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Real Estate: The unwind and its side effects

We are seeing a broad-based real estate pullback, with prices correcting in most tier-1 and tier-2 cities alongside sharp drops in transaction and new launch volumes. The drivers for this slowdown are a mix of supply-side factors (banks have pulled back lending to developers) and demand-side factors (the Black Money Bill has created fear amongst speculators). The result is not just a drop in demand for building materials and challenges for lenders with big mortgage, LAP and housing finance books, but also a generalised slowdown in GDP growth, as the sector which drives 50% of India's capex and 30% of its jobs conks off. Our four large-cap SELLs on this real estate correction are Ultratech, Asian Paints, ICICI and HUL.

A broad-based real estate slowdown

Whilst the RBI's Housing Price Index suggests that prices have moderated on a pan-India basis, data from property websites suggests a deeper slowdown in India's large cities, with prices falling by 7-18% YoY. Alongside this, we are also seeing a significant drop in transaction volumes: our visits to five property registration offices in Mumbai suggest a sharp drop in the registration of new residential properties and data from property valuers in Maharashtra and Tamilnadu suggest that transaction volumes have fallen by 10-15% per annum for three consecutive years now. Also, new launch volumes are down 40-80% on a pan-India level (see Exhibit A).

Combination of supply-side and demand-side factors trigger the slide

Supply side: (a) RBI data suggests that the banking system seems to have turned the tap off for property developers over the past year. This has in turn made developers either stop construction or cut prices. **(b)** The NDA has cut subsidies sharply (down 9% in FY16) and is shifting subsidies to Direct Benefit Transfer. As a result, the ability of the politician-and-builder to pilfer subsidies to fund real estate construction has been checked. **(c)** The knowledge that there is many years' worth of unsold real estate inventory in most of India's tier-1 and tier-2 cities is causing investors to hold back further purchases.

Demand side: (a) The draconian Black Money Bill went live on 1st July and has made HNW families reluctant to invest in Real Estate. **(b)** The 8% point gap between the gross rental yield and bank base rate highlights the unattractiveness of real estate for investors. **(c)** Key state governments (Maharashtra, West Bengal, Delhi) have hiked "ready reckoner" rates sharply this year and thus prevented prices from dropping to a market clearing level.

Investment implications

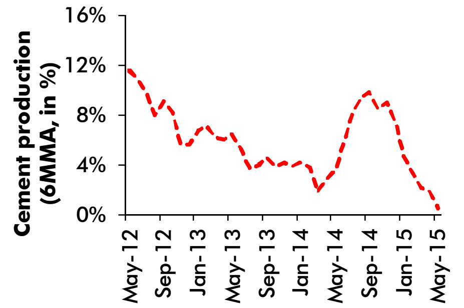
Real estate accounts for half of India's capital formation and 30% of its job creation. With the sector on the slide, GDP growth is under pressure, directly, because of the drop in investment, and, indirectly, through pressure on wages. We reiterate our FY16 GDP growth forecast of 7% (vs consensus' 7.8%). Beyond real estate itself, the sectors most impacted are: **(a)** Cement – we expect YoY volumes to remain flat in 1Q; **(b)** Paints – we expect weak volume growth of 3-4% again in 1Q; and **(c)** Lenders – 15% of the banking systems' assets are directly exposed to real estate and the experience of other Asian economies suggests that once property prices start falling, NPAs have a tendency to more than double from their pre-stress levels. Our key large cap SELLs on this theme are: Ultratech, Asian Paints, HUL and ICICI Bank.

Exhibit A: New launches in the real estate sector have dropped significantly in CY15

	New property launches (in '000s)			
Period	NCR	Mumbai	Pune	Kolkata
Jan-Mar'12	24	41	22	5
Jan-Mar'13	27	31	16	6
Jan-Mar'14	20	22	13	5
Jan-Mar'15*	4	9	2	3

Source: *Propequity, Ambit Capital research. Note NCR stands for National Capital Region. *Excludes March'15*

Exhibit B: Cement production growth has fallen to an all-time low in recent months



Source: *CEIC, Ambit Capital research*

Exhibit C: The four large-cap SELLs on the back of the unwinding in real estate prices

Stock	Ticker	Mcap (USD bn)	Stance
HUL	HUVR IN	30.7	SELL
ICICI	ICICIBC IN	28.7	SELL
Asian Paints	APNT IN	12.0	SELL
Ultratech	UTCEM IN	13.5	SELL

Source: *Bloomberg, Ambit Capital research*

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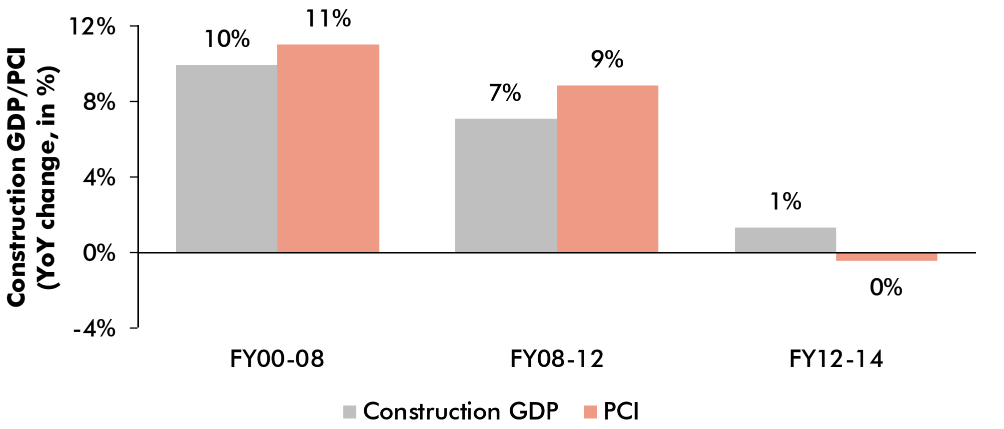
The real estate sector finally unravels

The construction sector in India saw an unprecedented boom over FY02-08, due to a surge in GDP growth and hence per capita income. The construction sector grew at an average rate of 8.75% YoY over FY02-10 vs an average of 3.41% over FY93-01 (see the exhibit below). Due to this rapid growth over FY02-10, the construction sector became the largest employment creator in India. As per the NSSO, employment in the construction sector grew by 59% over FY2000-10.

The construction sector in India saw an unprecedented boom over FY02-08 as GDP growth and hence per capita income surged

Exhibit 1: Real estate prices rose due to higher construction sector growth coupled with higher per capita income (PCI)

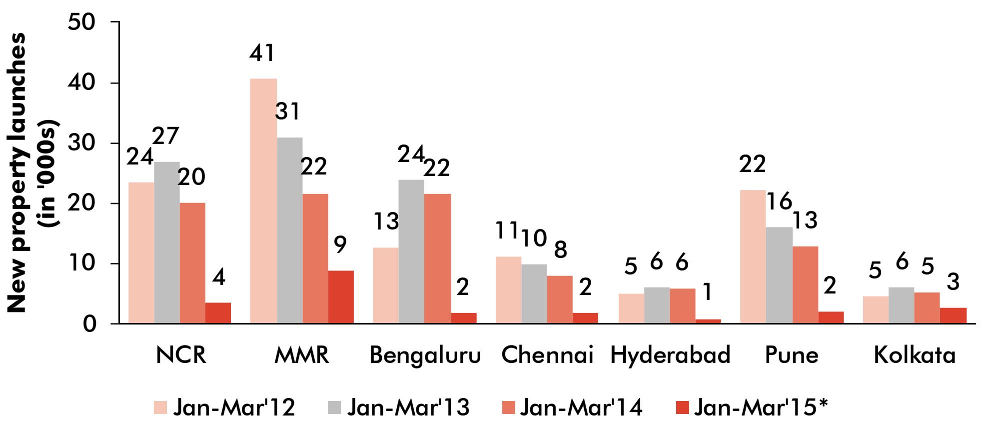


Source: CEIC, Ambit Capital research

However, since FY13, the real estate sector has slowed down considerably. This is evident through not only from a slowdown in construction activity but also from the growth rate of jobs in the construction sector. Construction sector jobs grew by only 13% CAGR over FY10-12 vs 73% CAGR over FY05-10.

