Realty bites: Just hold your horses

Most real estate development companies are highly overvalued compared to their current earnings. Investors should exercise caution instead of being overconfident, says Parag Parikh

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GOOD NEWS is coming in from every quarter. The quarterly results of most companies are showing a healthy trend. Industrial production is on the rise and funds flow into the market is also buoyant. When the positives outnumber the negatives, we tend to ignore the negatives. But we need to take note of two important factors — inflation and interest rates, both of which are showing an upward trend. However, amidst such optimism, we tend to get overconfident about our abilities to make money in the market.

Let's see what's happening in the real estate sector. Real estate prices and rentals are skyrocketing, and so are the stock prices of real estate developers. Going by the track record and prevailing prices of real estate, it's dangerous to invest in such companies. Most real estate development companies are highly overvalued compared to their current earnings, rather than the popular valuation metric of 'land banks'. Moreover, they all plan to develop malls, housing colonies, office buildings, multiplexes etc. The business model of these companies rests on a combination of direct sales and leasing in order to earn rental income. The important questions to be asked are: What is the management quality? Are the valuation estimates reasonable? Are the profitability estimates realistic? Will there be legal or government-imposed hurdles in the development?

Considering the current state of affairs, there will be a lot of uncertainty in such projects. SEZs are recent examples. It's better to invest directly by buying a flat, plot or office space.

These plans seem exciting, but will people be able to do business by investing in or renting such highly inflated pieces of real estate? Going to malls feels good, except for the vendors who rent the shops. The rentals are so huge that most of them find it difficult to break even, compelling them to increase their prices to cover such overheads. But today's customers are becoming smarter. Most malls attract huge crowds, but are people really buying?

Businesses thrive in a competitive environment and if people think they'll be able to extract more rent from their realty investments, they're in for a rude shock. Then there are multiplexes. Just because a few early entrants have witnessed huge success, everyone wants to enter the business. A host of realty development companies are including multiplexes in their business plans. Home entertainment industry has changed with the advent of broadband, CAS and DTH. You can now watch movies sitting at home. So, can multiplexes be considered as great an investment opportunity as they are made out to be?

During 1999-00, we witnessed the internet boom. At that time we thought technology will change everything. Today, technology plays an important role in our lives. We have broadband and doing business on the web has become easier and safer than what it was seven years ago. We now use the internet for services such as booking tickets, paying bills and shopping.

But today, we are revisiting the bricks-and-mortar business models. Banks and stock brokers are competing with each other to open more branches. Private equity investors are willing to value bricks-and-mortar businesses at much higher levels and are investing at a premium. So, when technology has matured and is ready to be used more efficiently, we want to shun it and go for the bricks-and-mortar models. This shows the fickle-mindedness of investors. If you are a wise investor, identify the next best dream and wait for the herd to chase it.

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