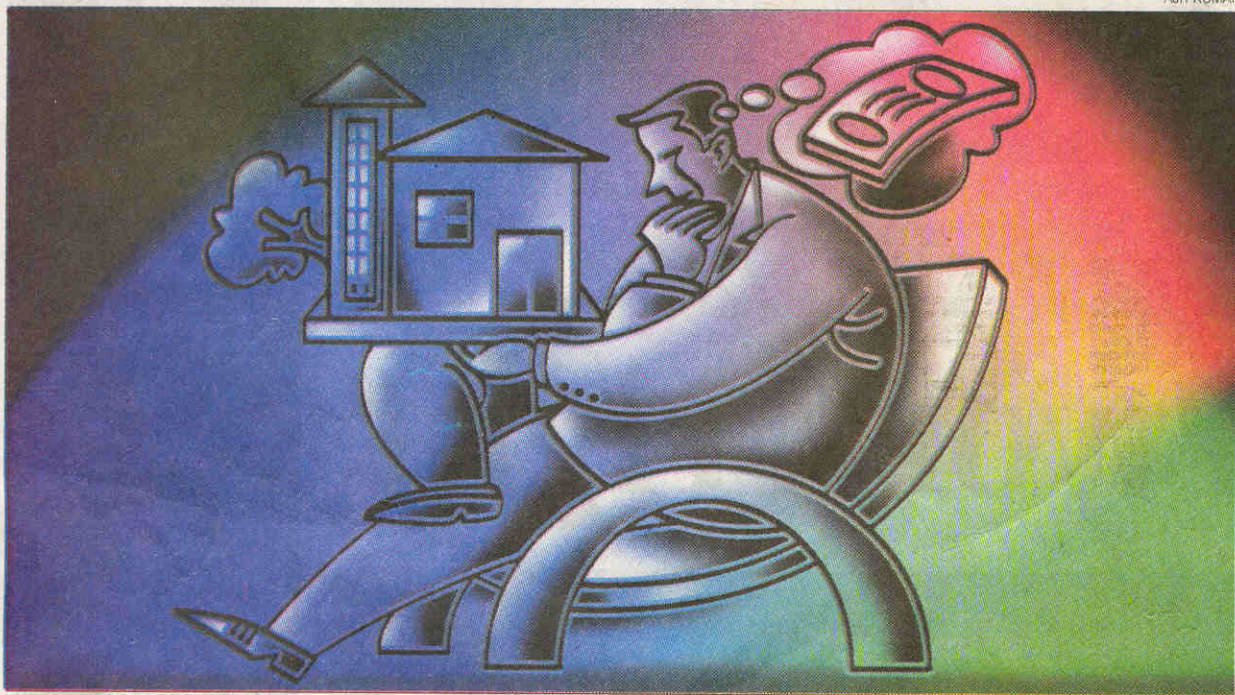


Sure, real estate should form part of portfolios. But the way it is transacted today, not many investors can include it in theirs

Here's the real deal



Rohit Sarin

If debt was the star of 2002-03 and stocks of 2003-04, then real estate was the asset class that shone in 2004-05. Although in the absence of established benchmarks, it's hard to quantify that performance, property prices did surge in 2004-05, while debt returned a dismal 0.04 per cent for the year and equities gained 16 per cent amid high volatility.

This short-term returns pattern throws up intriguing questions. Like, are asset classes negatively correlated, which creates a lead-lag effect? If so, should you time your entry into, and exit out of, various asset classes? If not, should you diversify across asset classes?

We advise our clients to diversify and allocate a portion of their balance sheet to real estate, so as to achieve balanced growth while containing risk. The break-up between various asset classes should be based on your risk-return profile. But

before you invest in real estate, keep these broad parameters in mind:

Return

Theoretically, in the long term, real estate lies between debt and equity on the return spectrum. So, if you expect an annual post-tax return of 6 per cent from debt and 14 per cent from equity, your expectation from real estate (rental yield plus capital appreciation) should be 10 per cent. At present, in most real estate markets across India, rental yields from a bluechip property are 8-10 per cent pre-tax or 5.5-7 per cent post-tax. So, the balance 3-4.5 per cent has to come from capital gains.

Risk

On the risk spectrum too, theoretically, real estate lies between debt and equity. You can be reasonably sure to earn 6 per cent from debt with only a theoretical risk to capital over the long term. However, in equity,

not only might you not earn 14 per cent, you might even lose your capital. In real estate, your invested capital is at risk, but you earn at least rental income.

Liquidity

Low liquidity is a major drawback in real estate investing. Unlike debt and equity investments, real estate investments are not easy to sell.

Concentration risk

Since the ticket size for any attractive investment opportunity in real estate is much higher than in other asset classes, it is not a feasible option for all investors. If you invest in property, chances are, you'll end up putting an unusually high percentage of your portfolio in real estate, which is not desirable. Real estate mutual funds get around this limitation, but they will take some time coming.

Leveraging

Alternatively, one can think of investing in real estate using borrowed funds, which are repaid using the rentals the property generates. Your own investment will be restricted to the margin money—generally 20 per cent of the property value. The cost of funds is currently 7.5-8 per cent for

The high transaction size requirement in real estate makes it unfeasible for most investors

investing in a residential property, 12-14 per cent in a commercial or retail property. Given the current pre-tax rental yields (4-6 per cent for residential, 8-10 per cent for commercial), the rental income will only partially meet the cost of financing. For a positive

arbitrage, decent capital gains are a must.

Sector selection

There are three real estate segments: residential, commercial and retail. Each has a different risk-return profile. Residential is the least risky, retail the most risky. Likewise, for returns. Given the relatively higher margin of safety between the cost of financing and rental yields, coupled with tax benefits on home loans, consider the leveraging option only for residential properties.

Transaction cost

Compared to debt and equity, transaction costs are extremely high in real estate. There are one-time costs in the form of 6-10 per cent stamp duty, broker commission and documentation fee. Costs incurred to maintain the property could amount to 0.5-1.0 per cent of the property value every year. Finally, there could be terminal costs like capital gains tax, which can be avoided by having a holding period of at least three years and investing the resultant capital gains in Section 54EC bonds. However, keep in mind, your real returns from these bonds will be negative, as they carry a minimum lock-in period of three years and the current post-tax return is only 3.7 per cent a year. Therefore, returns in real estate should not be measured over three years, but over six years.

There is definitely a case to include real estate in your portfolio. But given the limitations that exist currently and its risk-reward ratio, real estate doesn't compare favourably with other asset classes. Unless you have big money and liquidity isn't an issue, and can identify top properties, wait for real estate funds. Till such time, either protect your wealth in debt or compound it through equities. ♦
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