Peering into 2016

Taking Pulse of Investors' Preference

Foreword

Like any coin, the real estate sector has two sides. One side, that has seen phenomenal activity on the back of changing demographics, robust capital markets and fairly strong fundamentals. The flip side has seen the sector continue to grapple with numerous challenges - be it regulation, fragmentation, lack of transparency, capacity constraints, lack of enforcement and implementation of reforms etc. and above all the access to low cost capital.

Given all these factors, the Indian Real Estate market is undoubtedly a paradox. Once the realm of high-risk investments with astronomical projected returns; the sector has always struggled with the availability of capital. Even today, despite several positive policy and regulatory changes having taken place, the influx of capital remains somewhat sluggish; resulting in real estate to some extent still being locked outside the financial market and unable to leverage investments. The sector being capital-intensive further faces a liquidity crunch with most banks and financial institutions adopting a cautious approach to lending to realty business.

At a time when nothing else seemed to work, private equity investments helped prop up the market. But even PE investments hit the trough, with more talk of exits being prominent in comparison to the supply of fresh funds. But are exits actually taking place? Are funds and fund managers making the projected returns they first started out with? Is PE money the only lifeline that developers are now left with?

Given that investors still feel somewhat wary about investments in India due to a lack of risk assessment tools and expertise, there is always a sense of déjà vu of a slowdown similar to 2007 and the last two years. However 2015 saw several policy reforms & initiatives such as relaxing FDI norms, implementation of REITs, RERA getting the Cabinet's nod. We hope that over time, these will pave the way for a more reformed, regulated and transparent real estate market in the country.

Today we see a more mature investment market - looking to dabble in both debt and equity financing. Driven by the need to increase returns through expanded investment opportunities and a desire to diversify, investor interest in international property markets is once again on the rise and India definitely seems to be leading that interest.

2015 was a mixed year - while it was a tough year overall, for real estate investments it fared well. There was a definite turnaround in investor sentiment on the back of all the positive changes implemented, which is expected to uplift the sector further. So will 2016 see a further dip in interest rates and heightened economic activity, providing additional fillip to the sector? Will 2016 be the year for home buyers? Which asset classes will see more momentum than others? This research paper is an attempt to gauge the investment sentiment and pulse of the market. The idea is to evaluate trends, opportunities and new frontiers that will pave the way for the market in 2016 and beyond, I am truly hopeful that 2016 will unlock the investment floodgates for realty.

Devina Ghildial
Managing Director - South Asia
RICS

January 21, 2016

Foreword

Private Equity (PE) capital has been instrumental in propelling the real estate boom in India, a sector where banking finance has had its own restrictions to cope with. After a relatively muted CY 2013 and CY 2014, PE Investors increased their bets significantly in the Indian real estate sector in CY 2015 with estimated investments aggregating to USD 5.1 billion across 86 deals (up from USD 2.3 billion across 63 deals in CY 2014).

A decade has passed since the Indian real estate sector was first opened to Foreign Direct Investment (FDI) – PE investors have thus had the benefit of incorporating their learnings from the previous investment cycles in their current investment strategies. Additionally, Institutional Limited Partners are more than ever before reviewing historical performance, integrity, quality, stability and experience of management teams, quality of reporting, operating controls and quality of corporate governance. Fund raising is available only for investors with demonstrated track record and proven capability. Thus, what is clearly emerging as a trend is a preference for quality. Developers who have an established track record and have the ability to conceive, design, develop and manage marquee projects and forge strong customer relationships with the right cash flow management strategies are the ones that will be at an advantage in attracting the right set of capital providers. From a successful deployment strategy standpoint, the current market environment requires solutions to be designed to meet the needs of the developers rather than adopting a 'one-size fits all' approach. For instance, high-yielding debt solutions in a self-liquidating residential product may no longer be competitive. Funds that will be successful in the medium to long term will be the ones who can come out with innovative solutions. As we stand on the threshold of 2016, a number of interesting questions confront us - will the private equity investment momentum continue in 2016? Will investors embrace the affordable housing theme? Will the first set of REIT listings hit the capital markets in 2016? More importantly, will the underlying fundamentals of the market improve?

