TECHNICAL PAPER

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INDIA'S REAL ESTATE MARKET – OUTLOOK OF STRUCTURED HIGH YIELD DEBT

EXECUTIVE SUMMARY

- Post the global financial crisis of 2008, structured debt investment deals in the real estate sector became popular with private equity funds in India. These were primarily debt transactions arranged in a manner that provided assured returns to the investor along with a possible upside, if the deal structure so allowed.
- Between 2010 to 2014, the number of structured debt deals increased by more than 6.3 times, whilst the total value of such investments increased by 3.6 times.
- Going ahead, investors looking at entering into new structured debt transactions may need to factor in ever changing market dynamics, end-use constraints, cash flow mismatches and the issues presented by the high cost of funding.

INTRODUCTION

- Prior to allowing foreign direct investments (FDI) in India real estate in 2005, projects were primarily funded by traditional sources such as cash-flows through sales, bank and private lending. Post 2005, a number of global real estate funds, private equity funds, hedge funds, strategic investors and foreign developers entered India and numerous funding options became available. Several real estate developers also garnered funds through stock market listings, in both domestic as well as overseas stock exchanges.
- With the Indian markets opening up for global investors, FDI inflows in the Indian real estate sector, which were totally USD38 mn in FY 2005-06, increased significantly to nearly USD2.2 bn in FY 2007-08. Consequently, dependency on the banking sector declined significantly and the total deployment of gross bank credit to commercial real estate and housing was around 8.0% in 2008 compared to 12.8% in 2006[1].
- However, post the global financial crisis of 2008 a significant shift in the nature, quantum and source of capital availability was observed. Banks became extremely wary of extending loans to the real estate sector, as developers were unable to garner sufficient sales amidst subdued demand conditions, leading to a major impact on the loan servicing. With banks shying from funding real estate projects in early stages (including land acquisitions); developers were forced to raise capital from private equity funds, real estate funds and NBFCs. As depicted below, bank loans to Indian real estate sector have declined over the past few years, due to stricter lending norms. Deployment of gross bank credit to commercial real estate and housing declined from 10.0% in FY10 to 8.1% in FY14[2].

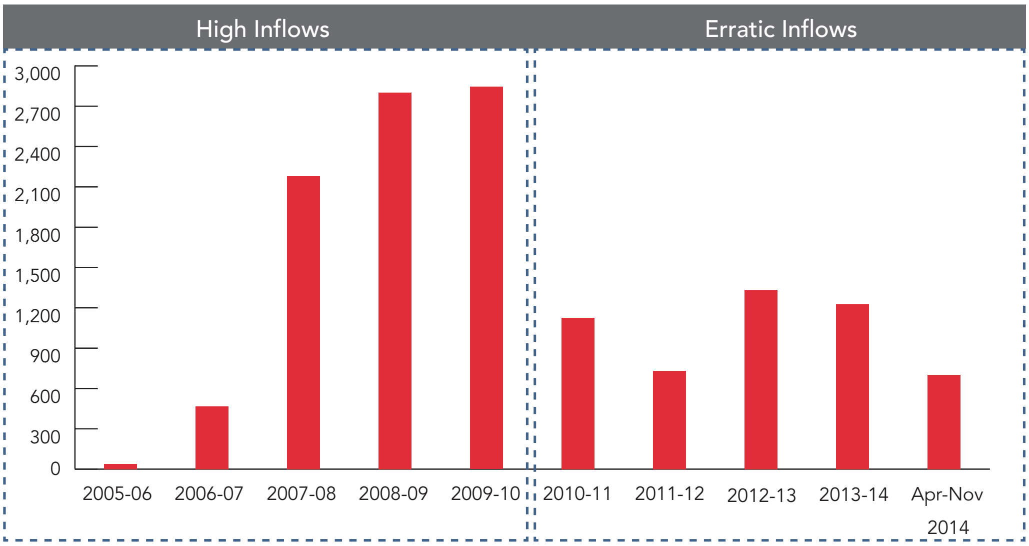
Funding sources for India real estate

Pre 2005	Post 2005	
Pre-FDI	Post-FDI and pre-global financial crisis	Post-global financial crisis
• Cash-flows through sales • Bank lending • Private lending	• Stock markets • Private equity funds • Bank lending • Private lending	• Private equity funds • NBFC lending • Bank lending • Private lending

