

# -Detailed Report- The story of real estate in Colombo

## Part B – A closer look at the last Colombo real estate slump : When did it happen and what caused it?

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## Key Question we set out to explore:

*“What happened during the 2008-2009 real estate slump and what were the reasons for the slump?”*

## What we did

- Reviewed the CBSL land price index data to analyse the extent of the price slump
- Investigated the reasons provided by the CBSL and other stakeholders for the price slump

## Key questions to answer

- What happened to the land price indices during the 2007-2009 period?
- What was the impact of the price slump?
- What were the reasons for the price slump?

## What's in this report

What happened to land prices during the 2008-2009 period? →

What were the reasons behind the Price Slump? →

Views in Detail →

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# Key Takeaways

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## Key takeaways

- Real estate prices in Colombo experienced a slump during the 2008-2009 period, with **residential land prices being the most severely affected segment.**
- Beginning at around 2005, low interest rates, increasing construction costs and heightened demand of property for investment purposes led to an accelerated growth in real estate prices. In contrast, **increased interest rates, excess supply and political uncertainty** contributed to the slump in the real estate market in 2008-2009.
- Residential real estate prices took an **extensive period to recover from the slump of 2008/2009.** The residential land price index revealed that it took over 3 years to recover in nominal terms while in inflation adjusted terms it took over 5 ½ years.
- At the same time, residential land prices **within the bounds of the Colombo Municipal Council (CMC)** were the most severely impacted. This maybe a reflection of the heightened apartment constructions that were taking place in Central Colombo.

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# What happened to land prices during the 2008-2009 period?

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# How did real estate prices change over the period?

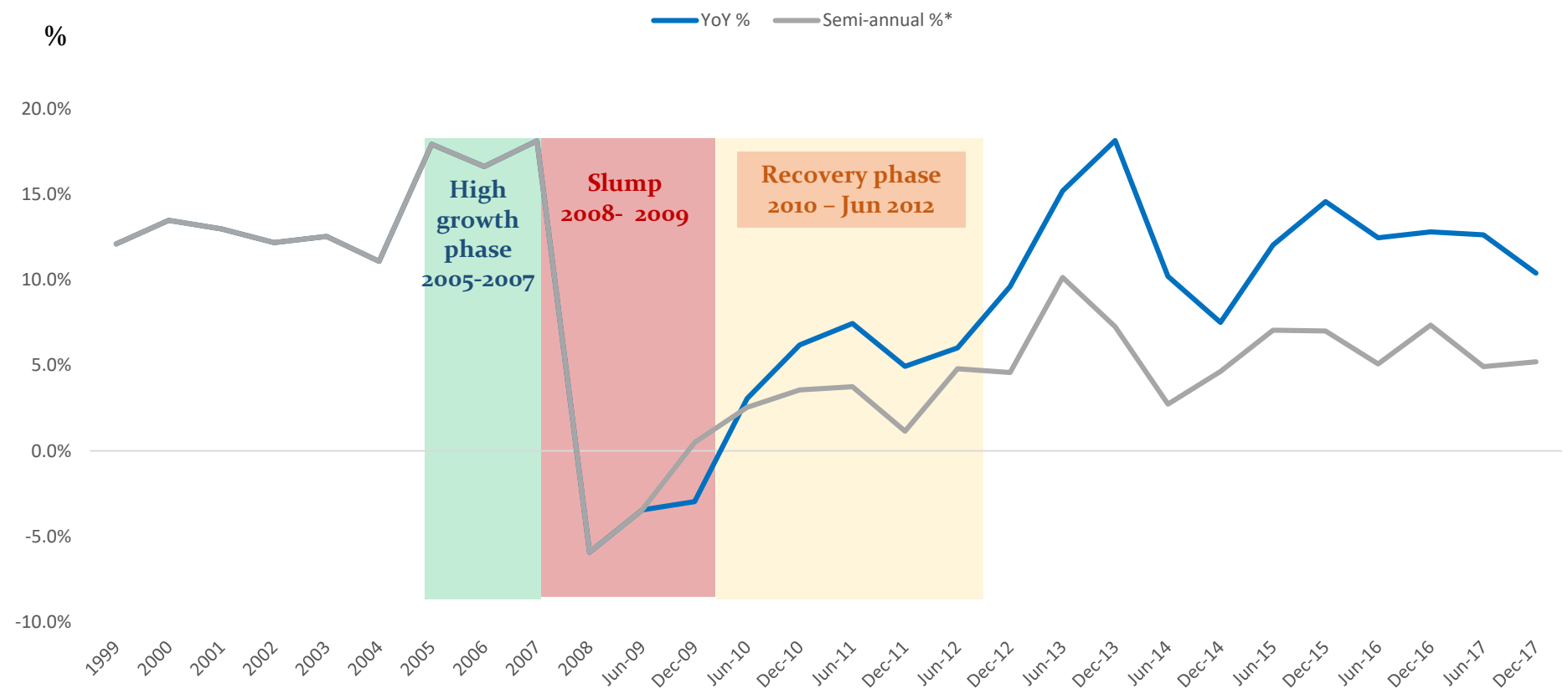
# Executive Summary

- Based on the CBSL land prices indices, all segments (Commercial, Industrial and Residential) recorded an [accelerated pace of growth in the 2005 -2007 period](#). This growth in land prices, alongside other factors, **made investments in real estate more expensive** and thus set the stage for the real estate slump of 2008-2009
- After reaching a peak by end 2007, all segments recorded a Year on Year (YoY) drop in prices **for the first time in 2008** since the start of the Land Price Indices. The indices reached their lowest points in June 2009 and **remained at a depressed level till the end of 2009**. [The residential land prices experienced the most significant price drop](#).
- Subsequent to the slump, the indices began its gradual recovery from end December 2009 onwards with [the indices taking 1.5-3 years to recover to their pre slump peaks](#). Residential land prices **took the longest time to recover (3 years)** while industrial property was the quickest to recover (1.5 years)
- In inflation adjusted terms, the [real estate price drop is more pronounced](#), with **the index continuing to experience price drops (albeit at a slower pace) during the 2010 -2012 period**. As a result the residential price index took over 5 ½ years to recover to its previous peak level.
- In addition, an analysis of the [land prices within the bounds of the Colombo Municipal Council \(CMC\)](#) as well as the overall Colombo District revealed that both indices experienced a dip in prices over the same period.



# Change in Overall Land Price Index (LPI) over time

The overall land price index experienced a negative YoY and QoQ growth in Land prices for the first time in 2008 which continued until June 2009. On a YoY basis, a negative growth was witnessed until December 2009.

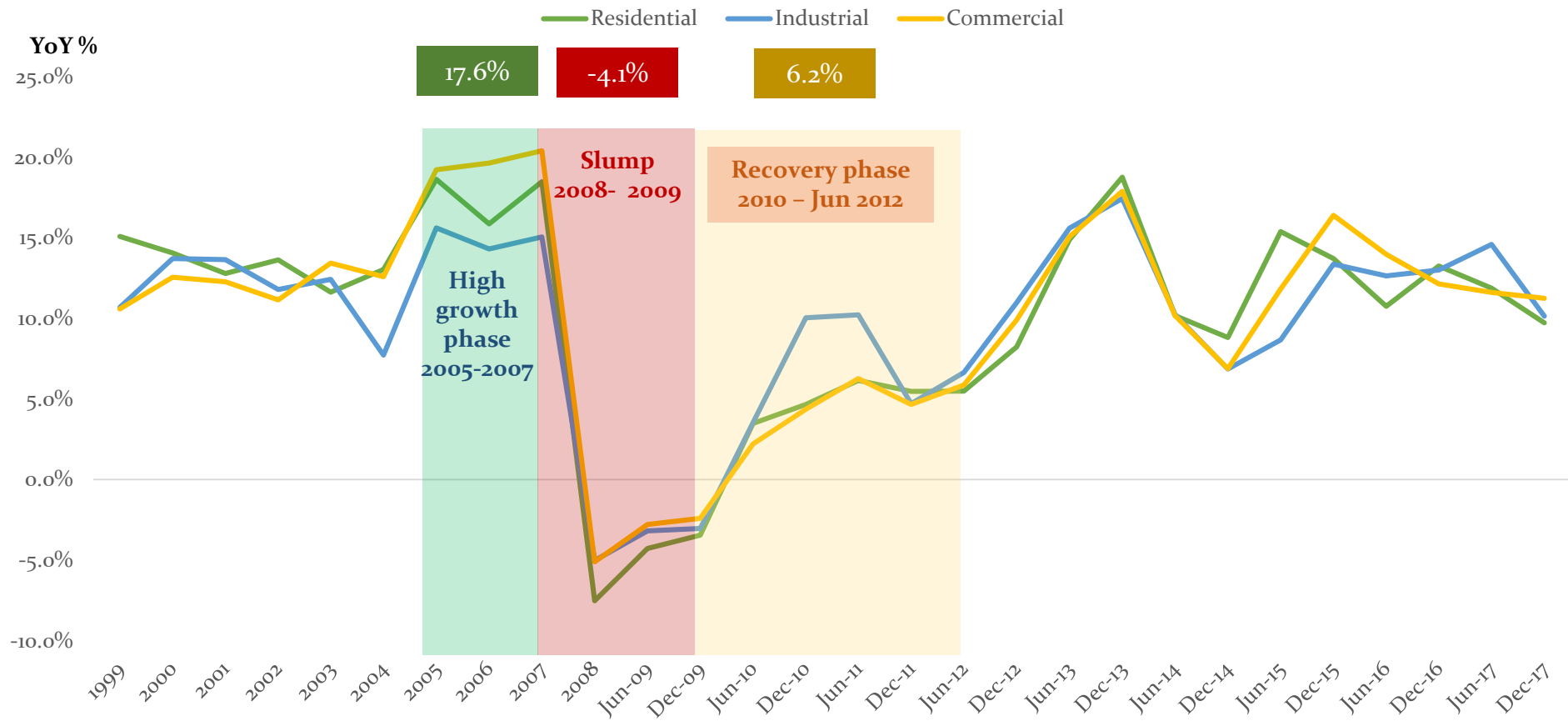


\*The Semi-annual change in the index is only available from Dec-09 onwards

Source: CBSL, Frontier Research Analysis

# Change in Land Price Index over time – Segments

The residential property segment recorded the most severe price drop during the slump period



The boxes show the Annualized returns on the overall real estate price index during the period

Source: CBSL, Frontier Research Analysis

## Time taken to recover from the slump

- The Residential property index, which experienced the most severe price drop during the slump, also took the longest time to recover
- The industrial property segment was the quickest to recover from the slump. It was also the segment that experienced the slowest price growth during the high growth phase between 2005-2007.