Some of the opinions that emerge from the survey undertaken as a part of this report are indeed heartening. Basis the responses, capital flows are expected to increase with newer sources likely to enter the market. Market sentiment is expected to improve with implementation of regulations such as RERA. The respondents are overwhelmingly optimistic on the markets fundamentals (sales) improving in 2016. The respondents are however circumspect on the possibility of REIT listings hitting the Indian capital markets in 2016 and the emergence of affordable housing as a viable investment theme.

The detailed responses to questions like these have been covered in this paper which is a continuation of our effort to tune in to the voice of the investor community. The paper is our attempt to gauge the investment patterns and key investment themes for 2016. It has been our endeavour to achieve thought leadership in the Indian real estate sector. This paper is a small step towards that vision.

We welcome your thoughts and feedback on this paper. Please send in your comments to marketing.india@ap.jll.com. Wishing you exciting times ahead in the New Year!

Ramesh Nair
Chief Operating Officer and International Director
JLL India

January 21, 2016

Introduction

It was the best of times, it was the worst of times,
it was the age of wisdom, it was the age of foolishness,
it was the epoch of belief, it was the epoch of incredulity,
it was the season of Light, it was the season of Darkness, it was the spring of hope, …

Perhaps when Charles Dickens penned these famous words in 1859, he did not realise how apt these would be to the Indian Real Estate sector at the beginning of 2016.

Heralding a new year is more than the mere changing of dates; it is a new start to efforts afresh; underpinning a new sense of opportunity. As stakeholders in this industry, we believe that we are at a new inflection point as far as Indian real estate investment is concerned. The investor community has moved up the learning curve; changing the investment philosophy and it now sees itself as a long term partner to the developer community. There are positive changes proposed as far as regulatory frame work is concerned, further easing investment and most importantly there is a sense that perhaps fundamentals themselves may be improving as indicated by uptick in sales velocity.

It was important for us to see if these thoughts were also mirrored in the investors' minds. Carrying out a perception survey at the beginning of the year provides an added advantage of a well-defined time frame (next 12 months) against which to position questions. Talking to only investment professionals was an intuitive decision for us; we wanted to sense the pulse of the money supply and in doing so this report dovetails seamlessly with the paper JLL came out with in November 2015, entitled Real Estate Private Equity 3.0.

SUMMARY OF SURVEYRESPONSES

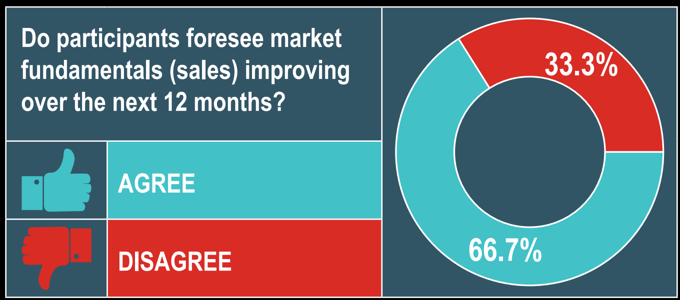
2016 has begun on a mixed note for Indian Real Estate; while there are still concerns on slower sales and subdued demand there are also indicators of positive regulatory changes that may boost investor and buyer sentiment.

Appropriately, we carried out an anonymous survey of seasoned Real Estate Investors in January 2016 through an online platform which saw excellent participation. Such sentiment surveys capture the mood of the participants and through specific queries identify participants' areas of concern and hope. The focus of this survey was to understand the sentiment on various factors including return expectations, exits, preference on asset typologies and cities as well as impact of new and proposed regulatory reforms over a time frame of next 12 months.

MARKET FUNDAMENTALS

While availability of investment capital may not be a concern, question marks have been raised on the underlying strength of the fundamentals indicated by the velocity of sales. The markets have witnessed significant stress with sales under pressure due to increasing prices, longer delivery timelines for projects and a range of such factors.

