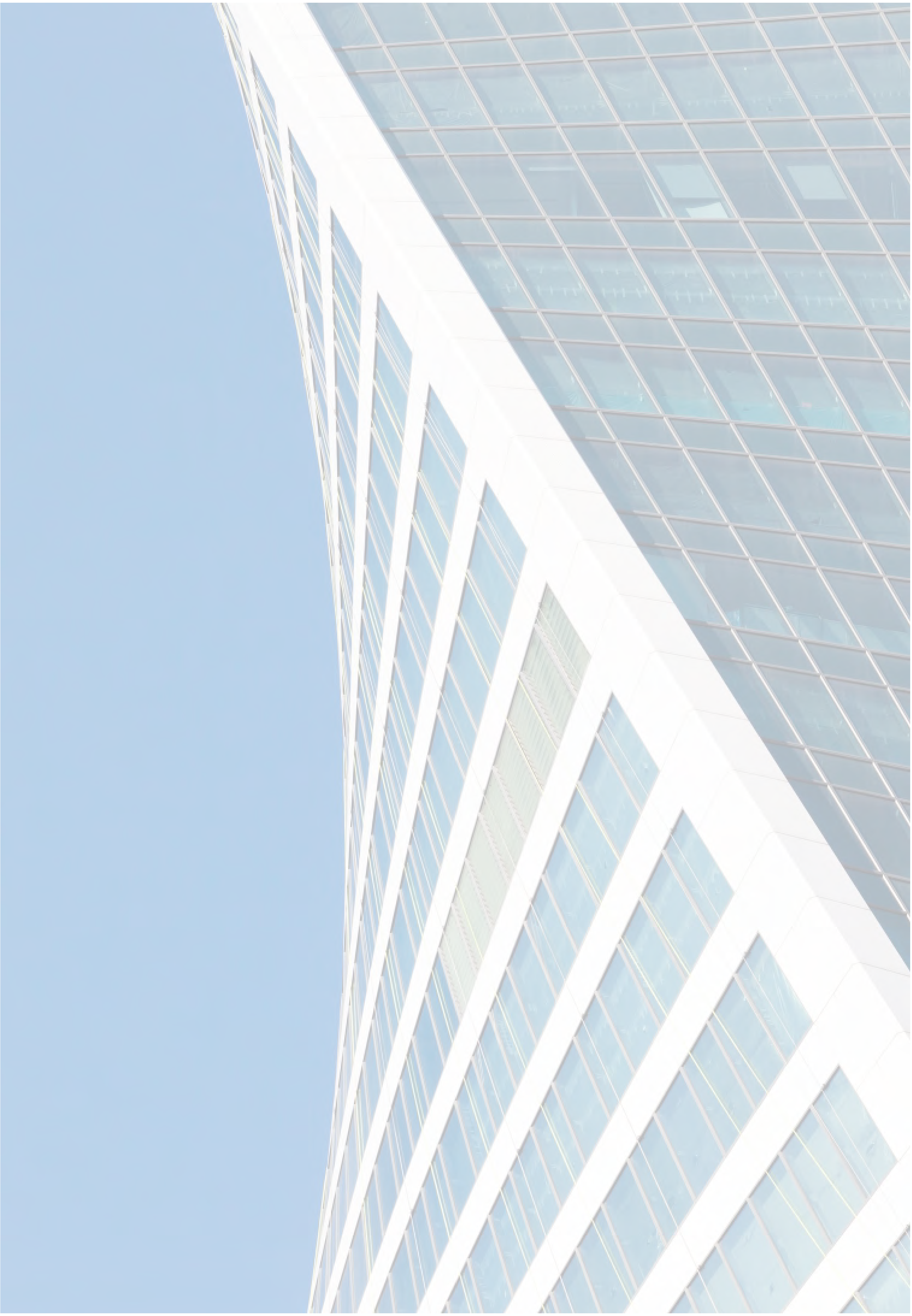
RESEARCH

Knight Frank

ANALYSIS OF INSTITUTIONAL FUNDING IN REAL ESTATE

REPORT 2017

FOCUS ON PRIVATE EQUITY



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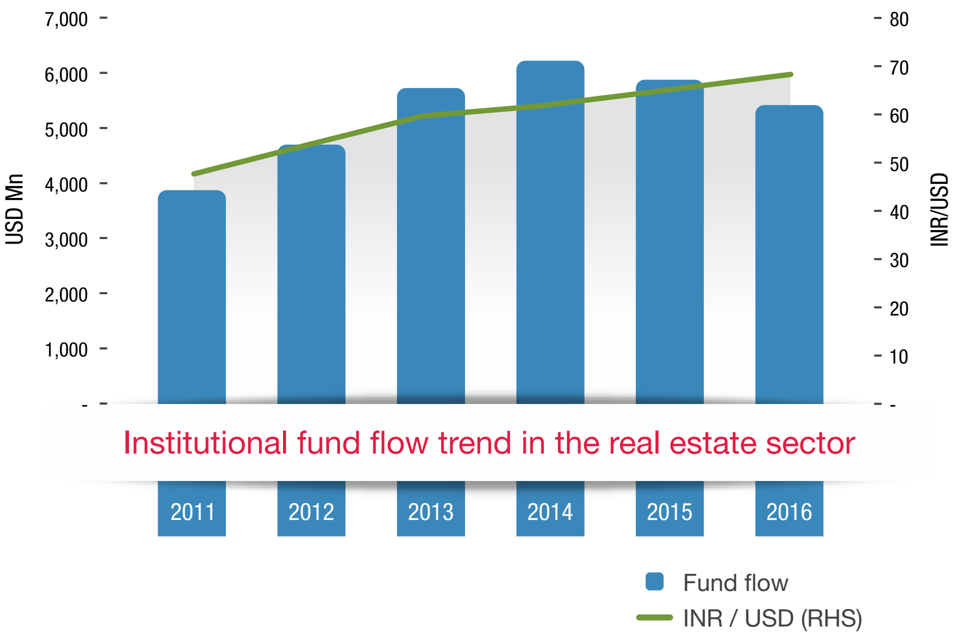
INSTITUTIONAL FUND FLOW TREND IN INDIA'S REAL ESTATE SECTOR

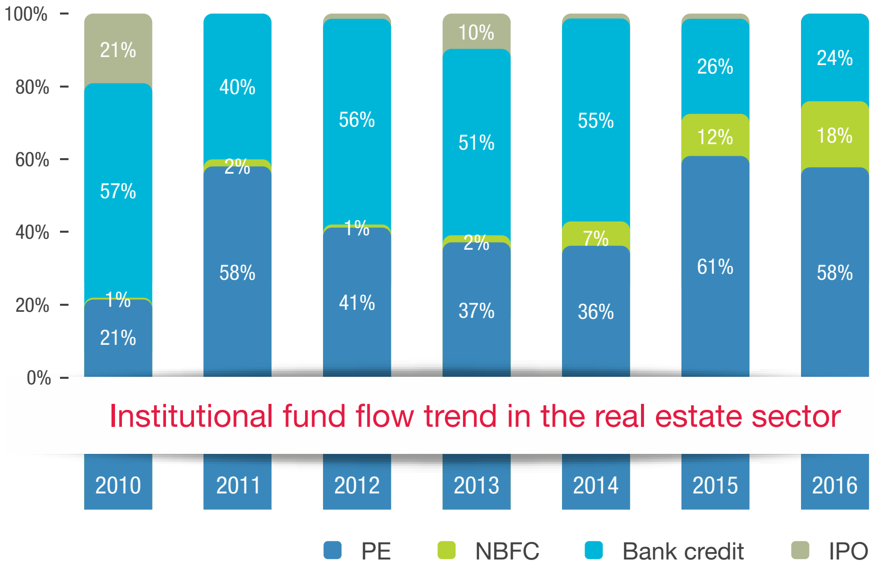
USD GAINED 43%, FUNDING HIGHER BY 40% BETWEEN 2011-2016



Note:
PE includes entity-level equity, project-level equity and various types of structured debt. NBFCs include all the non-banking financial institutions registered in India. Bank credit is the commercial real estate loan offered by scheduled commercial banks. Initial public offer (IPO) includes follow-on public offer (FPO), rights issue, qualified institutional placement (QIP) and institutional placement program (IPP)

- The total funding in the Indian real estate sector increased by 40% from USD 3.8 bn in 2011 to USD 5.4 bn in 2016. This takes in to account the fund flow on account of private equity, NBFC, bank credit and IPO
- Accentuated by a 43% appreciation in USD, this fund flow translated into a significant increase in rupee denominated investments in the sector
- Over the last 3 years (2014-16), while the slump was visible at the ground level, fund flow remained at a robust INR 362-379 bn

