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IDBI capital

# Real Esate Sector

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## Introduction

The real estate story in India is growing bigger by the day as it continues to receive an ever-increasing influx of funds. While more than 35 big-ticket foreign funds have already checked in, the first half of 2007 will see at least 20 more funds making an India entry. Meaning, US$ 10 billion of foreign direct investment (FDI) will be injected into the real estate sector.

Merrill Lynch forecasts that the Indian realty sector will grow from US$ 12 billion in 2005 to US$ 90 billion by 2015. Prominent global funds including Carlyle, Blackstone, Morgan Stanley, Trikona and Warbus Pincus are sitting on a total corpus of US$ 12-15 billion, say experts.

Retailers in India--the most aggressive in Asia when it comes to expanding their businesses--are creating a huge demand for real estate. The Jones Lang LaSalle third annual Retailer Sentiment Survey-Asia revealed that India topped the chart with 45 per cent expanding rapidly followed by Greater China at 27 per cent and other South East Asian capitals at 6 per cent.

Real estate is one of the 'hottest' investment destinations at present, second, perhaps only to stocks. There has been considerable interest in it for quite sometime now, mainly due to blistering appreciation in real estate prices. While the interest is restricted largely to institutional investors and HNIs, retail investors are already salivating at the prospect of participating in the real estate opportunity once mutual funds get the green signal to launch real estate mutual funds (or REITs, as they are known in the US).

Traditionally, Indians have had a fascination for physical assets and when they can afford them, they cannot seem to get enough of them. That explains why real estate and gold figure high in the 'must-invest' list for a lot of Indian investors.

A progressively changing regulatory framework and increasing importance of urban development are transforming the real estate landscape of India. However, certain risks - mainly the sharp run up in property prices - remain, which may impact demand across segments.

Indian Real Estate Landscape is transforming: Aided by progressive regulations and a planned approach to urban development, large-scale projects and improving governance standards are replacing a highly fragmented market structure and general lack of transparency in the Indian real estate sector.

Strong potential and profitability; but not without risks: Residential development is the largest segment of the Indian real estate market and also the most profitable. The strong demand and profitability in the sector may, however, be at risk - mainly on account of the sharp run up in property prices and upturn in interest rates (residential), rising rentals (commercial and retail) and confusion on regulations (SEZs).

Real estate development is estimated to be in the region of US$ 15 billion, growing at a pace of 30 per cent each year. Almost 80 per cent of real estate developed is residential space and the rest comprise office, shopping malls, hotels and hospitals. This double-digit growth is mainly attributed to the offshoring and outsourcing business, including high-end technology consulting, call centers and programming houses which in 2003 is estimated to have accounted for 10 million square feet of real estate development.

The sustained demand from the Information Technology sector certainly changed the urban landscape in India. It has been estimated that in India, there is a demand for 66 million square feet of IT & ITES space over the next five years. Several multinational companies continue to move their operations to India to take advantage of lower costs. With human resources being the key element in this industry, the hiring and housing of people, both at their work place and home assume great importance and therefore the need to create space for people to work and live, which in turn triggers the development of other related infrastructure.

The predominant trend has been to set up world-class business centers, often campus-style establishments, bearing a distinctive corporate stamp. So distinct are some of these locations that they are being termed as the "temples of modern India" - just an indication of the extent of real estate development taking place.

Another case in point is Gurgaon, a suburb of New Delhi, which has seen a radical change in not just its skyline but also in its basic urban demographics. Gurgaon was once described as just a little town built on a cow pasture. But in the past three years, Gurgaon has sprouted six malls - with five more under construction and has a skyline of shiny new office buildings and call centers. Gurgaon is a shopper's paradise and the malls are vertical versions of their US counterparts: five story high bazaars, housing almost every international brand be it Nike, Nokia, Tommy Hilfiger, Levis, McDonalds along with multiplex cinemas, escalators and huge parking lots.

The advent of call centers, programming houses and other such BPOs in India has led to an influx of over 785,000 new jobs. Outsourcing has changed the face of commercial real estate in India, but its greater impact has been the demographic shift characterized by rising disposable incomes and increased consumerism.

The real estate market in India predominantly continues to remain unorganized, fairly fragmented, mostly characterized by small players with a local presence. Traditionally, developers were viewed with an element of skepticism. Developers were often identified with dealing with large amounts of unaccounted money, lacked transparency and would use unscrupulous means to obtain various regulatory approvals. Lending to developers was perceived as being risky as builders were known to borrow for one project and utilize it for another or overstretch their limits and not have sufficient funding to complete the building.

But things have clearly changed today: for starters, developers have realized the merits of corporatising themselves and enhancing transparency in terms of their financials. While earlier even the reputed builders had difficulty accessing formal channels of credit, today almost every bank and housing finance company has relationship tie-ups with developers and are keen to lend to them at competitive rates. Lenders are also monitoring the projects more closely. For instance, lending to developers is often through an escrow mechanism which ensures that funds are utilized only for that particular designated project. Today specific projects of developers are also being rated. The objective of the ratings is to help the financers as well as the end users to take a decision while investing in a real estate project. The rating system also means a greater amount of transparency and disclosure on the part of the developers.

In 2002, the Government of India permitted 100 per cent foreign direct investment (FDI) in housing through integrated township development. The merits of FDI are well known - it provides the much needed investment in the sector, brings professional players equipped with real estate expertise and facilitates the introduction of new technology. However, the FDI rules in its current form are rather stringent - prior approval of the Foreign Investment Promotion Board is required which admittedly can be rather tedious and there is a lock-in for repatriation of original capital invested for a period of three years. What is rather self-defeating is the stipulation of a minimum land holding of 100 acres. Getting 100 acres of free land in an urban area is almost impossible and consequently barely a handful of projects have been approved. If the minimum area restriction is reduced at least by half and repatriation of profits after the construction period is completed is allowed, FDI in this sector will certainly pick up. In this aspect we have a lot to learn from our Chinese compatriots. Recently, the Securities and Exchange Board of India, India's capital market regulator has permitted venture capital funds to invest in real estate - this augurs well for the industry.

# The domestic real estate scenario

The Indian real estate industry has witnessed dramatic changes over the last two years. There are several reasons for the booming real estate industry. The integration of the Indian economy with the global economy has led to an increase in corporate activities. This has led to a huge increase in demand for commercial and retail space.

Let us briefly examine the different categories of the Indian real estate industry:

1. **Residential**

   Demand for residential space has grown by 30% pa for the past five years led by a host of reasons:

   - Population of 1.1 bn growing at 2% pa
   - Shift from joint to nuclear families creating demand for new homes
   - Easy availability of finance - Banks have been increasing their lending to consumers. Borrowers can borrow upto 75% of the property value. Consequently bank credit in India as a percentage of GDP has grown from 25% in 2001 to 44% in 2006
   - Rising income and affordability levels - Incomes have grown by 50%-100% over the last two years, primarily due to GDP growth of more than 7% and benefits off global off-shoring. However the maximum percentage increase is in the highest income group. Apart from this, there has also been an attitudinal shift from saving to that of saving/ spending. India is gradually becoming a consumption-oriented nation
   - Low interest rates - The effective rate (post-tax) on interest on home loans has decreased from 11.73% in 2000 to 5.93% in 2006, thanks to Income Tax deductions available on interest and principal repayments
   - The existing shortage of 22 m housing units and an annual incremental demand 4.7 m units

   But there is also a flipside to this - there is a serious concern about the real estate market overheating. Higher prices coupled with an increase in housing loan interest rates (hovering around 12%-13%) has led to:

   a. **Unaffordability**

      For the common man the dream of buying a home has been further delayed. The speculative element has crept in and almost two-third of the sales are to investors. This has pushed up the real estate prices to unaffordable levels. ICICI, one of the leading housing finance institutions has seen a YoY decrease of 20% in 2007 in new housing loan applications.

   b. **Increase in loan tenure**

      Loan tenure has increased from 120 months in 1998-99 to 190 months in 2006. The recent increase in the interest rates has increased the tenure to as much as 20 years and in some cases to even higher than that.

   c. **Increase in EMI to income ratio**

      EMI to income ratio has increased from 32% in 1998-99 to 39% in 2006. At this ratio, a salaried individual finds it very hard to meet EMI payments and the family's day-to-day expenses on education, health, food and travel. The cost of residential housing, which was typically 4 years of the gross earnings of an individual, today is at least 6-7 times.

2. **Commercial**

   Demand for commercial space is driven by the fact that India is poised to become the back-office to the world while the large domestic population is attracting multinationals to satisfy local consumption. Around 103 m sq. ft. of new office space, including IT, is likely to hit the Indian market by 2008.

   a. **IT/ ITES**

      Indian IT/ ITES sector has about 60% of the global offshore market and occupies 80% of the office space. In 2006, IT/ ITES companies absorbed office space of around 22 m sq. ft. across five major cities. The sector needs 60-80 m sq. ft. by 2010. The sector is expected to grow at a CAGR of 28% and reach US$ 60 bn in export revenues by 2010.

      This sector is expected to undergo a huge change in 2009 by which time the tax breaks given to IT Parks will have been taken away and will only be allowed to SEZs.

b. **Retail**

Organised retail industry, which was 2% of Indian retail industry, has been growing at 25%-30%. It is expected to grow at the same pace and reach US$23bn by 2030. Currently 360 malls are underway and 110 msqft will come up by 2010.