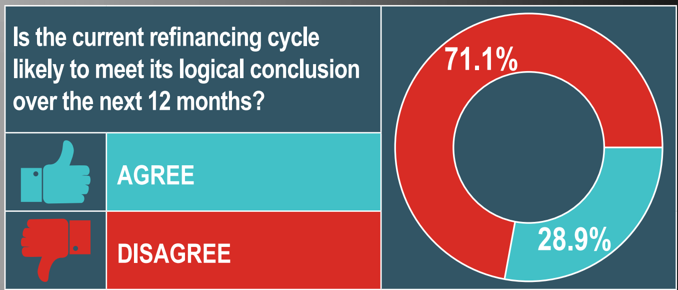
What is heartening to note is that a majority of the respondents feel that they expect sales improving over the next year and this indeed augurs well for the real estate market.



2 REFINANCING CYCLE

A number of investments over the past couple of years or so were in fact refinancing of investments/debt extended by an earlier set on investors/ lenders and not necessarily deployed towards growth capital purposes. One benefit of refinancing for the issuers will be achieving a competitive cost on financing, since there would have been progress in the project since the time the previous investments/debt were obtained thus lowering the risks for the incoming investor.

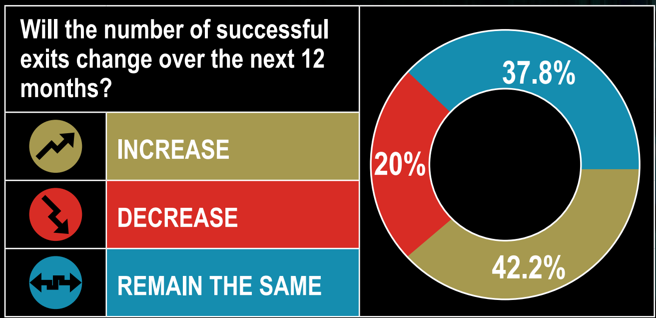
Basis the responses of the investors in this survey, majority of the participants seem to believe that the said refinancing theme is set to continue beyond the next 12 months.



3 SUCCESSFUL EXITS

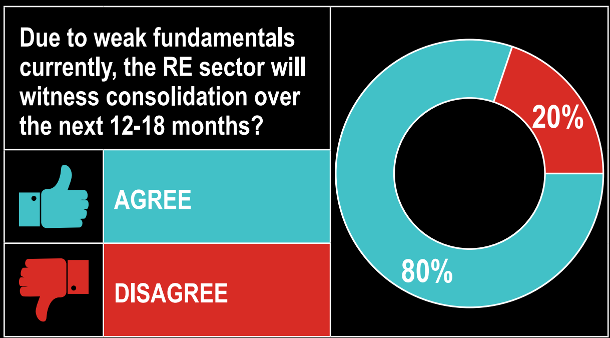
As of date, the public markets are not attractive for Indian Real Estate sector and lower velocity of sales has meant that exits have been a concern. Majority of exits over the last 12-18 months have been characterized by refinancing or by developer buyback.

2016 seems to herald a better day as only 20% of the respondents believe that number of successful exits will actually decrease. In fact almost 43% believe that exits will actually increase going forward.



4 CONSOLIDATION

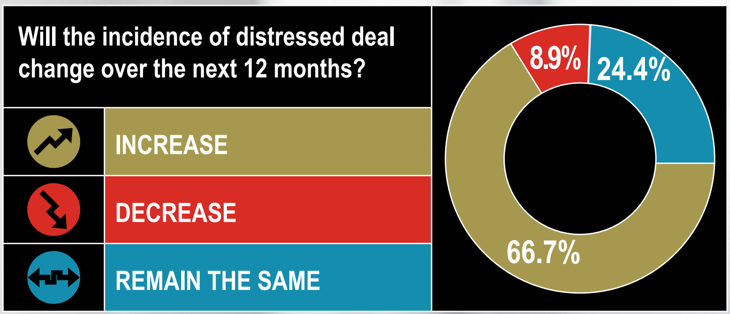
The real estate sector has witnessed some stress particularly in sales with buyers increasingly demonstrating preference for projects of some of the Grade A names. With sales under stress, some of the smaller players may find it unviable to sustain independently over the long term. Increase in consolidation which has already been witnessed at a project level seems to be the theme going forward as indicated by the survey.