Source: Cushman & Wakefield Research

[1] Reserve Bank of India (RBI)
[2] RBI

Fig 1 – FDI in Indian real estate (in USD mn)



Source: Cushman & Wakefield Research, Department Of Industrial Policy & Promotion (DIPP)

FDI inflows continued on a strong trajectory upto FY 2009-10. However, post FY 2009-10, FDI inflows in Indian real estate declined significantly, as global players became unsure about the potential of Indian real estate sector considering the subdued demand, prevailing regulations and cumbersome procedures.

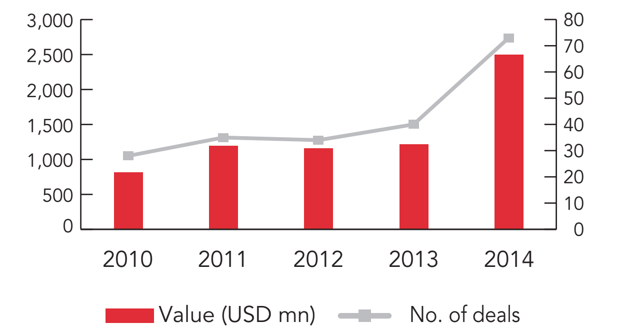
PRIVATE EQUITY FUNDING IN INDIAN REAL ESTATE

Post global financial crisis, private equity funds are increasingly considering only project-level funding in order to protect their investments in case of any defaults/failures by the entity. For project-level funding, it is relatively easy for private equity funds to assess the risks vs. returns and take apt investment decisions. Initially, real estate funds infused equity in various projects with an aim to get higher returns. However, private equity funds faced many issues in projects that had an equity exposure, such as:

- Losses due to project delays/terminations leading to developers' inability to garner sales and manage cash flows amidst decreasing capital values and subdued demand.
- In case of projects that had to be terminated, equity contributors were given the last preference and as a result, lot of capital was eroded, as the developer had to prioritize debtors.
- Exit opportunities for invested funds were also limited as the available pool of private equity diminished significantly, hedge funds largely exited and public markets dried up.

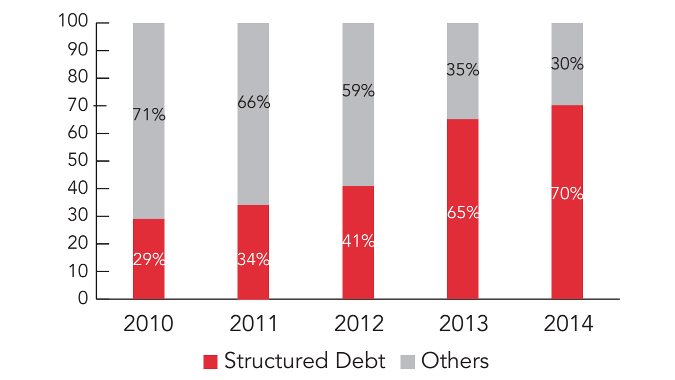
This led to private equity funds shying away from entering into pure equity deals in the Indian real estate sector. As a result, many deals executed post 2010 came-in as structured deals, which were primarily debt transactions arranged in a manner that provided assured returns to the investor alongwith a possible upside as per the deal structure. Structured debt transactions offer a very attractive investment option giving the investors fully secured and full recourse high-teen guaranteed returns in local currency. Encouraged by this structure, many new funds raised since 2010 have focussed mainly on the structured debt strategy for investments in residential projects. The fund raising activity was slow in 2010 and 2011, but as the economy showed some signs of improvement and to be better prepared for the future, massive fund raising was witnessed between 2012 and 2014 (around USD 5.2 bn). As depicted below, nearly 53% of total no. of real estate private equity transactions in India between 2010 and 2014 came in as structured debt deals. The chart depicts increasing share of structured debt deals, which peaked at 70% in 2014.

