

## **US Housing Collapse and Lessons for India**

The house prices in US have fallen by almost 20 per cent since they peaked in year 2006. With inventory levels of unsold homes at twice the normal level and number of houses going into foreclosure (home loan default) rising, the expectations are that the average price decline for home would be around 30 per cent by 2010 from the peak level of 2006. If inflation increases and the central bank of US is forced to raise rates substantially then the decline in average home prices could be up to 40 per cent. This fall in house prices have a number of lessons for Indian real estate market. The Indian real estate market shares number of features with US housing sector before its collapse. In our opinion the Indian real estate is ripe for correction, if not a collapse. We present the logic for our conclusion below.

The reason for US housing collapse was easy availability of credit, which fuelled high home prices leading to too many houses being constructed. A number of speculators rather than end users bought homes with the hope that rise in home prices would make their speculation profitable. This continued for at least three years after which home prices stopped rising. With home prices no longer rising the loans could no longer be refinanced at higher value, making loan servicing difficult and in many cases leading to defaults. Once defaults took place, the supply of homes increased and home prices fell even further. At the same time because of the losses suffered by lenders on home loans, it became difficult to get new loans for buying homes. Lenders had lost too much on bad loans, some of them bankrupt while others had too little capital. So when supply had increased there not buyers for the same, either because they are not able to get finance or because they were seeing that prices are falling and are waiting to get even better price. The buyers are still waiting and home prices continue to decline at ever faster pace.

Speculation with easy money was the reason for eventual collapse of US housing sector.

In India the same thing is happening in following stages:

1. **Easy availability of credit and rising income:** The first rapid increase in real estate price was mainly fuelled by decreasing interest rates. Interest rates on housing loans declined from a high of 15 % before 2000 to a low of less than 7% around 2004 and 2005. This happened at time when salaries were rising. Also with the coming of private sector banks especially ICICI Bank credit was easily available. New customers with high purchasing power fuelled the first phase of price rise.
2. **Speculation begins:** The next phase of this real estate bubble started with speculative buyers entering the market. Post 2005 interest rates stopped falling instead they started increasing. This should have lead to stagnation in of real estate prices. Instead the price rise continued. The demand came from speculators rather end users. These buyers hoped to sell at a higher price. This stage was also helped by stock markets. Funding came to real estate companies like DLF, Omaxe, Parsvnath etc. through IPOs. Players like Unitech saw a very rapid climb in their share prices. Using these funds, as well as funds from Private Equity entities they bid up land prices. So, it was also easier to sell houses and commercial properties at ever higher rates. Speculation seemed very profitable.
3. **Speculation ends:** Speculation ended with three events. (a) Stock market fell so companies did not have a major source of funding anymore; (b) Loans became expensive and also difficult to get with banks restricting lending and (c) Home price stopped increasing. The high profit margin on sale of homes in last couple of years had increased the supply rapidly. As supply increased demand has dried.

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Small developers are first to blink. Already one hears discounts up to 30 per cent in some premium projects. The large developers will follow soon after. The large financing plans of majors DLF and Unitech have fallen flat in face of global collapse to share prices. With little funding available developers would feel even more fund crunch going forward.

4. **Bubble Bursts:** The next stage is capitulation. With fund crunch imminent prices will be cut even more. At the same time with little chance of interest rates coming down the affordability of end user would remain low especially compared to the elevated supply. That would fuel another round of price cuts. We expect a correction of at least 30 per cent from peak prices in metros. In worst cases the price correction could be up to 50 per cent.

The share price of Unitech and DLF should suffer badly. In our opinion the economic profit of these companies is much lower than shown accounting profits. Additionally, their corporate governance standards are abysmal. Another 50 per cent correction in their share prices would not be surprising at all. For details on these companies contact us.