Real estate unraveled

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The pejorative use of the term 'Washington Consensus' by the critics of globalisation notwithstanding, the debate between them and the protagonists of globalisation and liberalisation seems largely to have been settled in favour of the latter.

It has also been accepted, albeit a bit grudgingly, that the initial gains from opening up the economy are mostly cornered by the super rich and though everybody prospers, the already rich become richer much faster. Viewed from this perspective one should not grudge the sudden spurt in the valuations and bottom lines of real estate companies.

However, there does seem to be a disconnect between the actual gains cornered by real estate players and the rightful gains that should accrue to them in a liberalising economy. Surely, if a sector makes 65-80% profits while other sectors are happy to make 25-30%, there is something amiss. So what makes this sector and its players so stupendously efficient? Have they unveiled new, path-breaking managerial practices or just serendipitously stumbled upon the elixir of eternal profit-making at super-normal levels?

One obvious reason is that real estate, as an asset class, is at the peak of its demand and perceived value today in India's development curve. Contrary to popular perceptions land is a scarce resource in India, a country with a low land-to-man ratio. In addition, all infrastructure developments — highways, airports, ports, industries and all verticals of urban infrastructure — have to start with development of raw land. Consequently, developed land has outstripped all other asset classes in demand and value appreciation. Real estate developers seem to have simply benefited by the sheer chance of handling an asset class which happens to be the most important resource at a particular time in this country's history. So much for their luck but what about man-made reasons?

One reason that has contributed to high land prices, according to real estate developers, is the slow release of open land by government agencies at extremely steep reserve prices. It forces them, they say, to pass on the high price to the consumer. This averment is only partly true for even if the reserve prices had been low there would be a fat chance of developers charging lower prices from consumers. Some state authorities still allot land, instead of auctioning it, at even less than half the open market price.

Do the allottee developers base their selling price on the allotment rate? No, they still base it on the open market price. However, the other half of the averment — agencies sitting on large chunks of land — is true, though privately the developers are not complaining. One, any governmental action or inaction that adds to the scarcity crunch is welcome to them. Two, most agencies have stopped releasing land directly to the ultimate consumers and all releases are auctions of bulk land which can be bought only by the developers and builders. They are winners all the way.

However, the coup in this game of seizing super profits is pulled off through a governmental instrument — change of land use (CLU). All governments make a show of treating land use as sacrosanct while, in practice, changing it at the drop of a hat. This dual-use technology transfers enormous additional value to an already inflated asset because an extremely high premium is placed on the original land use by making it appear immutable and inviolable. Different land use changes transfer different premiums to the changed use and the enterprise value increases in geometric proportions. The moment the land use of a piece of agricultural land is changed to residential, the enterprise value more than doubles. If the change is for commercial, or township, or IT park, or SEZ, the enterprise value goes up three, four, even five times. The rest, as they say, is mere financial jugglery.

With scores of domestic and foreign funds wanting to invest in 'approved' projects (read, projects with CLU certificates), a developer only has to divest 30% equity in the project to not only recoup his entire original cost but make a clear profit too. The remaining 70% equity will bring in windfall returns which you and I cannot even imagine. It is no wonder, therefore, that a large percentage of players masquerading as real estate developers are merely land aggregators and land converters with little or no in-house expertise in development. The only skills required are having enough money to buy (or procure allotment of) land of a lower perceived premium and getting it converted to a higher one.

The SEZ policy, an entirely well-intentioned enterprise of the government to combine the objectives of industrialisation, infrastructure creation and export competitiveness, too, seems to have benefited the real estate players. The developer was supposed to have been a subordinate player in the SEZ, not the main promoter: the industry protagonist was supposed to be the main promoter. However, with 'land in possession' being the overriding parameter of approval of SEZ, the developer has emerged as the main promoter in many a SEZ, since he is in a much better position to have land in possession, particularly for pint sized SEZs. Although the board of approval (BoA) is very cautious in giving approvals for construction in the non-processing areas of SEZs being promoted by developers, it would be difficult to argue that the developers themselves look at their SEZs as anything but integrated townships with tax benefits.

Lastly, a few states have given an entirely new meaning to transferred development rights (TDR) in some of their PPP projects. A TDR is basically a mechanism to attract a builder-developer to take up a socially desirable project in lieu of additional FSI which he is free to sell. However, some PPP projects have been structured in such a way that the TDR are actually large tracts of freehold hand. Imagine getting hundreds of acres of land free of cost along with FAR as part of a PPP project. Some public-private-partnership indeed!

The entire scenario resembles a match where one side runs away with the bat, ball, stumps and score-sheet because there are no match referee and umpires. The first and most important need is for the central and state governments to appoint regulators in this totally unregulated sector.