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What ails the Real estate Development Industry in Mumbai & some solutions to ?

Real estate is one of the most important sectors of any market economy. The number of sectors this industry directly or indirectly influences has a huge impact of the people of the country, their wages thus influencing many social parameters. Real estate as a sector is an important customer to several major industries like cement, steel, building materials, financial services, capital goods to name a few. In addition to this, the sector provides major employment in the informal sector especially the surplus farm labourers who are free in the non-harvest season.

What has ailed Mumbai's Real Estate in the past 20 years since 2005.

Real Estate prices in Mumbai saw an unprecedented increase from 2003 to 2013- a phenomenon fueled by foreign capital entering the country coupled with surge in credit disbursement. At the same time, average income didn't grow at the same pace making housing incredibly unaffordable for majority of the population. In some pockets like Lower Parel, Matunga, Mahim; the real estate prices have gone up by 5x from 2007 to 2014.

Coupled with this meteoric rise, the state started charging hefty premiums and ancillary taxes to fund its fiscal budget. The truth is, prices are still high in the city of Mumbai and the prime reason for this is the state government and BMC.

A study by Vishal Bhargava states "Tough financing is only a peripheral factor in the stalling of 6,000 redevelopment projects. Most of them are stalled due to unviability and many more will join the list going forward as well. The disdain with which authorities view end-buyers is best demonstrated in their approach to the Ready Reckoner Rate (RRR). The RRR has two uses – 1) When a builder goes to buy premiums from the BMC – its pricing is derived on the basis of a percentage of RRR. 2) When a buyer buys a flat from a builder then he pays a stamp duty and that has a relation to the RRR. Higher the ready reckoner rate – greater is the amount that builders have to pay for completion of the project and greater is the amount of stamp duty that consumers pay while purchasing a flat. Both result in a higher purchase price for the flat and have caused enormous demand destruction. Such is the level of delusion in the minds of authorities that today many areas have an RRR higher than the market price. The market price may fall but RRR rarely ever does. Example: Lower Parel had RRR in 2013 of Rs 2,81,900/square metre. Despite keeping it unchanged for the last two years – its current RRR is 43 percent higher than 2013 levels even as market prices remain largely unchanged in the last 6 years."*

Currently, the cost of construction ranges from 2100/sq. ft. for a low rise mid quality building to 3500/sq. ft. for a premium high rise. Despite this, the premiums, charges, ground rents, labour cesses, estate taxes, labour cesses and various charges levied by the BMC under various headers contribute to over 30-45% of the project costs. In a sector where construction usually contributed to majority expense, these additional charges are just passed on to the end user leading to higher charges.

Solutions to this- Government/ BMC discipline.

Currently, the BMC earns 30-35% of its revenue from the city property tax. The second largest source of its revenue is Development charges (various charges and premiums collected from the developer). With 2019 being the second year of property market downturn, the collection of development charges has reduced by 30% over the past 2 years. It is high time that the BMC realises that high premiums have made several projects unviable. The frequent policy flip flops and lack of clarity have made many under construction projects unfeasible. Since, the RR rate has been the bed rock of all BMC charges, it needs to look into aligning the RR with market conditions and on ground scenario. For now, the BMC realising the meek situation of the market has introduced several installation-based schemes to pay the charges. However, none of the charges have been waived or reduced. The sooner the BMC understands this, better will it be for its finances and future budget expectations.

Solutions to this- Builders managing cashflows stringently.

In the heydays of the real estate bull run, builders often made ludicrous offers to the land owners, often paying hefty sums up front. With cheap credit availability in the last decade, this became a norm and even though a huge initial capital outlay is extremely expensive (real estate loans often carry 14-18% interest rates), rising prices often meant that most projects were profitable. However, those days are gone and stringent cash management is the only way to survive in this market in the long run. Following pointers are a must for developers operating in the redevelopment space in Mumbai

1. Low acquisition cost: Deep value development is the only way to make money in a competitive environment. The margin of safety is a good cushion to the unpredictable nature of the development industry. Prefer no upfront payments. Manage upfront costs by area agreement with the owner instead of upfront cash payment.
2. In case there is some payment to be made (instead of dealing in areas), the payment schedule should be linked to approval stages and not time. The reason for this is that departmental approvals have no

timelines. Engineer transfers, leaves, regulation changes and suspensions are a commonplace. Indian Bureaucratic machinery is the number one hindrance in project timelines.

3. Avoid leasehold lands/ collector owned lands as the current premiums on those are a huge dent on profitability. In case of leasehold properties avoid conveyance of the same due to added transfer premiums. A development agreement works out to be much more efficient to avoid higher duties.
4. Negotiate any transit costs & maintenance corpus well. The same are not to be considered as incomes.
5. Try to put the onus of all initial documental costs on the land owner. All previous arrears, charges for breach of older approvals, getting title in place should be preferably bourn by the original land owner or shared by both parties.
6. Schedule projects properly. Don't commit to any capital outlay without knowing the repercussions. Soil investigation before the offer in order to ascertain the depth up to which the excavation might be required along with feasibility of a basement and/or pile foundation.
7. Keep overheads low. Try for models like development management for a fee. They are way more capital efficient for the developer but might cause a hindrance to the land lord.
8. Sale 15-20% of flats initially to fund the construction. Pursue aggressive marketing without much price expectation. Remember, cost of debt is 14-17%, so an initial buyer will (and rightly so must) expect a significant discount at the time of purchase.
9. Don't be afraid to walk out of a bad deal. Real estate development is a quagmire of regulations, rules, science, art, negotiation and myriad other agencies. Not only does it require superior finance acumen but also a delicate eye to design detail along with legal knowledge. Consider all the factors before saying yes to any proposal.