However, since FY13, the real estate sector has slowed down considerably

Exhibit 2: New launches have dropped by 40-80% YoY in Jan-Feb 2015

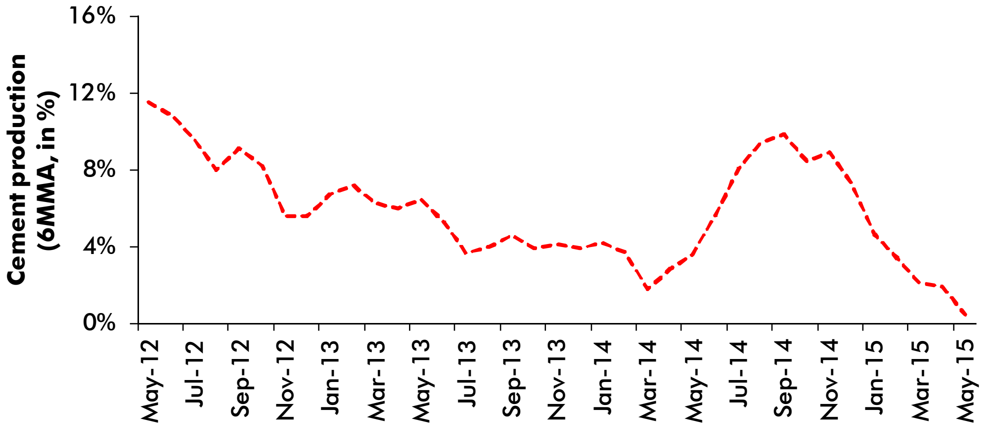


*Source: Prop Equity, Mint and Ambit Capital research. * This excludes March 2015*

The slowdown in the construction sector is not only visible through the drop in new launches but also through a sharp decline in cement production on a pan-India basis. Data released by the Office of the Economic Adviser, the Ministry of Finance, suggests that cement production has dropped significantly in recent months (see the exhibit below).

The slowdown in the construction sector is not only visible through the drop in new launches but also through a sharp decline in cement production

Exhibit 3: The six-month moving average (MMA) for cement production dropped to 0% in May 2015

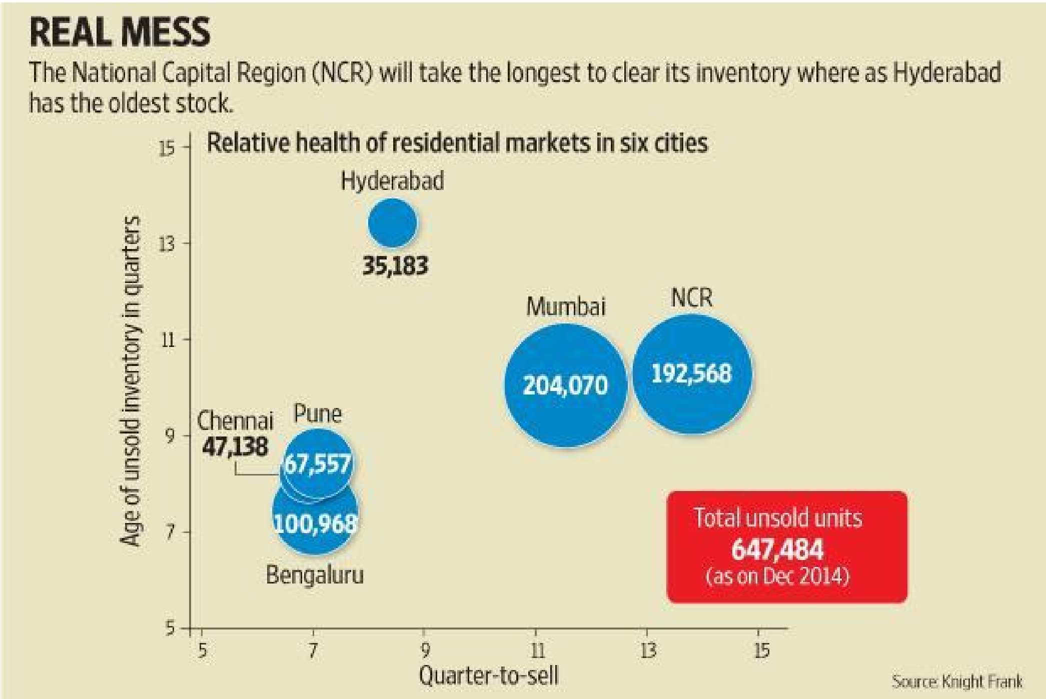


Source: Office of the Economic Advisor, Ministry of Finance, Ambit Capital research

With sluggish demand, not only have new launches fallen (see the exhibit above), but real estate inventory has also started piling up in major cities across India (see the exhibit below). Data from property research houses suggest that regions like Mumbai and Delhi would take as much as 11-14 quarters to clear the existing inventory (see the exhibit below). Real estate brokers say that the time taken to clear the inventories in a healthy real estate market should be around 4-6 quarters.

With demand being sluggish, not only have new launches fallen, but real estate inventory has also started piling up

Exhibit 4: Experts suggest that sluggish demand has led to piling up of real estate inventory which will take at least 11-14 quarters to clear



Source: Knight Frank (as shown in the January 28 issue of the Mint: http://www.livemint.com/Money/xz8jxXEDlyi4qPeheHchWI/Real-estate-inventory-piles-up-across-6-cities.html)

Just as importantly, transaction volumes in the real estate sector seem to have fallen sharply. We used two approaches to get a fix on this dynamic:

Transaction volumes in the real estate sector seem to have fallen sharply

- We visited five property registration offices in Mumbai (Vikhroli, Chembur, Prabhadevi, Andheri and Jogeshwari) on weekday mornings only to find them wearing a deserted look. Discussions with the staff manning these offices suggest that the whilst the people coming in for rental agreements has remained the same over the past year, the number of people coming to buy/sell property has dropped sharply over the past 2-3 months and so has the launch of new residential properties (see the exhibit below). Executives working for lenders have made the same point to us.

- We sought data from property valuers who operate in Maharashtra and Tamil Nadu. The data given by them is shown in the tables below and suggests that in each of the last three years, transaction volumes have corrected by 10-15%.

Exhibit 5: Transaction in property has declined in Maharashtra in recent years…

	Transaction values (in Rs. Billion)	YoY change (in %)
FY12	145	
FY13	134	-8%
FY14	120	-10%
FY15 (est.)	108	-10%

Source: Property valuers' networks, Maharashtra. Note FY15 data is an estimate from valuers

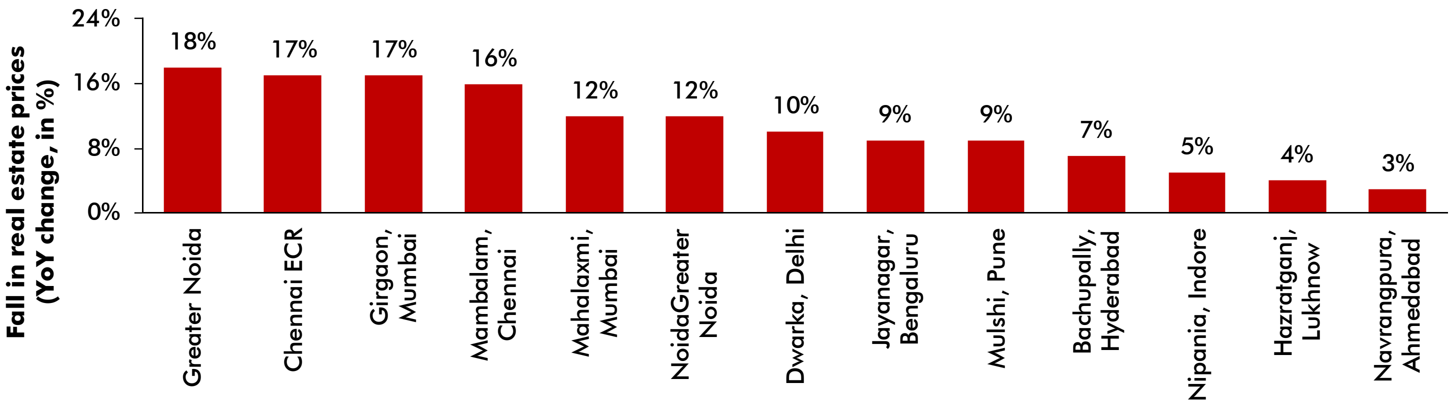
Exhibit 6: … and so has been the case in Tamil Nadu

	Transaction volumes (in millions of units)	YoY change (in %)
FY12	3.5	
FY13	3.1	-12%
FY14	2.7	-14%
FY15 (est.)	0.2	-10%

Source: Property valuers' networks, Tamil Nadu. Note FY15 data is an estimate from valuers

Finally, alongside the drop in transactions volumes, we are also seeing real estate prices correcting. In Delhi, our meetings with businessmen who live in south Delhi suggest that prices in this prime part of Delhi are down 20-25% over the past year and transaction volumes have fallen sharply. In the smaller cities, the situation seems to be worse, with our contacts in Jaipur, Rajkot and Lucknow also pointing to a 15-20% YoY correction and sellers saying that it is hard to receive bids for properties that they have put up for sale.

