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Indian real estate players taking economic crisis into its stride – a case study of DLF Ltd

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ABSTRACT

Real estate sector is under deep crisis due to global financial meltdown. To mitigate the impact of GFM the real estate players were forced to adopt uncalled for practices such as lay-off, suspension of capital intensive projects etc. resulting into job losses. DLF Ltd, a leading real estate player in Indian was giving lot of thrust to sell its core assets such as residential, industrial and commercial plots to ease liquidity crunch faced by it due to GFM. As there are very few buyers available in the real estate market today the real estate players are wooing them by offering incentives and have adopted various management practices to neutralise the impact of GFM on their bottom-line. The real estate players have adopted practices such as redefining capital structure, low cost housing projects, value engineering, asset monetization, offering discount etc. to face the burnt of GFM effectively rather than adopting uncalled for means. These management practices adopted by Indian real estate players have helped them not only in bringing down adverse impact on bottom-line but also in managing their business effectively. In the back drop of this a study has been conducted to study effective management practices do adopted by DLF Ltd, a leading player in the Indian real estate market to manage global financial meltdown.

Introduction

Let's Understand ABC of GFM

GFM is the century's most talked about economic crisis. To understand the root cause of global financial meltdown (GFM) let us have a glimpse of what was happening in the housing sector of America for past couple of years. There was a boom in housing sector of America. A combination of low interest rates and large inflows of foreign funds helped to create easy credit availability where it became quite easy for people to avail home loans. The increased demand for the real estate resulted into substantial increase in prices of real estate. With huge money available with the banks, they started extending loans at liberal terms and conditions relaxing banking prudential norms. The banks had given loans even to borrowers whose credit score rating is below 620, (borrowers who are considered as high risky borrowers and loan products are offered to them at prime rate and not at best rate) as they felt that it was a good time to sell housing loan. Since the demands for homes were at an all time high, many homeowners used the increased property value to refinance their homes with lower interest rates and take out second mortgages against the added value of home to use the funds for their personal spending. All these developments in the U.S. real estate market led to supply exceeding demand which in turn resulted into decline in home prices from the mid 2006. The nose diving real estate prices in U.S. market forced banks to rethink about refinancing.

The problem became global issue from American backyard because most of the bankers around the world were of the view that real estate prices will shot up drastically in future. Hence, they decided that sub prime lending is a lucrative business as it gives two percent more return that prime lending business. In case of the default by sub-prime borrowers the bankers could have gone for foreclosure (the legal proceedings initiated by a banker to repossess the property for loan that is in default) and recovered their loans by selling the houses at higher price prevailing in the market. In either case sub-prime lending was more fruitful in the opinions of bankers.

With real estate stocks prices soaring high and with enough liquidity in the market many big fund investors like hedge funds and mutual funds saw sub-prime loan portfolios (mortgage backed securities investment) as attractive investment opportunities.

Hence, they bought such portfolios from the lenders, which in turn increase the money supply with the lenders for fresh funds to lend. The sub-prime loan market thus became a fast growing segment. Major American and European investment banks and institutions heavily bought these Mortgage Backed Securities to diversify their investment portfolios. Meanwhile the concept of CDOs (Collateralized Debt Obligations) caught the pace in US market. CDOs are just like mutual funds with two significant differences. First unlike mutual funds in CDOs all investors do not assume the risk equally and each participatory group has different risk profiles. Secondly, in contrast to mutual funds which normally buy shares and bonds, CDOs usually buy securities that are backed by loans. Majority of large American and European investment Bankers were went frenzy after CDOs. As a result of that the problem which was in America's backyard spread to other financial markets of the world.

With the supply exceeding demand the real estate prices crashed leaving behind house owners with homes worth less than their mortgage. As a result of this fact most of the borrowers preferred to vacate their houses rather then repaying mortgaged loan. As default rate kept on skyrocketing the

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bankers were left with no choice but to repossess the homes to recover their loans.

As real estates prices started declining, the MBSs business turned to be unattractive and risky. As the home prices were falling rapidly the lending companies which were hoping to sell MBSs and recover the loan amount, found them in a situation where loan amount exceeded the total cost of the house. Eventually, there remained no option but to write off losses on these loans.

Global Financial Meltdown and Its Impact on World

Global meltdown has shaken almost all economies of the world. US, Japan, Germany and Italy are major economies that are officially in recession. The world growth projected to slow down from 5.4 percent in 2007 expected to be 0.9 percent in 2009. Developing countries economic growth rate is expected to decline from 7.9 percent in 2007 to 4.5 percent in 2009. Investment growth predicted to fall by 1.3 percent in developed countries and rising only 3.5 percent in developing countries versus 13 percent in 2007, mainly due to tighter credit conditions and increasing uncertainty. Weakening global demand is depressing commodity prices. Metal and food prices have fallen from their recent peaks.