However, it seems that mall development has followed a herd mentality as there is little differentiation between products. Developers have treated it as an opportunistic business rather than a focused business strategy.

Talking to end-consumers of retail space, it was discovered that the current rentals being charged by mall owners is way above the affordable levels. For example, a fast food chain has a capacity to pay up to 15% of its revenues in rentals, it is nowadays getting proposals where it has to pay as much as 28%. The choice is between footprint and profitability; in this case the company chose profitability and so has stunted its growth/ expansion.

c. **SEZs**

The Government of India has sanctioned 200 SEZs ranging from IT to textiles to engineering. Around 100,000 hectares of land is proposed to be developed in these SEZs which provide tax benefits and competitive infrastructure.

However land acquisitions has become a contentious issue and the dust is yet to settle on this front. Meanwhile, the government has placed more onerous responsibilities on SEZ developers and it remains to be seen which projects actually see the light of day.

d. **Hospitality Sector**

Domestic and international operators are planning to invest in 3-4 star category hotels. India requires another 75,000 to 100,000 rooms in the next five years to meet growing demand.

## Opportunities? Or lost Opportunities?

The returns have been phenomenal in all segments in the real estate sector over the last few years. Real estate prices have increased by 50%-100%. The stock market too has been smiling at real estate stocks. If one had bought Unitech shares in December 2005 for Rs. 16and sold in December 2006 at Rs. 450, he would have made around 27 times his investment!

## Risk is a significant part of the equation

The key sector risks for Indian property are legislative changes regarding tax breaks currently available for mortgagees, higher interest rates and vastly inadequate infrastructure. Travel through India is still a bumpy ride. All modes of transportation are in desperate need of modernisation, roads are congested, airports are not up-to-date and, while rail is the preferred mode of travel for most. Many of India's laws remain archaic, even if they are being slowly repealed. Asset ownership is extremely fragmented for both office and retail space. The key company specific risk surrounds their ability to ramp up production to unprecedented levels. Failure to deliver is likely to lead to a significant sector de-rating.

## Regionally fragmented market

Although the likes of DLF and Unitech are rolling out pan India, yet real estate market in India remains largely unorganised and fragmented with a handful of real-estate developers dominating a city / region. Going national is difficult to do and few, if any, developers have done it successfully. Property regulations are very much state based. The key reason has been importance of understanding of local market and environment. It also can be a matter of 'who you know', not 'what you know', particularly in Tier II and Tier III cities. New entrants will likely take a while to understand these local nuances.

In the medium-to-longer term, the companies that possess quality land bank, healthy balance sheets, efficient market share, proactive management and strong local expertise are in a better position to capture market opportunities.

## Transparency levels are improving yet far from international standards

Real estate sector in India has traditionally been unorganised involving illegal transactions to evade tax or utilise their unaccounted money. However this trend is witnessing a decline mainly due to a change in buyer profile (larger proportion of buyers are end users), increasing easy availability of housing finance which would obviously not fund the cash component and favourable changes in the stamp duty law. Additionally property transactions, ownership records as well as land titles are unclear and the legal system is fraught with loopholes. Also in the building industry, standards are not uniform or enforced.

## Improving Infrastructure

India has made significant progress in the development of its telecom infrastructure, and is now beginning to tackle its inadequate transport infrastructure. Major programmes include 'The Golden Quadrilateral' project to provide an interstate road link between its four largest metropolitan areas - Mumbai, Delhi, Kolkata and Chennai. New international airports are planned for Bangalore, Hyderabad and Pune, together with upgrades and privatisations of both Mumbai and Delhi international airports.

Shipping and logistics are the next focus of infrastructure investment, with growing dependence on global cost efficiency. Significant capital allocations are also expected for 'soft infrastructure' projects including healthcare and education. The current push for infrastructure development, with its accent on public-private partnerships, is likely to have a highly favourable multiplier effect on the Indian economy and real estate market.

We shouldn't get ahead of ourselves though. Travelling through India is not easy. It still has some way to go before it even matches China for ease of travel (and we are not saying for an instant that travelling through China is necessarily easy either). Growth in infrastructure provisions will be good but this is coming off a fairly low base.

## Infrastructure improving but still a significant issue

Travel through India is still a bumpy ride. All modes of transportation are in desperate need of modernisation, roads are congested, airports are not up to date and while rail is the preferred mode of travel for most, Mumbai for instance does not have enough rail tracks for a city of 15m plus people. For an office asset to be classified as A Grade, it must have its own water tanks and back-up power generator as government-provided services are not reliable. Water supplies have a 'waste' factor of 50% due to unauthorised diversions from government-laid pipes. Partly as a result of this floor space ratios (FSR) across the country are generally <2:1 as current infrastructure cannot keep up with development potential.

Though the real estate sector is growing at a blistering 30 per cent annually, cities in India are crumbling with little or non-existent infrastructure, traffic snarls and increasing pollution: all a result of haphazard or no urban planning. This is apparent in Tier II and Tier III cities that are seeing so much real estate action for the first time.

Cities around the globe have been through major transformations in the past decade in order to remain magnets for business and growth. While some have undertaken impressive redevelopment programmes, others are creating new models such as multi-core urban zones to reduce congestion. Dubai, Beijing, Hong Kong, Bangkok, Tokyo and Singapore are key examples. Mumbai, the financial powerhouse of India, houses the headquarters of some of India's and the world's most respected corporations and institutions. There is no dearth of visions for Mumbai city, but what is lacking is effective implementation. Public investments with Central help and State facilitation need to leverage private investments.

## Significant growth potential in FDI

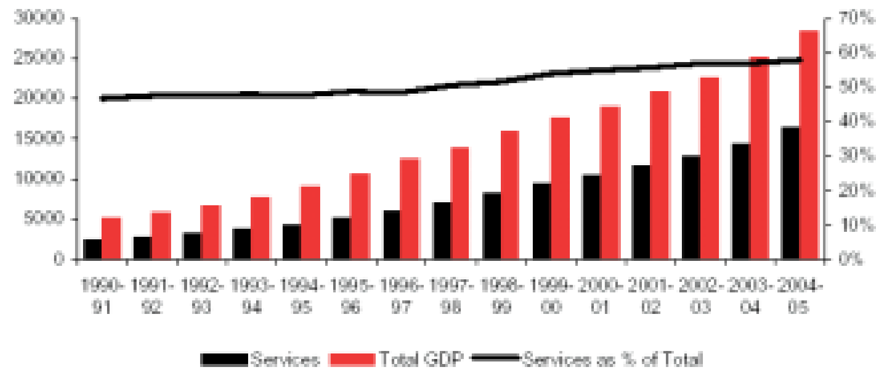
Key FDI sectors have been IT, telecoms, electronics, pharmaceuticals, automobiles and financial sectors. While growth has been strong, nonetheless FDI is still well below its full potential, and low by global standards, estimated at less than 1% of GDP (compared to 2.4% in China and 1.8% in Brazil). There should be a rapid acceleration in FDI inflows, as India increasingly attracts the attention of the global investment community and further reforms are introduced. In a recent survey by AT Kearney, India is ranked as the world's second most attractive investment destination, behind only China. However FDI flows are far behind those entering China. In 2005, China experienced US$60.6bn of FDI in flows versus India's US$5.3bn.

## India the most preferred location for outsourcing

India has a large skilled labour pool, with 2.5m new graduates added to this pool each year, most of whom are proficient English speakers with strong technical and quantitative skills. The country has a total graduate population of nearly 50m, of which an estimated 14m are young university graduates (those with seven years or less of work experience). This pool is 1.5 times the size of China's and almost twice that of the US. It is estimated that there are 150,000 IT professionals in Bangalore as against 120,000 in Silicon Valley. Meanwhile, wage levels and the cost of living are still low by international standards.

India's service sector accounts for 50% of the country's GDP and has been the main engine of economic growth in recent years.

Share of services in GDP



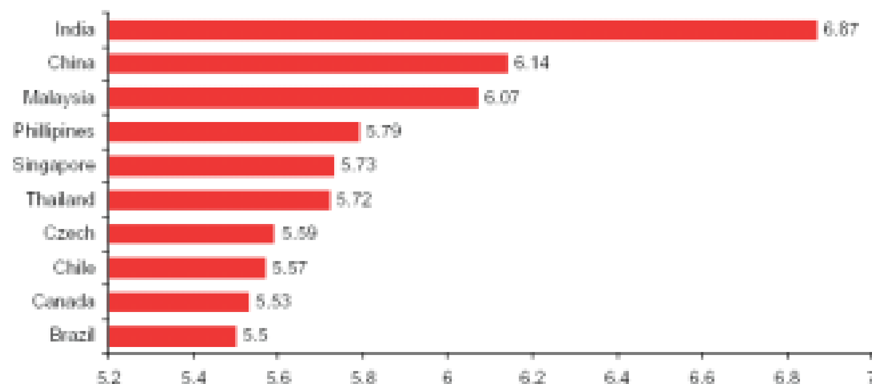

Led by IT and ITES (IT Enabled Services), India has become the favoured location for business outsourcing. However, it is important not to think of this as just call centres. India's service sector is rapidly changing, and moving up the value chain, from a provider of low-cost services (e.g. call centres) to high-value IT, business processing management and high level analytics and consulting.

