Realty Bytes

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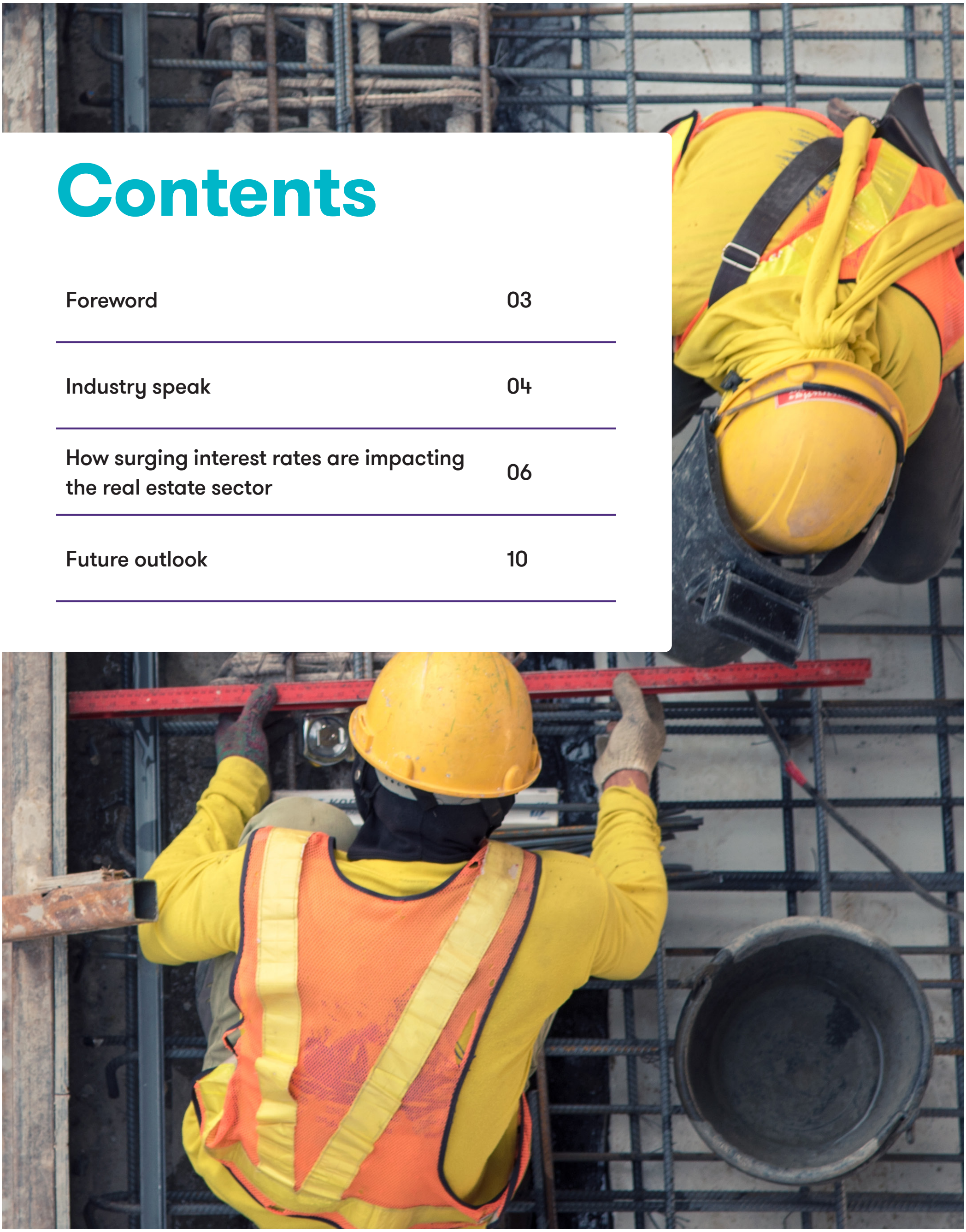

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Foreword

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The year 2022 was a remarkable year for the real estate sector, particularly in the post-pandemic period. The sector showed promising growth prospects in the residential segment and positive trends on the commercial and retail sides. Real estate has been one of the largest contributors to India's growing GDP. There has been a huge surge in demand because of low home loan rates, hybrid working culture, and the younger generation's changed priorities on working closer to home. Demand was driven by all these factors, helped partly by attractive offers from real estate developers before the onset of the festive season.

Due to expected increments in RBI repo rates in recent times, the sector was tested against loan rates, and developers felt this could cause the demand to go down, impacting the sector's growth and attractiveness. However, this claim fell apart as the demand for high-end real estate, both in the commercial and housing segments, is still high. One of the main reasons for the steady demand could be that the end users are aware of such loan rate fluctuations considering global and domestic inflation. The customers are more interested in long-term returns and sentimental value attached to their housing acquirement than the loan rates, which will eventually even out in the long term of say, 15 or 20 years.

