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India's Construction Sector Gets a Boost

The construction sector in India contributes about 8% of the Gross Domestic Product. However, it offers employment opportunities to a large number of skilled and unskilled persons. To reinvigorate growth activity in this sector the government has taken very meaningful and far reaching decisions. The decision to pay upfront, 75% of the amount involved in a dispute even if government proposes to challenge the arbitration award, is very significant. Home buyers have been provided a level playing field now with the passing of the Real Estate (Development and Regulation) Act of 2016. This will provide a fillip to the purchase of apartments and make loans more easily accessible. An analysis of these decisions is attempted in this paper.

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In the context of the Indian economy it has to be recognised that the agriculture and real estate sectors play a very critical role. With the rains in the current season being normal, it is expected that agriculture production will get a much needed boost. Recognising that the real estate sector also needs to be given a major thrust, and to ensure that major projects which are held up for want of funds and heavy over-leveraging to banks, the Narendra Modi Government has taken

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a few decisions, which might well set the economy on an upward trajectory very soon. Let us analyse some of these decisions.

The government has eased the arbitration procedure in the construction industry to ensure a faster completion of projects and ease the problems of loan repayments. An array of measures – for quick dispute resolution, pumping in liquidity and dealing with stressed assets – has been put in place to revive the stalled construction and real estate projects. The government has allowed the transfer of cases initiated under the old arbitration act to the purview of the new and expeditious dispute resolution law. It has approved the release of 75 percent of the amount in dispute against bank guarantee and provided for a conciliation board comprising experts on new contracts. The arbitration law has also been simplified so that the process of dispute redressal could be made easier. The establishment of a commercial court has also been provided. Contractors would henceforth have the option to shift their disputes with public bodies to the new arbitration procedures. In cases where arbitral awards have been made and public bodies are challenging them, 75 per cent of the arbitration amount will have to be released to the contractor against a margin-free bank guarantee. The amount will have to be spent by the contractor to complete the project and pay back his or her dues to bank(s) and financial institution(s). The surplus can be spent on project expansion.

In the case of government contracts where disputes with contractors arise, deciding to err on the side of caution, departments have sought arbitration as a routine. Even if the awards go against the government, they continue to file appeals. In this process, the contractor suffers as his payments are held up during the pendency of the appeal. This impinges very adversely on his liquidity position. Recently, in recognition of this complication, and in a far reaching decision involving the real estate and construction sector, the Government of India has decided that in the eventuality of an arbitration award going against the government, 75% of the amount involved in the contract will be paid upfront into an escrow account even if government proposes to challenge the award. This decision can potentially release over Rs 20,000 crore to cash-strapped construction companies, and it will give a big boost to the construction sector which is the largest employer in the country. Construction companies which don’t get their money despite winning arbitration awards suffer double jeopardy. With funds stuck in construction they have limited ability to service their borrowings and have banks breathing down their necks. On the other hand, this also limits their ability to bid for fresh contracts. Seen in this perspective, the new policy will help to reinvigorate the sector with dual benefits viz.:

(i) release funds which will be used for clearing bank liabilities and, (ii) speed up the execution of projects.

According to National Institute for Transforming India (NITI) Aayog estimates, 597 cases involving Rs 52,488, crore spread across central government enterprises such as National Hydro-Electric Power Corporation (NHPC), Oil and Natural Gas Corporation (ONGC), National Highways Authority of India (NHAI) and Indian Oil Corporation, are under arbitration and pending appeal in various courts. The government acknowledges that over Rs 22,000 crore of arbitration claims involve the NHAI itself. It is estimated that out of this, Rs 6000 crore can be released immediately.

How progressive this decision is and how much of benefit it will do to the companies is best illustrated by the fact that immediately after this decision was made public by the government, the share prices of the Hindustan Construction Company (HCC), a prominent construction company undertaking large government contracts, hit the upper circuit filter of 20%! This is so because the company has already won Rs 3200 crore worth of awards and has another Rs 4500 crore or so of claims pending in arbitration courts.

In another rather rare instance of the government displaying a deep insight into the entire business of granting contracts and having them operationalised, it has decided to move away from 'item-rate' contracts. Experience had been that these types of contracts often lead to huge delays and involve corrupt practices, in that a government engineer has to certify, for instance, how much of cement and bitumen has been used before a payment is released. The Cabinet has approved moving away from item-rate contracts to the more transparent Engineering Procurement and Construction (EPC) contracts where the builder quotes a single number and receives tranches of payment upon the completion of certain milestones. Item-rate contracts are now being phased out by NHAI, but they constitute a sizeable volume for other government contracting agencies.

It could be argued that in clearing 75% of arbitration awards, government is playing into the hands of the construction lobby. However, it needs to be appreciated that the majority of awards go against the government and, given that the average settlement time for claims is more than seven years, the government ends up paying a very large amount as interest as well. This argument gains currency since in the case of the NHAI, out of a total of 347 arbitral awards, only 38 went in its favour.

It would be recalled that following a Bombay High Court verdict against the tax department, the Finance Minister had observed that the government would, by and large, not litigate matters where courts had already ruled. If government were to follow this business-friendly trend in other sectors as well, it will go a long way in improving the 'doing business in India' indicators.