5 DISTRESSED DEALS

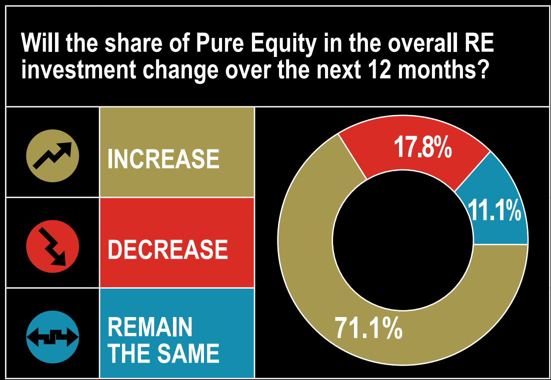
With continued headwinds vis-à-vis underlying fundaments, pressure on residential sales driven by slow uptick in demand has resulted in some stress. Not surprising as stated earlier, the refinance story will continue to play out beyond 2016. This distress was anticipated and a number of institutional players continue to scan the horizon for such opportunities.

Approximately 67% of the respondents believe that incidence of distressed deals will increase over the next 12 months.



6 SHARE OF PURE EQUITY DEALS

Pure Equity investments have seen a return and been on the increase and the momentum is expected to continue over the next year. This aligns with the recalibration of the investment community's role as a long term partner with key and select developers. A majority of the respondents are of the view that the share of pure equity in the overall investments is expected to increase over the next 12 months.



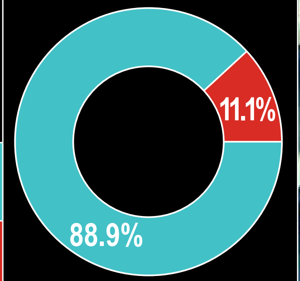
7 EQUITY INVESTMENTS - GRADE A

Equity investments have been in vogue and critical partnerships have been forged between leading funds and Grade 'A' developers. The benefit of this however does not seem to have percolated to relatively new developers that do not have a strong institutional financing track record. With its relatively long term approach and relatively high risk, equity investors have chosen to partner with some of the large names that have the track record of having obtained and repaid financial investors. This view has been overwhelmingly vetted by the respondents.

Equity investments will be restricted to the Grade A names and will not be available for developers with limited institutional financing track record over the next 12 months?

AGREE

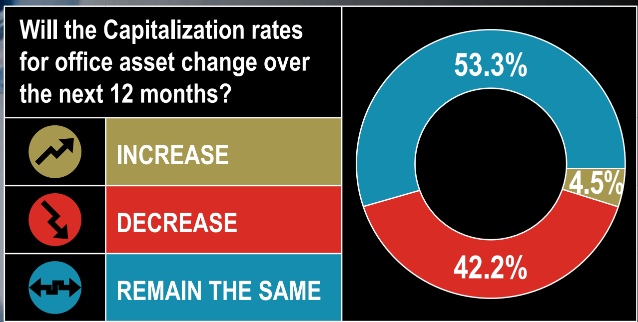
DISAGREE



8 CHANGE IN OFFICE CAPITALIZATION RATE

Steady yield compression as a result of overall change in interest rate regime and maturity of the Indian real estate markets has been a constant expectation since the Indian real estate sector first started attracting institutional foreign capital from 2005 onwards.

