

# Indian Real Estate Revisited

## Coming Out of the Trough

After the recently concluded national elections in the world's largest democracy, there is just cause for controlled optimism and cheer. In a country that is more than twice the size of the European Union and which speaks more than 50 languages and numerous other dialects, 417 million people turned up to vote for a new government and choose from a bewildering array of 300 political parties. The voting was electronic, and the results were out in less than half a day of counting.

The result was a clear majority for the Congress Party-led coalition — a party with a left of center approach. But more importantly, in stark contrast to what was widely feared, the election results have delivered political stability and given a strong mandate to the new government. The Congress Party is not overtly dependent on any coalition partner — which has been the bane of policy decisions for more than 20 years — and we can look forward to the government undertaking reforms that can help revive growth in a steady manner. In many ways, this verdict is being viewed both politically and economically as a game changer for India.

### PROPERTY INVESTMENT DESTINATION

As a real estate investment destination, India entered the radar of the global investment community only around 2005–2006. The entry of global investors was a result of favorable policy changes, fueled further by a surfeit of liquidity in the global market. The usual suspects turned up — Morgan Stanley, Goldman Sachs, Merrill Lynch, Lehman Bros., J.P. Morgan, Deutsche Bank, Wachovia and

so on, along with a number of homegrown players such as HDFC, Kotak Mahindra, ICICI, IL&FS, etc. Liquidity was further bolstered by hedge funds

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With the financial meltdown, the number of players left standing has dramatically altered, and capital is now scarce. The Indian economy is still chugging along and is expected to clock a growth of 6 percent or more — down from nearly 9 percent but still a robust growth rate when compared to other economies around the globe. However, the mood is somber, and the excesses of the bull market are still being digested.

The central bank of the country, the Reserve Bank of India (RBI), was perhaps the first to recognize (globally) the pitfalls of

the excess liquidity and its impact on the real estate market. RBI took steps to cool down the market as early as June 2007 by raising interest rates and increasing the risk weightage for real estate lending in particular.

Before going deeper into the Indian real estate market, it is important to understand some fundamental facts of this market:

1. There is as yet no REIT market in India.
2. Historically most commercial real estate stock is held strata title.
3. Loan-to-value levels in India have rarely crossed the 65 percent to 70 percent limit even during the peak of the bull market.
4. The gross exposure of the banking sector to real estate lending (excluding residential mortgages) is approximately 6 percent of the total lending and hence no cause for alarm.
5. Foreign debt is NOT allowed in real estate in India (and likely will not be allowed in the near term).

From 2006 to 2008 the sector received approximately US\$6 billion of foreign investment, much of it essentially as debt masquerading as equity. Much of this also came with very light covenants. In fact, the view on the street is that this investment is indeed equity and will probably take a write-down.

The structure of the financial markets also has led to conservative lending standards in real estate and infrastructure sectors. While India has perhaps one of the most robust and liquid equity markets, various regulatory issues have kept the debt markets out of the realm of reforms.

As a result, the lack of long-term debt availability and the lack of liquidity of debt paper have constrained financial closure for infrastructure projects and capital-intensive asset classes such as hotels and commercial real estate development.

### IN CORRECTION MODE

The real estate market has been in a correction mode for more than 18 months now, and in most parts capital values have corrected by more than 30 percent. The availability of long-term risk capital had enabled developers to put up a fair amount of supply in commercial real estate. The heady rentals (upward of US\$12 per square foot per month in Mumbai) were previously unheard of in the Indian market. Naturally, the developers changed plans and converted potential residential plots to commercial.

RBI's tight money policy strangled the developers and home buyers as well, and the mortgage rates quickly climbed to unaffordable levels. This slowed down the residential market. The "Affordability to Reach 2005 Levels by 2010" table below shows the affordability index, which

combines the mortgage finance rates and property prices for a typical borrower.