On the supply side, the developers supported the sector's growth and attractiveness by offering different schemes to improve buyer affordability. A few developers introduced remarkable discount offers to lure and utilise the potential of the festive seasons, while some others offered subvention schemes to reduce the burden of increased loan rates/EMI on customers for a period of time. This will, however, negatively impact the profit margins of developers, which raises questions about the sustainability of such schemes.
On the commercial side, the government has played a key role in increasing the benefits for developers by introducing various schemes and policies and investing in REITs and InvITs, which could be a potential game changer in the future. With a change in the hybrid working model and employees returning to workplaces, office space and co-working space requirements will increase despite fluctuating loan rates.

It is a well-known fact that a large segment of real estate sector is driven by customer's requirement and preferences. With the increased demands of sustainable living and luxurious as well as affordable housing, the sector is going to witness high demands even if the loan rates change to manage domestic inflation. However, to attract strong investors towards REITs and InvITs, the government needs to bring out schemes such as PM Awas Vikas Yojana to keep increasing the customer base in tier-one and tier-two cities.

Industry speak

Post Covid, the perception towards life has changed. The new generation wants to live a better life with good amenities in big sized homes. Even the increase in interest rates has not significantly impacted the demand. The average age of people buying homes is also seeing a trend towards a younger generation as buying a home instead of renting becomes the preferred choice of many.

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The continuous interest rate hikes have caused little turbulence to the sector as it was expected considering the inflation. However, the impact of rising interest rates seems to be short term as residential housing buying sentiments are driven by hybrid work culture and covid impact on customer's choice to stay closer to the families. Although, government and bank institutions need to take a call on addressing the other factors that are affecting interest rates. There are possibilities that in an year's time, this may impact the demand side but for now, the industry growth is going to prevail.

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How surging interest rates are impacting the real estate sector

Background

The Reserve Bank of India (RBI) has revised the repo rate multiple times during the current financial year, and its impact on housing loan interest rates is likely to slow down the pace of growth in the residential real estate segment. Repo rate refers to the rate at which commercial banks borrow money from the RBI. An increase in the repo rate translates into a higher cost of borrowing by the banks for retail and other loans. This cost is usually passed on to the borrowers, as in the case of home loans, where we have seen an increase in interest rate leading to higher home loan Equated Monthly Instalments (EMIs).

In response to the rising costs, real estate developers have increased property prices.
The real estate sector is expected to contribute significantly to the country's GDP and potentially transform the economy. With the launch of Real Estate Investment Trusts (REITs) and better supply conditions, and increasing demand from buyers, interest rates will play a major role in the long run. The housing, commercial, and luxury segments can do better if there is a government push for relaxed rates by banks and flexible policies. This can place India on the map of recognised real estate markets.

Impact on customers (demand):

The RBI has increased repo rates multiple times to balance the impact of high inflation, resulting in an increase in home loan rates for home buyers. Some large housing financiers have introduced cuts in home loan rates to cater to the rising demand for real estate. Post-October 2022, lenders such as the Housing Development Finance Corporation, State Bank of India, Bank of Baroda, and the Bank of Maharashtra cut their home loan rates by 15-30 basis points (bps). While these special rate cuts were offered to lure buyers during the festive season, this is not a sustainable model to address the demand for homes. Lenders will have to eventually do away with additional cuts and discounts.

The changes in bank loan rates have not impacted the housing market because interest rate fluctuations get adjusted in the longer term of loans. If the rates increase further, these lenders will have very limited scope to increase tenures or provide flexibility in terms of payments to customers seeking affordable housing.

The Covid-19 pandemic lowered the demand for home loans as people focused more on their essential needs and had less disposable income to cover their EMIs. Those who already had running loans were given a moratorium period to cool the pressure off. But as the economy recovered post the peak pandemic times, a low-interest rate regime improved buyer affordability and rekindled demand for home loans. Most of us know that consumer preferences have changed significantly across industries due to Covid-19, and a similar trend has also been observed in real estate.

Homeownership tops the list of priorities of Indians with preference of homes shifting from small homes in metro cities to larger homes in the peripheral areas of cities. Thus, despite higher interest rates, the demand for housing from small homeowners is likely to remain robust.

Home loans generally have a tenure of 20 years, and when we look at the recent rate hikes through a 20-year lens, it is clear that over 20 years, the repo-rate hike and reduction typically average out.

The Covid lockdown has reignited the desire to buy a home among the millennials, who are generally referred to as the 'Generation Rent'. As per a study, 63% of millennials today want to own a home in comparison to 49% of millennials during the pre-Covid time.

A renewed desire to own a home post-Covid, the anticipation of property prices appreciation over the next decade, an increase in the rental yield from 1-3% to 3-5%, and still-affordable home loan interest rates all indicate a major boom in the real estate market for the foreseeable future.