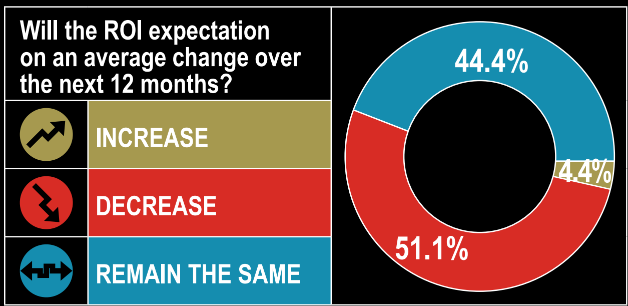
While over a third of the respondents do believe that office cap rates will see some compression over the next 12 months; the overwhelming majority has opined that cap rates will remain stable.



9 RETURN ON INVESTMENT EXPECTATIONS

As stated in JLL's November 2015 paper, we believe it is unlikely that the investor community will refocus on higher returns at the cost of higher risk.

Aligned to this expectation, majority of the respondents believe that overall ROI expectations will decrease over the next 12 months.



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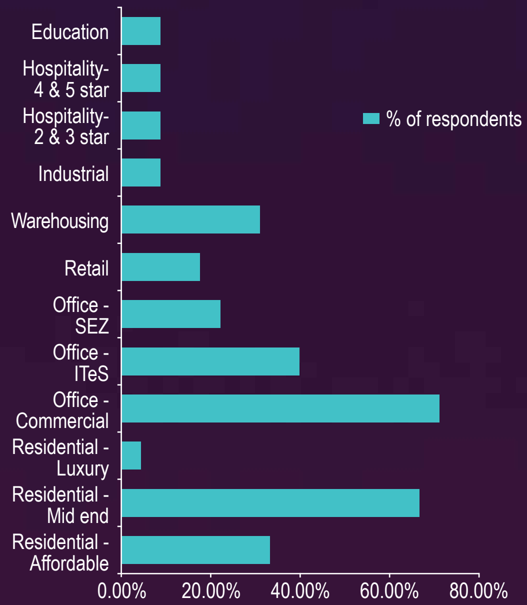
TOP 3 ASSET TYPES

Commercial office space has emerged as the top asset class among investors, with mid segment residential asset class as the close second. IT and IT-enabled services as an asset class rounds up the top 3. It would be interesting to explore if the delay in passing of the GST bill has had an impact on the investors rankings for warehousing and industrial assets classes.

Over the next 3 years, which top 3 asset type would be part of your investment portfolio?



11 TOP 3 CITIES

There are really no surprises when it came to selecting the top cities as the preferred investment destination. Mumbai and Mumbai Metropolitan Region emerged as the top city with Bangalore coming in at close second among the respondent pool. Pune beat National Capital Region to round up the top 3.

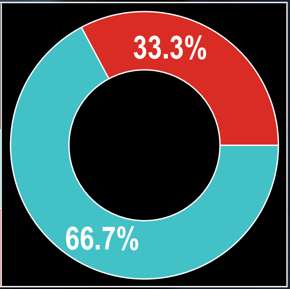
Over the next 3 years, which top 3 cities would be part of your investment portfolio?

12 RELAXATION IN FDI GUIDELINES IMPACTING SMALLER PROJECTS

The relaxation of the investment criteria vide PN 12 of 2015 generated a lot of euphoria in the investment community since there were important clarifications particularly with respect to investment in completed assets. With the project size criterion being done away with, it is believed that smaller projects especially in cities like Mumbai will attract greater investments from FDI compliant funds. Approximately 67% of the respondents believe that the relaxation in FDI guidelines will lead to a higher investment in smaller projects.

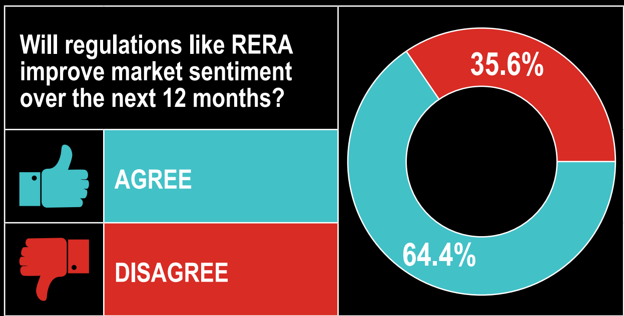
Will the recent relaxation in FDI guidelines lead to a spurt of investments in smaller projects over the next 12 months?