New opportunities are emerging in engineering design, biotech research, equity research and market research. India is witnessing strong growth in R&D activity, particularly related to electronics and telecoms. Many of the major US and Asian IT and telecoms firms have a significant R&D presence in India, including Hewlett Packard, IBM, Intel, Cisco, Samsung, Microsoft, Oracle, Dell, Motorola, Nokia and Texas Instruments.

Over 10 years of outsourcing and off-shoring activities has established a deep multi-national and domestic corporate base, creating strong demand for commercial office space:

- Outsourcing is resulting in the rapid expansion of multi-national third-party service providers such as Convergys, EDS, Accenture and EXL
- The large multi-nationals continue to spur growth - including GE, Prudential, HSBC, Bank of America, Standard Chartered and American Express
- A significant trend is the emergence of Indian software companies as key drivers. The largest, such as TCS, Infosys, Wipro and Satyam are becoming global brands, and are not only expanding rapidly across India, but also internationally into markets such as China, Europe and North America

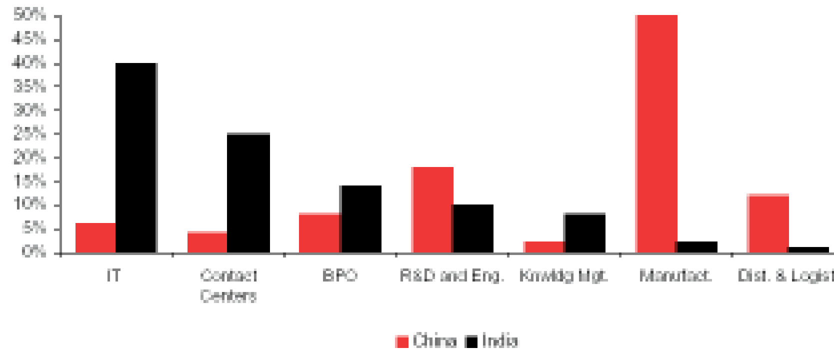
AT Kearny's 2005 Global Services Location Index (X)




*Source: AT Kearney, 2005*

India continues to top the AT Kearney Offshore Location Attractiveness Index by a significant margin, due to its mix of low costs, significant depth in human resources and critical mass of existing outsourcing activities. Exports will continue to be important to the IT and ITES sectors, but increasingly the domestic market will be the key driver of growth, underpinned by the strength in the economy.

**Location preference by business functions**




*Source: AT Kearney, 2005*

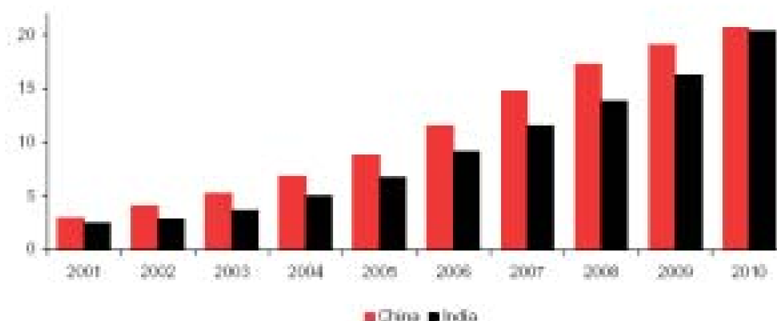
India is increasingly a source of healthcare products in emerging markets. Leading multinational pharmaceutical companies, such as GSK, Pfizer, Merck and Novartis are already active, but the sector is expected to parallel the growth of the IT sector, with increasing outsourcing to Indian companies. Major pharmaceutical firms are looking at India as the favoured destination for clinical research and development.

## Favourable demographics

A large middle class has emerged in India and is currently estimated at around 300m, half of whom are under 25 years of age. India's National Council of Applied Economic Research expects a further 180m to join the middle classes by 2010. India has a large, young and urbanising population. The country is urbanising at a rapid rate of 2.5% annually. The number of cities over one million is expected to double from 35 in 2001 to 70 cities by 2025. India's 'mega-cities' of Mumbai and Delhi will be the world's second and third-largest cities by 2015.

With a strong economy, real annual personal disposable incomes are set to increase by 8-10% annually over 2006-10, providing a significant boost to the demand for lifestyle products and services. Median household incomes are expected to grow from US$2,000 in 2005 to US$3,200 by 2010. The following figure shows how households that earn >US$5,000 are expected to grow over the next four years. It should match China by 2010.

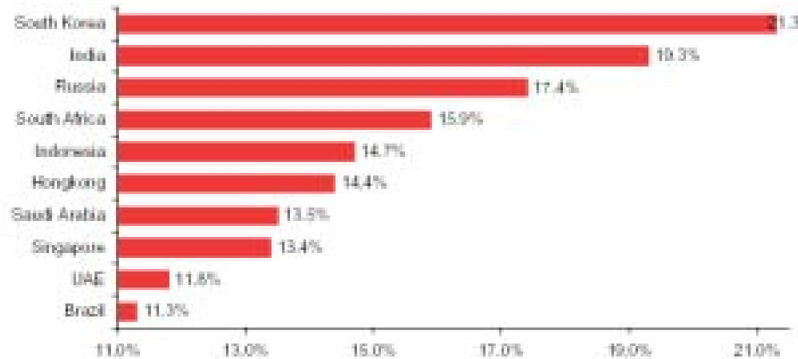
**% of households earning more than US$5,000 pa**




*Source: Economists Intelligence Unit, August 2006*

The number of high net worth individuals is rising rapidly in India. In macro terms, this is partly due to the fact that India is a free market economy (rather than state run) which is developing quickly. In fact, growth in this category is far higher than more developed Asian regions such as in Hong Kong or Singapore.

**Growth in high net-worth individuals in 2004-05**




## Population distribution unique

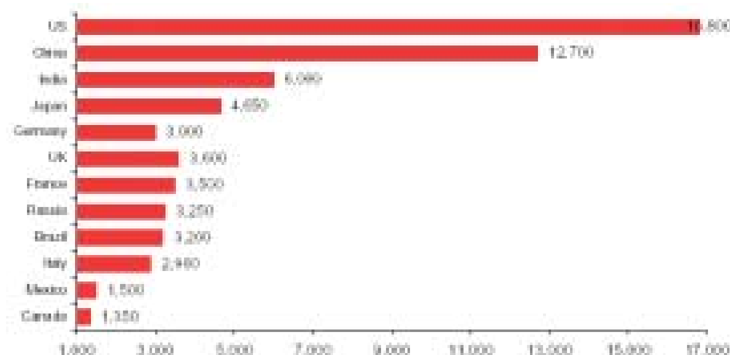
The country's population of 1.1bn is set to continue to increase until at least 2030, before stabilizing at around 1.5bn. By this time, India will have overtaken China as the world's most populous country. India has a very young population profile. Half of its population is under 25 years, and the country's median age is 24 years (2005), compared to 33 in China and 43 in Japan. India's large population is now being viewed as one of its key strengths. A young and urbanising population is unleashing significant demand for products and services, and is providing massive labour market opportunities.

India's young population is clearly very different to both China and western nations. The aging population phenomenon that developed nations are facing is some time off for India. The difference with China is also significant. China's one child policy means relatively fewer an issue now, it will become an issue in the future.

## Unique demographic drivers

There is little doubt that India has huge potential. Even stating this risks stating the obvious. It is the fifth-largest economy in the world (ranking above France, Italy, the United Kingdom, and Russia) and has the third-largest GDP in Asia. It is also the second-largest among emerging nations. (These indicators are based on purchasing power parity). The estimated size of organized Indian real estate sector accounts for US$12bn of India's US$800bn GDP economy which is far less compared to mature economies.

**World's largest economy's in 2010 (GDP, US$ bn); purchasing power parity)**



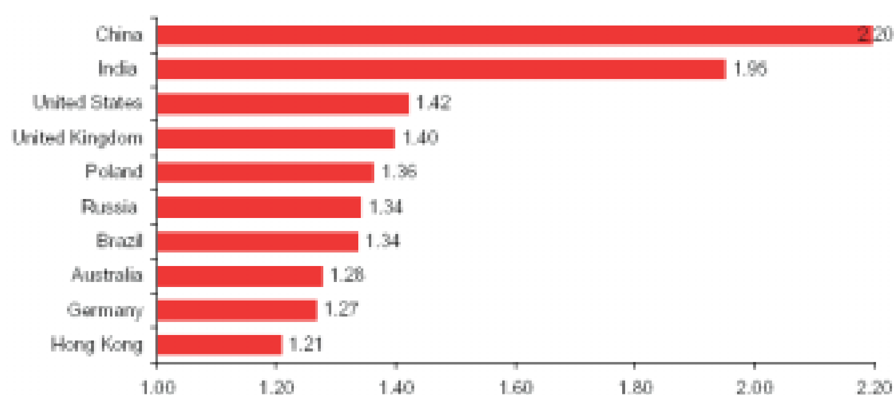

*Source: EIU 2006*

Relaxation of foreign direct investment rules has expanded the mountain of capital in every sector of Indian economy. The government is making efforts in liberalizing the guidelines and norms for investment through FDI, making them more NRI friendly. Growth in the Indian real estate sector was estimated at 30% last year, owing to FDI norms and related growth drivers. By 2010, the real estate sector is estimated to reach US$45-50bn in size. The real estate has the potential to touch US$90bn in size in 10 years.

Real estate prices in general have been on an upswing in all markets across most sectors over the last two years. An estimated 30m homes are expected to be sold in the next five years. Driving through major markets, the boom is very evident to the naked eye - with infrastructure being updated, BPO offices being built on the outskirts of almost every major city and residential towers springing up. Our bumpy ride through India was not caused so much by erratic driving but more due to new roads being built seemingly everywhere.