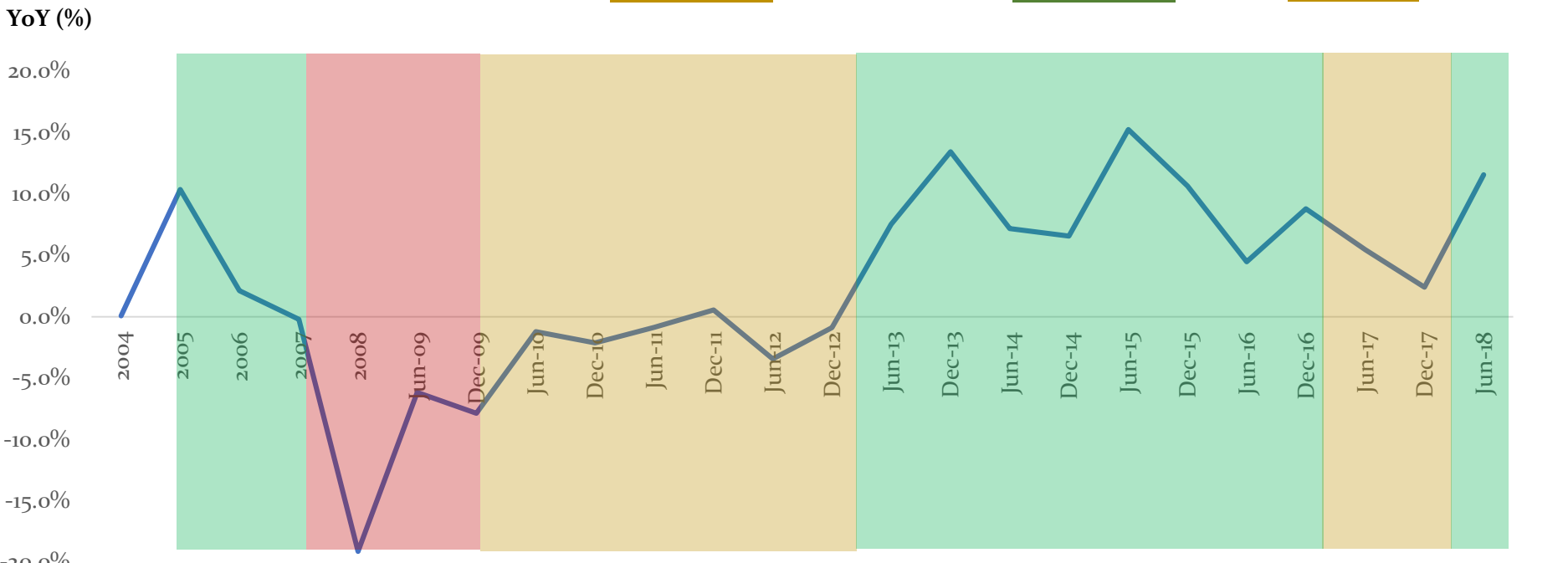
Index	Index Recovery Year*	No. of years from index low point to recovery
Residential	Jun-12	<b>3 years</b>
Commercial	Jun-11	<b>2 years</b>
Industrial	Dec-10	<b>1.5 years</b>
Overall	Jun-11	<b>2 years</b>

\*This is the year in which the index value recovered to or above its previous peak index value

Source: CBSL, Frontier Research

# Inflation adjusted Residential Land Price Index (2002 = 100)\* – Real Returns

<b>High Growth</b> 2004-2007 3.1%	<b>Slump</b> 2008- 2010 -9.7%	<b>Stable</b> 2011- 2012 -0.2%	<b>High Growth</b> 2013- 2016 9.9%	<b>Slow Growth</b> 2017 2.4%	<b>Rebound</b> Jun-18 11.6%
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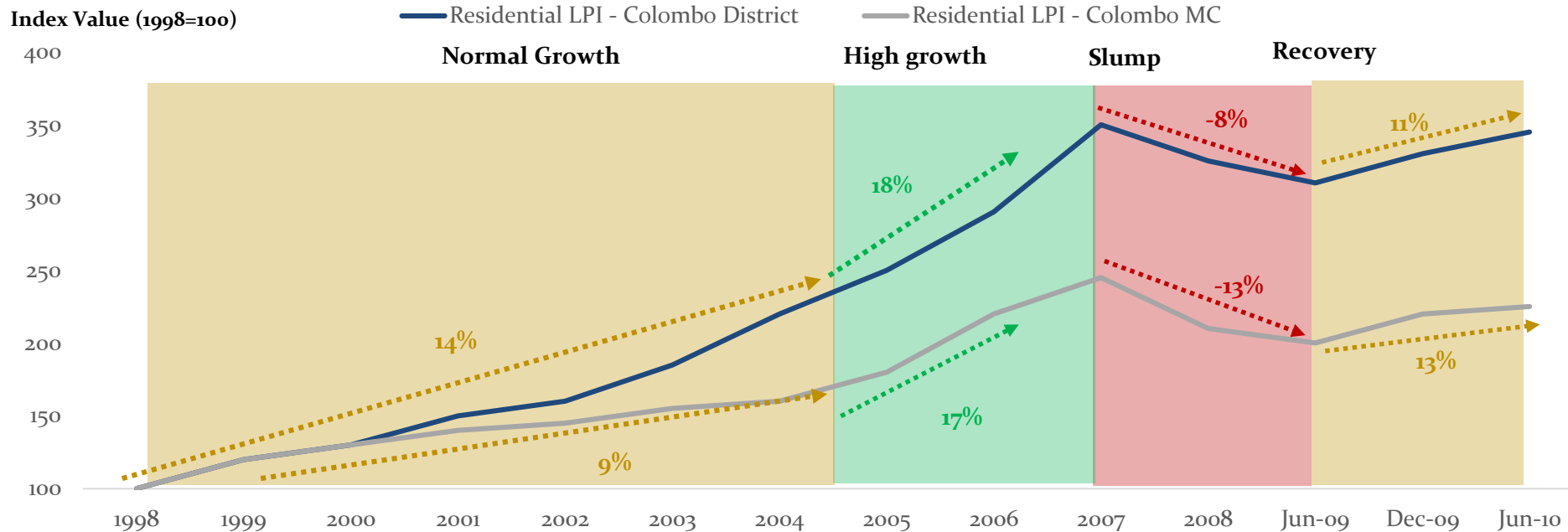
The Boxes show the Annualized returns on real estate during the period

\*Real returns have been computed by adjusting for the corresponding inflation rates over the period

Source: CBSL, Frontier Research analysis

# Residential Land prices - Colombo District Vs. Colombo Municipal Council (MC)

- Residential property prices within the bounds of the Colombo Municipal Council (CMC) witnessed a more significant drop in land prices compared with the Colombo district overall
- This may reflect of the fact that the majority of activity relating to large scale residential apartment complexes were taking place in Colombo Central.

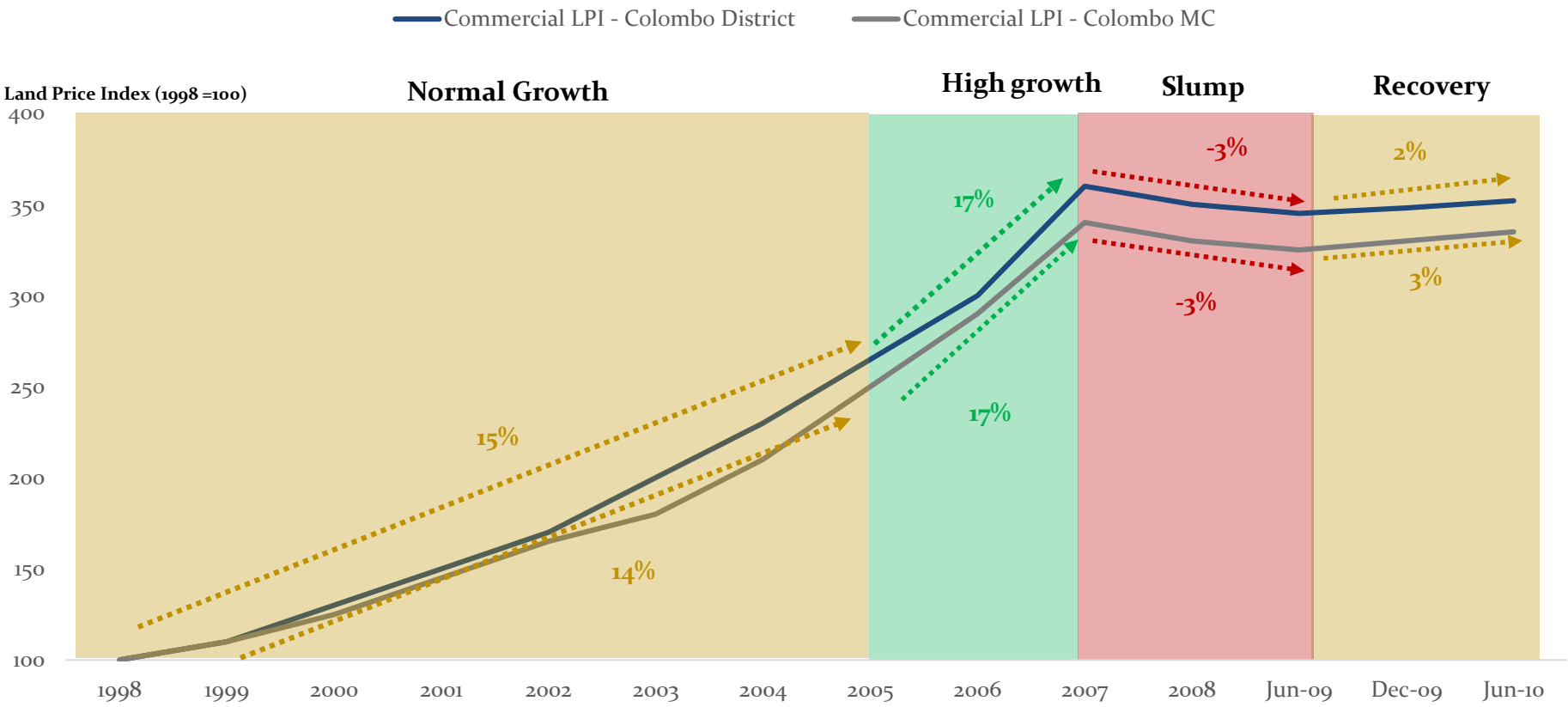


\*The percentage changes shown in the above graph are in Compounded annual Growth rate (CAGR) terms and are prepared based on the approximate index movements in the charts provided by the CBSL in its 'Financial System Stability Review 2010'

Source: CBSL. Frontier Research analysis

# Commercial Land prices - Colombo District Vs. Colombo Municipal Council (MC)

▪ In the case of Commercial property, the drop in prices during the 2008-2009 slump were similar in both the Colombo district overall as well as within the bounds of the CMC



\*The percentage changes shown in the above graph are prepared based on the approximate index movements in the charts provided by the CBSL in its 'Financial System Stability Review 2010'

Source: CBSL, Frontier Research Analysis

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# How were real estate prices affected during the slump?