Fig 2 – Real Estate Private Equity Trends (Total # of real estate private equity deals)



Source: Real Capital Analytics (RCA), Cushman & Wakefield Research

Fig 3 – Real Estate Private Equity Trends – Type of real estate private equity deal (basis number of deals)

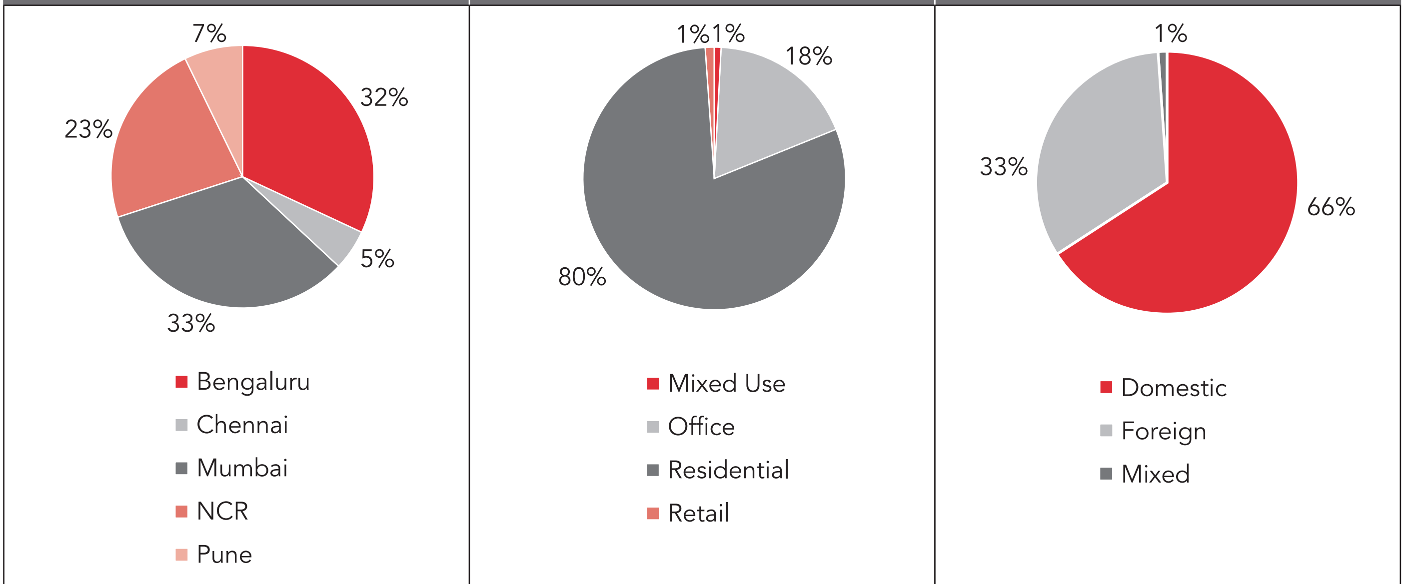


Source: Real Capital Analytics (RCA), Cushman & Wakefield Research

The value and number of structured debt real estate private equity deals has risen significantly from 2010. Whilst 53% of total number of real estate private equity deals were structured debt type, 35% in value terms came in as structured debt deals. In value terms, share of structured debt real estate private equity deals increased from 31% in 2010 to 37% in 2014. In terms of city-wise contribution, Mumbai leads with 33% share in total deal value and 32% share in total number of deals.