- AGREE
- DISAGREE



13 RERA - MARKET SENTIMENT

The implementation of RERA is being keenly watched by market participants and is expected to shape up as a path breaking legislation for the industry. This legislation is likely to improve the confidence of the buyers in the developer community which in turn could positively impact sales. Approximately 64% of the respondents seem to echo this hypothesis.



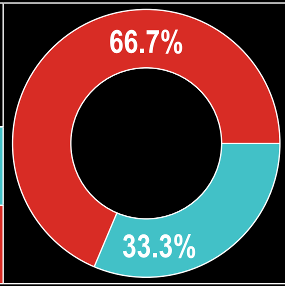
14 REIT LISTINGS

While it's clearly been a while since the draft REIT legislations were announced by SEBI, there were several concerns relating to taxation and other aspects that were voiced by the market participants. While the intention of the authorities has been clear and measures have been announced to address a few issues, it seems, basis this survey, that at least 2016 will not be the year where we witness the first REIT listings in the Indian capital markets.

Will the first set of REIT listings hit the Indian capital markets in the next 12 months?

AGREE

DISAGREE



15 NEWER SOURCES OF CAPITAL

The year 2015 had seen a number of new Investors in the real estate space. This included some of the large global PE funds. It is expected that this trend is likely to continue in the year 2016 with more new entrants in the Investor Landscape. Approximately 62% of the respondents felt that in 2016 it is likely that institutions from Japan and China could come knocking in the India real estate market.

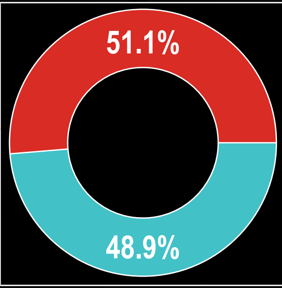
Are newer sources of capital (Japan, China) likely to start investing in India in the next 12 months?

16 AFFORDABLE HOUSING AS AN INVESTMENT THEME

While there has been a lot of thrust by the Government on the 'Housing for all by 2022' initiative and also to provide affordable housing, it seems that from a pure investment perspective, the jury is still out on the viability of the same. Ostensibly due to low margins/profitability and the relative longer project gestation, approximately 51% of the respondents are negative on the possibility of the affordable housing being a viable investment theme.

Are funds likely to consider affordable housing as a viable investment theme over the next 12 months?

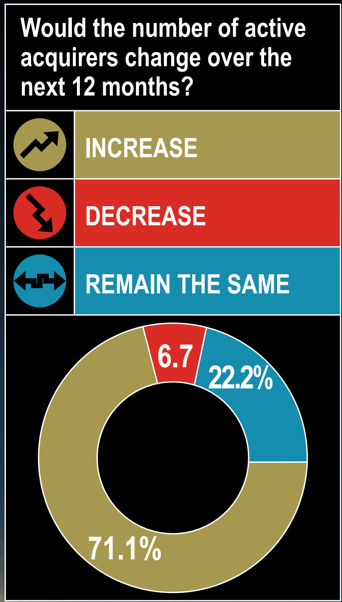
- AGREE
- DISAGREE



17 ACTIVE ACQUIRERS AND DIVESTORS

Fund raising scenario has improved since the election of the Modi government. With sufficient dry powder ready to be deployed, shortfall in Grade A core assets fit for acquisition and a possibility of distress deals on the horizon, the number of active acquirers should see a steady increase.