The government has taken another similar business-friendly decision by granting in-principle approval for allowing highway developers to defer premium payments in the case of stalled projects. This will ease the financial stress in the highways sector. Under this proposal, the National Highways Authority of India (NHAI) will identify projects that are under stress and deserve leeway in terms of payment of dues. The Highway Ministry's proposed giving the NHAI Board the liberty to set parameters for selecting the stressed projects that would benefit from the restructuring of premium payments quoted at the time of bidding for the project. The move is expected to benefit lenders as they can now recover their dues first instead of competing with NHAI. It is likely that about 40 premium based projects awarded after April 2010 will be reviewed. The decision will help build a positive sentiment among investors and in the market.

The Cabinet Committee on Economic Affairs (CCEA) has also cleared the revised tolling policy, which limits the toll the developers can collect till they complete construction within the approved time-line. Under the revised tolling policy, for highway projects involving expansion from four lanes to six, developers can collect only 75% of the current toll amount during the construction period without the yearly escalation applicable to the toll rates. Only after the construction is completed can the developers start collecting the full toll and at the escalated value. Also, if a developer fails to complete the project on time, he will no longer be allowed to collect toll. This has been done with a view to compensate commuters during the time when highway quality is poor because of construction work, as well as to dis-incentivise the developers from delaying projects.

These decisions are in addition to the Budget proposal of 2014-15 which had proposed the introduction of Real Estate Investment Trusts (REITs), which have been successfully used as an instrument for pooling of investments in several countries, with a view to earning income and distributing the earnings from pooled investments among the investors who have contributed to the pooled corpus in the first place. Securities and Exchange Board of India (SEBI) had issued regulations in this regard vide the SEBI (Real Estate Investment Trusts) Regulations, 2014. However, on account of the restriction under Foreign Exchange Management Act (FEMA) Regulations, actual investment had not occurred. In a decision taken in May 2015, the government made REITs eligible under FEMA such that the entities registered and regulated under the SEBI (REITs) Regulations of 2014 would be able to access foreign investments.

The proposal recognises REITs as eligible financial instruments or structures under the Foreign Exchange Management Act (FEMA). This approval is expected to catalyse foreign investment inflows into the completed rent-yielding real estate projects, which was earlier prohibited under the FEMA Regulations. The logic of introducing the instrumentality of REITs is to reduce pressure on the banking system, to which the real estate sector looks for funds, free the existing funds of banks and to encourage construction activities. REITs while attracting long term finance from foreign and domestic sources including NRIs would make available fresh equity to the sector. SEBI has also decided to include hotels, hospitals and convention centres under its definition of real estate as part of efforts to ease the norms related to REITs and make the investment vehicles attractive for investors and developers. Hotels, hospitals and convention centres fall under the domain of infrastructure as defined by the Ministry of Finance. But SEBI believes that large townships and commercial projects often offer business parks, hospitals and hotels as part of the projects and that each of these are rent-generating completed assets. So, such assets should fall within the definition of ‘real estate’ or ‘property’ under REITs.

The Indian real estate sector is going through a cash crunch, and SEBI’s decision will help increase the flow of capital in this industry. It will make REIT a viable product for investors and a fund-raising instrument for real estate players. The decision will also help in attracting small investors to become a part of the real estate growth.

Due to the difficulties being faced by the real estate sector, a huge amount of trust deficit has developed between home buyers and the companies. Buyers who have not been able to get the apartments for which they have already made payments have dragged these companies to the Supreme Court. However, the plea of the companies before the court is that they do not have funds to either complete the projects or to refund the amounts paid by the buyers. The debt of this sector is assessed at about Rs 80,000 crores. Since home loans are not easy to come by, the sales have also been anaemic. This has adversely affected the capacity of the companies to service their borrowings.

There is however, a silver lining in the form of the Real Estate (Regulation and Development) Act 2016 (RERA). This law ensures transparency from builders and stringent provisions for compensation in case of delays. Time limits have been prescribed within which regulatory and appellate authorities have to decide the disputes. The more important provision is for the developers to keep 70% of their funds in an escrow account so that they cannot siphon off these funds to other accounts/projects. The Act also provides a level playing field for the buyers and developers as the present day agreements to buy are heavily loaded in favour of the companies. This will help inspire confidence among buyers and greater confidence in banks to provide mortgage loans.

Coupled with the 7th Pay Commission's decision to hike the salary of state- as well as central-government employees by almost 23.6% it would have a positive impact on the demand side of residential real estate, as it would boost sentiment for home ownership among a set of buyers who have traditionally been very conservative in matters pertaining to large financial commitments. The increase in demand would be uniformly seen across India's more liveable cities. Pricier cities would not see much of an impact on this account, as this segment of potential home buyers will be looking primarily for budget homes.

Revitalising the construction sector will serve as a major boost to the economy since it is a major employer and would help boost the demand for cement, steel, bricks, specialised labour like carpenters, plumbers, electricians etc. These decisions will provide relief to the companies, and ease the stress on the balance sheet of banks too. It will provide much needed liquidity in the system and help roll over some of the funds that are locked in stalled projects. On the whole, it will help reinvigorate growth in some sectors of the economy.

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