Impact on real estate developers (supply):

Property prices have continued to rise since the beginning of this financial year, in response to the impact of inflation and high-interest rates on the real estate market. Real estate developers have started to undertake mitigating measures to soften the impact of rising interest rates on home buyer affordability and to support the continuation of the robust sales momentum.

The frequent increase in home loan interest rates has resulted in developers and financial institutions quietly withdrawing subvention schemes from the property market for homebuyers. A subvention scheme is a tripartite agreement between a buyer, the developer, and the institution providing the home loan. The terms of the agreement give the buyer a break from paying interest on the loan for a specific duration. These schemes benefit buyers who want to buy homes but do not want to pay EMIs until they have taken possession of their units. Until such time, the developer services the home loan account.

Only a handful of developers continue to offer subvention schemes. Some are absorbing the impact of the increase in interest rates, while others are designing the scheme in a way where the down payment by the buyer is higher than what it used to be. This helps them cut down on the interest rate hike-related risks and sweetens the deal for the customer, as there is no significant difference in the apartment's price compared to a subvention scheme and a regular non-subvention offering.

On the commercial side, corporates are keen to provide hybrid working models by taking on leased workspaces, which is fuelling the demand for commercial properties in the post-pandemic period. With government push and schemes such as the Pradhan Mantri Aawas Yojana and new types of investments through REITs and InvITs, there is a huge possibility of increased investment in commercial properties that will strengthen the commercial real estate market in India. Besides this, the Indian commercial real estate market has shown great potential for growth as employees return to offices. During the pandemic, there was a trend of reverse migration to tier-two cities because of the hybrid work culture. This trend has changed the way home buyers make their buying decision. Tier-two cities have now become an attractive option for buyers looking to own homes with large open spaces.

Impact on REITs

REITs are akin to a fund that invests in real estate-related assets. These assets include office buildings, retail stores, corporate parks, industrial warehouses, and shopping malls. REITs own these assets, which are leased out to commercial tenants. REITs are a good investment option because they offer a regular income stream and the potential for capital growth. Similar to shares, REITs can be easily brought and sold on stock exchanges.

In periods of economic growth, REIT prices tend to rise along with interest rates. A growing economy increases the value of REITs because the value of their underlying real estate assets increases. In a growing economy, the demand for financing also increases, resulting in increased interest rates.

Higher interest rates can affect REITs in two ways. It makes their funding tougher or more expensive since most REITs require or depend on some borrowed money to finance their growth strategy. This is similar to how real estate investors take out mortgages to buy properties. As interest rates rise, funding becomes tougher, adding to the cost of capital.

Secondly, the yield of income stocks such as REITs generally moves in tandem with risk-free rates. As treasury yields rise, investors expect the risk premium, which is the difference between what they can get on a risk-free investment and a so-called risky investment such as REIT, to stay the same roughly.

Future outlook

The Indian real estate sector is a major contributor to India's GDP. While the sector saw a decline in demand during the Covid period, things are looking better now. Demand is on the upswing despite the recent interest rate hikes. According to a CREDAI report, housing prices in the top eight cities in India (Delhi – NCR, Mumbai, Kolkata, Pune, Hyderabad, Chennai, Bengaluru, and Ahmedabad) rose 6% y-o-y during the quarter ending September 2022. This resulted in new launches and increased housing demand. The industry is set to witness growth in demand and sales in new projects in the future.

The real estate sector's contribution to the country's GDP was 7% in 2019-2020 and is expected to be 10% by 2030, contributing about USD 1 trillion to the economy, as per government projections. But the interest rate scenario will be a key factor in this journey.

The real estate sector, which has a large unsold inventory of under-construction buildings, has seen an increase in demand for homes after the festive season. Real estate developers are using this opportunity to sell their projects at discounted prices. With a change in buyer expectations and the rise of hybrid working model, customers have shown a preference for buying properties rather than renting one.

According to a report, residential sales have increased by 51% in the post-Covid period, and home sales have increased by 7.5%. But despite the bright outlook, the industry faces some challenges in terms of an increase in mortgage rates.

An increase in income and demand for sustainable living has led to demand for larger homes to accommodate bigger families, especially in tier-two cities. Since the lockdown restrictions were lifted, demand for homes has increased in major cities across India, particularly premium and luxury homes. This is partly because of increased disposable income with more hybrid employment opportunities in the post-Covid period.

The increase in the repo rate is a temporary blip for the sector. From a long-term perspective, the industry is reasonably bullish, given that demand is back to the pre-Covid levels and will only increase from here.

The broader real estate sector is currently on solid ground, and any little adjustments may not impact purchasing decisions. There is no significant impact on the luxury housing segment because of the current increase in repo rates, as buyer demand in this segment is not guided by interest rates. The positive sentiment will continue in the luxury segment driven by changes in buying patterns post the pandemic. Unlike other housing categories where buyers may postpone their purchase decision, the rate hike is expected to have a limited impact on luxury home buyers.

Acknowledgements

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