One thing that is abundantly apparent is that there is unbridled optimism in India. This optimism appears based on expectations for growth and a positive outlook for the property sector generally. The following figure shows that the attitude of only those in China is more optimistic.

FDI Confidence Index




*Source: AT Kearney Report, 2005*

## The question of clean title

The difficulty of obtaining title guarantees in India means that title records provide only for presumptive rather than guaranteed title. Many landowners invariably have irregularities of title such as non execution or non registration of conveyance deeds and inadequate stamping and may be subject to encumbrances that the 'owner' may not be aware of.

To detect these discrepancies among the publicly listed property companies in India is almost impossible. In most cases this is not disclosed.

## Land bank quality

This is the most important factor as property is about 'location, location and location'. If location is good and the land bank has been substantially acquired at prices well below current levels, developments may see a very good response even if all the other qualities are substandard.

### Something on SEZs

- The quality of each developer's land bank is judged on four key criteria: 1) Tier-1 cities vs Tier-2 cities, 2) land-bank diversification, 3) urban vs suburban and, finally, 4) average scale of each project. In terms of preference, we rate land bank in urban areas of primary cities as the highest quality as we believe the underlying value of such land banks is most secure and easy to realize
- By the same token, land bank in suburban areas in Tier-2 cities is the least preferred. In general, we prefer large-scale over small-scale projects, as this leads to economies of scale.

### Rising mortgage rates and stricter RBI regulations

Lower interest rates on housing finance from India's retail banks and housing finance companies and favourable tax treatment of loans, have helped fuel the recent growth of the Indian real estate market especially residential. However, interest rates in India are heading north, which could discourage consumers from borrowing to finance real estate purchases and depress the real estate market. Additionally, regulations like stricter provisioning increased risk weightage norms imposed by the RBI in relation to real estate loans could reduce the attractiveness of property or developer financing. RBI or the GoI may take further measures designed to reduce or having the effect of reducing credit to the real estate sector.

## Valuing a Company

### Management

The assessment of management takes into account factors such as ability to add value, management of capital, conflict of interest, vertical integration of the business and adequate resources for business operations. Adequate disclosure is also a crucial component recently lacking in India's property market.

### Asset turnover

Rapid asset turnover minimises the impact of market changes and recycles cash faster. Asset turnover is determined by the years of land bank, completed GFA pa, FY07 ROA and ROE. This is also where we bring in the companies' PER in our analysis.

### Gearing

In valuations for property companies where the cost of debt is lower than the cost of equity, DCF valuations generally suggest that the higher the gearing, the lower the discount rate. This may overlook stretched balance sheets, low interest coverage or short loan maturity, which may have an impact on the going concern of companies when markets are difficult.

### Sector Segmentation

#### Residential: Still a price and volume game

Regionally there continues to be a focus on volume growth over margin expansion from major price increases. This is not the case in India. The Tier-1 city boom is spreading more slowly to the Tier-2 and Tier-3 cities. We expect residential price growth of up to 15% in the Tier-2 cities and 15-25% in the Tier- 3 cities over the next 12 months. Meanwhile, affordability has improved by a factor of 3x in the past ten years due to lower mortgage rates and increased tax breaks.

According to DTZ, approximately 80% of the demand in the real estate sector in India lies in the residential segment. Low per capita housing stock, higher disposable income, the falling age of first-time home buyers and all-time low interest rates coupled with surging home loans is fuelling demand for the sector. The housing sector is currently growing at 30-35% pa. Significant demand is also coming from investors who view housing as a safer investment option when compared to shares and mutual funds.

Key drivers include:

- A growing middle class and increasing urbanization, resulting in shortages of housing units in the suburban regions of urban areas;
- An increase in disposable income levels, due to a decrease in marginal tax rates and increase in total incomes making housing more affordable;
- An increase in the rate of household formation, due to a structural shift from a joint family system to nuclear families. Young professionals are moving out of home earlier than in previous decades;
- Changing attitudes to home ownership - the current average age of a new homeowner is now 32 years, compared with 45 years a decade ago;
- Increasing affordability of residential property, due to declining interest rates and tax related incentives.

## Shortage of housing stock

According to the government's 10th Five-Year Plan, which ends in 2007, the country is facing a housing shortage of over 20 million units. Within this shortage 70% - 80% is in the low-income segment. The plan estimates the country's housing requirement at 4.5 million units per year. The government aims to provide housing for all its citizens by 2012, requiring an investment estimated at close to $800bn. While admirable, this would appear an impossible target to meet.

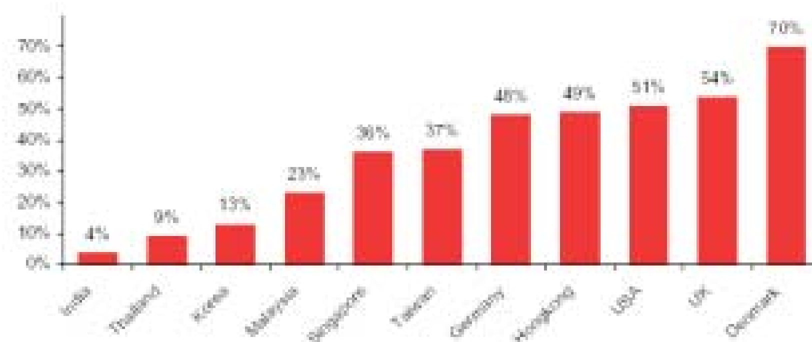
## Availability of mortgage financing

Getting a mortgage is easier than ever. Modernisation of systems and a higher level of commercial focus along with lower interest rates relative to a few years ago has revived interest. The rise of the private sector banks has assisted this greatly. However, they still account for only around 20% of the Indian banking sector which shows substantial opportunity for additional growth.

Additionally, India is moving away from the old system of the employer (say, a government sector) providing emplyees with accommodation, cars etc. Now packages are more likely to be financial remuneration only, enabling the employee to buy their own dwellings.

The mortgage to GDP ratio (ratio of outstanding home loans to GDP) in India is tiny in comparison with other economies. In developed countries the ratio varies from 25% to 70%. For the latest available year, the mortgage to GDP ratio in India is just 4%.

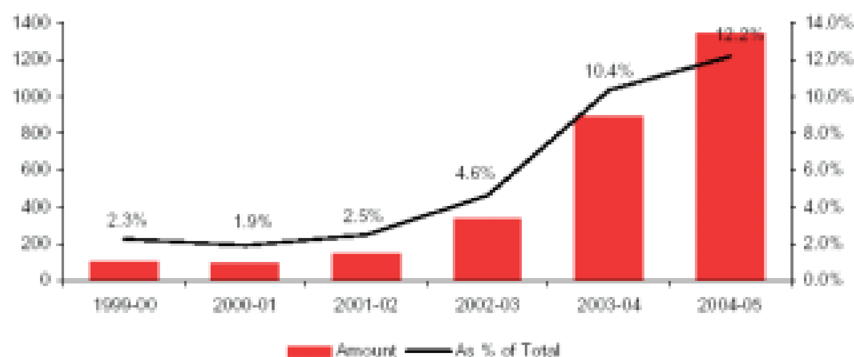
### Mortgage as a % of GDP




*Source: NBO, August 2006*

From the following chart, it is clear that mortgages will become an increasingly important part of India's economy. After being just 2-3% of total bank loans in 2000-2002, residential mortgages in 2004-05 were 12.2% of total bank credit.

### Housing loans as a percentage of total bank credit (Rs bn)



## SEZs likely to take some time to make an impact

Special Economic Zones (SEZs) are taking India by storm. The Ministry of Commerce and Industry estimates that there is about 5,000 acres of established SEZ land - tiny compared with regional peers. Tax breaks for India's SEZ operators are numerous. Our impression is that while the establishment of SEZs is undoubtedly positive, it will probably take developers longer to make money from them than the market currently anticipates.

## What's a SEZ and where did they come from?

According to KPMG, the concept was first envisioned by China in 1970 with an aim to initiate development in economically backward areas of the country. The government had declared a few areas as "development technology promotion zones" to promote transfer of superior foreign technology. The government also offered various fiscal incentives, flexible labour laws and favourable foreign ownership laws. The focus was a clear promotion of export activity. The concept was a success and was copied with modifications in other countries in South East Asia and South America.

Very few of us are aware that an SEZ is a delineated duty free enclave considered to be foreign territory for the purpose of duties and tariffs. Goods and services coming from this area into DTA (Domestic Tariff Area) will be treated as being imported. With a view to boost the investment climate and economic growth, the Government of India introduced a policy on 1st April 2000 for setting up SEZs in the country. The SEZ policy was envisaged with a vision to provide internationally competitive and hassle free environment for exports. The Special Economic Zones Act (No. 28 dated 23-06-2005) was enacted by the Parliament to provide for the establishment, development and management of the special economic zones for promoting of exports and other peripheral activities related to exports. There was no intention of spurring the Real Estate sector by introducing such a policy as it was not intended with such a vision.

## Still early days...

SEZ development in India is in its infancy and the detailed guidelines are not set in stone at this stage. However, there are complications. What happens to the value of land that is nearby and is not zoned as a SEZ? It will surely drop significantly in value? Many other important questions too remain unanswered.