US has reported a 14 years high in unemployment. Total job loss in the recession in US till December was 2.59 million. In the span of 39 years US retail sales fell for the first time, as consumer cut down on their spending. Major investment banks were collapsed in US, which includes Government National Mortgage Association and Freddie Mac, Lehman Brothers, American International Group (AIG), Merrill Lynch, Bear Stearns Hedge Fund, JP Morgan Chase. Auto major General Motors, Ford Motors and Chrysler CLC had also collapsed. In order to revive badly affected economy the Federal Reserve and US government came out with bailout packages. Morgan Stanly and Goldman Sachs converted themselves into Federal Bank holding companies. 'Madoff scam' a big investment scam took place in US, resulting into billions of dollars of loss to top banks in Europe and Asia. Aircraft company Boeing has laid off 4500 jobs on account of falling demand. Motorola, a mobile handset maker sacked 400 people.

Global Financial Meltdown and Its Impact on Indian Economy

In the age of globalization, no country can remains isolated from the fluctuations of world economy. Heavy losses suffered by major International Banks is going to affect all countries of the world as these financial institutes have their investment interest in almost all countries and India is no exception to it. IMF projected a growth rate of 6.3 percent during 2008-09 for India as against 9 percent during 2007-08.

Indian manufacturing sector's contribution to GDP was 5.29 percent in first quarter of 2008-09 as against 10.05 in 2007. Industrial production index declines from 9.9 percent in first half of 2007 to 4.1 percent in first half of 2008 first time in 15 years, a negative growth of 0.4 percent. Export has witnessed 15 percent drop during first half year in 2008. In October 2008 export declined by 12 percent and there was decline of 9.9 percent in November 2008 compared to previous year. The FDI inflow was $15508 million during 2007-08 (April to September) which was negative i.e. $6421 billion during 2008-09 (April to September). External commercial borrowing was $1804 million during 2007-08(April to September) which was declined to $2173 million during 2008-09 (April to September).

The Impact of GFM on Indian Real Estate Sector

Most of the Indian industries such as tourism, infrastructure, real estate, automobile, banking, IT etc are hit hard by the GFM. Real estate sector is one of the serious victims of the GFM and has tested the slowdown earlier than other sectors in the country. The impact of GFM on the real estate sector can be understood from the fact that the sector is suffering from steep demand and poor availability of funds. The bottom-line of players in real estate business has been hit hard by the GFM. The real estate companies such as DLF, Unitech developers etc. were known as cash-rich developers in the country before the GFM spread its tentacle world over. Real estate developers are struggling hard to improve their bottom-line.

To over come the liquidity crunch, real estate players in the country have resorted to uncalled for practices such as lay-off, suspension of capital intensive projects etc. resulting into job losses. These sort of uncalled for practices have become the norm of the day for the Indian real estate players. However some of the better management practices do adopted by selected real estate players in the country is worth mentioning as they are able to mitigate the impact of GFM effectively without causing any panic to stakeholders such as promoters, bankers, venture capitalists, labourers, employees etc.

To record the some of the better & effective management practices do adopted by real estate players during the time of crisis a study has undertaken.

Abbreviation:

GFM: Global Financial Meltdown

Methodology

The information for the study has been collected from secondary sources and observations. The study is descriptive in nature.

Period of the Study

The period of study has been confined to July 2008 to June 2009.

Meaning of Key Words Used

Global Financial Meltdown: Crisis in debt market, sub-prime mortgage market, currency market, banking industry, Mutual fund industry and capital market crashes in US, European and Asian countries is called as GFM.

Management practices: The process of designing and maintaining an environment in which individuals, working together in groups, efficiently accomplish selected aims. Sub-prime Loan: Loan to home buyers who have less than 620 credit scores in (American home loan market) i.e. high default risk ratings. In other words, loan to borrowers who would otherwise not have assess to credit market. In other words, it is offering housing loan to borrowers whose financial capabilities to repay the debt is far below the minimum requirements prescribed by the banks.

Mortgage Backed Securities: Bonds issued by Government National Mortgage Association, Freddie Mac and other Financial Institutions of US to investors including to Provident Funds, Investment Banks etc. are called as MBS. These securities are nothing but bundle of mortgage loan converted into bonds and issued to investors to finance lending of banks to sub prime borrowers. In order to meet their growing demand for home loans, banks in America issued bonds which are backed by mortgage called as MBSs.

