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PRIVATE EQUITY

Trends in Real Estate Investing

The Year gone by

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The year 2016 has been a highly eventful year for real estate as various policies with far reaching implications such as RERA, GST and the much debated demonetization were introduced. These measures will bring a fundamental change in how business is conducted in this sector and will yield immense benefits in the long term especially for the institutional players.

The demonetization move by the government has led to a high level of uncertainty in the real estate sectors. To meet the challenges and requirements of the new RERA, developers will need to maintain high degree of corporate governance and customer satisfaction. This shall lead to consolidation in the industry and developers having a solid execution record will be much sort after by consumers and investors. These developers shall also be the ones having institutional backing enabling them to recover faster from the current slump in business.

In the last year, the residential segment has seen reduction in new launches across geographies as developers have focused on completion and delivery of projects on hand. In the immediate aftermath of demonetization, a drop in residential sales across cities has also been witnessed and this has accentuated the subdued demand scenario.

Private Equity Trends

Affordable housing	Increasing private equity participation on account of government thrust on 'Housing for all' initiative with various incentives for the developer
Structured equity	Decreasing interest rate regime will necessitate PE players to adopt quasi equity structures to achieve target returns
Warehousing	Infrastructure push and introduction of GST to boost organized warehousing and institutional participation through specialized funds
Inbound investments	Increasing transparency, easing of FDI norms and strong macroeconomic tailwinds to garner higher interest from global players
Commercial Office space	Grade-A commercial properties with BFSI, e-commerce and manufacturing tenants to generate attractive yields

On the commercial office space segment, we are seeing an upward trajectory after a fairly long period of consolidation. Office markets across top 6 cities (Mumbai, Pune, Bengaluru, Chennai, Hyderabad and NCR region) of India have performed exceedingly well in 2016 despite major uncertainties due to Brexit, US elections and slowdown in IT/ITES spending by Europe and USA. This year saw 40.6 Mn sq ft of transactions, that is slightly higher than last year. Though demand for office spaces was much higher in 2016, the same could not be converted into fresh leases due to shortage of good quality spaces in prime locations leading to many occupiers delaying or curtailing their demand.

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Additionally, there was a dip in the new supply that entered these top six cities during 2016. Vacancy levels, which had peaked in 2012 has seen huge improvement and is the lowest in recent history at 13% with Bengaluru and Pune at 6% and 8% respectively. With inadequate supply of Grade - A commercial spaces, in the last few years, the demand – supply mismatch is likely to rise. Hence, rentals are likely to increase steadily, leading to attractive capital gains in the next 4 - 5 years. I strongly believe that investment in commercial real estate will generate good returns in light of bottomed out capital values and increasing rentals. With BFSI, e-commerce, manufacturing leading the economic growth, Mumbai, is one of the exciting markets to watch out for and I expect strong demand and capital appreciation in Mumbai especially for Grade-A commercial assets. Given the low returns on traditional yield products, I strongly believe that commercial real estate investments is a compelling investment choice especially in light of increased absorption and favourable outlook for Grade A properties.

From a macro perspective, India saw over USD 5.6 Billion being invested through PERE in 2016 of which approx. USD 3.4 Billion was invested into residential and the rest into commercial assets. This action has been dominated by platform level deals and large ticket size commercial transactions. Exits by private equity funds reach approximately USD 1,022 million dollars and we ourselves achieved about USD 95 million of exit across our residential and commercial funds.

Budget Highlights

Affordable housing	Budget measures provide a significant boost to this segment and we shall see increasing number of developers undertaking such projects
Joint Development Agreements	Deferment of capital gains tax till project completion to result in more supply of land and consequently more opportunities for private equity investors
Refinance by NHB	To put a downward pressure on interest rates
Norms on thinly capitalized companies	This change, though not completely clear currently, may impact a highly efficient repatriation strategy for investments made in highly leveraged sectors such as real estate.

The Year In Progress

As always in a tough market environment, one has to dig deeper to find the real diamonds. We expect that institutions and private equity funds will have to go beyond the plain vanilla to spot the market outperformers in terms of the segment, location and investment structures.

