developer community. Eventually, the process should streamline across states; they should follow MAHARERA's footsteps after General Elections 2019.

The states that have been able to set up the RERA regulatory bodies are struggling at all stages – from registration of projects to dispute resolution – because of severe manpower shortage. Maharashtra became the first to resolve this issue to a certain extent by setting up a 33-member arbitration committee to try and ensure that reconciliation between the developers and the applicants (with grievances) can be achieved outside the RERA court to circumvent excess load of the court.

One of MAHAREGA's out of court arbitration meetings being held in Mumbai

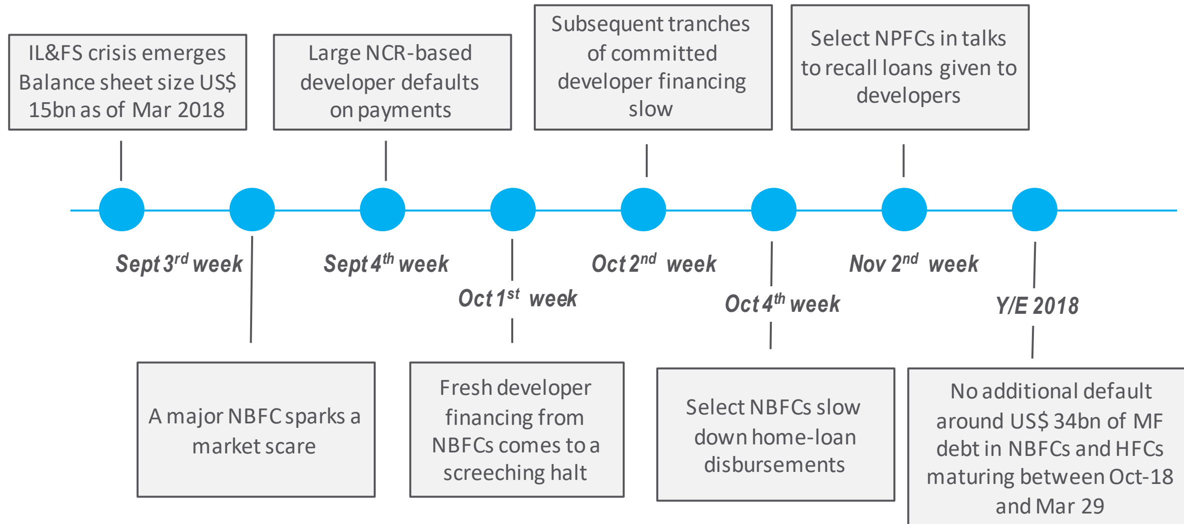
MAHARERA's 33-member committee includes:

- 18 builders who are members of developers' bodies including the Confederation of Real Estate Developers Association of India (CREDAI) and National Real Estate Development Council (NAREDCO). Builder representatives include Niranjan Hiranandani, Paras Gundecha, Rajesh Prajapati, Mukesh Mehta, Pravin Doshi, Vijay Wadhwa and Rajan Bandelkar.
- 15 representatives of Mumbai Grahak Panchayat and Grahak Panchayat Pune to represent homebuyers' interest.
- 15 teams with two members each and three extra conciliators who can be part of the teams in case of any shortfall due to any reason.

NBFC liquidity crisis, implications on residential real estate

Since IL&FS entered troubled waters last year, India's NBFC sector has been facing liquidity concerns. For the sector, commercial real estate (construction financing) and housing represent almost a third of the total lending. After demonetization and GST, developers were cash strapped and NBFCs came to their rescue. NBFC funding to developers saw 30%+ CAGR over FY16-18.

NBFC crisis

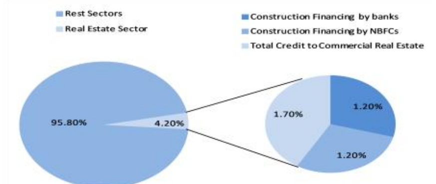


Source: Anarock, PhillipCapital Research

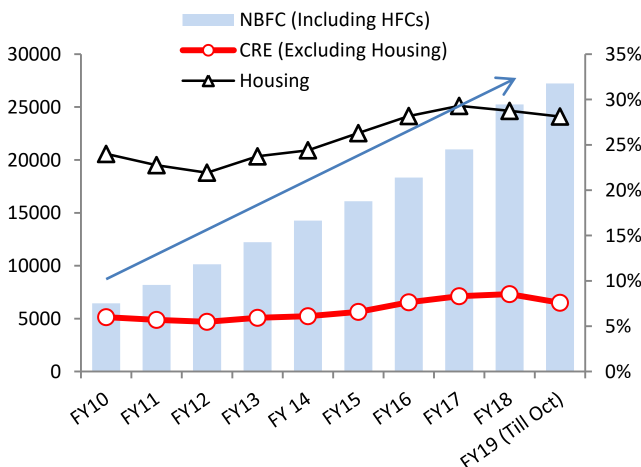
NBFCs have halted new disbursement for residential construction financing

Our checks show that the NBFCs have halted all new disbursements of construction financing loans for the residential segment, along with some existing credit lines. We believe the reason for halting credit lines is that NBFCs are choosing a conservative path to avoid an asset-liability mismatch – it is widely known that NBFCs fund long-term borrowings with short-term funding. On the commercial side, things are slightly better; NBFCs continue to provide Lease Rental Discounting to tier-1 and tier-2 players.

Presently HFCs and NBFCs dominate the previously bank-dominated construction financing segment

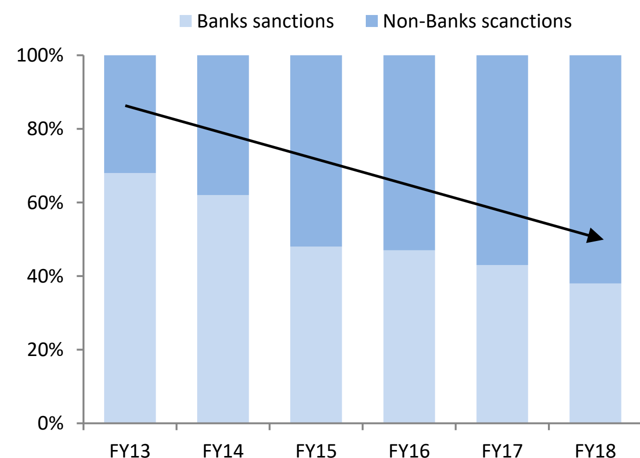


NBFCs: Lending trends to housing and CRE (Commercial Real Estate; construction financing) (INR bn)



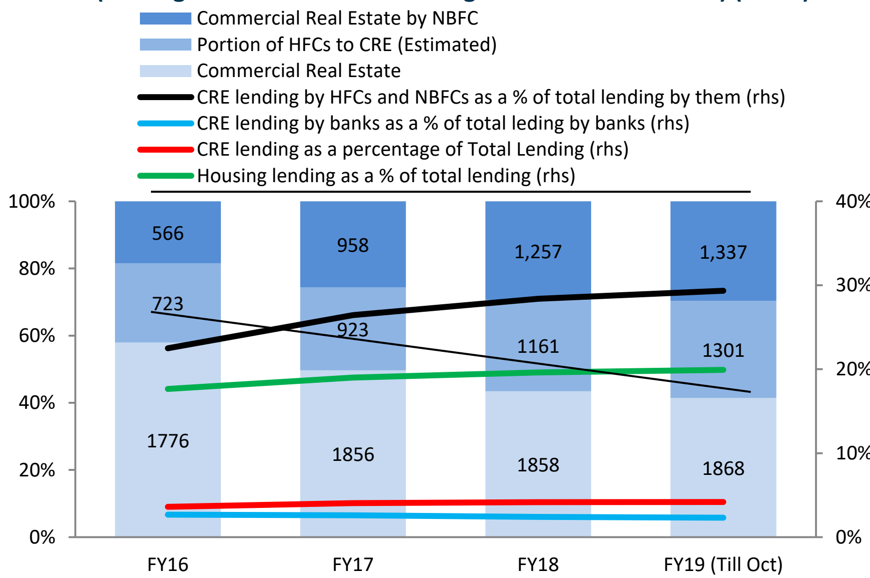
Over the past nine years, lending by NBFCs have grown by around 400%; share of construction financing has grown proportionally over the years

Trend: Banks vs. non-banks (NBFCs + HFCs) lending towards construction financing



Over the past six years proportion of lending by banks towards construction financing has consistently dropped to around 40% from 63% (over FY13-18), indicating the rise of NBFCs and HFCs lending share towards construction financing

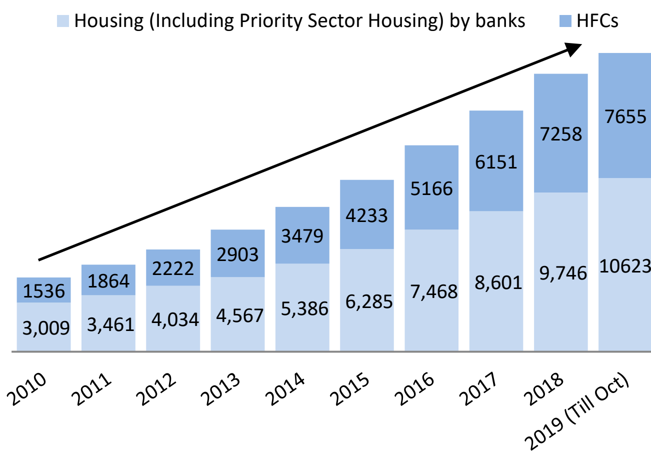
Total CRE (lending for construction financing trend over FY10-FY19) (Rs bn)



Source: RBI, NHB, PhillipCapital India Research

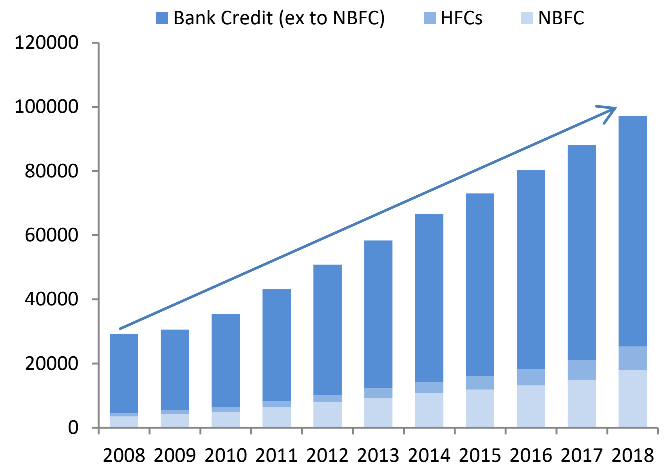
The share of construction financing lending by NBFCs have spiked up in past three years owing to the deficit created by the banks and constitute a major share of their loan portfolio now. From Rs. 466

NBFCs: Lending to the housing sector



Lending to the housing sector has grown steadily with HFCs capturing more share – to around 75% in 2019 from around 50% in 2010

India credit profile



Overall credit growth in India has been strong. Total credit has grown 4x over the past 10 years

Source: RBI, NHB, PhillipCapital India Research

NBFC crisis delayed execution; pace of construction has slowed down

Our channel checks suggest that over the short term, though construction work is going on, its pace has slowed down. If this situation persists over the medium term (say for 2-3 months) it would create a major systemic risk for the industry and may lead to a stalling of projects and even a declaration of bankruptcy by certain players.

Even if NBFCs are able to resume disbursements and lending at the pre-crisis rate, we still reckon borrowing will become costlier by 100-150bps on an average (in some cases it has gone as high as 400-500bps). All four companies that we are initiating coverage on – Godrej Properties, Sobha, Phoenix Mills, and Oberoi – have either very low (from tier-1) or no funding from NBFCs and should not be affected.

We have created a scenario analysis to analyse the impact of the NBFC liquidity crisis on developers. This crisis led to a 150bps increase in interest rate. Our analysis suggests that this would lead to decrease in IRR by 5-7%

NBFC liquidity crisis: IRRs to dip by 5-10% due to 150bps increase in interest

Assumptions (Rs mn)					
Total consideration of the project	10000	**Cost of Land**	2000	**Cost of construction**	4000
Kept in Escrow Account	30%	**Debt**	3000		

	Impact Analysis					
Particulars	**Year 1**	**Year 2**	**Year 3**	**Year 4**	**Year 5**	**Year 6**
Construction Progress	5%	10%	25%	25%	20%	15%
Collection Schedule	10%	10%	25%	25%	25%	5%
Pre-NBFC liquidity crisis						
Outflow	-2500	-500	-750	-750	-750	-750
Inflow	1000	1000	2500	2500	2500	500
Net Cash	-1500	500	1750	1750	1750	-250
Cumulative Cash flow	-1500	-1000	750	2500	4250	4000
Interest Cost	13%					
Cumulative Cash flow post interest	-2687	-2187	-437	1313	3063	2813
IRR	25%-30%					
Post-NBFC liquidity crisis						
Outflow	-2500	-500	-750	-750	-750	-750
Inflow	1000	1000	1000	1500	1500	4000
Net Cash	-1500	500	250	750	750	3250
Cumulative Cash flow	-1500	-1000	-750	0	750	8000
Interest Cost	14.5%					
Cumulative Cash flow post interest	-2746	-2246	-1996	-1246	-496	6753
IRR	20%-25%					

Source: PhillipCapital India Research

The implications of IND AS115

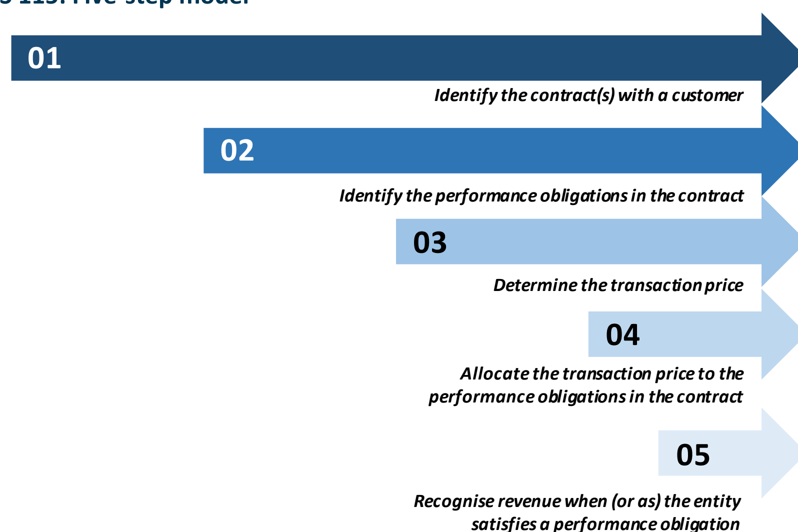
Shrinking P&L, bloating balance sheet; all eyes on cashflows

The new accounting standard Ind AS 115 (FY19) brought about a significant change in the reporting methodology of real-estate players. This new standard superseded all existing guidance available under Ind-AS for revenue recognition, including Ind AS 18 (revenue), Ind AS 11 (construction contracts), and Guidance Notes on real estate.

Globally, under IFRS 15, revenue from contracts with customers is applicable for accounting periods beginning on or after January 1, 2018. Ind AS 115 is an equivalent standard, so under it, this parameter is effective for accounting periods beginning on or after April 1, 2018

Ind AS 115 changed the way many real estate developers account for their sales contracts. Previously, they used *Percentage of Completion Method* (POCM) in which they would start recognizing revenue once a certain threshold of construction and sale was reached and thereafter in proportion with the progress percentage. IND AS 115 uses the Completed Construction Method under which the revenue as well as expenses are recognised only when there is assurance of revenue (in most cases this would imply that revenue is booked on application/receipt of the occupation Certificate (OC) by the builder).

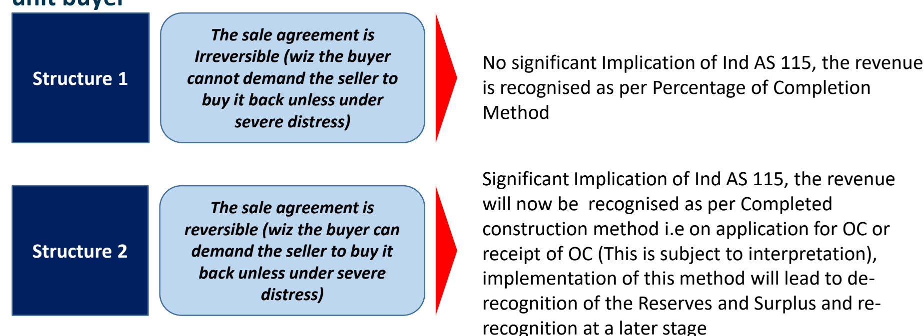
Ind AS 115: Five-step model



Source: PhillipCapital India Research

The revenue recognition as per IND AS 115 revolves around the assurance of revenue, which in turn depends on the type of sale agreement made by a developer with the buyer. In the following diagram, we have explained the probable scenarios of the sale agreement and the revenue-recognition mechanism attached to them.

IND AS 115: Transition to SOTP based on the structure of the agreement with the unit buyer



Source: PhillipCapital India Research

Structure 2: Majority of tier-1 real estate players follow the second agreement structure. Under this:

- Buyers can re-sell flats to developers whenever required. In this scenario, the sale of a unit does not guarantee an assured collection – as per Ind AS 115, the revenue in such a sale cannot be recognized.
- All the developers following this contract structure have to change their accounting method to *Completed Construction* (recognising revenue and expenses only once the project is complete) from *Percentage of Completion Method*. Note that the law is a bit loosely defined, so some players have chosen to recognize revenue on receiving the Occupation Certificate (OC) and some on application of OC.

The firms have to adopt a retrospective approach. They will have to write-back the revenues booked so far for on-going projects and re-book the same revenue again when the firm applies for or receives an occupation certificate.

An example:

- If a firm has sold 50% of a project value at Rs 2bn (i.e., Rs 1bn of an on-going project) since its launch two years ago, then over these two years it would have recognised this Rs 1bn and its corresponding expenses.
- Under the new approach, the firm would needs to write off Rs 1bn recognised for now.
- When the project receives OC, this Rs 1bn plus the incremental area sold until the OC was received, along with an expense proportional to total sales – will be recognised. This re-recognition of Rs 1bn will lead to a misleading upward adjustment in revenue showing incorrect financial position.

We believe that all these firms should take an average three years to retrieve the written-back equity on their books. Because of this, their balance sheets and P&Ls would not be able to show their true underlying positions – that is, they wouldn't reflect revenue and expenses in a straightforward way – and therefore cash flow statements would be a key indicator of the financial performance of the projects.

A major implication of the adoption of these standards is that revenues of these firms shall be lumpy going forward.

- Players following structure 1 won't see any significant change in their accounting policies. They will continue to report as per percentage of completion method.

IMPORTANT: Because of written-off amount re-entering the books, companies' balance sheets and P&L statements will not be able to show the 'real underlying' – i.e the real-time sales and expenses incurred at any given point for the next 2-3 years

Also, during the entire project life cycle the revenue and expenses will be capitalised, which will lead to bloating of the balance sheet and shrinking of the P&L

Hence, cash flow would become a really important metric that will be tracked

List of real estate players and their corresponding equity write-backs

Company	Equity write-back (Rs mn)
Godrej Properties	7,411
Oberoi Realty	No/Negligible impact
Phoenix Mills	1,132
Sobha	7,570
DLF ltd	53,828
Brigade Enterprise	4,066
Purvankara	6,100
Prestige Estates	8,992
Sunteck Realty	No/Negligible Impact

Source: Company Financials, PhillipCapital India Research

Note: as per company financials in Q1 FY19

PMAY (especially CLSS): Proving to be revival lever

Pradhan Mantri Awas Yojna (PMAY)

Housing for All – Old wine in a new bottle

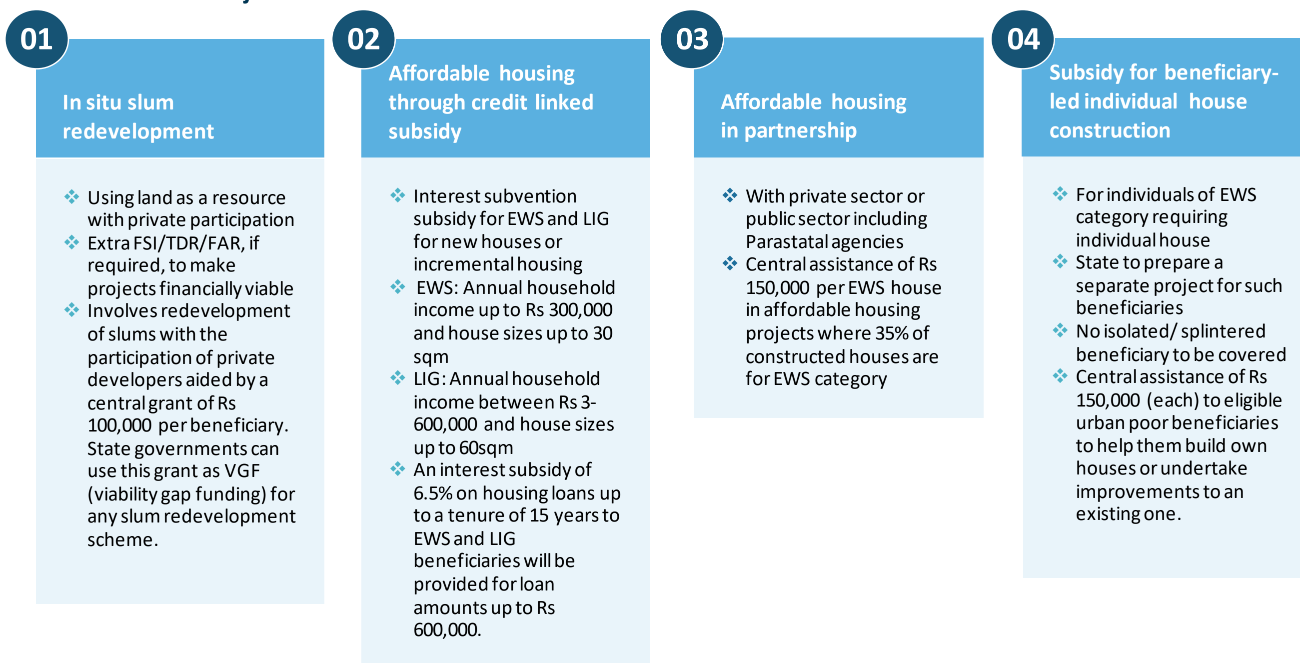
Under this programme, the government has set an ambitious target of achieving Housing-For-All by 2022 – marking 75 years of the country's independence. The government envisages *pucca* houses with water connections, toilet facilities, and 24x7 electricity.

Under the National Gramin Awaas Mission (NGAM) – which is part of PMAY – the government plans to spend Rs 3.5tn to build c.30mn houses for the homeless by 2022 in rural areas. NGAM replaced the Indira Awaas Yojana (IAY) that covered BPL families only. The houses will be built for the Economically Weak Section (EWS), ST, SC, and women (irrespective of caste and religion). Housing for All, along with *100 Smart Cities,* should provide a major thrust to the real-estate sector.

A demand for 25mn homes is estimated (4x of the entire current stock) up to FY22 in the MIG (Mid Income Group) and LIG (Low Income Group) categories.

Under the scheme, central assistance is provided to Urban Local Bodies (ULBs) and other implementing agencies through States/UTs for:

Pradhan Mantri Awas Yojna



Source: Company Financials, PhillipCapital India Research

Credit Linked Subsidy Scheme (CLSS)

CLSS is an attempt to make PMAY a realistic measure rather than just populist

Under PMAY, government has been able to craft a space for private players by introducing the Credit Linked Savings Scheme. Basically, CLSS offers interest subvention on home loans taken by eligible Indians for buying or constructing a house. For developers it means demand impetus, ensuring higher sales velocity for their projects.

The Credit Linked Subsidy Component will be implemented under Central Sector Scheme while other three components (in-situ slum redevelopment, affordable housing in partnership, subsidy for beneficiary-led house construction) will be implemented under the Centrally Sponsored Scheme (CSS) The PMAY scheme is

operated using a bidding system wherein the players bid for the construction project against either a fixed fee or a fixed fee plus bonus or fixed fee plus land parcel for generic development. The model varies from state to state. CLSS is an open scheme where the developer is free to choose a land parcel and proceed with development as per its convenience, within the specification mentioned in the table below defined in the Credit Linked Subsidy Scheme.

For developers: Under the scheme, developers have to adhere to size specifications and other stated norms. They receive multiple benefits, chief among which is tax saving. Due to expectations of huge demand for housing under CLSS, many tier-1 developers have either started their projects under the scheme or are scouting for opportunities within. However, our ground research also suggests that due to the complexity of the clauses in this scheme, many developers are shying away from it or are adopting a very conservative approach. A major risk to the scheme is the current government not returning to power in the coming general elections.

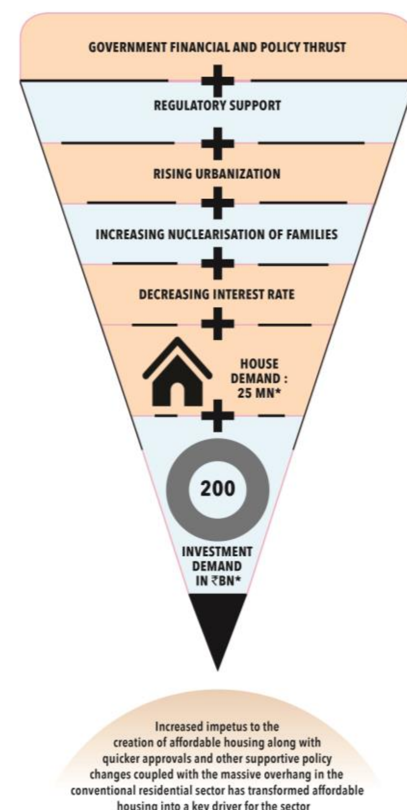
For buyers: Under this, buyers can avail interest rate subsidy on buying a house in such a project – the amount of subsidy is defined on the basis of the income group that buyers fall into. This subsidy, coupled with an already benign interest rate and affordability at a decade-best level, has brought the dream of a house within reach of many.

The Credit Linked Subsidy Scheme has been classified according to the income levels of beneficiaries:

1) Economically Weak Section
2) Low Income Group
3) Middle Income Group – 1
4) Middle Income Group – 2

Based on these income levels, the projects have different constraints to be followed. The table below depicts various CLSS categories and their constraints/rules.

Affordable Housing: Riding on multiple thrusts



Credit Linked Subsidy Scheme – Tailored plans for income groups

Criteria	Existing Instructions (CLSS – EWS +LIG)	Revised Instructions (CLSS – EWS +LIG)	CLSS (MIG-I)	CLSS (MIG-II)
Household/ Annual Income (Rs)	Upto Rs. 6 lakhs	Upto Rs. 6 lakhs	Rs. 6.01-12.00 lakhs	Rs. 12.01-18.00 lakhs
Property Area (Carpet Area ##)	30/60 sqm*	30/60 sqm*	160sqm	200sqm
Location	9694 towns	9694 towns	Urban -2011*	Urban -2011*
Woman Ownership	Yes (except for construction)	Yes (except for construction)	NA	NA
Max Loan Amt for Subsidy	Upto Rs. 6 lakhs	Upto Rs. 6 lakhs	Upto Rs. 9 lakhs	Upto Rs. 12 lakhs
Subsidy %	6.50%	6.50%	4%	3%
Subsidy Amount	Rs. 2.20 lakhs	Rs. 2.67 lakhs	Rs. 2.35 lakhs	Rs. 2.30 lakhs
NPV	9%	9%	9%	9%
Max term of loan (on which subsidy will be calculated)	15 yrs	20 yrs	20 yrs	20 yrs
Property should be Family's	1st home	1st home	1st home	1st home
Validity	2022	2022	31/03/2020	31/03/2020
Applicability	Loans approved on/after 17/06/2015	Loans approved on/after 01/01/2017	Loans approved on/after 01/01/2017	Loans approved on/after 01/01/2017

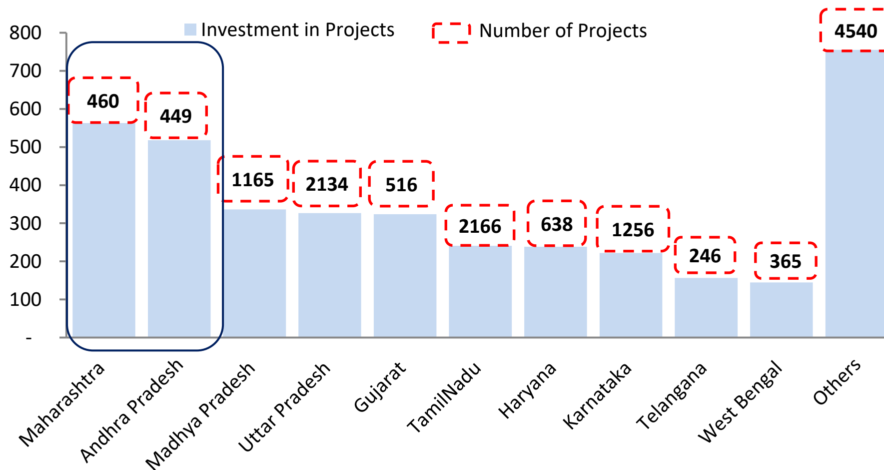
Source: State Bank of India, Ministry of Housing and Urban Affairs, PhillipCapital India Research

Status of PMAY

Few states have been on the forefront of PMAY implementation, with Maharashtra leading by infusing Rs 5.63bn since the inception of the programme followed by Andhra Pradesh, Madhya Pradesh, UP, and Gujarat. The programme is implemented with a joint corpus formed by the central government and the state. The highest amount of assistance by the centre has been provided to Andhra Pradesh at Rs 1.45bn followed by UP and Maharashtra. The PMAY program in states that are more dependent on the centre's assistance (Andhra Pradesh, Madhya Pradesh, UP, Tamil Nadu) faces an inherent risk if the ruling party doesn't win General Elections.

Maharashtra and AP at forefront of investment allocation

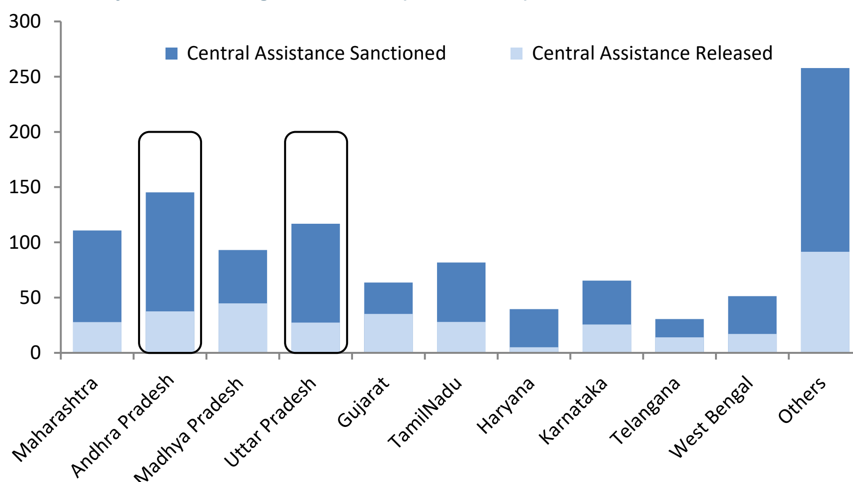
Investment in projects (INR 10 mn)



Source: Pradhan Mantri Awas Yojana, PhillipCapital India Research

MP, Tamil Nadu and Karnataka have been allotted highest amount of central assistance (as a% of total Investment)

Assistance by the central government (INR 10 mn)

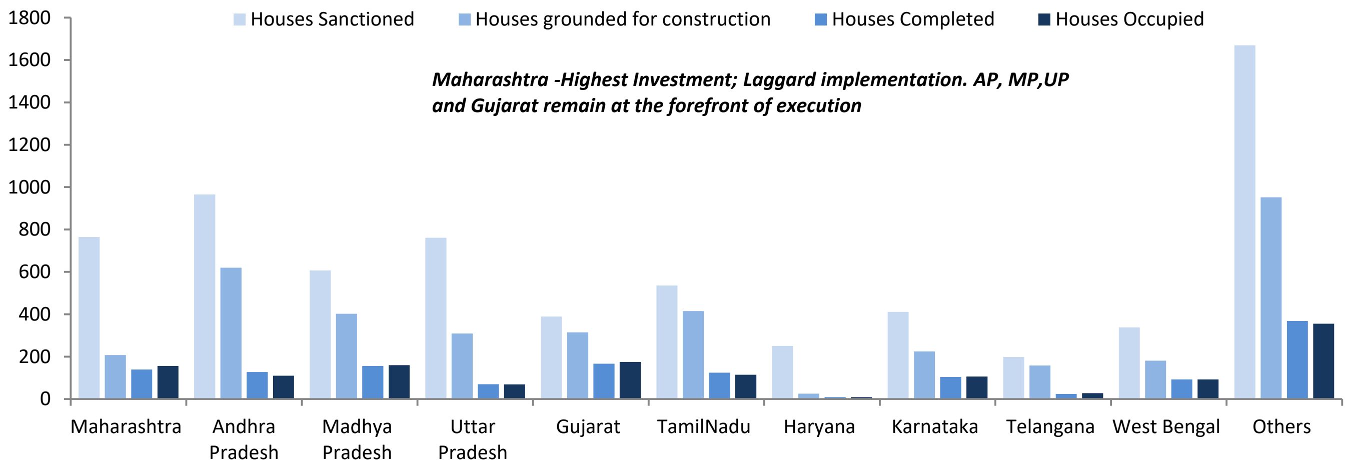


Source: Pradhan Mantri Awas Yojana, PhillipCapital India Research

While many states have shown good progress in terms of grounding houses only few states such as Andhra Pradesh (620,000 houses grounded out of 965,000 planned) and Tamil Nadu (415,000 out of 536,000 planned) have been able to deliver the houses. The rest of the states have lagged behind in terms of execution.

Grounding houses or grounded houses is an industry term – it means houses where construction has begun

Number of houses under construction in select states

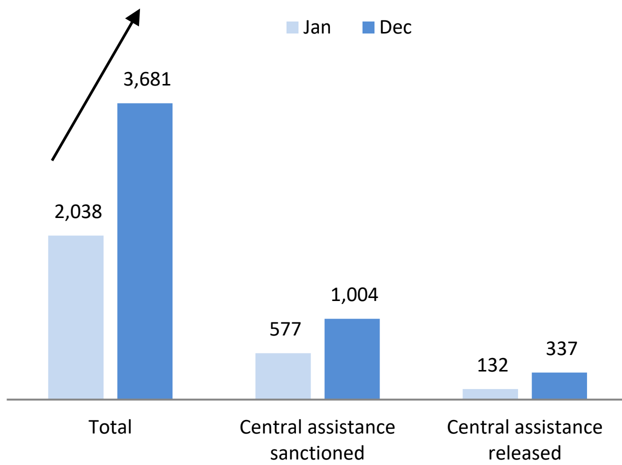


Source: Pradhan Mantri Awas Yojna, PhillipCapital India Research

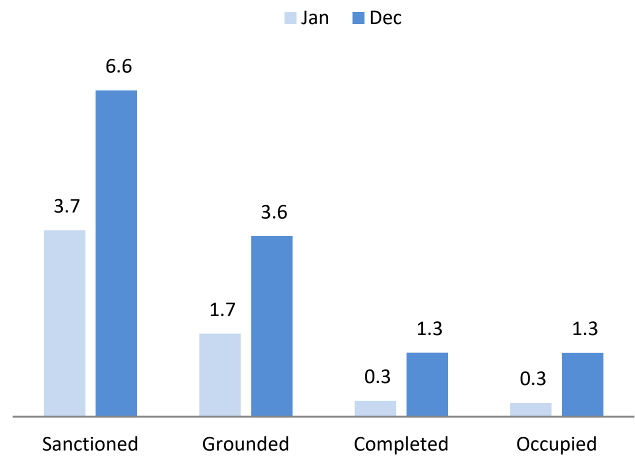
Status of PMAY across India: UP, AP, Tamil Nadu, MP, Gujarat and Maharashtra have seen strong investments for construction of houses

In CY18, the implementation of PMAY picked up pace. Total investment sanctions by states increased 80% to Rs 36.8bn in December 2018 (from Rs 20.38bn in January 2018). This time around, the progress isn't just limited to the budget sanctioning, but has also reflected in execution, as the total number of houses grounded in the year went up by 75% to 6.6mn (from 3.7mn in January). This shows the state governments' commitment towards the implementation of PMAY.

PMAY: Picking up pace…

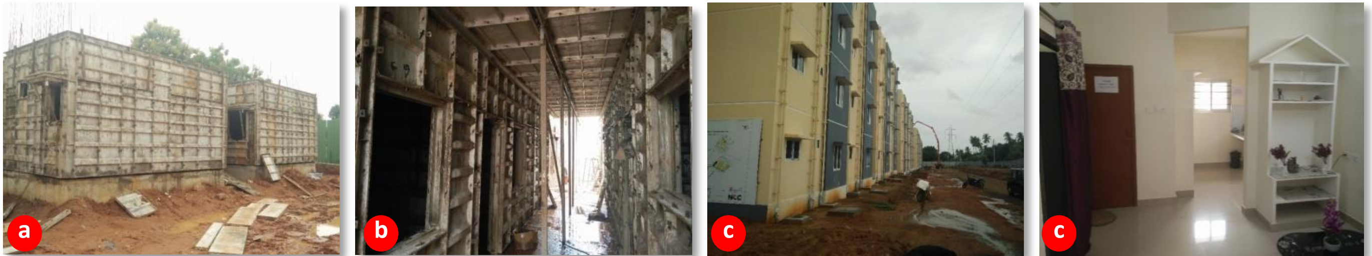


…translating into reality at a robust pace



Source: Pradhan Matntri Awas Yojna, PhillipCapital India Research

Implementation of one of the projects undertaken under PMAY



a. Structure erected from aluminium formworks
b. Aluminium formworks used in MIVAN technology
c. View of a block of flats complete, and ready to move-in

Conclusion

- The residential real-estate sector is on a path towards recovery, but it remains plagued by the massive inventory overhang. The sector *has* seen a trend reversal over the past few quarters – with demand outstripping supply.
- Our research suggests that the sector is in the middle of a transition – from investor-led demand to end-user-led demand.
- Hence, it will also transition from a *Pricing Play* to becoming a *Volume Play*.
- Mid-ticket size (budget) and affordable housing (including PMAY) will drive the sector.
- Execution capabilities and strong brand presence will drive premiumization and valuations.
- Despite an overall bearish outlook, certain players will be able to capitalize on opportunities and continue to deliver consistently high performance.
- The sector has seen a directionally positive Budget 2019, which brings a new ray of hope (conditions apply).
- The slashing of GST rates may actually result in home prices going up. GST rates have been cut by 7% – bringing normal under-construction rates down to 5% from 12% and PMAY to 1% from 8%. This will provide an impetus for demand. However, this move comes without input tax credit for developers. Since margins of developers are already under pressure, many may not be able to absorb the differential tax loss and will raise prices.
- According to our research, currently, affordability is at its best level of the last five years, which should spur demand.
- With implementation of IND AS 115 and the sector being dependent on execution capabilities, cash flow will be keenly watched.
- Rising debt and scarce liquidity are key concerns.
- We reckon that the next supply wave will hit in 2021-22. And by then, if demand doesn’t catch up, the sector may again enter a bearish phase. Until then, demand should stay slightly above supply, leading to a fall in overall inventory levels, keeping prices steady.

CHAPTER 3:
Commercial segment – Demand supply dynamics fairly balanced for now

Commercial segment: Pre and post 2010

Era 1: Pre-2010. Dawn and dusk of old-school commercial assets

Before 1990s, commercial real estate as a concept didn't exist in India. It was restricted to small pockets in only Mumbai and Delhi. The License Raj Era posed significant business environment challenges and with India having only a few large corporates, the demand for the commercial spaces was very low.

New-age sectors led to the rise in demand for swanky commercial spaces

Commercial real estate started picking up pace with the advent of the Indian IT sector in the late 1990s. As these players grew in size, the demand for Grade A quality spaces started rising and spreading throughout India. To meet this demand, commensurate supply started pouring in. High rental yields attracted many players to the commercial segment by the early 2000s; with growing demand from IT, BFSI, and GICs (Global In-House Captives) the demand for commercial spaces thrived.

Insulation from regulatory and business environment headwinds keep the annuity play intact

Subprime ripple effects

After 2008, the subprime crisis led to a slowdown in IT and BFSI spend globally and India faced ripple effects, as a major share of the business of these fast-growing sectors and Indian IT giants came from the US. The BFSI sector also slowed down. By 2008, the pace of supply was already outstripping demand and after 2008, demand for commercial spaces saw a dramatic slowdown, which led to very high inventory levels and a drop in realization yields.

Era 2: Post 2010 – thriving, after changing

Consolidation, insulation from regulatory and business environment headwinds and equity influx

- **Consolidation:** Before 2008, many small developers had entered commercial real estate to ride the annuity wave. One key difference between commercial and residential assets is that the former are capital intensive. With falling demand and consequent lower yields and higher vacancy, it became difficult for smaller players to survive in this capital-intensive area. This led to consolidation in the industry by around 2010.
- **Supply slowed down:** Consolidation allowed the sector's supply to slow down via natural progression. After 2013's Eurozone crisis, supply hit an all-time low and in select micro markets, there was a turnaround when demand began to outstrip supply as the economy started to pick up pace. Rising demand brought about new business districts. For example, BKC in Mumbai when the traditional central business district (CBD) was south Mumbai (Ballard Estate, Fort, Nariman Point) and DLF Cyber city in NCR when the traditional CBD was Connaught Place. The rise in demand was for the Grade A quality office spaces with high-end amenities and infrastructure in the Business Districts and not for the standalone commercial structures in the cities. Overall, at a pan-India level, since 2013, transactions have been outstripping supply, which has led to a continuous fall in vacancy levels from a peak vacancy level of 20% in 2012 to around 12% in 2018.
- **Commercial is relatively insulated:** Insulation from RERA, GST, and the liquidity crunch (demonetisation and NBFC liquidity crunch) are a boon for the sector. RERA (a buyer protection norm) is primarily applicable for projects that includes multiple buyers. A commercial property is typically owned by the developer and leased out; it is typically outside RERA's purview,. Also, as the developer typically owns the property and leases it (no selling involved), there is no question of different GST (under-construction, ready to move in). While demonetization did have a temporary impact in supply in 2016 and 2017, the sector recovered soon because it has easy access to LRDs (Lease Rental Discounting) from banks, which is why the recent NBFC crisis also hasn't really affected commercial real estate as much as it did residential.

DLF Cyber Hub, Gurgaon

Bandra Kurla Complex, Mumbai

LRD is a term loan offered usually to property developers against rental receipts from lease contracts with their corporate tenants. Such a loan is based on the discounted value of the rentals and the underlying property value

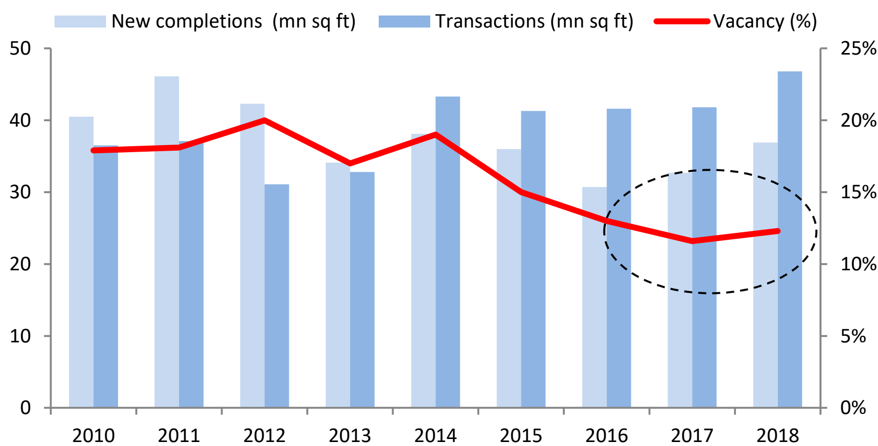
Demand dynamics….

Demand has now out-stripped supply

In CY18, supply at a pan-India level (considering Ahmedabad, Bangalore, Chennai, Hyderabad, Kolkata, MMR, NCR, and Pune – basically, top-8 cities) was 36.9mn sq. ft., 24% lower than transactions (demand) of 46.8mn sq. ft.; overall vacancy level was c.12%, dropping from highs of 19% in CY14.

Sectors driving demand spree are discussed in detail in sections below.

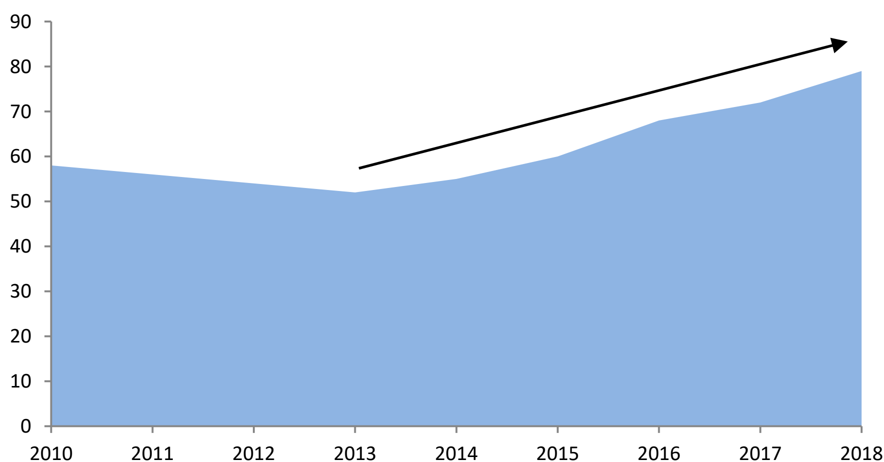
Demand continues to outstrip supply: Vacancy at decadal lows



Source: Cushman Wakefield, PhillipCapital India Research

Due to higher demand vs. supply, average rentals (per sq. ft. per month) have risen c.33% to Rs 79 from Rs 60 in CY15-18. Overall stock of commercial spaces in India currently stands at c.670mn sq. ft. out of which c.587mn sq. ft. is occupied (accounts for only seven cities mentioned below).

Weighted average rental (per sq. ft. per month) – 9% CAGR from 2013

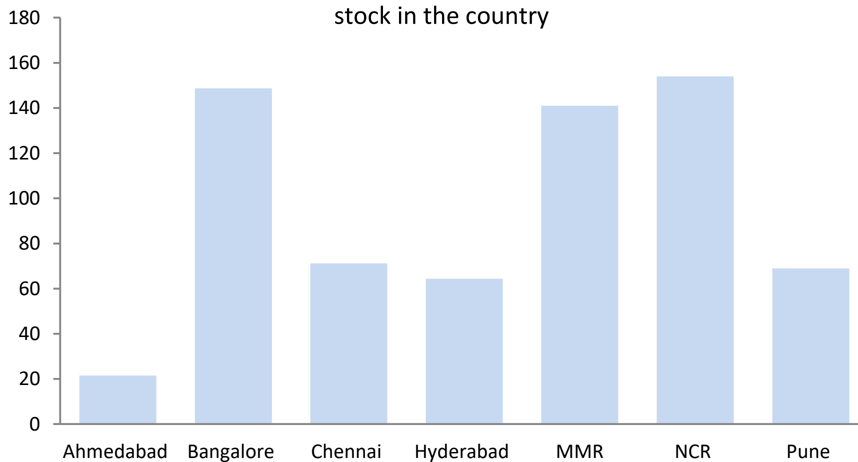


Source: Cushman Wakefield, PhillipCapital India Research

NCR, MMR, and Bangalore combined constitute a third of total commercial stock in top-three cities), which incidentally are the key drivers of commercial real estate in India. While Hyderabad, Pune, Chennai these three cities are rising rapidly and emerging as major commercial centres in India

Office stock (in mn sq. ft.)

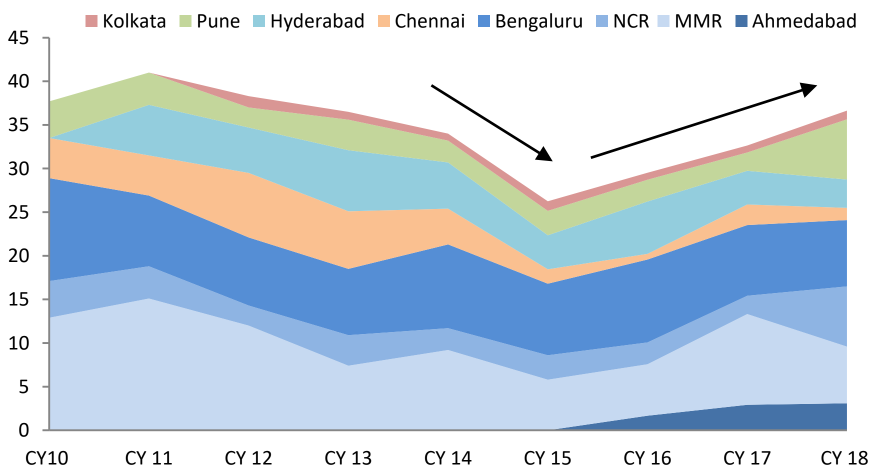
Bangalore, NCR and MMR have the highest office stock in the country



Source: Cushman Wakefield, PhillipCapital India Research

Supply of commercial spaces in various cities has slowed down. Across all major cities, supply declined from CY11 to CY15. Our ground research suggests the CY14 aberration was because of a deliberate delay in projects by developers fearing that the spill-over effect of the Eurozone crisis in India might dampen demand. After CY16, the supply of commercial spaces across cities has improved. The commercial segment is more a regional play rather than a national play, unlike the residential segment.

Supply trend across cities (in mn sq. ft.)

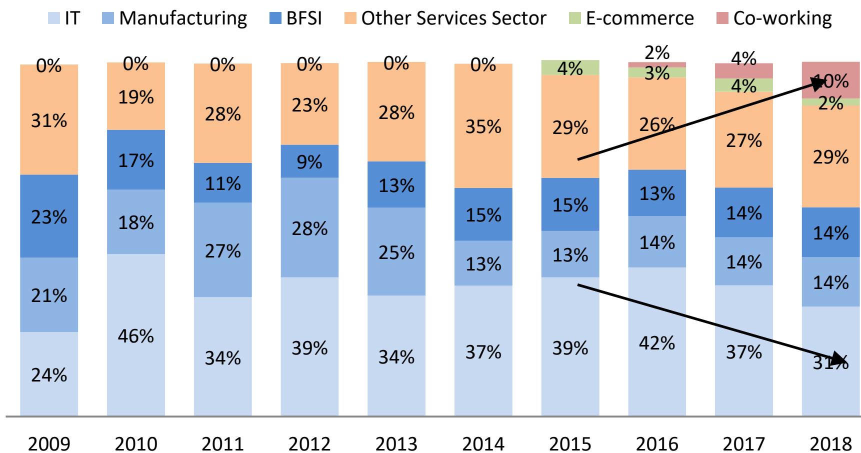


Source: Cushman Wakefield, PhillipCapital India Research

Industry recalibrating: Shift in demand drivers

In the past, the IT sector and GICs (global in-house captives) were major drivers of commercial real estate in India for a greater part of the micro markets. Manufacturing and BFSI are the next biggest, but while they are huge contributors in terms of the space hired, due to their cyclical nature, they are relatively conservative about renting space.

India office absorption by sector

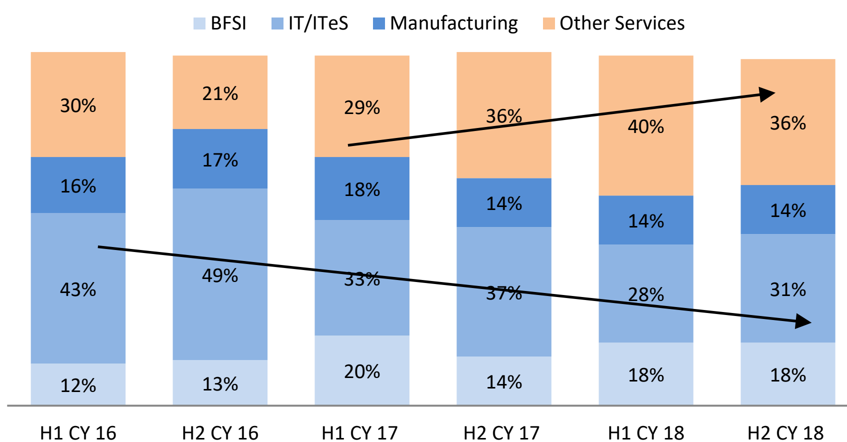


Source: Cushman Wakefield, PhillipCapital India Research

IT sector slowdown: An alarming signal for the commercial sector

Over CY16-18, demand dynamics for commercial real estate have changed significantly. With the IT sector facing headwinds, its share of lease in the commercial segment fell to 30% from 40% over CY16-18.

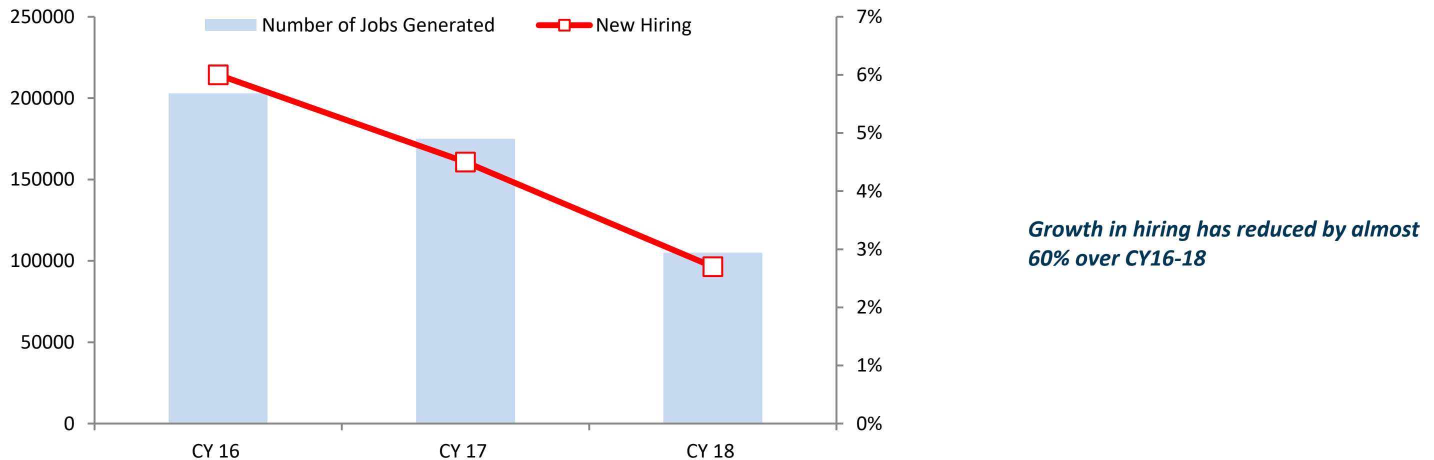
Sector mix: Share of IT falling, others rising led by co-working spaces



Source: Cushman Wakefield, PhillipCapital India Research

IT's slowdown is visible in a fall in its hiring and earnings pace. As per data provided by NASSCOM, the sector employs 3.96mn people, and over CY16-18, new employment generated by the sector fell to 3% of the employment base from 6% earlier (to 105,000 from 203,000). Across the top-five Indian IT giants (TCS, Infosys, Wipro, HCL Tech, and Tech Mahindra) there is an overall slowdown in revenue growth in these years.