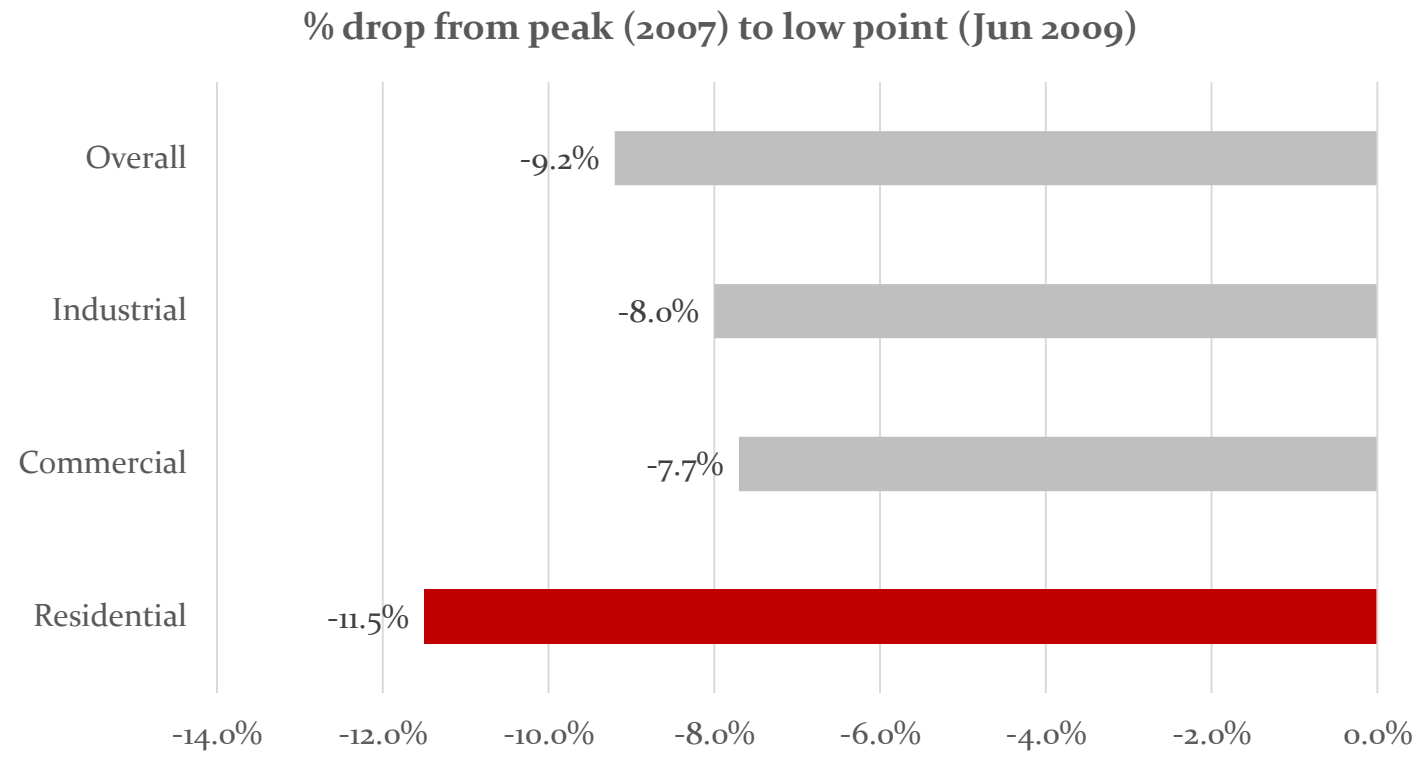
## Executive summary

- During this period, [residential land prices recorded the most significant drop](#) (-11.5%) while Commercial property was the least affected (-7.5%). Interestingly, this was despite the higher growth recorded by the Commercial property segment during the high growth phase experienced in the 2005-2007 period. This may reflect differences in the nature of demand for residential versus commercial property where in the case of the former, an **increase in speculative activity** was a contributor towards the price slump whereas in the case of the latter it was driven by **real demand** given the low availability of suitable Commercial property.
- In inflation adjusted terms, the [drop in residential land prices were more severe](#), with land prices falling by 19% by end 2008. The **index remained bearish for a longer period with the index** taking till June 2012 (Over 4.5 years since the peak in 2007) to reach the low point of the slump.
- A similar trend was witnessed in [land prices in Colombo CMC](#) where **residential property recorded the steepest slump (-18%)** while Commercial property in Colombo CMC was less affected (-4%). By June 2010 (the latest date for which the data had been published), all indices were yet to recover to their pre slump peaks with residential property in Colombo CMC being further away from its peak index value.



# Impact of the real estate slump – By segment

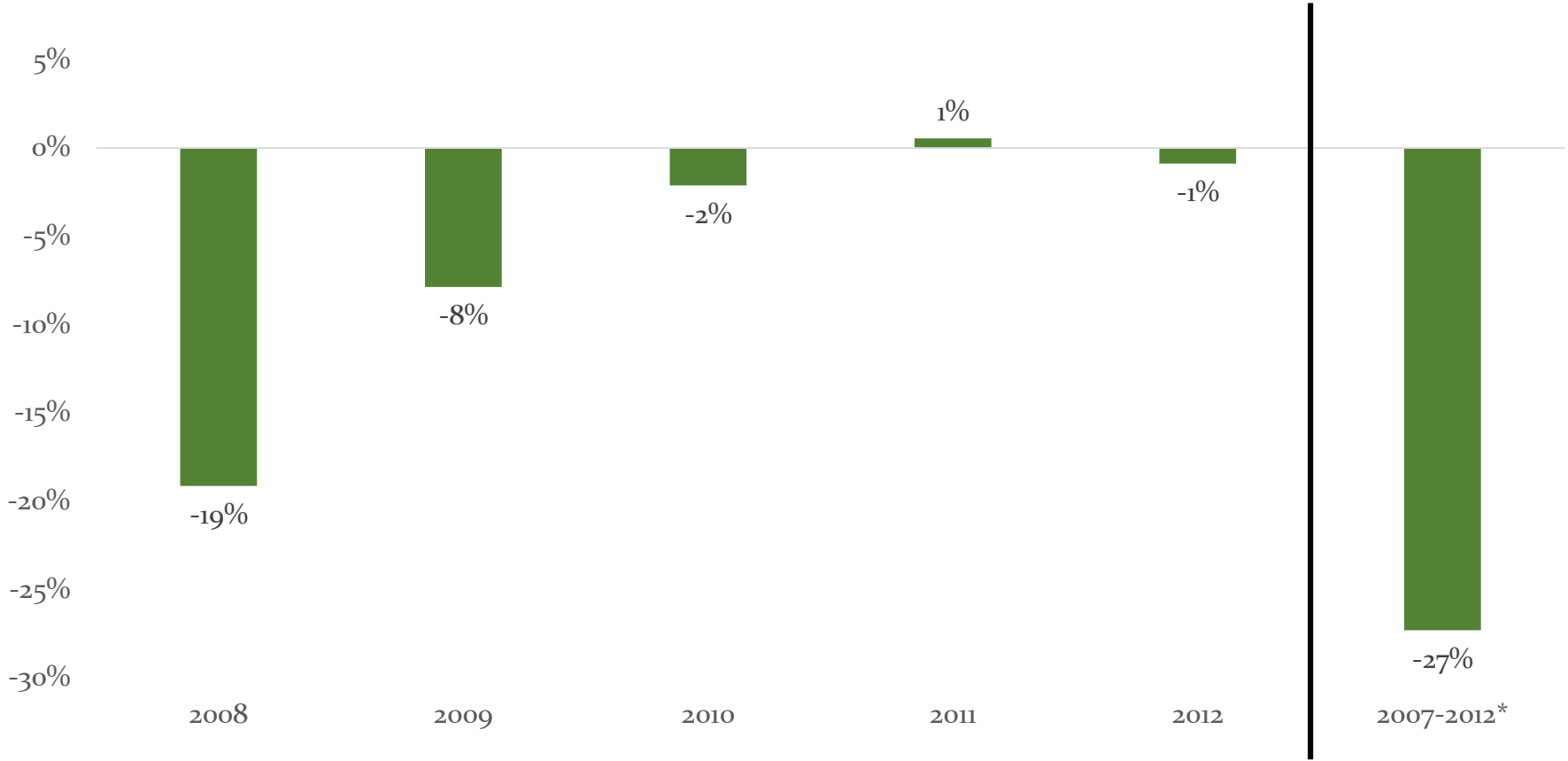
- Residential property experienced the most severe drop in prices over the period, while the commercial property segment was the least affected



Source: CBSL. Frontier Research Analysis

# Magnitude of the price slump in inflation adjusted terms (real terms)

The following chart shows the Year on year (YoY) change in the residential land price index in inflation adjusted terms