Affordable Housing: Hitherto, affordable housing has suffered from lack of focus from developers because of economic non-viability. Over the past couple of years, we have witnessed greater focus on affordable housing by all stakeholders, especially from the government in line with its commitment to 'Housing for All'. The recent budget announcement provided additional benefits to this sector ensure housing for all by giving affordable housing an industry status. This will help developers in accessing lower cost funds, achieving better margins on account of 80 IB tax benefits and creating supply for the first time home buyer. The qualifying size of affordable houses being amended from built up area to carpet area is a significant move in expanding the bracket of homes under affordable housing such that even a 2BHK house in non-metros gets included in this category. This widens the affordable housing opportunities for home buyers and developers. Even prior to the budget, private equity funds had started eyeing opportunities in affordable housing and we also had many enquiries from overseas investors for this space. With the budget announcements, this sector looks even more attractive, and I feel we can expect private equity funds and foreign investors to increase their stake in this sector. Developers with the requisite execution expertise and ability to quickly churn projects will be partners of choice for such funds to enter into affordable housing.

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Structured Equity: Deal structuring in the recent past has mainly centered on mezzanine & structured debt to developers. Going forward, given the falling interest rate regime, high yield debt products will cease to excite developers. We have had a good experience in debt products for residential assets as we introduced such structures six years back and over the period have returned over 20% IRR p.a. across these investments. In my opinion, PE players will have to revisit the drawing board to change the nature of their participation in real estate and will need to take quasi equity positions or pure equity positions to achieve targeted returns. Such transactions, however, shall primarily, be with developers with a strong track record of execution and timely repayment to investors.

Logistics and Warehousing play: In addition, we are seeing higher interest from global institutional players for alternate real estate asset classes such as industrial estates, industrial parks and warehousing. With impetus being provided through initiatives such as Make in India, Ease of Doing Responsible Business, GST, etc these asset classes could provide steady yields. An increased allocation to infrastructure at Rs. 3.96 lakhs crore and to national highways at Rs. 64,000 crores in the budget also augurs well for the manufacturing sector and allied sectors which automatically translate to higher demand for logistics and warehousing. Going forward, we expect greater institutional participation in logistics especially warehousing development. We will see more funds with specialist fund managers to focus and manage these investments. Entry pricing in industrial real estate is competitive presently and hence should provide good medium to long term returns.

Foreign Participation: With the recent easing of increasing foreign direct investments rules and best practices being adopted, the real estate sector has been maturing and is expected to attract more foreign capital. Further the proposed abolishment of Foreign Investment Promotion Board in 2017-18 in this union budget, increases the prospects of raising foreign funds. This makes the sector more transparent and attractive for investment through FDI route which in turn will help in raising larger capital at cheaper cost of funding providing an impetus to investing in real estate. PE funds are looking to leverage on this rising interest amongst foreign investors.

On the flipside, provisions introduced in section 94B for thinly capitalized companies could impact the use of debt for foreign investments in Indian companies. Debt has always been a more tax efficient method of finance than equity as dividend income is not tax deductible. Thinly capitalized companies (where debt is higher than equity) have used this to re-characterize debt into equity and avail tax benefits. The budget proposes to bring in provisions which will limit this interest deduction that can be claimed by Indian companies for payments made to their associated enterprise situated overseas. This was an efficient repatriation strategy and this change will impact investments made in highly leveraged sectors such as real estate and infrastructure. In relation to foreign funds investing by way of compulsorily convertible debentures or non-convertible debentures, I feel it is not clear if this section 94B will be triggered on account of such funds being classified as an associated enterprise. In my opinion, a clarification is required to exempt foreign funds from this provision.

The years to come

Today, we are in the midst of sweeping changes which shall impact the industry for the long term. Though it is foolhardy to predict anything, what I definitely foresee is a cleaner, more stable, more institutionalized sector over the next few years. For private equity funds, key will be to be more hands-on in respect of their knowledge of micro markets, project development, and statutory approvals and processes and operations management. A fund manager with full cycle expertise shall carve a niche for itself.