Exhibit 7: Real estate prices have fallen both in Tier I and Tier II cities

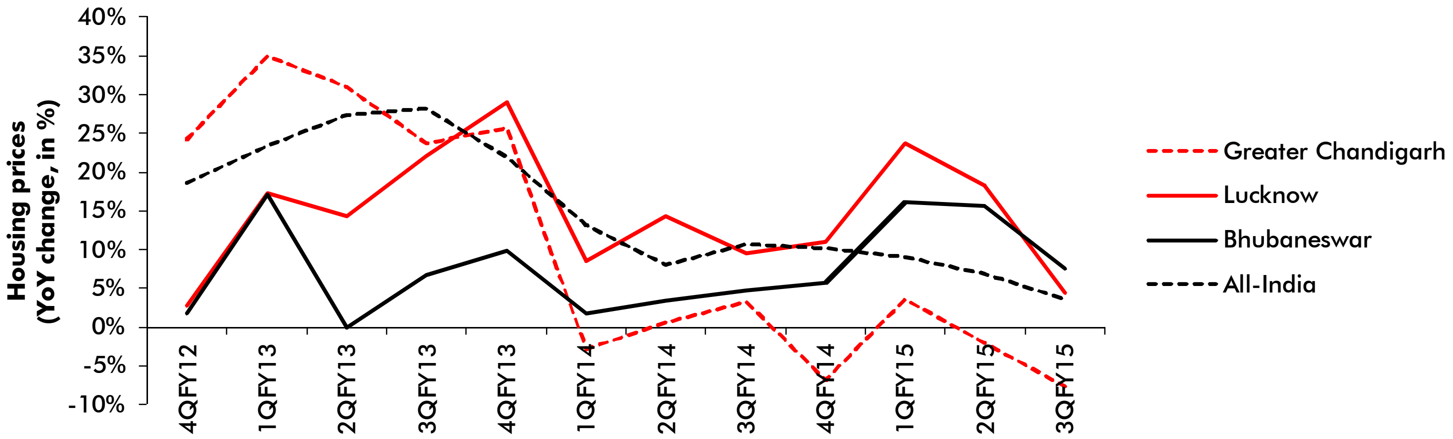


Source: PropTiger, magic bricks and 99 acres, Ambit Capital research. Note: The YoY fall in prices is from April 2014- to April 2015.

In our discussions regarding the real estate market with clients, we have often heard from clients that the property price correction is simply restricted to the big cities whilst the smaller cities are in better shape. This is not true. Data from the RBI (which is available only till 3QFY15) suggests that property prices in tier-2 cities (e.g. Lucknow, Bhubaneswar and Chandigarh) have also moderated in the past few quarters - see the exhibit below which is based on data from the RBI).

Property prices in tier-2 cities have also moderated in the past few quarters

Exhibit 8: Housing prices in tier-2 cities have also come off recently



Source: RBI, Ambit Capital research

Takeaways from our discussions with real estate brokers and Government officials in property registration offices

Our discussions with pan-India real estate brokers and officials in property registration offices regarding the price and volume corrections underway suggest that:

- **Real estate inventory is at its peak:** Real estate inventory is at its peak in NCR (14-16 quarters to sell), largely in the mainstream markets such as Delhi, Gurgaon and Noida, wherein launches have reduced significantly. The situation in Tier 1 and Tier 2 cities is similar.

Real estate inventory is at its peak in NCR (14-16 quarters to sell)

- **Land prices have stagnated/reduced:** Over the past 18 months, land prices have stagnated or reduced due to the following reasons: (a) land transactions in primary real estate markets have dried up; and (b) developers fund land purchase from debt, and given the extremely low demand, they do not want to an interest burden right now.

  With land acquisition in rural India having come to a standstill over the past 18 months (probably due the Land Acquisition Bill that was passed on September 4, 2013), a powerful mode of wealth generation has been stopped in its tracks. As land prices have stagnated in rural India over the past 12 months, the "wealth effect" that rising land prices had created over the past decade seems to have ebbed away.

Over the past 18 months, land prices have stagnated or reduced

- **Footfalls at property registration offices have fallen sharply:** Between mid-June and mid-July, we visited five property registration offices in Mumbai (Vikhroli, Chembur, Prabhadevi, Andheri and Jogeshwari). The Government officials in these offices told us that whilst people coming in for rental agreements is the same as last year, the people coming in to buy/sell apartments have dropped significantly in recent months.

Government officials in property registration offices told us that people coming in to buy/sell apartments have dropped significantly in recent months

- **Further price correction is inevitable:** Whilst stated prices (prices which the real estate agents quote) remain elevated, transaction prices have already fallen by 10-15%, and real estate brokers are saying that a further correction is a must for inventory liquidation. Discounts have increased significantly in the secondary transactions market and distressed real estate liquidation by lenders (who have not been repaid by developers) is becoming increasingly common.

What has triggered this sharp slide?

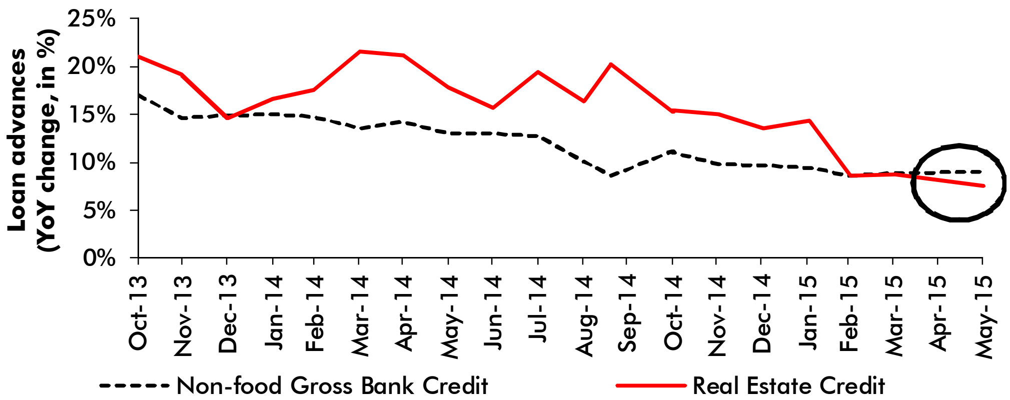
Nobody that we have met in our travels across India over the past month can quite nail down precisely why real estate prices are going backwards and why transaction volumes have dropped off so sharply. However, basis our discussions, we believe that a mixture of factors – three on the supply-side and three on the demand-side – have driven the price and volume correction.

The three **supply-side factors** responsible for the fall in real estate prices are:

- **Lending squeeze by banks to commercial real estate:** Lending by banks to commercial real estate has grown by just 7.5% during the course of one year ending 29 May 2015. This is slower than the overall lending by banks at 8.5%. Usually in India, lending to real estate grows much faster than overall bank credit growth (see the exhibit below).

