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INDIA | PROPERTY
10 November 2016

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Real Estate Sector: Aftermath of demonetisation

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The demonetisation of 1000 and 500 Rupee currency notes is a bold and welcome step by the government. It is being touted as the surgical strike on black money aimed towards removal of the parallel economy running on unaccounted cash accumulated through tax evasion. In the long run, this measure along with Real Estate Regulation and Development Act 2016 (RERA) will align the real estate sector to the international standards of doing business resulting in more fund flow from institutional investors, banks and higher unit sales. However, it should significantly reduce liquidity in the market in the near term and should lead to an immediate period of deflation, as money becomes more expensive. In the short term, we expect transaction volumes to go down and downward pressure on prices especially in land and secondary market sales in residential and commercial real estate.

The government of India announced the demonetisation of 1000 and 500 Rupee currency notes on 8 November 2016. This bold step is expected to reduce tax evasion and wipe out unaccounted money from circulation, which is estimated by various sources to be 30% of the country's GDP.

In the real estate development cycle, black money is utilised mostly at the land acquisition stage and also during the secondary sale of residential units and strata sale of commercial units.This quantum varies and is higher in the business community dominated cities as compared to cities dominated by the salaried class. It is not to say that unaccounted money is not involved in construction, liaising approvals and marketing of the projects but that is much less in comparison.

We have analysed the impact of the demonetisation of the currency notes on the real estate market in short to long term.

Stage 1: Immediate Aftermath (next 1 to 3 months)

As per the Reserve Bank of India (RBI) estimates, more than 86.4% of the total value of banknotes in India were in the denomination of INR 500 and 1000 rupee notes as on March 2016. The government policy of withdrawal of these two currency denominations will make it difficult for those evading taxes to declare their unaccounted money and will result in significantly reduced liquidity in the market in the near term. We expect, an immediate period of deflation, as money becomes more expensive and those who have incurred financial losses are likely to curb spending.

Impact - Pause in the market

1. We expect little or no transactions in land, commercial strata sale and secondary sale of residential units at least for the next 3 months. The primary reason for this lull in the market is that the majority of the players will get busy in figuring out how to account for the black money and reduce their losses. At the same time, investors with white money will also adopt a wait and watch approach in the expectation of a decrease in prices.

2. Developers will be negatively impacted and can expect a worsening in their cash flows. However, most Grade A developers had stopped the practice of taking cash in primary sales.Thus they are less likely to be impacted on an immediate basis.

Stage 2: Short to Mid-term (3 to 12 months)

We expect a fall in inflation rates in the next 3 to 12 months. This should trigger RBI to reduce interest rates in the next cycle by about 50 basis points. The reduction in bank rate will put pressure on the banks to reduce home loan and construction financing rates.

The effective price of real estate to the buyers should thus reduce, but not enough to trigger massive sales due to uncertainty in the markets. We expect, a few properties to be available on sale in the secondary market at a further discount due to the financial stress.

Primary market sales will continue to be subdued as buyers will prefer secondary distressed property over primary markets. We expect greater incentives rather than a reduction in prices of residential units in the primary market. We are anticipating the usual resistance to lower prices. As RERA starts kicking in, it shall make the business environment more transparent and stringent.

Impact - Good time to buy property from the secondary market

1. We expect home prices to reduce in the luxury segment first due to the paucity of money in the market and the infusion of secondary market units on sale at lower rates. The delta between primary and secondary markets should thus increase.
2. In the affordable housing segment, we expect both transaction volumes and prices to remain largely unimpacted because black money component is limited in this segment and demand is robust.
3. In our opinion, commercial rents may see a marginal upward pressure in low vacancy markets such as Bangalore, Pune and Hyderabad because new projects may take more time to get complete.
4. It will also be a great time to invest in real estate from the perspective of an institutional investor as valuations will be attractive.
5. There will be a negative impact on retail investment sales market as retail investor money will largely diminish.
6. Due to expected lower margins for developers, we are likely to see the evolution of more efficient and cheaper construction techniques; and lower land prices.

Stage 3: Long term (1 year onwards)

Along with other regulatory changes such as “The amendment of Benami Transactions (Prohibition) Act, Goods and Services Act (GST), and Real Estate (Regulation & Development) Act (RERA) this amendment is a step in the right direction towards improving transparency in real estate transactions.

We also believe that this pro-active government will make the real estate approval process easier and shorter, as a part of its ease of business initiative. This will encourage the entry of more foreign entities (developers and funds) in the Indian market and more liquidity for the Indian developers who have an established track record. This should lead us to a new era of lower interest rate regime, fair competition and a more predictable business environment. At the same time, it will lead to a higher threshold to entry in the real estate business.

Impact - Institutionalisation of Real Estate

In the long run, this will lead to an economy that is more aligned with global compliance standards and industry with high levels of corporate governance making it easier for foreign entities to invest in India. We expect cap rates to compress due to the influx of money. It should also boost REIT (Real Estate Investment Trust) listing in the Indian market. We should see a more robust institutional investment market as retail investment participation in these segments will shrink.

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