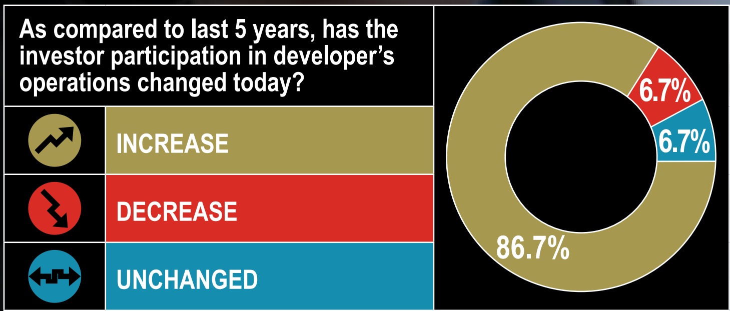
Indeed, the investors clearly think that the number of active acquirers will increase over the next 12 months. Aligned to this expectation, majority of the respondents believe that the number of active divestors will increase over the next 12 months.



18 INVESTOR PARTICIPATION

2010 was the early part of what JLL considers the second phase of investment in Indian Real Estate characterized by structured equity investors. Over the last 5 years there has been a sea change in the investor behavior as well as constitution. With more diligence pre deal to more active participation post deal today's investor is more hands on.

Indeed, the significant majority of investors opine that compared to last 5 years, investor participation has increased in developer's operations.

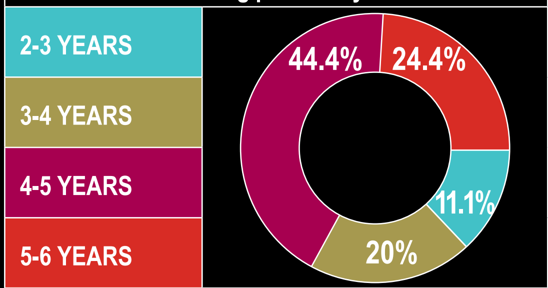


19 IDEAL HOLDING PERIOD

Holding periods are an inherent function of the investment philosophy as well as the larger deal landscape. While short term highly opportunistic deals are always highly desired, the holding period responses can be a good indicator of type of deals being chased.

Approximately two thirds of the respondents believe that their ideal holding period is more than 4 years.

Based on past experiences and strategy, what would be ideal holding period of your investment?



CONCLUSION

As seen in the conclusion of JLL white paper entitled ‘Real Estate Private Equity 3.0’ (November 2015), we believe that PE investment community has learnt from the past and that Indian Real estate is now in a phase characterised by fewer but definitely more long term partnerships between developers and investors.

Since that paper was written; 2 important things happened. PN 12 of 2015 generated excitement in the investment community and further cemented the Governments’ stated position of easing investment norms in Real Estate. However, the failure of Parliament’s winter session to clear the much delayed GST Bill, which promised the biggest tax-reforms in the country, caused concerns.

This investor survey has given a clear line of sight on various aspects that are important to the real estate investor community.

On a positive note, a significant majority (almost 70%) foresee sales improvement over the year. Investors clearly voiced that the refinancing cycle is not expected to meet its logical conclusion at least in 2016 however the number of successful exits will increase over the next 12 months.

Respondents believe that there will be continued consolidation over the next 12-18 months. Aligned to this thought, incidence of distressed deals will increase. With pure equity making a comeback, while majority of respondents expect its share to increase in the overall pie; such equity will only be available to select Grade A developers.

Majority felt that while office cap rates will remain the same; the average ROI expectations on the other hand will actually decrease over the next 12 months.

Commercial office as asset class and mid-level residential are the top 2 assets preferred by investors with IT/ITeS office rounding up the 3rd spot. On the preferred cities; Mumbai and Bangalore are the top 2 cities with Pune coming a distant third beating NCR.

Majority have also opined that recent and proposed regulatory initiatives like PN 12 of 2015 and RERA respectively will enhance investment in smaller projects and positively impact the sentiment by boosting buyer confidence. However majority of the respondents do not believe that the REIT listings will debut in 2016.

Majority of the respondents believe that Japanese and Chinese investors will enter Indian real estate in the coming year and participants are not gung-ho on affordable housing being an attractive investment opportunity. Large majority felt that the number of active acquirers and active divestors will also increase over the next 12 months.

In summary; the investor sentiment is of renewed possibilities; where investors believe that overall 2016 will be a better story than 2015. As stakeholders; we sincerely hope that most of these expectations come true.

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