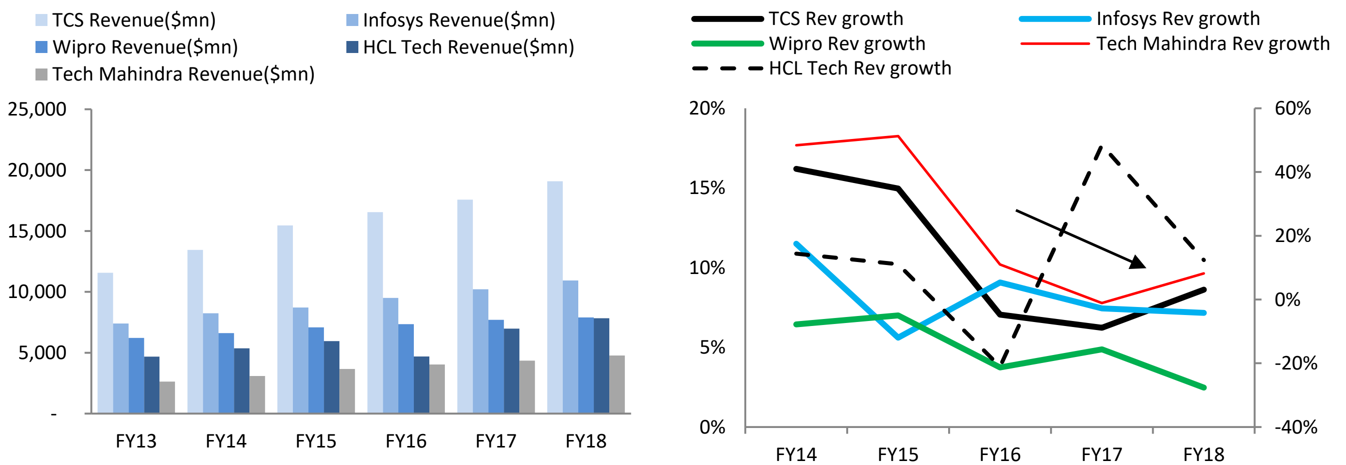
IT: Fall in hiring shows slowdown



Source: NASSCOM, PhillipCapital India Research

Growth in hiring has reduced by almost 60% over CY16-18

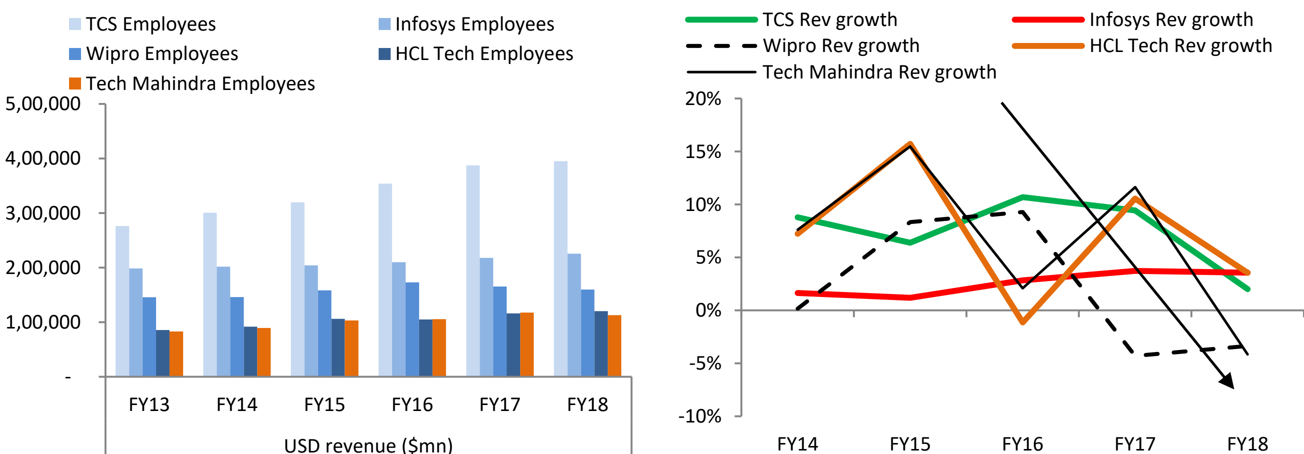
Slowdown in IT is evident from the slowdown in the revenue growth of Indian IT majors



Source: Company Data, PhillipCapital India Research

IT majors: Slowdown in revenue growth and employment

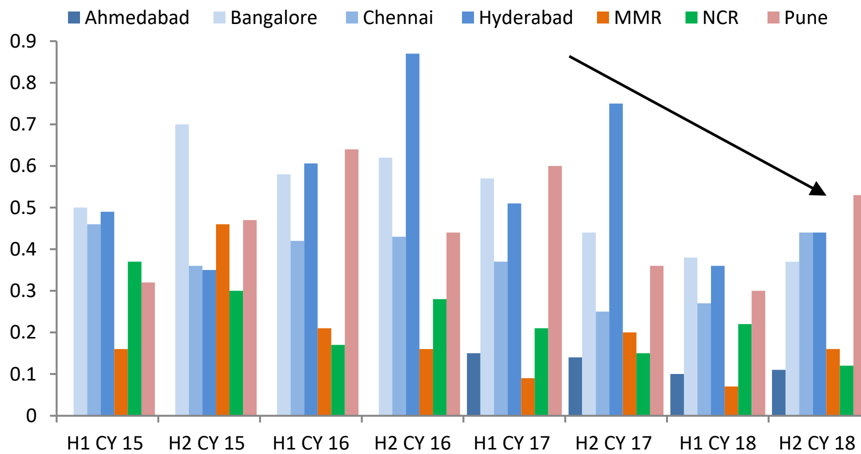
Slowdown by hiring by IT firms is evident from slowdown in the growth of their number of employees



Source: Company Data, PhillipCapital India Research

The fall in share of space leased by the IT sector can be seen across all the cities barring a few, which our ground research suggest might be because of lack of quality office spaces in those particular places or because some players made pre-lease commitments whose delivery might have led to the temporary spurt (especially in CY16). However, by and large in the last two years, the effect of a slowdown in terms of space hired by the IT sector is clearly visible.

Fall in share of space rented by IT across cities corroborates IT slowdown story



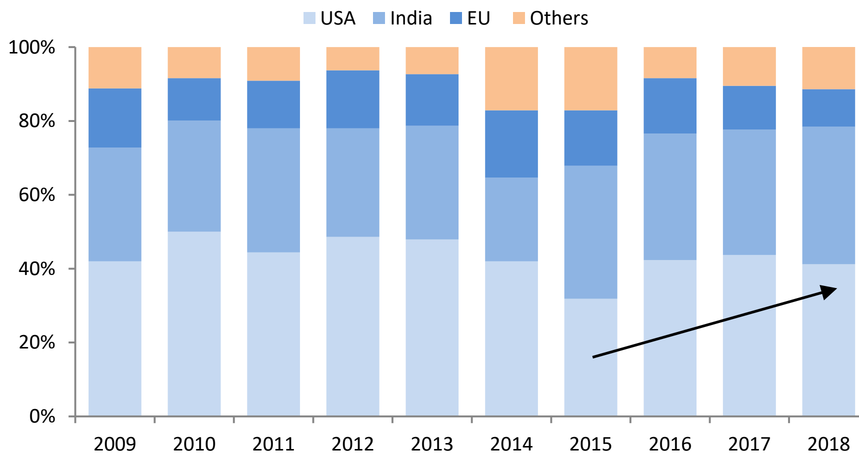
Source: Cushman Wakefield, PhillipCapital India Research

The demand journey: IT → ecommerce → co-working spaces and GICs

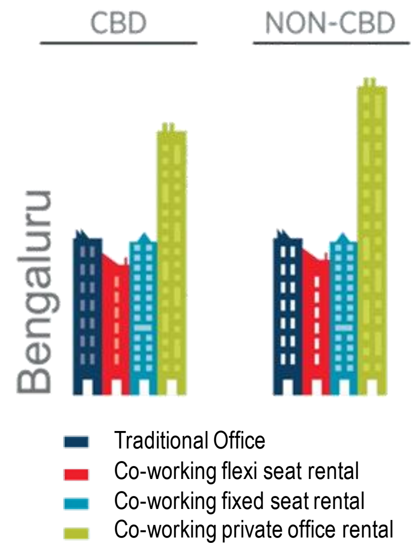
There has also been a marginal rise in the uptake from the BFSI sector.

- **IT sector slows down**: Cut in technology spends globally led to increasing demand for and spend on innovative products and on more analytics driven products is closing down certain global economies. On-going gradual shift in hiring patterns of the IT companies. Earlier contacts of these IT firms with clients were on a fixed headcount basis, which are now migrating to fixed-price no-headcount basis, which reduced in surplus or 'forced' over-recruitment by IT players.
- **Ecommerce grows:** We believe the void created by the lack of demand in 2015-16 was filled by the e-commerce sector – whose share increased to 4% of the total leased space. Then the ecommerce sector also slowed down in 2017-18 leaving another void.
- **Co-working spaces emerge:** The void left by ecommerce has begun to be filled by co-working space players, which are growing at a fast pace.
- **GIC:** The void created by the core-IT sector was partly filled by the IT/ITES sub-sector – GIC (Global In-House Captives). There has been a significant rise in demand for commercial spaces by GICs, as India becomes a favoured geography for many US-based companies. As the growth outlook for India has been consistently amongst the highest in the world, many firms have entered the Indian market with an aim to expand their global footprint and to be a part of India's growth story. This is corroborated by World Bank's India ranking in ease of doing business – which has improved dramatically over the past five years to 77 from 139. From a 25-30% pie of total leasing pre-2014, US-based companies' renting of space has gone up to 35-40% in 2014-2018. Firms like Amazon, Google, Microsoft, and Goldman Sachs have taken huge spaces on lease. As these GICs have better operating efficiency because of lean structure and overall cost effectiveness of 30-35% due to the operation shifting to India, there is continued demand from them.

US-based firms back on a renting spree



Source: Cushman Wakefield, PhillipCapital India Research



CBD
- Bengaluru - Includes M.G.Road, Millers Road, Vittal Mallya Road, Residency Road, etc.
- Gurugram - DLF Cyber City and MG Road,
- Mumbai - Bandra-Kurla Complex

NON-CBD
- *Bengaluru* - Outer Ring Road, includes Sarjapur, K.R Puram, Hebbal
- *Gurugram* - Golf Course Road
- *Mumbai* - Andheri-Kurla Road

Will co-working spaces drive the next leg of the commercial segment?

India is at the cusp of a co-working revolution with several large players spread across the country. The country is seeing a proliferation of start-ups and SMEs aided by government's efforts to promote them under the "Make in India" campaign. This provides a perfect platform for co-working business centres to cater to the office-space needs of these growth-seeking start-ups and freelancers.

Besides companies, people such as business nomads, expats or those travelling to the country for a limited period prefer to work out of co-working spaces. Until a few years ago, they would have opted to work from coffee shops. One key – aspect of co-working spaces is that it provides an office-type professional environment and setup for start-ups and individuals.

There are several benefits of operating out of a co-working environment:

STRAIGHT LEASE	CO WORKING LEASE
• Asset heavy • Capital intensive • Property leased by operator • Full control of services, amenties, branding • Higher risk • Optimises revenue through membership	• Asset light • Operator undertakes fit-outs, branding • Co-working company gets a fixed share of revenue • Various ratios for revenue share • Allows company to focus on core competency

- Companies are offered an organised and synergized working environment along with business networking opportunities with other users.
- Start-ups and SMEs stand to save as much as 15–20% by working in a co-working space, while enjoying the benefits of a fully functional, plug-and play modern workplace.
- The model provides access to a number of shared amenities and services such as conference rooms wi-fi connections, refreshments, and recreational spaces, as well as the flexibility to scale up or decrease.

A cost-benefit analysis of co-working spaces by Cushman Wakefield

- Cost-benefit analysis of various micro-markets in CBDs and non-CBDs performed by Cushman Wakefield proves that co-working with a fixed-seat rental is a lucrative alternative for many players.
- On an average, the cost per seat per month in a co-working centre in NCR (CBD Delhi) is about Rs 10,000-15,000 while it is Rs 12,500-16,000 in CBD Gurugram. With prime rentals in Gurugram averaging Rs 260-270 per sq. ft. per month, rent for an office space of 700 sq. ft. housing 10 employees would amount to a whopping Rs 189,000 per month plus HVAC expenses, which are typically about 10% of rent, plus basic infrastructure cost and an additional service staff. In contrast, 10 seats in a co-working centre would cost Rs 160,000 per month. However, when the number of employees increases to say 20, co-working space might seem more expensive at Rs 320,000. However, for companies that have higher seats requirement, co-working players operate on a private co-working-space model that operates on the 'economies of scale' concept offering space for larger requirements at a discounted rate.

The co-working segment has quickly grown in terms of participation

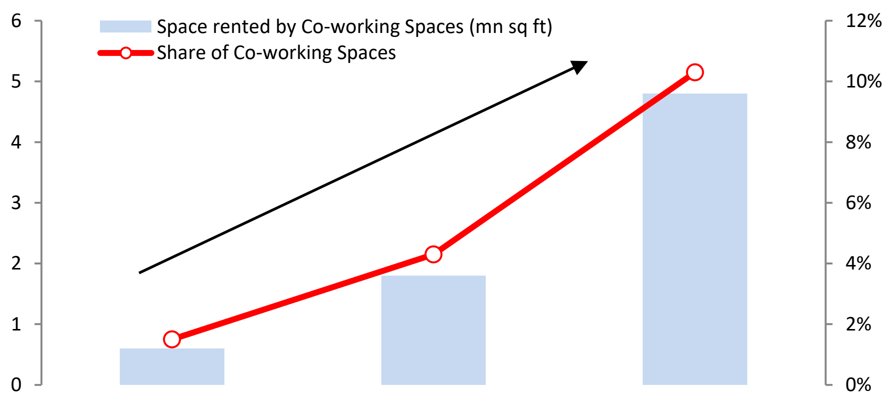
There are players like WeWork – a US-based shared office space giant that has signed an agreement with the Embassy Group to develop a facility in Bengaluru at an estimated investment of US$ 100mn.There are also home-grown co-working players like Awfis, which has managed to get an investment of Rs 1.3bn from Sequoia capital and is growing rapidly.

Some major co-working spaces in India

In total, co-working spaces in India have leased out more than 9mn sq. ft. of space, while more 6mn sq. ft. is estimated to be pre-leased. In 2018, the leasing transactions by co-working spaces stood at 4.8mn sq. ft., which translates into 10.3% of the total transactions in the top-8 cities. At present, India has about 300 co-working spaces.

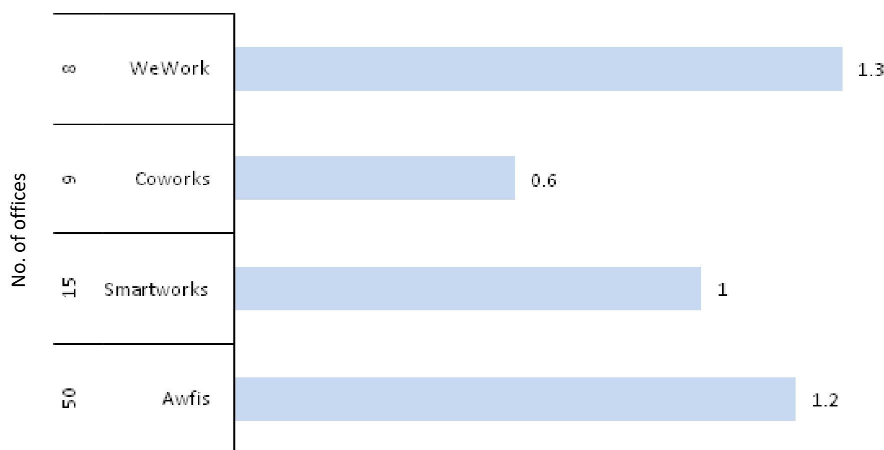
Not only individuals and start-ups, but even mature firms prefer hiring co-working spaces for a variety of reasons – to meet temporary demand, to augment a need for quality office space, or to have a presence in a particular geography or area. Global giants like Google, Amazon, Tata, and Siemens have already started operating from co-working spaces. So far, key players such as WeWork and Awfis have leased out more than 1mn sq. ft. Awfis currently operates more than 50 setups while MyHQ operates more than 80.

Meteoric rise in share of co-working players



Source: Knight Frank, PhillipCapital India Research

Area leased by key co-working players



Source: Cushman Wakefield, PhillipCapital India Research

WeWork and Awfis are at the forefront of leasing spaces across India

Not just growth, innovating from the get go

For example, Awfis is the first company in this space to have introduced a mobile app that enables users to find and book office and meeting spaces on a real-time basis in its centres across the country. Besides its own managed co-working spaces, Awfis also offers a large repository of listed third-party meeting rooms in hotels in various cities. Another co-working player, myHQ, offers a mobile app that lets customers book a corner in cafes, restaurants, and hotels. As opposed to a conventional co-working model, myHQ converts unused spaces into work areas. Additionally, one could even avail discounts on food and beverages at a pub or chosen café.

Bangalore, Mumbai and Gurgaon have been at the forefront of the co-working revolution, even as cities such as Chennai, Hyderabad, and Pune are seeing a rapid rise. Ahmedabad has also seen its first co-working space transaction in H1 CY18.

Is consolidation the future of co-working players? Maybe after a bit

Strong demand and low entry barriers have given way to intense competition among co-working operators to capture a slice of the burgeoning pie. With more than 120 operators in top-eight cities, companies are scaling up as they chase better valuation and funding, fending off competition in the process. In India, established developers such as Embassy and RMZ have forayed into this space either by partnering with a co-working company or by starting its own services. At the same time, domestic flexible workspaces players such as 91 Springboard, Innova8, Awfis, Smartworks, and CoWrksare ramping up operations rapidly, with stiff competition from foreign operators such as WeWork.

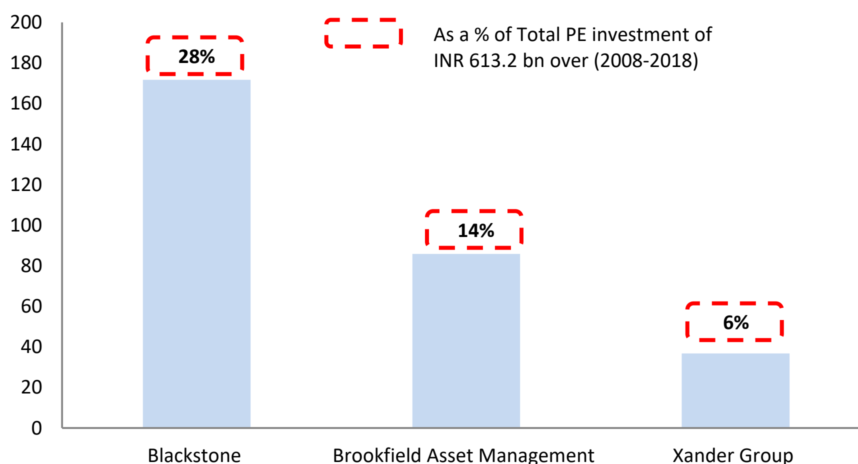
However, as more supply of commercial office supply pours in over the next 2-3 years, the scenario might change. Currently, most players are focusing on attaining scale, but as the co-working space becomes too crowded to capture market share, companies will begin to look at ways to fend off competition and enter newer markets with a better stronghold on the industry. They can achieve this through consolidation or organic expansion. After the current frenzy settles, the market may go through a consolidation phase through M&As, stake purchases, or even complete buyouts.

In a situation of scarce supply with low vacancy levels in traditional office spaces across some cities, as well as long gestation periods for setting-up a traditional office space, firms are considering putting teams in flexible workplaces for definite periods of time. We expect corporate occupiers to continue to use need-based leasing models more frequently going ahead. However, despite the current growth frenzy and innovative approach by co-working players, it is still unclear if the co-working as a category will continue to garner higher share of the commercial leasing pie – we would wait and watch.

PE investors – the invisible saviours?

The commercial real-estate segment in general is capital intensive, unlike the residential segment, which is aided by cash flow from unit buyers during its execution cycle. Commercial developers have to keep raising debt to fund their next project (if they are operating on a leasing model). Although liquidity is easily available in form of LRDs, it does mean debt levels will keep rising. In order to avoid excessive debt burden, these developers need liquidity in the form of equity infusion. Over the past decade, private equity players have kept the sector's wheels turning, augmenting their liquidity needs. From 2008 to 2018, these players have pumped in c.Rs 613bn into the Indian commercial segment. Blackstone Group and Brookfield Asset Management have been the largest investors in the Indian office-space segment over this period.

Largest PE investors over 2008-18



Source: PhillipCapital India Research

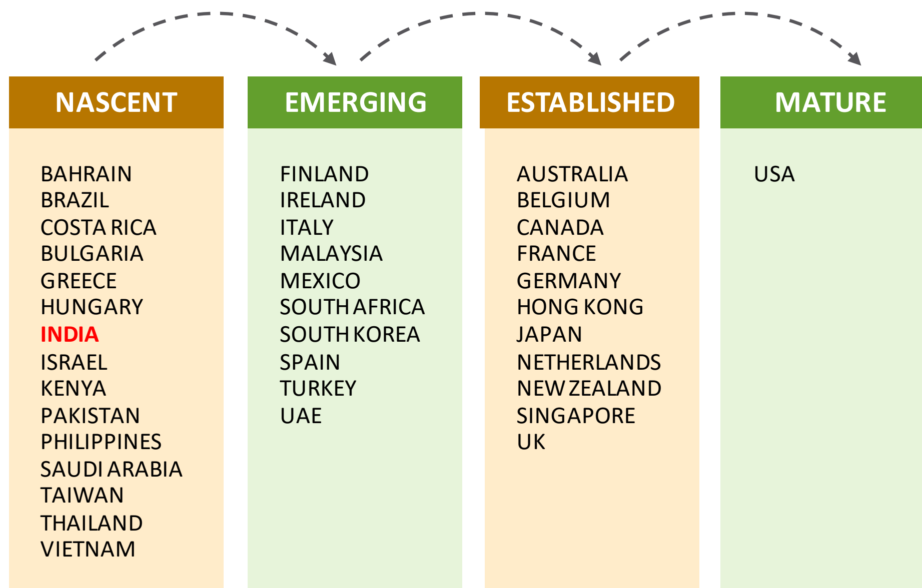
Over the past few years, several pension and sovereign funds are competing for aggregating Grade A commercial spaces across key micro-markets. Not only existing assets, but also greenfield assets continue to garner investor interest as demand continues to outstrip supply of Grade A quality spaces, and as price escalations have happened in key micro-markets over the past couple of years. Our research suggests that as many investors continue to chase limited supply of quality commercial assets, strong influx of equity from private equity players will continue.

A real estate investment trust typically owns and (often) operates income-producing real estate. REITs may own commercial real estate such as office and apartment buildings – to warehouses, hospitals, shopping centres, and hotels. Some REITs also finance real estate

The first REIT by Blackstone has been launched and is garnering good response. If this is successful, it will not only mark the dawn of new era for Indian commercial real estate, but it will also lead to an increased interest from PE players, as already invested players will have easier exit opportunities in REIT.

REITs – Will these keep the commercial RE engine chugging?

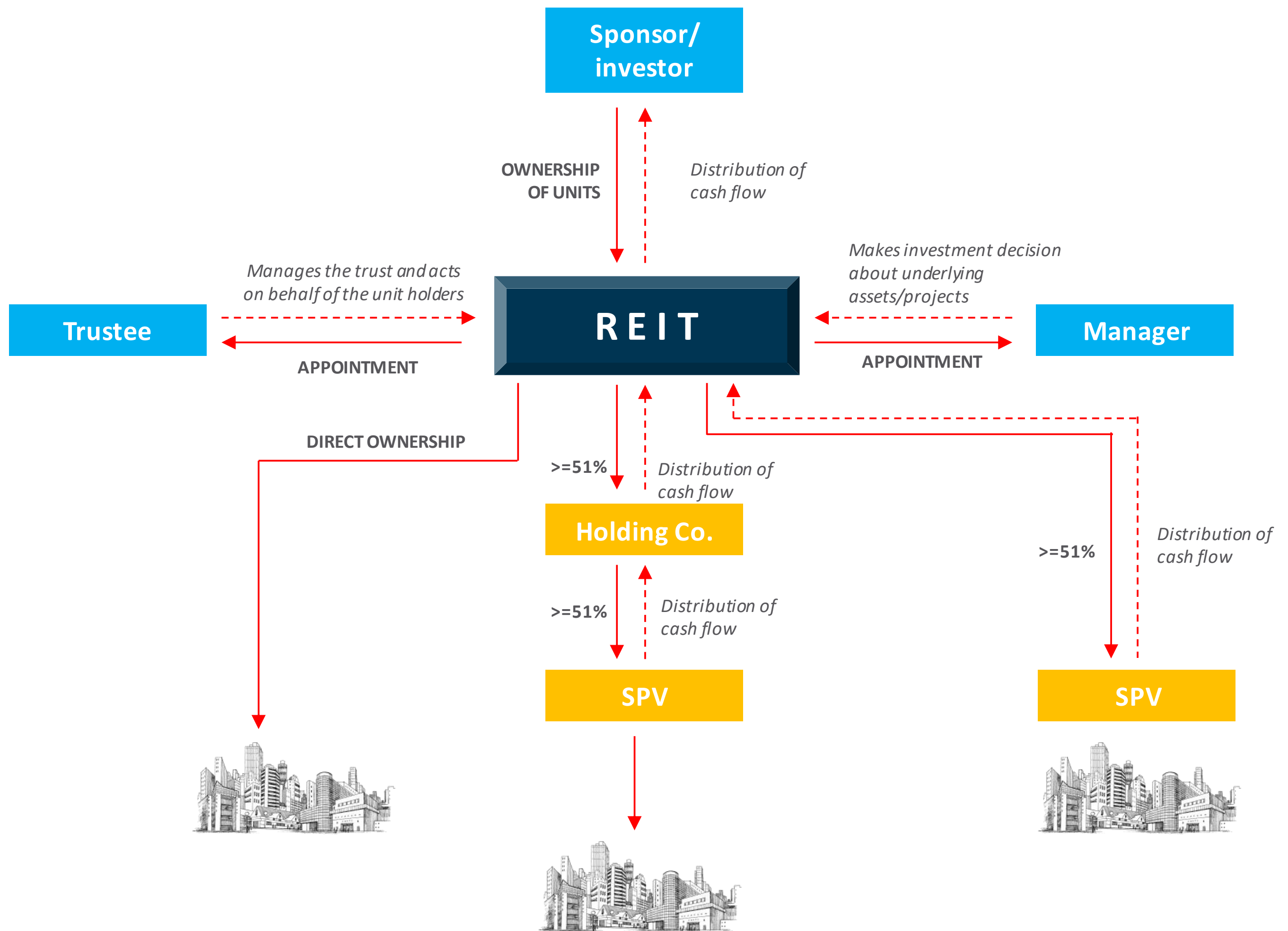
REITs have been successfully operated across the world for more than a decade. They provides an alternate investment category that shields investors from management and risks attached to real estate while allowing investors to enjoy the advantages of the yield that a huge property offers, even when they put in a small amount.



Source: Phillip Capital Research

With REITs becoming a reality in India, developers and private equity players in commercial real estate now have an opportunity to exit from their investments in completed assets. The liquidity generated can allow developers to focus on their core business of development, which has a different risk-return profile compared to operations and management of a completed asset. A good feature of REITs is that developers can exit partially and continue retaining a large share in the asset that they have created. REIT units are listed on an exchange, which will keep developers updated about the underlying asset value, which could help them to raise higher and cheaper finance from banks and other financial institutions. It is likely that REITs in India would give returns that are similar to other countries. A diversified REIT that focuses only on rental income can generate returns in the range of 9-11% (per year) with an additional return of 2-3% due to capital appreciation.

REIT structure in India



Source: PhillipCapital India Research

REITs may usher in higher regulation and transparency

The Securities and Exchange Board of India (SEBI) will govern REIT structures in India, which could help achieve desired professionalism and transparency in the Indian real-estate sector. A REIT would have to appoint independent trustees, managers, auditors, and valuers to help ensure that their functioning complies with SEBI's guidelines. Experiences in different facets of real estate are a prerequisite for the appointment of a manager in a REIT, helping to ensure professionalism in real-estate investments.

After many amendments and a two-years wait, the first REIT in India has gone live and has garnered good response. Blackstone, along with Embassy Group has launched a REIT worth Rs 50bn, which is Asia's largest in terms of portfolio size at 33mn sq. ft. Its underlying assets are spread across Mumbai, Pune, Noida, and Bangalore.

If this REIT is successful, we expect many players to pool in assets to create REIT structures – which would alleviate the liquidity issue that plague the sector. REITs could keep the commercial engine chugging.

Conclusion

Low supply is keeping the commercial segment strong – but it's coming

Currently, the commercial segment is performing well because of the low pace of supply and very low vacancies in Grade-A office spaces, creating a shortage for them. Our research shows that because of rising rental yields, demand, the interest shown by private equity players, low interest rates, and a growing economy – supply over CY19-22 is going to ramp up at a tremendous pace. We expect 170mn sq. ft. to hit the market in the next four years.

The demand journey: IT → ecommerce → co-working spaces and GICs

In the past the Indian IT sector was the key demand driver for the commercial spaces, over CY17-18 the Indian IT industry has slowed down hiring due to the slowdown in the IT sector and fundamental changes in its hiring pattern. Earlier contacts of these IT firms with clients were on a fixed headcount basis, which are now migrating to fixed-price no-headcount basis, which reduced in surplus or 'forced' over-recruitment by IT players leading to slowdown in leasing by the IT players.

Earlier the demand growth for commercial spaces was aided by the rise in demand from e-commerce players (over CY15-16) which has now died down

Co-working spaces and GICs emerge

The void left by ecommerce has begun to be filled by co-working space players and GICs (Global In-House Captives), which are growing at a fast pace.

We believe that demand led by co-working spaces is unsustainable, as the competition in the co-working spaces grows, the consolidation in the co-working industry might take place leading to slowdown in demand by them.

Private Equity investors – possible saviours

As the commercial segment is a capital intensive one, liquidity availability remains a key. The segment has an easy access to funding – debt (in form of LRDs) as well as equity (with increasing infusion from Private Equity players). The strong trend of Private Equity investment Over the past decade, private equity players have kept the sector's wheels turning, augmenting their liquidity needs. From 2008 to 2018, these players have pumped in c.Rs 613bn into the Indian commercial segment. We expect the trend to continue which shall aid the growth of the commercial segment and keep a check on overall debt levels.

It all hinges on demand keeping up pace; REIT could boost sentiment

- The commercial segment is faring really well due to demand being higher than supply, it being insulated from the impact of RERA and GST, and being relatively unscathed by demonetization and the NBFC crisis with liquidity available in the form of LRDs and private equity investments.
- India's first REIT is here – if it is successful, it will bolster investor confidence and lead to adequate liquidity in the market.
- In the short term, we expect the trend of pre-leasing to continue in the key micro-markets.

Over CY22-23, India is likely to see strong supply of commercial spaces especially in key cities – we believe that if demand keeps up pace, then this segment will remain strong. Players will keep enjoying high rental yields and low vacancy. If demand falters, the commercial segment could turn bearish in the medium term.

CHAPTER 4:
Retail Segment: An execution play

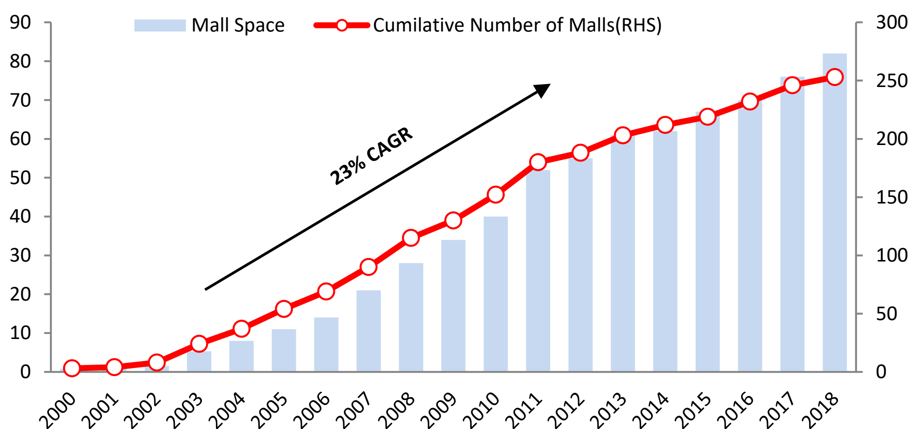
Retail: Is a second mall-wave coming?

History of malls in India – meteoric rise, trudging now

The retail real-estate segment in India (basically malls) is in quite a nascent stage – is the coming second wave an opportunity to fill the gap? Or is an apocalypse impending?

- **The early days:** The mall culture hit India around the turn of the millennium. Malls become almost an instant hit and from just 24 in 2003, their number grew to 180 in 2012 – a 23% CAGR.
- In two decades, the penetration of malls has ramped up speedily as malls provided India's shoppers a differentiated experience in an air-conditioned environment, the luxury of all their purchase needs under one roof, many options to choose from within a specific category, and F&B outlets to indulge their taste buds.
- Over 2005-08 Indian malls evolved to offer entertainment such as movie theatres, family entertainment centres, gaming zones, and events and celebrations.
- 2012-2016: The bull run took a breather and the number of malls went up only to 219 from 180 in those four years. The slowdown happened because many of these malls started 'dying' across cities, which made developers wary of entering this space.
- **After 2016:** Mall space addition began rising again at a healthier pace.

Breather over 2012-16; healthier pace of increase has begun again



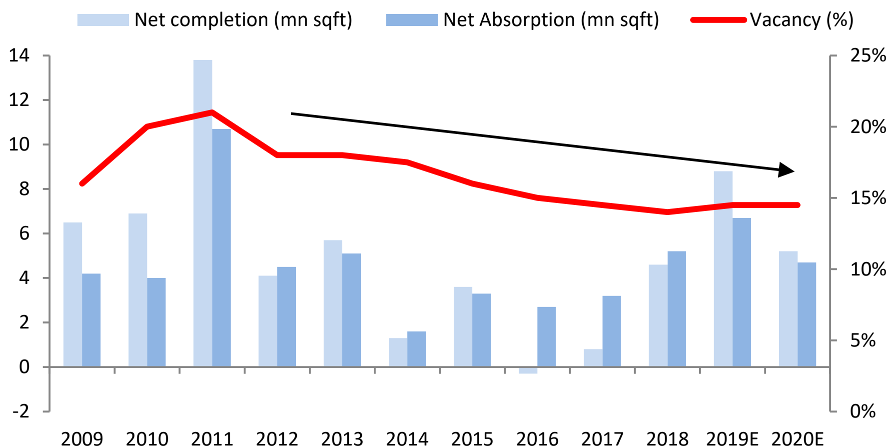
Source: JLL, PhillipCapital India Research

Currently, there are more than 250malls in India with a total space of 82mn sq. ft. With many malls unable to break even and sustain over the years, the industry's focus has sharpened. It is a game of execution, and survival of the fittest

Outlook: Cheerful

Over the last couple of years, India saw a significant dip in the supply of mall spaces, which led to a dip in overall vacancy levels at a pan-India level. Over 2019-20, we expect a healthy c.14mn sq. ft. of additional mall space to come into the market. Overall vacancy levels should stabilize at around 15%.

FY19E-20 will see strong supply and vacancy levels rising marginally



Source: JLL, PhillipCapital India Research

The phenomenon of dying malls – an execution issue

We conclude that malls in India have been shutting down because of execution failure rather than competition from e-commerce. We look at what really went wrong.

Execution is tougher than construction: A lesson learnt the hard way

Malls aren't just about shopping – they are all about the experience. They are a destination for people – to shop, eat, and to entertain themselves. In the past, malls have largely failed because their mangers failed to understand this concept. They also failed miserably at catchment analysis, execution, and having the right product mix. Those mall that treated their renters as just tenants rather than business partners, missed out on achieving higher sales.

The four pillars of mall success

We have concluded that the success of malls rests on the following four pillars:

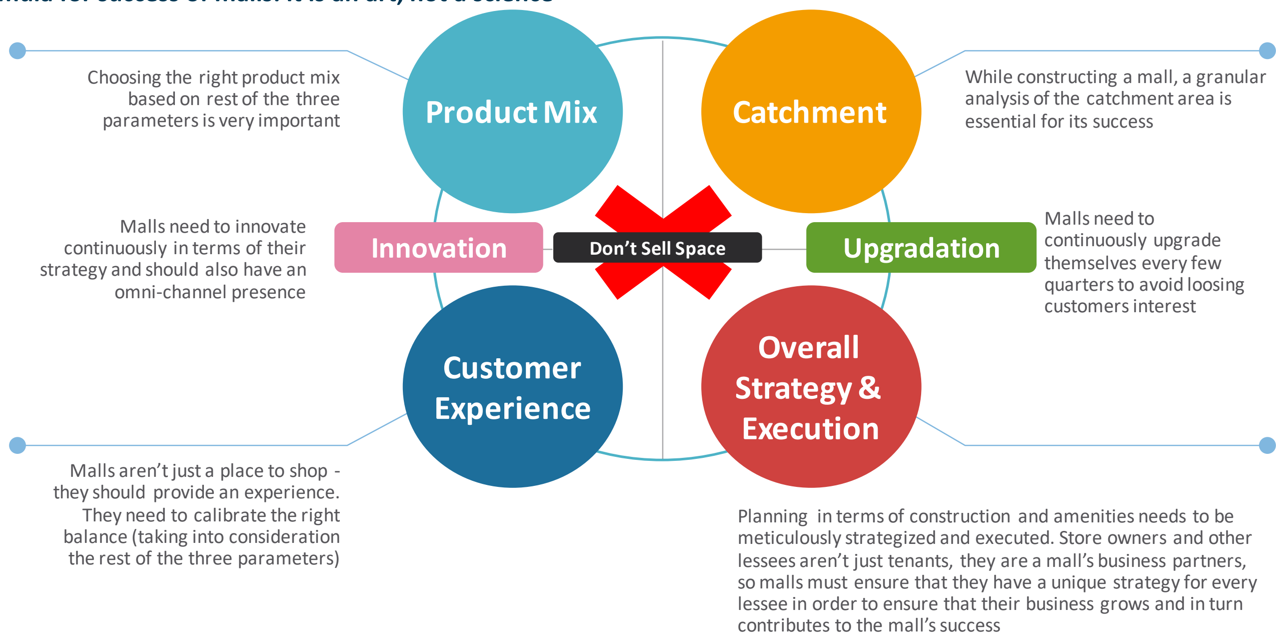
1. Catchment analysis (location of the mall)
2. Execution and strategy for constructing and operating malls
3. Customer experience
4. Product mix

The three thumb rules for mall success

Other than the Four Pillars, there are three Thumb Rules:

1. **Do Not Sell:** Malls shouldn't sell any space – they *must* lease the entire space. This is so that developers can have complete control over the mall's execution. Many developers began to sell and in time, their malls failed.
2. **Innovation**: Continuously need to improve and bring in original ideas. New techniques to ensure high footfalls are a must. Malls also need to adopt an omni-channel approach to avoid obsolescence.
3. **Upgradation**: Malls need to upgrade themselves periodically to ensure superior customer experience.

Formula for success of malls: it is an art, not a science



Source: PhillipCapital India Research

Product mix and upgradation

We have deduced that in a typical mall this is how the space is distributed:

- 35-40% – Apparel stores
- 15-20% – F&B
- c.10% – Wellness and pharmacy
- c.10%- Cinema
- 5-10% – Super-market or hyper-market
- Rest – Jewellery, furniture, footwear, electronics, bookstores and other entertainment outlets

Anchor tenants are important: Around 10% of total tenants are 'anchor' tenants – long-term renters (typically 7-9 years) with a large leased area.

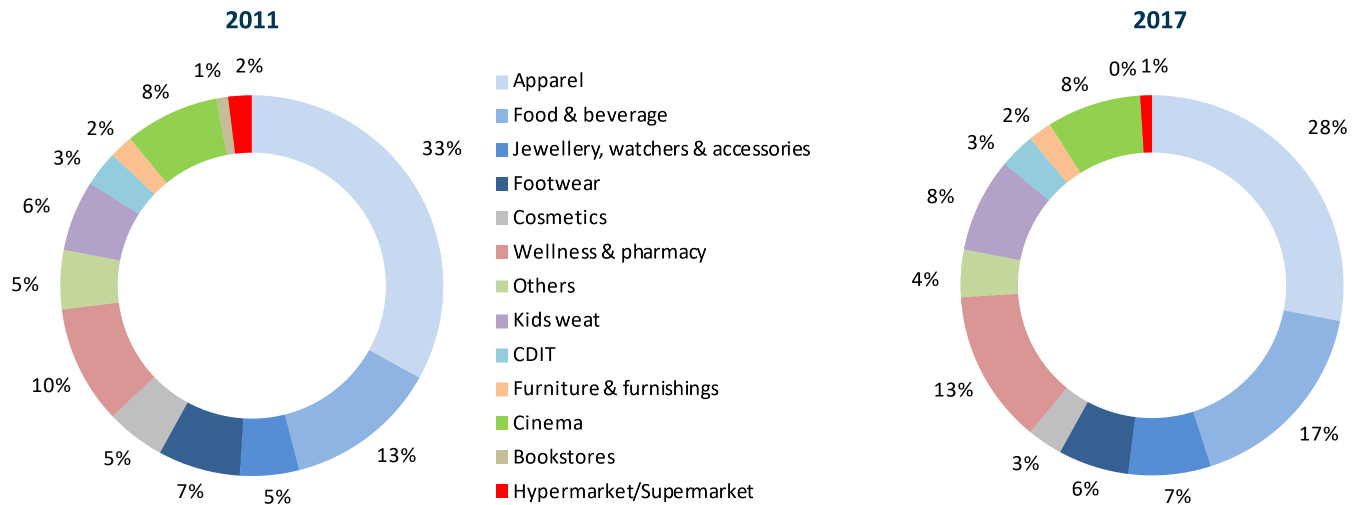
Choosing the anchor tenant wisely is also a key parameter for the success of a mall

The composition of malls must change rapidly as per customer expectations

Over the years, composition of malls have changed dramatically as visitors' expectations evolved. A few examples:

- In the initial stages, mall developers did not give too much importance to food courts and multiplex cinemas, but quickly realised that these were crowd magnets and increases space allocated to them and upgraded them.
- Jewellery and accessories share has increased over the years.

Composition of Select City Walk Mall, Delhi – 2011 vs. 2017. Share of apparel and cosmetics reduced while F&B, wellness, and kids wear increased



Source: JLL, PhillipCapital India Research

Catchment area: Of prime importance

- Important both before undertaking mall construction and after the construction.
- Catchment analysis provides developers with key insights about the quantity and quality of footfall that a mall can expect and tells them about preferences etc.
- Based on catchment area analysis, developers can devise a strategy for mall construction and execution and develop a niche targeted strategy (its own USP) to attract high and consistent footfall.

Customer experience: A never-ending, ever-changing process

- Customer come to malls for an 'experience', not just to purchase things.
- Mall need to keep engaging its customers at various levels – from conducting events to arranging discounts and festive sales.
- They also need to keep upgrading F&B offerings to provide a unique experience to its customers.
- The space-share of the outlets that provide an experience – restaurants, cafes, QSRs, theme-based entertainment – has gone up significantly over the last five years in top malls.

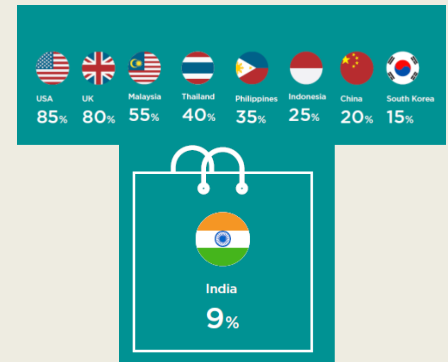
Overall strategy and execution

Malls need to carefully strategize every granular detail. Our analysis suggests that malls that treat lessee's like partners rather than tenants ensure that they get their every support in terms of promotions or helping overcome certain issues. Such developers are more successful than the ones who keep a developer-renter relationship.

Due to the failure in execution, poor quality mall spaces are shutting down and there is a demand for superior quality mall spaces in India

Case study of US malls: Ecommerce threat demystified

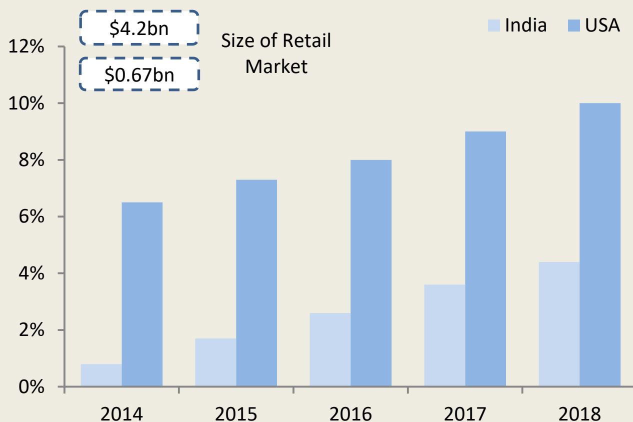
Grade-A malls survive regardless



As US market is the most mature retail market across the world and we consider it appropriate to draw a parallel with India's retail industry. Despite the spending trends in both the countries being significantly different, our ground research suggests that the factors drawing customers towards shopping in malls remain the same.

The US market has maximum penetration of e-commerce (10%, can be called considerable). India's current e-commerce penetration levels (4%, low) is comparable to US' 2012 level. We expect the Indian retail market to follow US' trend.

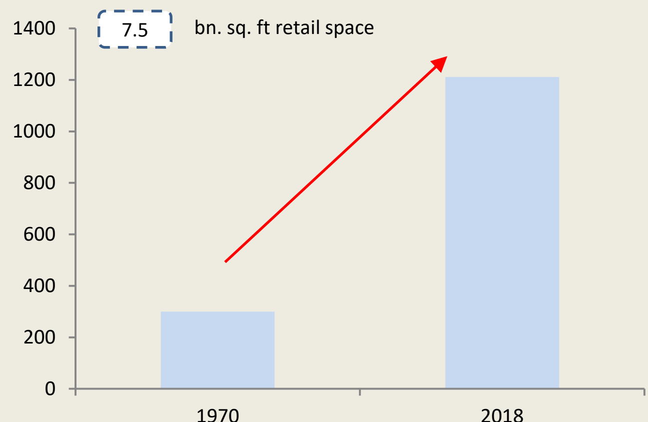
Share of e-commerce in overall retail - rising steadily



Mature market with strong penetration of e-commerce

- In the US, the first mall opened as early as 1954.
- As of 2018, there are 1,211 malls in the US.
- US online sales are expected to capture c.35% of the total retail market by 2030.

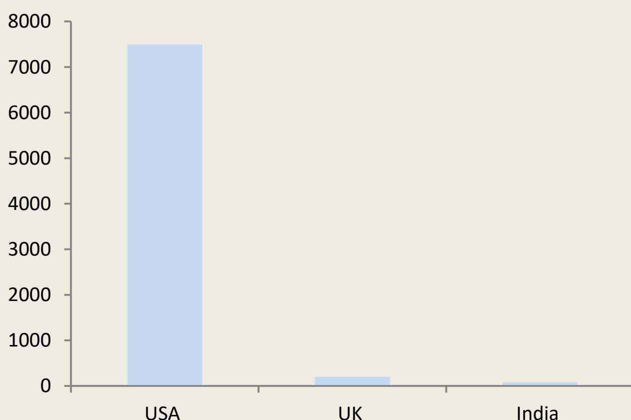
Number of malls in the US - risen at a tremendous pace



US – A problem of oversupply, not ecommerce

- Over the next few years, the US might see 25% of its malls closing down (recent analysis by Credit Suisse and UBS on the US retail market_.
- We reckon these malls are dying not because of a rapid rise in e-commerce but because of oversupply.
- Currently, USA has c.7.5bn sq. ft. of mall space – the highest in the world, followed distantly by the UK at c.200mn sq. ft. India currently has c.82mn sq. ft.

Mall spaces (mn sq. ft.)-USA has almost 90x retail (mall space) compared to India



Conclusion: Grade A quality mall spaces will keep doing well

- The US faces such a huge oversupply of mall spaces that c.2% of the total stores in malls are likely to close in FY19 and this run-rate is likely to continue over the next couple of years, translating into 10% shutting down over the next five years.
- Closures will take place in Category B and C mall spaces only.
- Our secondary research suggests that there is no "Mall Apocalypse" in the US market. Grade A quality Malls will continue to perform well with very high occupancy levels as people will keep going to malls to test products in stores before buying them, for the 'instant gratification' that malls provide of being able to leave a store with a purchase in hand, and for the experience. These are barriers that e-commerce struggles to overcome.
- Though the occupancy rates in US malls have dropped to 85% in 2019 from 96% in 2006; about 80% of US' 1,200 malls have vacancy levels of 10% or less. Sp the current situation can be considered healthy.

Drawing parallels from the current US scenario, we believe that in India too, Grade A (superior quality) mall spaces will continue to enjoy 100% trading occupancy and very low vacancy levels.

E-commerce is not a major threat

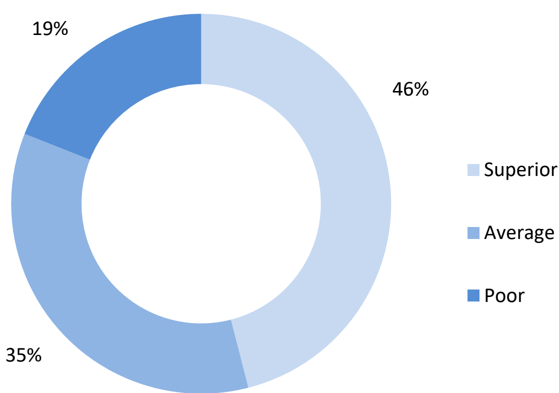
We do not see e-commerce becoming a major threat to Indian malls anytime soon, but to mitigate its impact, malls need to adopt a few strategies to ensure that consumption keeps growing at a healthy pace. These include measures such as experimenting with its mix to encourage repeat visits and adopting an omni-channel approach (to sell mall merchandise online too). This will help malls to rope in online customers by offering them the mall's schemes – which will aid customer retention and help marketing.

Learnings: Higher superior mall space supply ahead

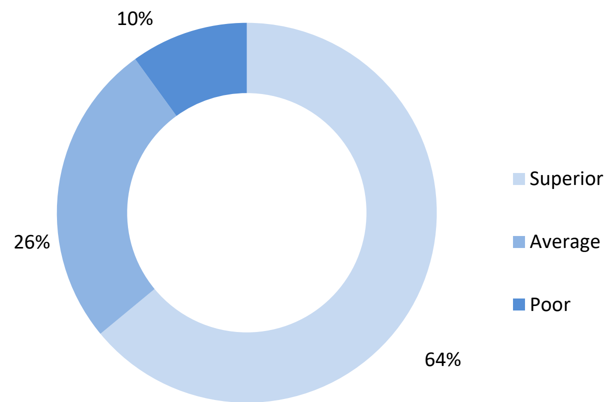
Over 2019-22, 90 mall projects entailing 34mn sq. ft. will begin operations. We expect c.64% of these spaces to be Grade-A quality vs. 46% share during the last wave of 2008-12. Because the years 2013-17 saw extremely low new supply, we haven't considered it for a granular analysis.

This wave of superior quality malls is a major positive for the sector. A large chunk of this mall space addition is going to take place in Bangalore (5.5mn sq. ft.) and NCR (3.8mn sq. ft.). Amongst all markets, NCR and Ahmedabad have the highest vacancy levels and we believe that upcoming superior quality mall spaces might take relatively more time to stabilise there.

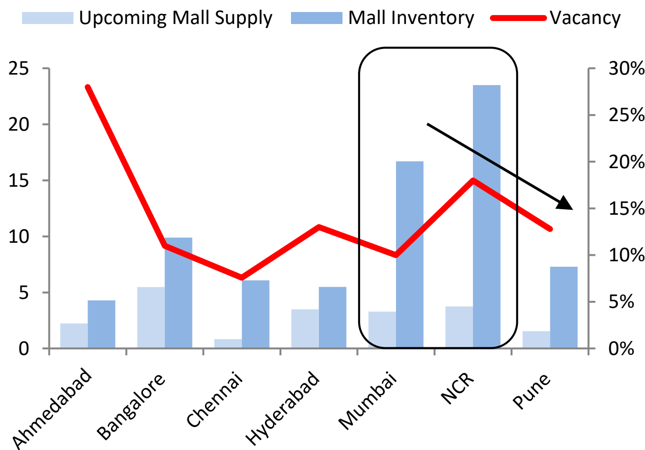
Operational mall stock from 2008 to 2012



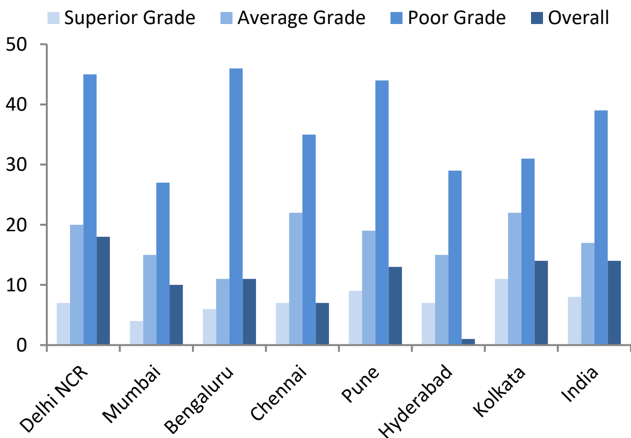
Supply over 2019-22: c.90 malls with c.34mn sq. ft.



Bangalore and NCR to see maximum mall space addition

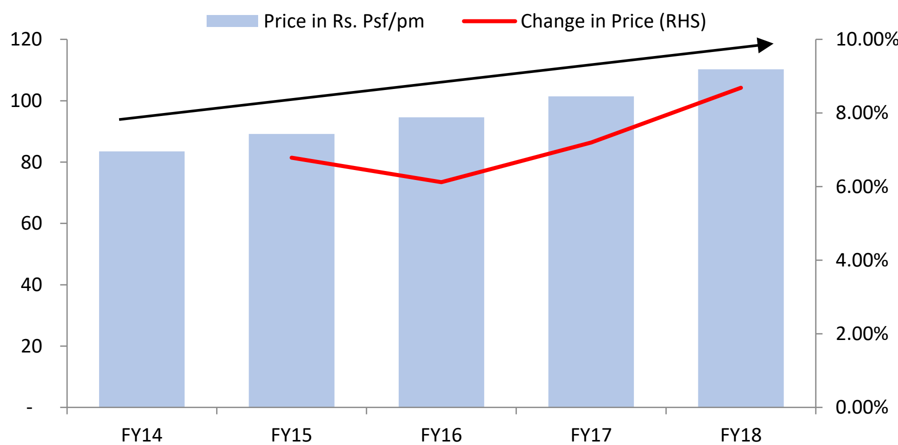


Superior quality malls see single-digit vacancy across cities



Source: Cushman Wakefield, PhillipCapital India Research

Healthy 7% CAGR in price realisation – an incentive for retail developers



Source: Cushman Wakefield, PhillipCapital India Research

Healthy price escalation continues in Grade A mall spaces in top five cities – NCR, MMR, Pune, Bangalore, and Chennai

Conclusion

Insulated from the worst of recent changes and events

- Most malls operate on an annuity model– so they are outside the gamut of RERA and GST (as they aren't being sold).
- The retail segment faced the brunt of demonetization, but events such as the NBFC liquidity crisis haven't dented the retail segment much because of the easy availability of credit in the form of LRDs (Lease Rental Discounting).

Seeing high interest from private equity players

- This is because retail annuity assets provide a higher rental growth (6-7% p.a.) and higher yield (due to base rent + revenue share above a certain sales threshold) than rental growth in commercial assets (which is typically 5% p.a.)
- They also provide (at least Grade A spaces do) a relatively better visibility in terms of rate hikes
- Various players such as Blackstone, CPPIB, GIC, Xander Group, and APG have invested Rs 186bn in Indian retail assets over the last five years – which bolsters our confidence in this segment's future.