The underlying success factor for any development project is this: cash is king. Managing your levered free cash flow is the best way to ensure success.

A page out of NVR Inc.'s book- One of the best performing stocks in the US markets since the past 30 years
One of the Best performing stocks in the US listed market is a Property developer! Let that sink in. Barring a few tech companies, NVR Inc. has given cumulative returns of over 17100% since 1994 to 2024! How did they do it?

A core tenet of NVR's business model is its approach to lot acquisition and land development. Unlike other home builders, who typically purchase and develop land, NVR doesn't own land, rather it negotiates with developers for the exclusive option on finished lots. By offering an upfront cash deposit and agreeing to purchase the finished lots at a premium price, the company is a preferred partner for developers who can use NVR's credit rating to procure favorable financing from lenders. By avoiding the capital intensive and multi-year process of land development, NVR has been able to generate a return-on-equity (ROE) between 20- 30%, compared to 12-14% ROE for most large home builders. Additionally, this strategy acts as a risk mitigation tool, allowing the company to reassess, renegotiate, or withdraw from commitments during housing market downturns. NVR's unique business model also acts as a barrier to competitors looking to emulate its success. NVR's size and experience outpace small and mid-sized builders who cannot match its land procurement, construction efficiencies, or marketing ability to compete on an equal footing. Meanwhile, large competitors are culturally and structurally wedded to land development due to their multi-decade experience in that arena, large development teams, and billions invested in land ownership.

- NVR's unique business model outsources capital intensive, low return activity of land ownership and development, enabling higher returns on equity.
- The company's focus on home construction has allowed it to eliminate inefficiencies and achieve a best-in-class "cycle time."

NVR is unique in that it relies nearly entirely on options to secure its land (representing 86% of controlled lots). NVR enters into option contracts with land developers that give it the right, but not the obligation, to take down finished lots at a predetermined price and pace. (In the Mumbai context, this represents developers who are conforming parties, selling their respective projects after acquiring the IOD or CC.)

NVR attempts to structure its purchase agreements so that it takes ownership of the lots on a just-in-time basis, immediately before building a sold home. The only recourse to NVR is a nonrefundable cash deposit up to 10% of the full purchase price. This model has performed excellently throughout the cycle, as invested capital is consistently low, and the firm is able to walk away from or negotiate option contracts when land values plummet or the firm thinks it won't be able to profitably build on such land. the culture among most homebuilders is land developer first, homebuilder second. Most homebuilders believe they are experts in both land investment and land development. It takes a lot for executives to swallow their pride, admit that land ownership and development is a very difficult, capital-intensive business, and pursue a home building only business model.

Land Speculation

Most home builders are closet land speculators. It is not uncommon for the profits from owning and selling the land to dwarf profits from home building. Of course, land speculation is not a free lunch for outsized profits. The issue with this model is that buying large quantities of land requires significant capital, which typically comes in the form of debt, and ties up money for years leading to poor returns on that capital. Buying land with lots of debt in the hopes that someone pays more for it is a great example of the "greater fool theory". He who holds the land last when prices finally retreat (and the land can't sell fast enough) often goes bankrupt.

Local economies of scale

The company leverages relationships and volume with suppliers, contractors, realtors and other business partners to realize cost and revenue benefits leading to higher profits. There is no magic to NVR's successful formula, but the company's relentless focus on efficiently building homes in markets where they can "win" allows them to replicate their moat in each new geography.

Vertical Integration

While homebuilding is clearly the core competency and main driver of profits, NVR does not strictly build homes. They also operate a title services and mortgage origination subsidiary, NVRM.

Some of the ways they optimize the building process include offering fewer customization options per model and per community, pre-assembling interior and exterior walls and staircases, and optimizing the physical building of the home. This results in NVR typically delivering homes in under 90 days from the time they undertake the contract.

Homebuilders typically start out as land developers and are therefore used to and drawn to the short-term, leveraged returns that the land speculation business can bring. Rather than do homebuilding and land development like the rest of the industry, NVR only focuses on homebuilding. NVR uses options to control land, which gives them the right but not the obligation to buy a parcel. Compared to developers who may end up with land no one wants, NVR only exercises the option when there's clear demand to build on the land. Despite NVR's land-light strategy's success, the industry's use of land options remains lower than it was during the housing boom in 2004-2006. It is really hard for traditional homebuilders resist the land development game.

Focus on geographies that your brand is strong in

An underappreciated part of NVR's business model is its prefabrication factory network. NVR has seven factories scattered across its territory, from which it pre-fabricates building materials like framing, panels, doors, and other components for its communities. Roughly 90% of NVR's communities are serviced by its factory network and most of NVR's communities are within 100 miles of its factories. (One Indian developer with a similar model is Sobha. Sobha has its own factories for many building components giving them almost near vertical integration). Unlike most homebuilders, NVR broadly avoids competing in top metro areas, instead opting for promising secondary and tertiary metro areas like Richmond, Virginia and Greenville, South Carolina. Despite all the advantages, a key factor in homebuilder profitability is finding cheap but still desirable land.

Many of NVRs strategies are replicable in the Indian context, many are not. Developers should choose wisely

* https://www.cnbctv18.com/real-estate/mumbais-real-estate-is-on-its-deathbed-its-time-to-bury-it-5126521.htm