Lending by banks to commercial real estate has grown by just 7.5% during the course of one year ending 29 May 2015

Exhibit 9: Gross non-food credit in April-May 2015 grew faster than the growth rate of loans to the real estate sector for the first time in two years



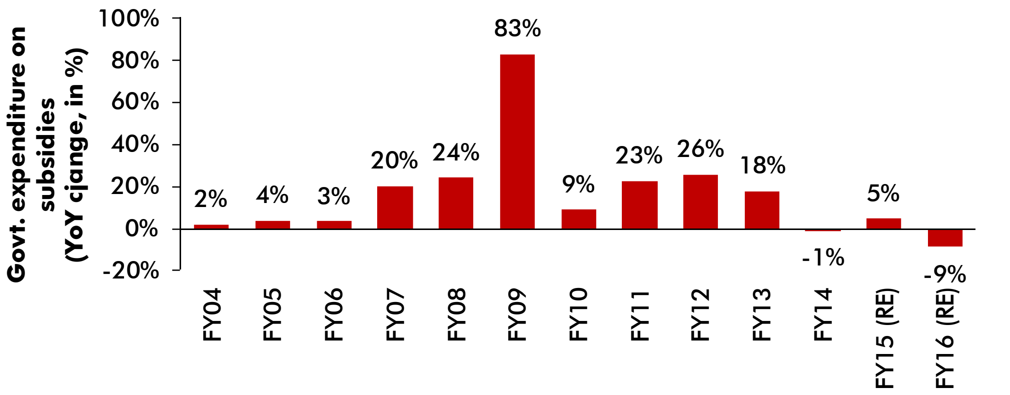
Source: RBI, Ambit Capital research

This suggests that the banking sector seems to have cut off the funding tap for developers. That is not only resulting in new launches dropping off, but it is also creating a funding squeeze for developers, which is making them more pre-disposed to cutting prices.

- **Squeeze on subsidies:** Subsidies under the UPA regime grew at a staggering CAGR of 19% per annum from FY04-14. A substantial portion of these subsidies (30-50%) was pilfered by the political class and used by them to fund investment in gold and real estate. The NDA has cut subsidies sharply (down 9% in FY16) and is shifting subsidies to Direct Benefit Transfer (DBT); at least 10% of the overall subsidies have already been moved to the DBT. As a result, the ability of the politician-and-builder to pilfer subsidies to fund real estate construction has been checked (see the exhibit below).

The NDA has cut subsidies sharply (down 9% in FY16) and is shifting subsidies to Direct Benefit Transfer (DBT)

Exhibit 10: Spending on subsidies is budgeted to contract at 9% YoY in FY16



Source: Union Government budget documents, Ambit Capital research

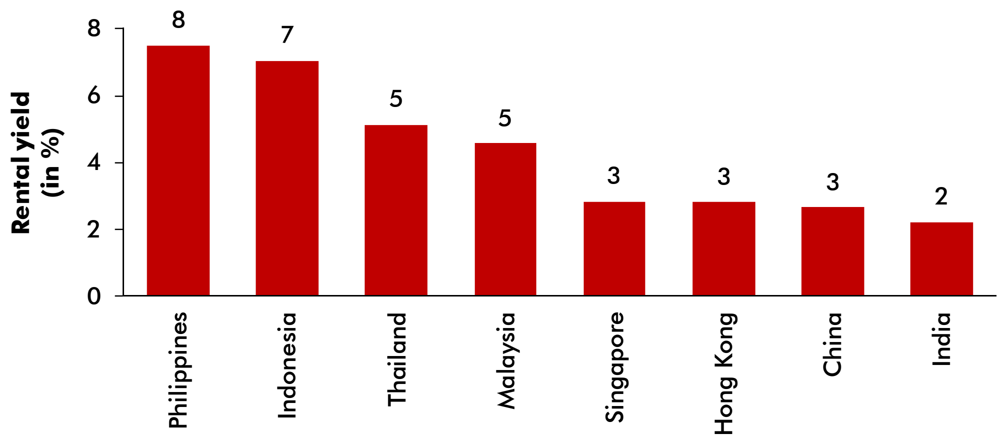
- **Rising inventories:** The knowledge that there is many years' worth of unsold real estate inventory (see the exhibit on page 3) in most of India's tier-1 and tier-2 cities is causing investors to hold back their purchases. Data from property research houses suggest that regions like Mumbai and Delhi would take as much as 11-14 quarters to clear the inventory (see the exhibit below). Real estate brokers say that the time taken to clear the inventories in a healthy real estate market should be around 4-6 quarters.

The three **demand-side** drivers for the correction in real estate prices appear to be:

- **Affordability:** Rental yields in property markets in India have remained extremely low as compared to its other Asian peers (see the exhibit below), thereby pointing to the over-valuation of this asset class mainly because it can absorb black money.

Rental yields in property markets in India have remained extremely low.

Exhibit 11: Rental yields in India are extremely low relative to peers

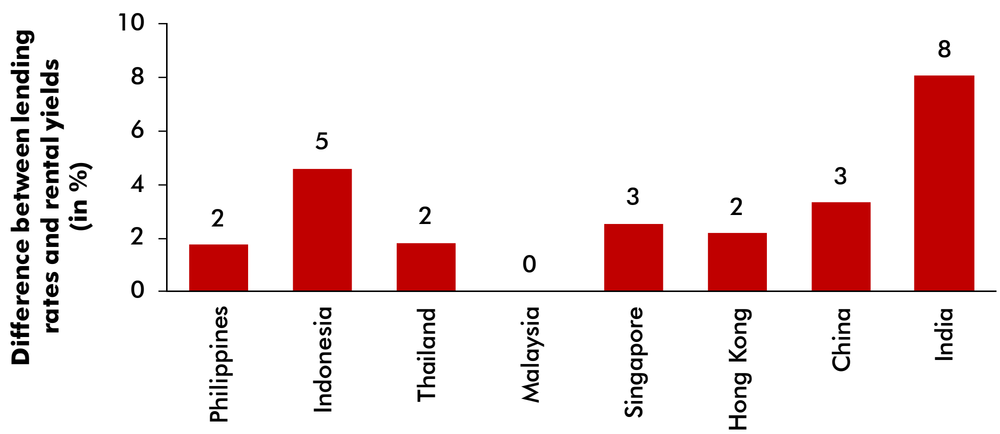


Source: Global property guide, Ambit Capital research.

In a fairly-priced real estate market, the rental yield tends to be somewhere close to the cost of borrowing. Instead, Mumbai has a rental yield of close to 2% (this is gross of tax and maintenance charges) whilst the lending rate hovers around 10%. The difference between lending rates and rental yields is one of the highest in India (see the exhibit on the next page). Even if one assumes that buyers are willing to live with only 5% rental yields (as they might have an extremely bullish view of capital gains arising from real estate in India), this would imply halving of real estate prices in Mumbai.

In a fairly-priced real estate market, the rental yield has to be somewhere close to the cost of borrowing

Exhibit 12: Difference between rental yields and lending rates is one of the highest in Asia



Source: World Bank, Global property guide, Ambit Capital research.

Another way to gauge affordability is to look at the house price: income ratio. A study done by the RBI suggests that the median house price to income ratio has increased in recent quarters up to 3QFY15, indicating reduced affordability (see the exhibit below). This unaffordability in turn could be a reason for the inventory pile-up seen in recent quarters.

The median house price to income ratio has increased in recent quarters

Exhibit 13: Affordability of real estate has decreased recently

Source: RBI, Ambit Capital research

- **Squeeze on black money:** Whilst official figures are not available that quantify the size of the black money percolating through the real estate sector, research suggests that more than 30% of India's real estate sector is funded by black money (see the exhibit below). Our channel checks suggest that individuals who are involved in real estate transactions for their personal needs in Mumbai are routinely asked for black money payments ranging from 10% to 30% of the transaction value.

