THE DEVELOPING NATURE OF INDIAN REAL ESTATE FUNDS

PANELISTS AT THE HUBBIS INDIAN PRIVATE BANKING FORUM 2014 IN MUMBAI IN LATE AUGUST ASSESSED THE STAGE OF DEVELOPMENT OF INDIA'S BURGEONING SECTOR FOR REAL ESTATE FUNDS – AND LOOKS AT THE LESSONS IT HAS LEARNT IN RECENT YEARS.

Indian real estate developers, as well as private equity funds which invested into them pre-2008, have made a number of mistakes that they need to learn from – and believe that they have done so.

Those errors include being too optimistic on land requirements and valuations, but developers were also unfortunate to be hit by headwinds.

This was the outcome of the panel discussion on whether it was time to invest in real estate funds at the Hubbis Indian Private Banking Forum 2014, held in Mumbai in late August.

Amit Bhagat

ASK Property Investment Advisors

"There can be re-rating of cities where infrastructure isn't as developed, or the developers are not as mature"

INDUSTRY TOO NASCENT

When asked about the mistakes made by the real estate industry pre-2008, Amit Bhagat, chief executive officer & managing director of ASK Property Investment Advisors, said that the industry started out as private equity funds but were not able to understand the developers' DNA and governance, as well as the market irrational exuberance.

"So they essentially did excel sheet-underwriting between 2005 and 2008," he explained. However, these funds could not deliver and turned into mezzanine financing funds.

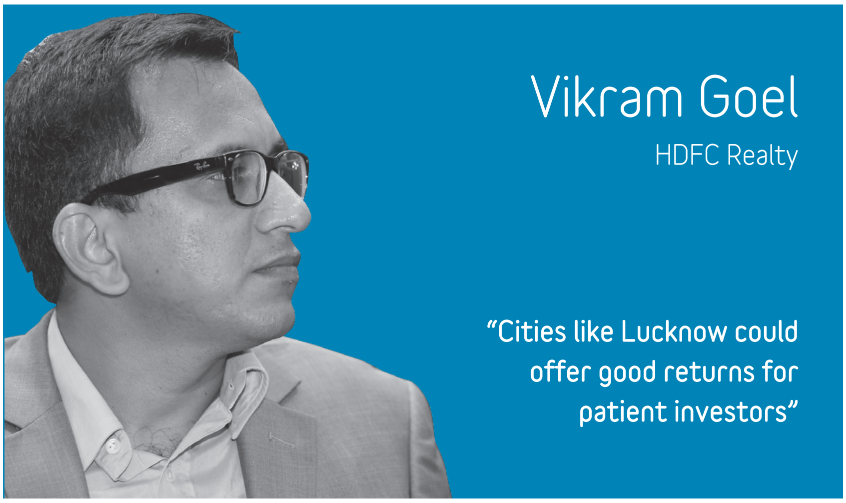
The other main issues were the long gestation projects and income-yielding assets. The combination of land being treated as equity, the mismatch of valuations and expectations without safety margins, and the lack of alignment of interest meant that the situation unraveled.

Bhagat's view was that everyone has learnt from mistakes made pre-2008.

Ravi Ahuja, executive director at Cushman & Wakefield, took a higher level perspective, saying that it is important to have gist of pre-era as well as post-era.

"Looking back at 2005 to 2008, globally there was excess money chasing real estate in almost all the cities; everyone wanted a land bank," he said.

"Valuations were crazy with excess money chasing few deals; at one point there were 300-plus fund managers in this sector," he added.



But he also stated that the macro-economic parameters were different: GDP rates were high, growth rates were different and inflation was low. The situation changed: GDP fell to 5%, inflation rose to 9%, and the rupee-US dollar exchange rate has fallen from 40/42 to 60/62.

In addition, there were numerous regulatory changes affecting different cities; DCR changes, Telangana issues affected Hyderabad, Dwarka express way was delayed – even today it will take another two more years to connect.

Ahuja's point was there is a stark difference between product pricing and replacement theory. Many properties in Bangalore and other cities, for example, are available at less than replacement cost.

"Corporate growth and technology such as IT growth are all are playing vital roles in making land available at a price that is less than the replacement cost," he explained.

He believes that while it would have been hard for the funds to predict the change in economic circumstances, they now know about regulatory risks; they have learnt to invest only after approvals have come in.

Hrishikesh Parandekar, chief executive officer and group head – broking, wealth management and asset management, at Karvy Group, agreed that the industry has learnt from the past.

He said he is still bullish on real estate as an asset class as it creates value from converting land into various uses, thereby generating sustainable – and good – returns.

Indeed, Parandekar was bullish enough to say that not only does Karvy distribute real estate funds, but also manufactures its own – buying into the premise that real estate is straightforward enough to make money from.

