In a First, Domestic Institutional Capital To Target Office Assets in India

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The Real Estate investment industry has evolved considerably over the last 10 years, since the opening up of the real estate sector to foreign investment in 2005. The sector has seen nearly US$ 40 bn[1] of investment since 2005 and has witnessed multiple changes such as,

- Nature of investments (Equity/opportunistic investment to secured debt/annuity assets investment)
- Increasing dominance of foreign capital
- Blind pool funds being replaced by club/managed accounts

Till date, domestic capital has been active in the residential real estate sector, with approx. US$ 4 bn[1] of investments. In stark contrast, foreign investors have been acquiring real estate annuity assets (leased office/retail malls etc) with nearly US$ 4 bn[1] being invested by key foreign investors like Blackstone, QIA, Brookfield, GIC etc.

The primary reason for this dichotomy in investment strategy is the nature of domestic capital currently available in India for real estate investments. The available domestic capital is predominantly non institutional and retail in nature. Long-term institutional capital providers like pension funds, retirement schemes and insurance companies have not invested significant amounts in the Indian real estate sector primarily due to regulatory restrictions.

Due to a number of forces at work detailed below, India is poised to see a noteworthy change in this trend. We expect to start seeing domestic investors allocate significant capital to office assets.

Domestic Savings Growth Story[2]

India's domestic savings are expected to grow to 40% of GDP from the current savings rate of 31% by FY 2025. Household financial savings are estimated to grow to US$ 900 bn by 2025 at a CAGR of 20% over the next decade from the current savings of US$ 150 bn. Key drivers of this savings growth are,

- Higher GDP and Income Growth
- Favorable Demographics
- Lower Government Spending and Lower Taxation

One key characteristic of this growth is the increased allocation towards financial instruments. Primary drivers for this increased allocation are,

- Central Bank's focus on ensuring a positive interest rate regime
- Increased thrust by the Government to improve Financial Inclusion and Financial Literacy
- Greater focus on undisclosed income (reducing incentive to invest in gold/real estate)
- Policy changes (reforms in investment guidelines of pension/retirement schemes)

[1] Source: Brookfield Financial Services Report and Kotak Realty Fund Estimate
[2] Source: Kotak Institutional Equities May 2015 Strategy Report and Kotak Realty Fund estimates

Key Regulatory Policy Changes: Increasing Allocations towards Alternate Assets/Equities

The Government and regulators in India have embarked on a path to encourage investments by pension funds/retirement schemes in alternate assets.

- **August 2013**: Insurance companies permitted to make investments in AIFs
- **April 2015**: Retirement schemes permitted to invest up to 5% of their AUM in equity markets
- **May 2015:** The Government cleared the tax rules for REITs in the annual budget. The Government also announced that it would permit foreign investment in domestic investment vehicles called Alternate Investment Funds ("**AIFs**")
- **June 2015**: Indian pension funds permitted to invest up to 5% of fund AUM in units of Real Estate Investment Trusts ("**REITS**")

With these measures, investments by domestic institutional investors (DIIs) in annuity assets, like offices, retail malls, toll roads etc is expected to increase.

The Market Forces of Demand and Supply on an Upswing

The office assets market in India is on an upswing with both demand and supply factors turning favorable,

- Increased demand for office space from both traditional as well as new-age companies is leading to an increase in rents in some micro markets. Office leasing in the top 10 micro markets of India has increased by 30%[3] in 2014 compared to 2013.
- Limited development of office assets over the last 4-5 years post the Global Financial Crisis has led to a reduction of supply overhang. Supply of office space is expected to fall further going forward.
- Beneficial regulatory changes have also been announced by the Government and the capital markets regulator in the form of REIT regulations

Improved Liquidity for Office Assets

The exit environment for office investments in India has also improved significantly over the last few years with nearly US$ 4 bn[4] of investments being made by investors. Under the current allocation norms, pension funds can invest US$ 0.4 bn[5] in units of REITs. This allocation is expected to increase to US$ 10 bn[5] by 2020 further improving the liquidity of the office investment market.

In conclusion, we believe that grounds are being laid for the creation of a liquid market for annuity assets in India, especially office assets, by 2020. The interplay of economic growth, favourable policy changes and improving demand-supply dynamics in the sector, coupled with availability of long-term domestic capital augurs well for annuity real estate assets in India over the next decade. Close to US$ 20 bn[5] of domestic capital is expected to be allocated towards annuity assets by 2020 in India. Increased demand for office assets will lead in to a corresponding increase value, an added positive factor for making office investments in India.

(Views are Personal)

[3] Source: JLL REIS Market Report
[4] Source: Brookfield Financial Services Report and Kotak Realty Fund Estimate
[5] Source: Kotak Realty Fund Estimate