More than 30% of India's real estate sector is funded by black money

Exhibit 14: Research suggests that more than 30% of India's real estate sector is funded by black money

Title	Key relevant finding	Source	Year
Weeding out black money from real estate: What government should do to make housing affordable	Even though no official figures are available, it is safe to assume that anywhere between 30% and 40% of real estate transactions — be it the purchase of land or an apartment in a metro — involve black money.	Pankaj Kapoor, MD, Liases Foras, a real estate research company	November 2014
India's parallel economy	Another big source of generation of black money is the real estate sector which has witnessed an unprecedented boom in the past ten years or so. In Delhi, the ratio of unaccounted value of real estate transactions to the total value is as high as 78%. The same ratio is 50% in Kolkata and Bangalore. In smaller towns and semi urban centres, nearly 100% of property transactions are conducted in cash.	National Institute of Public Finance and Policy	July 2014
An Empirical Study on the Transfer of Black Money from India: 1948-2008	Roughly 72.2% of the illicit assets comprising the underground economy is held abroad while illicit assets held domestically account for only 27.8% of the underground economy.	Economic and Political Weekly	April 2011

Source: Various, Ambit Capital research

The size of India's black economy expanded materially under the erstwhile Government and given that black money finds high acceptance in physical assets such as real estate, a large portion of these funds were presumably channelised into real estate. However, the NDA Government is engineering a clamp down on black money in India. The FY16 Union Budget explicitly aimed to disincentivise the black economy and curb the demand for physical assets. With the new Black Money Bill (which was passed by the Parliament on May 26) and with the Cabinet approving the Benami Transactions Bill in May this year, the crackdown on black money will continue further.

The NDA Government is engineering a clamp down on black money in India

In particular, the Black Money Bill, which was notified as a law on 1st July 2015, is a particularly draconian law, as: (1) It makes having undeclared assets overseas a criminal rather than a civil offence and provides for ten years of jail if proven guilty; (2) Once the Government serves a person an affidavit listing his/her undeclared assets overseas, the onus of proof shifts to the defendant to prove that he's not guilty; and (3) The act empowers the Government to seize the individual's domestic assets as well.

Our discussions with Chartered Accountants who advise some of the largest family offices in India suggest that there is real concern amongst ultra-High Net Worth investors with regards to the Black Money Bill. The Economic Times reports that 80K Indians have already applied for tax residentship in Dubai and Singapore to escape the clutches of this new law (http://goo.gl/6pO2GT). In fact, post the Income Tax Department publishing the rules on the implementation of the Black Money Bill in late June, there are reports that in several Indian HNW families, at least one member will seek citizenship abroad to escape the sanctions of this bill (http://goo.gl/ST9GLb).

The Benami Transactions Bill is likely to be passed in the Monsoon Session of Parliament which begins on 21st July. The Bill provides for attachment and confiscation of benami properties (properties registered in others' or fictitious names to hide ill-gotten wealth) and also a fine with imprisonment.

As the black money flow into the real estate sector dries up, sale and real estate transaction volumes seem likely to dry up further.

- **The rise in "ready reckoner" rates:** Starting January 2015, the Maharashtra State Government increased the ready reckoner rates (the price which is set by the State Governments and which becomes the floor price for property prices) by 15-20% in Mumbai, by 40% in the suburbs and on average by 15% across Maharashtra. Similarly, ready reckoner rates (circle rates) in Delhi were increased by 20% this January. Kolkata too went through a ready reckoner rate hike. Due to the rise in ready reckoner rates, demand for properties have been subdued, as builders cannot quote below the reference price stated by the Government and buyers are not ready to pay higher prices in an already subdued demand environment. The rise in ready reckoner rates will further act as a dampener to the already sluggish property demand.

Starting in January 2015, the Maharashtra State Government increased the ready reckoner rates by 15-20% in Mumbai

Macroeconomic implications

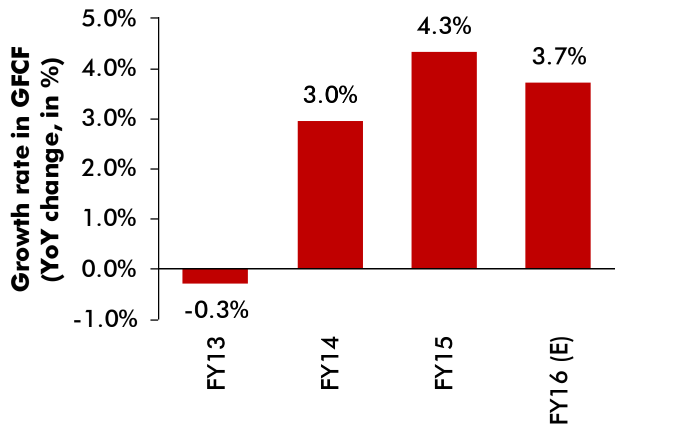
Direct impact on GDP growth

Real estate is, by a country mile, the biggest source of capital formation in India. Over the past decade, half of India's capital formation (i.e. investment) has come from this sector. Hence, the throttling of prices, volumes and new launches in this sector does not bode well for GDP growth in FY16.

Real estate is, by a country mile, the biggest source of capital formation in India

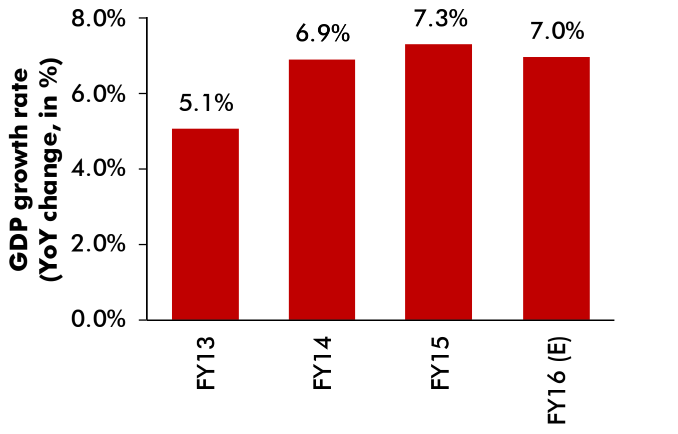
Our expectations based on statistical modelling and our travels around the country are that GDP growth in FY16 will be lower than in FY15. This will be due to lower investment growth in FY16. Specifically, we expect GDP growth in FY16 to be 7% YoY vs 7.3% YoY recorded in FY15. Note that the "consensus" expectation for FY16 GDP growth is 7.8% (for more details of our GDP estimates, click here for our note date 19 May).

Exhibit 15: We expect investment growth to be lower in FY16…



Source: CEIC, Ambit Capital research

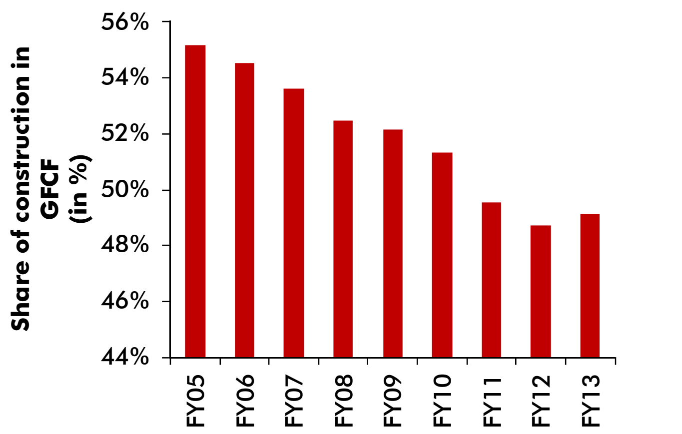
Exhibit 16: … resulting in lower GDP growth rate



Source: CEIC, Ambit Capital research

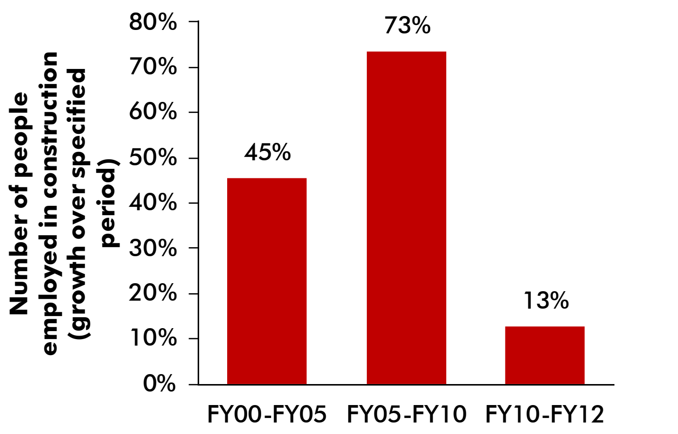
Impact on consumption through the impact on job creation and wages

Exhibit 17: Share of construction in GFCF has been falling rapidly in recent years…



