MARKET PERSPECTIVE

by Parry Singh, Subhash Bedi and Raj Inamdar

Taking Stock of Indian Real Estate

An Overview of 2010 Sector Trends and Long-Term Fundamentals in the Indian Property Market

India's economy has emerged largely unscathed from the global financial crisis of 2008 to 2009. During the past two years, India's real GDP growth per year has been sustained at 6.7 percent in fiscal year 2009 and 7.4 percent in fiscal year 2010. Given India's positive growth fundamentals, private equity real estate investors operating in India have been able to generate attractive returns from investments in various sectors, including value-oriented residential housing and budget hotels. In particular, value-oriented housing is the Indian real estate segment least sensitive to global market conditions, with demand buoyed by long-term fundamentals such as rising urbanization, income growth, youthful demographics and a burgeoning middle class with substantial savings and increasing purchasing power.

Despite this fertile terrain for real estate investing in India, prior to 2009 many global investment banks, hedge funds and private equity firms allocated excess capital to luxury housing, five-star hotels and suburban IT office projects that were more exposed to global market conditions, which exacerbated price corrections and oversupply situations. Many of these global financial players have recently exited the India real estate sector and remain on the sidelines, largely due to non-India factors, including limited partner withdrawals, global portfolio solvency issues, uncertain regulatory environments in home markets and generally increased caution following the global financial crisis.

As a consequence, there is now a shortage of institutional equity capital available for Indian real estate, which favors the few remaining private equity investors active in the market. Investments made in 2010 and 2011 are therefore well situated to produce substantive returns, given the limited competition and strong pipeline of investment opportunities available, including preferred return transactions and completion financings across asset classes. In the long term, India's real estate market continues to offer investors a range of attractive opportunities across sectors (such as affordable housing and budget hotels) and throughout the capital stack (including opportunistic equity, fixed-return instruments and core yield strategies).

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LONG-TERM MACROECONOMIC FUNDAMENTALS INTACT

Following the global financial crisis of 2008-2009, India's economy recovered quickly, illustrating the country's resilience and long-term macroeconomic strengths. With a gross domestic savings rate exceeding 30 percent of GDP and households with less overall leverage than those in most developed nations, India's consumption and capital investment segments began recovering quickly after the middle of 2009. Further, India's conservative banking sector had limited exposure to subprime-related securities and structured credit investments, which have been viewed as key catalysts of the global financial crisis. In addition, India's central government enacted a series of effective fiscal and monetary policy measures to counteract the financial crisis, measures that are now being unwound to ward off incipient inflation.

Thus, the global financial crisis helped create measurable pent-up demand for both affordable housing and large-ticket durables such as automobiles. Developers not only launched more affordable housing projects in 2009 to satisfy unmet middle-class demand, but annual absorption also increased from 44 percent to 56 percent year-over-year in India's top metropolitan areas despite the global financial crisis (see "Affordable Housing Absorption in India," page 14). Similarly, demand for automobiles grew over 25 percent in 2009–2010, sustaining a long-term compound annual growth rate in excess of 10 percent (see "Automobile Sales Trends in India," page 15). India's unleveraged middle-class consumer has therefore been essential to the country's economic performance in 2009–2010, and demand for large-ticket automobiles and affordable housing is expected to grow in excess of 7 percent to 10 percent per year in the coming years.

GROWING MIDDLE CLASS AIDS RESIDENTIAL PROPERTY

India currently has a substantial housing shortage, estimated at 25 million units, due to the country's population growth, inadequate housing stock and increasing urbanization. This shortage is intensified by the growing prevalence of smaller-sized households, as nuclear families now represent a larger share of the population. Demand for residential real estate has been propelled by rising middle-class incomes coupled with the increasing usage of mortgages from a low base. Despite these favorable trends, the global financial crisis fomented a correction in residential prices in India, particularly in the premium segment where prices fell 20 percent to 30 percent in many micro-markets. Buyers of luxury villas and flats, including wealthy nonresident Indians abroad, were particularly susceptible to declining stock market prices and a negative wealth effect, which curtailed high-end expenditures. Consequently, many developers shifted their focus to affordable housing and reduced ticket and unit sizes accordingly, thereby generating high sales volume in 2009–2010 despite the global financial crisis. As shown in the graph "Potential for Growth of Affordable Housing in the Indian Residential Sector," below, the "achievers" segment — the prime demographic for affordable housing — already contains more than 28 million households and is growing more than 15 percent per year. In addition, the even larger "aspirers" segment presently has limited private-sector housing stock to choose from, creating a long-term window of opportunity for both low-income housing builders and micro-mortgage lenders now actively targeting this sector.