More healthy (Grade A) supply coming online

- We expect a more healthy supply of mall spaces coming in from FY19 to FY23.
- Our research suggests that there is a demand for Grade A superior quality mall spaces in India
- The execution of the mall will decide its fate. Based on our calculation, some malls in India may close due to poor execution, but at least in near to medium term we do not expect e-commerce to significantly disrupt Grade A malls' business
- Grade A malls will continue to command higher rentals and will have lower vacancies.

Retail propellers: Insulation from RERA and GST, easy access to liquidity in the form of LRDs, interest from private equity players

Risks

Rising interest rates: In a scarce liquidity situation and with mounting debts of developers, if the interest rate do not remain benign, serious issues may crop up as many already in troubled players.

No improvement in implementation of RERA: The residential sector's revival has banked upon the implementation of RERA in the manner intended.

Liquidity scarcity continues: If the liquidity remains scarce, it would have serious repercussions. Currently, private equity players have stepped up as the sector's primary lenders, but this remains restricted to tier-1 players. We believe that if external commercial borrowings (if allowed) would provide required liquidity for the sector.

High GST rate on raw materials used for construction: The government has tried to provide an impetus to the sector by slashing the GST rates by 7% across normal and PMAY projects, bringing them down to 5% and 1% respectively, but without Input Tax Credit (ITC). Without ITC, in the current market scenario, all developers may not be able to absorb the differential tax loss and could hike prices, nullifying the government's intent of demand revival. For demand revival to happen (as the government intended after GST cuts) the GST rates on construction materials also need to be cut.

Continuation of PMAY: We believe that the PMAY will be a key driver for the sector. If the next government decides to discontinue the scheme or reduces benefits attached to the scheme, the residential segment could be pushed into a bearish phase.

Subdued demand: Demand dynamics for the sector primarily dependent on macroeconomic factors and if the Indian economy slows down, it will prove detrimental for overall demand in the sector.

Regulatory headwinds: This is one of the largest factors affecting the sector's recovery and growth momentum If further regulatory headwinds come up, the sector may plunge into a bearish phase again.

Decline in rental yields: If this happens, the sector may lose investor interest (including from private equity players) which may push it into a bearish phase.

Annexure

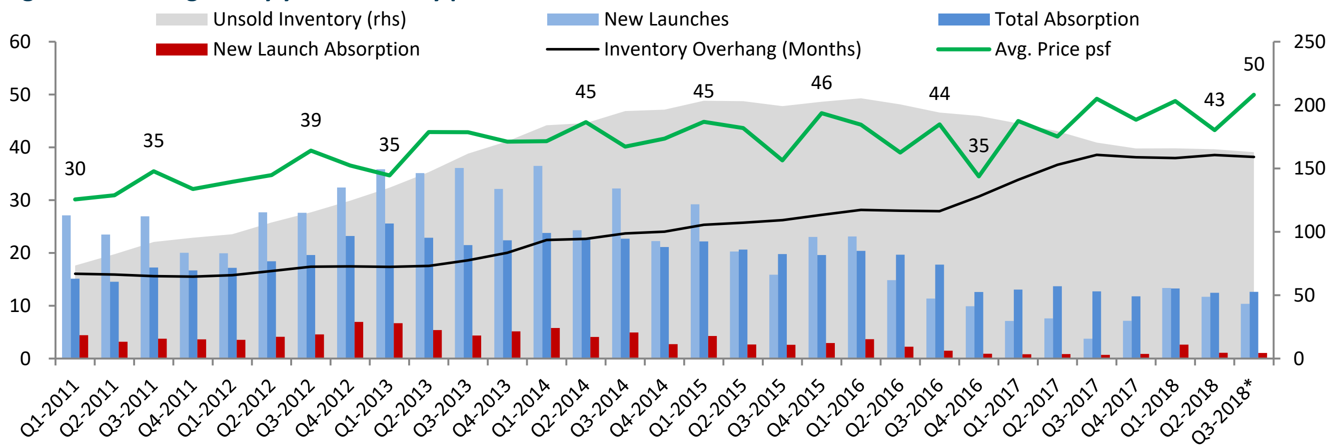
Analysis of residential micro markets

Bangalore

Falling inventory levels, price volatility; demand outstrips supply marginally

- Saw a trend reversal relatively early; so inventory overhang is lesser here.
- Price has corrected over Q1-CY18 to Q3-CY18 and supply has ramped up again, reducing the gap between demand and supply to a minimum.
- We believe Bangalore's market will see stable demand-supply ahead, stable inventory levels, and demand marginally higher than supply – our forecast is based on our research.

Bangalore: Reviving slowly yet at a steady pace



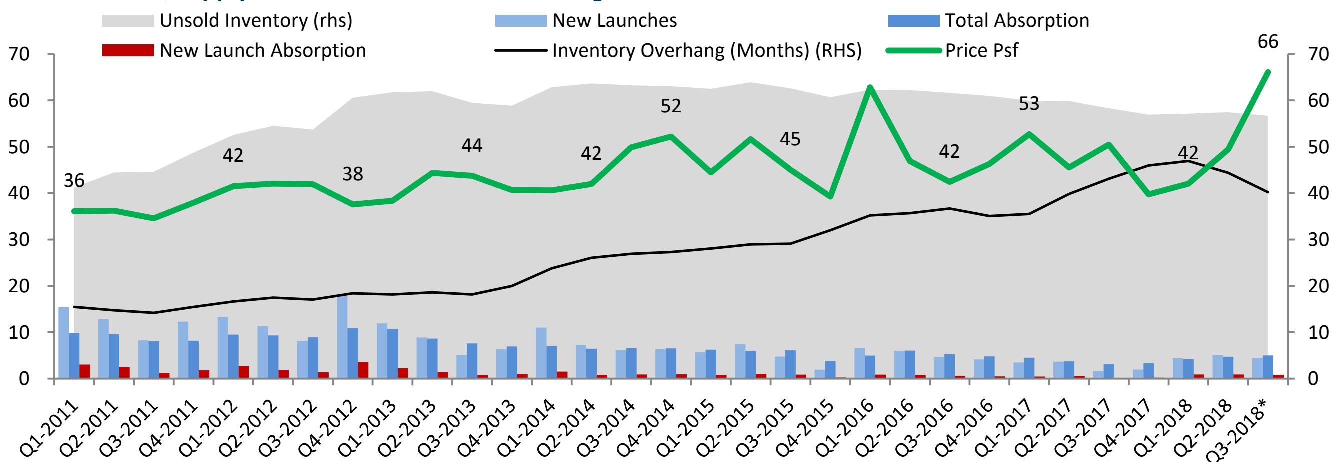
Source: Knight Frank, PhillipCapital India Research

Chennai

Falling inventory overhang. Prices rising as demand outstrips supply marginally

- Late trend reversal. Demand-supply moved in tandem, keeping inventory levels and price steady.
- Demand started to outstrip supply over Q1-Q3 CY18, so some pricing power returned. We believe this is temporary trend, as the next wave of supply should hit the market in 2021-22. Until then, demand-supply will be in tandem and prices steady.

Chennai: Stable; supply needs to weaken for a meaningful revival



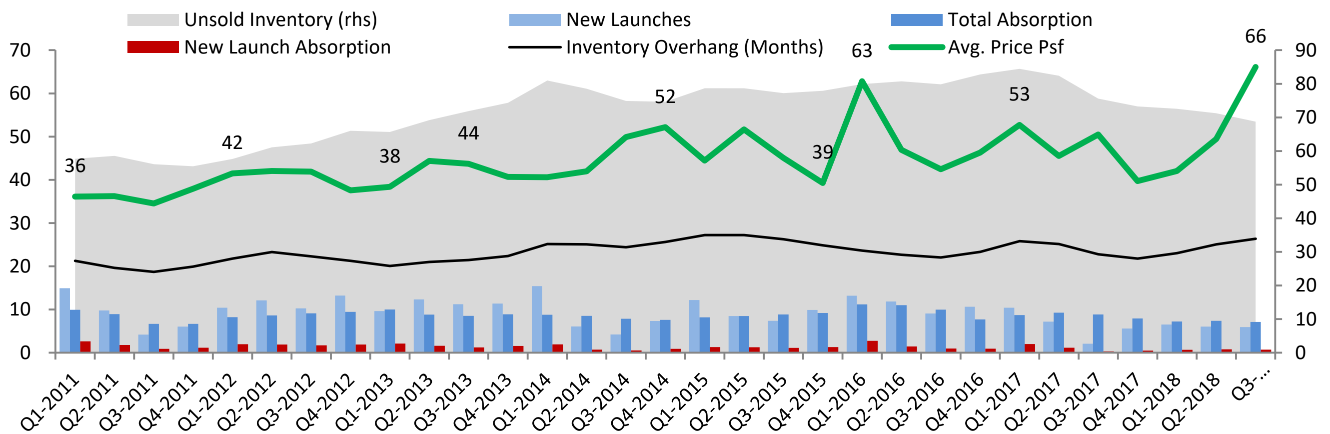
Source: Knight Frank, PhillipCapital India Research

Hyderabad

Inventory overhang falling. Prices rising as demand outstrips supply marginally

- Saw a trend reversal relatively early.
- Supply was subdued here because of general issues plaguing the sector and specific legacy issues in Hyderabad.
- We reckon supply is set to improve as legacy issues resolve.
- Demand-supply will move in tandem near term, putting a check on prices; inventory overhang will keep declining.

Hyderabad: With legacy issues behind, reviving at a steady pace



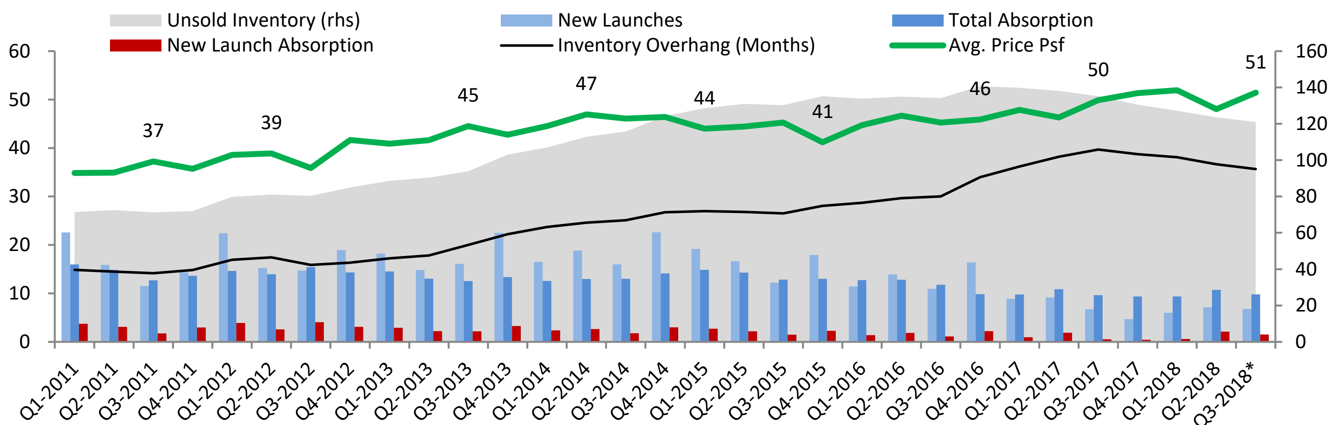
Source: Knight Frank, PhillipCapital India Research

Pune

Inventory overhang falling. Prices stable. Demand-supply gap high

- Saw a trend reversal relatively early, so overall inventory levels and inventory overhang are lesser.
- Price has been stable with demand much higher than supply.
- We see price stability and declining inventory continuing near term.
- In the medium term, as supply ramps up by 2022, the falling inventory overhang will stabilize.

Pune: Reviving at a healthy pace, yet owing to relatively high inventory, it will take a significant time to revive



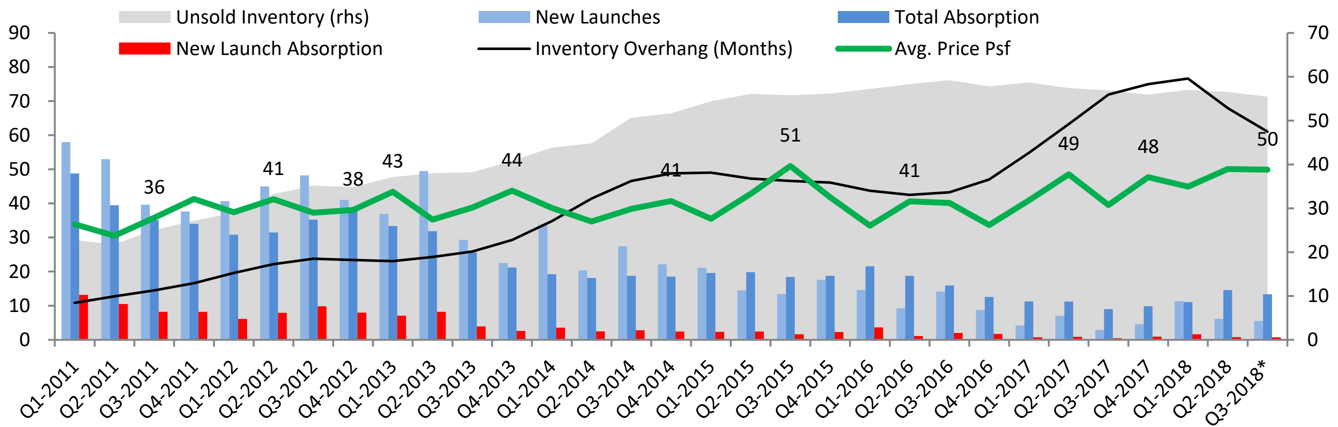
Source: Knight Frank, PhillipCapital India Research

NCR

Inventory stabilizing. Price steady, with demand outstripping supply quite a bit

- Earliest trend reversal due to rampant price increases and very high inventory levels in the past – this led to significant price correction, which now seems to be stabilizing.
- Demand continues to outstrip supply by a high extent.
- We reckon the next wave of inventory hitting the market by 2021-22, until then demand will be slightly higher than supply and price volatility will prevail.

NCR: With price-correction-cycle complete, NCR market's revival has begun at a healthy pace



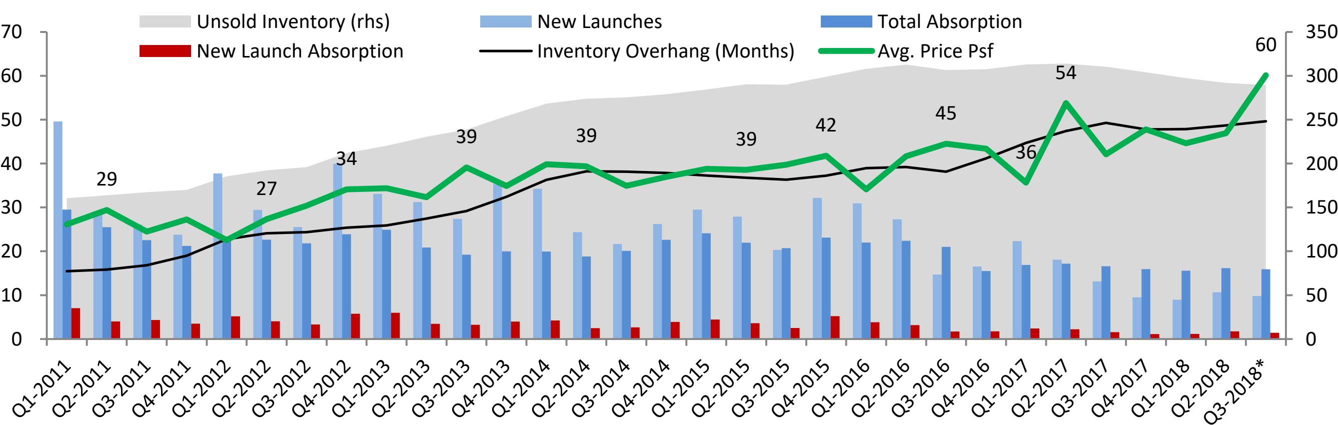
Source: Knight Frank, PhillipCapital India Research

MMR

Inventory declining; demand outstrips supply marginally. Price volatility remains

- Saw a trend reversal relatively early as there was a massive inventory overhang.
- The inventory levels and overhang have stabilized, leading to stable prices.
- The next wave of inventory should hit the market by 2021-22; until then, inventory should decline and prices should remain steady as demand stays steadily higher than supply.

MMR: Has started showing a steady signs of revival



Source: Knight Frank, PhillipCapital India Research

Commercial segment: City-level dynamics

IT dominant cities continue to see high demand

	Rents Declining	Decline Slowing	Rents Recovering							
	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Bangalore	-17.7%	3.3%	10.8%	5.3%	-0.6%	0.8%	6.8%	8.1%	6.2%	7.1%
Mumbai City	-34.3%	0.8%	1.1%	0.8%	0.5%	0.2%	-1.6%	-0.3%	0.4%	1.5%
Delhi City	-41.8%	2.2%	3.2%	1.3%	0.0%	0.0%	0.5%	-2.4%	-0.9%	1%
Mumbai Suburbs	-34.3%	0.0%	7.4%	1.1%	2.1%	0.6%	3.0%	2.3%	1.4%	3.7%
Gurgaon (Prime)	-31.1%	2.8%	11.8%	5.7%	5.0%	1.0%	2.8%	0.3%	-0.7%	1.2%
Gurgaon (Off Prime)	-38.2%	-2.4%	9.8%	4.4%	2.1%	0.7%	0.0%	1.4%	7.1%	7.5%
Noida	-16.6%	-9.0%	3.3%	2.7%	3.6%	0.2%	4.3%	3.1%	3.6%	4.5%
Chennai	-22.4%	0.0%	6.4%	4.9%	4.4%	0.6%	3.5%	3.3%	2.1%	3.2%
Pune	-20.7%	0.0%	3.4%	7.3%	6.8%	1.8%	10.6%	7.1%	3.0%	4.6%
Hyderabad	-14.0%	0.0%	4.1%	5.1%	1.1%	1.1%	4.6%	6.8%	1.9%	5.7%
Kolkata	-27.4%	0.0%	5.7%	8.2%	-0.3%	-0.5%	3.4%	1.0%	3.0%	5%

Source: Anarock, PhillipCapital India Research

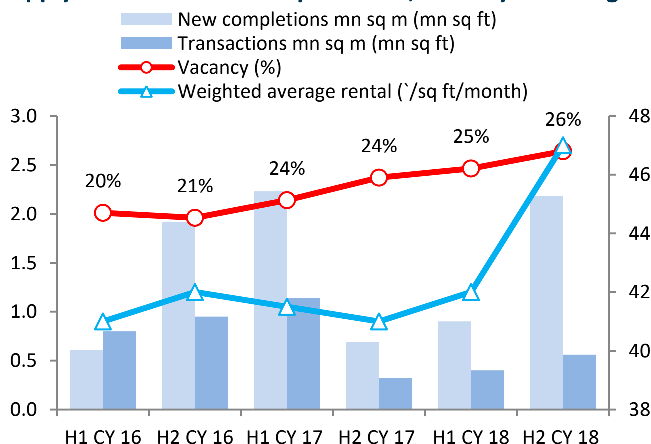
Ahmedabad

Demand picking up, but supply may outstrip demand

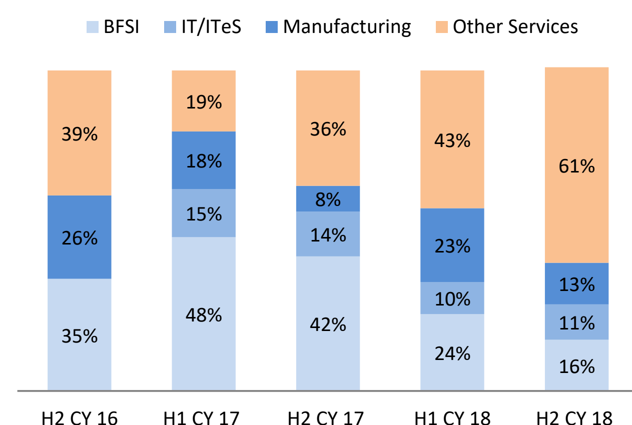
- Over the past 4 quarters, as the presence of corporates increased, demand for quality commercial spaces is rising, but supply continues to outstrip demand.
- Overall vacancy levels in the city were as high 26% in the second half of CY18, but the market has started picking up slowly over the past couple of years.
- This market is mainly driven by BFSI, manufacturing, and 'other' services-led demand.
- The city saw its first co-working space transaction in CY18.

Our take: *In the next four years, Ahmedabad might see huge supply coming in. If demand doesn't pick up accordingly, vacancy levels in the city might escalate.*

Supply continues to outstrip demand; vacancy levels high



Dominated by BFSI and other services sectors



Source: Cushman Wakefield, PhillipCapital India Research

Bangalore

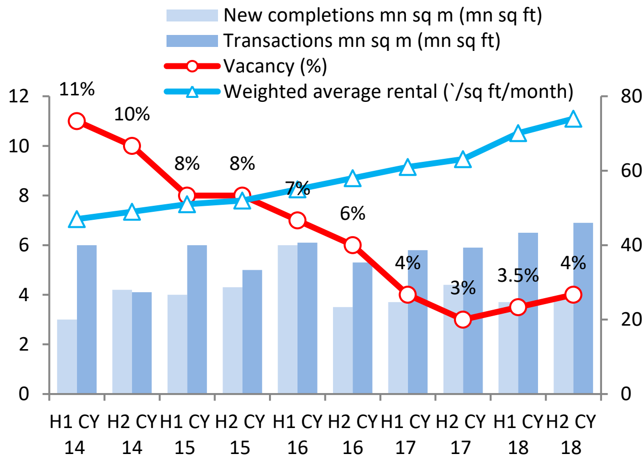
Rally will continue; but with IT slowdown, which sector will drive growth?

Bangalore consistently shows strong pre-leasing trends due to weak supply and strong demand

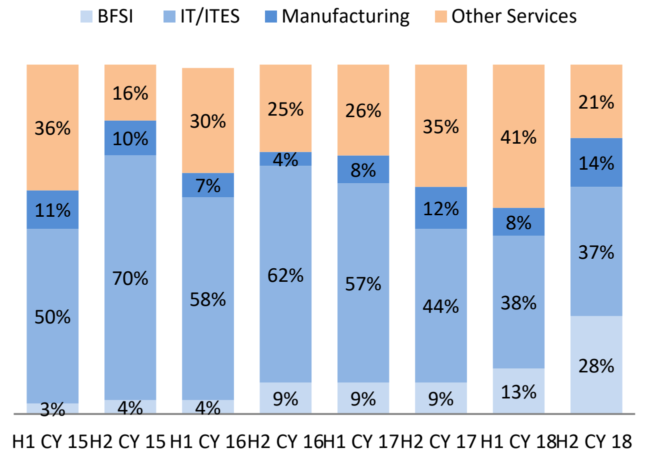
- Historically a key market for Indian commercial real estate.
- Over the past decade, high demand from IT players led to shortage of Grade-A commercial spaces in the city. Price yield increased and vacancy levels dipped to low single digits. The market has also seen strong pre-leasing.
- While the key driver – core IT – has been declining, the void is being filled by the rise in demand from GICs and a new rising category – co-working spaces.

Our take: *Supply will ramp up in the next four years, but it wouldn't be at the current run rate, and demand should keep up. This will help keep vacancy levels in low single digits, leading to better price yields. Strong pre-leasing trend should also continue.*

Bangalore market trend



Bangalore market



Source: Cushman Wakefield, PhillipCapital India Research

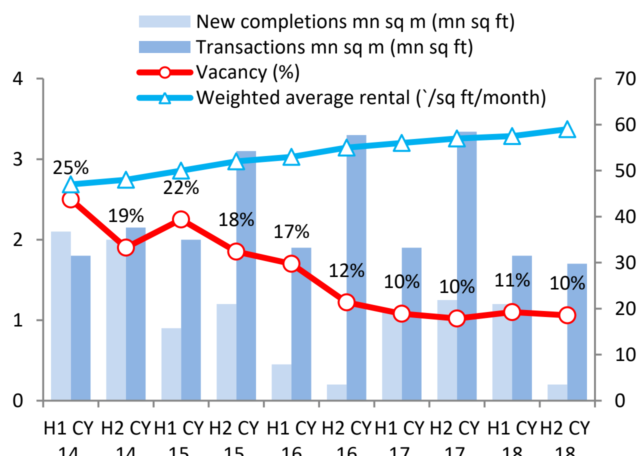
Chennai

IT/ITES, manufacturing slowdown– a lasting concern or just a temporary blip?

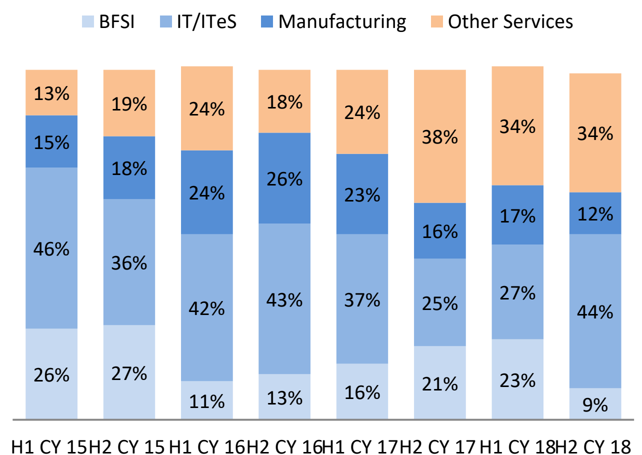
- This market has been predominantly driven by the conventional IT sector.
- With high demand and lack of Grade-A quality supply, rentals ramped up significantly and vacancy levels dropped to around 10% in CY18 from +20% in CY14.
- Like Bangalore, Chennai might also see rising demand from GICs and co-working players.
- CY18 transactions have fallen significantly vs. CY16 and CY17, but this seems to be because of a supply shortage.

Our take: *Over the next 3-4 years, despite strong supply coming, demand from GICs, co-working spaces and the manufacturing sector will keep vacancy levels low at c.10% – which will lead to a steady increase in price realizations.*

Strong demand, weak supply pinning vacancy rates at low levels



IT demand weakening. GICs and other services (especially co-working spaces) filling the void



Source: Cushman Wakefield, PhillipCapital India Research

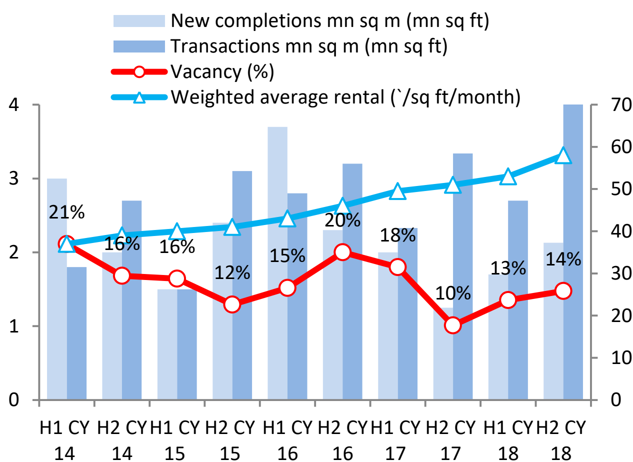
Hyderabad

Legacy issues behind, strong supply coming; everything hinges on demand

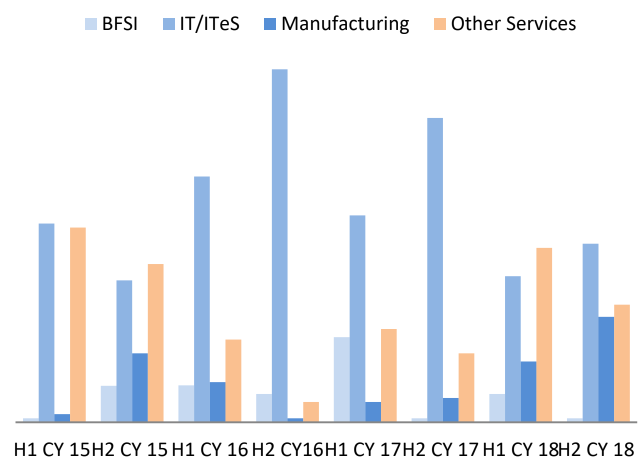
- This market has historically been driven by the IT sector, but over the past couple of years the mix has changed with BFSI and manufacturing also contributing.
- Due to legacy issues, the city has seen muted supply of commercial spaces, which led to dropping vacancy levels. These touched 11% in CY18 from 16-17% in CY13-14.

Our take: *The city is likely to see massive supply in the next few years, which was held back due to legacy issues. Despite high demand, in the near term, supply might be overwhelming, which could lead to an increase in vacancy levels and lower rents. However, over the medium term, this market will maintain momentum and fetch incrementally better yields.*

Demand rising, vacancy levels dipping



Changing dynamics: BFSI and manufacturing demand rising



Source: Cushman Wakefield, PhillipCapital India Research

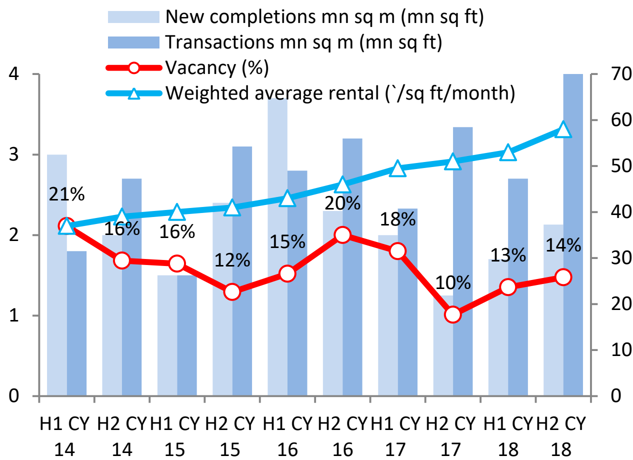
MMR

Oversupply will continue to be a scourge in the short term

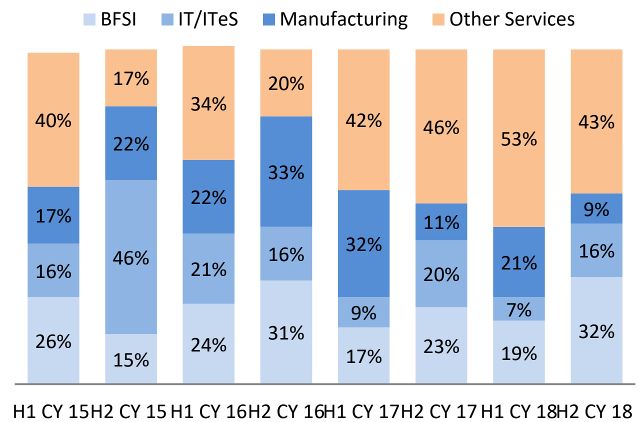
- Unsurprisingly, commercial demand in India's financial capital is dominated by the BFSI sector and other services sectors.
- However, as BFSI is cyclical. Usually these companies are conservative while leasing commercial spaces, which has created space for a new segment to ramp up over the past two years – co-working spaces.
- Despite demand being higher than supply, the city is seeing high vacancy levels of around 14% because of a large inventory overhang.

Our take: *Over the next 3-4 years, MMR should see supply slowing down. In the near term, we expect vacancy levels to be relatively high and rentals to stabilize unless demand from some another sector apart from BFSI and co-working spaces ramps up. However, we do not expect this to happen for some years. In the medium term, vacancy levels in MMR are likely to decline and garner better yield realizations.*

High inventory plaguing MMR, but vacancy levels are dipping



BFSI and other services continue to dominate



Source: Cushman Wakefield, PhillipCapital India Research

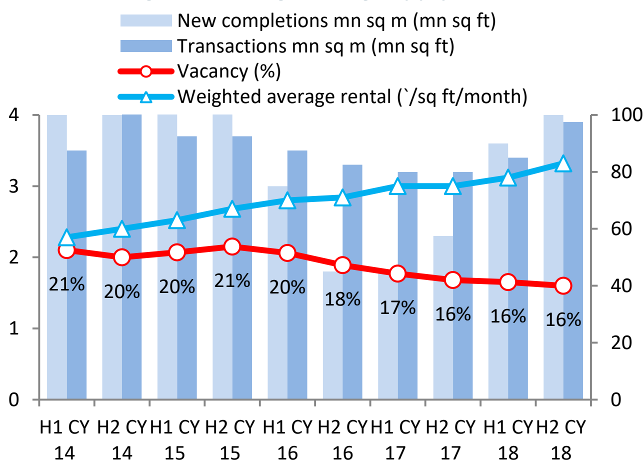
NCR

Will an upcoming supply wave bring a slowdown?

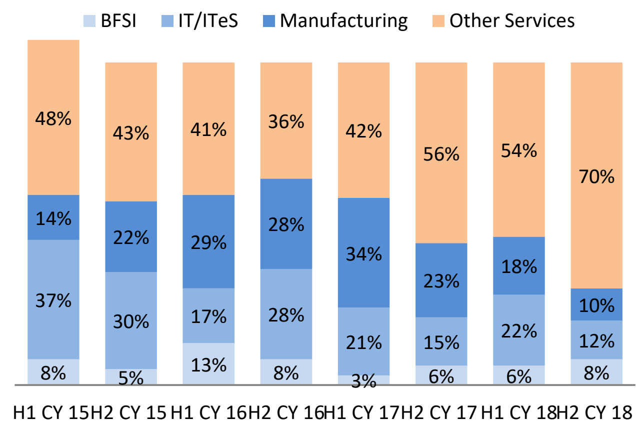
- Predominantly led by the other services sector. The Noida and Greater Noida micro-market is led by the IT sector and the Gurgaon market is led by the BFSI and other services sector.
- Overall vacancy levels are as high as 16%, but the key areas such as DLF Cyber Hub and Connaught Place are seeing very low single-digit vacancy rates.

Our take: *The city's commercial sector doesn't face a risk due to IT slowdown. However, a wave of massive supply will hit NCR in the next few years, which could lead to increase in vacancy rates and lower hikes in rentals.*

Vacancy have dipped steadily. Strong demand continues along with strengthening supply



Other services and manufacturing continue to dominate



Source: Cushman Wakefield, PhillipCapital India Research

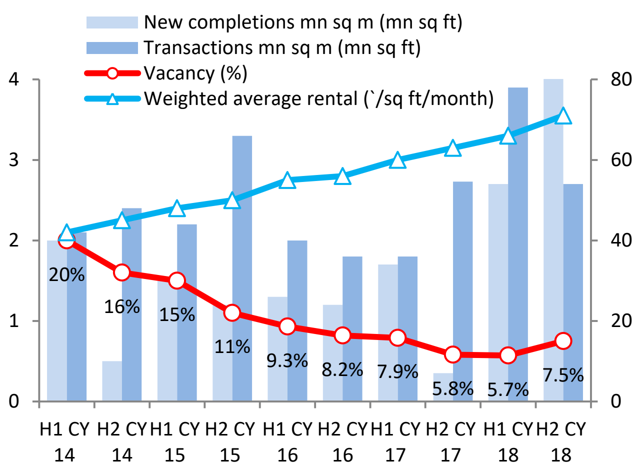
Pune

With slowdown in IT, does danger loom around the corner?

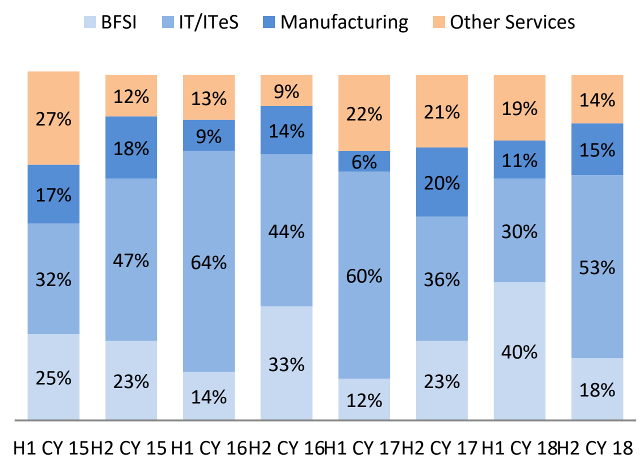
- Like Bangalore, Pune enjoys one the lowest vacancy rates and highest price yield realizations in India.
- Predominantly led by the IT sector – so a slowdown in IT will be a key concern.
- Seeing a pickup in leasing by co-working spaces, which could help to fill a void left by IT.

Our take: *The supply rate over the next few years will slow down and demand from IT will also decelerate. Therefore, Pune's vacancy rates will stay in low single digits and rental yields will increase over the short to medium term, unless the IT sector enters a deeper bearish phase.*

Demand-supply dynamics in sync (on an average) – keeping vacancy levels low



IT continues to dominate – a possible concern because of slowdown in its growth



Source: Cushman Wakefield, PhillipCapital India Research

Companies Section

PhillipCapital

Phoenix Mills Ltd (PHNX IN)

Retail king: Expanding portfolio, huge untapped potential

INDIA | REAL ESTATE | INITIATING COVERAGE

24 May 2019

Phoenix Mills has a diversified presence across retail, residential, commercial and hospitality with primary focus on retail, where it has mastered the art of execution – a key ingredient for success. We believe that its upcoming strong additions of retail and commercial assets (unlike residential, these should see continued strong growth) place it at the right place at the right time. This, along with its well-placed strong existing portfolio, execution capabilities, and strong realization growth in annuity assets, should drive revenue CAGR of 10% over FY19-21. Also, surplus FSI in existing and upcoming retail assets will ensure strong future growth, an added advantage. PHNX currently trades at a significant discount to NAV.

Diversified segment mix provides stability: PHNX has a diversified presence across retail, residential, commercial, and hospitality, which provides revenue visibility. It is the right mix of volatile and stable revenue streams.

Focused management; alignment towards retail business: Over the years, PHNX has diverse experience in successfully developing and managing malls. The success of malls totally depends on execution, and we reckon PHNX is and has been working continuously towards improving its execution strategy and customer experience. There is significant demand for superior quality malls in India and annuity assets will drive the Indian real-estate (RE) sector.

Strong existing and upcoming portfolio. One-stop shop: PHNX has a diverse portfolio with 9 completed and 5 under-construction retail assets, 5 completed and 2 under-construction commercial assets, and 2 completed and 1 under-construction residential project across 9 cities. Three of the upcoming retail projects and one commercial project are funded through equity infusion by CPPIB. The total leasable area of its malls will rise to 10.8 mn sq. ft. in FY23 from current levels from 5.9 mn sq. ft., and commercial leasable area to 3.3mn sq. ft. from 1.2mn sq. ft. This upcoming retail portfolio shall ensure PHNX's status as a one-stop shop for brands that target a presence in multiple markets in superior retail spaces.

Master at its trade: PHNX's experience over the years has made the retail segment its forte. Its strong brand portfolio (600+ brands across various assets), differentiated approach towards target audiences by creating Phoenix Market City (mid and mid-to-high tier) and Palladium (premium) brands, differentiated and unique approach towards mall execution, and customer engagement provides good visibility for the mall's consumption growth.

Huge untapped potential: As PHNX typically aims to build retail assets of c.1 mn sq. ft. of leasable area, it requires 20-25 acres of land. Also, because its malls are usually no more than 4-5 stories high, there is a huge surplus FSI, which it uses later to build either a commercial, hospitality, or residential space (in this order of preference). Also, it has untapped development potential at its key project High Street Phoenix. All this provides visibility for future cash flow and business potential.

Revenue growth and margin expansion over FY19-21 and beyond: We expect revenue CAGR at 5% on increasing rentals and ARRs, 2 commercial properties and 2 retail (currently under development) becoming operational and improved sales velocity of the real estate projects. We expect EBITDA margins to improve to 53% from 48% on better margins of certain retail, commercial, and hospitality assets, as they mature and decrease in the share of residential segment (comparatively lower margin); we don't expected project addition in its residential portfolio. By FY24, upcoming retail assets (5) and commercial assets (2) would be operational and stabilised, leading to higher incremental revenue growth and even better margins.

BUY
CMP RS 616
TARGET RS 800 (+30%)

COMPANY DATA

O/S SHARES (MN) :	153
MARKET CAP (RSBN) :	94
MARKET CAP (USDBN) :	1.3
52 - WK HI/LO (RS) :	725 / 25
LIQUIDITY 3M (USDMN) :	1.0
PAR VALUE (RS) :	2

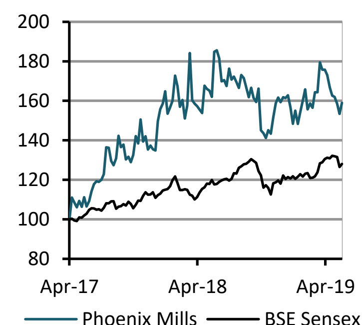
SHARE HOLDING PATTERN, %

	Mar 18	Dec 18	Sep 18
PROMOTERS :	62.8	62.8	62.8
FII / NRI :	27.1	28.7	28.6
FI / MF :	5.0	3.6	3.6
NON PRO :	1.0	1.0	0.9
PUBLIC & OTHERS :	4.2	4.0	4.2

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	2.7	4.4	-13.4
REL TO BSE	2.1	-3.8	-26.4

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY19E	FY20E	FY21E
Net Sales	19,816	23,865	21,162
EBIDTA	9,931	12,053	11,217
Net Profit	4,489	4,867	3,672
EPS, Rs	27.0	28.5	20.5
PER, x	22.8	21.7	30.1
EV/EBIDTA, x	14.6	12.6	13.5
P/BV, x	2.7	2.5	2.4
ROE, %	13.1	12.0	8.1
Debt/Equity (%)	1.1	1.2	1.3

Source: PhillipCapital India Research Est.

Dhaval Somaiya, Research Associate
Vaibhav Agarwal, Research Analyst

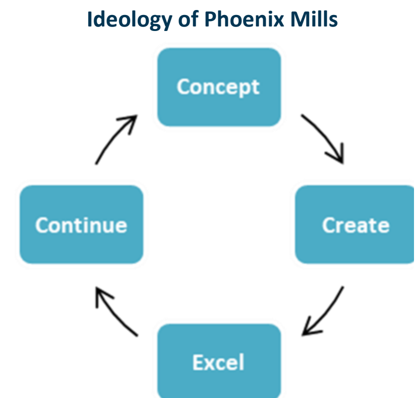
Phoenix: Transformation from Mills to Malls

Phoenix Mills (PHNX) began as a textile-manufacturing mill in 1905 on a 17.3-acre land parcel in Mumbai. It was listed on the BSE in 1960. Over the years, as the dominance of the textile industry reduced in India, the promoter (the Ruia family) decided to develop its land parcel in the heart of Mumbai – it entered the real estate segment. It built its first commercial centre – Phoenix Centre – in 1986, followed by a residential tower in Mumbai in 1992.

After the success of these two projects, PHNX decided to foray deeper into the segment and in 1999 it transformed its mill into a shopping and entertainment destination – High Street Phoenix (HSP). Back then, most of India was unaware of the mall and hypermarket culture. High Street Phoenix introduced Asia's largest bowling concourse and first hypermarket called *Big Bazaar* among other attractions. By 2003, this place had become a successful entertainment destination and helped the management learn the nuances of the retail business in India.

In 2004, the management decided to covert High Street Phoenix into a mall by introducing additional 400,000 sq. ft. retail space. By 2006, it decided to build its first luxury hotel at this property. In 2007, PHNX raised a QIP of Rs 13bn to expand its portfolio. The next year, it added a premium space in HSP called *Palladium*. By then, the management had a clear focus to foray into the construction of retail, commercial, hospitality, and real estate businesses with a primary focus on retail assets. With the expertise and liquidity that it got from completed projects, Phoenix Mills began Phoenix Market City malls in Pune, Bangalore, Mumbai, and Chennai.

Ideology of Phoenix Mills



PHNX-CPPIB alliance

- In 2018, PHNX entered into a strategic alliance with Canadian Pension Plan Investment Board (CPPIB) to acquire, develop, and operate retail (primarily), commercial, and hospitality properties. CPPIB invested Rs 16.6bn in Island Star Mall Developers Pvt. Ltd. (ISMDPL), PHNX's subsidiary, for a 49% equity stake. The rest was with PHNX, whose contribution to the alliance was PML Bangalore (which was transferred to ISMDPL).
- As of 2019, PHNX has developed nine retail assets and five more malls are under development out of which three are under the CPPIB platform.
- PHNX has two hospitality assets, two completed and one under-construction residential assets, and five rent-yielding commercial assets with plans in place for two more.

Timeline of PHNX's evolution

- **1905** - Started by the Ruia family; began operations as a textile company on 21 acres of land in Lower Parel, Mumbai
- **1986** - Opened Phoenix House and Phoenix Center with 350,000 sq. ft. of office space
- **1996** - Phoenix House
- **1999** - Opened High Street Phoenix Mall
- **2001** - Big Bazaar started operations at High Street Phoenix
- **2002** - Built the first multi storied residential luxury tower: Phoenix Towers
- **2007** - Successfully raised Rs 13bn through a QIP and preferential issue. Announced the development of 'market cities' in Mumbai, Pune, Bangalore, and Chennai
- **2008** - Palladium, Mumbai
- **2009** - Opened a luxury mall -- The Palladium -- at Mumbai
- **2010** - Phoenix United Lucknow
- **2011** - Phoenix Market City Bangalore, Pune, Mumbai
  - Launched Chennai -- The Crest. Phoenix Paragon Plaza, Mumbai, commercial
- **2012** - Phoenix United Bareilly, Centrium, East Court, Palladium Hotel - Completed
  - Launched commercial development Art Guild House in Kurla, Mumbai
  - Launched One Bangalore West, residential development in Bangalore
- **2013** - Phoenix Market City Chennai
- **2014** - Launched Fountainhead Residential development in Pune
- **2015** - Phoenix Paragon Plaza, Courtyard by Marriott - Agra, Launched Kessaku, Luxury Residential Development, Bangalore
  - Announced Strategic retail platform with CPPIB for development of Greenfield & Brownfield retail-led assets in India
  - Palladium hotel rebranded as The St. Regis, Mumbai; Acquired controlling stake in Gangetic Hotels, Agra
  - Successfully raised INR 2.83bn through a QIP in July 2015
- **2016** - Art Guild House
- **2018** - Palladium Mall, Chennai
- **2019** - Fountain Head Phase 1, Pune

Annuity, hospitality assets keep portfolio stable

Annuity and hospitality assets drive top-line; real estate assets free up capital

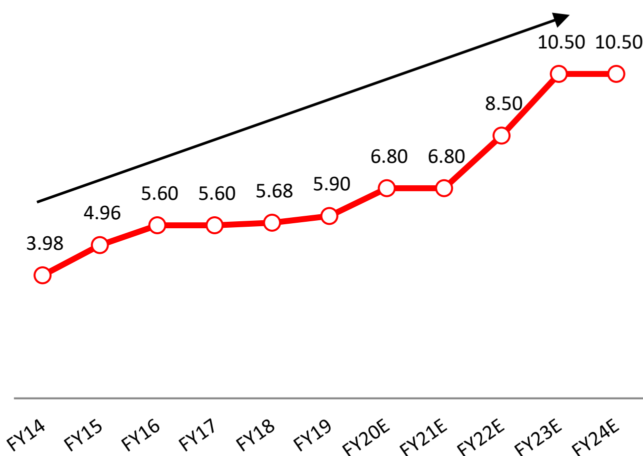
We like PHNX's revenue mix of retail and commercial rentals, hospitality, and real estate – because while real estate and hospitality are relatively more volatile, retail and commercial annuity provide stability and revenue visibility.

Details of its portfolio

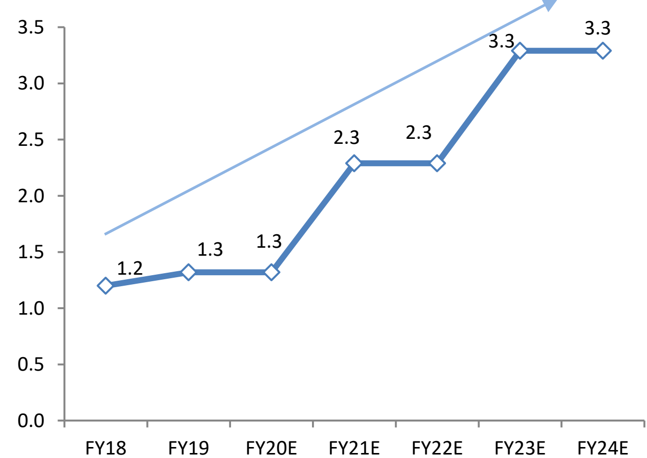
Currently, PHNX has a diverse portfolio across nine cities, which will take its total leasable malls area to 10.8mn sq. ft. from current 5.9 mn sq. ft. and commercial leasable area to 3.3mn sq. ft. from current 1.2mn sq. ft.

- Retail assets: 9 completed, 5 under construction
- Commercial assets: 5 completed, 2 under construction
- Residential projects: 2 completed, 1 under construction

Total leasable area (malls)



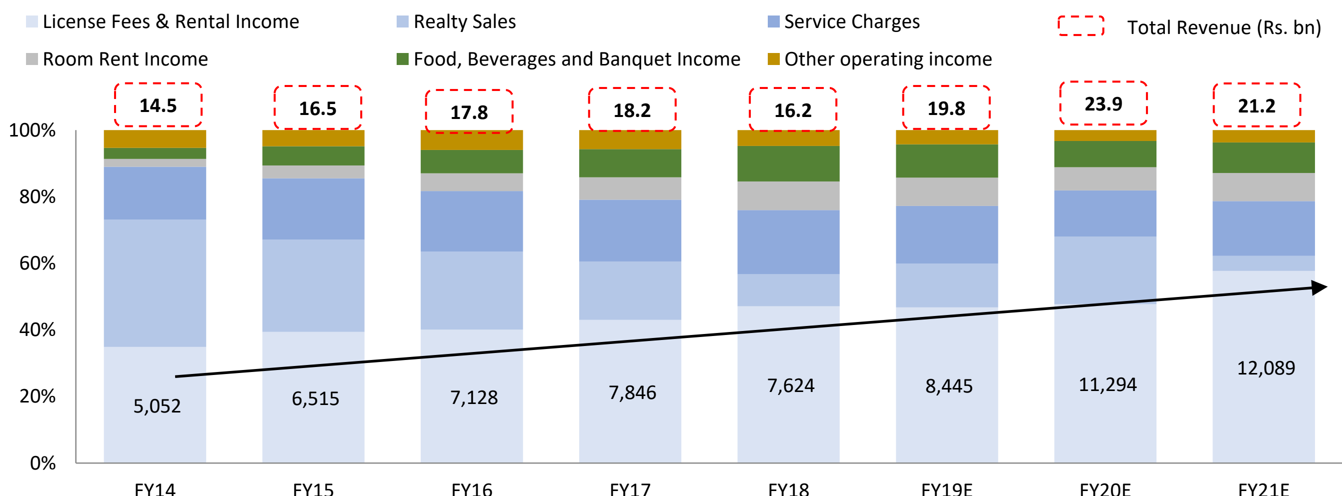
Total commercial leasable area



Source: Company Data, PhillipCapital India Research

Revenue breakup (%)

Over FY14-21 the share of its rental income will rise to 58% from 35%. This shows the strong alignment of the management towards the retail business. Hospitality business' revenue share will rise to 16% from 5% while realty business' share will fall to 5% from 38% as revenue will not be recognised because of IND AS 115, and assuming no new residential projects are undertaken



Source: Company Data, PhillipCapital India Research

Retail, hospitality, residential revenue share

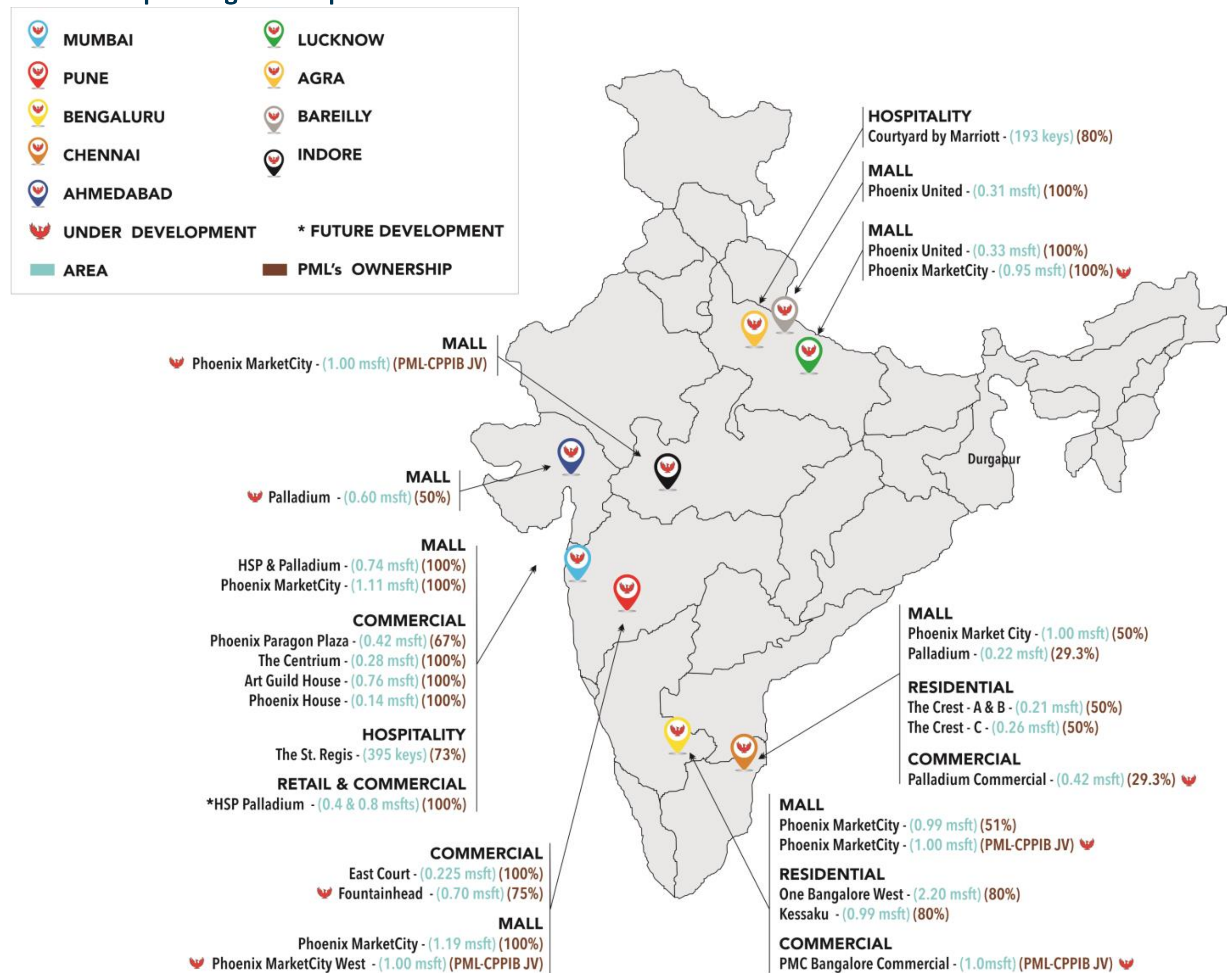
Retail: Over FY19-21, we expect retail's share to rise to around 58% from current levels of 43% based on four reasons:

1) Increase in rentals from existing retail and commercial assets.
2) Palladium Chennai and PMC Lucknow beginning operations.
3) Fountain Head Phase 1 operationalization (Pune – commercial project).
4) Lag in real Estate revenue recognition due to the implementation of IND AS 115.

Hospitality: These revenues should stabilise around 18% in FY19-21.

Residential: These revenues will continue to look weak because there won't be any revenue recognition from the sale of new phases of One Bangalore West (residential project) over the coming years.