In terms of asset-wise contribution, residential sector had a major share in the structured debt deals. Around 80% (in value terms) and 94% (in no. of deals) was pertaining to residential assets. Structured debt office transactions were around 18% in value terms and 3% in terms of total no. of deals, whilst the rest came from retail and mixed-use assets. Domestic funds were very active in the structured debt transactions and accounted for 66% of total value of structured deals and 84% of total number of structured deals concluded between 2010 and 2014.

Fig 4 – Structured debt real estate private equity deals (2010-2014)

City-wise trends	Asset-wise trends	Fund ownership-wise trends
		
Mumbai, Bengaluru and the Delhi-NCR accounted for around 88% of the total structured debt deals between 2010 to 2014.	Residential projects accounted for 80% of the total structured debt deals between 2010 to 2014.	Domestic funds accounted for 66% of the total structured debt deals between 2010 to 2014 whilst foreign funds had a 33% share.

Source: Real Capital Analytics (RCA), Cushman & Wakefield Research

Some of the large funds involved in structured debt deals in India include Qatar Investment Authority, Kotak Realty Fund, Piramal Group, Indian Infoline Finance Limited (IIFL), HDFC, Peninsula Brookfield, Standard Chartered, ICICI Prudential AMC, Reliance Capital and Morgan Stanley. These top 10 funds accounted for around 63% value of total structured debt real estate private equity deals concluded between 2010 and 2014 and 50% of total no. of deals. Nearly 73% of total investments done by these top funds were in residential assets, signifying the focus and importance of residential sector in the structured debt deals.

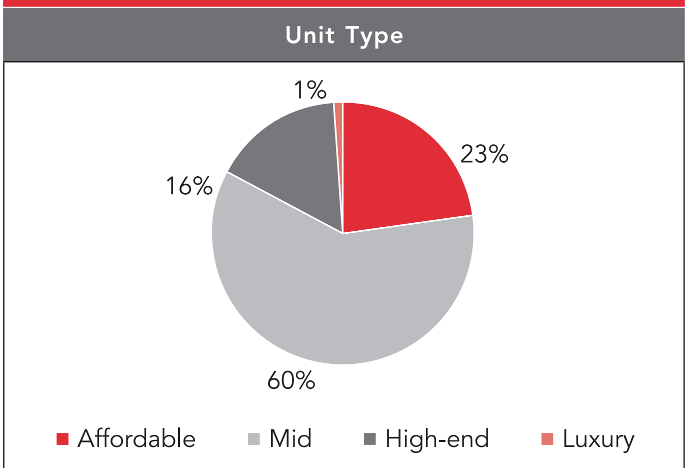
Fund/Investor	% Investment in:			
	Mixed-Use	Office	Residential	Retail
Qatar Investment Authority	Nil	100%	Nil	Nil
Kotak Realty Fund	Nil	Nil	100%	Nil
IIFL	Nil	Nil	100%	Nil
HDFC	Nil	Nil	100%	Nil
Piramal Group	5%	Nil	95%	Nil
Peninsula Brookfield	Nil	Nil	100%	Nil
Standard Chartered	Nil	100%	Nil	Nil
ICICI Prudential AMC	Nil	12%	88%	Nil
Reliance Capital	Nil	Nil	100%	Nil
Morgan Stanley	Nil	Nil	100%	Nil