Source: CEIC, Ambit Capital research

Exhibit 18: … which has resulted in slower employment generation in this sector



Source: NSSO, Ambit Capital research

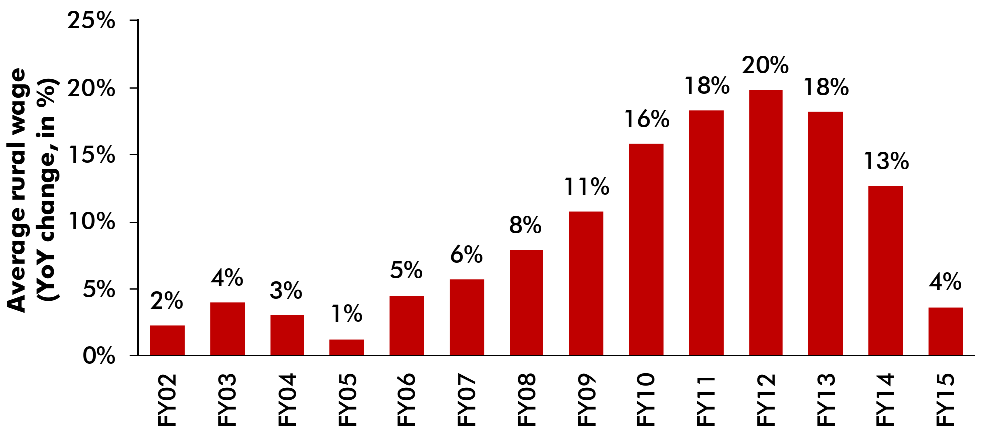
Real estate has been central to job creation and capex generation over the few past years. As per the NSSO, the biggest source of job creation in India over the past 10 years has been the construction sector (construction sector has contributed to roughly 30% of all the jobs created over the past decade). In this context, the mass layoffs on construction sites seem to be resulting in wage pressure in the blue-collar job market.

Real estate has been central to job creation over the past few years

India is facing unprecedented rural distress

Based on our discussions with civil servants in Delhi and in state capitals and based on our own trips to the interiors of the country, it would appear that India is facing unprecedented rural distress. The farmers' strained finances – driven by a combination of the fall in cash crop prices globally and low hikes in Minimum Support Prices two years in a row - mean that they are unable to employ rural labour. This, in combination with reverse migration from unemployed construction workers (casualties of a major slowdown in the urban construction sector), seems to have put downward pressure on rural wages, which might now be shrinking after having grown at their lowest rate in 10 years in FY15 (see the exhibit below). (For more details, *click here* for our 24th February 2015 thematic on rural India.)

Exhibit 19: Rural wages in FY15 grew at their slowest pace in the last decade



Source: RBI, Ambit Capital research

Investment implications

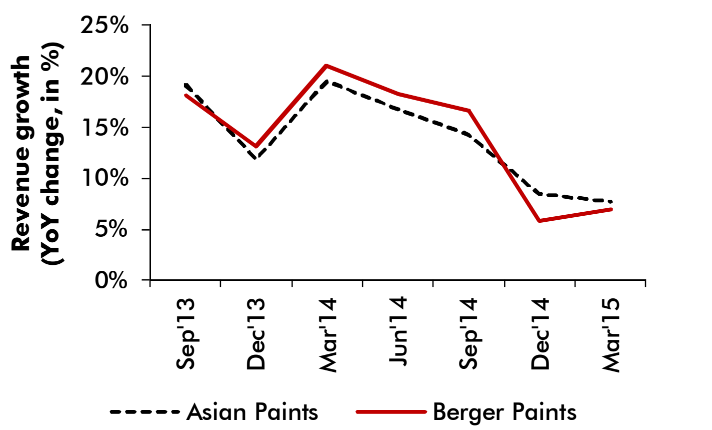
Homebuilding materials

The slowdown in construction activity has resulted in cement volumes declining in 4Q

The slowdown in construction activity has resulted in cement volumes declining in 4Q (Ultratech, ex-Jaypee, the largest player in the sector, reported a 9% drop in cement volumes in 4Q and ACC reported a 10% drop); also, revenues of paint companies have stagnated (Asian Paints and Berger Paints – companies which habitually report double-digit revenue growth – reported revenue growth of 6.9% and 7.7% respectively in 4Q; see the exhibit below). Given the outlook on real estate prices, an extension of this slowdown in construction activity and hence a demand slowdown for cement, paints and electricals appears to be on the cards in FY16.

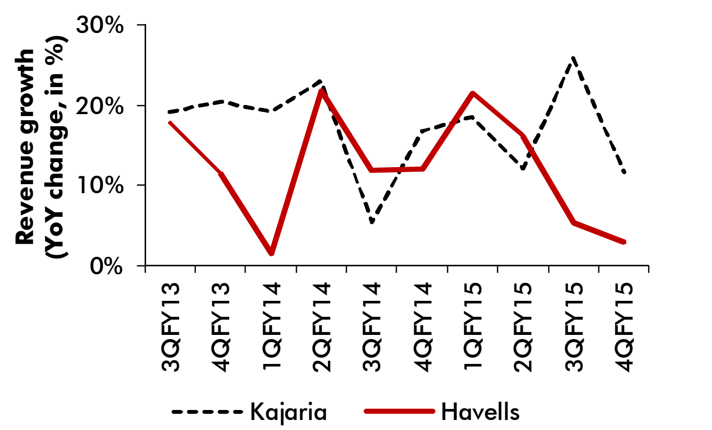
This view was also echoed during our one-day conference on building materials with channel partners on 24 June 2015. The key takeaway was that volume growth in almost every single category in 1QFY16 will be weak or negative. Moreover, nothing that we heard suggested that the demand situation in 1Q is any better than it was in 4Q. Alongside demand weakness, we continue to see working capital cycles being stretched in paints and pipes (click here for the takeaways from that conference.)

Exhibit 20: Paints companies saw a decline in revenue growth in the last few quarters...



Source: Bloomberg, Ambit Capital research

Exhibit 21: ...and so did other companies in the real estate supply chain



Source: Bloomberg, Ambit Capital research.

Our highest conviction large-cap SELLs in the building materials sector are:

UltraTech's poor capital discipline in pursuance of expansions will keep RoCEs suppressed for the next 2-3 years

UltraTech Cement (UTCEM IN, mcap US$13.5bn, SELL, TP Rs2,337, 25% downside): UltraTech is viewed as a proxy play to the cement demand recovery in India, as it is the only pan-India player which has the scale, surplus capacity and exposure to the institutional segment. Prima facie, this appears to be a reasonable assumption, but even if all of these were to work in the company's favour, UltraTech's poor capital discipline in pursuance of expansions will keep RoCEs suppressed for the next 2-3 years (at 11-14%, with no major improvement over the last five years and significantly lower than the peak RoCEs of 23-24% in FY07-10). Despite continued expansions, UltraTech's volume growth (at 4%) has lagged the industry average and its regional peers for the last three years (10%/8% for Shree/Orient). Despite focusing on improving the fuel mix, new capacities and network expansion, its unitary costs are one of the highest in the industry, and more importantly the highest amongst large players. Its FY09-14 cross-cycle EBITDA average of Rs1,060/tonne was similar to large peers' average and lower than Shree's.

Consensus' lofty EBITDA growth expectation (30% CAGR over FY15-17; our EBITDA estimates are 7%/10% lower than consensus in FY16/FY17) will need to be moderated to account for on-ground realities (i.e., prolonged demand recovery and volatile pricing in seasonally strong months).

The stock is trading at 13.8x one-year EBITDA (a 40% premium to its last five-year average). We see little merit in paying rich multiples (to play an elusive demand recovery) for a company with low cost efficiency, poor capital discipline (and hence sub-15% RoCEs for the next three years) and high likelihood of earnings cuts.