Phoenix: Expanding its footprint



Source: Company Data, PhillipCapital India Research

Retail: What makes Phoenix's malls stand out

Right place, right time, right skills

Due to the scarcity of Grade-A-quality retail spaces, their demand has outstripped supply. Not surprisingly, these assets have been generating incrementally better rental yields consistently over the past couple of years. Going forward, PHNX's primary focus will remain on retail, commercial, and hospitality assets (by using surplus FSI on the land parcels it buys for malls).

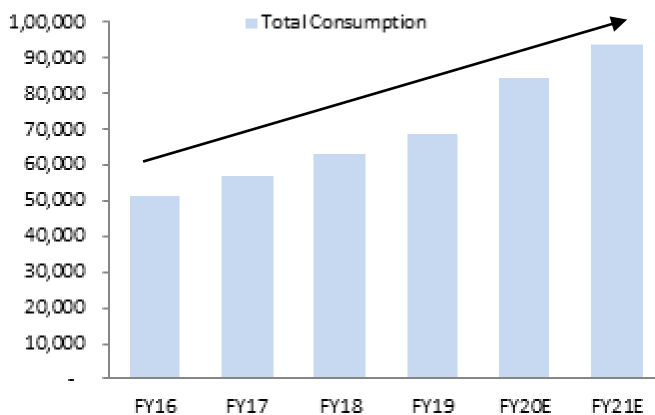
PHNX has mastered the high-risk, high-return stakes in retail

A retail asset's annuity model is more advanced than a commercial one. Retail is an execution play and if a developer is successful in mastering this, returns are significantly higher than a commercial asset.

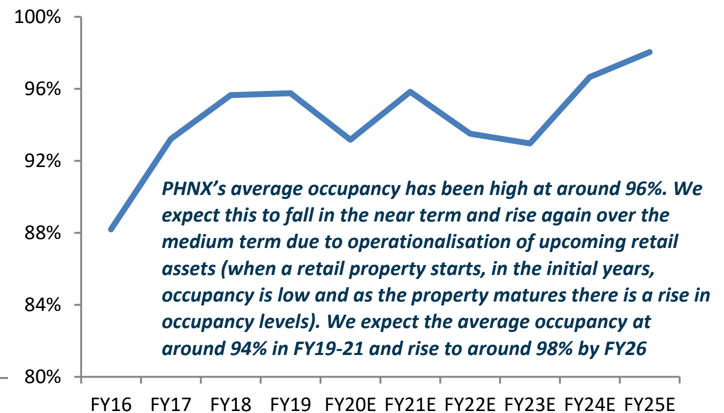
We believe that PHNX has mastered retail (mall) execution by leveraging its diverse experience in managing retail assets. We have discussed this in detail in the industry section (click here). The success of a mall depends on what we call its four pillars (product mix, catchment, customer experience, and overall strategy and execution) and three thumb rules – innovate, upgrade, and do not sell. We believe that the reason for PHNX's success in its retail portfolio is that it has adhered to all the four pillars and all three thumb rules. This has led to consistently low vacancy rates, high trading occupancy, high growth in consumption, and higher rental yields for PMLs properties.

PML hasn't sold any part of its any retail asset, which gives it complete authority over its entire property. This is the most important factor for a mall's success

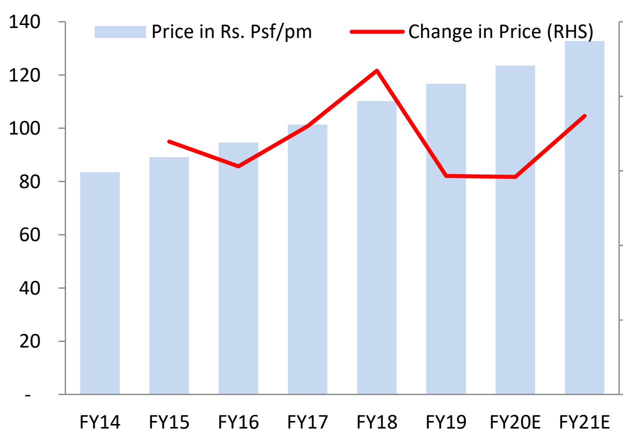
Consumption to grow at 10% CAGR over FY19-21 (Rs mn)



Overall average occupancy for retail assets

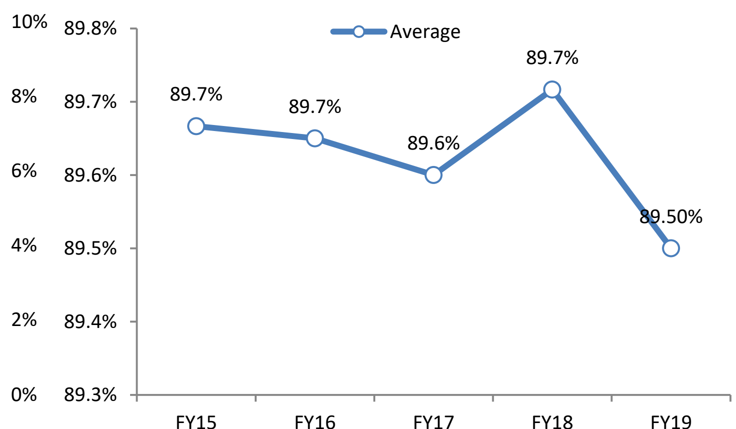


Phoenix's malls: Price realization seeing a healthy 7% CAGR



Price realizations (psf/pm – per square feet per month) over FY14-19 have seen 7% CAGR. Over FY19-21 we see these at 6.5%-7.0% CAGR

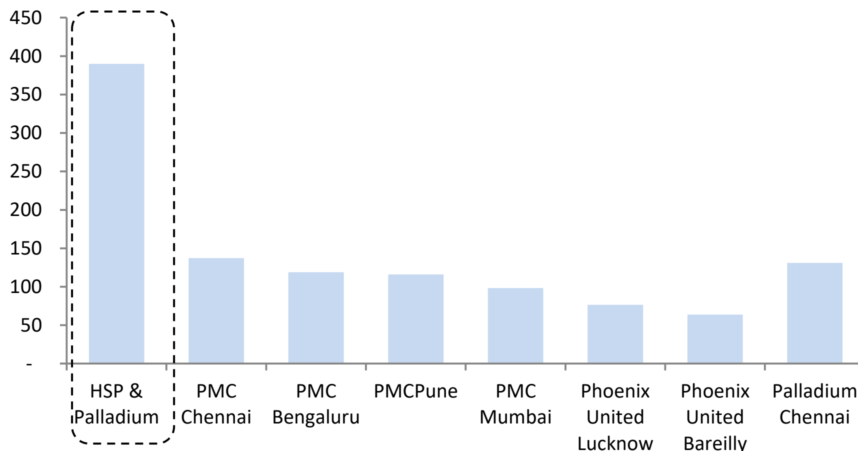
Phoenix's malls: Average trading density remains steady at high levels (around 90%)



The average trading density for PHNX's malls has been consistently high – at around 90% – over FY15-18

Source: Company Data, PhillipCapital India Research

Phoenix's malls: Average rentals psf/pm in FY19



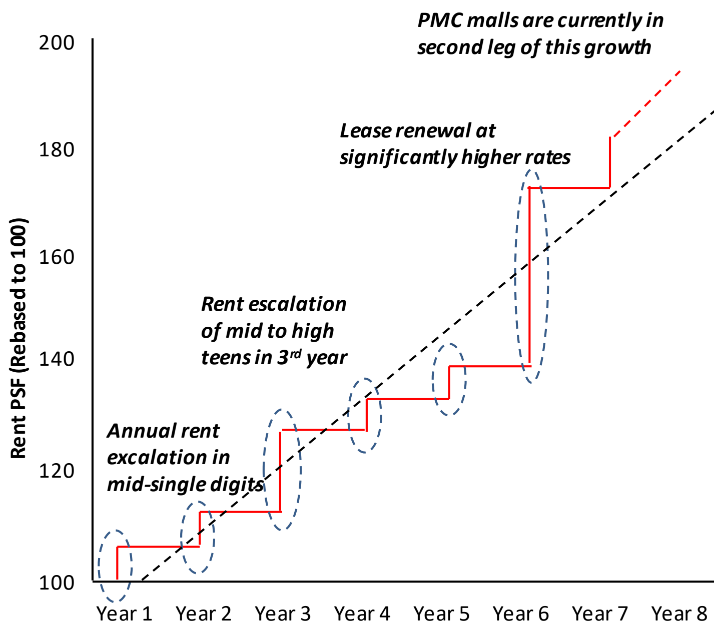
Source: Company Data, PhillipCapital India Research

HSP and Palladium command the highest rentals; average rate for the other malls is Rs 120 psf/pm

In a typical retail setup, the mall developer has three revenue streams:

1. Rental income
2. Revenue sharing from a lessee when a lessee crosses a hurdle rate of total revenue
3. HVAC (heating ventilation and air conditioning), CAM (common area maintenance) – this is typically not income as it is usually fully passed on to the lessee and is shown as an expense from the mall's books

Malls have a steeper rent appreciation cycle compared with commercial assets



Majority of retail lease agreements at PML pay higher of minimum guarantee (MG) rents and revenue share (% of consumption)

Generally MG escalates by mid-double digits at the end of 3 years and mid-to-high single digits annually in the interim

Typically a lease is renewed at the end of 5th year and the renegotiated MG / revenue share is significantly higher

Source: Company Data, PhillipCapital India Research

Phoenix has been very cautious in choosing its catchment areas

Phoenix Market City, Kurla, Mumbai, for example, is close to the domestic and international airports, with easy connectivity to south Mumbai via the Sea Link; also, the project is almost equidistant from the Eastern and Western Highways, ensuring easy connectivity to eastern and western suburbs.

High amount of focus on customer experience and strategy

Over years of operating malls, PHNX's strategy is centred around improving customer experience. Our on-the-ground research suggests that PHNX meticulously plans the placement of brands in its mall. It has created two distinguished types of malls:

1) Phoenix Market City (PMC) – which is typically a large setup (1mn sq. ft.+ leasable area) that houses many Indian and foreign brands (mid- to high-range)
2) Palladium: This is typically a relatively smaller setup in terms of leasable area and houses only exclusive premium brands.

PML provides a customizable layout of its malls online for easy access to its customers

1, 2: Layout of some stores in Palladium;
***3**: PML's publication keeps customers updated about latest fashion trends and brand arrivals*

PML provides a customizable layout of its malls online

PHNX seems to have adopted a multi-faceted approach – it engages with its customers through:

Special discounts which serve two purposes – attracting footfall and helping the brand to boost its sales

Assigning dedicated helplines for different services at the mall

Organizing events (including festival celebrations) at the mall for better customer engagement. PHNX has also created a specific series of events at HSP called Awestrung

Halloween fest organized at HSP

Concerts organized at HSP

New and innovative entertainment formats

Apart from the multiplexes and Time Zones, PHNX has introduced several other entertainment formats like Snow World (an artificial snow theme park), Amoeba (bowling alley and video games), and Flight for Fantasy (flight pilot simulation ride) – which serve as attractions and help achieve higher footfalls, both repeat and new.

It has also launched a Gourmet Membership Card (for PMC Mumbai and PMC Pune) which allows users to avail of discounts across various dining, beverage, and coffee shop outlets at PHNX's malls. Under this scheme, PHNX also provides vouchers for access to multiplexes and inline stores. It also includes passes for special events at the mall and easier accessibility to parking spaces. All this provides a wholesome experience to customers at discounted prices, ensuring customer loyalty, consistent footfalls, and consumption growth. PML has also introduced a Phoenix Gift Card, which is accessible across all Phoenix malls.

Diversity provides one-stop shop for customers

Visits to PHNX's malls reveal that it has a very focused approach towards the development of its retail properties. Most of its malls have >1mn sq. ft. of leasable area for a 'wholesome' experience to its customers. Because of this, PHNX is able to house more brands under one roof than its peers, which differentiates it to its users. Phoenix has an arrangement with more than 600 brands for its malls, which ensures a high level of customer satisfaction and is a competitive advantage against its peers.

Brands get maximum mileage with PHNX

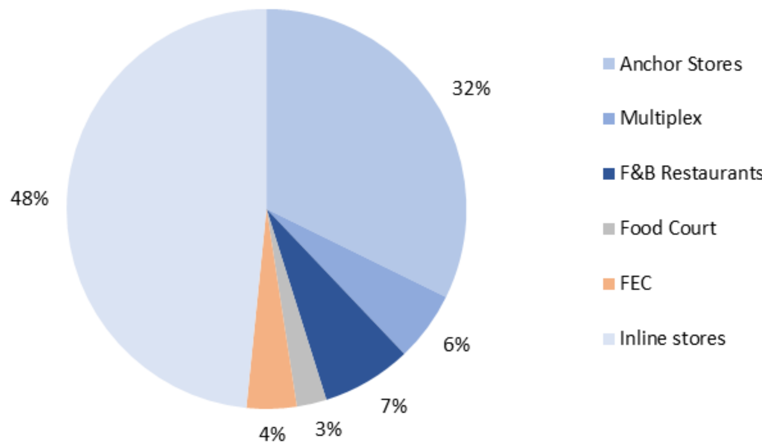
PML is the largest retail developer in India with the highest number of operating and upcoming retail assets. This is why with PHNX, any brand can make its presence felt at multiple cities. This gives PHNX an edge above other players.

Typical segment mix for its malls – anchor stores drive consumption

By leveraging its years of experience, it seems to have come to a typical segment mix for its malls. As per our analysis, 'anchor' stores occupy a major share of the pie at c.32%, 'inline' stores at 48%, F&B restaurants at c.7%, multiplex at c.6%, FEC (family entertainment centre) at c.4%, and food court at c.3%. This strategy provides greater revenue visibility – because anchor tenants typically have a longer tenure contracts (7-9 years) and usually have a stable and established business. This means as the revenue of anchor tenants rises, PHNX's could also rise because the structure of the deal between PHNX and its tenant includes a base lease plus revenue sharing.

Some of the marquee brands associated with PHNX

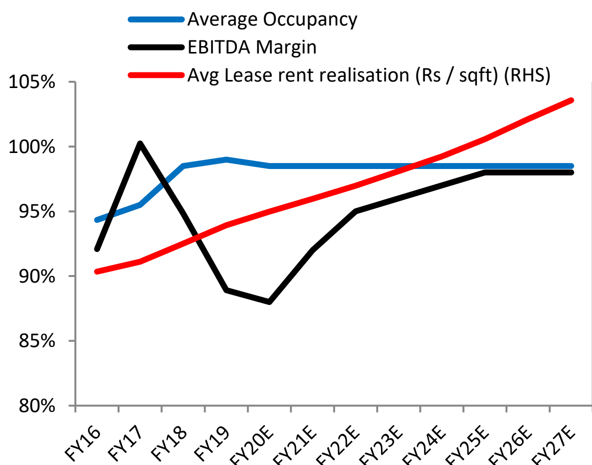
Typical mix of a Phoenix mall



Source: PhillipCapital India Research

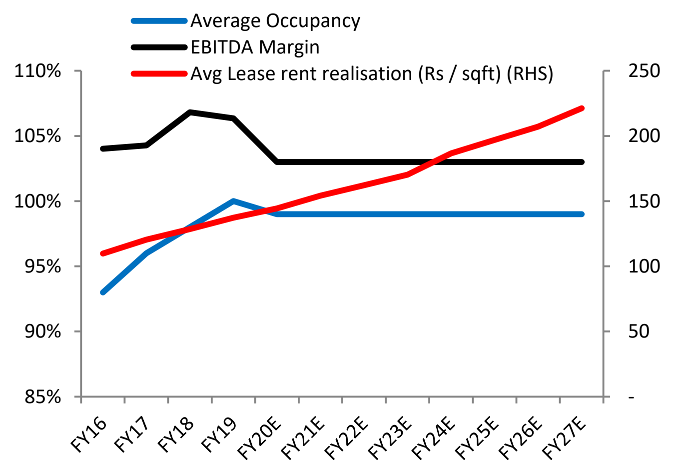
Occupancy rates, margins, and realisations for various PHNX properties

High Street Phoenix Palladium



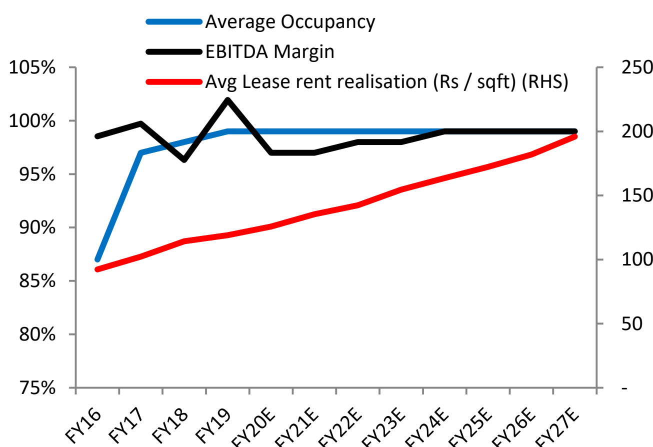
Average rentals CAGR: 11% over FY16-19
Average occupancy: 99%; EBITDA margin: 89%

Phoenix Market City Chennai



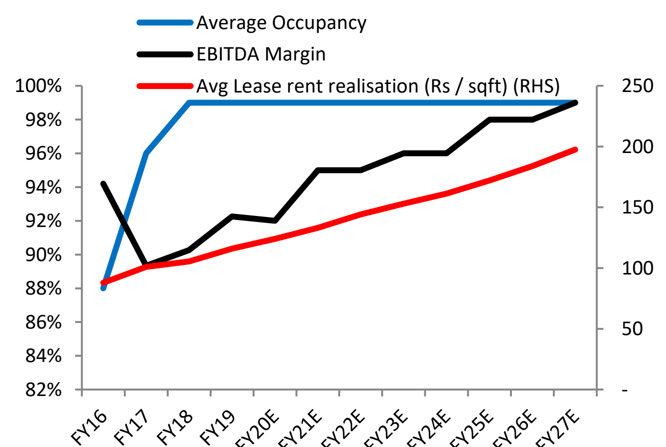
Average rentals CAGR: 8% over FY16-19
Average occupancy: 98%; EBITDA margin: 106%

Phoenix Market City Bangalore



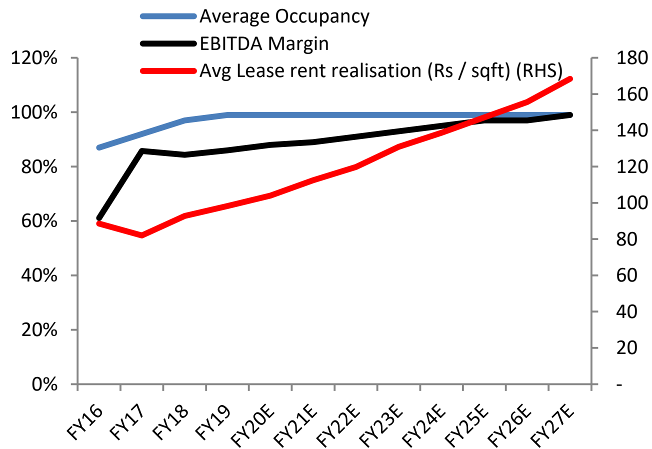
Average rentals CAGR: 11% over FY16-19
Average occupancy: 99%; EBITDA margin: 102%

Phoenix Market City Pune



Average rentals CAGR: 9% over FY16-19
Average occupancy: 99%; EBITDA margin: 92%

Phoenix Market City Mumbai



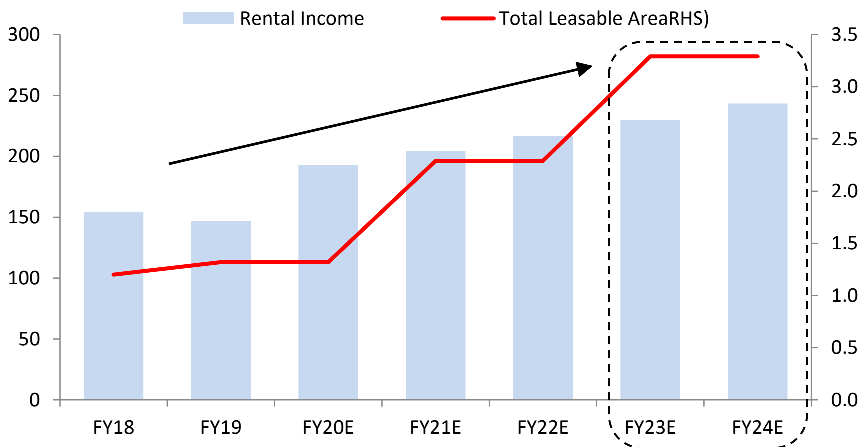
Average rentals CAGR: 6% over FY16-19
Average occupancy: 99%; EBITDA margins: 86%

Source: Company Data, PhillipCapital India Research

Commercial portfolio mix to improve

By FY24, PHNX's commercial portfolio is set to grow to 3.3mn sq. ft. from 1.2 mn sq. ft. currently; revenue should grow to c.Rs 250mn per annum from Rs 150mn currently because of revenue growth in existing properties and upcoming properties becoming operational – viz. Fountain Head, Pune phase-2 (0.5mn sq. ft.), Chennai Commercial (0.4 mn sq. ft.) and PMC Bangalore Commercial (1mn sq. ft.).

Rental income from commercial assets to rise from FY21

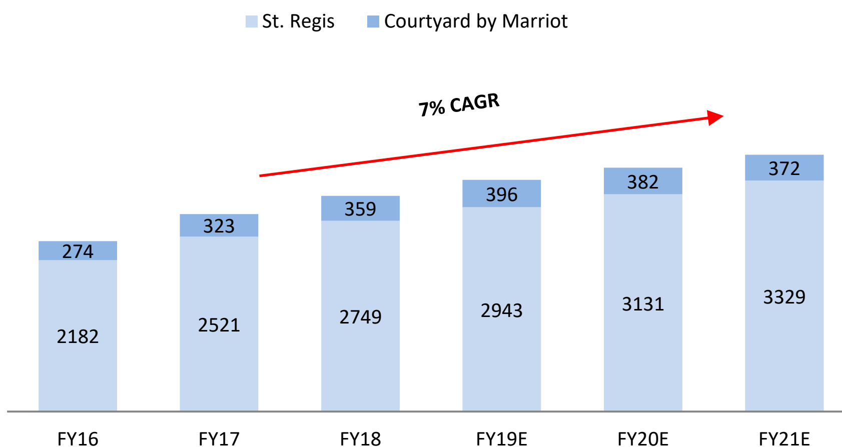


Source: Company Data, PhillipCapital India Research

Hospitality vertical: Stability continues

Currently, PHNX has two operational hospitality assets – St. Regis, Mumbai (395 keys) and Courtyard by Marriot (193 keys). St. Regis is its key hospitality revenue driver. The F&B to room-rent mix for both properties is 49: 51, which enhances performance stability and revenue visibility. We expect its hotels revenue CAGR at 8% over FY19-21 based on increase in average room rent (ARR) and increase in occupancy rates. Over FY19-21, EBIDTA margins of St. Regis will rise to c.44% from current 42% and those for Courtyard by Marriot will remain stable at 40%.

Hospitality revenue will see healthy 8% CAGR over FY19-21



Source: Company Financials, PhillipCapital India Research

Residential: Steady sales to drive cash-flow

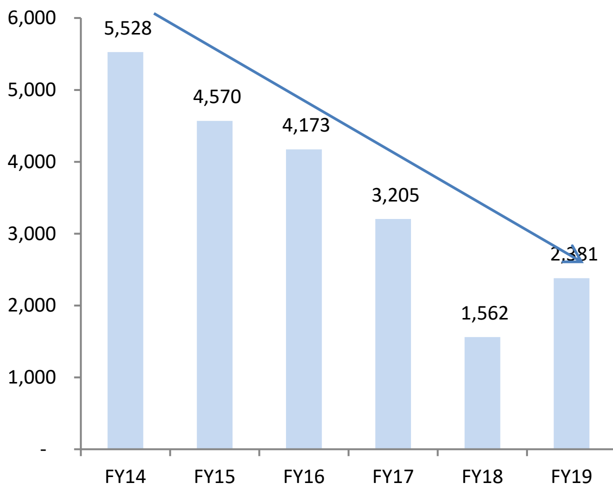
Overall share in the mix is declining though

Over the past couple of years, the Indian residential real estate sector has been plagued with various macroeconomic headwinds, business environment transitions (GST and RERA), and key government moves (such as demonetization and RERA). We believe that despite this, the sector seems to be reviving from FY18; even the government has started taking directionally positive measures such as GST rate cut.

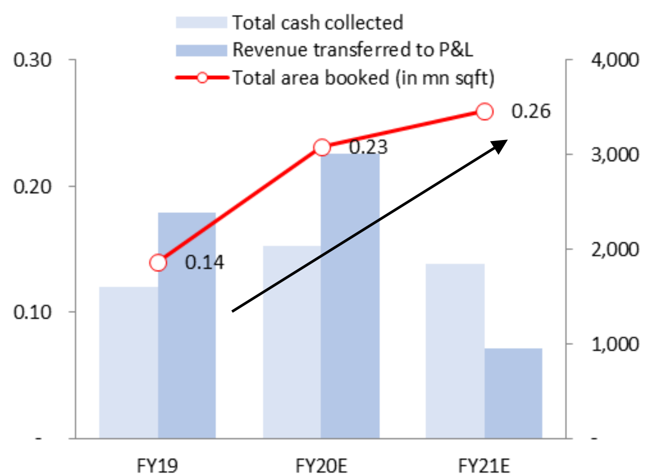
Over the past couple of years, PHNX's revenue from the residential segment was decreasing as the management focused more on its key segment – retail. PHNX has three residential projects – 2 in Bangalore (One Bangalore West and Kessaku) and 1 in Chennai (The Crest). The three projects have a total saleable area of 3.72mn sq. ft. out of which 3mn sq. ft. has already been constructed. Out of the constructed area, c.1.97mn sq. ft. is sold (as of 9MFY19). Over FY19-21, we expect PHNX to sell c.1mn sq. ft. of space from the remaining 1.75 mn sq. ft.

Because of the application of the new accounting standard (IND AS 115), revenue from the under-construction phase of One Bangalore West will not be recognized on the P&L, but it will reflect in the cash-flow statement. We expect the selling run-rate to improve over FY19-21 due to the reduction in GST rate to 5% from 12% in under-construction buildings and on improving demand.

Share of residential sales revenue is decreasing



Cash and revenue from the residential segment



Source: Company Financials, PhillipCapital India Research

Strong operating performance

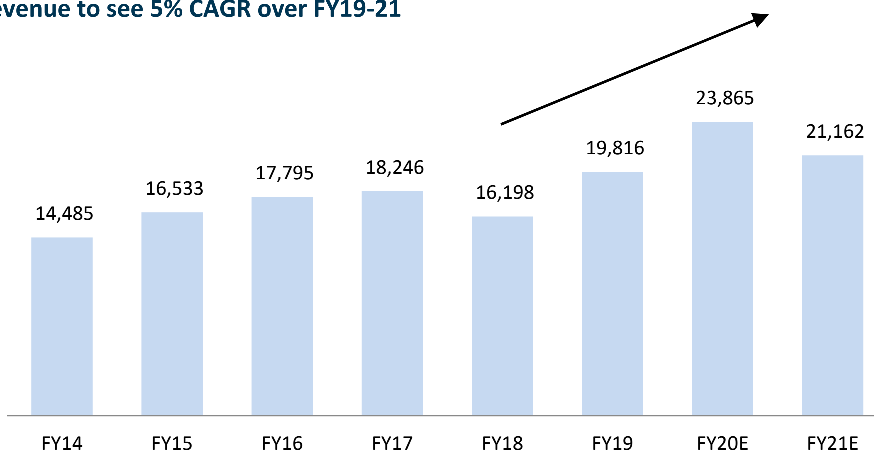
Our analysis suggests that PHNX's revenue is set to see 5% CAGR over FY19-21*. However, the actual growth rate could be well above this, as the revenue forecast doesn't account for the unrecognized revenue from the sale of residential units from the upcoming phases of One Bangalore West (owing to IND AS 115).

The revenue growth will be because of:

(1) Increase in rental rates for annuity assets
(2) Increase in ARR of the hospitality assets
(3) Increase in the sales velocity of the residential projects
(4) Operations of one commercial asset starting (Phase 1 of Fountainhead, Pune)
(5) Two retail assets starting (Palladium Chennai in FY19 and PMC Lucknow in FY20)

***Note:** FY21 revenue is laggard owing to residential revenue from further phases of One Bangalore West not being recognised

Revenue to see 5% CAGR over FY19-21



Source: Company Financials, PhillipCapital India Research

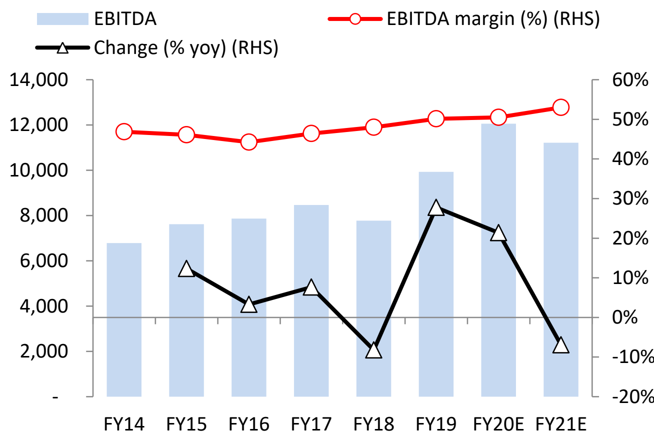
EBITDA margin for PML will improve from current levels of 50% to c.53% over FY19-21 because of:

1. Improvement in EBITDA margins of certain retail and commercial assets
2. Improvement in EBITDA margins of the St. Regis Hotel
3. Decrease of the share of the lower-margin residential segment (comparatively, annuity and hospitality segments yield better margins)

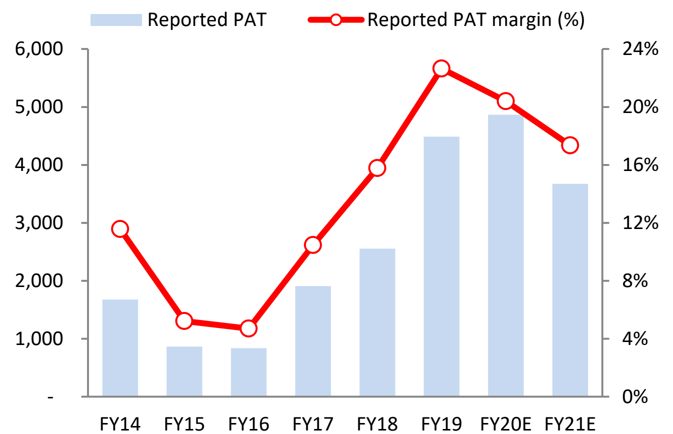
We expect PAT margins to reduce

1. PAT margins should reduce as debt and depreciation are set to rise because of construction of assets (addition of malls and commercial assets to the portfolio).
2. Reduction in revenue recognition from residential projects

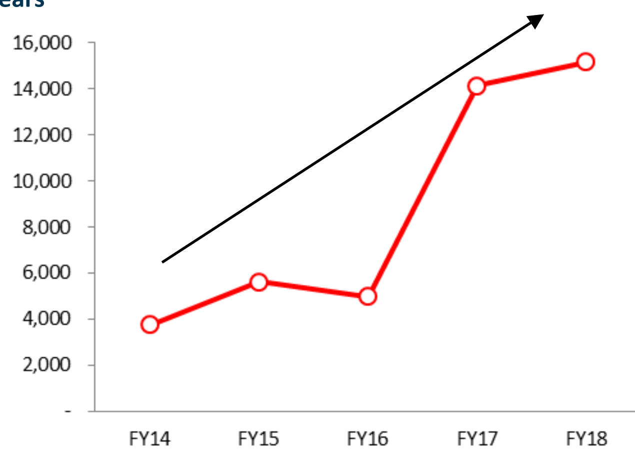
EBITDA margins to improve from 48% to 53%



PAT margins to reduce after FY20 because of increasing depreciation (as assets increase) and interest cost

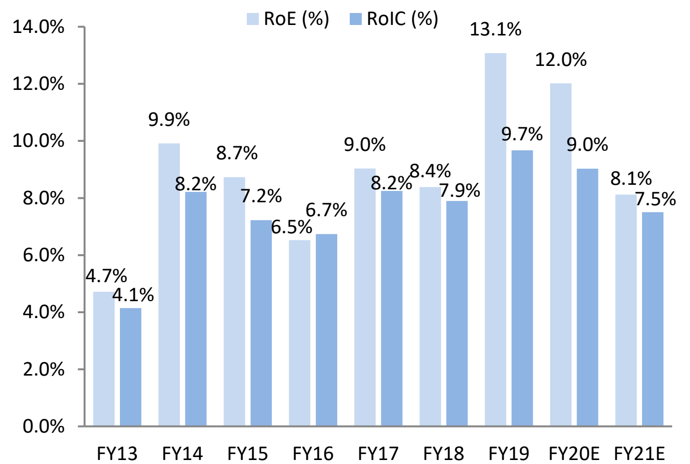


Cash flow from operating activities grew 4x in the past 4 years



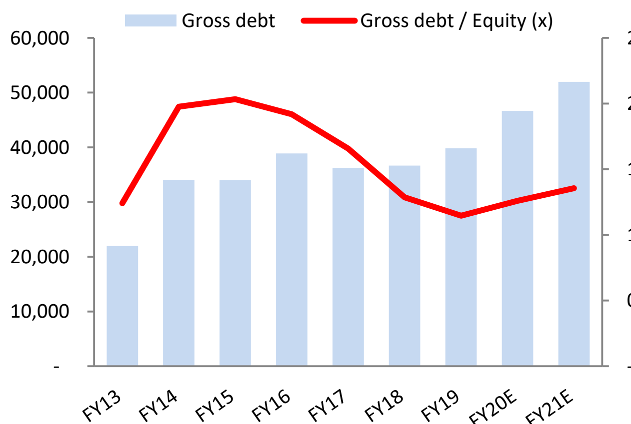
Over FY14-18, cash flow from operations has seen strong growth (about 4x)

ROE and ROIC to diminish because of reducing PAT



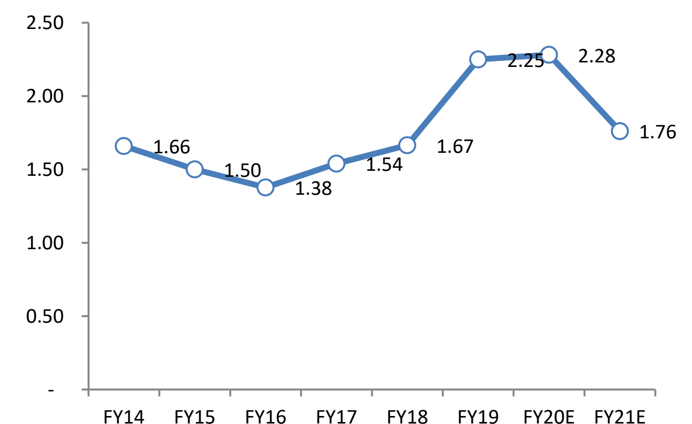
We expect ROE/ROIC to fall to 13.1%/8.1% by FY21 from current 9.7%/7.5% because of reducing PAT margins

Debt and gross D/E to rise – yet in a comfortable range



We expect PHNX's debt to rise to Rs 5.2bn in FY21 from current Rs 3.6bn, as the company will need capital to construct its five upcoming retail assets and three commercial assets over the next five years. This will lead to an increase in the D/E ratio to 1.4x by FY21 from current levels of 1.3x. 1.4x is a comfortable level. However, in the medium term, debt levels should fall, as the debt undertaken for upcoming commercial projects will be re-paid.

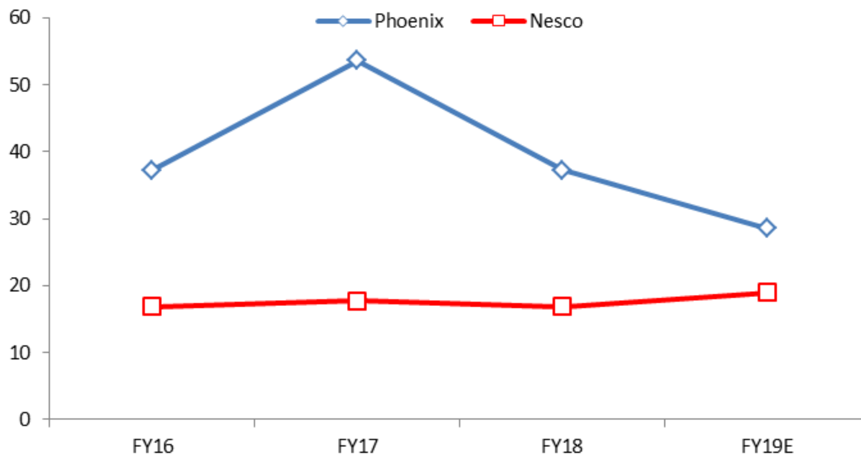
Interest cover to improve over FY19-20 and again stabilise in FY21



Though the debt will rise, we calculate that the interest cover ratio will rise to 2.28x in FY20 and to 1.76x by FY21 from current 2.25x. This is because of growth in revenue (and in turn EBIT) over FY19-20. However, even as overall revenue falls in FY21 due to reducing revenue from the real-estate segment and rise in debt levels pull down the interest cover, it will still be comfortable.

Source: Company Financials, Phillip Capital India Research

P/E ratio comparison with closest peer; right time to enter the stock



Source: Phillip Capital India Research

PHNX's P/E ratio is higher than its closest peer's due to the former's future development potential.
As the P/E ratio has declined from 53x in FY17 to 29x in FY19, it provides a good entry point for PHNX

Easy access to funding

PHNX has a diverse experience in raising funds through the equity route including successful QIPs in 2007, partnering with a couple of private equity players, and a successful strategic partnership with CPPIB. We believe it will have easy access to equity funding based on its experience, our belief of annuity assets being drivers of Indian real estate, and its strong brand and operational financial performance.

It has easy access to debt capital too, because the construction financing loans that it acquires for its annuity assets are usually converted into long-term Lease Rental Discounting (LRD) loans – lenders are typically comfortable with this type of structure.

Future visibility – A key driver of confidence

Future development potential on PHNX's already acquired and established land parcels and its experience in executing residential, commercial, and hospitality projects provide visibility and a cushion.

PHNX's focused approach towards retail assets can lead to many advantages: The firm typically follows a policy of creating retail assets with a leasable area of 1mn sq. ft. A mall of this size typically requires a land parcel of 10-15 acres (provided the mall is not more than 4/5 floor high; most of PHNX's malls are no more than this). So it usually has surplus FSI in all of its retail properties, where it can develop a hospitality asset in the future (like it did with St. Regis) or a commercial asset (like it is doing in PMC Bangalore commercial). This approach enhances its long-term growth visibility.

PHNX's key assets – HSP and Palladium – have a surplus development potential of 1.2mn sq. ft. where the firm plans to construct an additional 0.4mn sq. ft. of retail and 0.8mn sq. ft. of commercial space in the future, which will contribute significantly to revenue.

Valuation

We have used SOTP (sum of the parts) valuation methodology as all four verticals have different operations.

- **Retail**
  - We value this based on FY24 cash flow as all five upcoming malls will be operational and relatively stabilized by then
  - Capitalization rate of 8% (lower than commercial) as the revenue growth cycle of a retail property is steeper – typically 6-7% per annum on an average compared to a commercial property (5% per annum).

- **Commercial**
  - We value this based on FY24 cash flow as two upcoming commercial properties will be operational and stabilized by then; also to maintain uniformity in the year of projected cash flow used
  - We use a capitalization rate of 10% – higher than the retail vertical as the revenue growth cycle of a retail property is steeper – typically 6%-7% per annum on an average compared to a commercial property (5% per annum).

- **Hospitality**
  - We value this based on FY24 EV/EBITDA multiple of 15x
  - We considered FY24 EBITDA to maintain uniformity in terms of the discounting year selected

- **Residential**
  - Used the NAV method to value all the three residential projects
  - Discounted net cash flow from each project at a WACC of 13.1% to arrive at the NAV

The sum of NAV all the verticals has been taken (post debt and cash impacts) to arrive at the NAV of the firm and the target price of Rs 800, indicating an upside potential of 30%.

Segment	EV	Methodology
Retail Segment	1,29,131	NAV using Cap Rate of 8% - Basis FY24E Cash flow
Commercial Segment	11,110	NAV using Cap Rate of 9% - Basis FY24E Cash flow
Hospitality Segment	31,063	EV using EV/EBITDA- 15x FY24E EBITDA
Residential Segment	6,360	NAV method - WACC@13.1%
EV of the Firm	1,77,663	
Debt	56,187	FY24E Total Debt
Cash	449	
NAV	1,21,925	
No. of Shares	153	
NAVPS	800	

Source: PhillipCapital India Research

Risks

1. **Interest rate risk:** As the firm uses debt for construction financing and then converts it into long-term LRD loans, increase in interest rates will significantly impact cash flows.
2. **Increase in competition in the retail space:** We expect large amounts of superior-grade retail inventory entering the market in FY19-23 (covered in the industry section). More private-equity players are also investing in this space through equity infusion in retail projects by experienced players, providing much needed liquidity for retail companies to construct more assets. This could possibly thwart PHNX's existing and upcoming malls.
3. **Saturation of rental growth:** We reckon that as a retail property matures, its yield growth also tapers down, unless the mall's consumption keeps growing at a high rate.
4. **Slowdown of demand for commercial and residential spaces:** A wave of large residential and commercial inventory will hit the market around FY21-22, which could slow down the commercial segment and hamper the recovery of the ailing residential segment.
5. **Macroeconomic factors:** Adverse macroeconomic factors will affect all four business verticals, especially the retail model, as it is directly linked to people's spending patterns.
6. **Brand aggregator:** A few emerging brand aggregators hire significant space in a single mall. If these aggregators keep growing their brand portfolio, their bargaining power will increase, depressing PHNX's rental yield growth.
7. **Availability of land parcel:** Finding land parcels of 20-25 acres is extremely difficult.
8. **Revenue uncertainty due to IND AS115:** Due to this, revenue recognition of a residential project can take place only on assurance; in PHNX's case, this means that recognition will happen only after receiving the completion certificate/occupation certificate, which leads to uncertainty about when the revenue will be transferred to the P&L.
9. **Non-adoption of the omni-channel retail strategy:** PHNX does not have a strong omni-channel model, which would have insulated it against e-commerce players. Our ground research suggests that many of its peers have already adopted and successfully implemented the omni-channel model.
10. **Oberoi Realty's I-Ven mall coming up in the same micro-market as PHNX's key retail asset HSP Phoenix:** Oberoi Realty's mall, I-Ven, is coming up near PHNX's HSP Phoenix – which is the highest contributor to it retail-segment revenue). If the mall sees lower footfalls because of competition, PHNX's revenue growth will fall.

Financials

Income Statement

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Net sales	**16,198**	**19,816**	**23,865**	**21,162**
Growth, %	-11	22	20	-11
Raw material expenses	-1,319	-2,189	-1,604	-894
Employee expenses	-1,473	-1,615	-1,909	-1,693
Other Operating expenses	-5,632	-6,080	-8,298	-7,358
EBITDA (Core)	**7,774**	**9,931**	**12,053**	**11,217**
Growth, %	(8.2)	27.8	21.4	(6.9)
Margin, %	48.0	50.1	50.5	53.0
Depreciation	-1,983	-2,043	-2,708	-2,847
EBIT	**5,791**	**7,888**	**9,345**	**8,370**
Growth, %	(11.1)	36.2	18.5	(10.4)
Margin, %	35.8	39.8	39.2	39.6
Interest paid	-3,476	-3,505	-4,095	-4,751
Other Non-Operating Income	556	851	565	570
Pre-tax profit	**2,871**	**5,234**	**5,815**	**4,189**
Tax provided	-758	-1,099	-1,454	-1,047
Net Profit (adjusted)	**2,113**	**4,136**	**4,361**	**3,142**
Growth, %	11.0	95.7	5.5	(28.0)
Net Profit	**2,555**	**4,489**	**4,867**	**3,672**
Unadj. shares (m)	153	153	153	153
Wtd avg shares (m)	153	153	153	153

Balance Sheet

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Cash & bank	449	1,920	2,047	7,865
Debtors	1,292	1,955	1,903	1,687
Inventory	6,616	8,986	10,822	9,596
Other current assets	5,780	5,271	8,516	7,551
Total current assets	14,136	18,132	23,288	26,699
Investments	8,290	7,450	7,450	7,450
Gross fixed assets	63,314	73,915	80,915	81,875
Less: Depreciation	-10,356	-12,399	-15,107	-17,954
Add: Capital WIP	5,025	8,960	10,085	15,224
Net fixed assets	57,983	70,476	75,892	79,145
Goodwill	3,711	3,711	3,711	3,711
Total assets	**84,120**	**99,769**	**1,10,341**	**1,17,005**
Current liabilities	14,023	13,741	13,537	12,973
Provisions	1,100	630	630	630
Total current liabilities	15,123	14,371	14,167	13,603
Non-current liabilities	35,819	38,424	45,273	50,590
Total liabilities	50,942	52,795	59,440	64,193
Minority Interest	4,661	12,233	13,044	13,293
Paid-up capital	306	307	307	307
Reserves & surplus	28,211	34,435	37,550	39,213
Shareholders' equity	28,517	34,741	37,857	39,519
Total equity & liabilities	**84,120**	**99,769**	**1,10,341**	**1,17,005**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Pre-tax profit	2,871	5,234	5,815	4,189
Depreciation	1,983	2,043	2,708	2,847
Chg in working capital	7,588	-3,277	-5,232	1,841
Total tax paid	-296	-1,639	-1,455	-1,047
Cash flow from operating activities	**15,066**	**5,015**	**5,366**	**12,011**
Capital expenditure	-15,355	-14,537	-8,124	-6,099
Chg in investments	-4,194	840	0	0
Cash flow from investing activities	**-18,317**	**-12,011**	**-7,053**	**-4,999**
Free cash flow	-289	-9,521	-2,758	5,911
Equity raised/(repaid)	0	1	0	0
Debt raised/(repaid)	410	3,145	6,851	5,317
Dividend (incl. tax)	0	-367	-940	-1,020
Cash flow from financing activities	**2,888**	**8,948**	**1,815**	**-1,194**
Net chg in cash	-363	1,952	128	5,817

Valuation Ratios

	FY18	FY19e	FY20e	FY21e
Per Share data				
EPS (INR)	13.8	27.0	28.5	20.5
Growth, %	11.0	95.5	5.5	(28.0)
Book NAV/share (INR)	186.3	226.6	247.0	257.8
CEPS (INR)	26.8	40.3	46.1	39.1
CFPS (INR)	2.9	12.5	13.4	51.3
DPS (INR)	2.4	5.1	5.5	4.2
Return ratios				
Return on assets (%)	6.1	7.5	7.1	5.9
Return on equity (%)	8.4	13.1	12.0	8.1
Return on capital employed (%)	7.7	10.0	9.5	7.7
Turnover ratios				
Asset turnover (x)	0.3	0.3	0.3	0.3
Sales/Total assets (x)	0.2	0.2	0.2	0.2
Sales/Net FA (x)	0.3	0.3	0.3	0.3
Working capital/Sales (x)	(0.1)	0.1	0.3	0.2
Receivable days	29.1	36.0	29.1	29.1
Inventory days	149.1	165.5	165.5	165.5
Payable days	340.8	264.7	216.7	234.6
Working capital days	(32.3)	33.9	108.2	90.2
Liquidity ratios				
Current ratio (x)	0.9	1.3	1.6	2.0
Quick ratio (x)	0.5	0.6	0.9	1.3
Interest cover (x)	1.7	2.3	2.3	1.8
Total debt/Equity (%)	1.3	1.1	1.2	1.3
Net debt/Equity (%)	1.3	1.1	1.2	1.1
Valuation				
PER (x)	44.6	22.8	21.7	30.1
PEG (x) - y-o-y growth	405.4	23.9	396.7	(107.5)
Price/Book (x)	3.3	2.7	2.5	2.4
EV/Net sales (x)	8.3	7.3	6.4	7.2
EV/EBITDA (x)	17.4	14.6	12.6	13.5
EV/EBIT (x)	23.3	18.3	16.3	18.1

PhillipCapital

Sobha Ltd (SOBHA IN)

The backward-integrated player; riding the correct wave

24 May 2019

INDIA | REAL ESTATE | INITIATING COVERAGE

Sobha's primary focus is on residential RE. Its auxiliary verticals (contractual construction and manufacturing) provide more stability and an enhanced experience to its customers. We like Sobha for: (1) Its strong execution capabilities and pre-sales trend, (2) its focus on diversifying itself into other cities (currently its key focus is Bangalore), (3) its entry into affordable housing under PMAY (majority of its projects are in the mid-tier range) with the salaried class as its major clientele, (4) its strong contractual and manufacturing verticals with revenue visibility of Rs 25bn over the next 30 months; manufacturing is inching towards 100% capacity utilization, and (5) its strong growth in bookings and cash flow over FY19-21. Sobha trades at a discount to its NAV.

- **Unique backward-integrated model provides stability:** Sobha calls its business model 'backward-integrated' and we agree because it has a contractual construction division and a manufacturing business (including glazing and metal works, concrete products) apart from its mainstay real-estate development business (mainly residential). Other than providing a better customer experience, this model lends stability – as the other verticals provide cash-flow visibility against the relatively volatile real-estate business.
- **Strong presales:** While the industry faces a sales slowdown, Sobha's continued incremental momentum in strong pre-sales provides stability and growth support.
- **Track record of minimalistic inventory overhang:** The industry, including some of the Sobha's peers, grapples with an inventory overhang while Sobha has maintained its track-record of minimal completed inventory overhang at 2-3%.
- **Clear focus on real-estate development (primarily residential):** Residential real-estate development is its forte; management will continue to focus on this.
- **Foray into affordable housing (PMAY), a flashback for Sobha:** Ready to capitalise on PMAY, it launched its first project under PMAY in Q3FY19 and a second in Q4. It is likely to be successful in this; in its pre-IPO days, it has developed affordable projects. Though PMAY projects will be margin dilutive, they provide Sobha with a 'volume play' rather than 'margin and pricing play', which we believe will be the way forward.
- **Target audience calibrated with precision**: With end users becoming actual buyers vs. investors earlier, mid-tier housing and affordable housing will be the drivers of the sector.. Sobha is hitting a bull's eye in this direction, with majority of its projects falling under affordable (despite being at a relative premium pricing, we consider them 'mid-range affordable') Most of Sobha's client base is salaried (mostly end users). Based on these factors, we expect Sobha to continue its sales momentum despite sector's sluggishness.
- **Attempting harder to get out of its comfort zone – a.k.a Bangalore:** Over the years, Sobha's key focus has been Bangalore. However, it is attempting hard to diversify – Bangalore's share in its on-going projects has reduced to 57% from from 72% earlier, which provides us confidence in Sobha's growth strategy.
- **Bookings CAGR at 15% over FY19-21:** On the sales boost provided by affordable housing project, subvention scheme, and improved sector environment.
- **Strong contractual/manufacturing order book; overdependence on Infosys reduced:** This division has an order book of c.Rs. 2.5bn to be executed over the next 2.5 years, and now has lesser exposure towards Infosys' orders – a positive despite non-Infosys orders earning lower margins (because of its long-standing relationship and bulk orders). Our analysis suggests that management has been focusing on enhancing these divisions, which could boost contractual and manufacturing businesses. Strong order book, easy convertibility (book to revenue), and strong positive correlation to real estate vertical ensures consistent stable performance visibility.
- **Strong land bank – the biggest cushion:** Strong land bank of c.2,500 acres translates into a saleable area of 205mn sq. ft., which provides strong visibility for future projects.
- **Gross operational cash flow CAGR of 15% over FY19-21:** On stronger bookings from the residential segment and strong order book in manufacturing and contractual verticals.

BUY

CMP RS 506

TARGET RS 620 (+23%)

COMPANY DATA

O/S SHARES (MN) :	95
MARKET CAP (RSBN) :	48
MARKET CAP (USDBN) :	0.7
52 - WK HI/LO (RS) :	590 / 271
LIQUIDITY 3M (USDMN) :	1.9
PAR VALUE (RS) :	10

SHARE HOLDING PATTERN, %

	Mar 19	Dec 18	Sep 18
PROMOTERS :	56.0	56.0	55.9
FII / NRI :	24.6	27.0	28.3
FI / MF :	13.7	11.7	10.2
NON PRO :	0.9	0.8	0.9
PUBLIC & OTHERS :	4.9	4.6	4.7

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.6	14.4	-2.3
REL TO BSE	0.9	6.2	-15.3

PRICE VS. SENSEX

Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY19E	FY20E	FY21E
Net Sales	34,421	41,871	48,800
EBIDTA	6,733	6,163	7,218
Net Profit	2,971	2,618	3,121
EPS, Rs	31.3	27.3	32.5
PER, x	16.1	18.6	15.6
EV/EBIDTA, x	10.5	11.6	10.1
P/BV, x	2.2	1.9	1.7
ROE, %	13.3	10.4	11.1
Debt/Equity (%)	109.6	100.8	94.2

Source: PhillipCapital India Research Est.

Dhaval Somaiya, Research Associate

Vaibhav Agarwal, Research Analyst

A unique backward integrated model

Backward integration, legacy, quality, efficiency, and execution track record

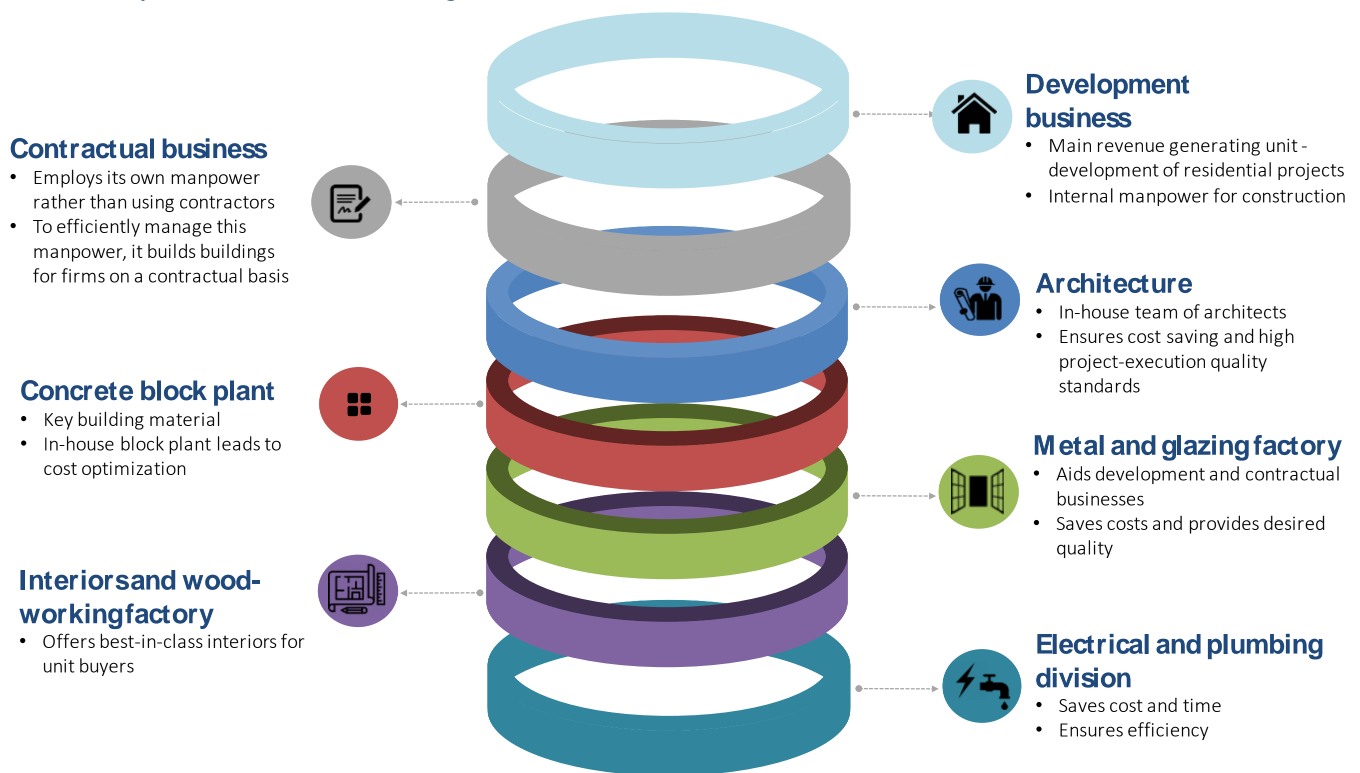
From a small developer to a backward-integrated real-estate giant

Sobha is a real-estate development and construction company. The firm began its first residential project in 1997. By 2006 (when it was listed) it had constructed 21 residential projects in Bangalore aggregating 1,552 apartments covering approximately 2.98mn sq. ft. of super built-up area. Its residential projects include presidential apartments, villas, row houses, super luxury apartments, and luxury apartments (with amenities). Its development business mainly comprises of the residential projects, yet it also has commercial and retail assets in its portfolio. Currently, in residential real estate, it has on-going projects amounting to 28.13mn sq. ft. saleable area.