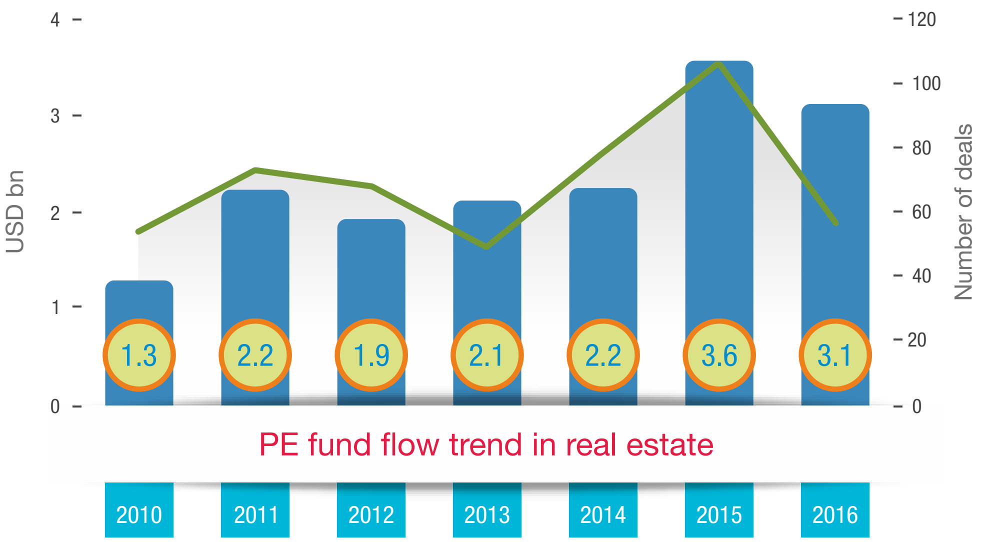
IN VALUE TERMS, MORE THAN HALF OF THE REAL ESTATE SECTOR'S INSTITUTIONAL FUNDING REQUIREMENT IS MET THROUGH THE PE ROUTE



- In the current scenario, close to 60% of the real estate sector's institutional funding requirement is met through the PE route, which is in sharp contrast to 2010 when less than one-fourth funding came through this channel
- Bank credit, which used to account for anywhere between 50% - 57% of the sector's institutional funding requirement till 2014, has witnessed a sharp reduction in the last two years to 24%-26% range. Rising non-performing assets (NPAs), higher risk provisioning and mounting losses in the real estate industry have led to significant reduction in credit offered by banks
- Similarly, the IPO route, which was one of the preferred channels of fund raising in 2010, has vanished in recent years due to poor credibility in the financial market of the companies operating in this sector. No major real estate developer has raised funds through this route since 2013
- NBFCs have gained a significant market share over the previous two years and currently contribute about 18% of the total institutional funding requirement of this sector
- PE players have replaced banks and are currently the biggest source of institutional finance for the real estate industry. Currently, PE funding is not just restricted to equity but has largely moved towards a quasi-equity type of structure

2016 HAS OBSERVED A 13% DROP IN TERMS OF PE FUND FLOW IN REAL ESTATE

- The year 2015 witnessed the highest amount of PE fund flow in real estate since 2010 with more than USD 3.6 bn investments across 100+ deals
- However, 2016 has observed a 13% drop in terms of PE fund flow with less than 60 deals taking place through this route. However, in terms of the average deal size, 2016 has recorded the highest amount at USD 56 mn, significantly higher than USD 34 mn in 2015. Brookfield's purchase of Hiranandani Developers' Powai commercial office portfolio for more than USD 885 mn has helped to push the average deal size during 2016 to such a level
- A sharp drop in new launches and the mounting unsold inventory in the residential segment have reduced PE activity in the current year. Additionally, the limited number of new office projects in the pipeline and absence of any major land deals have reduced the need from developers to seek fresh funding during the year
- Lodha Developer's USD 345 mn structured debt from Piramal Fund Management and Blackstone's USD 209 mn acquisition of L&T Realty's Seawoods Mall were some of the major deals during the year