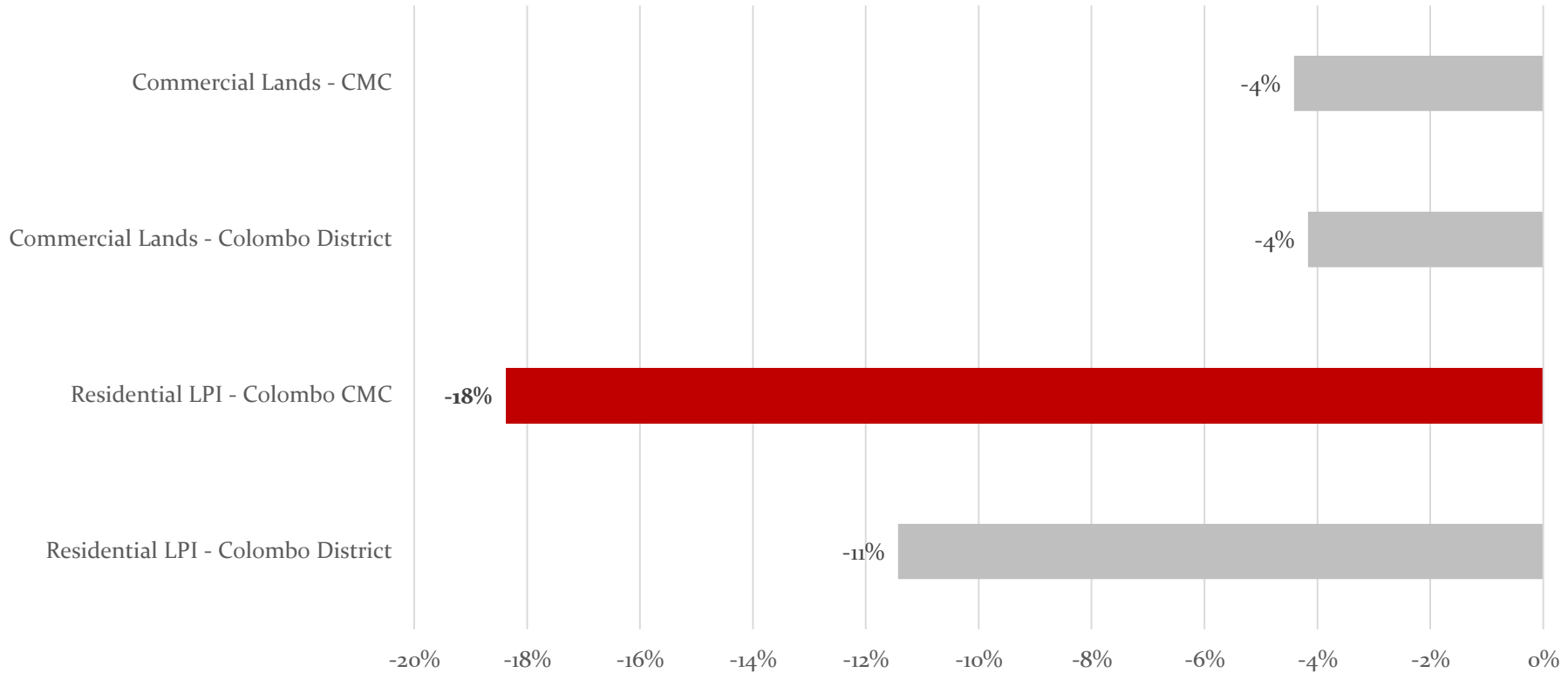


\*Index price change from Dec 2007 to Dec 2012

Source: CBSL, Frontier Research Analysis

# Impact of the real estate slump – Colombo Central Vs. the rest

% drop from peak (2007) to low point (Jun 2009)



Source: CBSL. Frontier Research Analysis

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## What were the other implications of the price slump?

## Executive Summary

Apart from investors in real estate who experienced negative returns over this period, Property developers and Banks were the two main parties that were impacted during the real estate slump

- **Developers** - A number of developers, including large developers, experienced difficulty in continuing with their projects with [certain projects being forced to be delayed or being abandoned outright](#)
- **Banks** - Certain Banks which had [lent to property developers](#) saw their financial performance impacted during this period, resulting in worsening bank impairments

## Impact of the Price Slump – Developers

- **There was a Significant drop in the number of announcements of new apartment projects.** In the previous years leading upto the slump, they would have tendered on an average for at least 2 -3 new projects every month
- Developers had **trouble meeting their payments** to contractors due to the inability to sell their apartments as buyers delayed their purchases in expectation of further price falls
- Developers were **forced to stop construction midway or abandon projects** – Approx. 8-10 large scale construction projects particularly in the residential condominium market were abandoned or discontinued owing to poor market condition and a lack of demand.

See our Special Report on **“Failed real estate projects in Colombo: When did they happen and what caused them?”** for a more in-depth analysis of the projects which failed during the real estate slump.

Source: Varied News articles , [LBO](#), [Asia Tribute](#)

# Impact of the Price Slump – Banking Sector

A number of Commercial banks reported in their annual reports that they were exposed to the real estate market primarily due to lending to real estate developers which had an impact on their financial performance.

## Commercial Bank (COMB)

- Exposure due to lending to the Condominium Sector

**Premiere Pacific Group was one such example where a number of proposed projects were abandoned**  
*“A significant part of the financing will be through Commercial Bank which holds the coveted position of being the best Commercial Banker in Sri Lanka for the past seven years.” – [Read More](#)*

### **Extracts from COMB annual report 2007**

*“We were also forced to increase our provision for the condominium sector because of the increased potential for losses, given the sluggishness of the Market”*

*“This was the main contributory factor for the increase in the total provision to Rs. 1.777 billion, probably the highest ever in the Bank’s history” – [Read More](#)*

## Hatton National Bank (HNB)

- Reported that the sales of some of the real estate projects it had lent to were experiencing slower growth

### **Extracts from HNB annual report 2008**

*“Although sale of Spathodea Apartments, which has 48 apartments, has been relatively slow, we envisage all apartments being sold in 2009.” – [Read More](#)*

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# What were the reasons behind the Price Slump?

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# Key Factors that may have contributed to the price slump

Reasons	Likelihood of contributing to the slump	Commentary
1 High interest Rates	High	Higher borrowing costs placed <b>additional pressure on developers</b> while investors switched to <b>higher yielding interest earning assets</b>
2 High construction costs	High	High land prices, external pressures and high growth in construction activity lead to a <b>higher cost of development</b> . This in turn pushed up the sales prices of apartments prior to the slump.
3 Demand/ Supply imbalances	High	The construction boom experienced in 2005-2007 lead to a <b>surge in housing and apartment stock</b> which was not matched by demand
4 Impact of Global Financial Crisis	High	While the direct impact of the GFC on Sri Lanka's real estate market was limited due to the lack of foreign investor participation, there was at the same time, a <b>very high indirect impact on the domestic economy</b> , causing a collapse in investor confidence, which in turn severely impacted property developers and companies exposed to real estate investments.
5 Worsening security situation	Medium	The war intensified, leading <b>foreign investors and ex pat Sri Lankans to stay out of investing</b> in the real estate market
6 Fraudulent activity	Medium	Financial scandals such as Golden Key and Sakvithi impacted investor confidence.
7 Decline in Private Remittances	Low	Remittance growth which contributed to the rise in land prices in past periods began to decline.

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# Views in Detail

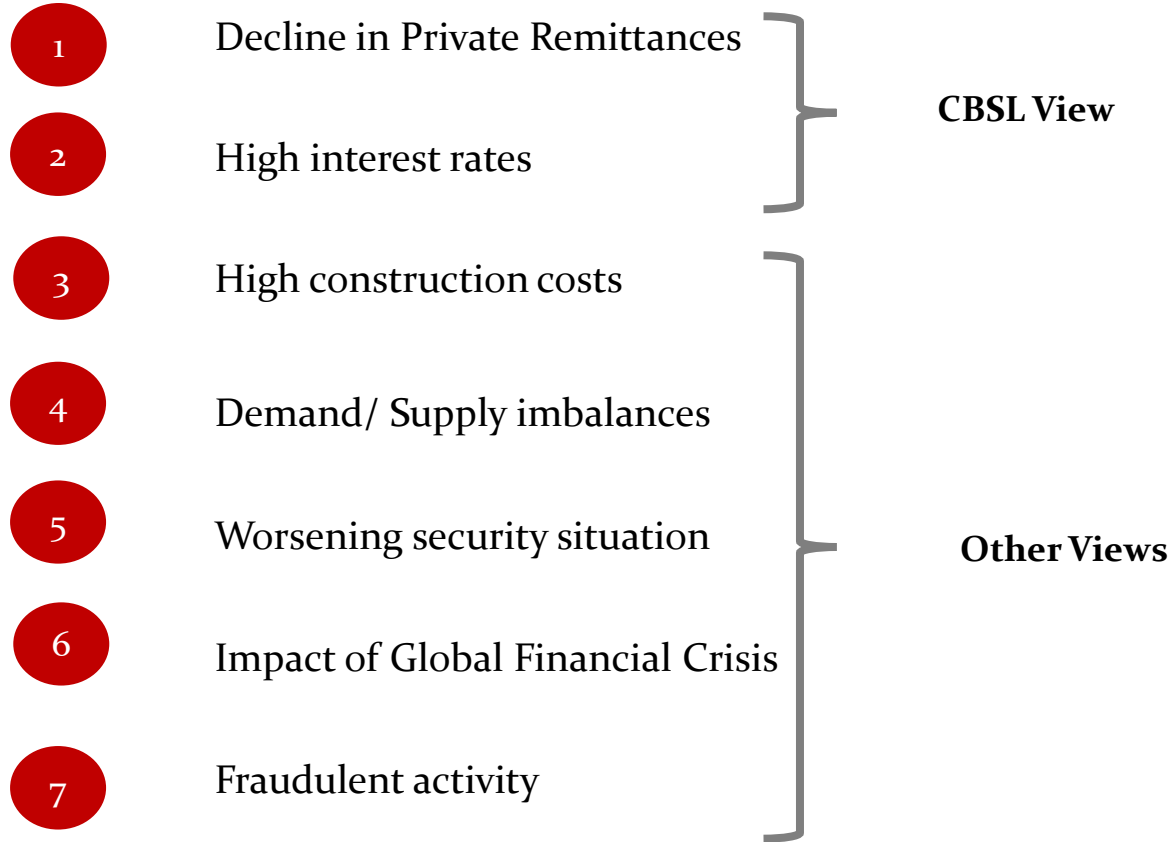
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## CBSL View

# Key Factors that may have contributed to the price slump

The below factors were gathered through CBSL views in the 'Financial System Stability review 2010' report, news reports and interviews conducted by Frontier Research.