Sobha also does contractual construction. This business began in an attempt to employ its idle resources. It has a long-standing relationship with Infosys and a majority of the contractual business is driven by projects awarded by Infosys. The firm completed its first contractual project for Infosys in 2000. Sobha has on-going contractual projects amounting to 6.35mn sq. ft.

We call Sobha backward-integrated company because it has the key competencies and in-house resources to deliver a project from conceptualization to completion. This is explained in detail in the info-graphic below.

Sobha: A unique full-scale backward-integrated model



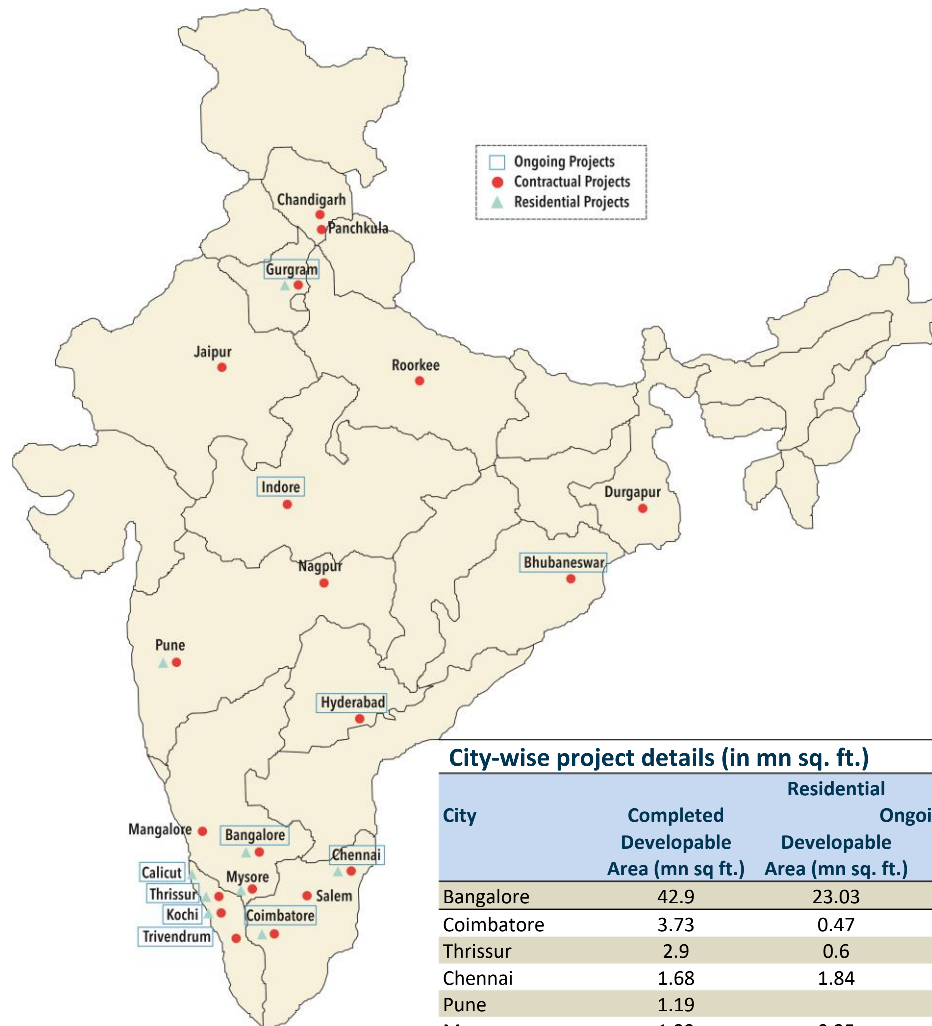
Source: PhillipCapital India Research

Backward integration ensures quality, on-time delivery, lower costs

- Products and services required for development and construction of a project meet set quality standards, timely delivery, and cost efficiency.
- Sobha does not depend on a third-party supplier for some of its key products and services required in the process of development and construction of projects.

Contractual + residential projects together increase geographical spread

Through its contractual and residential projects, Sobha has a presence in more than 22 cities – with active residential projects in seven cities and contractual projects across eight cities.



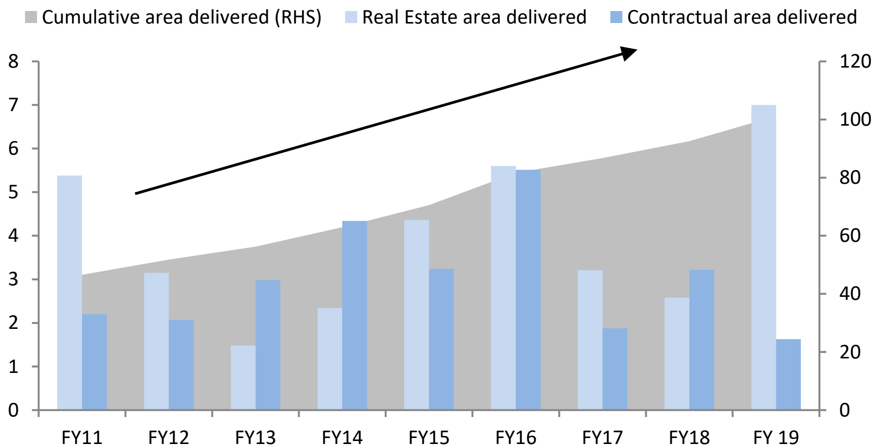
Source PhillipCapital India Research, Sobha Ltd

City-wise project details (in mn sq. ft.)

City	Residential			Contractual	
	Completed	Ongoing		Completed	Ongoing
	Developable Area (mn sq ft.)	Developable Area (mn sq. ft.)	Saleable Area (mn sq. ft.)	Developable Area (mn sq.ft.)	Developable Area (mn sq. ft)
Bangalore	42.9	23.03	16.46	11.75	3.64
Coimbatore	3.73	0.47	0.37	0.3	0.83
Thrissur	2.9	0.6	0.42	0.19	
Chennai	1.68	1.84	1.29	4.12	0.37
Pune	1.19			6.5	0.07
Mysore	1.33	0.25	0.14	9.36	0.29
Gurgaon	1.56	11.01	6.56		0.25
Cochin		5.01	3.21	1.66	0.09
Calicut		1.08	0.72		
GIFT city, Gujarat		0.71	0.52		
Hyderabad				5.32	0.6
Mangalore				2.4	0.04
Trivandrum				2.21	2.79
Bhubneshwar				1.29	0.23
Chandigarh				1.13	0.01
Jaipur				0.7	
Roorkee				0.45	
Panchkula				0.25	
Nagpur				0.22	
Salem				0.12	
Durgapur				0.17	
Indore					0.71
Others				0.65	
Total	**55.2**	**44**	**30.6**	**48.8**	**8.6**

By FY19, Sobha has delivered total residential projects amounting to 55 mn sq. ft. and contractual projects amounting to 48.8 mn sq. ft. – which cumulatively amount to a total of 101 mn sq. ft.

Execution track record: More than 101 mn sq. ft. area delivered by Sobha so far

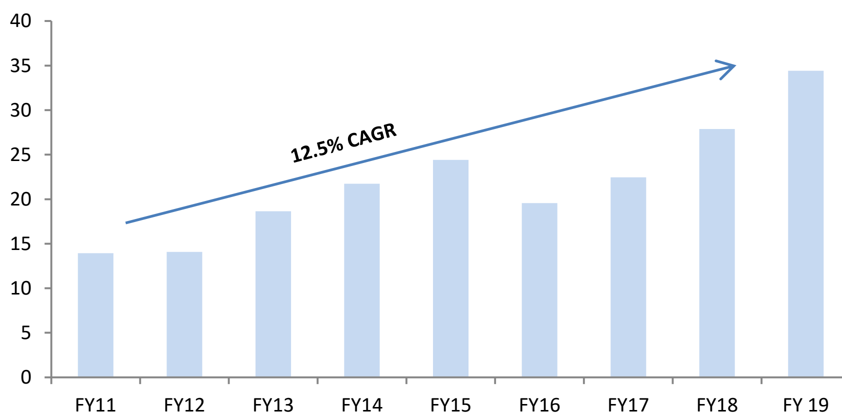


Source: PhillipCapital India Research, Sobha Ltd

Backward integration ensures operational and financial stability

By offering customers interiors, Sobha ensures highest quality while also using its manpower efficiently through its contractual business. The real-estate sector is cyclical – the contract construction and manufacturing businesses ensure that Sobha has a stable revenue stream. This is reflected in Sobha's revenue CAGR since FY11, which is a healthy 12.5% despite the bearishness in the sector and headwinds from macro-economic, regulatory, and business environment factors such as GST, RERA, demonetization, and the NBFC liquidity scare.

Revenue CAGR of 12.5% over FY11-18 (Rs bn)



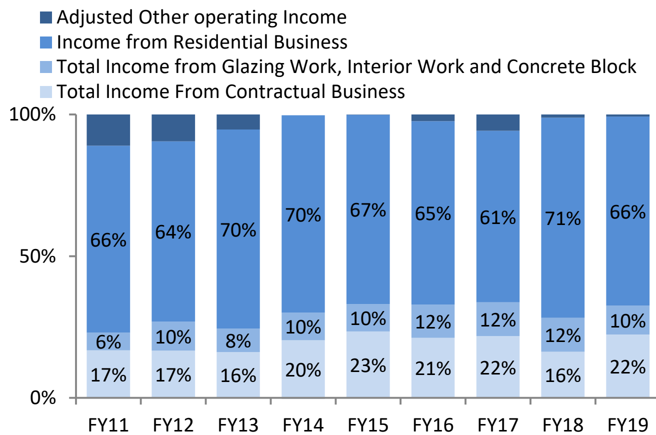
Source: PhillipCapital India Research, Sobha Ltd
***Note:** We do not include FY19 in the CAGR calculation as FY19 revenue is as per IND AS 115 and do not reflect the accurate financial position

Diversification provided insulation from headwinds

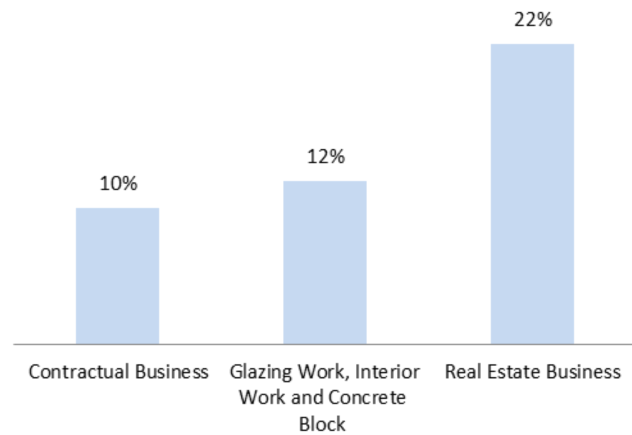
Our analysis suggests that it was diversification that backward-integration provided that helped Sobha remain insulated from headwinds. Over the years, segment revenue mix of all the three verticals is as follows (fairly steady):

- **Residential development:** 60-70% of total revenue
- **Contractual business:** 16-22%
- **Manufacturing:** 10-12%

Residential segment revenue: revived in FY18-19 from lows of FY17



Real-estate business drives segment EBITDA margins



Source: PhillipCapital India Research, Sobha Ltd

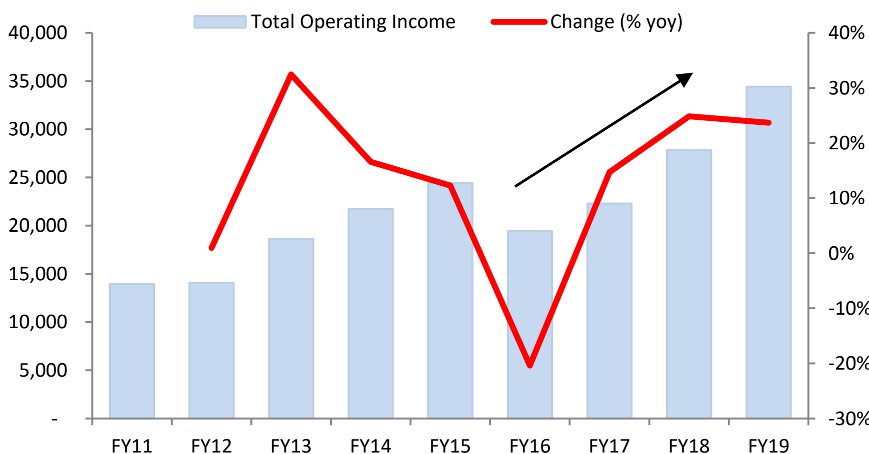
Residential development is a higher margin business (22%) than contractual and manufacturing. Contractual projects typically earn a margin of 10-12% with projects from Infosys in the c.12% range and others at c.10%. Manufacturing business earns a margin of c.10%.

Track record of strong financial performance

Revenue growth to remain strong, but may not show in numbers

Sobha's revenue has been increasing year on year, except in FY16-17 when it dipped due to demonetization, GST, and RERA pressure. Over FY16-18, revenue CAGR was 20% and due to a strong project pipeline, revenue is likely to continue growing at a similar pace. This may not reflect in numbers because of IND-AS115 (accounting standard).

Over FY16-18, revenue CAGR was 20% despite overall slowdown

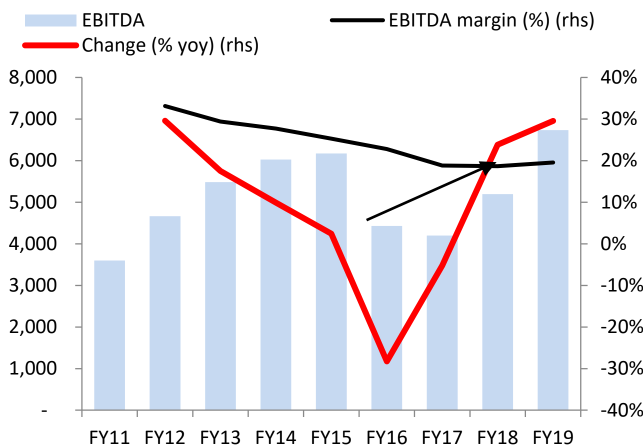


Source: PhillipCapital India Research, Sobha Ltd

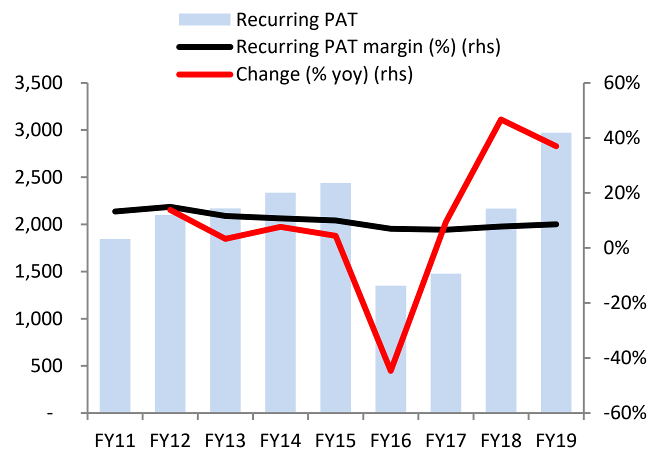
EBITDA and PAT margins to increase from here

EBITDA margins have kept shrinking due to an increasing cost base and stagnancy in price realisations. Over the past two years, EBITDA margins have been around 19%. However, due to Bangalore's improving market and Sobha starting to take marginal price hikes, we expect these to increase and stabilise at 20-22% soon. PAT margins are currently around 8%, which should also rise and stabilize at around 10%.

EBITDA margins stabilised around 19% over FY16-18



PAT margins stable at around 7-8% over FY16-18

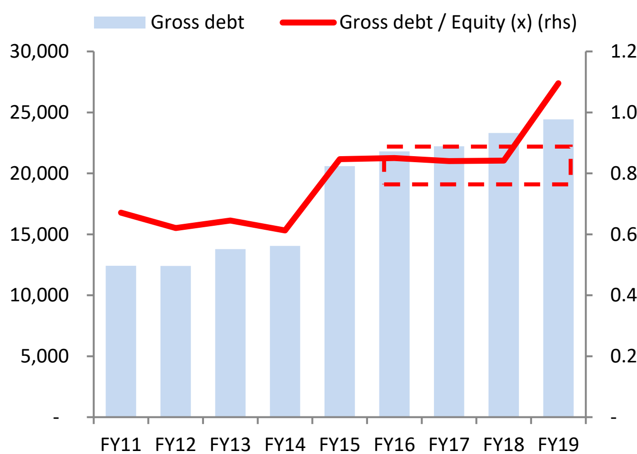


Source: PhillipCapital India Research, Sobha Ltd

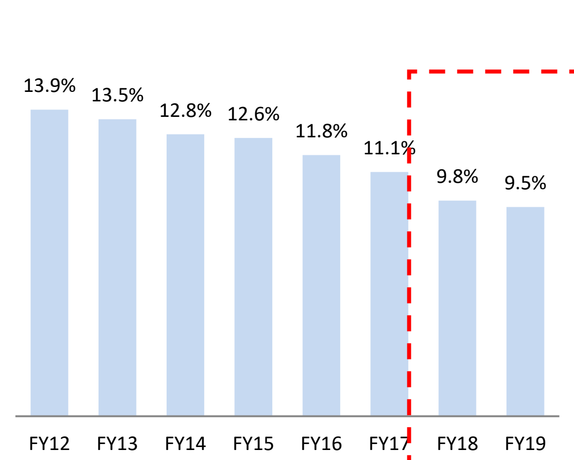
Debt to remain stable in the near term and decrease in the medium term

Despite headwinds, gross debt has stabilized at Rs 23-24bn. Sobha aims to ramp up project execution speed ahead leading to crunched RoI timelines, so we expect debt to remain stable at these levels in the near term and decrease in the medium term. D/E will remain stable at 1x in the near term. Comfortable debt levels are important in this sector. We believe that Sobha is better placed vs. peers with its current debt levels – this also reflects in its cost of debt, which is currently at around 10%, one of the lowest in the industry. Majority of the debt is construction financing lent by banks and a very small proportion is through NBFCs and other routes.

D/E rise marginally – remains in comfortable range



Interest cost has been one of the lowest in the industry



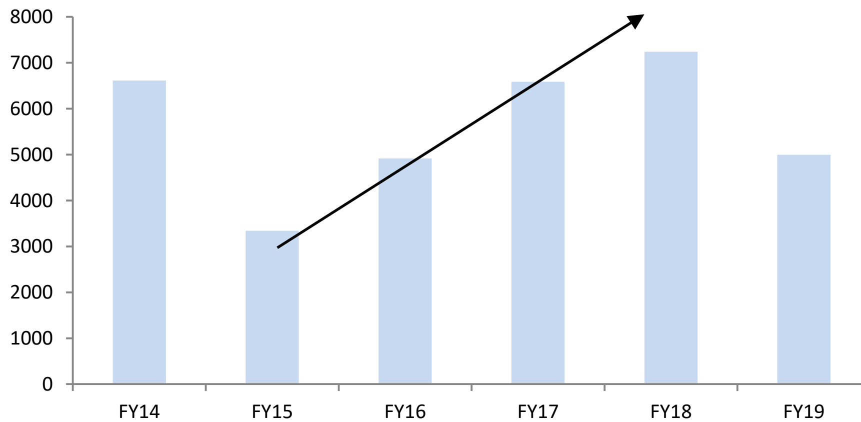
Source: PhillipCapital India Research, Sobha Ltd

***Note:** The rise is D/E ratio is owing to implementation of IND AS 115 and rise in debt by Rs 1000 mn

Healthy net operating cash flow

As discussed in the sections above, Sobha has remained insulated from the overall bearishness in the sector, which is also reflected in its net operating cash flow, which have been positive and consistently increasing yoy since FY15.

Net operational cash inflow CAGR at 22% over FY15-18

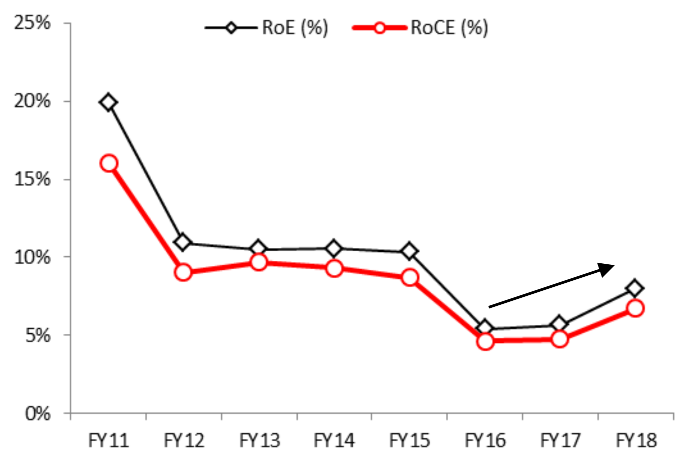


Source: PhillipCapital India Research, Sobha Ltd

The firm's current ratio seems to have stabilised at around 2.1x over the past three years, which enhances its debt-servicing capabilities. Many players have been struggling to have a positive net operational cash flow; while Sobha's net operational cashflow dipped in FY15, it has seen a healthy 22% since, which provides additional cash-generation and debt-serviceability visibility.

Current ratio (x)– remains stable at 2.1x

ROE and ROCE rising



Source: PhillipCapital India Research, Sobha Ltd

Sobha's ROE and ROCE had also hit rock-bottom in FY16-17, but as of FY18,they were 8% and 7%. Over the next 2-3 years, ROE will stabilize at historic average of c.10% and ROCE at c.9%. In the next 3-5 years, due to a strong project pipeline of on-going and up-coming projects, focus on pre-cast technology, and focus on affordable housing segments (under PMAY and mid-ticket-sized housing), we expect ROE to ramp up to 12-14% (in a scenario where the impact of IND AS 115 is neglected).

Real-estate business

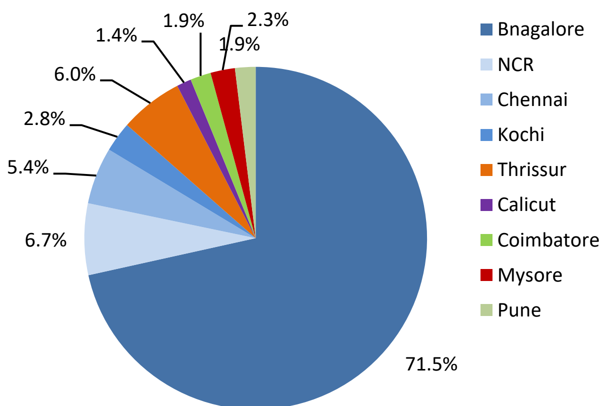
Sobha's real-estate business shows innovation, has execution capabilities and a rich land bank

Bangalore – largest revenue contributor in RE business

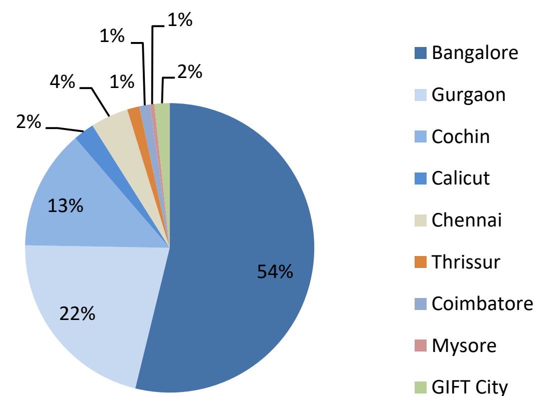
In real-estate development, Sobha's focus has remained largely on the Bangalore market. It has expanded its presence in south India, NCR, and Pune too, but Bangalore contributed to around 72% (21.8 mn sq. ft.) of its total delivered area of 30 mn sq. ft. in FY11-19. As of FY19, Bangalore comprises 54% (16.5mn sq. ft.) of the total saleable area of on-going projects followed by NCR (22% at 6.56mn sq. ft.), which indicates a shift in the management's policy to expand to other geographies going ahead. However, Bangalore continues to remain a key focus for the firm.

Is the Bangalore market an 'all eggs in one basket' phenomenon for Sobha or is this the goose that lays golden eggs?

Breakup of area delivered in FY11-19



On-going project breakup (saleable area wise)

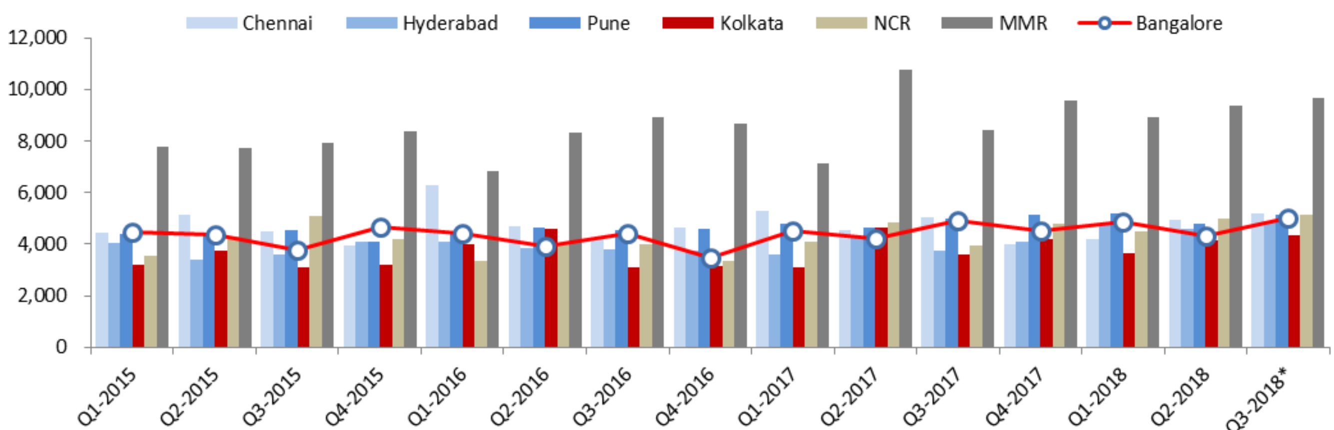


Source: PhillipCapital India Research, Sobha Ltd

Bangalore market stable amid IT slowdown and other headwinds

Unlike other cities, Bangalore hasn't seen any major correction in price despite macro-economic and business environment headwinds and the IT slowdown. In fact, over the past four years, prices have marginally appreciated 10-11% here (implying an annual rate of around 2.5%).

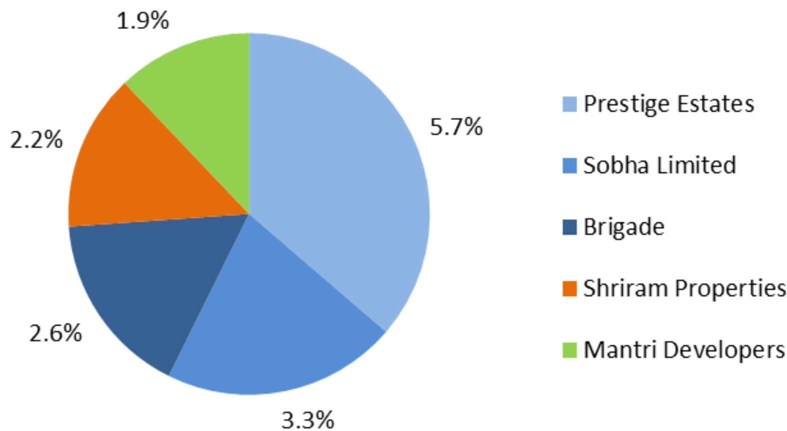
Despite headwinds, RE prices in Bangalore have been relatively steady



Source: PhillipCapital India Research, Knight Frank

Our research suggests that Sobha is the second-largest organized player (by market share) in Bangalore at 3.3%. Being one of the most dominant organized players makes Sobha's positioning unique, allowing it high customer retention and brand recall.

Sobha is one of the top-5 developers in Bangalore by market share



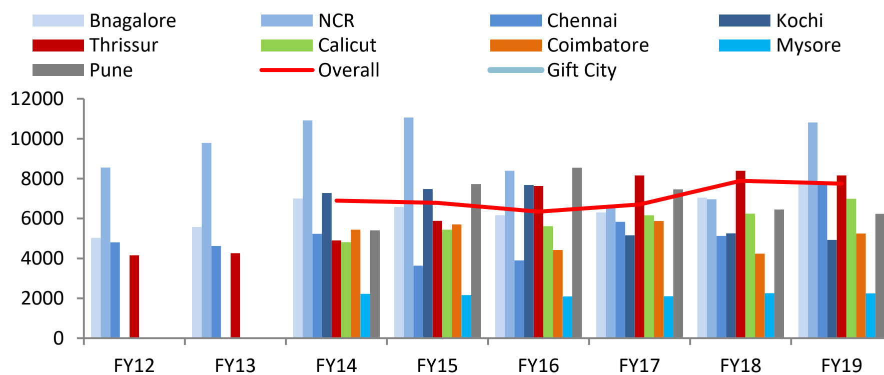
Source: PhillipCapital India Research, Knight Frank, Sobha Ltd

Considering that demand for quality spaces in Bangalore is going to remain high, Sobha is well placed amongst peers to capitalize on the opportunity

Despite sector slowdown, Sobha's project prices have stayed steady

Our research shows that Sobha's projects have been garnering strong response in southern cities and it has even been able to squeeze in some incremental price hikes. As it grows in south India, Sobha is also expanding its footprint in north India and has even entered Gujarat with its first project launched in GIFT City.

Sobha's projects across cities see pricing strength



Source: PhillipCapital India Research, Sobha Ltd

Pricing trends indicate that despite an overall slowdown in the market, Sobha hasn't seen price corrections between FY13 and FY16 and was able to actually hike prices marginally over FY17- FY19

Execution aided by strong pre-sales

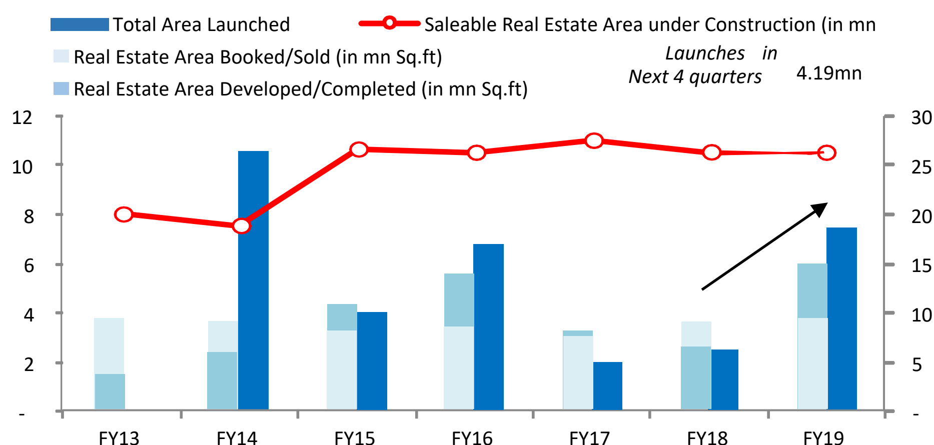
Robust pre-sales due to strong launch and early-phase response from customers

Sobha has maintained healthy sales momentum aided by strong pre-sales and a robust project pipeline

Sobha is usually able to get a strong customer response at its launches and during the early phase of its projects, which has led to strong pre-sales trends. We believe this is because of its strong brand presence, quality, and execution track record.

In FY19, Sobha has sold 4.0 mn sq. ft, delivered around 6 mn sq. ft and launched around 6.3 mn sq. ft. Currently, total development potential (to be constructed in on-going + upcoming projects) is 26mn sq. ft. of which around 18 mn sq. ft is yet to be sold which should yield a gross cash inflow of Rs 73.18 bn. By FY19, the firm has plans to launch 4.2 mn sq. ft. in the next four quarters.

Strong revival in bookings over FY18 to FY19; strong project addition to continue

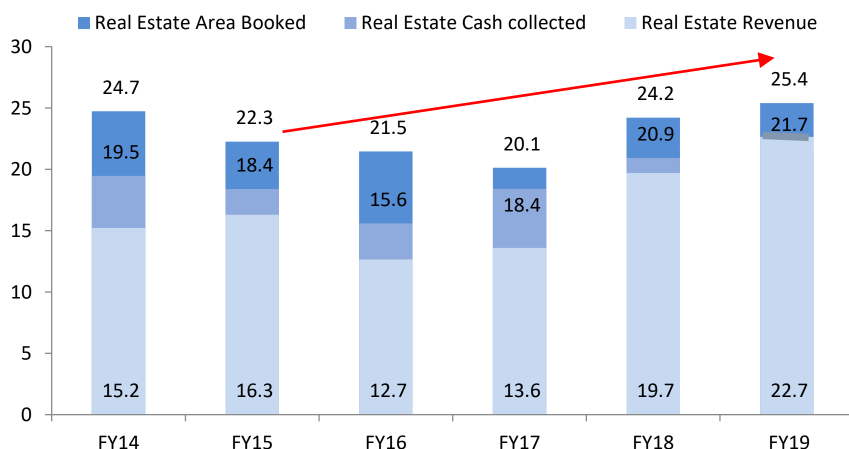


Source: PhillipCapital India Research, Sobha Ltd

Sobha's sales momentum was impacted due to demonetisation, GST, and RERA – and sales velocity dipped in FY17 and FY18. In FY19 sales recovered (sold 4.0 mn sq. ft).

This trend has reflected in revenue – after hitting an all-time low in terms of revenue in FY16, Sobha's revenue over FY16-19 has seen a CAGR of 25%, real-estate booking value CAGR was 16%, and real-estate cash collected CAGR was 16%.

Revenue, bookings, and cash collected grow at a steady pace



Source: PhillipCapital India Research, Sobha Ltd

Customer engagement: Pre-sales experience at its best

Sobha engages with customers at multiple levels – from customizing deals for clients in select projects such as Sobha International City, to adopting subvention schemes in some projects. It also engages with customers through festival offers and through home-finance interactive desks at site sales offices in order to provide customers with a clear view of what they would actually be paying for if they take a loan. Sobha also conducts events such as 'Sobha Soul Fest' for better brand reach, customer engagement, and enhanced customer experience. We believe that these practices have helped Sobha to maintain a healthy pre-sales momentum.

Sales offer at Sobha Dream acres, Bangalore

EMI calculator desk at site-sales office

Soul fest organised by Sobha

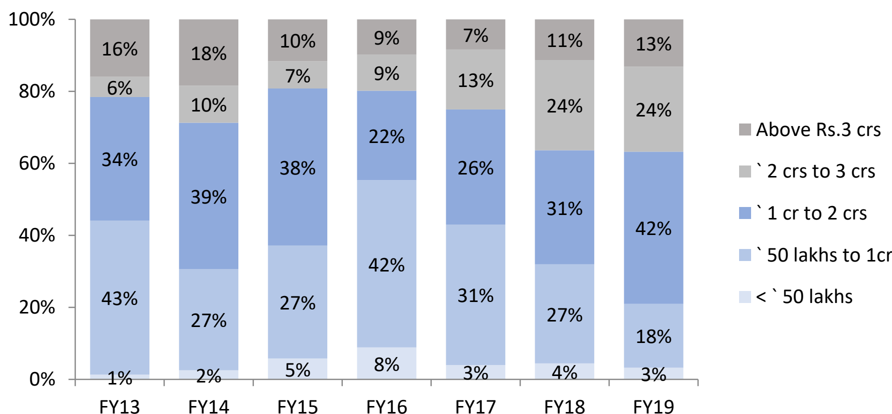
Well placed product placement

The sector is seeing a paradigm shift in dynamics and is transforming from an investor-led one to an end-user led one. With this, majority of the demand will shift to affordable housing (under PMAY and mid-tier housing) from luxury housing earlier.

Sobha hits bull's eye with affordable housing, mid-tier units, pricing, and salaried buyers

Sobha is well placed to ride this wave as 42% of its sales comes from the sale of units at Rs 10-20mn, followed by 18% from Rs 5-10mn units, followed by 24% from Rs 20-30mn units. This indicates that despite being a premium player, Sobha has the right placement in the right category.

Breakup of sales – by value

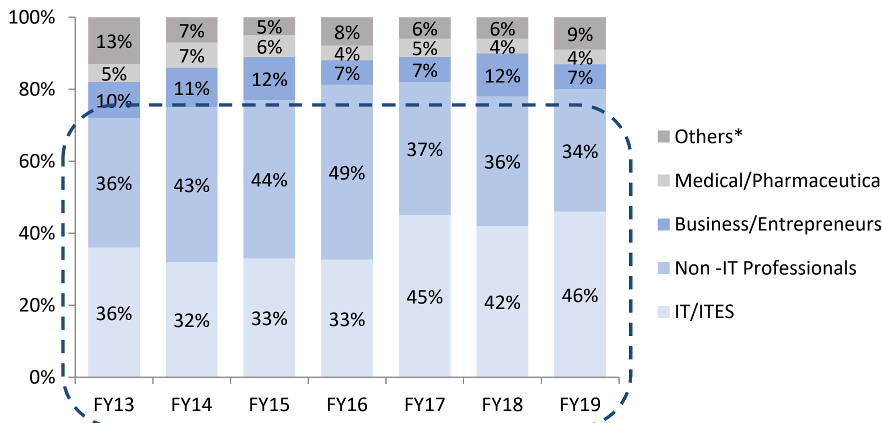


Source: PhillipCapital India Research, Sobha Ltd

Apart from the pricing placement of units, Sobha hits a bull's eye in terms of its target audience, as majority of the unit-buyers (80%) are salaried employees – which is reassuring, as it shows that bulk of its buyers are end-users and not investors. This also implies that its home buyers wouldn't easily default on their payments and have

an easy accessibility to home loans from banks and tier-1 NBFCs, which provides stable sales-velocity outlook.

Break-up buyers profession wise



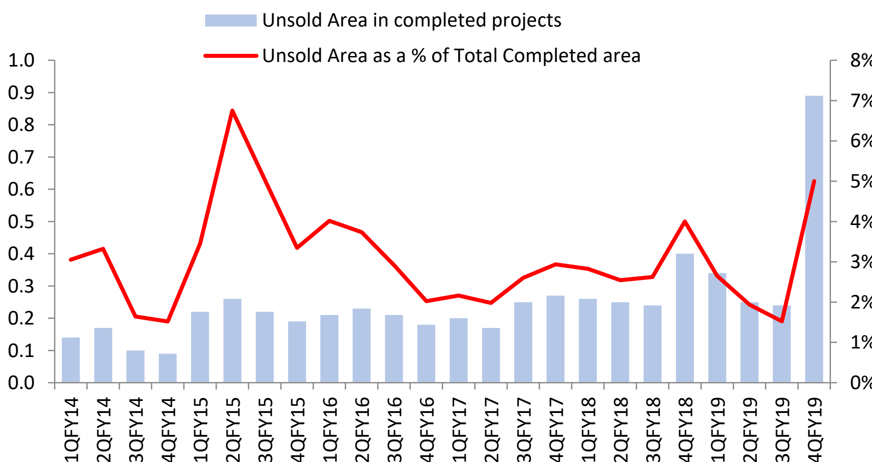
Source: PhillipCapital India Research, Sobha Ltd

Healthy new-launch pipeline; sales momentum to rise in FY20-22

Strong pre-sales and execution will lead to miniscule inventory overhang

Sobha has negligible completed inventory because of its strong pre-sales even as almost the entire industry is struggling with an inventory overhang. Sobha has had a track record of very low unsold area (2-3% historical average) out of its total completed projects – which reinforces its strong sales-velocity capability.

Sobha's inventory overhang is negligible



Source: PhillipCapital India Research, Sobha Ltd

***Note:** 4QFY19 inventory overhang appears to substantially high on account of some pending deliveries in the already completed projects, we see this as a one-off and expect the inventory overhang to again stabalise around 2% in coming quarters

Thematic development – quality + unique experience = Brand recall

Innovation Play – development strategy, innovative marketing, and pre-cast technology

Sobha has a strong presence in Bangalore and has multiple projects in some select micro-markets. In order to avoid cannibalization, Sobha develops "theme based projects" uniquely differentiating each one. The company also tries to ensure that it provides plenty of open space for amenities and utilities.

Sobha Silicon Oasis: Based on a French theme

Sobha International City: Based on an artificial city-based theme

Sobha Dream Acres: Based on a theme of affordable dream houses

This uniqueness helps the company garner incremental customers through word-of mouth publicity.

Sobha conducts detailed pre-delivery checks known as snagging

In order to ensure the quality of the delivered projects, Sobha follows snagging – a process to check the entire project for errors after completion. It performs interior and exterior snagging and calls it Project Clearance Procedure; it typically it takes 60 days to snag each floor. It involves five steps:

1. Door/window clearance
2. Paint clearance
3. Joint filling clearance
4. CRM clearance
5. Common area CRM clearance.

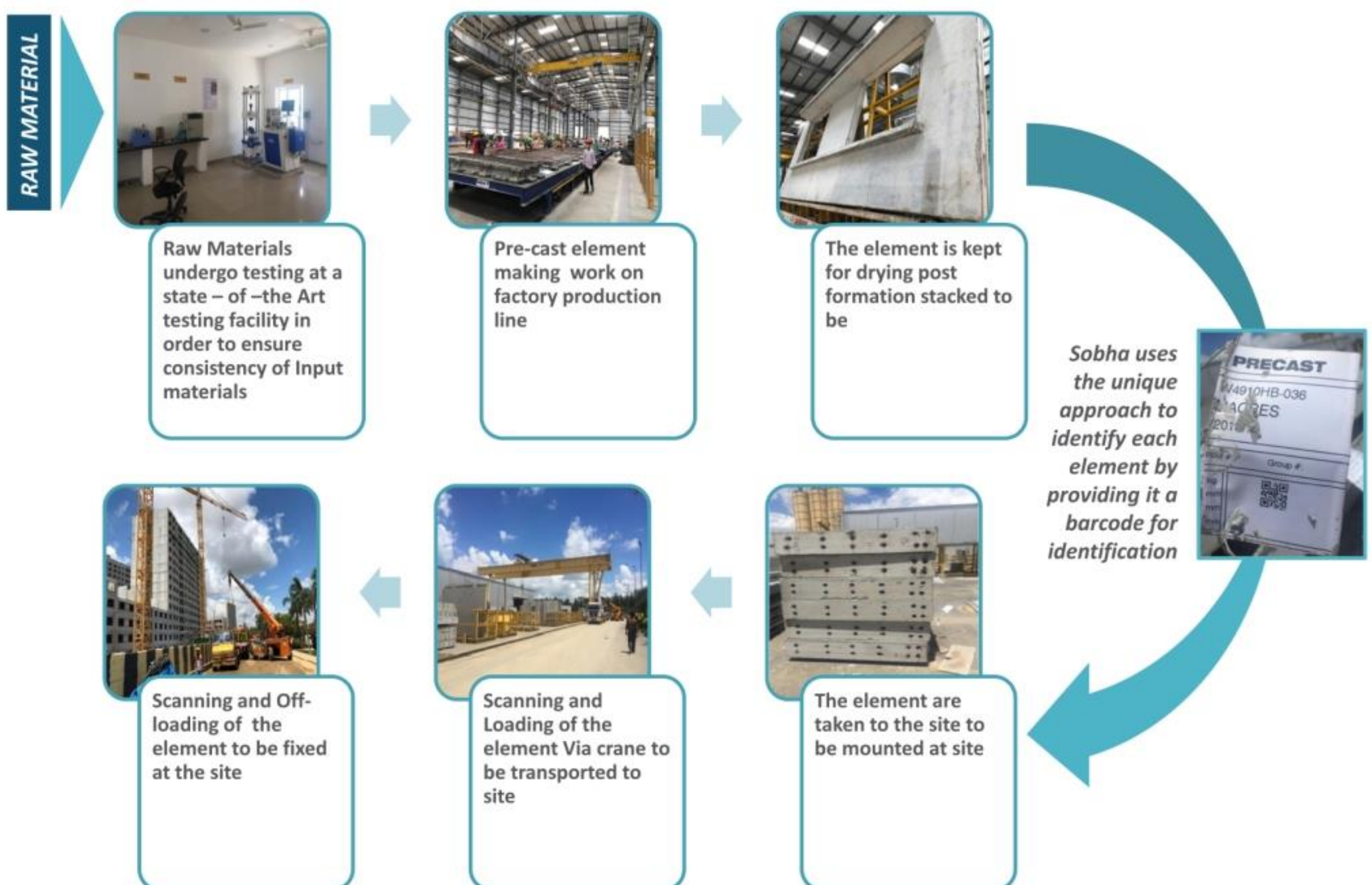
Pre-cast factory has reduced construction time

Sobha's pre-cast factory (for Sobha Dream Acres) – capitalises on the move towards becoming a volumes play as the industry swerves away from pricing

In May 2015, Sobha set up a fully automated pre-cast factory for its key Sobha Dream Acres project that is spread over 81 acres and will have 6,945 units in 71 towers. We reckon that typically such a pre-cast factory can produce from 150-250 elements per day, and compared with conventional aluminium-foam technology, it provides considerably higher speed and accuracy. We believe that it has reduced the construction timeline for Sobha to 3.0-3.5 years from 4-5 years earlier. Although the set-up cost of such a factory is high (our research suggests that a fully automated factory requires Rs 750-1,000mn), in the longer run, we believe it will help Sobha to optimize labour costs and increase its annual area-delivered run-rate.

This pre-cast factory is totally mobile and can be uprooted and shifted from the Sobha Dream Acres site to the next project once that project is complete.

Process of a pre-cast plant: Going forward, Sobha may put up more pre-cast plants in order to achieve better quality and cost efficiency and a better delivery run-rate



Riding the affordable housing wave: Déjà vu for Sobha

In its pre-IPO days, Sobha had quite a lot of experience in constructing projects under the then government's affordable-housing scheme. However, back then, the size of a dwelling under affordable housing was 1500 sq.ft, which provided Sobha a high level of comfort while foraying into affordable housing.

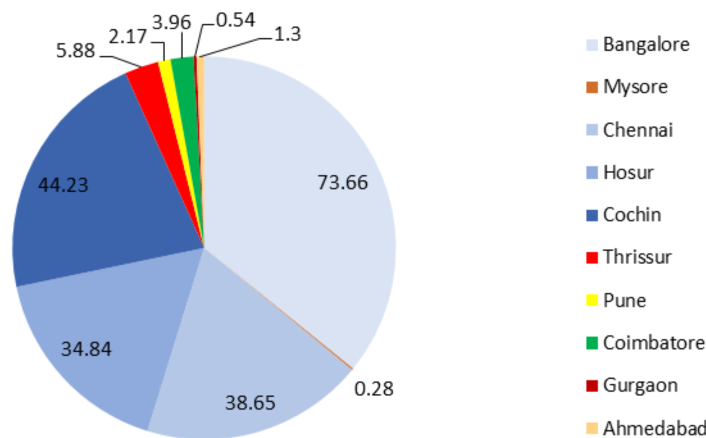
Today, Sobha seems to be once again riding the affordable housing wave again on the back of its budget projects and PMAY. Sobha's flagship project *Dream Acres(a budget housing project)* in Bangalore, has almost 7,000 units out of which more than 3,800 have already been sold. This project has maintained healthy sales velocity.

Sobha announced its first affordable housing project in Bangalore *Dream Gardens,* which has a saleable are of 1.24mn sq.ft in Q3FY19 and second project (Sobha Dream Heritage) under PMAY in Gift City, Gandhinagar, with a saleable area of 0.52 mn. sq. ft. For these projects, buyers will be able to avail interest subsidy and the GST rate is 1% instead of 5%. These projects can help boost Sobha's margins and help it to ramp up sales velocity. They will improve the company's topline, margins, and in turn translate into a healthier bottom-line and ROE.

Strong land-bank provides visibility

One of the key metrics that strongly supports Sobha's future growth is its strong land-bank. As of 2018, Sobha had a land-bank of 2,469 acres out of which its own share was 2,403 acres. This translates into a developable area of 205mn sq. ft. A majority of this land bank is in Bangalore (73mn sq. ft. developable share), followed by Cochin (44mn sq. ft.), Chennai (c.39mn sq.ft.), and Hosur (44.23mn sq.ft.), which ensures that Sobha will continue to have a strong project pipeline.

Sobha's share of developable area (in mn sq. ft.)



Source: PhillipCapital India Research, Sobha Ltd

Not shying away from rent-yielding assets

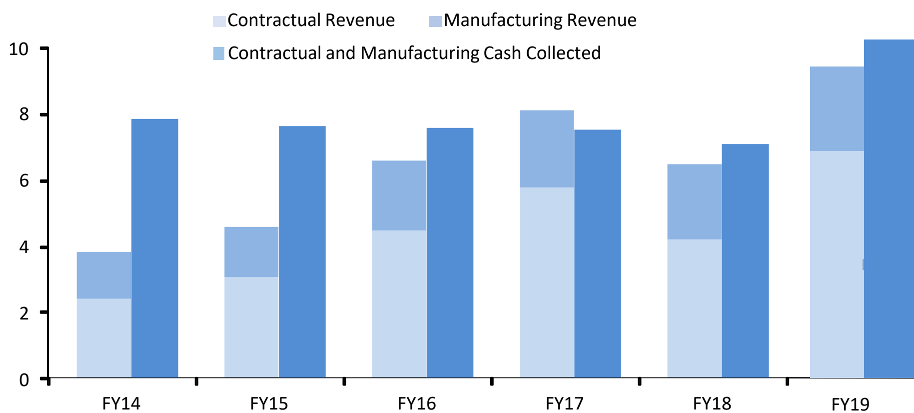
Sobha has a rent-yielding retail asset in its portfolio – Sobha City Mall (320,000 sq. ft.) at Thrissur. Our research suggests that it is one of the most successful retail assets in that micro market. Sobha is coming up with one more mall – 1 Sobha Mall – (St. Mark's Road Property Bangalore: 200,000 sq. ft.), which is almost complete. The company has also planned one commercial asset in International City, Gurgaon.

The contractual business

The contractual and manufacturing businesses have clear visibility and stability. The contractual order book remains strong on repeat orders from Infosys and Sobha's growing real-estate business

For Sobha, the contractual business is an auxiliary one – in its most simplified version, it employs Sobha's surplus manpower in constructing projects for corporates. Unlike Sobha's development business, which is primarily focused on residential projects, the contractual business undertakes diverse projects – it constructs corporate offices, IT parks, hotels, hostels, convention centres and studios, multiplexes, training centres, academic institutions, and food court. This business' revenue has a direct correlation with Sobha's real-estate development business; as its real-estate development business expands, the contractual business also gets room to expand (as more man-power will be employed). This room currently continues to be filled by consistent repeat orders from Infosys.

Contractual, manufacturing revenue cash collected (in Rs bn)

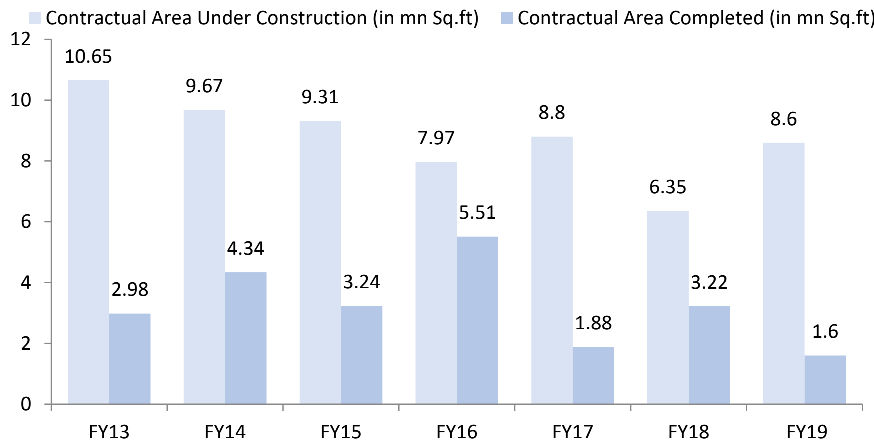


Source: PhillipCapital India Research, Sobha Ltd

One of the key aspects of contractual and manufacturing businesses is that revenue and cash flow are in sync. This is because the firm ensures minimal debtor days, which ensures quick translation of the order book into cash. As the real estate vertical's cash flow is volatile (as the project booking, cash collection, and revenue recognition are at a different pace), the 'in sync' nature of contractual and manufacturing business provides support. As of FY19, contractual revenue was 22% of total revenue (at Rs 34.4bn) while manufacturing was 10% (of Rs 34.4bn). Sobha's current contractual and manufacturing orderbook is Rs 25bn, which is to be executed over a span of the next 30 months, providing good revenue visibility for this vertical.

Infosys' famous Mysore Training Centre is constructed by Sobha

Contractual projects: Strong order-book

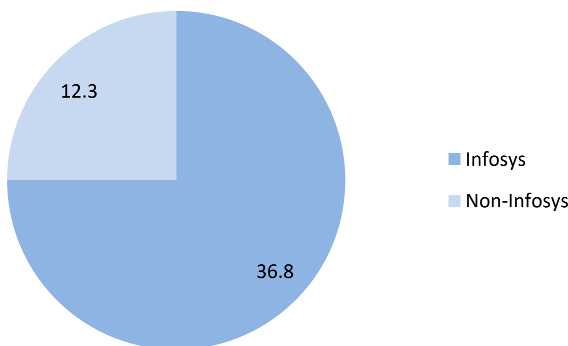


Source: PhillipCapital India Research, Sobha Ltd

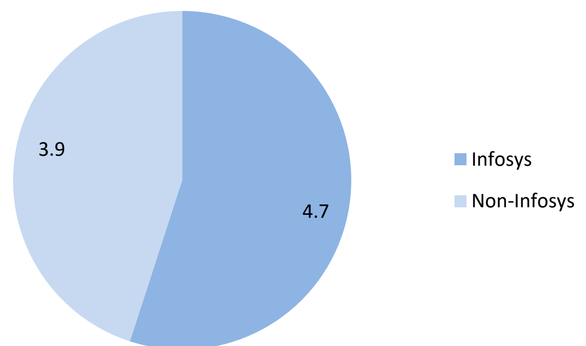
Infosys' BPO in Bangalore

By FY19, 75% (36.8 mn sq. ft.) of the total construction in the contractual segment was for Infosys and only 25% (12.5 mn sq. ft.) was for other players. Sobha prefers repeat orders from Infosys due to its long-lasting relationship and comfort with Infosys, and higher EBITDA margin (c.12%) compared with other projects (c.10%). Currently, its contractual projects span across eight cities.