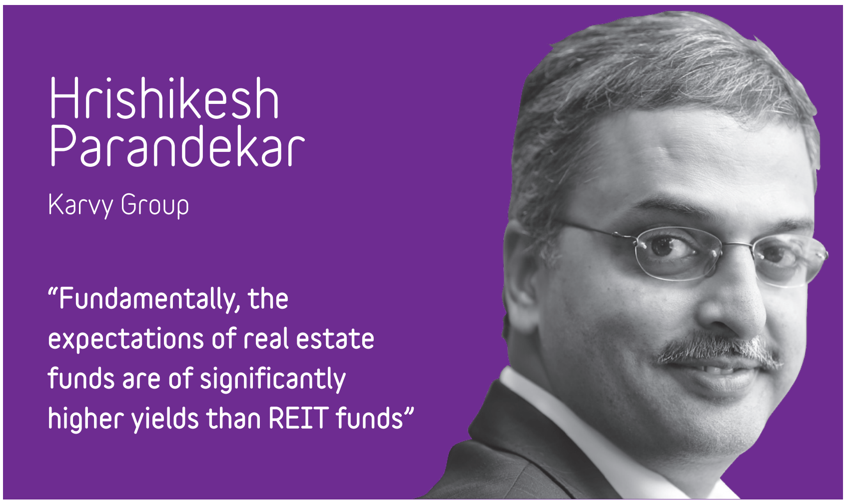
THE EXPECTATION FROM REITs

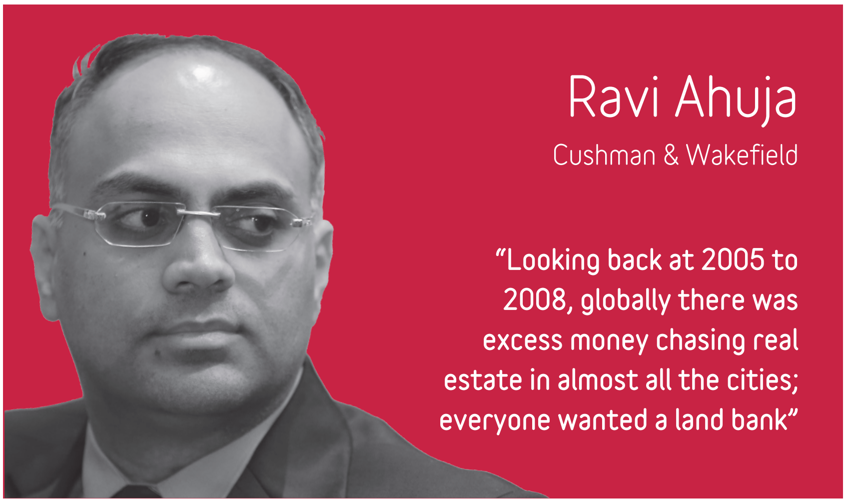
While real estate funds have been focusing on developments – at the higher end of the risk-return spectrum, investors also have an appetite for stable yield from leased assets.

In addition to buying pre-leased commercial real estate, the wealth management industry has been advising investors to invest in mezzanine yield structures to get higher yield.

Hence, the advent of REITs will not affect the demand for real estate private equity funds.

Said Parandekar: "Fundamentally, the expectations of real estate funds are of significantly higher yields than REIT funds. So the return profile is different and of course investor profile will also be different."





Parandekar added that he believes REITs will also attract a lot of foreign investors wanting exposure to Indian real estate.

Vikram Goel, chief executive officer of HDFC Realty, said that most of the market is with the people who want to buy their properties directly.

REITs will be somewhat restrictive in that they would only in commercial properties, he explained.

Their returns are better than residential, but most of the returns will flow from capital appreciation.

OPPORTUNITIES IN SMALLER CITIES AND DEVELOPERS

While the organised real estate fund industry has focused only in the top cities, Goel encouraged private bankers to consider smaller markets outside the top five cities.

For example, cities like Lucknow which is the capital of the most populous state, Uttar Pradesh, could offer good returns for patient investors.

However, Bhagat preferred to stick to the larger cities. He said investors had indeed invested in Coimbatore and Vizag into residential apartments during the 2005 to 2008 period.

However, they learnt the hard way that residential growth depends on the growth of white-collar jobs, which tends to happen only in the top seven cities in India.

Indeed, the political issues in the larger cities such as Kolkata and Hyderabad were significant enough to affect the real estate market in spite of their size.

"So there can be re-rating of cities where infrastructure isn't as developed, or the developers are not as mature," added Bhagat.

Given the reputation of low governance standards in the real estate sector, investors have no option but to choose the best developers.

They also look for good track records with net worth of US$50 million to US$200 million, and "such developers are available in top five cities only".

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