## Office space (commercial):

IT space leasing continues to boom with 12m sqf leasing in Bangalore, 6m sqf in Mumbai and 7.7m sqf in NCR (National Capital Region) in 2006.

## IT / ITES sectors main growth driver

Whilst the IT/ITES sectors will continue to be the main engine growth, their successes are gradually extending to the broader economy, which is resulting in a more diversified and robust commercial (office) real estate sector.

Several industries are being opened up by India's reform programme, and whilst large sections of the economy remain sheltered from global competition, further economic reforms are likely:

- India's financial services will enjoy strong growth driven by rising personal incomes, financial sector restructuring and liberalisation, and the growth of a more credit oriented economy.
- The manufacturing sector is booming, growing by 10%+ per year, and is expected to perform well, particularly in automotive, telecommunications and pharmaceuticals.
- India is one of the world's largest food producers, which has significant untapped commercial potential.

With India emerging as a leading hub of IT and ITES/BPO activities, these sectors will continue to be the main drivers of suburban office demand. The IT and ITES sectors accounted for 80% of the 25m sqf of office space absorbed in 2005. Jones Lang LaSalles estimates a requirement for about 50-70m sqf from the IT and ITES sectors over the next two to three years. As noted, the suburban fringe of the main cities has emerged as the primary growth market for offices, with 75% of office development in these areas. This sub-sector will continue to be fuelled by a 30% + annual growth forecast for the IT and ITES sectors.

The IT/ ITES sector is expected to form 7% of GDP by 2008 (3% currently) and to generate 4m jobs (1m currently). According to Jones Lang LaSalle, Leasing of IT/ ITES paces in 2004 equated to 9.5m sqf in Bangalore, 4.8m sqf in Delhi and its surrounds and 4.2m sqf in Mumbai. Almost 80% of demand for commercial space today is originally out of IT/BPO/Call centre sector. Most developers are providing a more efficient and better class of product now available, at a cheaper cost. Regionally though, from what we have seen, India still lags behind the rest of the region in regard to asset quality. As the ability to meet demand on time is the key success factor in this business, many developers have delivered built-to-suits (BTS) at a rate above 1,000 sqf per day. This means that a standard 120,000 sqf of building for a call centre client can be provided fully fitted out, in less than four months.

There have been some pretty significant numbers talked about with regards to future demand. A study executed by McKinsey-Nasscom estimates the total demand for office space will be a possible 500 m sqft in the next ten years.

The study cites the continued growth in the IT/BPO industry as being primarily responsible for 60-75 per cent of commercial real estate demand during 2005-15. While growth in the rest of India's non-IT and manufacturing sectors will fuel the remaining 25-40% of commercial real estate demand by 2015.

The DLF Group (not listed…yet), possibly the largest developer in India is aiming to provide around 25% of this. It has zeroed-in on the projected need for office space and is aspiring to develop 110m sqf in the next ten years. The company is planning 39m sqf of office space over the next three years.

## Demand to be spread across Tier-1 and Tier-2 cities

Office space demand for the next five years is likely to be concentrated in Tier-1 and Tier-2 cities including Delhi, Kolkata, Mumbai, Pune, Ahmedabad, Bangalore, Hyderabad and Chennai. Most areas appear to be dominated by a few large developers. This has a partial 'self regulation' effect. In our drives through India's IT office areas, we often saw what appeared to be half-finished office buildings. There are generally no regulations enforcing developers to finish developments they have started. When supply pressures occur and tenants are difficult to find, developers often simply stop building and start again when the market improves.

According to Jones Lang LaSalle, India's office space has doubled in the past three years to >100 m sqf in 2005 with the majority of space located in Mumbai, Bangalore and Chennai.

Despite recent growth, domestic office space is much less compared to other Asian countries or cities. Mumbai has just 12m sqf of office space against 70m sqf in Singapore. Our basic thoughts on India's key markets:

### Mumbai - financial centre

The CBD is stagnating due to virtually no supply of stock and poor quality assets. There is limited scope for new development. Mumbai remains India's financial centre with almost all investment banks, brokers and investment institutions making it their head office. Medium-term some scope exists in the Mills land which has been dogged by controversy and court cases. IT office parks are being established on the outskirts although rents are rising causing tenants to look to Tier-2 cities. IT companies generally won't pay more than Rs100/sqf. Rents in CBD Mumbai for better product are now ~Rs250 (HK$44 sqf/mth) and in office parks on the outskirts are around Rs90.

### Delhi - political capital

This is arguably India's most regulated office market. The market is relatively stagnant. For a city of its size and its national importance, the CBD surprises on the downside given its general state of disrepair and lack of new development. Almost all land in Delhi and the National Capital Region (NCR) is owned by the Delhi Development Authority (DDA). Therefore most commercial assets are under a 99-year lease. The general view is that the DDA has not efficiently promoted development. Most major development is in Gurgaon, which is a one hour drive from the CBD. On our recent drive through Gurgaon, it is apparent that the quality of buildings and planning here is superior to that in traditional Indian cities. However, master planning and quality of design still lag that in developed markets.

### Bangalore - IT leader

The outskirts of the city boasts scores of relatively new IT/ITES occupied buildings. This city highlighted to us that while the developer is likely to build acceptable roads and infrastructure, they are of limited use if the surrounding public roadways are inadequate (like they appear to be in Bangalore). It took us well over an hour to drive the relatively short distance from the city to the Whitefield BPO district in non-peak hour traffic. Supply is the second major issue. Economic rents in Whitefield are around Rs30 and current market rents are around Rs35. Rents have shown very little growth in the last few years and they are expected to be flat at best in the near future. The situation is similar for the other BPO regions such as Electronics City in the south.

### Chennai - high growth market

The overall market is expected to see supply of close to 10m sqf in the next 12 months. Originally it was serviced by just local developers and now all the majors are there. Rents are at around Rs38. However facilities and infrastructure are still clearly developing.

### Retail: Early days in long-term boom

With the retail sector also on a boom, the country is witnessing a spurt in extremely large retail spaces. Shopping malls with over 1 million sq ft of space have become the order of the day. About 20 of these are now at various stages of construction across the country. In the National Capital Region (NCR), Unitech's Great India Place has a million square feet (sq ft) of retail space. In Mumbai, at least eight malls covering over 1 million sq ft each include R-Mall at Ghatkopar, and two 1 million sq feet plus malls proposed for Thane. In Bangalore, at least three malls with similar dimensions are under development. Ludhiana will soon have a 1.6-million sq ft mall by Today Homes.

As the competition in the market intensifies, builders are going out of their way to be different. Specialised malls, designer brands and multi-movie options are marking the shopper's day out. Gurgaon, on the suburbs of New Delhi, has a jewellery mall and will soon have an auto mall. Bangalore will get an exclusive furniture mall. Two malls, first of their kind, targeting foreign tourists, will come up at tourist hotspots--Goa and Udaipur--with a projected cost of around US$ 22 million each. A furnishings mall is coming up on Elgin road in Kolkata. And India's largest theme amusement park, Noida Entertainment City (E-City), will stand upon 150 acres approximately.

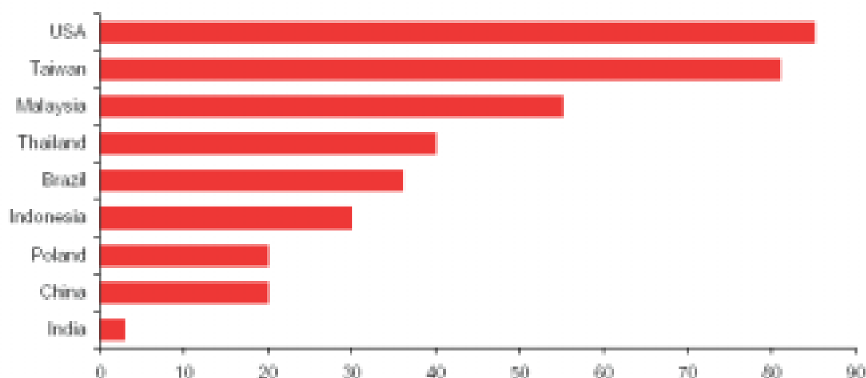
In what could perhaps become a trend in the booming retail business, Reliance Retail, Future Group and Bharti-WalMart are among leading retail companies that are acquiring housing societies and colonies in Ahmedabad to knock down and build mega-retail stores.

The biggest mall of the world--Mall of India--planned by DLF Universal along NH-8--will have 32 acres spanning a huge entertainment area and large city town squares offering a total retail experience.

Organized retail - which accounts for just 2% of the US$200bn sector - expect it to US$4bn to $15bn by 2010;

India's retail segment is dominated by fragmented, one-off, generally unorganised retail.

**Organised retail penetration is low in India**



There certainly is a lot of excitement in India when it comes to discussing the development of organised retail. And why not. Organised retail generates just 2-3% of India's overall retail sales. More than half of India's 1.1bn people are under the age of 25, and their disposable incomes are rising in a country where the economy is growing by on average 8% a year. India's US$300bn retail market is growing even faster, at about 30% annually. India's organised retail market, estimated at about US$6bn is forecast by AT Kearney to grow at 25-30% a year over the next four years.

The country's largest private energy company, Reliance Industries, the largest telco Bharti, and country's largest real estate company DLF are planning to step up their focus on India's retail market. The likes of Wal-mart and Tesco are looking to partner with these players.

