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The current real estate market in Mumbai

The volume of real estate development in Mumbai has always been related to the availability of funds rather than to demand. During periods of easy money (more liquidity), excess inventory has been created; whereas during periods of tight money, the decline in new projects allows for absorption of this excess capacity. This cyclical dynamic is a defining feature of the Indian real estate market and is often challenging to decipher due to the opaque nature of fund flows within the industry.

Fund flows into the Development Industry:

Public market money: The Securities and Exchange Board of India (SEBI) has recently increased the permissible investment by REITs in under-construction projects to 20% of their corpus (from the previous limit of 10%). While this relaxation could lead to the growth of REITs as construction lenders, it poses risks. Historical parallels can be drawn from the U.S. in the 1960s when REITs shifted from long-term ownership to short-term construction financing, leading to significant challenges. When the trust form was created by the US government in 1960s, the primary focus was long term ownership. However, by end of 1960s many of them shifted their sights to short term construction lending. Mind you, neither fund managers, nor Dalal street can fathom the techno-legal nature of the business of financing construction. In the aftermath of 2016-2017 dip in the Mumbai market (due to various factors in addition to ILFS, GST, RERA, Demonetization etc.) many real estate investors overnight had to become developers to recover their dues. Unfinished projects are essentially valueless without marketability. Neither institutions nor retail investors fully grasp the intricacies of financing construction, which demands far greater supervision compared to other forms of real estate investments.

Private market & crowdfunding: Pseudo REIT products (fractional ownership startups) have effectively distributed liquidity risk for developers while offering returns to retail investors. Their due diligence, encompassing both quantitative and qualitative factors such as builder credibility, has been commendable. However, the debentures offered to investors are only as good as the developer's ability to refinance or sell inventory. The cycle depends entirely on the ability of the developer to sell the asset in order to realize the profits.

New IPOs & companies planning to go public: Many new "non-viable" projects have been taken over by players (many from out of Mumbai) with a hope of showing a healthy order book to get a healthy valuation. The only way a developer often makes money in such projects acquired at lofty costs is at the behest of the existing occupants (in case of redevelopment) or new purchasers. At the time of completion, the developer cuts costs delivering substandard quality or "renegotiates" with existing occupants over unpaid rents. Many aspiring- to- go-public are ill informed about the competition in the Mumbai market. Operating margins of Mumbai based real estate companies are huge compared to rest of India but the market is "cut throat" to say the least. Without any margin of safety inbuilt in the project acquisition & with cost of debt looming close to 14%, these projects are dependent on rising prices to make any respectable margins on a project stage.

Oversupply of funds from other retail sources: This oversupply of funds leads to rampant development/ redevelopment led by newer players who do not have much holding power in case of a downturn. This matters primarily since the amount of real estate development that can be absorbed in any one year is finite. But this easy availability of funds is encouraging massive development during a period when demand is shaky. Easily accessible funding (either through institutions or groups of retail investors lured with the promise of easy returns) is attracting inexperienced or undercapitalized borrowers who are not qualified to be real estate developers. In redevelopment projects, which dominate the Mumbai market, developers face dual financial burdens: paying rents to displaced occupants and servicing interest on borrowed capital. Any delays due to inexperience or inefficiency led to escalating costs, making timely project completion critical.

Manpower problems:

The current real estate boom has significantly impacted the labor market, leading to job hopping, inflated salary expectations, and ethical compromises. The rapid expansion in demand for skilled professionals has, paradoxically, diluted the overall competence in the industry further lowering the ethical standards in an already infamous industry. It is not uncommon to see a project stuck after demolition since the main consultant did not "check" for compliance of all mandatory clearances from all government/ semi-government bodies.

While nobody can predict how long this excess will continue, as the tide turns the industry will see the need of real estate savvy individuals with management skills, technical flair, capital & integrity. Unfortunately, the industry for various reasons fails to attract passionate & technically proficient talent. Hence the shortage of individuals capable of alleviating the problem situations will persist.

What is likely to happen?