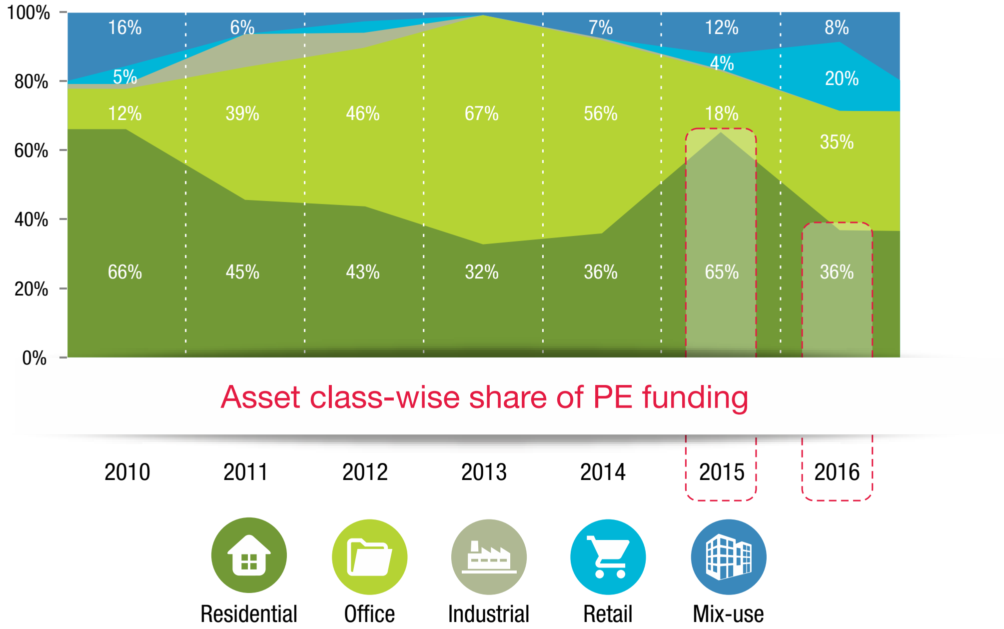


PE fund flow trend in real estate

Note:
PE includes entity-level equity, project-level equity and various types of structured debt from institutional players. It excludes non-institutional private funding, such as high net-worth individuals (HNIs), private financiers and advance from individual customers/ investors