# 1. Drop in Private Remittances

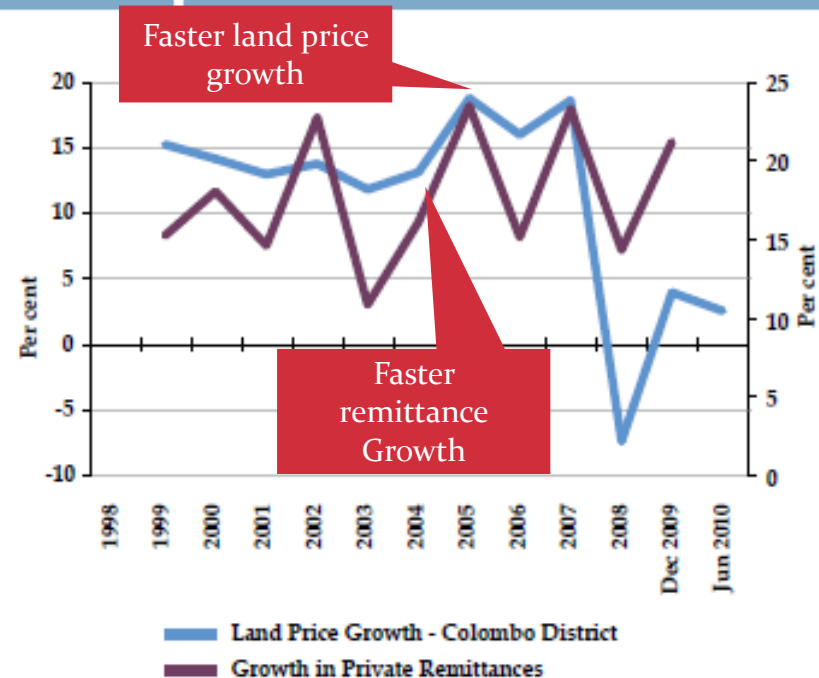
## Key Extracts

- Evidence of a positive correlation between private remittances and land prices growth
- 2002 - Periods of relative peace which saw the Ceasefire agreement in place coincided with higher growth in remittances and land prices
- 2004/2005 - Remittance growth peaked during this period which may partly have been on account of the Dec 2004 Tsunami which led to higher inflows

## Frontier's Analysis

- The data, however, doesn't suggest a strong correlation as Remittance growth continued unabated in 2007-2008
- Hence we do not believe that this was a primary contributor to the slowdown experienced in the real estate market

Chart B2-5 Trends in Residential Land Price Index and Growth in Private Remittances

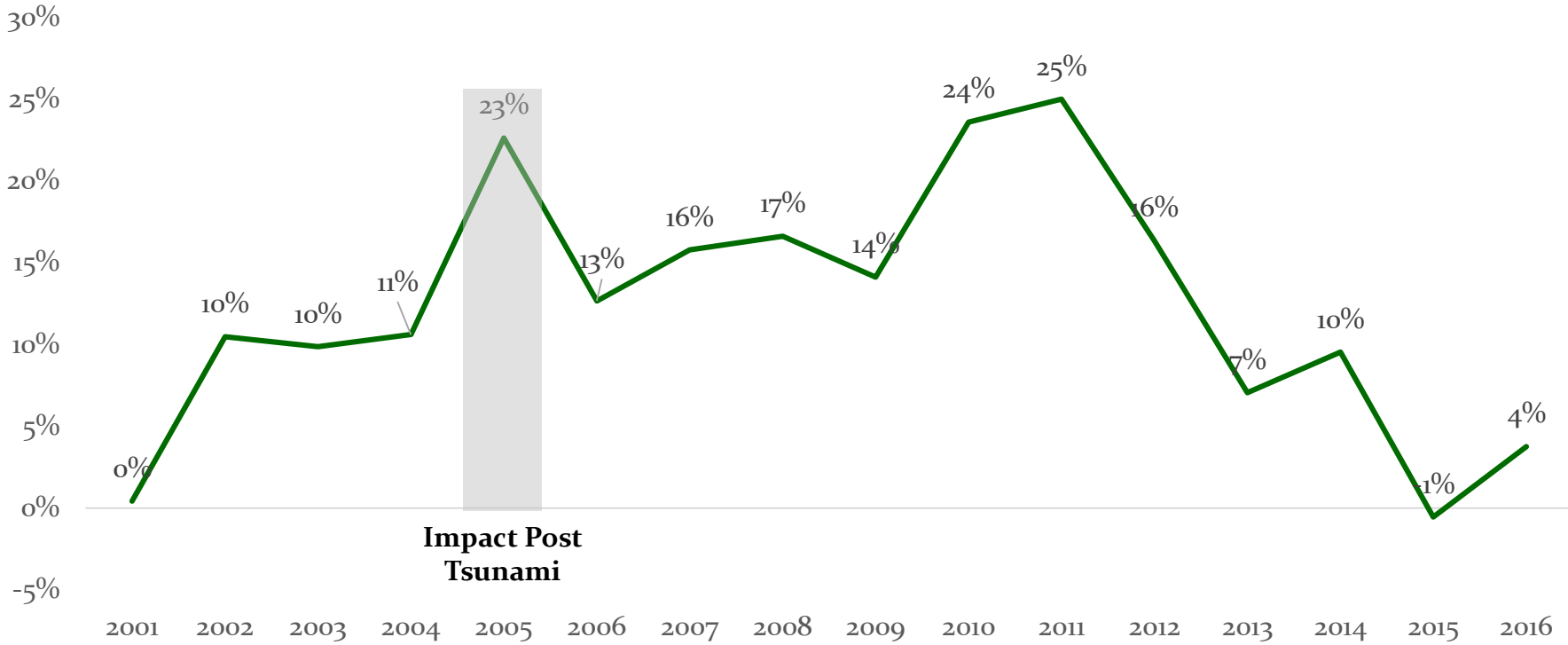


Source : Central Bank of Sri Lanka

Source: Financial System Stability Review, 2010

# 1. Drop in Private Remittances

### Worker Remittances growth (%)



Source: CBSL

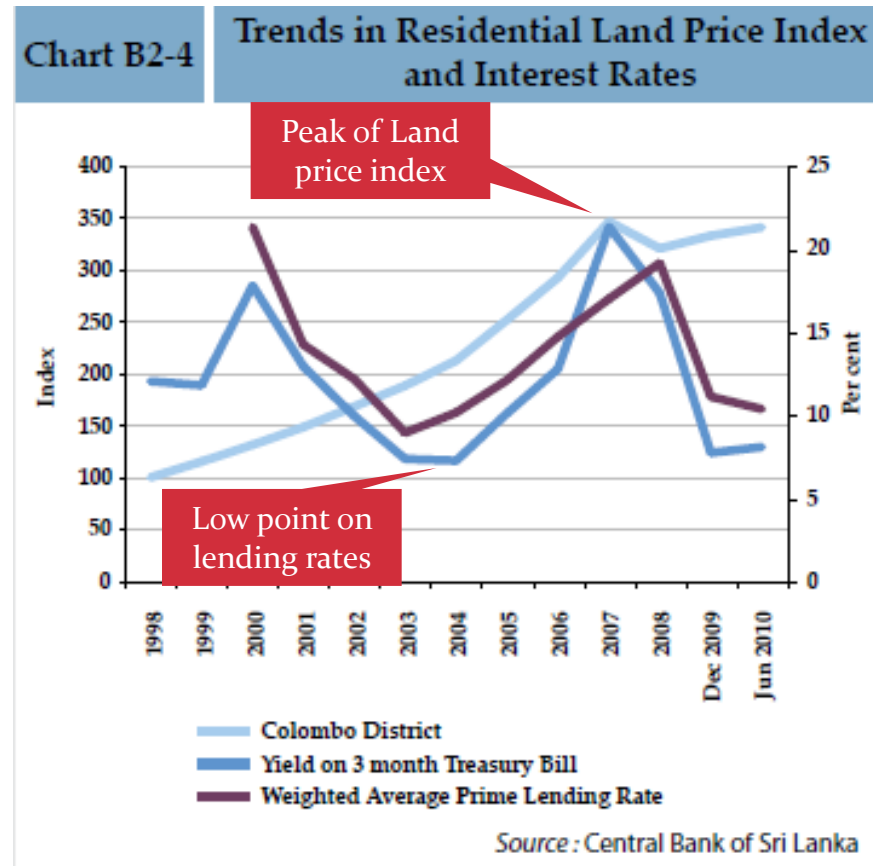
## 2. Drop and subsequent increase in Interest Rates

### Key Extracts

- Evidence of a negative correlation between interest rates and land prices
- Periods of lower interest rates correspond to with a lag, period of accelerated growth in land prices
- The peak in the yield on 3 month T-bill coincided with the weak Land prices in 2007
- Real estate prices subsequently recovered with the weakening of interest rates.

### Frontier's Analysis

- We believe that the lack of cheap funding to developers which exerted further pressure on their stretched cashflows dampened activity in the sector.
- On the demand side, the higher borrowing cost to investors in real estate as well as the more attractive rates of return offered by fixed income instruments may have dampened interest in the sector.