Sub-prime Crisis: As Banks have lent loan to high risk default rating borrowers, the default rate was very high. So, banks have taken over the homes from borrowers. Due to oversupply of homes, real estate prices started falling in US in June 2007. As the real estate prices have crashed and property got revalued causing huge loss to Banks. This has resulted in great fall of MBSs prices resulting in huge loss to investors in general and investment bankers in particular.

Second Mortgage: A mortgage taken out on property that already has one mortgage, with priority in settlement of claims given to the earlier mortgage. It is mechanism used by home loan borrowers in USA to consolidate debt by using the loan amount from the second mortgage to pay off other sources of outstanding debt, which may have carried even higher interest rates.

Non core-assets: Assets no longer used in the ordinary business operations of a company. They are likely to be sold in the near future, so the need for cash arise.

Value Engineering: It also known as Value Analysis, is a systematic and function-based approach to improving the value of products, projects, or processes or reduce the cost of components that add little value, especially high-cost components.

Objectives

The present study has been undertaken with the following objectives:

1. To study effective management practices do adopted by real estate players to manage GFM.
2. To draw conclusion about management practices do adopted by real estate players.
3. To offer suggestions which enable real estate players to manage GFM effectively.

Practices of Real Estate Palyers during Crisis Time

One of the sectors of the Indian economy whose bottom line have taken nose dive is real estate. But, the better management practices do adopted by the players in the industry has saved them from collapse. To beat the GFM, the real estate companies in India have resorted to various management practices such as dropping prices, revamping business strategy, modification in development plans and project formats, selling non-core assets, venturing into low cost housing projects, focus on value-engineering, etc.

DLF Ltd

DLF Ltd has carved a distinct name in the Indian real estate sector. The company has constructed residential and commercial complexes across the country with major focus areas of operations include New Delhi, Mumbai, Bangalore, Greater Noida, etc. DLF is India's largest real estate company in terms of revenues and market capitalization. According to company source it has over 425 million sq. ft. of land and the land is spread over 32 cities, mostly in metros and key urban areas across India. As a part of its strategy towards building world class hotel infrastructure the DLF has tied up with Hilton Hotels. DLF is known for its commitment towards keeping in view local preferences and put all efforts in delivering high quality in their projects.

Retailing and entertainment infrastructures are other key areas of the interest for the DLF Ltd. The company has 12 mn sq. ft of retail projects under construction and owns land resource of another 92 mn sq. ft for development in metros and other key urban destinations across the country as per the company source. With more than 90% of retail business being unorganized the DLF sees significant opportunities for growth in these businesses.

The Indian real estate sector is one among the badly affected sectors of the Indian economy due to GFM. As demand in residential and commercial segment has came down drastically causing severe damage to bottom-line. As a result of this the real estate players were forced to terminate employees in the process of cutting cost. However DLF Ltd led by example in showing how creative management practices can help companies to fight out the global financial crisis without taking harsh measures such as lay off , salary cut etc.

DLF Vs GFM

Redefining Capital Structure through Stake Sale

DLF Ltd being a leading player in the organized real estate sector in India has taken up number of projects, to finance those projects the company has raised huge amount debt from the market. As the demand for real estate in India came down crashing under the influence of GFM the company came under heavy debt burden amounting to Rs.13958 crore. In order to service the debt, the promoters have taken a decision to sell off their stake in the company to the tune of 10 percent. This move was expected to raise Rs.3860 crore to service the debt. The DLF Ltd has also restructured its short term as well as long term loans to over come from fund crunch.

Revamping Business Strategy

DLF Ltd was involved in developing commercial projects and leasing the same to corporate world. To manage the downturn in a better way, the company has revamped its business strategy. It has adopted a strategy called as 'build and sell' instead of 'build and lease'.

Value for Money - Venturing into Low Cost Housing Projects

DLF Ltd is planning to take up low cost home projects targeting middle income population of the country. In order to take up this project it has suspended the capital intensive projects (express highways, airports etc) as they are facing financial crisis due to GFM. DLF Ltd is also looking at the option of developing houses for low income category similar to the 'Nano Housing project' announced by Tata Group.

Effective Promotional Strategies ….

To dispose of unsold inventory of houses under Garden city project in Chennai, the DLF Ltd has introduced four price slabs, three for 'old customers'(Customer who have paid advances / installment but couldn't allotted homes) and one for 'new customers'(those who planning to purchase house). The company is offering discount of Rs.300 per sq ft to customers who had booked apartments for Rs.2800 per sq ft on the launch of project. Those who booked at Rs.3000 per sq ft last year are offered a discount of Rs.450 per sq ft and those who booked for Rs.3200 per sq ft between August 2008 and February 2009 offered a discount of Rs.600 per sq ft.