OFFICE AND HOSPITALITY RECOVERY, CAUTION IN RETAIL

India's office markets are showing early signs of recovery in 2010. Office vacancy rates have generally stabilized in the mid-teens across India's largest cities, with Bangalore having the lowest vacancy rate of approximately 11 percent. Three key factors are currently supporting the office sector's stabilization and revival:

Reduced Supply — According to a 2010 survey by DTZ, new office supply has reduced 30 percent year-over-year, indicating that much supply anticipated in 2008–2009 has not materialized due to project cancellations and postponements. In addition, developers continue to be wary of commencing delayed office projects.

Increased Hiring — The manufacturing and service sectors have demonstrated healthy growth rates in 2009–2010, helping drive office demand. In addition, IT/ITES companies that are large consumers of office space are now providing positive outlooks on recruitment.

Rental Trough — Tenants recognize that rents have stabilized at market lows, which has drawn them back into the leasing market to secure favorable deals.

The premium hospitality segment has witnessed a strong recovery in 2010, with the return of global business travelers and tourists to India lifting occupancy rates and average daily room rates. However, the most attractive hospitality investment opportunities are within the budget hotel segment that caters to the domestic travel market, which held up better than the premium category during the global financial crisis. Domestic travel has grown at a high compound annual growth rate of 12.3 percent since 1996 and accounts for the majority of the hospitality sector's revenues. In addition, the budget hospitality segment is currently experiencing a shortage of more than 50,000 rooms, and a range of international hospitality brands have recently entered the India market to capitalize upon this large opportunity.

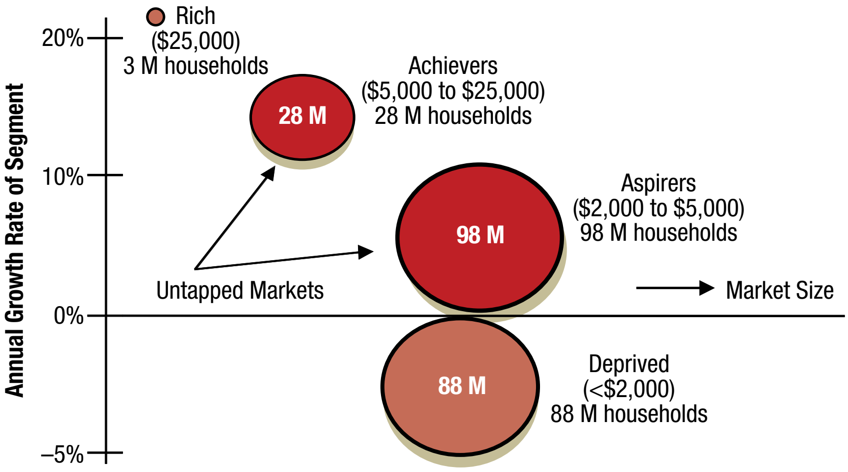
The formal retail sector remains the most challenged segment in Indian real estate, with extensive oversupply, low absorption and vacancy rates well in excess of 20 percent. Further rental corrections are expected, and many developers are therefore repurposing retail stock into alternative uses. Investment in India's formal retail sector involves higher risk than in other segments due to its operational nature, with scale, layout, tenant mix and common-area maintenance standards still not well understood by local developers; considerable competition from the informal retail sector, particularly in pricing and neighborhood convenience; and the strategic foresight required to understand competitor development plans within a project's catchment area. As a result of these factors, the formal retail sector will

Affordable Housing Absorption in India, Top Metropolitan Areas, 2008–2009

	Number of projects		Units on sale		Absorption rate (%)	
	2008	2009	2008	2009	2008	2009
Bangalore	15	26	2,633	5,049	41.1	42.9
Chennai	8	23	2,060	6,802	42.6	51.9
Faridabad	2	9	930	7,458	46.5	82.9
Ghaziabad	1	9	200	2,782	20.0	36.1
Greater Noida	2	5	542	2,180	32.5	37.2
Gurgaon	3	14	2,330	9,726	17.8	55.4
Hyderabad	12	9	1,458	1,552	20.1	30.9
Kolkata	6	10	1,250	1,040	58.4	45.5
Mumbai	6	15	1,287	11,925	28.3	51.2
Noida	2	6	1,600	9,004	92.6	66.6
Pune	19	32	3,889	8,076	42.9	59.9
Thane	2	12	1,012	5,920	85.5	48.3
Total	**78**	**170**	**19,191**	**71,514**	**43.9**	**56.0**

Source: PropEquity

Potential for Growth of Affordable Housing in the Indian Residential Sector (US$)



Note: M = millions of households; income groups represent annual income
Sources: NCAER, McKinsey, Red Fort Research

continue to present difficulties to real estate investors in India.