Source: Real Capital Analytics (RCA), Cushman & Wakefield Research

CHALLENGES

STATUS OF RESIDENTIAL ASSETS

Fig 5 – Residential real estate trends

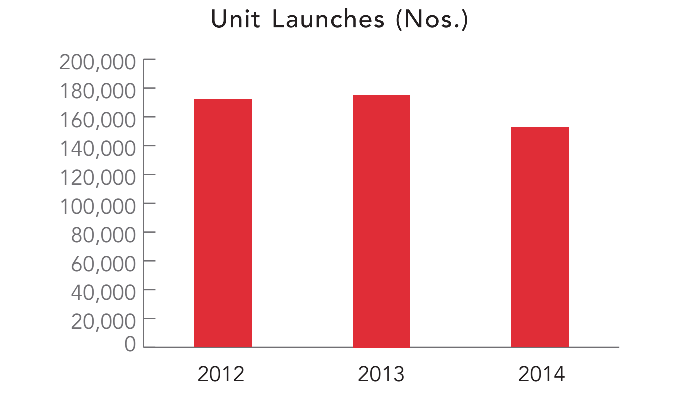


Source: Cushman & Wakefield Research

Considering that numerous approvals (around 30) are required for any real estate project in India, the overall execution timelines are highly dependent on uncontrollable factors due to delays in seeking necessary permits. In addition, due to ever-increasing land and input costs, many residential projects are being developed in the mid, high-end and luxury segments, whilst demand is highest in the affordable and mid segments. This demand-supply mismatch has created massive pressure on the sales, negatively affected the projected cash flows, increased the unsold inventory and made developers incapable of servicing the project-level funding secured from various investors. This is a vicious cycle and increasingly many investors are being extremely cautious and make investments only after conducting a detailed due diligence of the developer and the project under consideration. In fact, many global real estate funds and investors are extremely keen to invest only at a stage wherein all necessary project approvals are in place and actual on the ground construction has also begun with some sales volumes being achieved. Due to lack of initial stage funding for many projects, real estate developers are forced to infuse expensive capital during land acquisition and early stages of the project. This bears a significant impact on the overall project costs and as a result, the investors' returns expectations suffer in many cases.

Nearly, 500,000 new residential units were launched in top eight cities[3] of India between 2012 and 2014. Majority of the units (60%) were added in the mid segment whilst 16% were added in the high-end segment. Only meagre 23% unit additions came in the affordable segment. Considering the increasing population and rapid urbanization in India, the demand for housing units is likely to continue increasing in the future as well. As per government estimates in 2012, there was a shortage of 18.78 mn urban housing units in India. As per C&W estimates, total additional housing demand of 2.15 mn is likely to arise in the top eight cities between 2015-18. Existing under construction and planned delivery pipeline by 2018 is only around 1 mn units across top 8 cities, indicating a massive demand-supply mismatch. 56% of the total demand-supply gap across top eight cities is expected to arise in the affordable segment followed by 25% in the mid segment. These demand-supply estimates clearly indicate that the funding requirements for India real estate sector are likely to remain high in the future as well and it is time that new products/funding mechanisms are developed to meet financing requirements as well as to generate good returns for investors.

Residential real estate trends



Source:Cushman & Wakefield Research

KEY CHALLENGES IN STRUCTURED DEBT DEALS

Selecting the apt partner, in-depth analysis of the project (technical and financial viability) and collateral package assessment are key criterion in any lending decisions. This evaluation is crucial as real estate private equity structured debt investments are not covered under the Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act, 2002, which is available to the banks and public financial institutions (PFIs) in India. Thus, a comprehensive due diligence on the commercials, partner and legal aspects for a debt transaction is extremely important.

However, existing formats of structured debt transactions will be under pressure or may become unsustainable in the future periods, due to following key reasons:

1. **Changing market dynamics:** This product is primarily for residential projects where approvals are in place and sales have started. Post global financial crisis, residential real estate sector in India has been battered and sales have slowed down significantly. New project launches across cities have also declined by around 11% between 2012 and 2014. Hence, there is a drop in eligible projects/products due to both low sales velocity in existing projects and decline in new project launches.

2. **End use constraint:** Developing residential projects on a continuous basis is heavily dependent on the land bank that developers have created over a period. However, currently many developers do not have a significant land bank and there is an increasing need to acquire new land parcels for launching projects. Massive investments are required for such land acquisitions. However, existing structured debt funds are prohibited from investing in these formats as per their internal rules.