Completed contractual projects



Current contractual projects



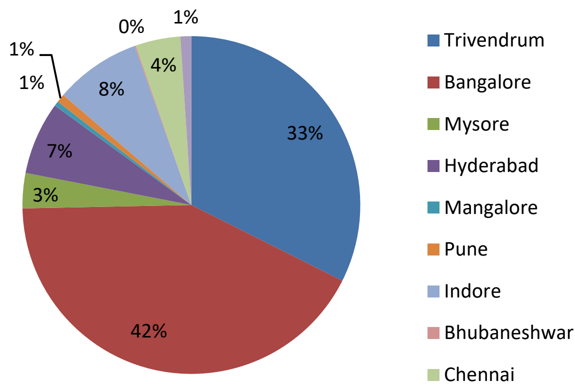
Source: PhillipCapital India Research, Sobha Ltd

Currently c.55% (4.7 mn sq. ft.) of on-going contractual project orders are from Infosys. We see this change as positive despite being a bit margin dilutive. This is because hiring in the IT sector is likely to remain subdued and we have reason to believe that many corporates have shown willingness to award Sobha contractual projects but due to its strapped bandwidth, Sobha hasn't been able to undertake many such projects (as its contractual vertical is an auxillary one).

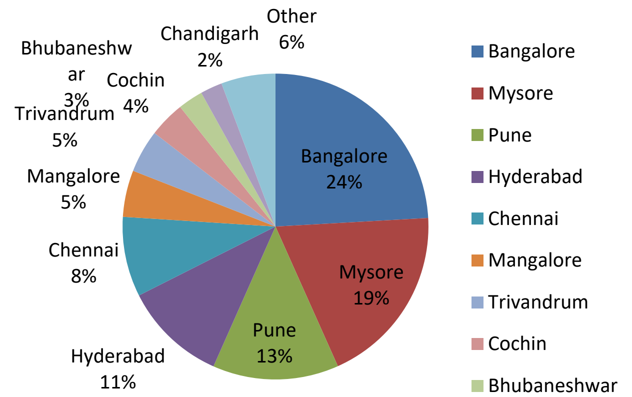
Currently, one of the major non-Infosys projects undertaken by Sobha is construction of Azim Premji University, Bangalore, and Lulu Mall, Trivandrum

Contractual and manufacturing businesses are a support function and management's key focus remains on real-estate development business. However, with growth in the real-estate business, the contractual business will also grow proportionately.

Majority of the on-going contractual projects are in Trivandrum



The majority of the completed contractual projects are in Bangalore and Mysore



Due to more diversification in geography in its contractual business, Sobha's reach at a pan-India level has increased. This will help further expansion

The manufacturing business; inching closer to maximum capacity utilisation

Sobha has four verticals:

1. Glazing and metal works
2. Concrete products
3. Interiors and furnishing
4. Mattresses

On the basis of our research and analysis we provide a snapshot about each of the verticals below:

Interiors and furnishing

- Consistent 17% yoy over past couple of years.
- Set up 1999
- One of the largest automated wood works factory in India
- Employs c.1000 people
- Present across more than 29 locations
- Factories are spread over 325,000 sq. ft. and manufacture all kinds of furniture-kitchens, wardrobes, home furniture, office furniture, door, door frames, and interior fit outs.
- USP: Custom-build joinery works and an in-house design studio.
- Customers: SP (Shapoorji Pallonji), Mahindra Lifespaces, Prestige, and Divya Sree.

Wood works at interiors and furnishing factory, Bangalore

Metals and glazing

- Set up in Bangalore in 2000.
- Manufactures aluminium doors, windows, structural glazing, SS cladding, architectural metal works, and pre-engineered buildings.
- Units are across three locations – Bangalore, Chennai and Sonipat; spread across 130,000 sq. ft.
- Employs c.650 people.
- Has a technical collaboration with Schuco International KG and is authorized to market their range of products in India.
- Clients: Infosys, ITC, Wipro, and Salarpuria Sattava.
- Grown at a rapid pace: Rs 2.5bn topline in FY18 from Rs 20mn in FY01; CAGR of 33% since FY16.
- To expand, it is currently working on manufacturing glazing work that can withstand extreme wind conditions.
- We reckon that at a yearly orderbook size of c.Rs 2.5bn, the division operates at c.83% capacity (out of which around 17% is captive consumption) and by FY21 it will operate at maximum capacity (or Rs 3bn).

Glass panes at Glazing and metal work factory, Bangalore

Metals work at Glazing and metal work, Bangalore

Mattress

- Sobha has been manufacturing mattresses since 2007 under the brand name of *RestoPlus*.
- Products range from Rs 10,000 to Rs 400,000
- Employs c.100 people
- We believe *RestoPlus* is the only spring mattress in India to employ a simulated testing of 'designated number of years of use' using Cornell Type Testing Machines.
- RestoPlus clients: Marriott, Taj Group, Park Plaza, Infosys, Wipro, and Mindtree.
- The division has started partnering with some large retail outlets as OEM suppliers in order to boost growth.
- Started growing fast from FY19 – 54% yoy topline growth in 9MFY19.
- Aims at expanding the business to 4x its current size in the next three years.
- Plans to set up an R&D lab to improve product quality.

Concrete products

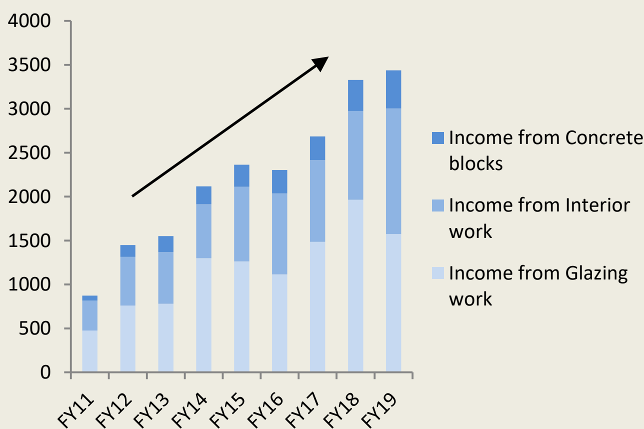
- Set up in 2005-2006
- Employs c.300 people.
- Spread over 8 acres
- Manufactures ready-to-use concrete products such as concrete blocks, pavers, kerb stones, water drainage channels paving slabs, and glass fibre reinforced concrete elements (GFRC)
- Production capacity: 28,000 blocks per day.
- Customers: Prestige Group, SNN Group, Infosys, Biocon, Purvankara, and L&T.
- Division plans to venture into new business areas such as crushers P Sand, and M sand – to eventually end up venturing into mortar-based products.

Concrete product factory, Bangalore

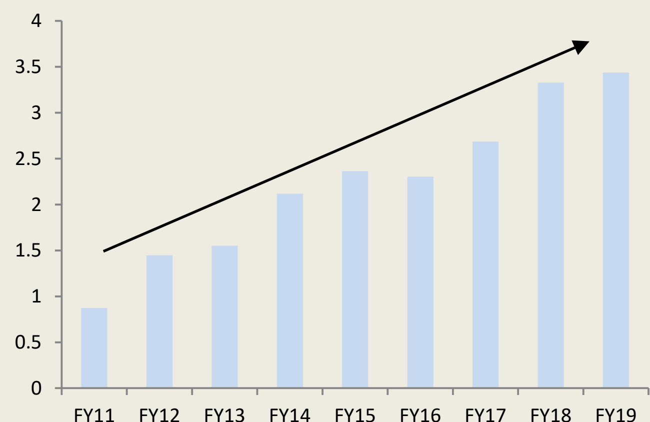
Manufacturing division makes Sobha a backward-integrated company in the true sense. It ensures that the quality of the material used is good (higher customer satisfaction, reputation building) and helps Sobha to save on costs. The products manufactured by all the divisions are used for captive consumption as well as for outside orders. Currently, glazing and metal works contribute maximum to manufacturing revenue at c.60%, followed by interiors and furnishing at 30%.

We believe Sobha is at a juncture where it can capitalize on its experience and grow its manufacturing business to a good extent. However, it is not likely to be a key focus of the management; currently it is a self-sustaining and steady business.

Manufacturing segment: Stable performance continues



Manufacturing revenue: Growth is in-line with the real estate vertical)



Source: PhillipCapital India Research, Sobha Ltd.

Our ground research suggests that currently the manufacturing division operates at about 80% capacity utilisation levels and because of the firm's multi-faceted expansion plans for all its manufacturing verticals, we believe manufacturing will operate at 100% utilization by FY21.

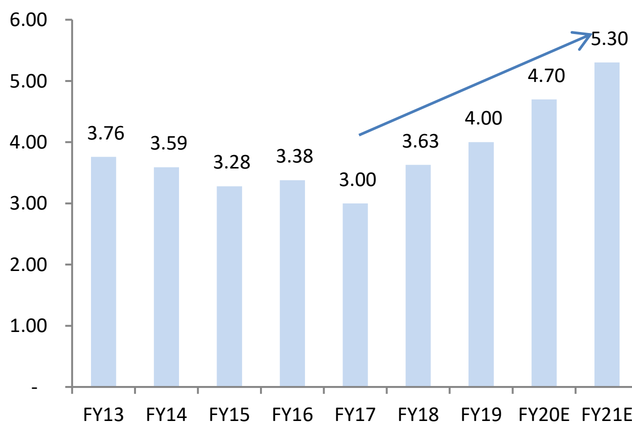
Operation cash flow to see healthy growth

Operational cash flow will grow at a healthy 15% CAGR over FY19-21 based on:

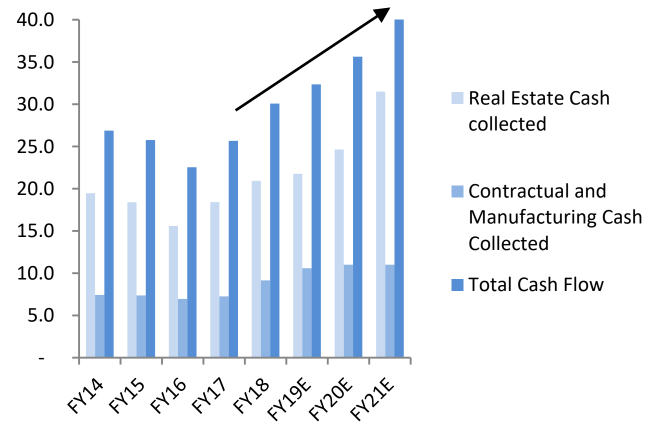
- Key project 'Dream Acres' being near completion
- Sales momentum to rise due to affordable housing projects
- Industry consolidation
- Organised players being preferred by buyers
- Strong contractual order book
- Bookings CAGR of 15% over FY19-21

Total operating cash inflow to see 15% CAGR over FY19-21

Bookings to see a healthy growth of 15% over FY19-21



Total cash flow (in Rs bn) to see healthy 15% CAGR over FY19-21 on account of stronger bookings



Source: PhillipCapital India Research, Sobha Ltd.

- *Because of a change in accounting standard to IND AS 115 from earlier AS-11 and AS-18, in Q1FY19, Sobha saw an equity write-back of Rs 7.57bn.*
- *Because a breakup of the exact nature of revenue that will be re-recognised in the book over the next 8-10 quarters is not available and nether is a detailed balance-sheet based on IND AS-115, we prefer to comment only on operational cash flow.*
- *We will not comment on revenue growth because:*
  1) *Detailed balance sheet is unavailable as per IND AS 115*
  2) *As per IND AS-115 revenue will be recognized on receiving of OC (occupation certificate), which makes revenue numbers become lumpy and haywire. We do not recommend looking at the profit and loss statement to gauge a company's performance but rather at the cash-flow generated.*

Valuation methodology

We use SOTP to arrive at the NAV of the company, using four parts:

- Residential projects – NAV arrived at by clubbing the NAV of each project obtained by discounting the project net cash flow at a WACC of 11.1%.
- Commercial projects – we apply a capitalization rate of 9% to FY19 net cashflows.
- Contractual and manufacturing –EV using EV/EBITDA method; we use 5x FY21 EBITDA to value the contractual and manufacturing verticals.
- Land bank – we value the land bank at 1x the book value.

In order to arrive Sobha's NAV, we adjust cumulative NAV of all four parts for cash and debt.

Valuation

Vertical	EV (Rs. mn)
Residential Projects	32600
Commercial Projects	5739
Contractual And Manufacturing Business	7200
Land	27402
Cash	9968
Pending Payment of Land	462
Long Term Debt	2263
Short Term Debt	20299
Current Maturities	1283
Total	**58602**
No. of Shares	95
Price Per share	620

Source: PhillipCapital India Research

Key risks to valuation

- **Continued slow velocity in the Gurgaon project:** The pain in this market is expected to continue; Sobha's projects are housed (Dwarka Expressway) here. There are no signs of completion and relief for the projects on the Dwarka Expressway. To add to Sobha's woes, the project has considerable high-ticket sized units. If market dynamics do not change, there could be an inventory overhang that would significantly hurt Sobha's performance.

- **Slowdown in the IT sector:** If the IT sector enters a deeper bearish cycle, we expect an overall slowdown in demand in Bangalore and Chennai markets. Sobha has a major exposure to Bangalore and a sizeable one in Chennai. It also has sizeable land bank in these two cities. A slowdown could hurt not just its real-estate development business, but also its contractual one as a majority of the contractual order book comprises of orders from Infosys.

- **Adverse changes in the macroeconomic environment:** In terms of job creation, inflationary pressure, and rise in interest rates could adversely affect Sobha's sales momentum.

- **Increase in systemic inventory overhang (especially in Bangalore):** Our estimates suggests that by FY21-22, a strong wave of residential inventory will hit the market (especially in Bangalore) which may lead to stiff competition for Sobha.

- **Discontinuation of PMAY:** After the General Election of 2019, the next government might discontinue PMAY or minimize benefits under the scheme, which could lead to a potential loss of opportunity that Sobha is trying to capture.

- **Lag in approvals:** Sobha has a large land bank with a huge development potential. However, execution of these projects are subject to regulatory approvals that, as per our analysis, have been a pain point for Sobha, like for many other developers.

- **Over-dependence on residential segment, lack of annuity portfolio:** Currently Sobha has only one annuity asset (retail property) and is in process of adding one more; we believe that because of this, it is missing out on an opportunity to ride the current annuity growth wave (especially in the commercial segment) and due to its over dependency on residential, its manufacturing vertical will slow down if this segment slows – pulling down its overall performance.

Financials

Income Statement

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Net sales	**27,830**	**34,421**	**41,871**	**48,800**
Growth, %	25	24	22	17
Total income	27,830	34,421	41,871	48,800
Raw material expenses	-3,337	188	-4,212	-4,930
Employee expenses	-1,985	-2,359	-2,666	-3,049
Other Operating expenses	-17,312	-25,517	-28,831	-33,602
EBITDA (Core)	**5,197**	**6,733**	**6,163**	**7,218**
Growth, %	23.8	29.5	(8.5)	17.1
Margin, %	18.7	19.6	14.7	14.8
Depreciation	-544	-623	-692	-888
EBIT	**4,653**	**6,110**	**5,470**	**6,331**
Growth, %	30.7	31.3	(10.5)	15.7
Margin, %	16.7	17.8	13.1	13.0
Interest paid	-1,978	-2,362	-2,178	-2,264
Other Non-Operating Income	164	348	348	348
Pre-tax profit	**3,171**	**4,483**	**4,027**	**4,802**
Tax provided	-1,003	-1,512	-1,410	-1,681
Profit after tax	**2,169**	**2,971**	**2,618**	**3,121**
Net Profit	**2,169**	**2,971**	**2,618**	**3,121**
Growth, %	34.9	37.0	(11.9)	19.2
Net Profit (adjusted)	**2,169**	**2,971**	**2,618**	**3,121**
Unadj. shares (m)	95	95	96	96
Wtd avg shares (m)	95	95	96	96

Balance Sheet

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Cash & bank	1,194	1,772	2,292	2,128
Debtors	3,272	3,271	2,753	3,209
Inventory	48,349	65,173	65,025	70,079
Loans & advances	8,306	5,699	5,699	5,699
Other current assets	17,026	17,185	17,185	17,185
Total current assets	78,147	93,100	92,954	98,299
Investments	4,431	5,057	5,057	5,057
Gross fixed assets	4,177	4,566	6,066	7,566
Less: Depreciation	-1,380	-1,949	-2,641	-3,529
Net fixed assets	2,797	2,617	3,425	4,037
Non-current assets	4,685	5,289	5,289	5,289
Total assets	**90,248**	**1,07,194**	**1,07,831**	**1,13,788**
Current liabilities	56,693	84,382	81,892	85,016
Provisions	362	555	555	555
Total current liabilities	57,055	84,937	82,447	85,571
Non-current liabilities	5,494	171	171	171
Total liabilities	62,549	85,108	82,618	85,742
Paid-up capital	948	948	948	948
Reserves & surplus	26,751	21,343	24,267	27,100
Shareholders' equity	27,699	22,291	25,215	28,049
Total equity & liabilities	**90,248**	**1,07,399**	**1,07,833**	**1,13,790**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Pre-tax profit	3,171	4,483	4,027	4,802
Depreciation	544	623	692	888
Chg in working capital	-24,949	12,520	-1,800	-2,385
Total tax paid	1,880	-4,654	-1,410	-1,681
Other operating activities	22,888	-8,643	-291	-1,604
Cash flow from operating activities	**3,535**	**4,329**	**1,219**	**20**
Capital expenditure	-3,341	-443	-1,500	-1,500
Chg in investments	-4,431	-626	0	0
Other investing activities	6,485	-1,367	735	387
Cash flow from investing activities	**-1,287**	**-2,437**	**-765**	**-1,113**
Free cash flow	2,248	1,892	454	-1,093
Equity raised/(repaid)	27,699	-5,408	2,924	2,833
Debt raised/(repaid)	2,788	-2,740	0	0
Dividend (incl. tax)	-241	-237	-240	-240
Other financing activities	-32,675	7,079	-4,198	-4,193
Cash flow from financing activities	**-2,428**	**-1,307**	**-1,513**	**-1,600**
Net chg in cash	-180	585	-1,059	-2,692

Valuation Ratios

	FY18	FY19e	FY20e	FY21e
Per Share data				
EPS (INR)	22.9	31.3	27.3	32.5
Growth, %	37.9	37.0	(13.0)	19.2
Book NAV/share (INR)	292.2	235.1	262.7	292.2
FDEPS (INR)	22.9	31.3	27.3	32.5
CEPS (INR)	28.6	37.9	34.5	41.8
CFPS (INR)	(370.6)	96.5	1.7	2.9
DPS (INR)	2.5	2.5	2.5	2.5
Return ratios				
Return on assets (%)	9.2	5.4	4.5	4.9
Return on equity (%)	7.8	13.3	10.4	11.1
Return on capital employed (%)	24.9	19.1	20.0	20.1
Turnover ratios				
Asset turnover (x)	1.3	0.9	1.2	1.2
Sales/Total assets (x)	0.6	0.3	0.4	0.4
Sales/Net FA (x)	19.9	12.7	13.9	13.1
Working capital/Sales (x)	0.7	0.2	0.2	0.2
Receivable days	42.9	34.7	24.0	24.0
Inventory days	634.1	691.1	566.8	524.2
Payable days	116.2	149.3	99.7	99.8
Working capital days	261.0	67.8	71.6	79.3
Liquidity ratios				
Current ratio (x)	1.4	1.1	1.1	1.1
Quick ratio (x)	0.5	0.3	0.3	0.3
Interest cover (x)	2.8	3.1	3.1	3.4
Total debt/Equity (%)	83.4	109.6	100.8	94.2
Net debt/Equity (%)	79.0	101.6	91.7	86.6
Valuation				
PER (x)	22.1	16.1	18.6	15.6
PEG (x) - y-o-y growth	0.6	0.4	(1.4)	0.8
Price/Book (x)	1.7	2.2	1.9	1.7
EV/Net sales (x)	2.5	2.1	1.7	1.5
EV/EBITDA (x)	13.4	10.5	11.6	10.1
EV/EBIT (x)	15.0	11.6	13.1	11.5

PhillipCapital

Oberoi Realty (OBER IN)

Diversifying; strong luxury and margin play

24 May 2019

INDIA | REAL ESTATE | INITIATING COVERAGE

OBER is one of the few players in the luxury segment in MMR that has been successful in the current tough environment. It has adopted the 'outright buy' model for its land parcels, which coupled with high realizations has led to much higher margins than peers. OBER has diversified into commercial, retail, and hospitality segments by capitalizing on past success in these asset classes, which provides much need stability to its slow-moving and volatile revenue streams. It is planning to launch an affordable luxury project soon, which will aid sales momentum (we believe mid-ticket-sized units are key drivers of the sector ahead). OBER has also shown agility in adapting to the changing business environment through subvention schemes to boost its sales. These structural changes coupled with its strong brand name and execution capabilities (quality + timeline) provide growth visibility and comfort. Even with these growth levers, it trades at a 24% discount to NAV.

Uniquely positioned in MMR's premium residential segment: Oberoi has entrenched itself in the niche premium real-estate category as it was traditionally focused on building only premium residential high rises in which it has a strong brand name and execution track record. It undertakes large land parcels for multi-purpose development, which provides its home-buyers with a 'wholesome' experience – retail, hospitality, and commercial projects in the same place.

Reviving sales through subvention schemes: Oberoi launched subvention schemes in Q1 FY19, which has led to a strong revival in its bookings – to 1.05mn sq. ft. in FY19 from 0.58mn sq. ft. in FY18 – an 81% increase. We expect this velocity to continue, based on improvement in the MMR real estate market and continuation of subvention schemes. We expect its residential bookings/revenue to see 15%/17% CAGR over FY19-21.

MMR market showing signs of revival: Over the past few quarters, MMR has shown signs of revival with demand outstripping supply, which led to overall inventory levels and inventory overhang falling. We believe this trend will continue and Oberoi's sales momentum will rise as a result.

Foray into mid-tier affordable luxury housing: Affordable mid-tier housing projects will be a key driver of the RE sector ahead. Oberoi is planning to foray into affordable luxury housing through the launch of its *Aspire* series on its Thane land parcel priced at Rs 15-20mn. We believe that this project will garner a strong response, considering that Oberoi's Borivali's Sky City, priced at +Rs 25mn (the smallest ticket-sized offering in its portfolio so far) has had a strong sales track record.

Diversification – moving towards a balanced mix: After successfully operating 1 retail, 2 commercial, and 1 hospitality asset, OBER now plans to develop 2 retail, 3 commercial, and 2-3hospitality assets. We expect the following revenue CAGRs over FY19-24 – commercial 25%, retail 34%, and hospitality 19%.

Revenue CAGR of 17% over FY19-21: Residential bookings will see 15% CAGR over FY19-21 on subvention schemes and improvement in the MMR market, increased occupancy in Commerz 1 and Commerz 2 Phase 1 (commercial projects), and improved rental yields in Oberoi Mall (Goregaon).

BUY

CMP RS 537

TARGET RS 660 (+24%)

COMPANY DATA

O/S SHARES (MN) :	364
MARKET CAP (RSBN) :	195
MARKET CAP (USDBN) :	2.8
52 - WK HI/LO (RS) :	607 / 25
LIQUIDITY 3M (USDMN) :	5.2
PAR VALUE (RS) :	10

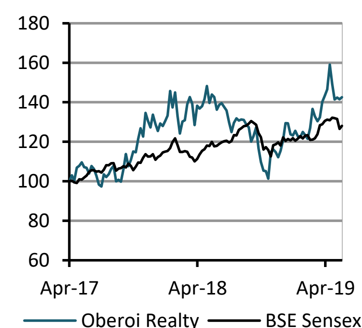
SHARE HOLDING PATTERN, %

	Mar 19	Dec 18	Sep 18
PROMOTERS :	67.7	67.7	67.7
FII / NRI :	25.4	25.4	25.8
FI / MF :	4.4	4.5	3.8
NON PRO :	1.0	0.9	1.0
PUBLIC & OTHERS :	1.5	1.5	1.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	1.7	6.9	7.5
REL TO BSE	1.1	-1.3	-5.5

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY19E	FY20E	FY21E
Net Sales	25,786	36,821	35,458
EBIDTA	11,515	14,029	14,656
Net Profit	8,061	9,879	10,312
EPS, Rs	22.2	27.2	28.4
PER, x	24.2	19.8	18.9
EV/EBIDTA, x	17.0	14.0	13.4
P/BV, x	2.4	2.2	2.0
ROE, %	10.0	11.1	10.4
Debt/Equity (%)	10.4	7.1	6.4

Source: PhillipCapital India Research Est.

Dhaval Somaiya, Research Associate
Vaibhav Agarwal, Research Analyst

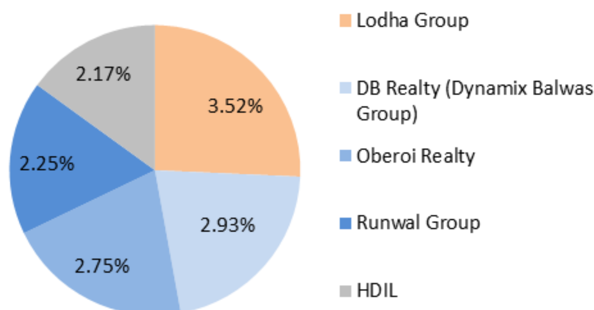
Luxury play and brand name

- Real-estate developer operating in Mumbai Metropolitan Region (Mumbai, Navi Mumbai, Thane).
- Track record of over 30 years.
- Established itself as a premium brand.
- Third-largest player by market share in MMR. As of FY18, it has delivered over 40 projects across MMR – 11.2mn sq. ft. saleable area.
- Focused primarily on developing luxury residential projects, typically above 50 storeys tall.
- Primary focus is on buying land parcels and developing residential projects, but it has diversified into retail, commercial, and hospitality over the past couple of years in an attempt to stabilise its portfolio and reduce over-dependence on the residential segment.
- It has:
    - Retail: 1 operating and 2 planned retail assets (excluding Sangam City Retail)
    - Hospitality: 2 operating and 3-4 hospitality assets – management is expected to take a call on I-ven Hotel; plans to convert it into part hospitality (small hotel) and part commercial
    - 1 operating and 1 planned commercial asset (excluding Sangam City Commercial), and 1 operating and 2-3 planned hospitality assets (management is expected to take a call on I-ven Hotel)
- Current saleable portfolio includes 12 residential projects (excluding Sangam City, Pune) and four each in completed, on-going, and planned phases. It has a land parcel in Thane that it plans to develop soon.
- Customer-centric approach and focus on delivering high-quality projects.

Focused on MMR – a positive
It plans to remain focused on this region for the following reasons:

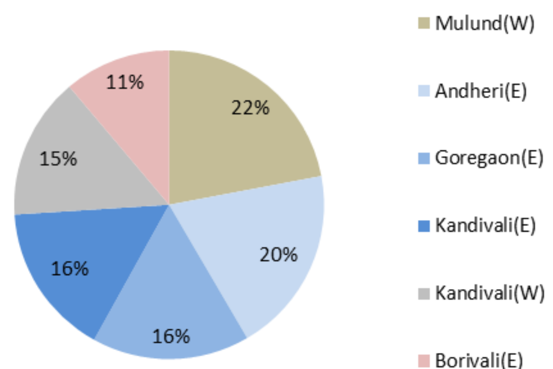
1. MMR's real estate market has one of the highest price realisations in the country, which aids Oberoi's objective of achieving higher EBITDA margins.
2. It builds high-rises as a policy – and MMR is the only region in India to have the most relaxed norms about building 50+ storey buildings.
3. It has an established legacy, experience, and brand name that it can leverage in the MMR region.

Oberoi: Third largest player by market share (in terms of upcoming inventory)



OBER is one of the largest players in MMR with approx 2.75% market share; it aims to scale up its market share there

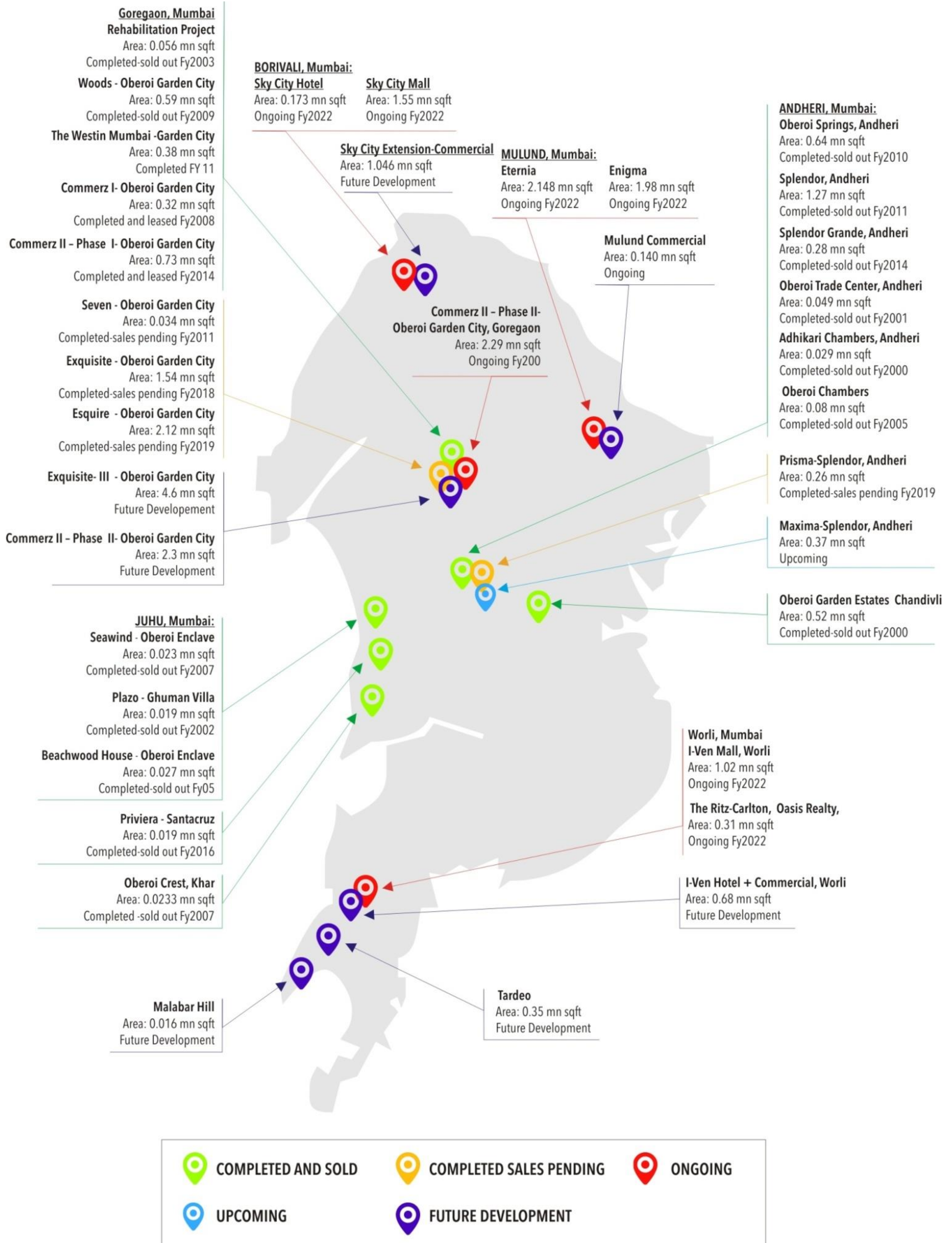
Oberoi's projects are in some of Mumbai's top high-demand areas



Majority of Oberoi's projects are in some of Mumbai's highest demand areas. Strategically placed projects enables Oberoi to maintain its sales velocity

Source: PhillipCapital India Research

Oberoi's project details



Source: Company, PhillipCapital India Research

Oberoi's residential buildings typically have a wide variety of amenities, providing a differentiated luxury product

Show Flat – Prisma

Show Flat - Esquire

'Destination development' for a wholesome experience

In order to provide a differentiated luxury product, Oberoi Realty provides what one may call 'destination development', which it believes gives a wholesome experience for its buyers. What this means is that in addition to posh residences, it aims to develop commercial, hospitality, and retail properties at the same location, and sometimes even educational complexes. This invariably helps the company to maintain its sales velocity despite its units being at a premium compared with most peers.

A few examples

- Its Goregaon project (Oberoi Garden City) houses commercial, residential, retail, hospitality properties, and a school. It has also planned to develop a hospital and educational complex on this land parcel.
- In its Borivali land parcel (Sky City), it has hospitality, commercial, residential, and a retail project.
- Oberoi's Worli project (Three Sixty West) is a hospitality and residential development and it is developing a retail property nearby.
- Its Mulund land parcel will house a residential and commercial project.
- We believe that Oberoi will follow a similar model for developing its recently bought land parcel in Thane.

Oberoi Garden City (Goregaon) layout

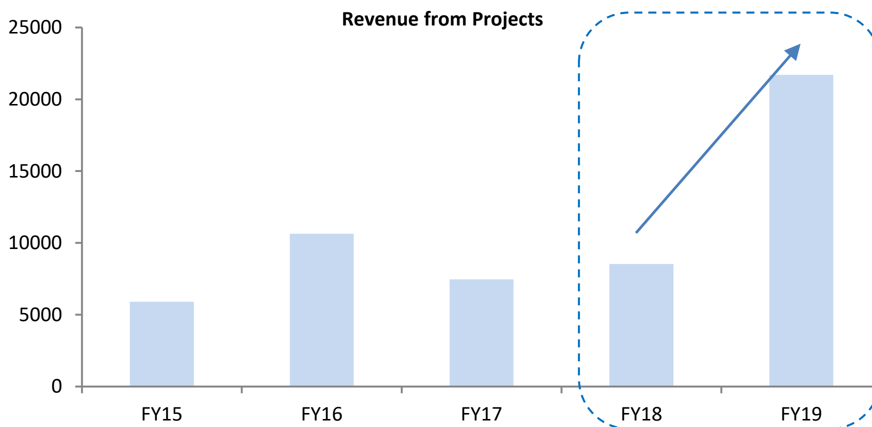
Oberoi Sky City (Borivali) layout

Source: Oberoi Realty

Residential segment: Reviving on subvention schemes

OBER has 12 premium residential projects (excluding Sangam City, Pune) of which 4 are complete, 4 are ongoing, and 4 are planned. All projects are in the MMR region – specifically in Goregaon, Borivali, Andheri, Worli, and Mulund. Oberoi typically develops premium projects and buys land outright (does not form JVs with land owners) so it is able to garner high margins (40-50% on average).

Residential revenue – reviving in FY19 (Rs mn)



Source: PhillipCapital India Research, Oberoi Realty

Total Saleable area across existing eight projects is around 15mn sq. ft.

Project Name	Size	Area Sold (As on FY19)
Exquisite	1.5	92%
Esquire	2.1	75%
Prisma	0.3	83%
Eternia	2.1	28%
Enigma	2.0	21%
Sky City	4.6	35%
Three Sixty West	2.3	24%
Total	**15.0**	

Source: PhillipCapital India Research, Oberoi Realty

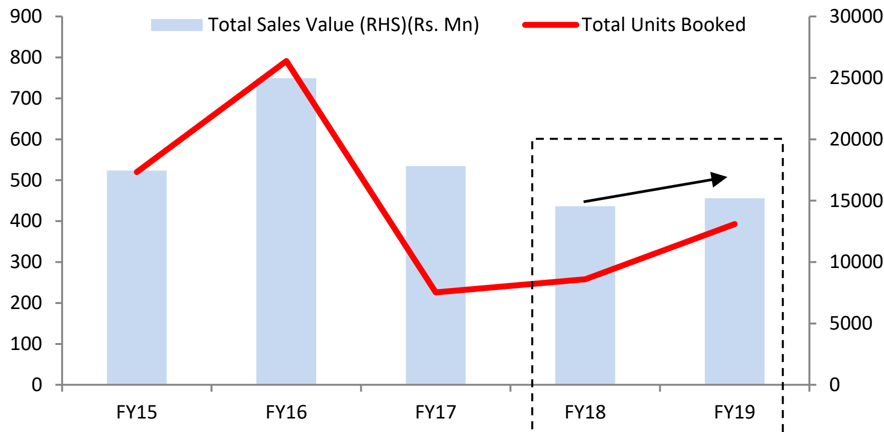
Subvention scheme – a key revival lever

Due to the general slack in the market, Oberoi has implemented subvention schemes for some of its projects – to boost sales velocity. It has adopted a precision-targeted approach by designing unique subvention schemes for each of its required projects as per their status.

For example:

- For its Mulund project, it has designed a 10:15:75 scheme under which the buyer pays 10% of the cost upfront, 15% over next one month, and 75% on possession.
- For its Borivali's Sky City project, Oberoi has launched a 5%:5%:85% scheme – 5% at launch, 5% within a year, and 85% on possession.
- For Exquisite and Esquire Oberoi (location), it has adopted a 25:15:15:15:15:15 scheme under which a buyer has to pay 25% and move in and rest 75% has to be paid over the next five years (15% each year).
- Also, going forward, we do not expect many players to place products in the premium category, which should lead to reduction in competition in this segment – giving Oberoi an added advantage.

Bookings reviving on subvention schemes, boosting sales velocity (primarily of lower-ticket-sized units)



Source: PhillipCapital India Research

Premium pricing or pricing play?

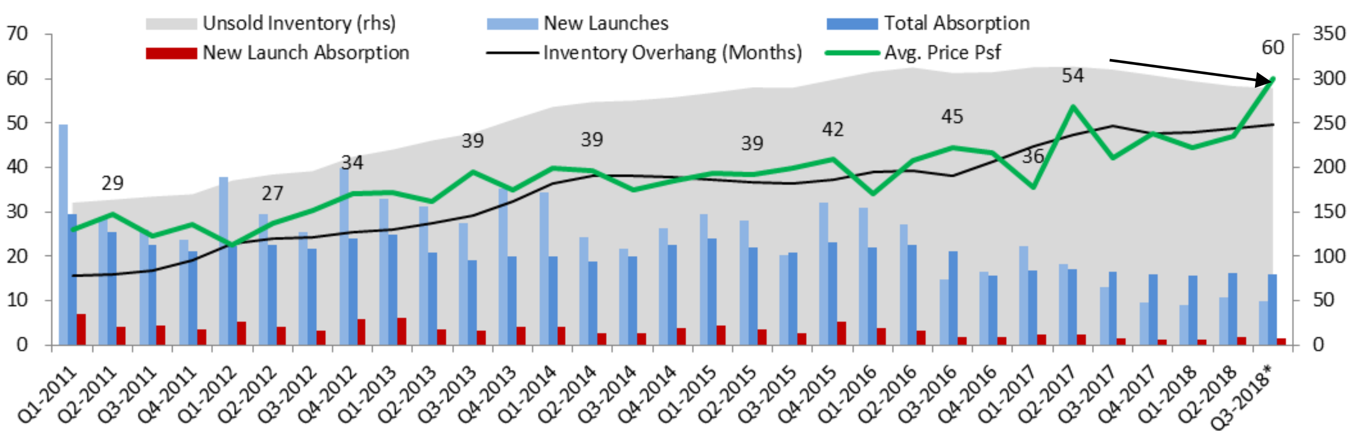
In the current RE market scenario, selling units at a premium to prevailing market prices without being able to push price hikes is akin to indulging in pricing play, in our opinion. Over the past couple of years, despite an overall slowdown in the real estate and mounting inventory and overhang, prices in MMR haven't corrected significantly. There was a large inventory build-up over CY16-18 but now, supply in the system has come down significantly and demand has started seeing some revival, halting the deterioration of inventory overhang – which seems to have stabilised around 48 months.

OBER is swimming against strong currents because of its premium pricing policy

Despite headwinds that its peers face, Oberoi realty has continued selling its projects at a significant premium (20-35%) to the market and due to its strong brand name, execution, and superior product in terms of construction and amenities. Oberoi has not only kept afloat in its markets but has also seen consistent growth in sales.

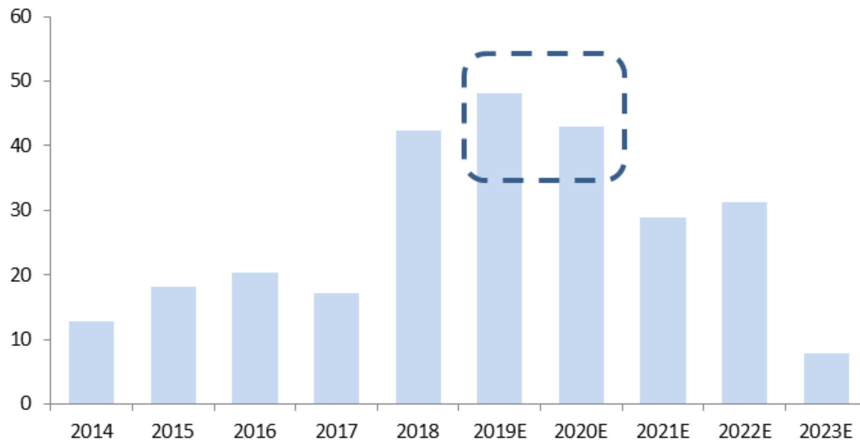
We believe that in near term, inventory overhang levels in the MMR region may start seeing a slow decline (on reviving demand) but we do not expect pricing to return. Oberoi might not be able to push significant price hikes in its projects but will continue to sell at a steady pace based on demand revival and implementation of the subvention schemes.

Prices in Mumbai have been flattish/corrected marginally over Q2 and Q3 CY18; the inventory overhang levels in Mumbai have started to stabilize



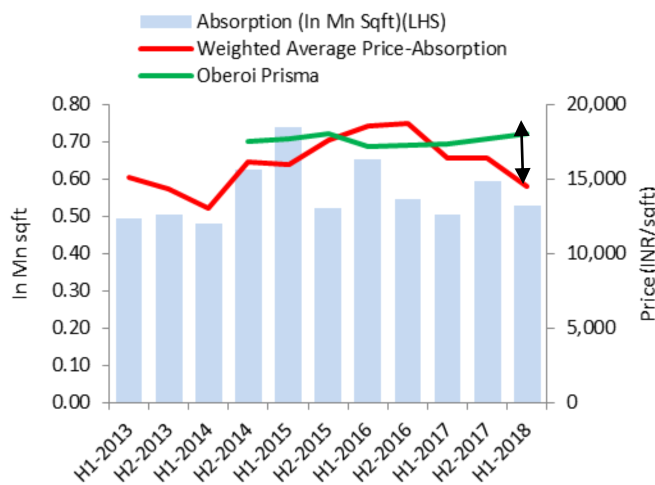
Source: PhillipCapital India Research, Knight frank

Supply in MMR to remain high for the next two years - expected to maintain sales pressure on Oberoi



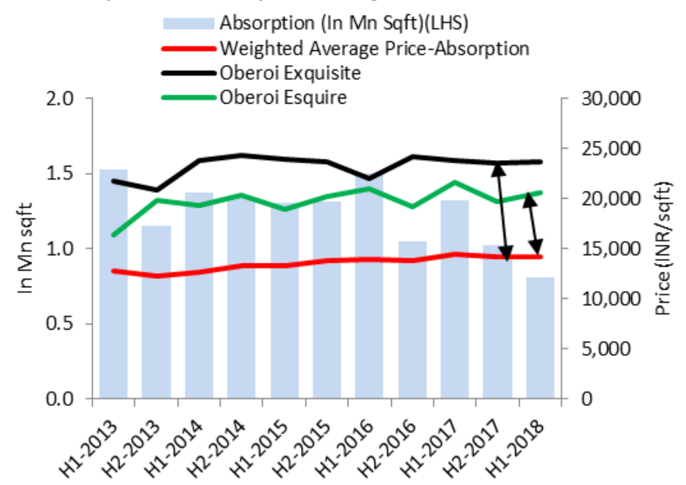
Source: PhillipCapital India Research, Knight frank

Oberoi Prisma, Andheri



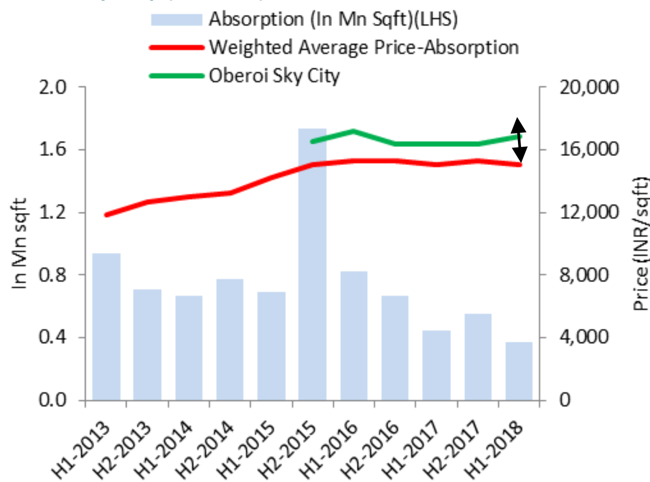
- Andheri (east) is a high demand market , which is positive prima-facie. But it also faces a high inventory overhang due to which the prices have been falling
- Due to this, premium gap between average market price and Prisma's price has widened.
- Hence, we expect the sales velocity of Prisma to remain subdued at current levels.
- Price realizations have been subdued for this project since its launch

Oberoi Exquisite and Esquire Goregaon

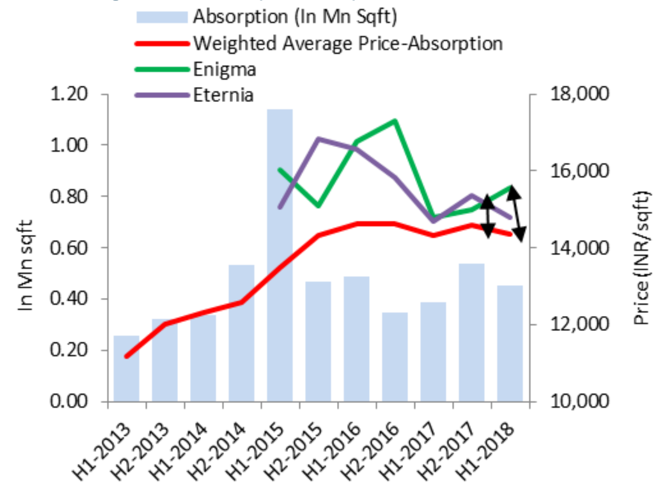


- Goregaon is a medium demand micro-market.
- In has recently past seen a dip in demand due to slower addition of quality residential-projects supply. This is why overall prices have grown only marginally, decreasing Exquisite and Esquire's price gap with average market prices.
- The declining gap provides an impetus for sales and this coupled with OBER's subvention scheme has helped gain momentum in these projects.
- Price realizations have been subdued for the projects since launch.

Oberoi Sky City (Borivali)



Oberoi Enigma, Eternia (Mulund)

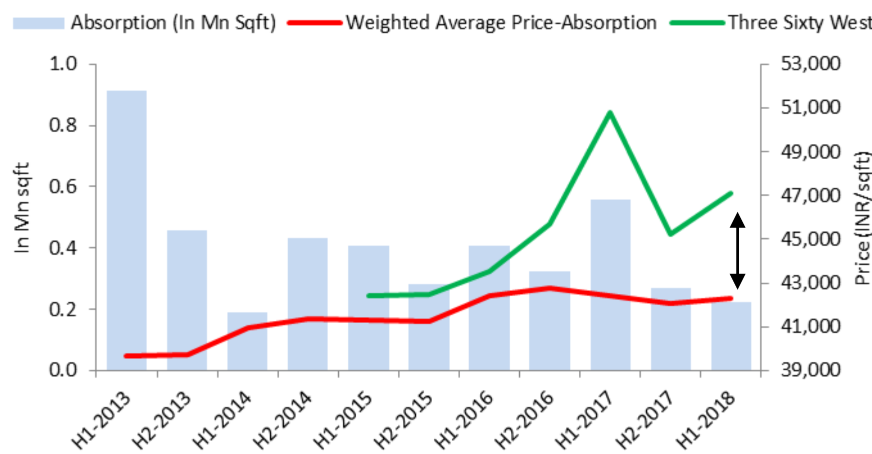


Source: PhillipCapital India Research, Oberoi Realty

- Borivali (east) is a low demand market
- Gap between average market prices and Oberoi Sky City's prices are low
- However, due to strong sales velocity (which should continue based on relatively low-ticket sizes vs. its other projects), the firm has been able to hike prices marginally in this project

- Mulund is a medium demand market
- Gap in average market prices and Enigma and Eternia's prices is flattish
- Subvention schemes should drive sales momentum in Eternia

Oberoi's Three Sixty West (Worli)



Source: PhillipCapital India Research, Oberoi Realty

- Worli is a low demand market
- Gap between average market prices and Oberoi Three Sixty West's prices are very high owing to the super luxury nature of the Three Sixty West
- Owing to high inventory overhang in the micro-market coupled with the fact that the project has very high ticket sized units we expect the sales velocity in this project to remain subdued, though we expect a marginal rise in sales velocity as the project is expected to receive OC in Q3 FY20

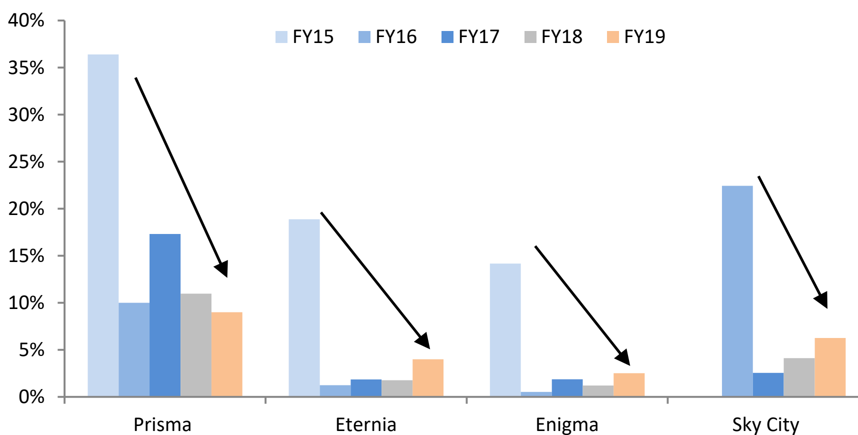
Tackling the post-launch slack

- Slow post-launch year sales
- High-ticket-sized inventory
- Continued inventory overhang

Over the years, booking analysis of various projects suggest that during the launch year, OBER's sales range from 15-35% of its total inventory, which number falls sharply to low single digits and remains subdued in post launch years. This makes 'time-to sell' of a project very high (typically 7-10 years).

We believe that with MMR being on the verge of a turnaround (as demand outstrips supply, existing inventory levels have started coming down for the first time) and overall inventory levels are declining. So the sales velocity of its projects is set to revive over 2-3 years, aided by its subvention schemes. We expect sales in these projects to grow from the historical average, albeit at a slow pace in near term and at a relatively good pace over the medium term.

Project-wise launch-year and post-launch-year sales trends



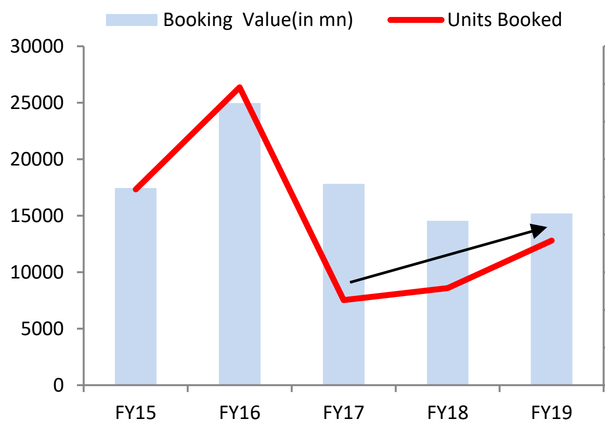
Source: PhillipCapital India Research

Oberoi has a trend of high pre-sales in launch years, which fall sharply in the years to follow. Curbing this trend is necessary to curb inventory overhang

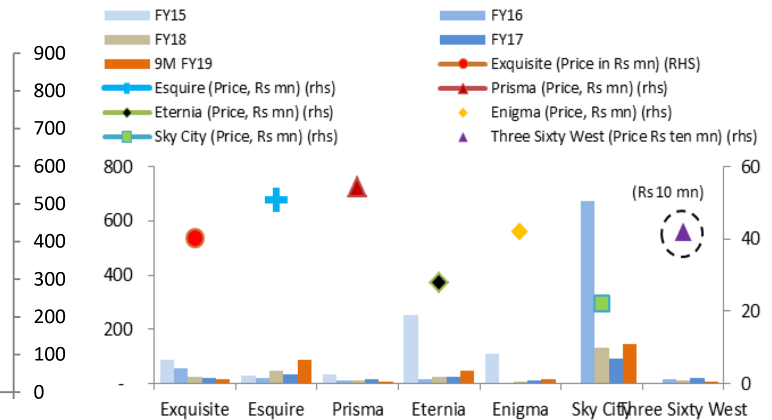
Relatively small-ticket-sized units to drive sales ahead

Over FY17-19, sales of the relatively small-ticket-sized units (i.e., Sky City, Enigma, Eternia, and Exquisite) have been the key drivers of growth in total booking. This trend can be observed from the graph below wherein overall booking value has been falling while the number of units booked have been rising, implying that the average value of the sold unit is declining.

Small ticket sized items drive sales



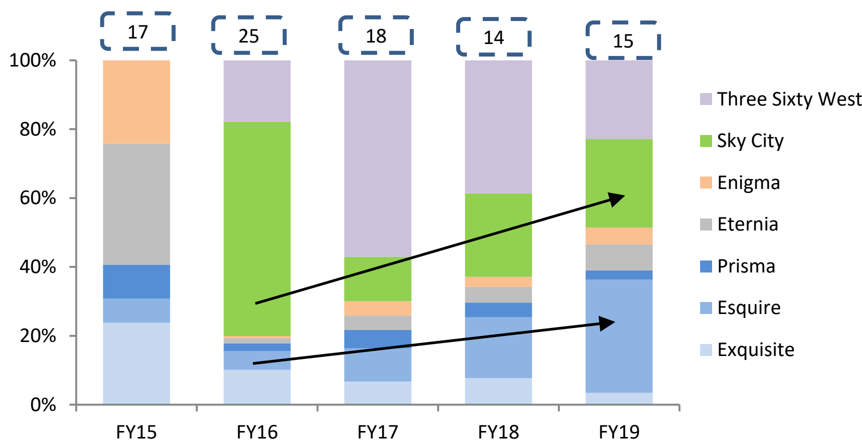
Sales trend (no. of units) vs. pricing points of various projects



Source: PhillipCapital India Research

The graphs depict an inverse relationship between the ticket size of the project and number of units sold, thereby re-enforcing our view of small-ticket-sized units having better sales velocity

Project-wise breakup of total bookings: Sky City, Esquire, and Three Sixty West still lead



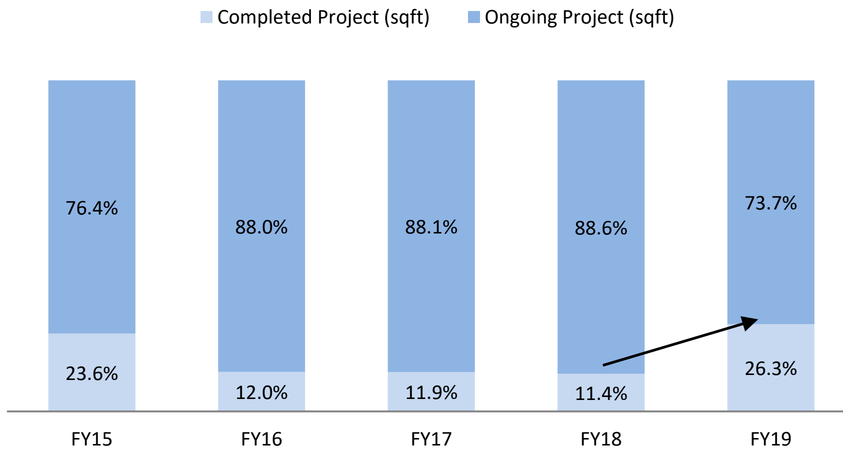
Source: PhillipCapital India Research

Historically, Oberoi has been managing inventory overhang (completed project inventory) well, but it remains something that the firm will have to deliver consistently

We have also plotted the year-on-year sales of units in various projects and its estimated current average price along with project-wise breakup of the total booking. Our analysis suggests that over FY16-19, Sky City and Eternia were projects that have high sales velocity and contribute significantly to total booking by value and volume. This confirms our view that relatively small ticket sized units will be key drivers of the sector Apart from Sky City and Eternia, Three Sixty West contributes significantly to the total booking value due to its very-high ticket size (Rs 350-450mn), but as three sixty West's inventory is very slow moving, we expect sales to be driven by the mid ticket-sized projects in the near to medium term.