The good news is that the correction in interest rates and property prices is likely to bring

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the index back down to 2005 levels. The early signs (green shoots, if you will) of revival in the residential market are appearing. Sentiment which had turned negative has now turned positive on the expectation of a stable government and early indications that domestic consumption demand is intact.

Unlike some of the more developed markets, the Indian economy has a high savings rate and a robust domestic market. The evidence at the ground level seems to indicate that the average

domestic real estate investor/home buyer has not been adversely affected in large measure.

If one were to look at the composition of savings in India during the past 12 years, the allocation to hard assets moved up sharply by 24 percent and 40 percent in 1995 and 1996, respectively, leading to a significant correction. However, since 2000, the allocation to hard assets has remained steady around the 50 percent mark and showed no significant increase in the bull markets of 2005–2007, thereby indicating that the bubble may not have been caused by an increase in allocation of domestic savings. This is good news, and we expect the volumes to come back once affordability hits the sweet spot as mentioned earlier.

Commercial real estate is expected to take longer to revive on account of increased supply and the uncertain environment for the growth of the outsourcing industry — which accounted for approximately 80 percent of commercial demand. The investment sales market is yet to reach an equilibrium wherein a trade can be concluded. However, domestic

<b>AFFORDABILITY TO REACH 2005 LEVELS BY 2010</b>												
Measurement of affordability of housing in India, March fiscal year-ends, 1999-2010E												
	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009E	2010E
<b>Increase in affordability in FY2010E owing to decline in interest rates and selling prices</b>												
Housing loan interest rates (%)	14.5%	13.9%	12.8%	12.1%	10.4%	8.9%	8.0%	8.5%	9.5%	10.5%	11.75%	9.25%
EMI per Rs100,000 on 20-year loan (Rs)	1,366	1,240	1,160	1,110	995	895	836	868	932	998	1,084	916
Average annual household income (for households with annual income > Rs200,000) (Rs)		577,201	606,061	636,364	668,182	701,591	736,671	788,238	843,414	902,453	947,576	947,576
Income growth (%)			5.0%	5.0%	5.0%	5.0%	5.0%	7.0%	7.0%	7.0%	5.0%	0.0%
Taxes (Rs)		115,440	121,212	127,273	133,636	140,318	147,334	157,648	168,683	180,491	142,136	142,136
Post-tax income (Rs)		461,761	484,849	509,091	534,546	561,273	589,337	630,590	674,731	721,963	805,439	805,439
<b>Selling prices decline by 10% each in FY2009E and FY2010E</b>												
Capital price in Koramangala, Bangalore (Rs/sq. ft.)		1,900	1,800	1,750	1,900	2,350	2,800	4,500	4,750	4,750	4,000	3,600
Price of 1,500 sq. ft. house (Rs M)		2.9	2.7	2.6	2.9	3.5	4.2	6.8	7.1	7.1	6.0	5.4
EMI payable assuming 70% LTV (Rs)		24,738	21,924	20,396	19,850	22,084	24,578	41,013	46,484	49,775	45,528	34,625
Price/income ratio (x)		4.9	4.5	4.1	4.3	5.0	5.7	8.6	8.4	7.9	6.3	5.7
Affordability Index (assuming FY2000 as 100)		100	84	75	69	73	78	121	129	129	106	80
Capital price in Bandra, Mumbai (Rs/sq. ft.)		7,992	8,791	8,000	8,500	8,500	10,000	13,000	16,000	20,000	18,000	15,000
Affordability Index (assuming FY2000 as 100)		100	98	81	74	63	66	83	103	129	113	79
100 rupees = US\$2.07 as of 29 July 2009; Sources: RBI, Kotak Institutional Equities estimates												

consumption growth could provide a supportive environment for the strata title sale market for commercial real estate on corrected values.

India also has seen a frenzy of retail development or “announcements” for retail development. The market is very fragmented, and retail formats and consumer tastes are still evolving. Again, the current policy of restricting the entry of foreign retailers has put the brakes on growth here. However, at a macroeconomic level, a growing middle-class population, rising economic prosperity and a populace whose expectations have been roused cannot be ignored.