India ranked 5th in the list of 30 emerging retail markets in the world and ranked first in AT Kearny's 2005 Global Retail Development Index. Key findings of the studies:

- An estimated 20% annual growth rate for the organised retail segment by 2010
- 500 shopping malls to be built in the next seven years
- 25m sqf by 2007
- Investment in the retail real estate segment yields 12-15%, higher than residential (5-6%) and office (9-12%).

## Foreign penetration inevitable... eventually

India's retail market remains closed to foreign competition relative to China with which it is often compared. This is the result of the authorities protecting local retailers. Local players are aggressive in their lobbying efforts, contending that local jobs will be lost if foreign companies like Wal-mart are allowed to operate in India. Wal-mart currently does not have a presence in India. At last count it was in 30 cities in China. The local retail landscape is still characterized by local shops and street shops, the vast majority family owned and run.

According to The Economist, the proportion of retail chains was just 3% of the total retail offering in India in 2004. The scope for growth is clear. However, foreigners can only have ownership of up to 51% in their direct investment - a strategy not suited to many overseas firms that don't like the JV approach.

### Major funds chasing the Indian property sector

| Fund | Size (US$ m) |
|---|---|
| Goldman Sachs proprietary India Fund (partly for real estate) | 1000 |
| ICICI India Advantage Fund | 800 |
| HDFC India Real Estate Fund | 720 |
| Horizon International Fund (Pantaloon Group) | 350 |
| Citigroup Property Investors | 350 |
| India aReit Fund (Piramal Group) | 350 |
| AIG Group | 300 |
| Deutsche | 300 |
| Maia (Malini Alles) | 250 |
| 3i Group | 160 |
| Xander RE Fund LLC | 150 |
| Kotak Mahindra | 100 |
| Kshitij Venture Capital Fund (Pantaloon Group) | 100 |
| Dream Fund (Dewan Housing Finance Ltd.) | 100 |

### Funds deployed so far

| Investor | Investee company | Amount (US$ m) | Nature |
|---|---|---|---|
| Citigroup Property Investors | Gera Developers | 125 | JV 50:50 |
| HDFC India Real Estate Fund | Ansal IT City & Parks | 100 | Stake-33% |
| Siachen Capital LLC | Nitesh Estates | 100 | PE |
| Capitaland | Runwal Group | 100 | JV 49:51 |
| Laing O Rourke | DLF | 100 | 50:50 JV |
| Morgan Stanley | Mantri Developers | 68 | PE |
| Morgan Stanley | Alpha G Corp | 65 | PE |
| 3i Group | Suntech group | 41 | PE |
| India aReit Fund (Piramal Group) | Suntech group | 13.6 | PE |

### Hospitality

With tourist arrivals growing at 15%, the Indian hospitality sector earned US$44mn in foreign exchange. All of India has 80,000 hotel rooms while Florida and Orlando have 115,000 and 140,000 hotel rooms respectively. The nationwide hotel boom is expected to add another 50,000 hotel rooms.

Historically, the hospitality industry has IRR of 10%-15% (over 10 years), but with the current cost accounting for 60% of the project costs, what could be the expected IRR could be anyone's guess. There is a need for budget hotels across the country, but with the escalating cost of property the word 'budget' would probably need to be redefined.

### Unravelling the rules and regulations

There are a myriad of state and national real estate laws in India. While many are being improved or repealed, trying to navigate through them can be difficult. The main implication is clear - local developers are best placed from a regulatory perspective. Foreign developers are generally best placed (there are exceptions) to enter the market via a joint venture structure. It appears also that the cash economy is rife, meaning the rules are often bypassed. The Indian authorities are slowing realising that if taxes or restrictions are too harsh then the participants will find ways around laws via payments not officially registered ('off the books').

For instance, there are signs of the stamp duty being revamped in Delhi. This will involve a reduction in the rate but also a different process of assessment. Instead of the authorities relying on the stamped purchase documentation in order to assess the payable duty, it will appoint independent surveyors to determine the rateable value of the property. In this way it believes the amount of stamp duty actually collected will increase as the tax rate comes down due to the changed procedure.

### Urban Land Ceiling and Regulation Act - being repealed... slowly

The Indian Urban Land Ceiling and Regulation Act (ULCRA) was enacted in 1976 to reduce land speculation and distribute land to the poor in urban areas by imposing a ceiling on the amount of land which could be owned by an individual. It imposed a ceiling on the amount of vacant land that any individual could possess in an urban area. In 'A' class cities such as Delhi and Mumbai, this was no more than 500 sqm. The excess land identified was required to be acquired by the central government after compensating the owners and used to provide housing to various sections of the population.

However, the Act ended up being unworkable. Sections 20 and 21 of the ULCRA provided a host of loop holes for the land owners who were not willing to part with their land. These sections empowered the state governments to grant discretionary exemptions for a variety of reasons, prompting almost all landowners with excess land to claim such exemptions.

The ULCRA thus became a vehicle for corruption. Those who could not or would not "coerce" the relevant authority to provide an exemption went to court, and the acquisition process became fraught with legal battles. Three decades after the enactment of the ULCRA, the government has so far acquired less than 4,000 hectares out of an estimated total amount of 166,000 hectares of excess urban land.

As a result, the central government has repealed this archaic law in 1999/2000, but the state governments have not followed the lead. Some states like Punjab, UP, MP, Rajasthan, Gujarat and Haryana have repealed this act. States like Maharashtra, Karnataka, Kerala and Orissa are yet to act on it. In fact, Maharashtra wants to repeal the ULCRA and enact another one of its own.

### Stamp duty so high it promotes avoidance

One of the many problems challenging the industry is the high stamp duty rates in the Indian states. These range in most Indian cities from 10-15%, payable by the purchaser. States such as West Bengal, Kerala and Bihar levy it as high as 20%. Some states even have a double stamp incidence, first on land and then on its development. Developed countries like Singapore have stamp duty levels of about 1-3%, Australia up to 5% and most others far lower than India. It is imperative that the stamp duty is lowered as otherwise it gives rise to a parallel economy which leads to a huge loss of government revenue.

Reducing stamp duties will encourage sellers to pay the lower stamp duties, instead of trying to avoid stamp and registration costs. The government collections may also increase due to this lower rate of stamp duty and wider collection base. The high duties have also encouraged unaccounted moneys being used in most real estate transactions in India. Similarly, the registration procedure requires to be made transparent and simple in order to facilitate additions/deletions and to put a check on corruption.

## Rent Control Act keeps rents low and buildings badly maintained

This act is provincial in nature and therefore differs from state to state. However the basic objective of the Act is common to all states. The Act has the effect of freezing rent at a certain level. This is clearly outdated and does not compensate the landlord appropriately. The Act allowed thousands of people to find affordable housing, at rents that were kept frozen at 1950 levels as long as the tenants stayed, (rents could be raised if a new tenant came in).

This Act allows tenants to live in the rented flat and pay exorbitantly lower rents. As a result, typical rental yields on residential property in Mumbai for instance are practically negligible. In some cases the amount a tenant extracts from their landlord for vacating the flat is good enough for him to buy another flat in a smaller city. Naturally, the amount a landlord earns from rent is not enough to pay the costs of maintenance on his aging building. As a result the tenant stops maintaining it and does not carry out repairs. The building often deteriorates to a state of disrepair. This is particularly evident when travelling through India.

The unusual thing about this state of affairs is not just that tenants pay extremely low rents. They also want their landlords to carry out repairs and keep their buildings in shape. Obsolete tenancy and rental control laws keep a large number of the urban properties off the market. As a result real estate prices are so inflated (via restricted supply) that many tenants can never hope to move from their rent-controlled flats. So they have no option but to stay.

## Why is the Act not done away with?

Since the number of tenants out number the number of landlords, the low rent the Act has them paying outweighs all other considerations. So any government that is considering repealing the Act will promptly lose the votes of millions of tenants. It will probably gain the votes of landlords, but in India tenants far out number landlords.

## Mill Owners Act being unwound… slowly

According to municipal rules-the Bombay Industrial Relations Act 1946 and the Factories Act 1948, the mill lands are reserved for industrial use only. They were mostly given to the mill owners at cheap rates by the British colonial government in Bombay in the early twentieth century to promote industrial production - mostly cotton manufacturing.

However in 1991, the city's land regulation laws were amended to allow 'development' of the mill lands. The Development Control Rules (DCR) of 1991 and subsequent amendments in 2001 paved the way for the lease or sale of a portion of mill land to private builders and to city authorities for infrastructure projects to 'modernise' India's financial and industrial hub.

Until 2003 an insignificant amount of development took place as the mill owners felt that the DCR was not favourable. As a result, in 2003 the Urban Development Ministry issued a 'clarification' reinterpreting the 2001 amendment in favour of the builder-mill lobby. That is until the citizens of the city protested and the Mumbai High Court in its order upheld the original 2001 amendment. Finally in March 2006 the Supreme Court upheld the 2003 clarification by Urban Development Ministry.

Now 58 mills spread over 602 acres of prime land will be developed into commercial spaces, shopping malls and high-end apartments.