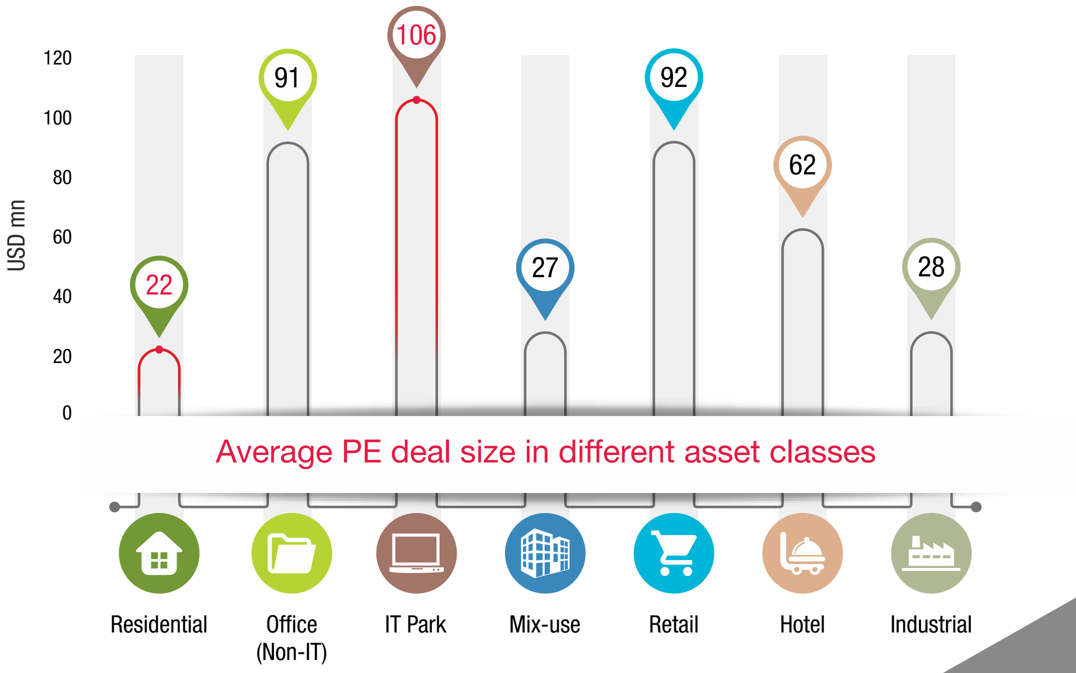
ASSET CLASS-WISE FUNDING TREND

RESIDENTIAL SEGMENT HAS BEEN REPLACED BY OFFICE SEGMENT IN TERMS OF PE FUNDING IN 2016



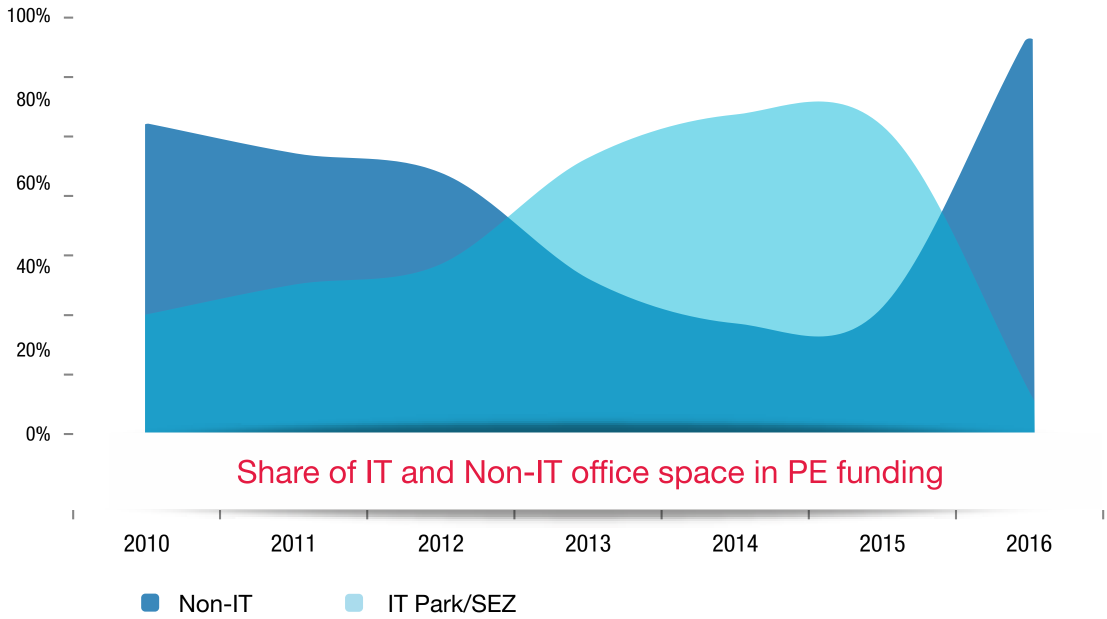
- A slowing sales volume and huge amount of unsold inventory in the residential segment seems to have shifted the focus of PE players in 2016 from the residential segment to office segment as compared to 2015
- Strong demands for office space, rising rental values and low vacancy levels have brought back the attention of PE players towards the office segment in 2016 with its share rising to 35% from 18% in 2015
- Shortages in quality retail space and increasing rental values have attracted PE players towards the retail segment in the last two years. Blackstone's purchase of L&T Realty's Seawood Mall and GIC's investment in Sheth Developer's Viviana Mall, are some of the large deals during the year

IT PARKS ATTRACT THE LARGEST DEALS WITHIN THE REAL ESTATE SECTOR IN INDIA



- Some of the major deals during the year in the IT park space include the USD 221 mn fund raising by Manyata Promoters (part of the Embassy Group) from Edelweiss and IIFL Holdings, and M3M's 3.5 mn sq ft Gurgaon IT park's stake sale to TRIL and Standard Chartered Private Equity
- Retail and Non-IT office sectors follow IT parks in terms of average deal size, primarily due to the higher area of development in these asset classes

INVESTMENT IN NON-IT SPACE IS BACK IN FAVOUR AS THE SLOWDOWN IN KEY WESTERN IT MARKETS HAS TURNED PE PLAYERS CAUTIOUS TOWARDS INVESTING IN IT PARK/SEZ PROJECTS