Mumbai's real estate market has undergone a prolonged time correction since 2016, with prices in many micro-markets stagnating. This correction presents significant opportunities for savvy developers with technical expertise, management skills, and integrity. It is likely that many projects will remain incomplete over the next five years. Delayed projects rarely yield returns commensurate with the risks, with some investors barely recovering their principal after years of frustration. Distressed properties will increasingly change hands from undercapitalized developers to liquid investors and established developers. However, completing such projects involves substantial legal, financial, and technical hurdles

Similar to last cycle, many investors will "turn" to becoming developers to get back their capital and finish their half-completed projects. After all, half completed inventory is not capital. They have to finish the same to get at least the principal back. Lawsuits and fraud claims will galore the pages of the newspapers. Numerous stalled/ delayed projects with barricaded sites but no construction activity have already mushroomed in various parts of the city. Most unbranded developers (doing standalone projects) won't be able to attract even site visits from prospective buyers till at least 40-50% of the superstructure is in place- leading to stretched working capital and fueling further delays. Many distressed developers will be selling their existing projects to "liquid" developers in order to "get out" of the project. Alternatively, many distressed developers will dispose (underwrite) some inventory at throwaway prices to fund the remaining construction and deliver the project. Many will be reprimanded by courts for siphoning money and cheating helpless purchasers. The same will be marketed as "Joint ventures" to avoid using the term "sell out"/ "distress"/ "exit". This is where cash rich, experienced players will see major opportunities in the coming years.*

Conclusion:

- Mumbai won't see a price correction. Time correction in some pockets is very much on the cards.
- Projects seeing the light of completion in Mumbai, will reduce in the next 2-3 years as liquidity is going to be tight. The big players will sustain while smaller ones will have to stretch their balance sheets and working capital.
- Two projects one street apart can sell at a price difference of almost 25-30%. Real estate in Mumbai is becoming brand-centric & product centric. An unbranded, no amenity project will sell at a 25-30% discount to a branded-full amenity project in the same locality.
- There will be a lot of demand for distressed properties where basic RCC structure is built. Properties will change hands from low liquidity developers to deep pocket developer/investors. Listed developers with a good brand will be big winners in this cycle.
- Rental yields in Mumbai are currently low (2-3%), and home loan interest rates (8-9%) significantly outpace these returns. However, rental rates are expected to rise over the next 3-4 years due to inflationary pressures and increased replacement costs for new construction.*

Advice to new Real Estate Developers entering Mumbai*

Low acquisition cost: Deep value development & Redevelopment is the only way to make money in a competitive environment like Mumbai. The margin of safety is a good cushion to the unpredictable nature of the development industry. Developers (in case of redevelopment) over committing to Landlords/ Society members/ tenants are in for a rude shock. Ignoring the margin of safety will prove very costly to newer/ inexperienced developers. By the time many inexperienced & smaller developers get done with their development projects, many will realize that development is far more complex and riskier than they had thought. In addition to the problem with site constraints in Mumbai Island city, regulators can change the game midstream with new fees and costs; the economy can shift causing demand to evaporate during the time it takes to get the building up. In fact, long after the building is completed, some of the clients continue getting notices for some fees charged by the city regulators on a retrospective basis.

Execution-Execution-Execution: Relentless construction scheduling, superior technical capabilities & timely completion is the often overlooked but absolutely necessary recipe for success.

Brand building: Build a brand based on speed of construction & quality not merely hoardings & advertisements. Majority of Island city and some parts of Western suburbs are not price sensitive markets. Purchasers value a safe branded developer and are willing to pay for surety (with demonstrated track record of completed projects), quality of construction and amenities.

To conclude, I shall reiterate what the legendary Sam Zell said. This might be applicable to many new developers.

"I think to stay in the development business, most developers must get 50% of their returns from real (and often delayed) cash flow and the other 50% from the intangible benefit of seeing their phallic symbols rise out of the ground. Otherwise, I can't see the reward."

*Indicates additional memorandum pertaining to the same.