### LOOKING AHEAD WITH OPTIMISM

As we look ahead, there are several factors that can give rise to a favorable investment environment over the next few years. The key elements are:

1. The private sector insurance players are now into their 10th year of operation and are gaining critical mass in terms of capital under management, and this bodes well for the equity market as well as the investment sales market.
2. The new government is not constrained by the coalition left parties and is expected to

address the growth of the debt market and address the fiscal deficit by divesting stakes in government-owned entities.

3. Amongst the eagerly awaited policy decisions are higher FDI limits in insurance and opening up the retail sector.
4. Private sector managers have been approved by the government to manage pension funds. The funds will be managed by six designated fund managers, namely Kotak Mahindra, ICICI Prudential Pension Funds, IDFC Pension Fund, Reliance Capital, SBI Pension Fund and UTI Retirement Solutions.
5. The government is expected to focus on infrastructure investments both on its own account and through the public-private partnership route.
6. We also expect the government to pass a number of bills likely to enable easier conduct of business. Limited liability partnerships (LLPs) could become a reality, and the REIT market will get a move on.

As I write this piece, the Indian equity markets have already staged a strong rally, signaling hope, and the latest GDP data for the last financial year ended March 2009 has put growth at 6.7 percent, which is ahead of expectations.

Listed real estate companies have raised about US\$1 billion

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of equity from public markets, signaling the return of risk appetite. Developers are reporting a robust pick-up in sales volume in this new environment. There is murmuring of the decoupling theory playing out.

All in all, structurally, the world's second-fastest growing economy is well poised to live up to its promise and deliver the goods. ♦

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### Current Boom Not Driven by Sharp Increase in Investment in Physical Assets by Households (US\$B)

	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007
<b>Net financial savings</b>	<b>28</b>	<b>24</b>	<b>33</b>	<b>34</b>	<b>42</b>	<b>48</b>	<b>50</b>	<b>59</b>	<b>59</b>	<b>73</b>	<b>74</b>	<b>98</b>	<b>109</b>
As a % of household savings	60.6%	48.8%	60.6	54.7%	55.2%	50.9%	47.9%	49.5%	44.3%	46.8%	43.9%	48.6%	47.5%
Currency	3.7	3.8	3.2	3.0	5.1	4.8	3.6	6.5	6.6	9.8	6.3	8.5	9.4
Net deposits	9.8	8.0	13.8	13.1	12.8	13.3	16.9	17.3	16.2	21.8	27.5	46.1	60.6
Shares and debentures	4.0	2.1	2.4	1.2	1.6	4.2	2.4	1.8	1.3	1.3	0.8	4.8	6.9
Net claims on government	3.0	2.2	2.7	5.0	6.4	6.5	8.8	11.9	14.5	17.1	18.1	14.3	5.7
Net insurance funds	2.6	3.1	3.6	4.4	5.2	6.4	7.6	10.7	9.4	11.3	11.6	13.7	16.3
Provident and pension funds	5.0	5.2	7.1	7.5	10.8	12.5	11.1	10.8	11.1	11.7	9.6	10.3	10.0
<b>Savings in physical assets</b>	<b>18</b>	<b>26</b>	<b>21</b>	<b>28</b>	<b>34</b>	<b>46</b>	<b>55</b>	<b>60</b>	<b>74</b>	<b>83</b>	<b>95</b>	<b>104</b>	<b>120</b>
As a % of household savings	39.4%	51.2%	39.4%	45.3%	44.8%	49.1%	52.1%	50.5%	55.7%	53.2%	56.1%	51.4%	52.5%
Growth (%)	23.7%	40.4%	-16.9%	32.5%	20.4%	35.6%	18.5%	10.0%	23.6%	11.6%	13.8%	9.6%	16.1%

Sources: RBI, Kotak Institutional Equities