Completed project inventory has been around 30% over FY16-19. The share of sale of completed project inventory has been around 11-12% over FY16-18, in FY19 the share of completed project inventory sales as a % of total sales stood at 26.3% owing to the implementation of the subvention scheme bringing the inventory overhang level down to approx. 26%. We believe that going forward this trend will continue which will lead to decline in inventory overhang.

Residential segment revenue



Source: PhillipCapital India Research

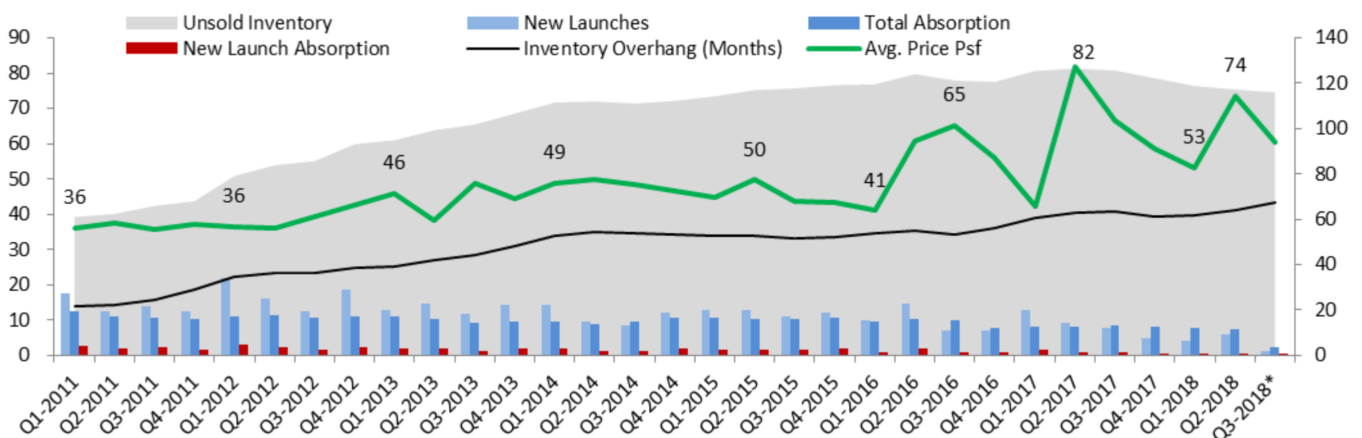
Plans to foray into the affordable luxury segment

We believe that the affordable housing (i.e., mid-ticket-sized units) will be the driver of the sector. Even Oberoi is planning to foray into this segment – it is planning to launch under its Aspire series. This segment will provide diversification, stability, and visibility of future cash flow. Its first affordable project is likely to be constructed on its recently acquired Thane land parcel (60 acres). We expect pricing at Rs 15-20mn for a two bedroom apartment.

Analysis: Thane district market

Thane has seen a massive real estate development with strong launches over 2011-16. Over these years, supply significantly outstripped demand, leading to mounting inventory. However, with structural changes that the sector has undergone over 2016-18, this suburb saw a sharp fall in supply – which led to a trend reversal. Currently, demand outstrips supply marginally in Thane, but it is plagued with a massive inventory overhang. Over CY18, the market has shown some signs of revival, but we expect a wave of inventory over 2019-20 – which is why the pain will continue.

Thane micro market: Plagued with high inventory overhang; starting revival journey

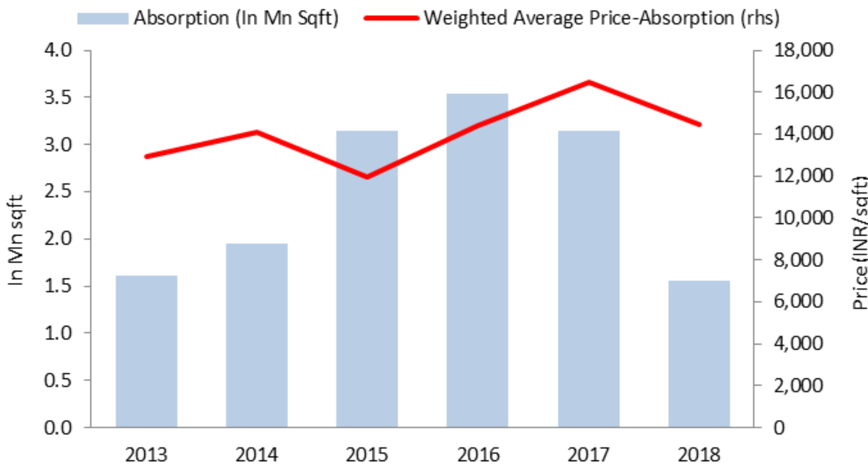


Source: PhillipCapital India Research , Knight Frank

Analysis: Thane West

Thane West (where Oberoi's project will be located) has been seeing a fall in demand for the last three years due to which the weighted average price is declining. Our analysis suggests that currently this market is facing a massive inventory overhang, which could dampen sales velocity in new projects ahead.

Absorption analysis - yearly



Source: PhillipCapital Research, Knight Frank, Oberoi Realty

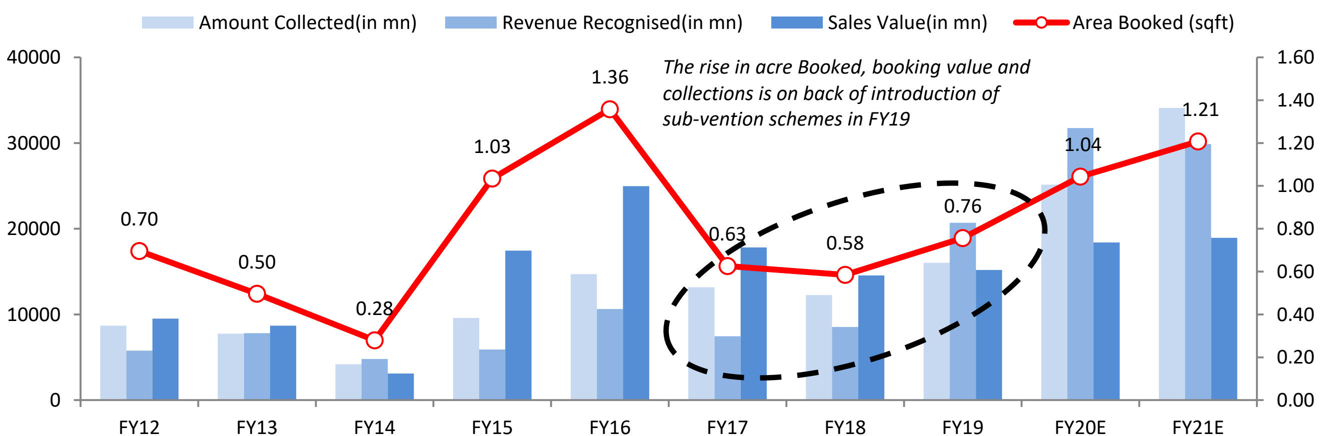
Residential bookings and revenue to see 15% and 17% CAGR over FY19-21

The residential segment will continue to post strong growth on subvention schemes and a conducive environment and the annuity model will keep performing well. Oberoi's performance during FY17 and FY18 was subdued due to macroeconomic and business environment headwinds. However, we believe sales should see significant growth (+100%) in FY19 because of:

- Improvement in sales velocity in Enigma (FY18: 9 units, FY19: 20 units), Eternia (FY18: 23 units, FY19: 54 units), and Esquire (FY18: 48 units, FY19: 107 units) on subvention schemes.
- Continued strong sales velocity in Sky City (FY18: 134 units, FY19: 178 units) and small improvement in sales velocity of Three Sixty West (FY18: 10 units, FY19: 12 units)

Over FY20-21, bookings will see 15% CAGR because of improved sales velocity in all projects on implementation of subvention schemes and better business environment in the MMR market. We expect an increase in sales velocity from Three Sixty West when it is complete. ***We see revenue rising sharply in FY20 because of revenue recognition from Three Sixty West and increased sales velocity.***

Residential segment performance – Bookings/revenue CAGR of 15%/10% over FY19-21

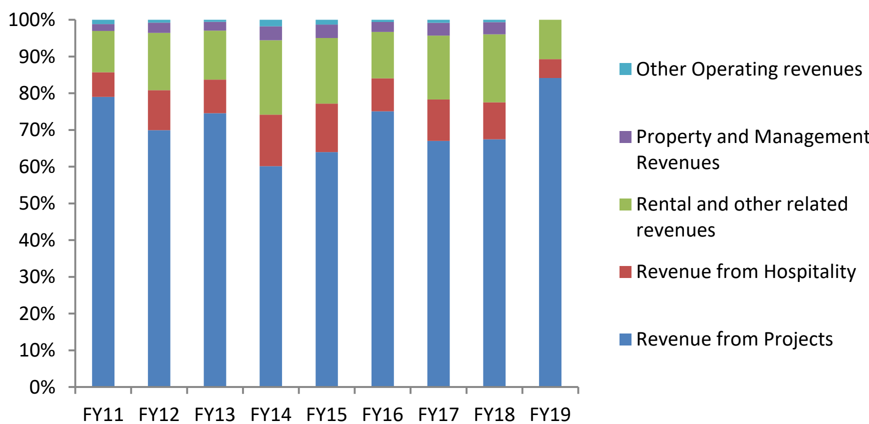


Source: PhillipCapital India Research, Oberoi Realty

Diversification: Capitalizing on the past experience

Despite the firm's core focus on the residential segment, the management has been aware of opportunities in the commercial, hospitality, and retail segments. As a result, it has forayed into these segments. Currently, apart from one operating retail property, two operating commercial properties, and one operating hospitality property, it has two upcoming retail properties, 2-3 hospitality properties, and two commercial properties. Foraying into these segments not only positions Oberoi to ride the on-going growth cycle in these segments but also provides revenue stability from annuity assets and reduces the overall revenue volatility attached with the residential real-estate and hospitality segments.

Over FY16-19, revenue from residential segment has revived; all other verticals grow at strong pace



Source: PhillipCapital India Research, Oberoi Realty

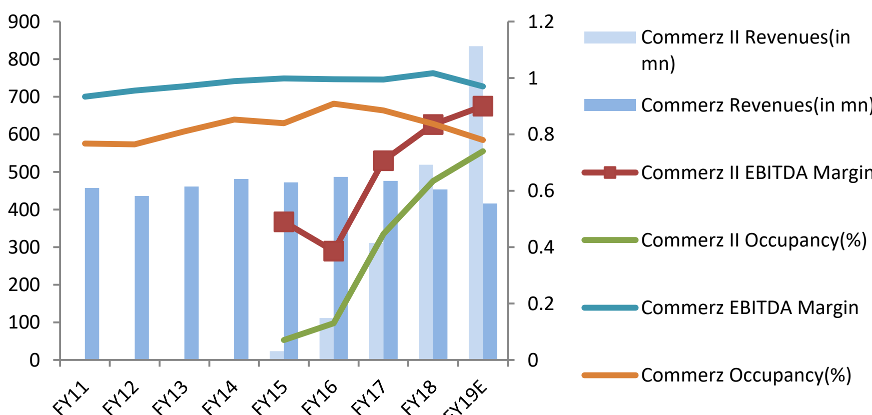
Commerz – 2 Phase 2 occupancy levels rising. Re-calibrated Commerz-1 commercial segment revenues are set to grow

Commercial segment

OBER currently has two commercial projects in Goregaon – Commerz-1 (320,000 sq. ft.) and Commerz-2 Phase 1 (720,000 sq. ft.). For both projects, the revenue rate is Rs 140 psf pm. For Commerz-1, EBITDA margin is around 95% and occupancy is around 78%, and for Commerz-2 Phase 1 the EBITDA margin is around 90% and average occupancy for FY19 is around 64%, but during Q4FY19 occupancy of Commerz 2 has risen above 90%. Due to the current commercial segment conditions in MMR, Commerz-1 contracts have been recently renegotiated at a slightly lower price, bringing it at par with Commerz-2 Phase 1 prices – which we believe should help to boost occupancy levels at Commerz 1 and Commerz 2 Phase 1.

Currently, we have taken into account only the Retail property at I-Ven. We haven't considered I-ven commercial and hotel. We would wait for further clarity

Commerz 2 occupancy rises; Commerz 1 recalibrated – commercial segment grows

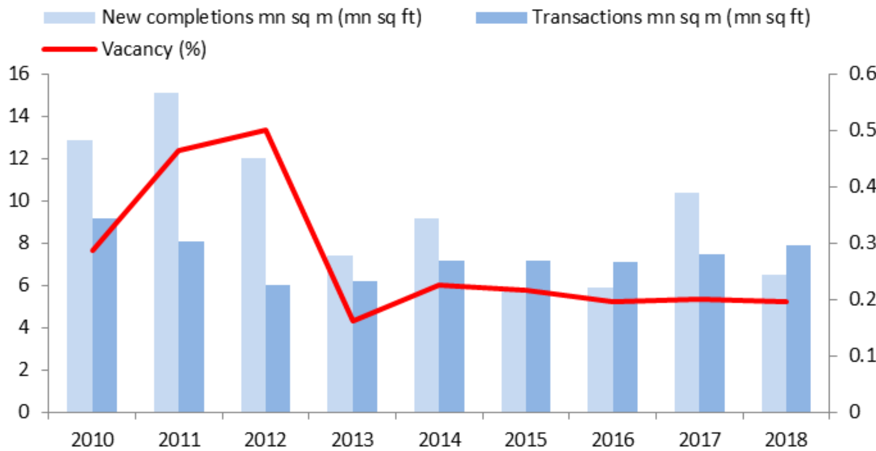


Source: PhillipCapital India Research, Oberoi Realty

MMR commercial market: Plagued by high vacancy

MMR commercial micro-market is plagued with high vacancy levels (around 20%), which we believe will remain at this level for a while, which will ensure pressure on rental yields. Due to this trend, we do not expect Oberoi's rentals to increase at any more than the standard 5% per annum rate.

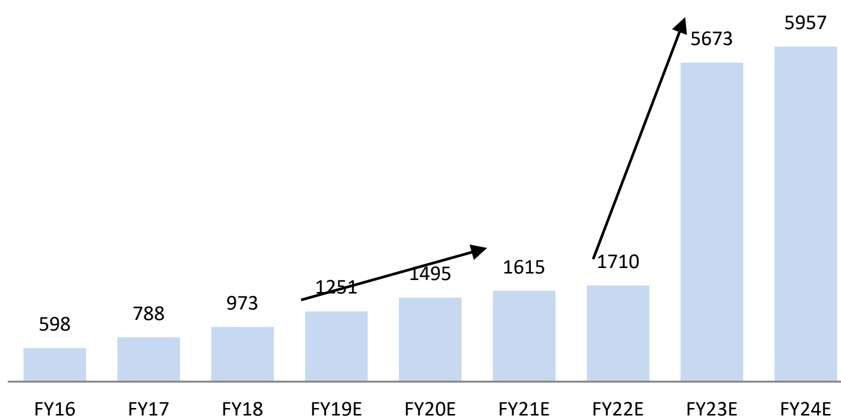
MMR commercial market plagued by high vacancy; keeps rental yields depressed



Source: PhillipCapital India Research, Cushman Wakefield

We reckon revenue from OBER's commercial vertical will see a CAGR of 15% over FY19-21 as occupancy levels rise in Commerz 1 and Commerz 2 Phase 1 (it will see a substantial rise in occupancy levels from current levels of 64% to around 95%). The segment should see a CAGR of 25% over FY21-23 as one more commercial property – Commerz 2, Phase 2 (2.3mn sq. ft.) becomes operational. OBER has plans to develop Mulund Commercial (0.14mn sq. ft.), Sky City Commercial (1mn sq. ft.) and I-ven Commercial (under discussion phase) soon.

Commercial revenue CAGR at 15% as Commerz 2 Phase 1 occupancy increases



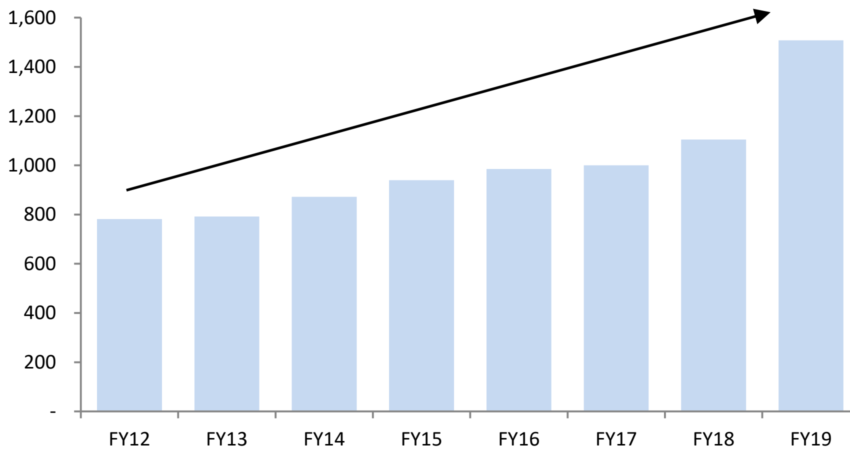
Source: PhillipCapital India Research, Oberoi Realty

Retail segment: With Oberoi Mall being a success, OBER is set to replicate this at two upcoming retail properties

Retail segment

Currently, Oberoi has one retail property – Oberoi Mall (0.55mn sq. ft.) at Goregaon. The mall has been consistently performing well with occupancy levels of above 95% and EBITDA margins of around 95%.

Mastered the art of operating a mall



Source: PhillipCapital India Research, Oberoi Realty

We strongly believe and our research shows that a mall's success depends a great deal upon its execution. In our industry section, we have discussed in detail what makes a mall successful (link). Our analysis suggests that Oberoi has the pillars of success in place and as a result it has been able to gather marquee brands and incrementally higher consumption translating into better revenue generation by the malls.

Loyalty Program App

National Beyblade Burst Competitions

6th - 7th Aril

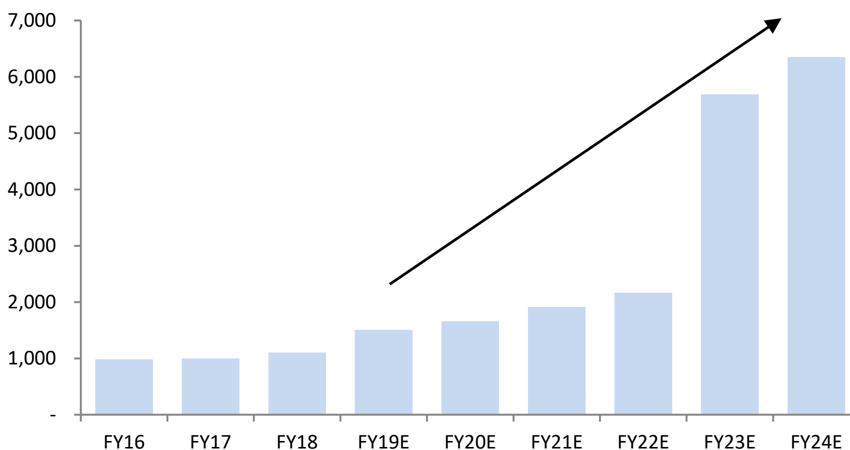
Event at Oberoi Mall

Tanishq Offer

April

Offer at the mall

Retail segment revenue: Set to rise once I-ven and Sky City Mall become operational



Source: PhillipCapital India Research, Oberoi Realty

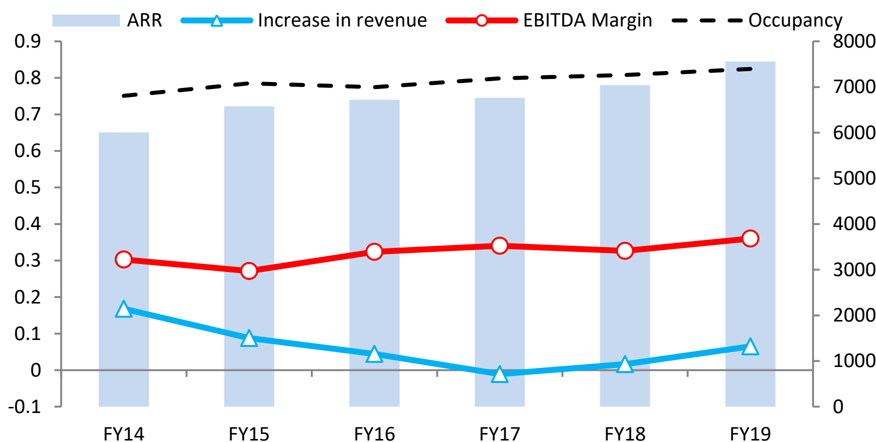
Oberoi has two under-construction mall properties – Sky City at Borivali (1.5mn sq. Ft.) and I-ven at Worli (1mn sq. ft.). They are expected to be operational by FY23

We expect revenue from the retail vertical to grow by more than 200% in FY22-23 as two more retail properties – Sky City Mall and I-ven Mall – becomes operational – which as per our analysis should take the share of rental income to 25% by FY24 from 18% currently.

Hospitality portfolio – Expected to repeat success story

Currently, Oberoi has one Hotel Westin (350 keys) and is adding two more hotels Ritz Carlton, Worli (221 keys - estimated) and Sky City (250 keys – estimated). Westin has been delivering consistently high performance over FY16-19. Currently, its occupancy stands at 82%, though ARR growth has been minimal. Westin has been able to generate consistent revenue (though flattish) in a tough market and business environment.

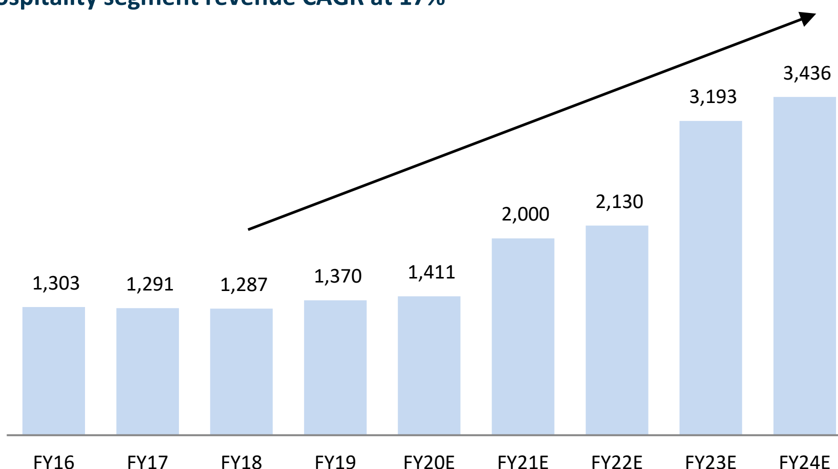
Hospitality revenue reviving on increasing ARRs and occupancy



Source: PhillipCapital India Research, Oberoi Realty

We expect revenue from hospitality to see 17% CAGR as Ritz Carlton Hotel becomes operational by FY21. The segment's revenue is set to rise by more than 110% in FY22-23 as two more hospitality projects – Sky City Hotel (Borivali) also becomes operational. We calculate that these should take the share of hospitality income to 15% by FY24 from current levels of 10%.

Hospitality segment revenue CAGR at 17%



Source: PhillipCapital India Research, Oberoi Realty

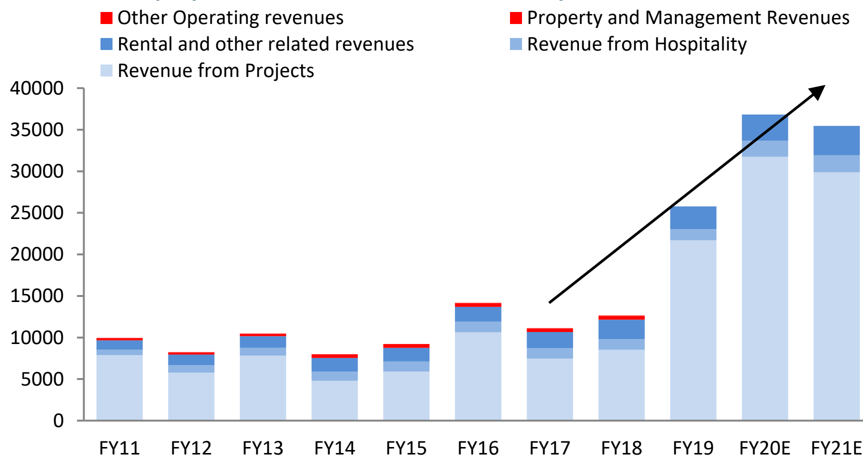
Continued strong financial performance

Revenue to rise at 17% CAGR over FY19-21

New developments will take the contribution of the non-residential real estate segments to (40-45%) from current levels of 28%. This provides revenue visibility and stability to the business model. Over FY19-21, we expect the revenue CAGR at based on:

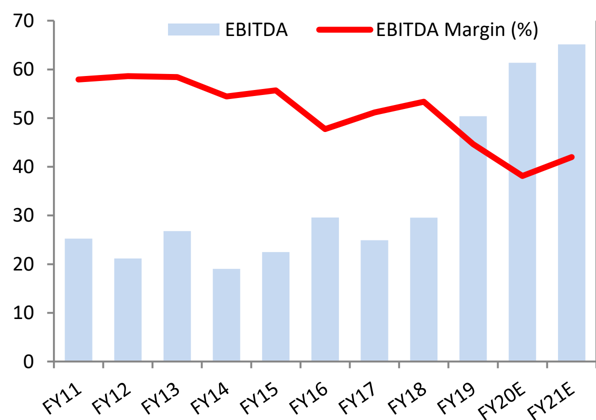
1. Revenue recognition from the Three Sixty West Project
2. Increased sales velocity from all residential projects on relaxed GST regulation (to 5% from 12%) and implemented subvention schemes
3. Increased ARR for Westin – increased occupancy for Commerz-2 Phase I, increase in rentals for Commerz-I, Commerz-II Phase I and Oberoi Mall.
4. Revenue will seem to be slowing down during FY21 as FY20 revenue is bloated because of the revenue recognition from Three Sixty West.
5. Improved ARR for Westin, increased occupancy for Commerz-2 Phase 1, and renewals in Oberoi Mall (at higher rental
6. Ritz Carlton Hotel becoming operational.

Revenue: 17% CAGR on sales velocity due to subvention schemes, rise in occupancy in commercial projects, and increase in mall rental yields

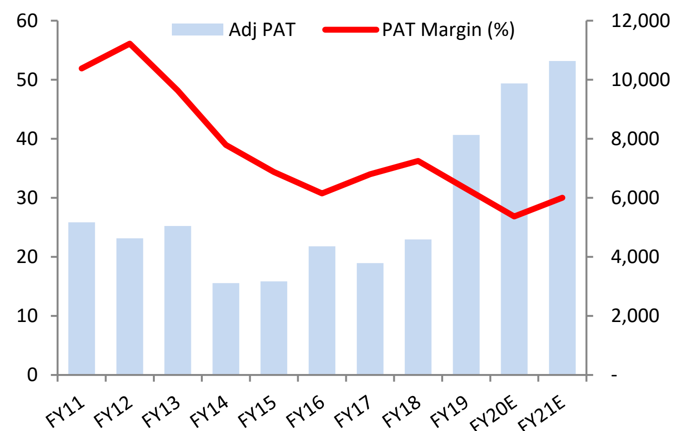


Source: PhillipCapital India Research, Oberoi Realty

EBITDA margin (%)



PAT margin (%)

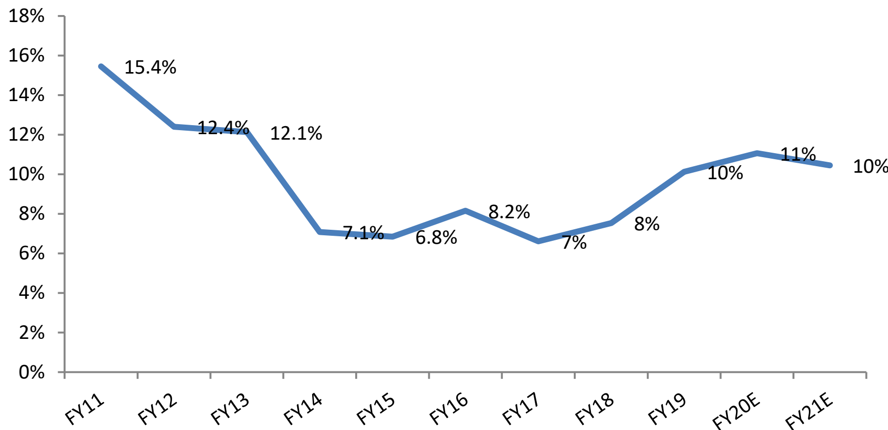


Source: PhillipCapital India Research, Oberoi Realty

OBER's EBITDA margins have been higher historically than its peers – at 50% vs. peer range of 18-25%. We expect its EBITDA margins in FY19 to dip to c.40% because of: (1) increased share of sales from Sky City and total land cost being loaded on the initial phases of project, and (2) higher cost of acquisition of the Borivali land parcel

compared to other land parcels. In the near term, margins will dip whenever the contribution of Sky City sales is higher while they won't in late phases of Sky City. PAT margins should remain steady at around 30% over FY19-21.

ROE

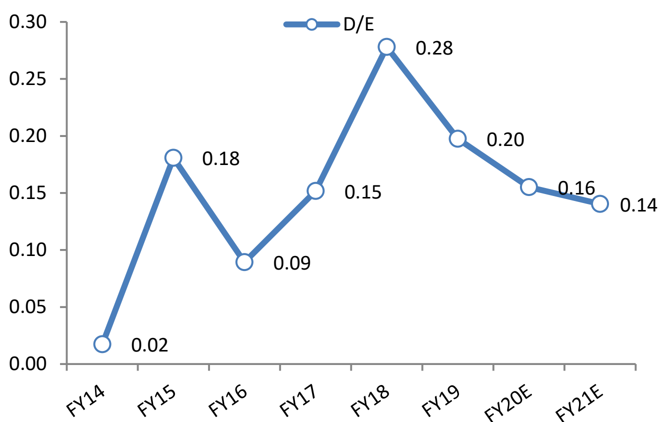


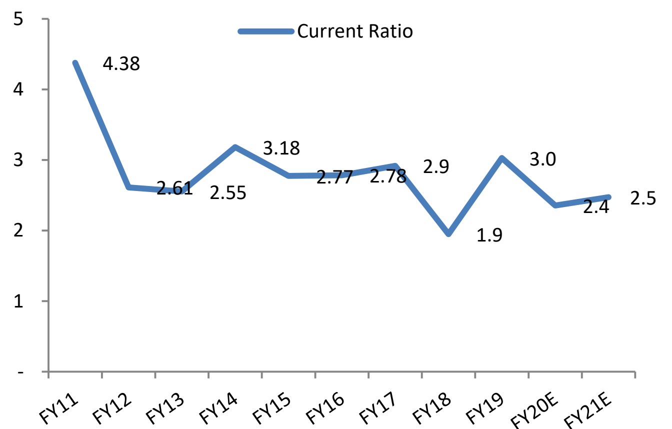
Source: PhillipCapital India Research, Oberoi Realty

We expect Oberoi's ROE to rise from current levels of 6.5-8.0% to levels of 11% because of:

1. Boost in sales from all projects due to subvention schemes and improvement in overall inventory overhang levels in MMR.
2. FY20 ROE to receive an additional boost because of revenue recognition from Three Sixty West.

Comfortable D/E and current ratio





Source: PhillipCapital India Research, Oberoi Realty

Over FY19-21, Oberoi's D/E ratio will decline as debt gets repaid and cash-flows from residential projects grow on increased booking velocity, improved occupancy in Commerz 2 Phase 1, and improved ARR in Westin. OBER has one of the lowest D/E in the industry, which provides comfort. Debt levels may rise over FY21-23 on debt taken for construction of Sky City Mall, I-Ven Mall/Commerz 2 Phase 2, Ritz Carlton Hotel, and Sky City Hotel Projects. We expect the current ratio to stabilise around 2.4x, supporting its debt-repayment ability.

Valuation

We use SOTP-based valuation. For this, we have computed NAV on project-by-project basis. The SOTP valuation has been divided into five parts:

1. **Residential segment:** Project NAVs calculated by discounting future cash flows at WACC of 15.6%.
2. **Commercial segment:** Project NAVs calculated by valuing the project on a capitalization rate of 9% applied on FY24 cash flows (as the upcoming commercial projects become operational and stabilizes by FY24).
3. **Hospitality segment:** Projects EV calculated by valuing the project on EV/EBITDA – at 15x FY24 EBITDA. FY24 because we expect the upcoming hospitality portfolio to become operational by then; also, assuming FY24 provides uniformity across commercial, hospitality and retail sector valuations.
4. **Retail segment:** Project NAVs calculated by valuing them on a capitalization rate of 8% applied on FY24 cash flows (as the upcoming retail projects become operational and stabilize by FY24).
5. **Thane land bank valuation:** EV by applying a 3x multiple to the book value of the land parcel.

Valuation

Residential Projects	EV	Comment
Seven	59.3	EV as per NAV method
Exquisite	3988.5	
Esquire	16300.9	
Prisma	1746.7	
Eternia	12915.9	
Enigma	5666.1	
Sky City	12396.5	
Three Sixty West	10941.5	
Exquisite-III	21069.4	
Malabar Hill	129.6	
Tardeo	545.1	
Maxima	1153.9	
Commerz	3979	NAV, Calculated with FY24E Cash Flow @ Cap Rate of 9%
Commerz-II Phase 1	9601	
Commerz-II Phase 2	44629	
Westin	10583	EV/EBITDA Method, valued at FY24E EBITDA @ 16x
Ritz	2358	
Sky City Hotel	4191	
Oberoi Mall	20403	NAV, Calculated with FY24E Cash Flow @ Cap Rate of 8%
I-Ven Mall	13204	
Sky City Mall	11318	
Thane Land Bank	22200	4x BV of Land
EV of Oberoi	229381	
Debt	8361	
Cash + CA	4577	
EV post debt	225597	
No. of Shares	340	
NAVPS	664	

Source: PhillipCapital India Research

Risks to valuation

Over-dependence on the MMR market: Oberoi Realty's operations are restricted to MMR. This market is facing high inventory overhang. A worsening situation may dampen sales velocity.

Inability to sustain high margins on expansion to other cities: As the property rates in MMR are among the highest in the country, Oberoi is able to garner high margins. It might not be able to do this in other cities.

Premium projects: Oberoi's units are priced at a premium while we expect the sector to be driven by end-user-led demand and mid-ticket-sized housing. As a result, Oberoi might see sales sluggishness due to lack of investor-led demand and relatively high pricing.

High inventory overhang: If Oberoi is unable to manage sales velocity in its completed projects, then it will not have adequate liquidity to fund upcoming projects because of increase in debt levels.

Inability to acquire new land parcels at efficient pricing: It is very difficult to find large land parcels in MMR at efficient pricing. If Oberoi is not able to do this, future developments may come under a cloud.

Overall market scenario: Oberoi is a premium player and its sales are more sensitive to market dynamics compared with mid-tier developers. If demand worsens, sales of luxury apartments are affected first.

Financials

Income Statement

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Net sales	**12,654**	**25,786**	**36,821**	**35,458**
Growth, %	14	104	43	-4
Other income	0	0	0	0
Total income	12,654	25,786	36,821	35,458
Raw material expenses	-4,679	-12,472	-20,848	-18,704
Employee expenses	-672	-734	-770	-809
Other Operating expenses	-551	-1,066	-1,172	-1,290
EBITDA (Core)	**6,753**	**11,515**	**14,029**	**14,656**
Growth, %	18.5	70.5	21.8	4.5
Margin, %	53.4	44.7	38.1	41.3
Depreciation	-491	-440	-540	-640
EBIT	**6,262**	**11,074**	**13,489**	**14,016**
Growth, %	20.3	76.8	21.8	3.9
Margin, %	49.5	42.9	36.6	39.5
Interest paid	-56	-69	-194	-164
Other Non-Operating Income	266	788	788	788
Non-recurring Items	36	69	0	0
Pre-tax profit	**6,496**	**11,737**	**14,113**	**14,731**
Tax provided	-1,907	-3,607	-4,234	-4,419
Profit after tax	**4,589**	**8,130**	**9,879**	**10,312**
Others (Minorities, Associates)	0	0	0	0
Net Profit	**4,589**	**8,130**	**9,879**	**10,312**
Growth, %	21.2	77.1	22.5	4.4
Net Profit (adjusted)	**4,552**	**8,061**	**9,879**	**10,312**
Unadj. shares (m)	340	364	364	364
Wtd avg shares (m)	340	364	364	364

Balance Sheet

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Cash & bank	1,167	4,253	1,543	1,304
Marketable securities at cost	135	3,388	3,388	3,388
Debtors	1,813	1,094	5,276	5,080
Inventory	42,467	41,655	41,994	45,710
Loans & advances	1,573	2,662	2,662	2,662
Other current assets	17,175	16,805	16,805	16,805
Total current assets	64,331	69,857	71,668	74,950
Investments	31,743	34,636	34,636	34,636
Gross fixed assets	2,798	1,978	16,247	22,904
Less: Depreciation	-710	0	-1,691	-2,331
Add: Capital WIP	1,124	1,251	1,251	1,251
Net fixed assets	3,212	3,229	15,808	21,825
Non-current assets	1,503	2,215	2,215	2,215
Total assets	**1,02,247**	**1,11,285**	**1,25,675**	**1,34,974**
Current liabilities	32,976	22,953	30,336	30,195
Provisions	55	131	131	131
Total current liabilities	33,031	23,083	30,467	30,326
Non-current liabilities	8,293	7,910	5,910	5,910
Total liabilities	41,323	30,994	36,377	36,237
Paid-up capital	3,396	3,636	3,636	3,636
Reserves & surplus	57,528	76,656	85,662	95,101
Shareholders' equity	60,924	80,292	89,298	98,737
Total equity & liabilities	**1,02,247**	**1,11,285**	**1,25,675**	**1,34,974**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Pre-tax profit	6,496	11,737	14,113	14,731
Depreciation	491	440	540	640
Chg in working capital	1,160	-9,338	2,863	-3,662
Total tax paid	-2,012	-3,486	-4,234	-4,419
Other operating activities	-8,193	1,006	-266	-266
Cash flow from operating activities	**-2,058**	**359**	**13,016**	**7,024**
Capital expenditure	-312	-457	-13,119	-6,657
Chg in investments	-8,571	-2,893	0	0
Chg in marketable securities	2,090	-3,254	0	0
Other investing activities	911	78	10,150	266
Cash flow from investing activities	**-5,882**	**-6,526**	**-2,968**	**-6,391**
Free cash flow	-7,941	-6,166	10,048	633
Equity raised/(repaid)	3,664	19,368	9,006	9,439
Debt raised/(repaid)	-707	-901	-2,000	0
Dividend (incl. tax)	679	727	727	727
Other financing activities	2,874	-19,827	-10,606	-11,039
Cash flow from financing activities	**6,510**	**-633**	**-2,873**	**-873**
Net chg in cash	-1,431	-6,799	7,175	-240

Valuation Ratios

	FY18	FY19e	FY20e	FY21e
Per Share data				
EPS (INR)	13.4	22.2	27.2	28.4
Growth, %	21.2	65.4	22.5	4.4
Book NAV/share (INR)	179.4	220.8	245.6	271.6
FDEPS (INR)	13.4	22.2	27.2	28.4
CEPS (INR)	14.7	23.2	28.7	30.1
CFPS (INR)	13.0	(1.5)	34.4	17.9
DPS (INR)	(2.0)	(2.0)	(2.0)	(2.0)
Return ratios				
Return on assets (%)	5.0	7.8	8.5	8.0
Return on equity (%)	7.5	10.0	11.1	10.4
Return on capital employed (%)	6.9	10.6	10.9	10.4
Turnover ratios				
Asset turnover (x)	0.4	0.7	0.8	0.6
Sales/Total assets (x)	0.1	0.2	0.3	0.3
Sales/Net FA (x)	3.8	8.0	3.9	1.9
Working capital/Sales (x)	2.4	1.5	1.0	1.1
Receivable days	52.3	15.5	52.3	52.3
Inventory days	1,224.9	589.6	416.3	470.5
Payable days	80.9	53.3	61.0	64.3
Working capital days	865.8	554.2	359.7	411.3
Liquidity ratios				
Current ratio (x)	1.9	3.0	2.4	2.5
Quick ratio (x)	0.7	1.2	1.0	1.0
Interest cover (x)	91.3	57.2	82.2	195.2
Total debt/Equity (%)	15.5	10.4	7.1	6.4
Net debt/Equity (%)	13.6	5.1	5.4	5.1
Valuation				
PER (x)	40.1	24.2	19.8	18.9
PEG (x) - y-o-y growth	1.9	0.4	0.9	4.3
Price/Book (x)	3.0	2.4	2.2	2.0
EV/Net sales (x)	15.1	7.6	5.3	5.6
EV/EBITDA (x)	28.2	17.0	14.0	13.4
EV/EBIT (x)	30.4	17.7	14.6	14.1

INSTITUTIONAL EQUITY RESEARCH

PhillipCapital

Godrej Properties (GPL IN)

Refocusing, Recalibrating, Rescaling – at the right time!

24 May 2019

INDIA | REAL ESTATE | INITIATING COVERAGE

Godrej Properties (GPL) – with its strong brand name, execution, and pre-sales, and robust project pipeline – is better placed then most of its peers to capitalise on the opportunities in the Indian RE sector as it consolidates. For this, GPL is in the process of realigning its business by increasing its stake in projects, adopting margin accretive models, and ramping up its execution speed – which provides strong growth visibility.

Strong project pipeline and addition: GPL has a strong project pipeline of 145 mn. sq. ft. (136mn residential, 9mn commercial) out of which around 67mn sq. ft. is on-going – providing good visibility. GPL aims to launch one project per quarter per market and is moving towards this target. In FY19, it launched 11 projects and added c.31mn sq. ft. Such strong project addition and stronger project pipeline provide good future visibility.

Continued strong launch-quarter bookings and pre-sales: Our analysis suggests that GPL has robust launch quarter bookings (typically 40% of the launched area) based on its strong brand name. This trend, coupled with the firm having a good near-term project pipeline, provides near-term booking and cash-flow growth visibility. GPL's bookings CAGR over FY14-19 was 20% (8.8mn sq. ft. from 3mn), despite macroeconomic headwinds. Incrementally strong bookings in area terms over FY17-19 have been because of implementation of subvention schemes and stronger project launches (marking strong launch-quarter sales).

Ramping up speed of execution: In its attempt to ramp up execution speed, GPL set up a pre-cast factory in Q1FY19 and is improving its execution mechanism to remain in sync with target project addition (to ensure a careful management of the throughput levels).

Refocusing on top-4 cities and a margin-accretive model: GPL has realigned its approach from a pan-India presence to a focused presence in top-4 cities – to achieve higher market share and stronger growth. We believe that this approach will help drive bookings, execution pace, and margins (as realizations in these markets are higher). GPL is looking at exiting the rest of the markets (exited Hyderabad). It has forayed into annuity-based commercial projects for the first time, which will provide much-needed stability.

Transition from an asset-light to relatively asset-heavy models: In order to increase its margins, GPL will move to having relatively higher stakes in projects (from an asset-light model earlier). Also, it will be add more projects under profit-sharing models (which are more margin accretive vs. revenue/area-sharing). GPL is also in the process of renegotiating projects with lower margins and under the Fund Management Platform, it will purchase land parcels (against its earlier norm) and foray into annuity-based commercial projects. These steps, coupled with a renewed focus on top-four cities, provides growth visibility.

Strong liquidity position: GPL has recently raised Rs 10bn from GIC (in 2018), two rounds for the Fund Management Platform (US$ 500mn), and has also passed an enabling resolution in Q4FY19 to raise Rs 25bn. This access to liquidity will ensure control over debt levels while transitioning to a relatively asset-heavy model.

Bookings and cash flow will be strong over FY19-21: We expect bookings and cash flow CAGR of 22% and 13% respectively over FY19-21 on stronger project additions and bookings.

No foreseeable upside: Despite our overall positive outlook about GPL's growth over FY19-21, we believe that current price levels capture its near-term potential. GPL aims to exit markets, restructure deals, and to add, launch, and execute projects in coming quarters. Once these events unfold and/or we see the stock at a better price point, we will review our rating.

NEUTRAL

CMP RS 847

TARGET RS 820 (-3%)

COMPANY DATA

O/S SHARES (MN) :	229
MARKET CAP (RSBN) :	194
MARKET CAP (USDBN) :	2.8
52 - WK HI/LO (RS) :	988 / 25
LIQUIDITY 3M (USDMN) :	7.6
PAR VALUE (RS) :	5

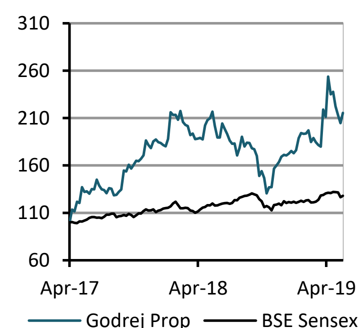
SHARE HOLDING PATTERN, %

	Mar 19	Dec 18	Sep 18
PROMOTERS :	70.8	70.8	70.8
FII / NRI :	13.8	13.9	14.4
FI / MF :	1.6	1.3	1.3
NON PRO :	5.6	5.8	5.7
PUBLIC & OTHERS :	8.2	8.2	7.8

PRICE PERFORMANCE, %

	1MTH	3MTH	1YR
ABS	-5.0	16.2	14.2
REL TO BSE	-5.7	8.0	1.2

PRICE VS. SENSEX



Source: Phillip Capital India Research

KEY FINANCIALS

Rs mn	FY19E	FY20E	FY21E
Net Sales	28,174	19,788	13,670
EBIDTA	1,780	1,572	4,713
Net Profit	2,532	2,018	2,088
EPS, Rs	11.0	8.8	9.1
PER, x	76.7	96.2	93.0
EV/EBIDTA, x	126.9	143.3	49.3
P/BV, x	7.9	7.3	6.7
ROE, %	10.3	7.6	7.2
Debt/Equity (%)	142.4	139.1	135.9

Source: PhillipCapital India Research Est.

Dhaval Somaiya, Research Associate
Vaibhav Agarwal, Research Analyst

Leveraging on its strong brand name and legacy

- Godrej Properties Limited (GPL)is a Mumbai-based real estate developer.
- It undertakes residential and commercial projects – with a primary focus on residential projects.
- GPL began developing its first project in 1991.
- Initially its operations were concentrated in MMR, which later expanded to include other cities such as Pune, Bengaluru, Kolkata, Hyderabad, Ahmedabad, Mangalore, Chandigarh, Chennai, Kochi, the NCR, and Nagpur.
- The firm was listed in 2010.
- So far it has delivered approximately 26.2mn sq. ft. of space across cities and has a project pipeline of 145mn sq. ft. (across 84 projects), out of which development of 67mn. sq. ft. (across 47 projects) is on-going and 78 mn. sq.ft is forthcoming (across 37 projects).
- GPL has been successful in leveraging the established brand name of its parent – Godrej Industries – to garner strong sales response for its projects.

The journey so far

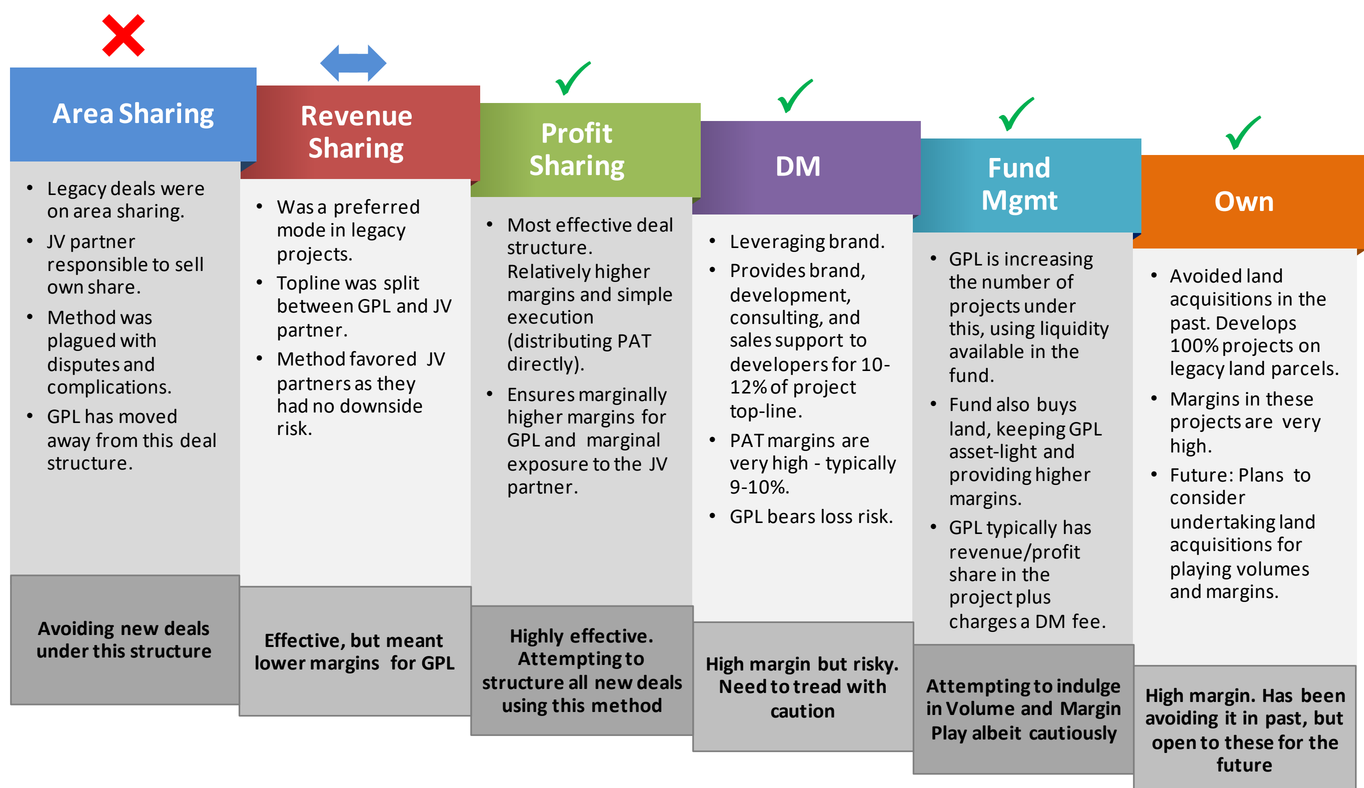
1989	- Godrej Industries forays into real estate
1991	- Initiated its first project in Thane, Mumbai
1994	- Delivered first residential project in MMR
1997	- Completed its first commercial project in MMR
1999-2007	- Expanded its presence to Pune, Kolkata, Bangalore, and Hyderabad
2008	- Expansion to Ahmedabad, Chandigarh, Kochi, and Chennai
2010	- Firm is listed - Expanded its presence to NCR
2012	- Sold 10% promoter's stake; valued at around Rs 4.5bn, through Institutional Placement Programme in order to dilute the promoter stake from 83.79% to SEBI's defined threshold of maximum 75% - Created 200mn (Rs 7.7bn) for Godrej Property Management Fund – 1 with APG as its lead investor. GPL has a 25% stake in it. It is fully deployed
2013	- Raised Rs 7 bn through rights Issue - Launched affordable housing project (budget housing) in Ahmedabad
2015	- Finished development of GODREJ ONE (Godrej Group HQ) in Vikhroli; designed by Pelli Clarke, Pelli Architects
2016	- Raised Rs 300mn for Godrej Property Management Fund-2 with APG as its lead investor. GPL has a 20% stake in it. More than 50% of the fund has been deployed
2017	- Tied up with Taj Hotels for a hospitality project on its Vikhroli land parcel
2018	- Raised Rs 100bn from GIC through a private placement - GPL decided to focus only on 4 micro-markets – NCR, MMR, Bangalore, and Pune and exit the rest.
2019	- Set up of first pre-cast factory in Godrej Golf Links, Greater Noida - Launches first commercial project (to be leased) under its Fund Management Platform

Unique agile business model

GPL has a unique multi-faceted approach to real estate. It undertakes construction of residential and commercial projects under various models. Since its inception, it has been cautiously avoiding land acquisition on its books for two reasons – (1) to remain asset light, (2) achieve higher execution turnaround in projects (as acquisition of land parcels involves a lot of due diligence, is capital intensive, and time consuming). Instead, GPL prefers JV partnerships with land owners. GPL develops projects under six formats:

1) Area sharing
2) Revenue sharing
3) Profit sharing
4) Development management
5) Fund management platform
6) Own

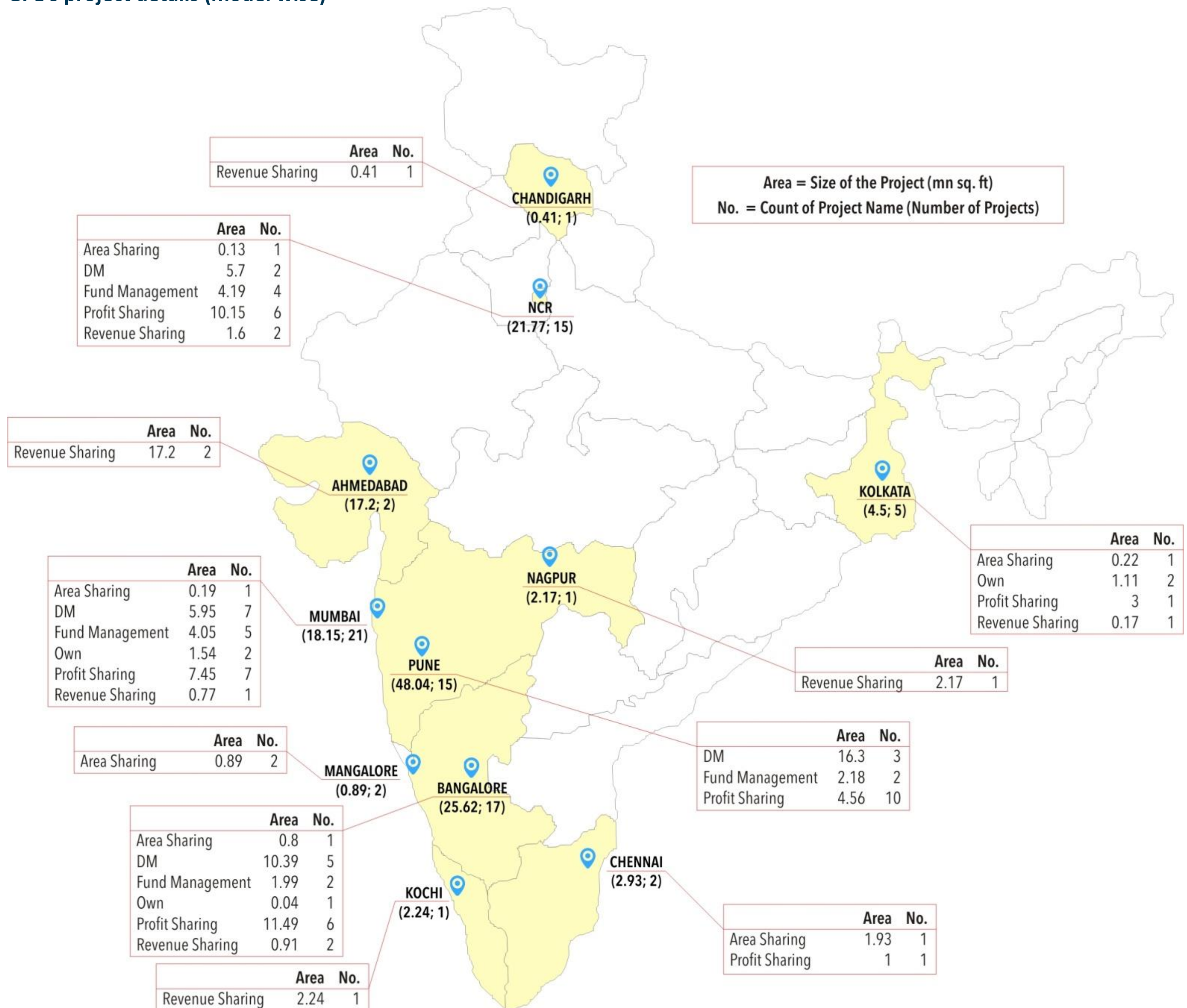
Profit sharing, DM, fund management and own formats: The way forward



Many reputed developers have attempted entering the 'development management' model under which they lent their brand name, development consulting, and sales capabilities against a fixed margin in the project – but have failed

Source: PhllipCapital India Research

GPL's project details (model wise)



Strong operational performance

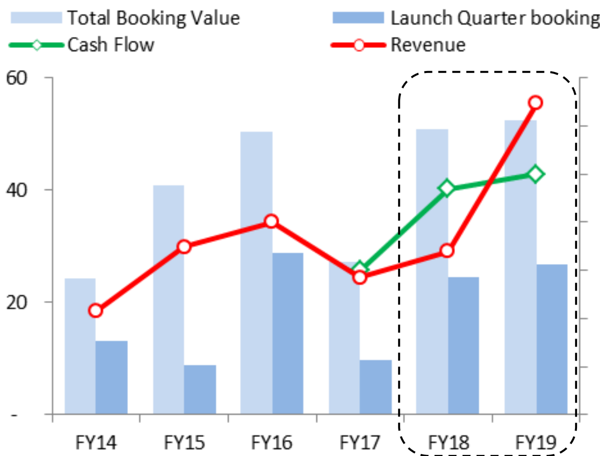
Pre-sales momentum growth continues

Over FY14-19, GPL's total bookings (value) saw 14% CAGR – from Rs 24bn in FY14 to Rs 52bn in FY19 – while in area terms, it saw 20% CAGR – from 3mn sq.ft. in FY14 to 8.8mn sq.ft. in FY19. The apparent slow growth in value terms is because: (1) the composition of high-price inventory in total sales mix has reduced (i.e., projects from MMR), and (2) majority of the high-ticket-sized inventory from One BKC is almost sold.