Source: Financial System Stability Review, 2010

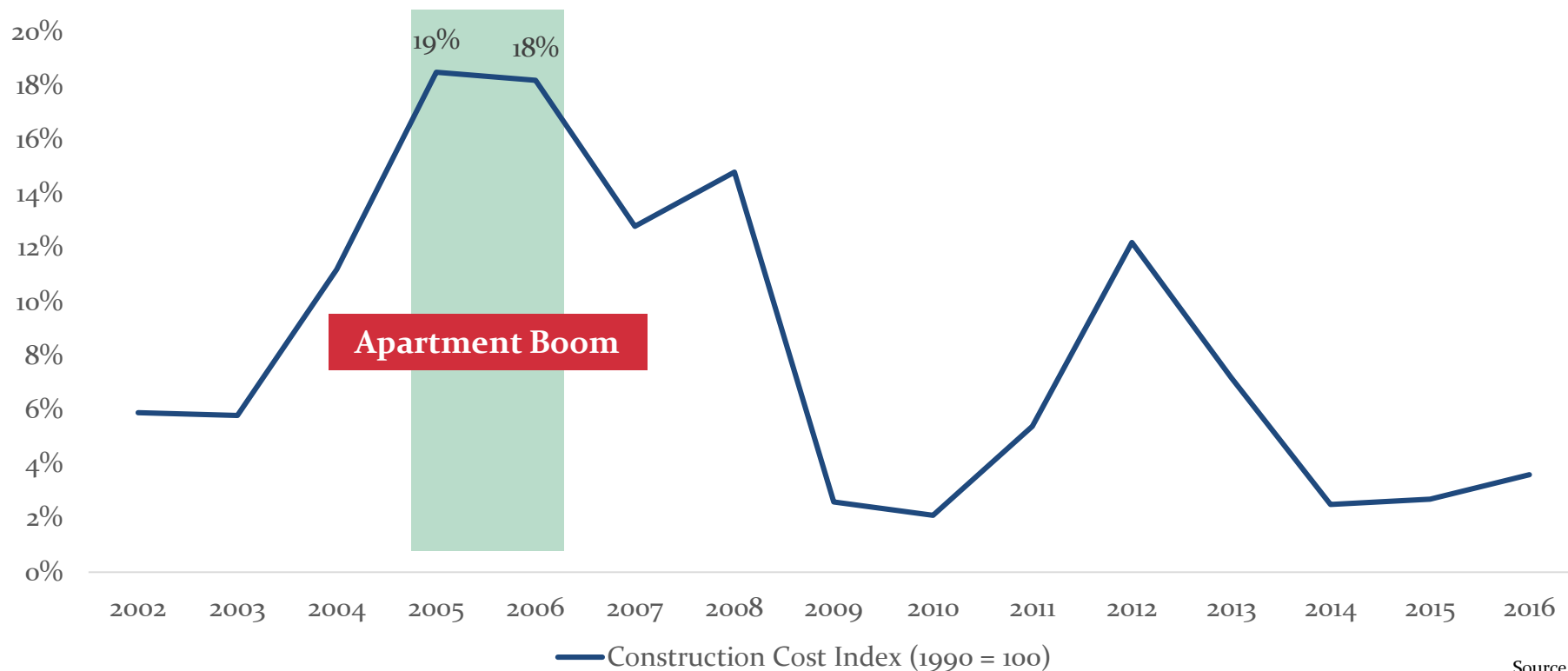
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## Other Views



### 3. Construction cost increases

- Significant cost increases experienced in the 2005 -2007 high growth phase of the real estate market would have contributed to the subsequent rise in property prices which may have dampened investor demand
- The higher costs were due to both cost push factors such as high oil prices which raised the cost of imported construction cost material as well as due to 'demand-pull' factors given the increased construction activity taking place over the same period

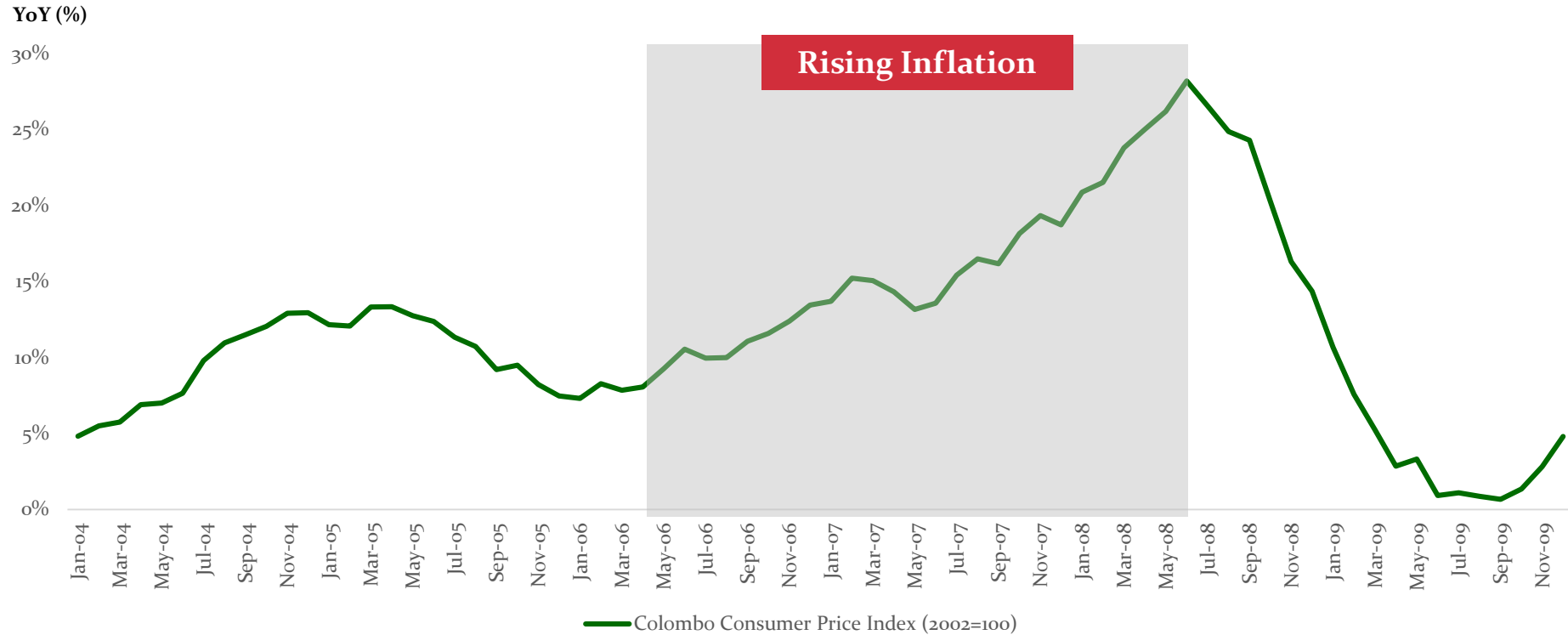


Source: CBSL

## 4. Demand/ Supply imbalances

### Increase in speculation and demand for investment purposes

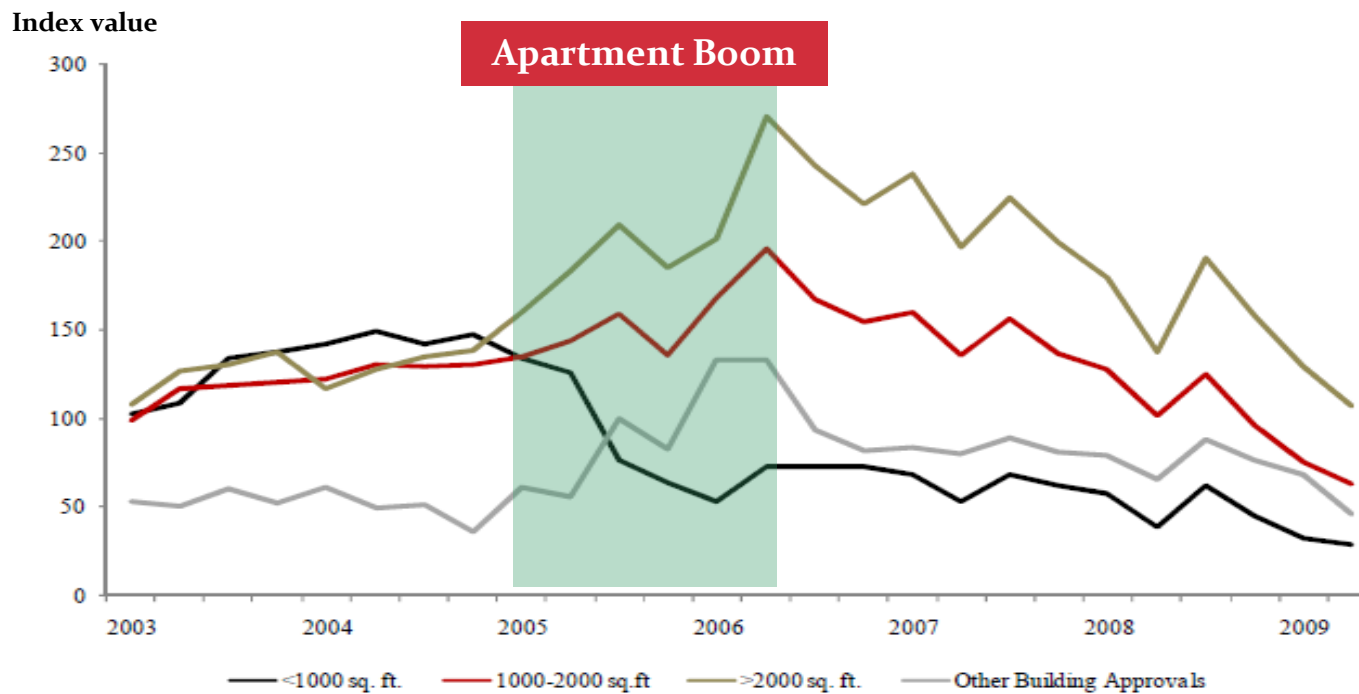
- Higher inflation & volatile exchange rates may have led to increased speculation in the real estate market as a hedge against volatility
- Condo and land prices in Colombo carry a 40 percent speculation premium – [Imran Furkhan, Economic Analyst](#)



## 4. Demand/ Supply imbalances

- A significant growth in housing approvals commencing from 2005 was observed which continued till 2006.
- New houses and condos, that have 4-year construction lags, start hitting the market in 2008/2009 shifting the scene to a buyers' market.