Asian Paints (APNT IN, mcap US$12bn, SELL, TP Rs717, 10% downside): We expect Asian Paints to leverage on its moats around an efficient and well-entrenched distribution network. This will enable Asian Paints to gain ~100bps of market share each year, especially from Kansai and Akzo in the 'Decorative Paints' segment, and hence deliver a revenue/EPS CAGR of 17%/23% over FY15-18E. However, we believe that the current valuations of 44x/36x FY16/FY17 earnings more than adequately factor in these longer-term strengths of the business. Our earnings forecasts are 5-6% lower than consensus for both FY16 and FY17. We expect downgrades to consensus forecasts over the next 3-6 months due to a combination of the following factors:

We believe that Asian Paints' current valuations of 44x/36x FY16/FY17 earnings more than adequately factor in these longer-term strengths of the business

(a) Input cost benefits from a fall in crude oil prices (which resulted in consensus earnings upgrades for Asian Paints during January 2015) are likely to be materially offset by price cuts/ increased dealer discounts/ higher promotions amidst high competitive intensity and high price elasticity of demand. After Asian Paints benefited from crude price declines and excise duty benefits in FY09, which resulted in a more than 700bps YoY expansion in quarterly EBITDA margins, these benefits were fully offset by eight consecutive price cuts in the subsequent quarters. Also, management commentary and pricing action taken over the past six months clearly suggests that the >300bps gross margin expansion that the firm reported in 4QFY15 is NOT sustainable.

(b) Weakness in consumer sentiment has resulted in elongation in the time taken to repaint, and hence we do NOT expect revenue growth of more than 6-8% YoY for the firm during 1HFY16. This macro demand weakness is further exacerbated by few near-term supply chain issues due to a shutdown of one of its manufacturing plants in south India.

Moreover, capital misallocation risks limit the visibility of its longer-term cash generation at the consolidated level. Our DCF-based valuation model generates a fair value of Rs717, implying a downside of 10%. We reiterate SELL.

FMCG

As rural incime growth stays under the hammer, partly due to the layoffs in the urban construction sector, this is likely to compress rural consumption. Our Consumer team's 1QFY16 distributor and dealer survey (*click here* for the survey) highlights the extent of the weakness in this regard:

As rural wage growth stays under the hammer this is likely to compress rural consumption

- Overall consumer purchase behaviour in 1QFY16 was just as weak as in 4QFY15, with no incremental moderation in demand.
- Channel partners in most categories expect the festive season to be the only positive catalyst, especially for urban demand.
- Demand for paints and jewellery has remained exceptionally weak.
- The benefits of softening input costs continue to be passed on to customers through price cuts and/or incremental promotions in paints and FMCG.

Our strongest large-cap SELL in this sector is:

Hindustan Unilever (HUVR IN, mcap US$30.7bn, SELL, TP Rs740, 18% downside): Volume growth rates in consumer staples have moderated from 9-10% over FY08-12 to 5-6% over FY13-15E. HUL's sales CAGR has moderated from 14% over FY09-13 to 9% over FY13-15, as rural growth has moderated in the last two years. HUL's Soaps and Detergents portfolio (~50% of sales) is almost fully penetrated, and hence increased per capita consumption and premiumisation are the next growth drivers for this segment. With expectations of slowing rural growth and no signs of revival in urban growth yet, we expect growth for this segment to moderate to 10% CAGR over FY15-18 vs 12% CAGR over FY12-15. Also, this portfolio faces intense competitive pressure from organised and unorganised peers in

We expect growth for soaps & detergents to moderate to 10% CAGR over FY15-18 vs 12% CAGR over FY12-15 a soft input cost environment, and hence price-led growth for this part of the portfolio will be minimal-to-flat over the next two quarters at least. (Note that the company took 7-8% price cuts in S&D in December 2014).

Uncertainty around urban demand recovery should keep the demand for HUL's personal care products such as skin and hair care (~20% of sales) muted for the next 2-3 quarters. The company also faces high competitive intensity in oral care (5% of sales) from Colgate and in premium skin care categories from L'Oreal. Consequently, we expect HUL's overall volume growth rates to remain subdued (5-6% CAGR over FY15-18E).

Following the drop in crude oil prices, HUL saw a series of EPS upgrades, as consensus expected gross margin benefits of 300-400bps translating into equivalent EBITDA margin expansion. Whilst the 4QFY15 results showed that the company would need to step up A&P spends to drive volume growth in a weak macro environment, we expect this trend to continue over the next two quarters as well. Hence, we expect consensus EPS cuts following the 1QFY16 results and we find the current steep valuations, of 43.2x/37.3x FY16E/17E, unjustified. We expect sales/EPS CAGR of 12%/18% over FY15-18E and our TP of Rs740/share implies FY16E/17E P/E of 35.5x/30.7x.

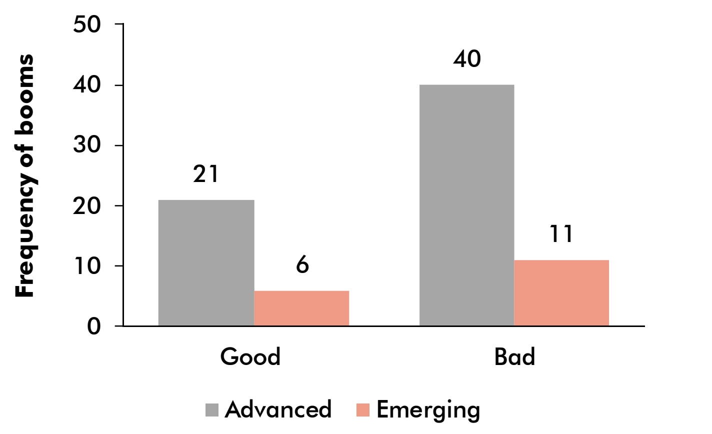
Banking and Financial services (BFSI) companies

A study done by the IMF suggests that out of 78 housing price booms in the past 40 years, 51 were "bad" (i.e. they ended up causing a recession) whilst only 27 were "good" (i.e. they did not end with a recession). Moreover, out of the 78 housing booms, as many as 47 were caused by private credit booms.

Out of the 78 housing booms, as many as 47 were caused by private credit booms

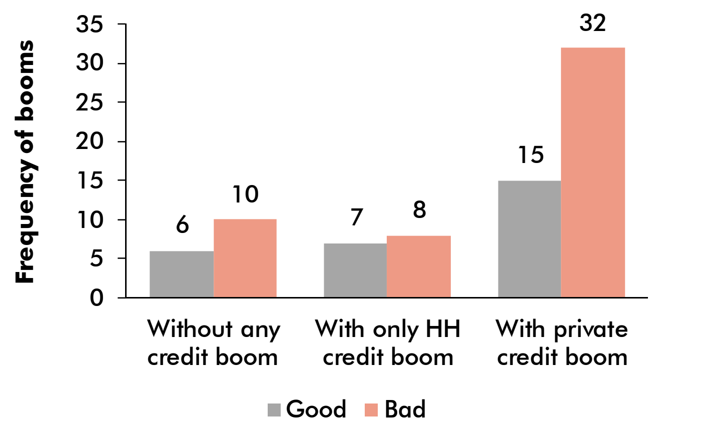
In this IMF study, a housing price boom is an event when the growth rate of house prices is greater than 5% or two standard deviations of the country-specific distribution of housing prices growth in a given quarter. Similarly, a credit boom is defined as an event when the growth rate of credits is greater than 10% or two standard deviations of the country-specific distribution of credit growth in a given quarter.

Exhibit 22: 65% of housing booms have ended up in a recession…



Source: IMF, Ambit Capital research

Exhibit 23: … caused majorly by private credit boom



Source: IMF, Ambit Capital research

The IMF study also concludes that most of these "bad" housing booms (close to 65%) also resulted in banking system crises. So how vulnerable is the Indian financial system to a prolonged real estate correction?

Majority of these "bad" housing booms (close to 65%) also resulted in banking system crises

The exposure of banks to home loans/LAP is currently at 10% of their aggregate loan book, with loans to developers accounting for another 3% of their loan book. Moreover, their exposure to Housing Finance Companies (HFCs) account for another 2% of their loan book. Overall banks' combined direct exposure to home loans/developers/housing finance companies amounts to US$142bn, which is 15% of their total loan book. Note: this figure does not include working capital loans given to SMEs with real estate as collateral.

Separately, housing finance companies (HFCs) have a total exposure of ~US$68bn to the real estate sector, out of which ~US$54bn is towards home loans, ~US$5bn is towards LAP and the remaining ~US$9bn is towards developer loans.