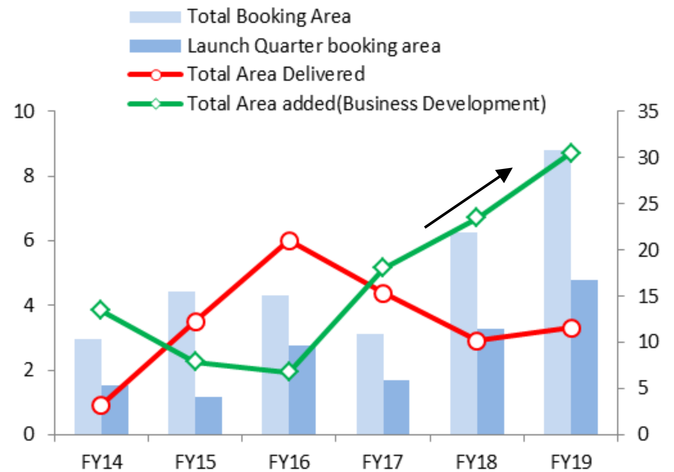
Strong booking trend provides revenue and future performance visibility

Revenue has grown to Rs 32.4bn in FY19 from Rs 11bn in FY14. GPL's performance in FY17 saw a considerable drop in bookings (area and value) and revenue due to macroeconomic headwinds. However, in FY18 and FY19, it saw strong growth (in area) to touch 8.8 mn sq. ft. (3.1mn sq. ft. in FY17) because of increased launches, introduction of subvention schemes, and an improved macro-economic environment.

As the unit mix tilted towards lower ticket sizes, bookings growth by value remained flattish over FY19



Despite a challenging macro-economic environment, GPL posted strong growth in bookings at 66% over FY18-19

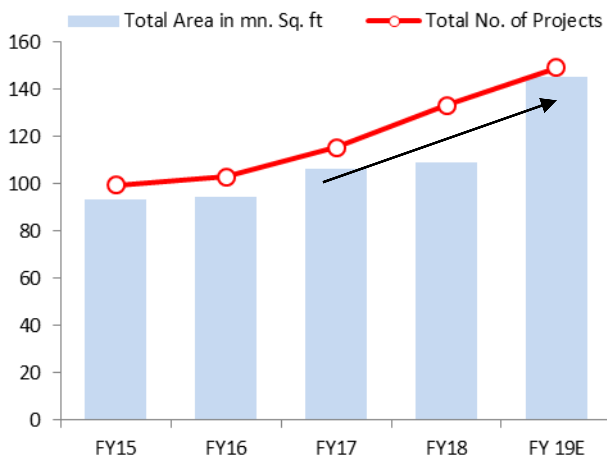


Source: PhillipCapital India Research, Godrej Properties

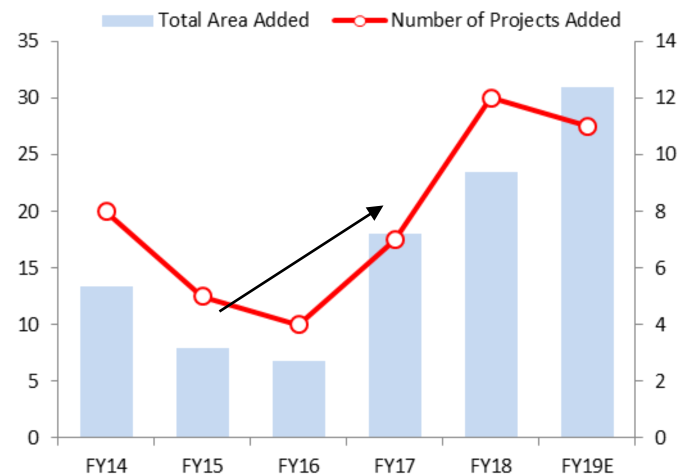
Future ready: Strong project pipeline and project addition

As of FY19, GPL has 84 projects in its portfolio, with a total saleable area of 145mn sq. ft. Over FY15-19, it has added c.52mn sq. ft. over 38 projects, marking a healthy project-addition CAGR (in terms of mn sq. ft.) of 9%.

Strong project pipeline



Strong project addition continues



Source: Phillip Capital India Research, Godrej Properties

*Note: By FY19 total area to 145mn sq. Ft. in FY19; Pune to 48mn (sq. ft.) from 23, MMR to 19.8mn from 18mn. Total projects for FY19 are 84; Pune 15 vs. 9 earlier, and MMR 23 vs. 21 earlier.

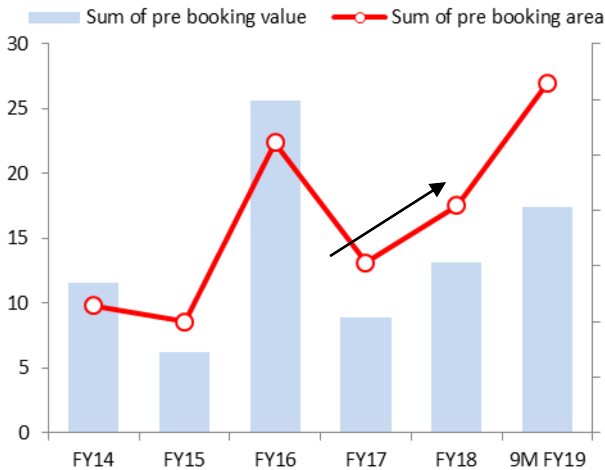
Despite macroeconomic and business environment headwinds, GPL has had incrementally stronger project additions – from 6.75mn sq. ft. in FY16 to 31mn sq. ft. in FY19.

A healthy project pipeline and incrementally strong and growing project addition, especially over FY16-19, provides revenue and growth visibility.

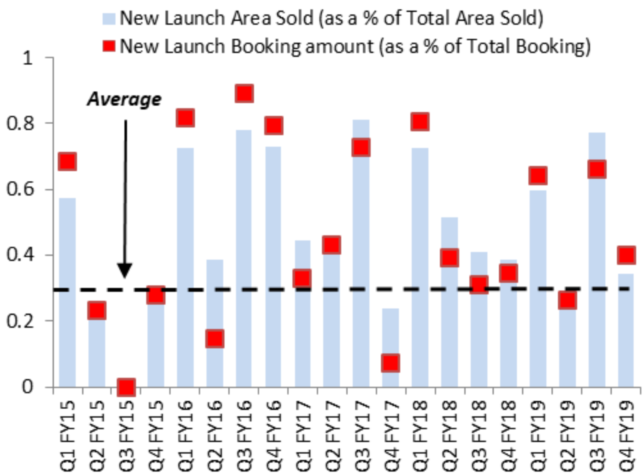
Strong launch-quarter sales despite headwinds

In an industry that is plagued with a massive inventory overhang, GPL has seen strong launch-quarter sales (area booked) – typically at least 25% of the total area booked in a quarter. Over FY15-19, these sales doubled to 12mn sq. ft. (averaged c.40% of the total area booked in a quarter). However, in terms of value these remain volatile due to the varying nature of ticket sizes.

Increasing launch quarter sales for new project launches



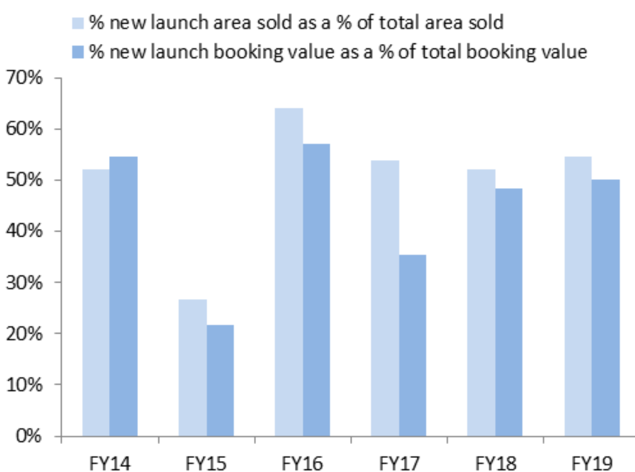
New launch quarter (phase +project) sales trend



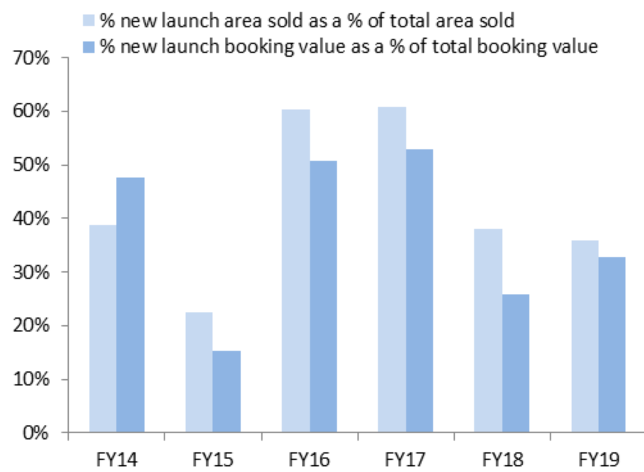
Source: PhillipCapital India Research, Godrej Properties

For GPL, area sold in the launch quarter (new phase + project) averages 40% of total area sold per annum, while bookings in area terms for new projects average 30%. Along with strong project pipeline and healthy project addition, launch-quarter sales will remain robust and aid sales velocity.

Launch quarter sales (new project + new phases)



Strong pre-sales continue (new project)



Source: Phillip Capital India Research, Godrej Properties

3Rs: Refocusing; recalibrating; rescaling

Players with strong liquidity position, execution capability, brand name, mid-ticket-sized offerings, and focus on volumes will deliver strong booking and cash-flow growth in the near to medium term, which we believe provides growth visibility.

Transition from asset-light model to relatively capital-intensive, albeit capping the downside risk

Towards a more capital intensive strategy

GPL has followed an asset light strategy since inception, as it did not typically acquire land, preferring JVs with land owners among other options. However, over the past couple of quarters, it seems to be more open to having larger stakes in projects and picking up high-ticket sized projects too. It is also adding projects under models that yield higher margins (profit sharing instead of revenue/area sharing, DM, and Fund Management). It seems to have foreseen the need to increase its share and opt for projects that have higher profitability, as the residential real-estate sector is moving towards consolidation. Due to regulatory and liquidity woes, smaller players will be weeded out, leading to a 'survival of the fittest' scenario. GPL is aiming to capitalize on this opportunity.

Re-entering the commercial segment

Swaying away from the build-and-sell model for commercial: Learning from the lessons of the past. A renewed attempt at entering the commercial segment in its true sense (annuity model).

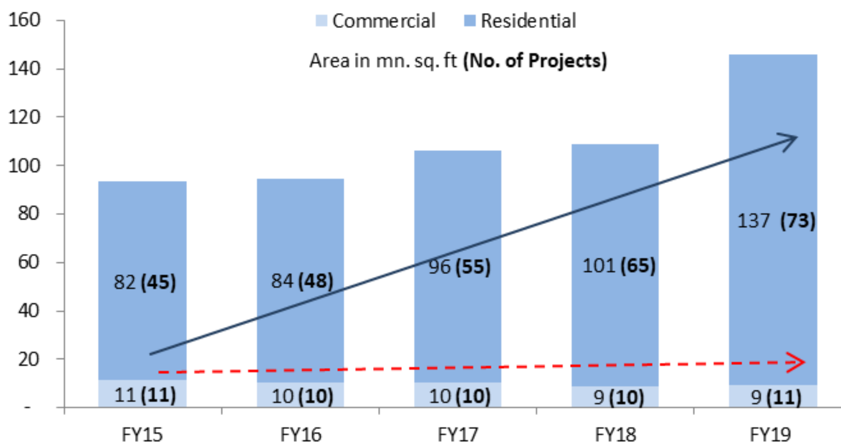
GPL has always had a build-and-sell model for commercial projects. In its attempt to build a large commercial project, Godrej BKC (its largest and key commercial project until date) experienced mounting debt, slow sales velocity, and blocking of capital for a long cycle. Due to this experience, GPL has approached commercial projects with extreme caution and maintained its focus on its forte – residential. Over FY15-19, the saleable are of its residential projects increased to 146mn sq. ft. from 82mn while commercial has stayed at 11mn.

In Q3FY19, GPL launched its second commercial project on Golf Course Road in NCR (measuring 1mn. sq. ft. leasable area). In Q2FY19, Godrej launched its first commercial project (Godrej Two) on its Vikhroli land parcel (in MMR). It will be based on a rental model and not the build-and-sell model. Its leasable area will be 1.4mn. sq. ft, under the Fund Management Platform, with a high stake by GPL at 50%.

We see GPL's new commercial projects as a positive move for its future:

- Commercial (annuity model) will continue to perform strongly. GPL's overdependence on residential real estate could be a cause of concern if that segment's situation worsens and we see annuity assets as a welcome move.
- GPL will continue adding annuity-based commercial projects, which should ensure more stability and provide additional revenue visibility.
- GPL's conservative approach towards commercial projects (opting for very few commercial projects on the build and sell model) is a positive sign because this model in commercial projects has proved detrimental to most developers.

Breakup of residential and commercial projects



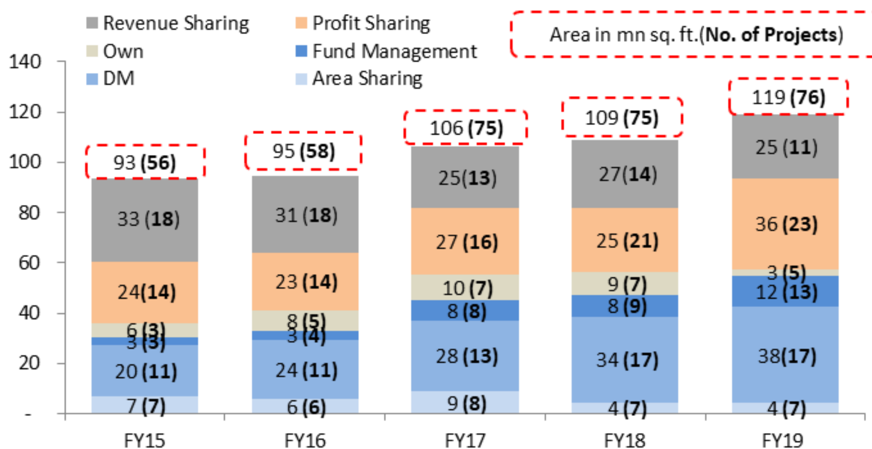
Source: Phillip Capital India Research, Godrej Properties

Aiming at renegotiating legacy projects, adding better margins ones

GPL has been trying to renegotiate its legacy projects – those on area-sharing basis or those with a very low revenue /profit share – to ensure more skin in the game. It has even attempted exiting very small projects altogether. This shows its inclination towards higher margins in these projects.

We reckon GPL stands to improve its margins by adopting projects under profit sharing, development management (DM), and the fund management platform. Our analysis of the projects that it has added suggests its DM projects increased to 38mn sq. ft. in FY19 from 20mn in FY15. Similarly, profit sharing projects increased to 23mn sq. ft. from 14mn and Fund Management Platform to 13mn from 3mn.

Breakup of projects on basis of type of project



Source: PhillipCapital India Research, Godrej Properties

Strengthening liquidity position and expanding margins

After its IPO in 2010 (to strengthen its liquidity position) GPL raised Rs 7bn equity through a rights issue and Rs 10bn in 2018 through a private placement to GIC.

GPL has also created a Fund Management Platform (FMP) where lead investors and GPL pool in capital (equity infusion) to undertake developments of real estate projects. Through FMP projects, GPL has gained in two ways – (1) by having an equity stake in the project – it has a revenue/profit share, and (2) by charging a development-management fee (typically 6-8%) to the fund in lieu of managing the

construction of projects. This is why we see GPL's margins expanding under the FMP model.

GPL has raised two rounds of equity for the Fund Management Platform	Amount raised	Godrej's stake	Deployment status as on FY19	Lead investor	Deal structure for GPL	Land acquisitions undertaken
Platform 1	USD 200mn	25%	Fully deployed	APG	25% equity stake in the project specific company plus a DM fee of 4-6%	Yes
Platform 2	USD 300mn	20%	Around 60% deployed	APG	20% equity stake in the project specific company plus a DM fee of 4-6%	Yes

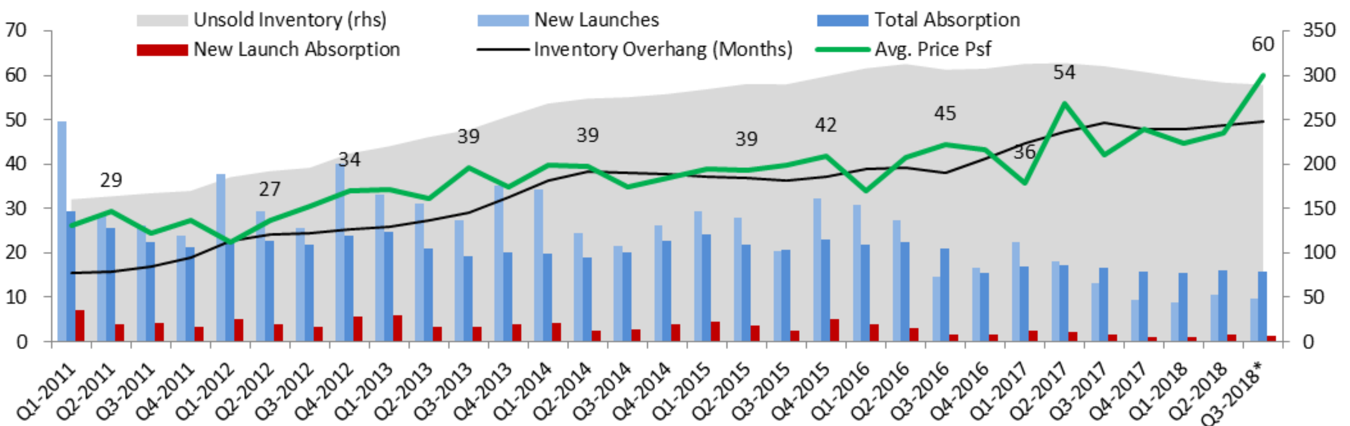
Source: PhillipCapital India Research, Godrej Properties

With an aim to remain asset light, GPL avoided acquisition of land in the past, but under FMP, if the opportunity presents itself, the fund undertakes outright purchase of land to develop land parcels. Due to this, GPL's margin may expand further even in projects (as owning land parcels leads to higher margins vs. forming JVs with land owners) where GPL has an indirect control over the land and it can simultaneously remain asset light.

Refocusing: On 4 cities from 12 earlier

In 2018, GPL shifted its strategy to focus strongly on top-four markets – MMR, NCR, Bangalore, and Pune, and exit from the rest. We reckon this is because of difficulty in being able to focus and capture market share across multiple markets simultaneously. This could also be due to weak realisation and demand in the other markets.

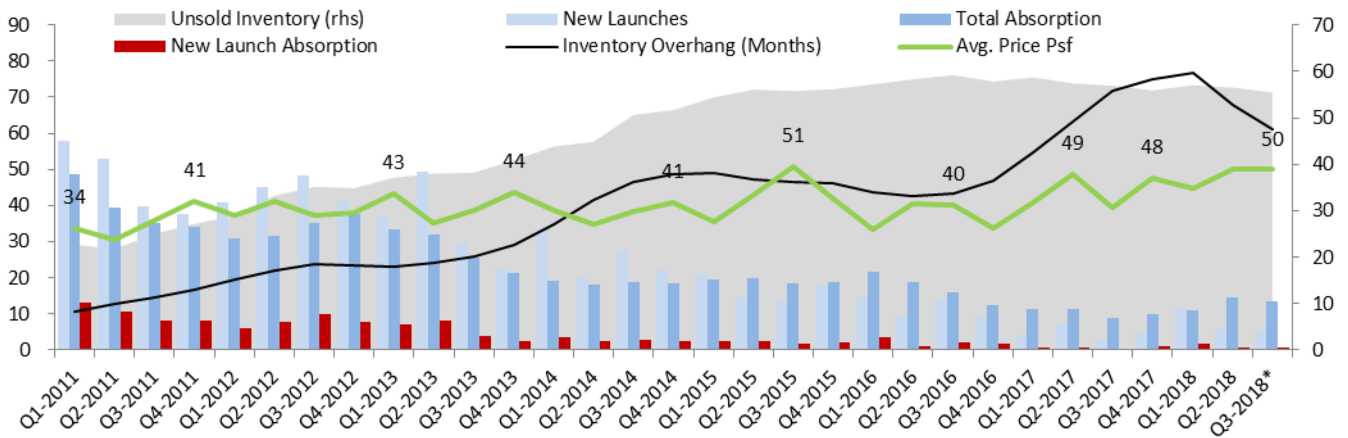
MMR – Signs of revival



Source: PhillipCapital India Research, Godrej Properties, Knight Frank

Over the past couple of quarters, demand has marginally started outstripping supply in MMR. So inventory overhang has steadied and inventory is declining steadily. We expect GPL's projects to capitalize on this phenomenon, based on steady realisations in MMR and because this is GPL's home ground, where it has a good brand name.

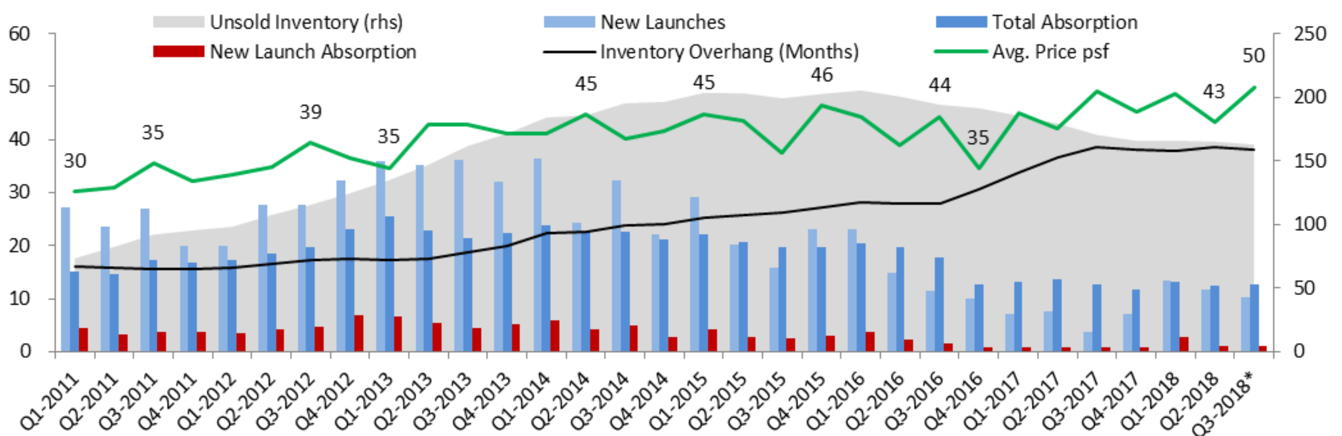
NCR: Pain ending



Source: PhillipCapital India Research, Godrej Properties, Knight Frank

After significant price correction and trend reversal (demand out stripping supply) for more than 8 quarters, finally, the pain in the NCR market seems to be ending. Stabilisation seems to have begun. NCR has a bad execution track record, so GPL will be able to capitalize on its strong brand name and strengthening presence in mid-tier pricing projects in NCR. However, we expect some of the GPL's projects in NCR to show relatively slow pre-sales response vs. the other three markets because of the prevailing weakness. GPL's performance in NCR will be a key factor on our watch list.

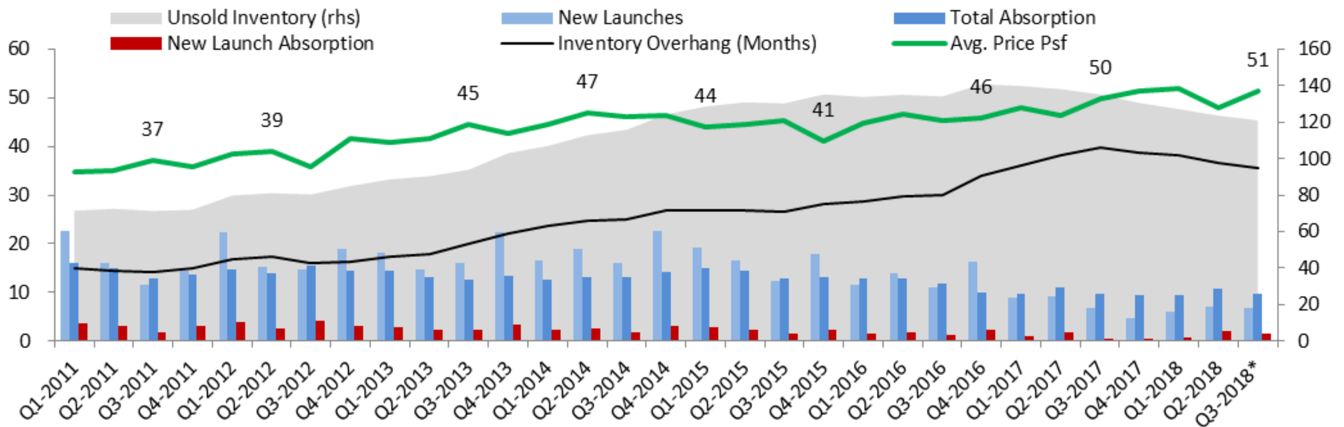
Bangalore: Revival mode



Source: PhillipCapital India Research, Godrej Properties, Knight Frank

Bangalore's slow yet steady journey towards revival has begun. Due to its long presence and the *Godrej* brand name, GPL can capitalize on this revival. However, it will have to face stiff competition from peers who have a very strong footprint and brand names.

Pune: On a revival path



Source: PhillipCapital India Research, Godrej Properties, Knight Frank

Pune, like Bangalore, has started a slow and steady revival journey. We believe that with its brand name and execution capabilities, Godrej can capitalise on this revival. With relatively lower competition from large players and a fast-expanding footprint in Pune (added 25mn sq. ft. in FY19; total Pune project pipeline at 48mn – highest in all four markets) providing near-term performance visibility, it seems to have identified the right opportunity at the right time.

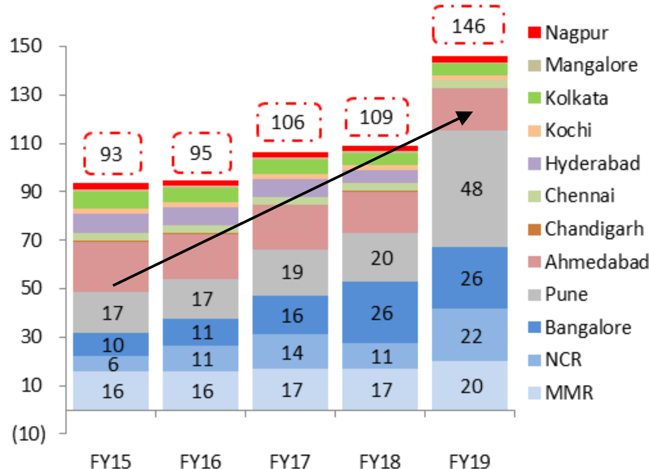
GPL aims to launch 1mn sq. ft. per quarter in all its four focus markets. Looking at project addition in late FY19, it seems to be trudging towards its goal

Goal of 1mn sq. ft. per quarter in all four markets

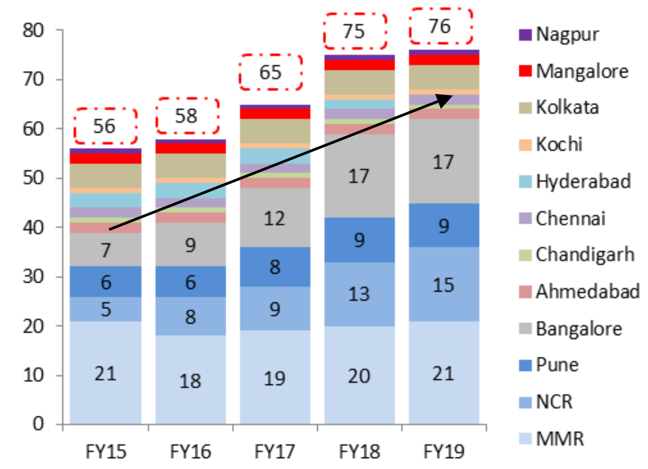
Over FY15-19 its projects (in sq. ft.)

- In MMR, it went up to 20mn from 16mn
- NCR to 22mn from 6mn
- Bangalore to 26mn from 10mn
- Pune to 48mn sq. ft. from 17mn

City-wise breakup of project area (on-going + forthcoming, mn. sq. ft.)



City-wise breakup of number of projects (on-going + forthcoming)



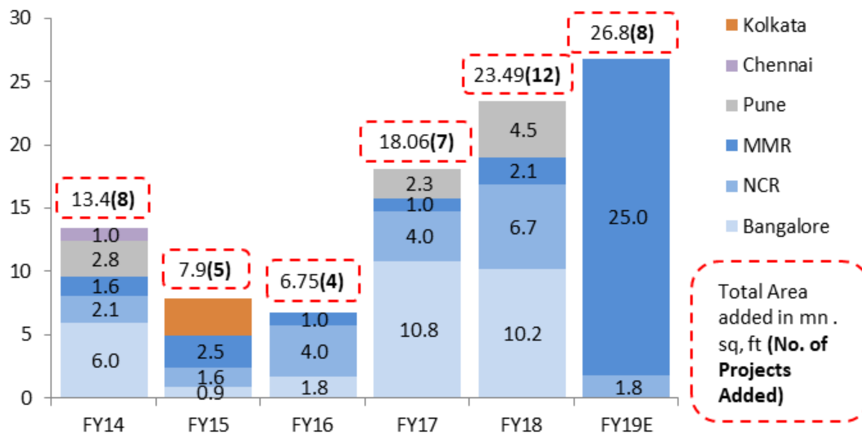
Source: PhillipCapital India Research, Godrej Properties,

Our analysis suggests that in order to focus on its four core markets, GPL has been operating each one like a separate firm, maintaining fully operational offices at all four locations and reporting zonal balance sheets and profit and loss statements internally to ensure adherence to its policies and to deliver full potential in each zone.

Volume play

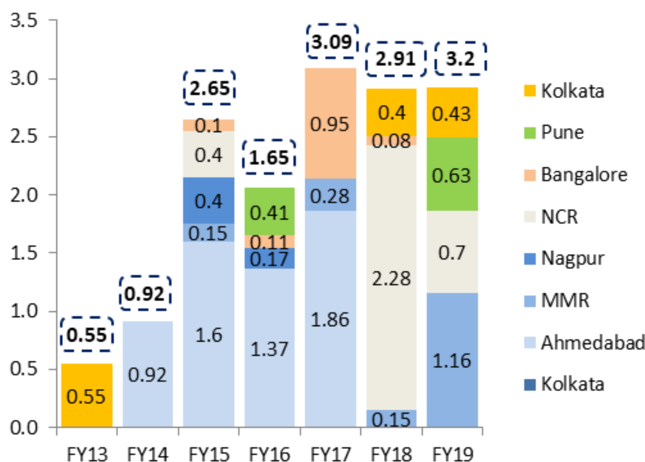
Over FY17-19, GPL realized the need to scale up in order to capitalize on the consolidation opportunity. Its new-project-addition velocity increased to 26mn sq. ft in FY19 from 18mn in FY17, providing future performance visibility.

Location-wise projects added

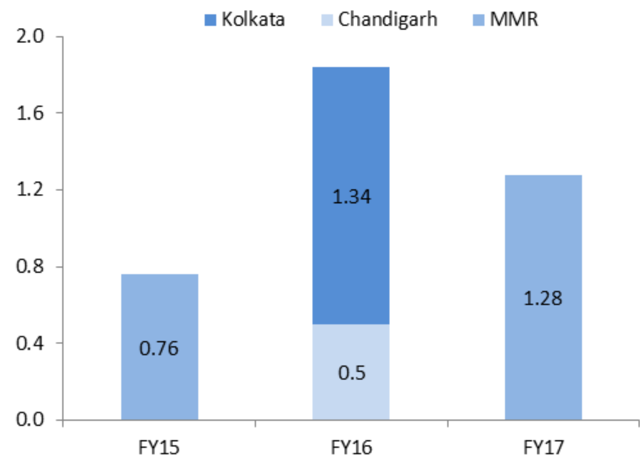


Source: Phillip Capital India Research, Godrej Properties

Steady pace of delivery of residential projects around 3mn sq. ft. per annum over FY17-19



Delivery of commercial projects



Source: PhillipCapital India Research, Godrej Properties

The delivery of the projects has risen after a slowdown in FY16 when it touched 1.65mn (sq. ft). Over FY17-19, it has stabilized at c.3mn. In commercial projects, total delivery was c.4mn over FY15-17. So far, GPL has delivered a total of 23.07mn. We expect delivery volumes to grow stronger over FY20-23 as project addition in FY17-19 has been relatively very strong.

Subvention schemes boosting sales velocity

GPL, like its peers in the industry, has launched subvention schemes for select projects in order to maintain sales momentum. We believe that these subvention schemes are crucial for GPL in certain projects in order to maintain strong sales momentum.

Pre-cast: Being future ready – albeit wisely

In Q1 FY19, GPL set up its first pre-cast factory on Godrej Golf Links in Greater Noida, a 4mn sq. ft. project (one of the largest on-going ones) consisting of villas and

apartments. This factory can construct 0.5mn sq. ft. per year (we estimate 200-240 elements a day). As of FY19, it has two pre-cast factories with an overall capacity of up to 400 elements per day (our estimate). We reckon that compared with peers, it has been able to set up its pre-cast operations in a more cost effective manner as these units are semi-automatic.

To understand pre-cast technology in detail, refer to our section on pre-cast in Sobha's report (click here)

Its Noida pre-cast factory equals faster execution, efficiency, and quality. Additionally, in NCR, construction bans during the night have started becoming a norm; so having a pre-cast factory helps in working on the project 24X7, increasing the execution speed significantly compared with peers.

Godrej Golf Links (GGL), Greater Noida site

Godrej Golf Links project layout

Pre-cast factory at Godrej Golf Links project site

Visible difference between quality of villa constructed using pre-cast and conventional technology at GGL

Affordable housing: Tried and tested

GPL is developing a large-scale budget housing project in Ahmendabad – Godrej Garden City – with c.20mn sq. ft. of saleable area. It has delivered around 6mn sq. ft. in this project. This affordable housing project shows that GPL is future-ready for executing affordable housing when an opportunity presents itself.

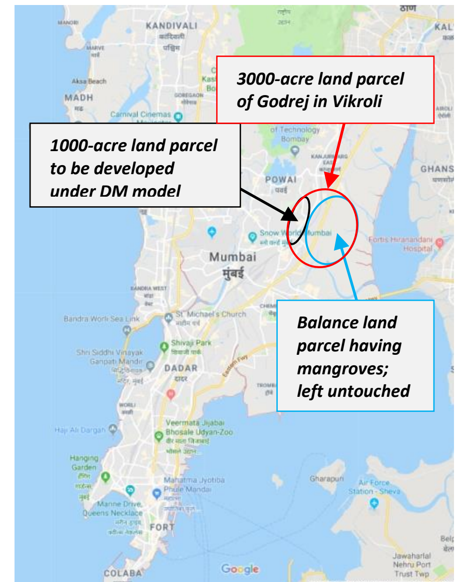
The average ticket size of GPL's projects (mid-range) places it in the high-demand range. At the same time, GPL is attempting higher skin in the game by undertaking larger stakes in bigger and higher-margin projects

Acquiring larger stakes in projects

GPL has acquiring larger stakes in projects in order to increase its margins. For example, it recently acquired the Fund Management Platform's stake in Godrej Platinum in NCR taking GPL's effective stake to 52.5% (revenue share) from 13% (profit share) earlier. Similarly, it acquired 50% in Godrej Two, buying a larger stake from the FMP. It has recently added (in April 2019) six large projects amounting to 25mn sq. ft. in Pune – a first such strong project addition at one go. It has also added one project in Bandra in Mumbai (60% stake) – it is expected to be a high-ticket one, yielding higher margins.

We believe GPL needs to add projects at a faster rate in MMR in order to ramp up its margins and booking value. It has shown significant growth in terms of booking area over FY17-19, but in terms of booking value, growth hasn't been significant due to lesser share of higher margin projects in MMR. Our research suggests that GPL has been trying to exit/re-negotiate very small projects or those in which it has a very small stake – all in its endeavour to earn higher margins (through higher stake).

In 2019, GPL added c.27mn sq.ft. of space; this progress (average run rate of projects added over FY16-18 has been around 16mn sq. ft.), we reckon, is a first step towards its aspiration of adding at least 1 project each quarter in each of its four markets.



Legacy projects: A journey toward an end

GPL is attempting to either renegotiate legacy projects or altogether exit them as it exits all markets except its four focus ones. It will be able to resolve problems related to legacy projects (such as Sundar Sangam, Anandam, Godrej Palm Grove) in the near term.

Vikhroli Land bank: A strong support to fall back on

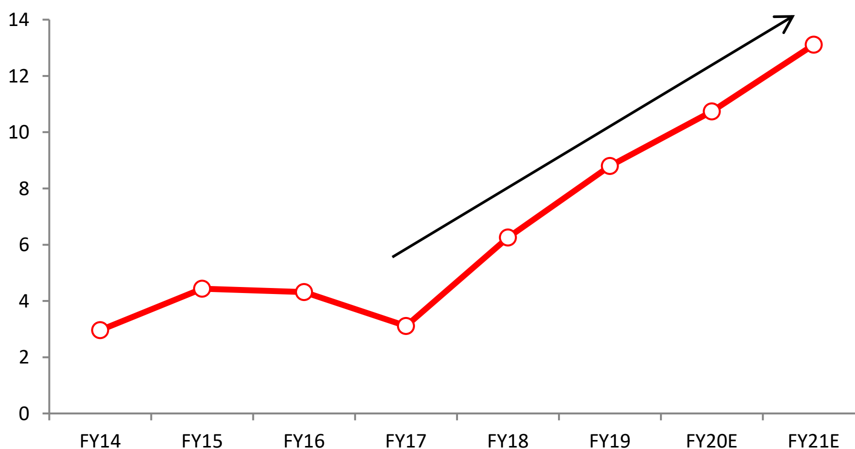
- Signed an MoU with one its group companies – Godrej & Boyce – to develop its 1000 acre Vikhroli land parcel against a development management fee of 10%.
- Developable potential of the entire land parcel is around 50-70mn sq. ft. We have assumed 60mn sq.ft. as total developable area over the next 18 years.
- The Vikhroli land bank deal provides potential.
- We believe that this provides a fallback option for GPL in case of any macroeconomic/business environment headwinds.

Strong operational and financial performance

Bookings

- Total bookings CAGR over FY14-19 was 20% to 8.8mn sq. ft. from 3mn.
- We expect bookings CAGR of 22% over FY19-21 to 13mn sq. ft. Reasons – strong project addition in FY19, GPL's aim of adding one project per quarter in each focus market, strong project launches, strong launch quarter sales leading to healthy growth in bookings, introduction of subvention schemes, and improving business environment.

Strong growth in area booked

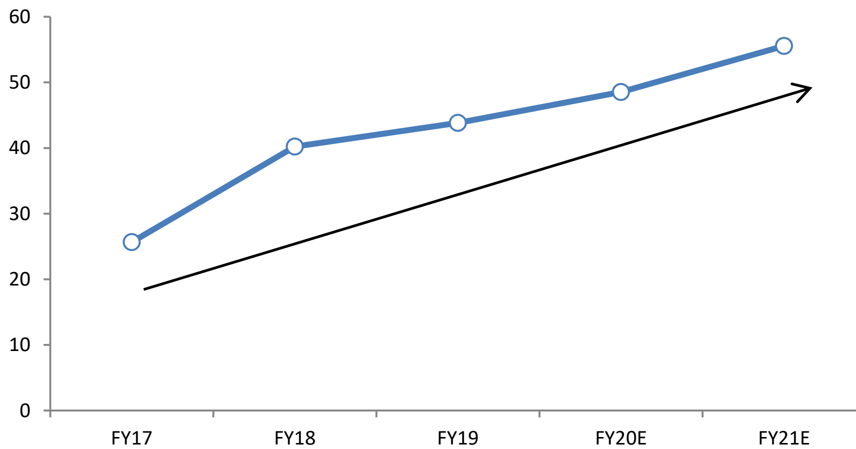


Source: PhillipCapital India Research, Godrej Properties,

Cash flow

- We see cash flow CAGR of 13% over FY19-21 to Rs 55bn from Rs 43bn.
- Reasons: Growth in total bookings. Stronger execution, partly due to the pre-cast unit in Greater Noida.

Strong bookings coupled + execution = Good operational cash flow (Rs bn)

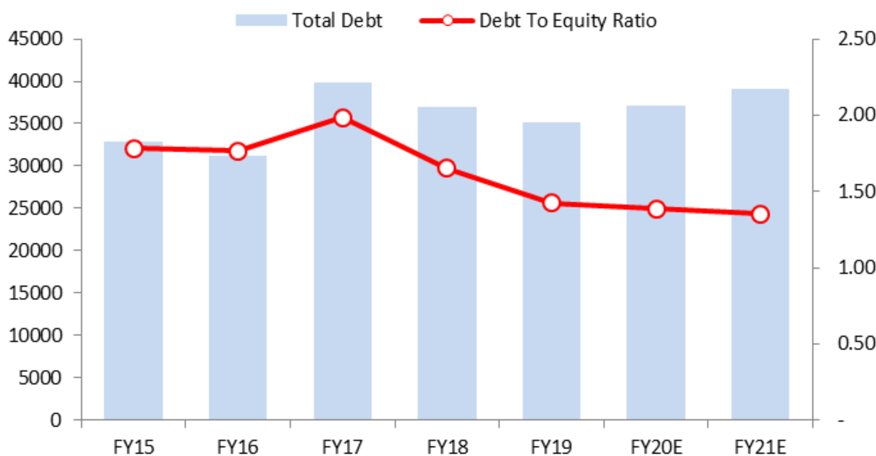


Source: PhillipCapital India Research, Godrej Properties,

Debt

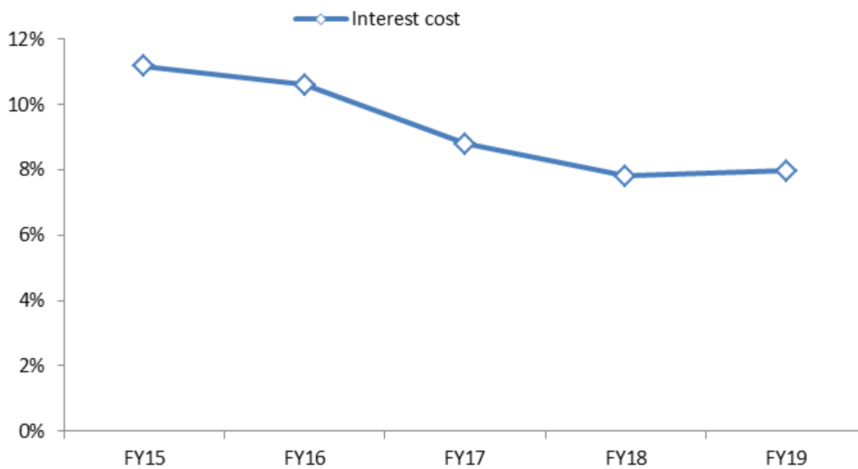
- Raised Rs 10bn from GIC recently.
- Overall debt levels have reduced.
- We expect the debt to rise at a moderate pace in the near term due to GPL's renewed stance of acquiring larger stakes in projects. Due to its strong brand name and execution capabilities, it has been able to raise debt at a relatively cheaper costs compared to prevailing industry standards.

Debt declined after equity infusion, leaving room for more



Source: PhillipCapital India Research, Godrej Properties,

GPL: Leveraging the brand name to get debt at a cheaper rate



Source: PhillipCapital India Research, Godrej Properties,

IND AS 115 impact

- Due to IND AS 115, balance sheet and profit and loss statement will not provide an accurate picture of the financial position and performance. Booking velocity, position of cash, and operating cash will be key indicators.
- Only cash flow statement will be able to reflect the true sense of growth in business.
- We refrain from providing revenue forecast as revenue will be subject to project completion, application, and approval of the occupation certificate.
- Ratios such as ROE, P/E, and P/B were used in past to portray a company's performance (both standalone and peer comparison) despite being seldom used for the RE sector. We believe these ratios will not be able to reflect the accurate picture.

Valuation

We have valued GPL on SOTP basis by considering eight parts based on the business model adopted.

1) Area sharing
2) Revenue sharing
3) Profit sharing
4) Development management
5) Fund management
6) 100% owned projects
7) Vikhroli land parcel
8) Commercial projects

- We valued the seven residential parts on NAV using a WACC rate of 11.3% to discount the net project cash flows.
- For the value of the Vikhroli land parcel (60mn sq. ft) we assume it will unlock over the next 18 years and we discounted it at a WACC of 11.3%.
- For commercial projects, we applied a capitalization rate of 9%.
- We have also provided a 20% business development premium to NAV .
- Using the SOTP method, we arrive at a target of Rs 820 and rate the stock Neutral.

We like GPL for its strong execution capabilities, strong pre sales, robust launch-quarter sales, unique business model, realigned business mode, strong project pipeline, and intense project addition. However, due to the recent rally in GPL's share price, it has already reached its near-term valuation potential. It remains one of our top picks in the sector. We will revisit our rating if the same pace of project addition continues (we get more clarity on the projects added), renegotiation of low-margin projects takes place, there is a quick exit from other markets (barring top-4 markets), and/or if the price of the stock is right.

SOTP valuation

Particular	EV
Area Sharing	3,565
Revenue Sharing	7,301
Profit Sharing	28,150
DM	48,037
Fund Management	4,555
Own Project	9,859
Vikhroli Land Parcel	62,667
Godrej Two	5,534
Debt	37,029
Cash & CA	21,661
No. of Shares	216
NAV	154,299
NAVPS	713
Business Development Premium	20%
NAVPS	840

Source: PhillipCapital India Research

Risks to valuation

Overdependence on residential in a tough environment: More headwinds for the RE sector may significantly impact pre-sales velocity. And with no annuity asset under its portfolio, operational cash flows will become volatile.

Slowdown in demand: GPL's key driver is launch-quarter sales. GPL is aiming at higher launches per year, so if demand slows in a specific market its pre-sales velocity will also slow down, leading to lower growth in bookings.

Brand value at constant risk in Development Management Projects: Majority of GPL's project sales velocity is based on brand and any damage to this due to faulty execution of DM projects may lead to significant slowdown in sales.

Need to ramp up execution speed: If the increasingly strong project pipeline does not come with speedy execution, higher throughput will lead to increased levels of debt and a subsequent slowdown in project additions.

Building an annuity portfolio will provide required stability: With Godrej Two and Golf Course Commercial and Godrej Two, GPL forayed into annuity assets. It must build an annuity portfolio that will provide stability to its business and revenue visibility.

Resolution in legacy projects: GPL is attempting at speedy resolution of legacy projects. If it is not able to do so, its capital will remain stuck and lead to either higher debt or slowdown in project addition.

Inability to exit other markets: With its exit from the Hyderabad market in FY19, GPL has proved its commitment to restrict itself to the top-four markets. However, if GPL is unable to exit current projects in other markets, it will lead to an increasing inventory overhang. It does not have a local presence in the markets that it has decided to exit, so the sales velocity of those projects pending in these markets could be painfully slow, blocking its capital.

Financials

Income Statement

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Net sales	**18,891**	**28,174**	**19,788**	**13,670**
Growth, %	19	49	-30	-31
Total income	18,891	28,174	19,788	13,670
Raw material expenses	-14,687	-21,939	-12,382	-2,610
Employee expenses	-1,384	-1,730	-2,076	-2,492
Other Operating expenses	-2,865	-2,725	-3,758	-3,855
EBITDA (Core)	**-45**	**1,780**	**1,572**	**4,713**
Growth, %	(101.8)	(4,074.1)	(11.7)	199.8
Margin, %	(0.2)	6.3	7.9	34.5
Depreciation	-161	-143	-204	-264
EBIT	**-206**	**1,637**	**1,368**	**4,449**
Growth, %	(108.7)	(894.3)	(16.4)	225.2
Margin, %	(1.1)	5.8	6.9	32.5
Other Non-Operating Income	5,075	4,185	5,231	2,450
Pre-tax profit	**3,368**	**3,482**	**2,883**	**2,983**
Tax provided	-1,019	-951	-865	-895
Profit after tax	**2,349**	**2,532**	**2,018**	**2,088**
Net Profit	**2,349**	**2,532**	**2,018**	**2,088**
Growth, %	13.6	7.8	(20.3)	3.5
Net Profit (adjusted)	**2,349**	**2,532**	**2,018**	**2,088**
Unadj. shares (m)	216	229	229	229
Wtd avg shares (m)	216	229	229	229

Balance Sheet

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Cash & bank	3,327	3,426	6,157	940
Debtors	1,242	1,599	1,599	1,199
Inventory	40,513	22,108	29,438	51,411
Loans & advances	12,538	13,732	13,732	13,732
Other current assets	8,898	14,334	15,334	13,334
Total current assets	66,518	55,199	66,259	80,617
Investments	278	248	248	248
Gross fixed assets	1,188	1,202	1,702	2,202
Less: Depreciation	-339	-483	-687	-951
Add: Capital WIP	715	996	996	996
Net fixed assets	1,564	1,715	2,011	2,246
Non-current assets	13,911	16,537	16,537	16,537
Total assets	**84,509**	**80,927**	**92,283**	**1,06,876**
Current liabilities	64,428	51,115	60,454	72,949
Total current liabilities	64,428	51,115	60,454	72,949
Non-current liabilities	5,119	5,123	5,123	5,123
Total liabilities	69,547	56,237	65,577	78,071
Paid-up capital	1,082	1,147	1,147	1,147
Reserves & surplus	13,880	23,544	25,560	27,658
Shareholders' equity	14,962	24,690	26,707	28,805
Total equity & liabilities	**84,509**	**80,927**	**92,283**	**1,06,876**

Source: Company, PhillipCapital India Research Estimates

Cash Flow

Y/E Mar, Rs mn	FY18	FY19e	FY20e	FY21e
Pre-tax profit	3,368	3,482	2,883	2,983
Depreciation	161	143	204	264
Chg in working capital	-12,555	-4,518	1,010	-7,079
Total tax paid	-1,019	-951	-865	-895
Other operating activities	21,621	5,191	-3,517	-523
Cash flow from operating activities	**11,576**	**3,348**	**-285**	**-5,250**
Capital expenditure	-1,725	-295	-500	-500
Chg in investments	-2,238	1,991	0	0
Other investing activities	-3,561	-1,676	5,231	2,450
Cash flow from investing activities	**-9,762**	**-4,970**	**4,731**	**1,950**
Free cash flow	1,814	-1,622	4,446	-3,300
Equity raised/(repaid)	14,962	9,728	2,017	2,098
Debt raised/(repaid)	5,000	0	0	0
Other financing activities	-24,891	320	-3,733	-4,014
Cash flow from financing activities	**-4,929**	**10,048**	**-1,716**	**-1,916**
Net chg in cash	-3,115	8,426	2,730	-5,216

Valuation Ratios

	FY18	FY19e	FY20e	FY21e
Per Share data				
EPS (INR)	10.9	11.0	8.8	9.1
Growth, %	13.1	1.7	(20.3)	3.5
Book NAV/share (INR)	69.1	107.7	116.5	125.6
FDEPS (INR)	10.9	11.0	8.8	9.1
CEPS (INR)	11.6	11.7	9.7	10.3
CFPS (INR)	(153.6)	(6.7)	(17.4)	(40.0)
Return ratios				
Return on assets (%)	5.6	3.1	2.3	2.1
Return on equity (%)	15.7	10.3	7.6	7.2
Return on capital employed (%)	23.4	10.1	6.5	6.4
Turnover ratios				
Asset turnover (x)	1.2	0.9	0.6	0.4
Sales/Total assets (x)	0.4	0.3	0.2	0.1
Sales/Net FA (x)	24.2	17.2	10.6	6.4
Working capital/Sales (x)	(0.1)	0.0	(0.0)	0.5
Receivable days	24.0	20.7	29.5	32.0
Inventory days	782.8	286.4	543.0	1,372.7
Working capital days	(23.9)	8.5	(6.5)	179.6
Liquidity ratios				
Current ratio (x)	1.0	1.1	1.1	1.1
Quick ratio (x)	0.4	0.6	0.6	0.4
Interest cover (x)	(0.1)	0.7	0.4	1.1
Total debt/Equity (%)	247.5	142.4	139.1	135.9
Net debt/Equity (%)	225.2	128.5	116.1	132.7
Valuation				
PER (x)	78.0	76.7	96.2	93.0
PEG (x) - y-o-y growth	6.0	45.0	(4.7)	26.9
Price/Book (x)	12.3	7.9	7.3	6.7
EV/Net sales (x)	11.5	8.0	11.4	17.0
EV/EBITDA (x)	(4,843.6)	126.9	143.3	49.3
EV/EBIT (x)	(1,052.9)	138.0	164.7	52.2

Rating Methodology

We rate stock on absolute return basis. Our target price for the stocks has an investment horizon of one year.

Rating	Criteria	Definition
BUY	>= +15%	Target price is equal to or more than 15% of current market price
NEUTRAL	-15% > to < +15%	Target price is less than +15% but more than -15%
SELL	<= -15%	Target price is less than or equal to -15%.

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