Housing Approval Index by Different Categories (1995=100)

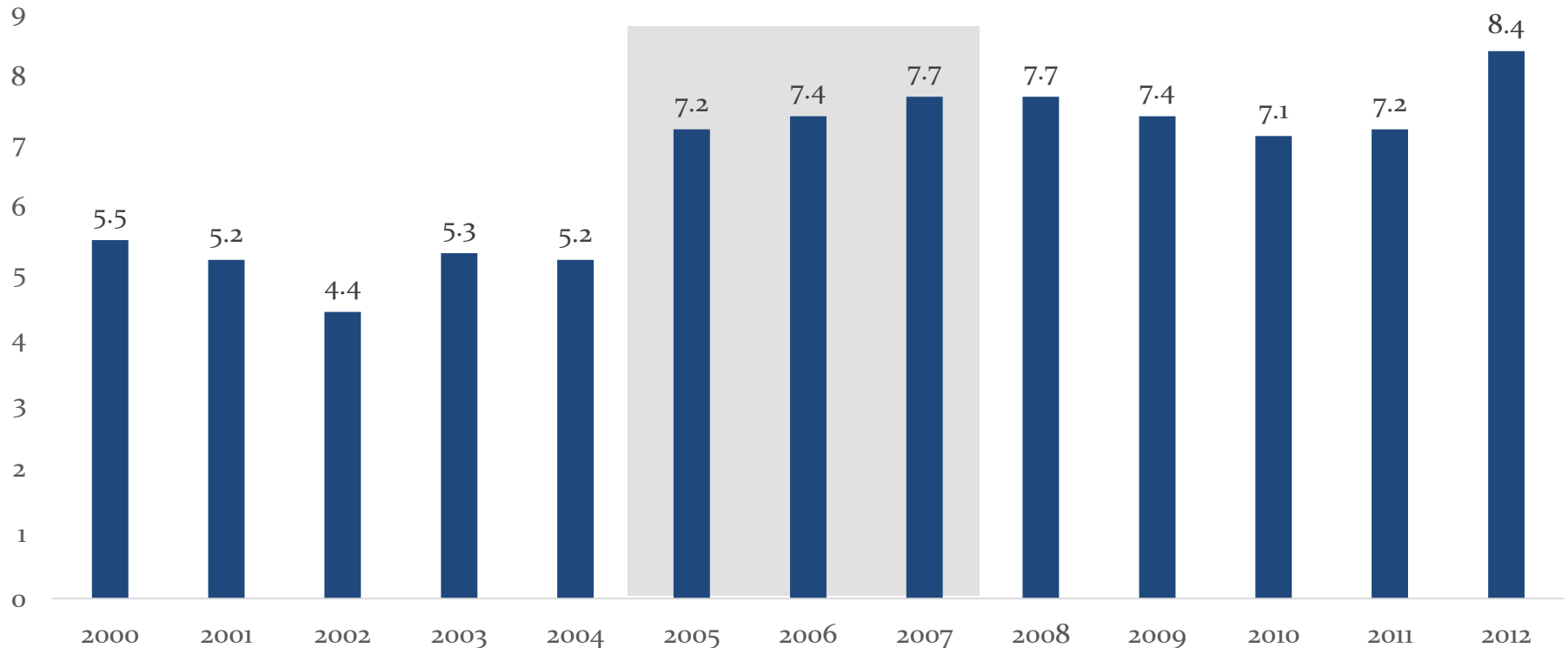


Source: CBSL

## 4. Demand/ Supply imbalances

- The pickup in construction sector activity in the run up to the slump is mirrored in the jump in construction related employment from 2005-2007.
- Growth was relatively slower between 2008-2010 and subsequently rebounded strongly in 2012

Construction sector employment % of Total employment



# Other reasons for the slump

## 5. Heightened Security risk

- With the intensification of the war there was a decline in the number of foreigners living in Sri Lanka, particularly in Colombo which resulted in lower demand for residential real estate.
- In addition, demand by Expat Sri Lankan's for real estate investments which had been on the rise due to the increased stability brought about by Ceasefire agreement, chose to stay out of market as the security situation became more uncertain

## 6. The Impact of the Global Financial Crisis

- Developers such as Overseas Realty (OSEA) reported that foreign investor interest in the real estate market had declined during the period
- *'The Purchase of houses and luxury apartments by foreigners particularly Sri Lankans living overseas declined due to the crash in global property prices'*. – Extract from OSEA Annual Report

## 7. Fraudulent Activity

A number of high profile events relating to fraudulent activity took place during the period

- **Golden Key** - *The collapse of the Golden Key Credit Card Company could signal a systemic collapse of some large finance companies* – [Read More](#)
- **Sakvithi Scam** - *The scam, which has reportedly defrauded about 5000 investors to the tune of a staggering Rs. 900 million, is now being considered one of the largest to have hit the country* – [Read More](#)

Source: [Daily News](#) & other News articles

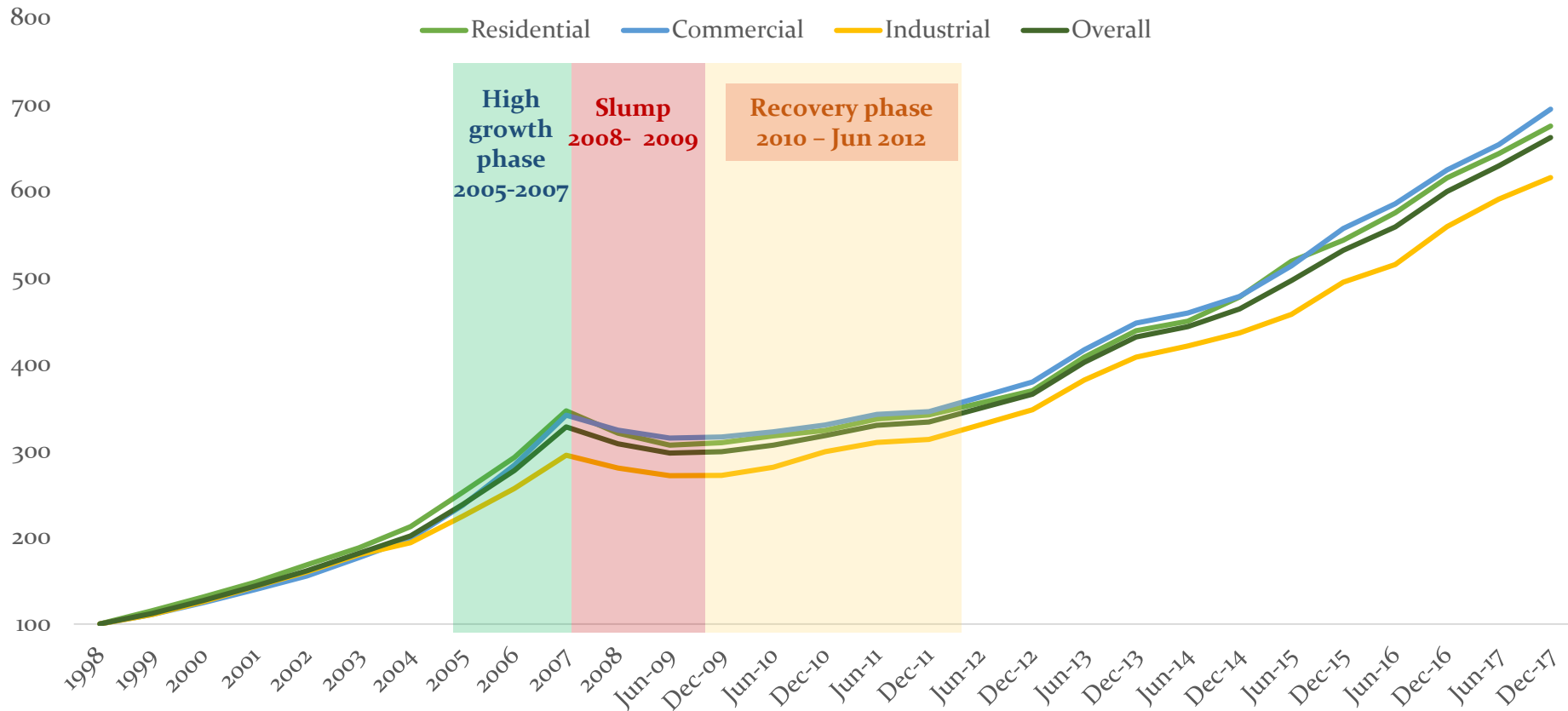
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# Supplementary