# FDI - Definition, Policy, Impact and Limitations

## FDI- Definition and Policy

FDI refers to the purchase by the citizens of one country of non-financial assets in another country. Foreign direct investment involves the acquisition or establishment of a firm, company or enterprise in a country outside of the registered corporate home country. FDI in real estate involves acquisition of land or building across all commercial, residential and retail segments through funds brought in from a foreign country. Any construction/development/redevelopment activity from such funds is also included in FDI. The following is the definition of FDI in real estate in the Indian context as stated in the FDI Policy. The FDI in Indian real estate sector is permitted through the automatic route across all real estate segments except agricultural and plantation properties subject to the conditions mentioned below. The previous policy stated that any FDI in real estate had to be approved by the Foreign Investment Promotion Board (FIPB) in addition to approval from the RBI. The previous policy's rules regarding Hotel/ Serviced apartments and Investments in SEZs has witnessed no change i.e. 100% FDI is allowed in these real estate segments.

i. Project Type: FDI is permitted in only green field projects

ii. Minimum Area Requirements: The minimum area to be developed under each project would be as follows:

  a. In case of development of serviced housing plots, a minimum land area of 10 hectare or approximately 101175 sqm

  b. In case of all construction development projects, a minimum built-up area of 50,000 sqm

  c. In case of a combination of the above two projects, any one of the above two conditions would suffice. This limit has been brought down from 100 acres that was required to invest in integrated townships subject to FIPB approval.

iii. Capitalization Norms: The minimum capitalization norm shall be US$ 10 million for a wholly owned subsidiary and US$ 5 million for joint ventures with Indian partner/s. The funds would have to be brought in within six months of commencement of business of the company. This condition remains the same as compared with the earlier policy

iv. Repatriation Norms: Original investment cannot be repatriated before a period of three years from completion of minimum capitalisation. However, the investor may be permitted to exit earlier with prior approval of the government through the FIPB. However, the income earned can be repatriated from the project. This condition remains the same as compared with the earlier policy

v. Other Legal Compliances:

  a. The Foreign company intending to invest, shall be registered as an Indian Company under Companies Act 1956. In case of joint ventures, an SPV other than the parent company of the joint venture partners needs to be formed to invest in real estate.

  b. Development of at least 50 per cent of the integrated project within a period of five years from the date of obtaining all statutory clearances, has to be completed instead of from the date of procurement of land as stated in the previous policy. The investor would not be permitted to sell underdeveloped plots (underdeveloped connotes, where roads, water supply, street lighting, drainage, sewerage and other conveniences as applicable under prescribed regulations, have not been made available). The investor must provide this infrastructure and obtain the completion certificate from the concerned local body/service agency before being allowed to dispose of the serviced housing plots.

  c. The project shall conform to the norms and standards, including land use requirements and provision of community amenities and common facilities as laid down in the applicable building control regulations, by-laws, rules and other regulations of the State Government/Municipal/ Local Body concerned.

  d. The investor shall be responsible for obtaining all necessary approvals, including those of the building/ layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules bye-laws/regulations of the State Government/ Municipal Body/ Local Body concerned.

  e. The State Government/ Municipal/ Local Body concerned, which approves the building/ development plans, will monitor the developer's compliance to the above conditions.

vi. Other Amendments

   a. IT/Business Park: In the previous regime, foreign investment was allowed in IT parks at the construction stage subject to such IT parks providing space to atleast 3 tenants. In press note 2 (2005) an amendment has been made and the number of tenants required have been brought down to 1 tenant.

   b. Industrial/Logistics/Warehousing: FDI policy in these properties was unclear earlier and has been amended by clearly allowing foreign investors to invest in them at the construction stage subject to a minimum of 50000 sqm. In addition to the above, the guidelines have also been relaxed for investment by foreign & domestic venture funds in real estate. Venture funds fall under the Foreign Institutional Investment (FII) category rather than FDI and have to be registered with the SEBI10. The difference between FDI and FII is the intension with which foreign Capital is invested in the country. In case of FDI, the intension is management control whereas in FII its purely ROI or return on investment.

Venture funds can invest in real estate if each investor brings in not less than US$ 11111 and eighty percent of the funds are invested in companies not listed on the stock exchanges or financially weak companies.

## Limitations of the FDI Policy

The decision to liberalise the FDI norms in the construction sector is perhaps the most significant economic policy decision taken by the Government in the year 2005. Until then, only Non-Resident Indians (NRIs) and Persons of Indian Origin (PIOs) were permitted to invest in the real estate sector. Foreign investors other than NRIs were allowed to invest only in development of integrated townships and settlements either through a wholly owned subsidiary or through a joint venture company in India along with a local partner. In spite of the wide spread acclaim received by the FDI policy, there are some foreseeable limitations and ambiguities in the new FDI rules.

i. FDI is not permitted in unlisted companies which are otherwise engaged in real estate development and own properties, some of which may be developed or partly developed. FDI is only permitted in green field projects and that too by forming a separate company to invest in real estate.

ii. The term 'built up area' is not clearly defined. It is difficult to ascertain whether built up area refers to the 'Super Built Up Area'14 or 'Carpet Area'.

iii. The policy states that 50% of the project must be complete within 5 years from the date of obtaining all approvals. The developers generally develop real estate in phases as per market demand and not as per stipulated time as it may lead to a supply glut or demand-supply mismatch.

iv. There is also an ambiguity with regard to the capitalization norms for FDI in terms of number of investors allowed. In other words, whether a single investor has to bring in US$ 5 million for a joint venture or multiple investors can bring in the said amount

v. There is no single window clearance formed for seeking approvals for real estate development despite the same being formed for other sectors to encourage investment. The policy nevertheless is indicative of India's willingness to draw foreign investment in the real estate sector at the same time providing adequate safeguards against speculative activities in undeveloped land. The foreign developers and investors/funds have also responded by entering the Indian real estate sector with many more expected to follow suit. This illustrates the opportunity that India in general and Indian real estate in particular offers.

## Impact of the FDI Policy

Developers that had entered India before the new policy were IJM, Edaw Ltd, Kikken Sekkel of Tokyo, Canada based Royal Indian Raj International Corporation, Dubai based Emaar Group, Ascendas, Lee Kim Tah Holdings and CESMA, a subsidiary of the Singapore government. With merely three proposals having come to the Foreign Investment Promotion Board (FIPB) in the four years preceding the policy change and no substantial investment from the overseas Indians, prompted the government to relax the FDI rules.

There are around 5-6 Funds in India both from India & Overseas namely, ICICI & Tishman Speyers (USA), Ascendas & GE (Singapore & USA), HDFC (India), IREO (USA), Fire Capital (India). The average ticket size of these investments likely to be made by these funds is around US$ 200-250 Million.

It is expected that atleast 15 more funds from the USA & South East Asia, with the same ticket size are set to enter the country taking the total corpus of investments to US$ 5 Billion without leverage. The expected corpus with leverage is expected to be atleast US$ 10 Billion. Some of the funds that are presently making enquiries on investing in real estate in India include Blackstone group, Berkshire Hathaway, Morgan Stanley, JP Morgan, CalPERS. Lehman Brothers, GIC to name a few. The objective of the existing funds varies as both investors and developers are setting up these funds. For example, Ascendas IT Park Fund & ICICI-Tishman Speyers will develop real estate whereas HDFC fund & Fire Capital are likely to be vanilla investors. IREO is a case study in itself, it is believed to have formed an SPV with a local developer in Pune in which it shall hold 25-35% equity and finance the balance by extending a loan @ 4% p.a. for the period of 15 years. It plans to increase its stake in the SPV by converting the soft loan into equity albeit in a phased manner.

Finally, developers like Keppel land (Singapore), Salim group (Indonesia) have entered India post the relaxation in FDI rules by entering into joint ventures with local developers or corporates. The Emaar group (UAE) too tied up with the New Delhi based MGF group to develop properties across India. It plans to build 100 shopping malls in the country. Apart from this, hotel chains like Accor and Four Seasons have also entered the country lately by entering into management contracts with real estate developers.

### Realty investment trusts: Mirage or reality?

A rising India is inter alia characterised by a robust real estate sector, which is witnessing a deluge of investment in land acquisition, development and construction. The spiralling growth of manufacturing, services, retail and hospitality sectors, together with rising levels of disposable income, has fuelled the demand for various classes of real estate.

Currently, the participation of small and medium investors is restricted to the residential sector, through direct purchase of property. Higher returns from fixed income yielding commercial property are beyond their reach. This limitation of participants in the commercial sector, and the over-use of debt funding in the past with limited access to the same today, has made the industry turn to Real Estate Investment Trusts (REITs) as the next big thing.

REITs, common in several developed countries, are generally open or close-ended companies/trusts that hold, manage, lease, develop and/or maintain properties for investment purposes. They are often, but not necessarily, traded on an exchange. The value of units/stock allotted to investors is computed on a NAV (Net Asset Value) basis, as the market value of assets minus liabilities. REIT invests in real estate directly, through properties or mortgages, or indirectly through subsidiaries.

An investor purchases units/shares in a REIT, similar to purchasing units issued by a mutual fund. While buying units of a mutual fund entitles an investor to participate in the shares invested in and dividends earned by the fund, purchasing units or shares of a REIT entitles an investor to participate in the property ownership by REIT and the related income streams, without having to fund the entire property value himself.

Globally, a REIT is required to be organised as a trust/company with a tax exempt or fiscally transparent status. A US REIT for example, is per se taxable as a domestic corporation and subject to corporate tax rules. At least 90% of REIT's taxable income must be distributed annually, with REIT receiving a deduction for dividends paid by it in computing its taxable profits. Amounts retained and not distributed are taxed in the hands of REIT. In the hands of shareholders, the distributions from REITs will be taxed and for this purpose are allocated to ordinary income, capital gains and return of capital.