The new customers were offered the apartments at discounted rate of Rs.2650 per sq ft. This discount offer has ensured a minimum savings to home buyers on the smallest apartments with 1200 sq ft works out to Rs.3.60 lakhs. The maximum benefit for the largest apartments with 2100 sq ft works out to be 13.6 lakhs. Further, the company has also announced that it will not collect any interest on delayed payment from existing customers.

Selling Non-core Assets…..

As DLF ltd is carrying burden of debt amounting to Rs.13955 crore. The company decided to sell its non core assets (hotel plots). DLF has a number of hotel plots located in Mumbai, Kolkata, Bangalore, Gurgaon, Baroda, Lucknow, Kasauli (Himachal Pradesh) and Sikkim. DLF had planned to raise Rs.10000 crore by selling land parcels, hotel plots, wind power business and treasury investments in the next 2-3 years according to executive director Y.K.Tyagi. This move is expected to reduce their debt burden.

Assets Monetization …..Making Money on Unprofitable Assets

Many a times companies facing pressures on profitability and are in dire need of capital are forced to monetize both core and non-core assets.

This becomes very significant at the time when the real estates properties are undervalued and when the economy is in severe crisis (as today) making raising capital from the market is quite difficult. To overcome from this problem the DLF Ltd has opted to Asset monetization. This helps in capital redeployment, reducing debt burden, improving financial ratios, eliminating real estate risk etc.

Focus on Value-Engineering

DLF Ltd has taken several cost cutting measures to improve its margins at the time of the global economic turmoil. It has adopted value-engineering techniques right from the preparation of designs to the completion of the project focusing every minute item of cost such as glass, tiles etc.

To reduce the cost of their projects DLF ltd is sourcing raw materials (such as cement and steel) from various low cost destinations across the globe. According to company source, the sourcing from low cost destination has helped them in saving cost on steel by 8-10 percent and cement becoming cheaper by 4-5 percent. In order to cut down costs, the company is also focusing on changing designs, improving material and planning efficiency in project implementation.

Findings

- The DLF Ltd has also restructured its short term as well as long term loans to over come from fund crunch. In order to overcome from the liquidity crunch, the promoters have offloaded their stake to the extent of 10 percent.
- To manage the downturn in a better way, the company has revamped its business strategy. It has adopted a strategy called as ‘build and sell’ instead of ‘build and lease’.
- DLF Ltd is also looking at the option of developing houses for low income category similar to the ‘Nano Housing project’ announced by Tata Group.
- To dispose of unsold inventory of houses, the company is offering discount to both customers who have already booked the apartments as well as to new customers. Under Garden city project in Chennai, the DLF Ltd has introduced four price slabs, three for old customers and one for new customers. The company has deferred its decision of collecting interest on delayed payment from existing customers.
- The company decided to sell its non core assets (hotel plots). DLF has a number of hotel plots located in Mumbai, Kolkata, Bangalore, Gurgaon, Baroda, Lucknow, Kasauli (Himachal Pradesh) and Sikkim.
- DLF Ltd has resorted to Asset monetization. This is suppose to helps in capital redeployment, reducing debt burden, improving financial ratios, eliminating real estate risk etc.
- DLF Ltd has taken cost cutting measures to improve its margins. It has adopted value-engineering techniques. To reduce the cost of their projects DLF is sourcing raw materials (such as cement and steel) from various low cost destinations across the globe.

Suggestions

- The company has planned to develop affordable homes for the middle class population of the country. While developing such houses the quality shouldn’t be compromised. This strategy will help the company to attract new customers and build its customers base in the long run.
- The DLF Ltd should look at possibility of tying up with banks to take care of home loans along with issue of application till allotment of house to be handled by banks (similar to the Tata Nano car).
- DLF Ltd can think of setting up house maintenance wing to solve customers’ problems relating to repair, maintenance, electricity, water, house-keeping etc. This will be an excellent customer relationship initiative which may send positive word of mouth for potential buyer.

The real estate companies in India have faced the burnt of GFM. As panic set in due to falling demand for house property some of the companies’ resorted to uncalled for practices such as lay-off, suspension of capital intensive projects etc. resulting into job losses. However some companies such as DLF Ltd were bold enough to withstand the pressure of GFM and adopted better management practices to mitigate impact of GFM. The focus of real estate companies has shifted from large products like big office buildings to affordable projects. They are offloading housing inventory at lower prices, arranging finance through private investors, holding back or delaying new launches etc. According to DLF Chairman K.P. Singh “innovation and its sheer size have come to DLF’s rescue.” The real estate sector can plays vital role in the economic recovery. The government of India should take suitable measures to boost the growth of this sector.

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