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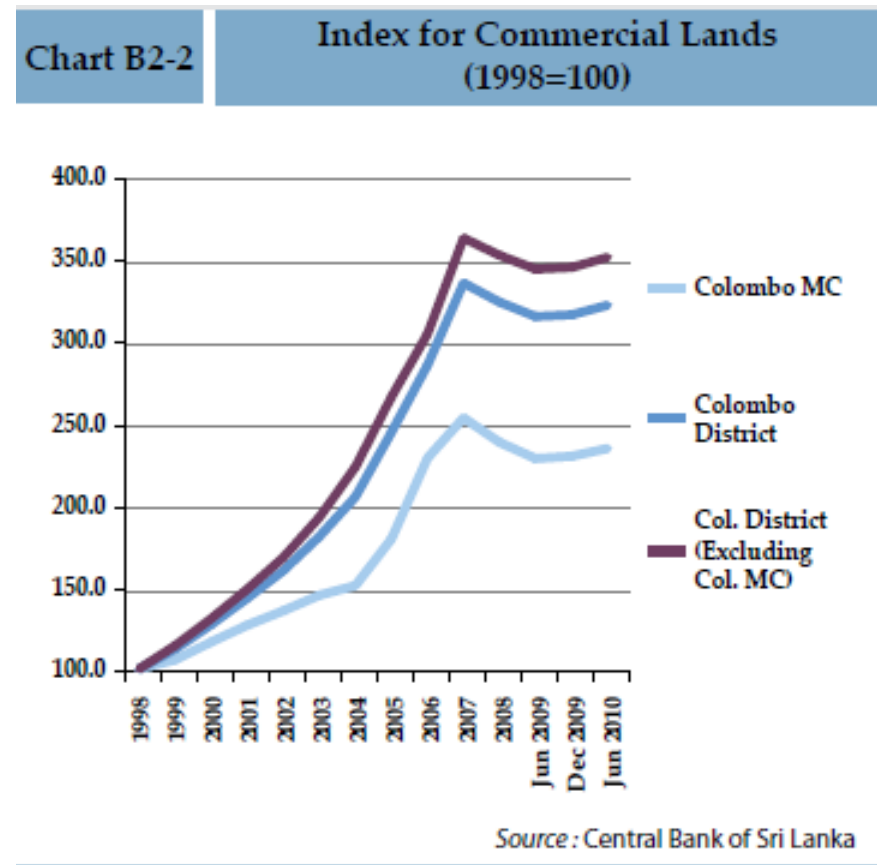
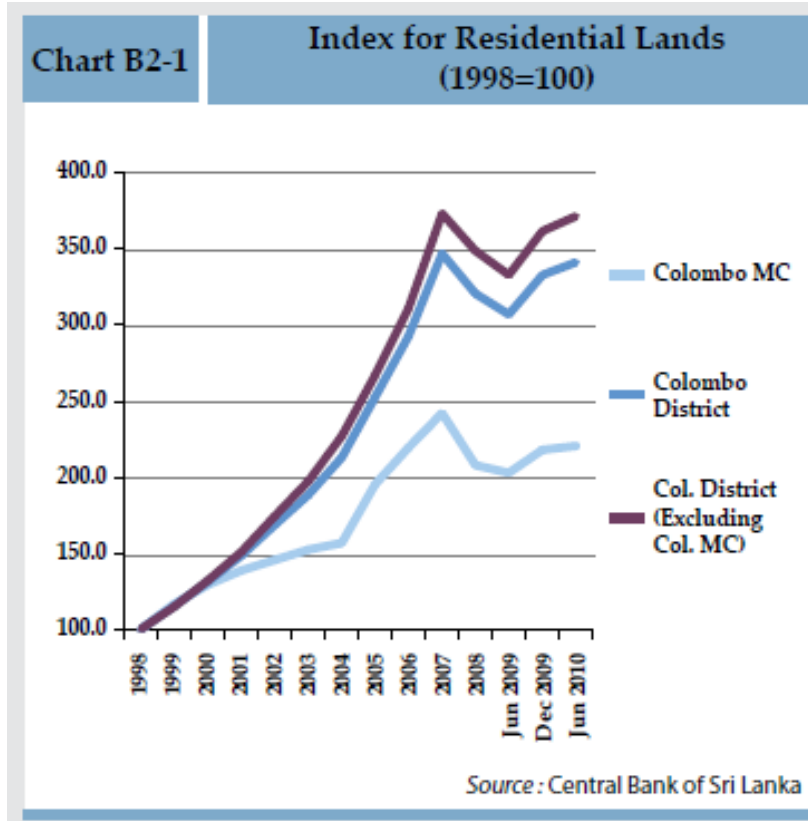
# Land Price Indices over time

Index value (1998 = 100)



Source: CBSL

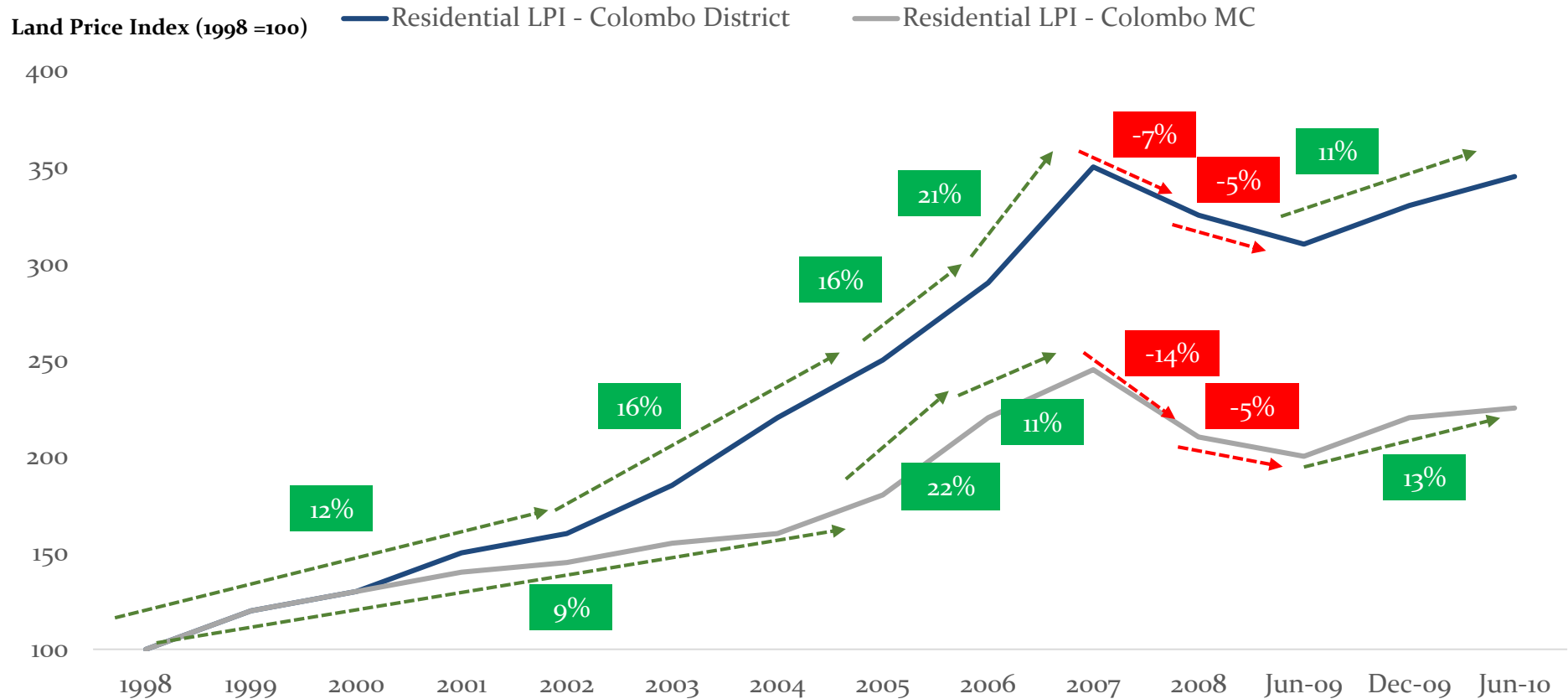
# Land Prices Colombo District Vs Central Colombo



Source: Financial System Stability Review, 2010



# Land Prices over time - Residential

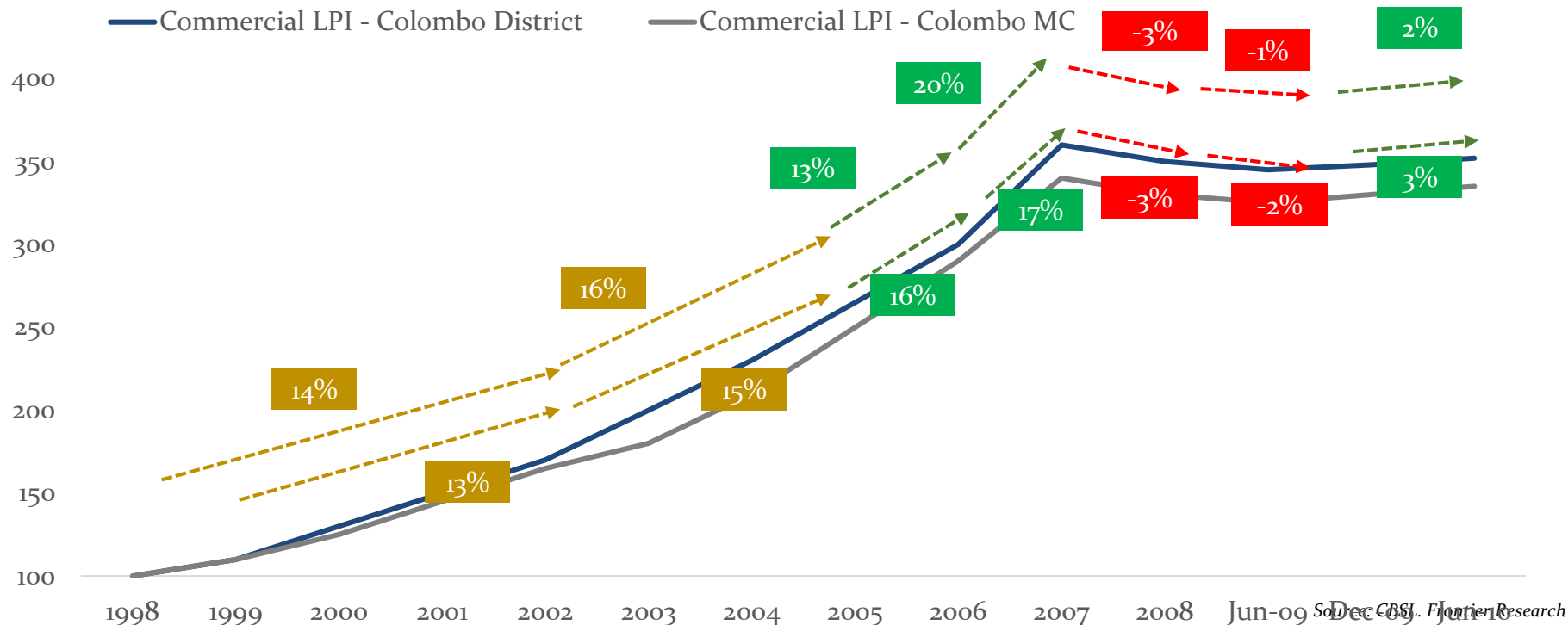


\*The percentage changes shown in the above graph are prepared based on the approximate index movements in the charts provided by the CBSL in its 'Financial System Stability Review 2010'

Source: CBSL. Frontier Research Analysis

# Land Prices over time - Commercial

Land Price Index (1998 =100)



\*The percentage changes shown in the above graph are prepared based on the approximate index movements in the charts provided by the CBSL in its 'Financial System Stability Review 2010'

## References

- CBSL – Annual reports, Press Releases, Financial System Stability Review 2010
- CSE – Company Annual Reports
- News Articles
  - Asia Tribute – [Time to Invest in real estate](#)
  - Sunday Island - [Sri Lanka property bubble on the bursting path August](#)
  - Daily News – [Property Development Recovery](#)
  - Daily News - [Premier Pacific Regency launched](#)
  - Sunday Times - [Sakvithi: King of all cons](#)
  - Sunday Times - [Golden Key: System and investors to blame](#)

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