POSITIVE TRENDS SINCE THE GLOBAL FINANCIAL CRISIS

Global market conditions in 2008–2009 provided a strong dose of reality to India's developers and investors alike. Overall, many developers responded admirably to the twin challenges of illiquidity and stalled projects. The developers that made it through difficult times demonstrated a high degree of flexibility as they restructured projects, renegotiated bank lines, conducted secondary offerings and entered into timely funding arrangements with several private equity players.

During the past 18 months, there also has been a sustained shift away from land bank agglomeration (which caused liquidity problems) to focused project execution and cash flow generation. Developers now recognize the difficulty of going public in today's market as skeptical retail investors who purchased overpriced issues in 2006–2007 are now putting a premium on profitability and discounting illiquid land banks. As a consequence, developers now appreciate the benefits of value-added private equity capital to fund their projects and are more amenable to accepting transaction terms that better align incentives with investors.

Finally, the most positive 2009–2010 trend in the India real estate market has been the shift toward affordable housing, which is one of the most robust long-term asset classes in Indian real estate. Developers are now more sensitive to supply and demand data and end-user needs when pricing and marketing such projects. In addition, most developers and investors now understand the extensive challenges involved in executing large townships and have shifted emphasis to smaller developments with superior road and mass-transit access.

LOOKING AHEAD TO 2011

Going forward, investors and developers in Indian real estate will have three major risks that need to be mitigated: execution, end-user affordability and incentive alignment.

In 2011 and beyond, developers should focus on differentiating themselves on execution ability and demonstrated customer satisfaction. Buyers of large-ticket automobiles and durables have come to expect quality, reliability and performance, and they now expect the same from India's real estate developers. In order to scale and have the capacity to execute large projects in multiple locations, developers will have to continue efforts to professionalize their organizational structures. Activist investors who are able to gain the respect of developers with value-added contributions and execution expertise will be best situated to keep projects on track, deliver long-term returns and maintain solid relationships within the developer community.

End-user affordability is another issue of concern for developers and investors. Since May 2010, data indicates a resurgence of residential pricing in some micro-markets and declines in sales volume as a result. Particularly in Mumbai, some developers have altered product mixes and are now re-emphasizing premium residential units to generate higher margins. Given recent inflation initiated by India's economic growth, the Reserve Bank of India is expected to continue its course of monetary tightening, thereby making mortgages more expensive and putting pressure on luxury residential sales. In addition, India's stock market indices have increased significantly since March 2009 lows, and any correction could have a negative wealth effect that may also impact the premium segment. In such an environment, developers and investors should remain vigilant about what was learned in 2009 and stay focused on affordability metrics by offering unit sizes, ticket prices and product specifications within reach of middle-class buyers.

Finally, the alignment of incentives between developers and investors is a third major risk to mitigate. During the past several years, the few private equity investors actively deploying capital into Indian real estate have been able to structure transactions that better align incentives with developer partners. Alignment methods have included completion financings with no cash-outs, preferred return structures, stricter project-level controls and various downside protection measures. Developers and investors alike have benefited from this alignment and have now forged long-term relationships designed to persist through market cycles. Going forward, developers and investors have the opportunity to nurture these mutually beneficial relationships and ensure that India's private equity real estate space remains an optimal sector for both generating long-term returns and enabling developers to scale for the decade ahead. ❖

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Automobile Sales Trends in India, 2003–2010

Category	2003–04	2004–05	2005–06	2006–07	2007–08	2008-09	Year- over-year growth 2008–09	2009–10	Year-over-year growth 2009–10
Passenger Vehicles	902,096	1,061,572	1,143,076	1,379,979	1,549,882	1,552,703	0.2%	1,949,776	25.6%
Commercial Vehicles	260,114	318,430	351,041	467,765	490,494	384,194	–21.7%	531,395	38.3%
Three Wheelers	284,078	307,862	359,920	403,910	364,781	349,727	–4.1%	440,368	25.9%
Two Wheelers	5,364,249	6,209,765	7,052,391	7,872,334	7,249,278	7,437,619	2.6%	9,371,231	26.0%
Grand Total	6,810,537	7,897,629	8,906,428	10,123,988	9,654,435	9,724,243	0.7%	12,292,770	26.4%

Source: Society for Indian Automobile Manufacturers