Exhibit 24: Exposure of lenders to home loans, LAP, developer loans and HFCs

Particulars	US$ bn	As a % of non-food credit
Exposure of banks to real estate	**~142**	**15%**
Housing loans	~98	10%
Developer loans	~26	3%
Loans to HFCs	~18	2%
Exposure of HFCs to real estate	**~68**	
Housing Loans	~54	80%
LAP	~5	7%
Developer Loans	~9	13%

Source: Company, the RBI, Ambit Capital research

Over the last decade, the combined real estate portfolios of banks and NBFCs have increased at a CAGR of ~20%. A breakup of this growth between value and volume shows that two-thirds of this growth has been driven by increased ticket sizes (due to the continued increase in ticket sizes), and volume growth for the sector has been relatively modest at ~8-9% CAGR over the last 10 years. Hence, loan growth of HFCs/banks would be an obvious casualty if real estate prices correct (see the exhibits below to get a sense of Indian banks' exposure to real estate).

Over the last decade, the combined real estate portfolios of banks and NBFCs have increased at a CAGR of ~20%

Exhibit 25: Banks have real estate exposure at 7-37% of their total advances*

	Real estate exposure as % of advances		
Bank	**FY13**	**FY14**	**FY15**
HDFC Bank	13%	12%	13%
ICICI	33%	34%	37%
Axis	31%	35%	34%
IIB	9.4%	14.7%	NA
KMB	25%	24%	22%
SBI	17%	16%	17%
Bank of Baroda	9%	11%	11%
Bank of India	9%	10%	12%
Union Bank	12%	15%	15%
Punjab National Bank	17%	18%	17%
Federal Bank	18%	18%	21%
SIB	5%	6%	7%
KVB	8%	10%	11%
City Union Bank	10%	11%	NA
DCB Bank	17%	17%	18%

*Source: Annual reports of Banks, Ambit Capital research. Note: * In this table we have used banks' real estate exposure in the numerator and the total loan book in the denominator. However, this ignores the fact that the banks might have further off-balance-sheet real estate exposure.*

Rising real estate prices, we believe, helped the asset quality trends in the segment to some extent, as borrowers were able to refinance the loan (thanks to the extra "value" created by higher prices). Hence, asset quality could be another casualty of a real estate correction, given that asset quality in all kinds of real estate loans has been pristine over the last 4-5 years.

Asset quality could be another casualty of real estate correction given that asset quality in all kinds of real estate loans has been pristine over the last 4-5 years

Whilst we don't have data on Indian banks' asset quality experience in home loans when real estate prices declined in India between 1998 and 2003, global experience indicates that a sharp slowdown in real estate prices almost always leads to spikes in the non-performing loans of the lenders. As seen in the exhibit below, 2-3 years into the slowdown, NPAs have a tendency to more than double from their pre-stress levels, as delinquencies rise in loans linked to real estate prices, such as developer loans, loan against property and home loans.

Exhibit 26: Global experience of NPL impact from fall in real estate prices

Country	Period of crash	Real estate price correction	NPA movements
USA	2006-09	~30-40%	From ~2% in 2006 to ~5% in 2009
Japan	1991-99	~70-90%	From ~3% in 1992 to ~5% in 1995
SE Asia	1997-2000	~50-90%	NPLs ratios had doubled and even trebled for certain countries in the region over 1997-2000.

Source: Ambit Capital research

Moreover, our discussions with Chief Risk Officers in banks suggest that:

- Mortgage demand has dropped off (due to the factors discussed earlier in this note) over the past year. Thus, in a bid to keep their loan books growing, all lenders have turned to LAP.
- SMEs are struggling for working capital. Thus, they are happy to tap into LAP. As a result, LAP as a whole is growing by 25-30%.
- The PSU banks have become active LAP lenders, as they believe this is a low risk product (thanks to the underlying collateral). The entry of the PSUs (which are offering LAP loans at sub-11% rates) is pushing the other lenders to do riskier LAP lending. Some of the NBFCs and housing finance companies have started doing LAP (see the exhibit below) of Rs10-15 crores (US$1.5-2.5 million).
- It appears that the non-bank lenders are doing heavy refinancing of their current LAP loans to keep their books growing and their NPAs low. Thus, a significant part of the growth in the LAP books comes from lending even larger sums of money to the current borrowers – see table below.

Exhibit 27: Much of the growth in the loan book growth came from increasing the average ticket size

	CAGR			
	Loan	No. of Customers	Avg. Ticket size	Time period
HDFC	21%	14%	6%	FY12-15
LICHF	21%	10%	10%	FY12-15
GRUH	30%	16%	12%	FY12-15
REPCO	25%	9%	15%	FY12-15

Source: Company, Ambit Capital research

Exhibit 28: HFCs have significant exposure to LAP (FY15 end)

HFCs	AUM (Rs bn)	LAP (Rs bn)	LAP (as a % of AUM)
Indiabulls Housing	490	132	27%
Repco	60	11	19%
Dewan Housing	190	34	18%
CANFIN	34	4	13%
LIC Housing	674	32	5%
GRUH	87	4	4%
HDFC	1,840	75	4%

Source: Company, Ambit Capital research

- Lenders might be understating their true exposure to LAP by classifying some LAP as "agricultural loans".
- LTVs are going up sharply – from 45% 2 years ago, many lenders are now happy to do 75%. Unfortunately, the "V" in the LTV is a suspect figure for the reasons discussed earlier in this note (price and volume correction).
- The way to gauge stress in the product is through the following ratio: "Current NPAs / Loan Book 2 years ago" (rather than the ratio that the lenders show in their results which is "Current NPAs / Current loan book"). This is because if a lender grows his loan book by 30% per annum, his "Current NPAs/ Current loan book" ratio will look respectable.
- The "Current NPAs / Loan Bk 2 years ago" ratio for the system has risen from 2% a year ago to 3% now. Credit rating agencies are saying that they can see credit quality deterioration in the loan pools that they analyse.

- Almost all the lenders – banks and non-banks – rely on Direct Sales Agents to bring in customers. "This is a DSA-driven product" said one of our sources emphatically. The DSAs are obviously commission-driven; hence they have an incentive to churn the customer. Thus, when a customer gets into trouble with his installments (which tends to happens around 18-24 months into the life of the loan), the DSA churns the customer into a new lender.
- The most-competitive LAP markets are the big cities. Here the SME community is hungry for credit and the DSAs are super-active. In the smaller towns in the interiors of the states, the situation is less competitive and hence you can do sensible lending without having to stick your neck out on the risk front.
- Funding the LAP product is not a problem for lenders as the wholesale market has abundant liquidity.
- The most-prudent lenders in this space are Sundaram Finance and Repco

Amongst the large private sector banks, the most-exposed lender appears to be **ICICI Bank (ICICIBK IN mcap US$28.7bn, SELL, TP Rs280, 11% downside)**

ICICI Bank has 27-28% of its loan book exposed to the housing sector

ICICI Bank has 27-28% of its loan book exposed to the housing sector through mortgages, LAP and loans to housing finance companies. In FY15, ICICI Bank saw 39% of its opening book of restructured loans falling into NPAs and just 2% of loans successfully exiting restructured loans. Overall, cumulative failed restructuring of ~Rs58bn over FY12-15 was around 44% of total cumulative restructured loans over FY11-14. Thus, given that roughly half of the bank's current restructured loans were restructured in the last two years, a high share of loans have been coming out of their moratorium period and slipping into NPAs. We expect this trend to continue in the next 12-18 months. In FY16, we expect total credit costs of ~123bps, out of which ~30bps are likely to be on account of failed restructuring. We are SELLers on ICICI Bank, as we expect rising provisioning cost in FY16E to lead to RoAs declining by ~13bps and only 10% EPS CAGR over FY15-17E.

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BUY	>10%
SELL	≤10%
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24. Ambit and/or its associates have financial interest in ICICI Bank.

Analyst Certification

Each of the analysts identified in this report certifies, with respect to the companies or securities that the individual analyses, that (1) the views expressed in this report reflect his or her personal views about all of the subject companies and securities and (2) no part of his or her compensation was, is or will be directly or indirectly dependent on the specific recommendations or views expressed in this report.

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