3. **Cash-flow mismatch:** In residential projects, cash-flows are lumpy, based on sales velocity, stage of construction and sales schemes adopted. In the initial period, there are high inflows and then free cashflow becomes lumpy as payments are linked to construction schedules. Further in lean markets, many sales have back-ended payments and there comes a stage when free cash-flows virtually become nil in the intervening project lifecycle. Monthly or quarterly coupon and principal servicing as opposed to sweep of free cash on an IRR format is difficult. This is being increasingly faced by projects, which were launched and invested during 2010 – 2012.

4. **Unsustainable Cost of Funding:** In residential projects that continue to garner good sales, developers consider refinancing the high cost debt at lower financing, which is available in brownfield residential projects, thus shortening the effective YTM to 18-24 months as opposed to signed term of 36-48 months. In effect, this is bridge funding as opposed to a longer term high yield investment due to cost of funding. Further, the senior secured position does not allow any construction finance, which is much cheaper (13-15%) and costlier funds are used for working capital, making the project unviable. In some cases, banks also compete with the structured debt deals by providing funds at a cheaper cost.

5. **Competition from Other Funding Options:** Fund of funds managers and fund managers are also expected to increase their allocations in joint ventures and club deals over the next two years, emphasising investors' desire for greater control over their investment[4]. Some recent examples are APG's investment in Godrej Properties in 2012 and GIC's investment in Brigade Enterprises in 2014.

[3] Ahmedabad, Bengaluru, Chennai, Delhi-NCR, Hyderabad, Kolkata, Mumbai and Pune
[4] ANREV — Investment Intentions Asia Pacific Survey 2015

OUTLOOK

DEBT FROM SCHEDULED COMMERCIAL BANKS

Banks have been extremely cautious to extend debt to the real estate sector over the last few years. The guarded stance is primarily due to continued subdued performance by the sector, which leads to an increase in NPAs for the banks. Consequently, banks' credit exposure to commercial real estate and housing has declined from 10.0% in FY 2010 to 8.1% in FY 2014.

Bank credit to real estate sector is likely to remain tepid in the future periods as well, considering that the sector is still grappling with subdued demand, faces many regulatory hurdles and the banks have their credit exposure and NPA norms. As a result, one can expect developers to rely on structured funding options from NBFCs and/or private equity funds. Having said that, demand revival on the back of improving economic outlook and regulatory reforms may alleviate banks' concerns and lead to an uptick in credit availability to the sector.

POSSIBLE MODIFICATIONS IN STRUCTURED DEBT DEALS

Structured debt deals are currently being commoditized and with increasing capital pools, it is leading to rate competition between the top funds. Hence, for structured debt to be sustainable, slightly different product structures would be more encouraging. A few innovations/changes that can be considered include:

1. **End use:** Funds to invest in acquisition strategies where project launch horizon is six to eight months. This is a highly sensitive call to be taken on a case-to-case basis and dynamics/land regulations of the city under consideration. A few investors are using this strategy and we believe that there lies a large market for these type of investments.

2. **Mezzanine structures:** Funds can also consider investing in subordinate debt position, where the senior lender is investing towards construction. This will enable project financial closure at very optimal pricing and higher cost of mezzanine towards resolving take out or other special needs of promoter. Not many investors are presently using this strategy.

3. **Pricing & Repayment:** The ideal average pricing would be an IRR of 18%. This should be obtained through a mix of around 10% to 12% coupon (monthly or quarterly) plus sweep of free cash-flows towards balance return and principal under the overall return period. This flexibility of repayment on a sweep basis will help to sustain project during the interim lean periods.

4. **Asset diversification:** Presently, structured debt deals are primarily concentrated only on the residential asset class. With office and retail leasing improving, and a large amount of office/retail stock struggling in final stages with debt overhang, a higher LTV lending on this with other collateral should be explored. This is the need of the hour and should be a part of the overall portfolio to start with for any investor.

With these adapted features, structured funding would become a regular product as opposed to the current opportunistic product and may lead to massive incremental investments in the burgeoning Indian real estate sector.

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