To qualify for the tax treatment above, REIT must satisfy the tests prescribed, including the requirement of deriving a significant portion of its income from relevant streams of dividend, interest and property income, substantial investment in real estate assets, etc.

In India, a fledgling attempt at introducing REITs in the form of Real Estate Mutual Funds (REMFs) has been made, with draft Securities & Exchange Board of India (SEBI) regulations on the anvil, albeit not in the public domain. These regulations are being closely scrutinised by the Association of Mutual Funds in India (AMFI), Sebi and Institute of Chartered Accountants of India (ICAI). Valuation norms and periodicity of NAV revision are likely to be difficult problems to resolve.

It is clear that the inherent merits of REITs span the entire spectrum of players in real estate. For an investor, the upside is the possibility of obtaining yields better than gilts and bonds with lower risk than equities. Developers find a cheaper source of alternate funding in a credit system where inflationary pressures have closed the tap on bank lending.

The picture is not completely full of promise, however, with traditional bugbears of the property sector (absence of regulators, inadequate land records, opaque dealings, cash deals) yet to be addressed.

The final form of Indian regulations must, therefore, have investor protection norms, including entry barriers for REMFs (to ensure serious participation), transparency in reporting NAVs, delineation from existing funds in cases of existing AMCs, investment/asset allocation norms and leverage/distribution stipulations. Know-Your-Customer (KYC) norms are necessary to avoid seepage of unaccounted money into REMFs.

The overall fiscal framework is therefore likely to be akin to that applicable to mutual funds today. Interestingly, Domestic Venture Capital Funds have already been established to invest dedicatedly or inter alia into real estate. These funds are likely to be deprived of their fiscally transparent status with the impending passage of the Budget proposals. The introduction of REIT framework would, however, provide some respite to such and similar funds.

While strong macro-economic fundamentals provide a conducive environment for introduction of REITs, the fiscal framework, certainty and benevolence in tax treatment of REITs must function as a facilitator in achieving these objectives.

## Need of the Hour: A Regulatory Body for Real Estate

Imagine a match without a referee. No rules are followed, might becomes right. Fair play is abandoned. Star players are deliberately fouled. Pandemonium follows. This scenario is possible in any industry with regulations but no regulators.

Take the case of real estate - a largely unorganized sector with a liberal sprinkling of small and big developers. While reputed developers have zipped through the learning curve to become professionally competent, many fly-by-night operators draw attention through their lack of transparency and inflated land bank claims. With no authority to put competitive market structures and regulatory frameworks in place, the situation could soon become a free-for-all.

Given the conditions, what the real estate industry needs is an equivalent of cricket's neutral umpire: An independent regulator with a clear mandate to ensure fair competition and protection of the interest of consumer, investor and the developer. This is necessary considering the real estate's pivotal role in driving our economy by providing infrastructure, commercial, retail and housing facilities.

In the telecom sector, which too is witnessing double digit growth, the presence of the Telecom Regulatory Authority (TRAI) has ensured fair play in an overcrowded market.

When disclosure norms for real estate companies going in for an IPO were tightened to ensure that land banks were valued at current market rates and not future projections, it was widely seen as the first step at putting a regulatory framework in place. On inspection though, it raised more questions than answers.

For instance, it is almost impossible to get genuine valuations of land assets in India. Lack of a scientifically established land database and professional evaluators have ensured that no two valuations will come anywhere close.

While emphasizing the need for a regulatory body in the real estate sector, there is also necessity to separate spin from fact. Like in cricket where not every batsman walks when nicked, not every real estate developer admits to fudging land valuation records. But with a regulator in place, all players will be assured of fair competition and equitable valuations.

While many would argue against a regulatory authority, likening it with Licence Raj, it would also help to learn from the Stock Exchange that it's better to be safe than sorry. And make no mistake about it: Even with a regulatory body in place, only the reputed developers will be in a position to raise money from the stock exchange. That's because only those with proven track records have the ability to execute projects on time. While small developers spend a bulk of their resources on developing land banks, it is the big developers who structure their funds to complete projects on time. It is this competency that draws the investor to vie for a real estate stock, ensuring the company's success in the market.

# Guide to better buying decisions

## Ratings & Risk Assessment

Housing and real estate form the backbone of the country's infrastructure and are critical drivers of economic development. With the Indian economy growing rapidly, the construction sector too has witnessed rapid growth. This has been primarily led by the housing sector, which has got an impetus from increasing urbanization and easy availability of housing finance. With government policies emphasizing faster economic growth, the real estate sector is projected to attract large investments in the coming decade.

Traditionally, investments in this sector have been constrained by the lack of information and agreed standards. The resulting uncertainty ensured that financial institutions were cautious in their exposure to residential and commercial real estate projects.

In light of this uncertainty and in order to provide third-party opinion to housing customers and financial institutions, CRISIL has developed two specialized products for the construction industry, namely, Developer Ratings and Project Ratings.

## Developer Rating

Rating of developers' track record in executing real estate projects as per the agreed quality levels and transferring a clear title within the stipulated time schedule.

## Project Rating

Rating of developers' ability to execute the specific project as per the agreed quality levels and transfer a clear title within the stipulated time schedule.

These ratings are opinions based on a developer's past track record in executing real estate projects and are indicative of his ability to do so in future. Factors such as construction as per the schedule and quality specifications, transfer of clean title and sales track record are assessed while assigning the rating. Developers with higher ratings will have properties that are legally sound and that are completed and delivered on schedule.

## Need For Rating

The Indian real estate market is highly fragmented and unorganised. Transactions are based on market perceptions and are generally characterized by uncertainty. Given the industry's dynamics, a rating is needed to highlight the developers' customer focus, help them build their brand and improve market perceptions. In addition, a rating also helps a developer to benchmark his services with the industry. Finally, a rating not only provides comfort to customers but also to financial institutions besides enabling the developer to access funds.

## Developer Rating - What it is and what it is not

It is not a credit rating of developers, but a rating of their project development track record and ability.

- It is not a legal opinion on the project, but it reflects the variability in legal risks.
- It is not an opinion on architectural design, but comments on the building's safety, inhabitable quality and adherence to norms.
- It is not an opinion on the adherence to costs, but assesses the impact of cost overruns on the project

## Affiliation with NAREDCO

CRISIL has conceptualised the methodology for the real estate developer rating in consultation with and after incorporating the relevant suggestions and recommendations of the National Real Estate Development Council (NAREDCO). The rating process has been developed after taking into account the specialised needs of the sector. CRISIL's association with NAREDCO enables it to leverage the latter's expertise and experience.

The National Real Estate Development Council (NAREDCO) is the apex national body of real estate developers. It is a self-regulatory body that aims to inculcate ethics and a code of conduct into the profession. Its members include the minister of urban development and food and consumer affairs, public sector organizations and practitioners from the real estate sector. NAREDCO's mission is to improve the confidence level of lenders, investors and consumers by bringing in professional practices through self-regulation and ultimately catalysing the growth of the sector.

## Benefits of real estate developer and project ratings

Real estate developer ratings will offer a useful comparative tool to the industry. The specific benefits to each of the constituents is outlined below:

- Real Estate Developers

  A Developer Rating gives real estate developers a tool to highlight their strengths in legal procedures, project execution and marketing. It can thus be used to command a better price.

  Project and developer ratings increase visibility and substantiate the informal word-of-mouth mode of appraising developers. This formalized process of assessing capabilities provides comfort to investors, especially non-resident Indian (NRI).

  The rating also acts as a benchmark for developers and helps them to identify their shortfalls vis-à-vis the best practices in the industry. This will lead to continuous improvements in quality and services levels.

  Further, a good rating can also help developers to mobilize institutional funds and other financial services for their projects and enhance their ability to market the project.

- Customers and Investors

  A good rating provides customers and investors the comfort that the rated developer has a good demonstrated track record and that the project will be completed on time with a clean marketable title transferred to him.

  The rating also provides a higher level of security for investments, especially those that have been made during the construction phase, thereby reducing post-investment dissonance.

- Banking, Financial and Lending Institutions

  Historically, given the sector's risk profile, institutions have been apprehensive about lending to the housing and construction industry. A good rating gives an independent third-party opinion on the developer's performance and ability to mitigate the high construction and market risks inherent in the sector.

- Government and Regulators

  The rating service gives an incentive to developers to maintain standards with respect to legal and construction practices. This is expected to facilitate the orderly growth of the sector, leading to a self-regulated industry framework.

# Conclusion

The real estate sector has been featuring on the Reserve Bank of India's radar for a long time. The central bank has been concerned about inordinately high prices of properties, both commercial and residential and has been issuing diktats aimed at easing them.

Rising interest rates, increasing risk weights for banks lending to real estate and now the clamp down on real estate companies borrowing abroad, all these measures suggest that the real estate price climb will be arrested. Reports of a price ease are doing the rounds, especially in metro suburbs. But it doesn't seem likely that there will be a correction in prime locations.

It can be concluded that despite the recent run-up in stock prices, there is still value to be found. Indian property companies are only now starting to share their land bank details with the market. Such detail is obviously critical in assessing the underlying value of the companies.

Without this detail, the company cannot be covered in a prudent manner by analysts. However, a word of caution. We have seen examples of land bank schedules in company presentations being what we would term 'highly optimistic'. It is essential to dig deeper via local inspections, discussions with agents and further consultation with management. This has been an important part of the initiation process.

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