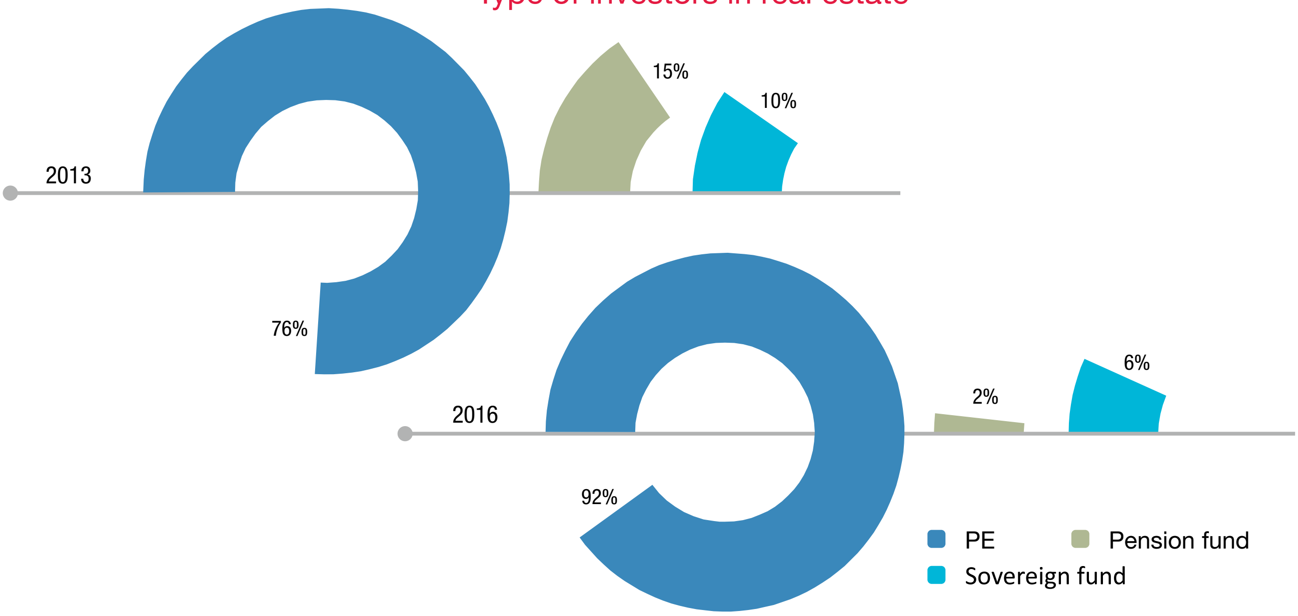
Share of IT and Non-IT office space in PE funding

- Share of IT park/SEZ in PE funding, which was on an upswing since 2010, has dipped drastically in 2016 Slowdown in the key western markets of USA and Europe, along with the uncertainty created due to a change in guard in the USA Government and Brexit, has turned PE players cautious towards funding such projects
- Share of non-IT, which includes commercial and corporate office space, was on a steady downfall since 2010. However, interest of PE funds seems to have revived in this space in 2016
- Lack of quality space in prime areas, rising rentals and a robust demand scenario for non-IT office space in the last two years seem to have finally got the attention of PE players

TYPE OF PE INVESTORS AND INSTRUMENTS PREFERRED

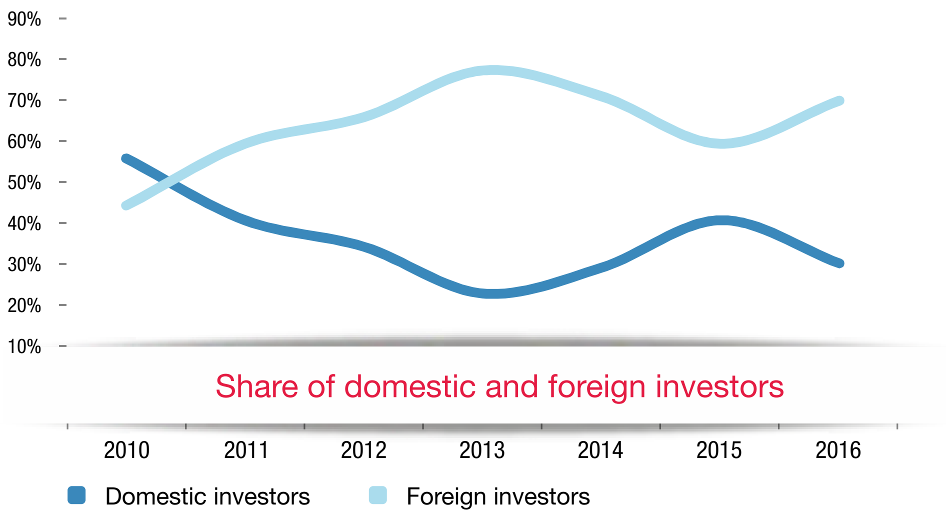
DIRECT EXPOSURE BY SOVEREIGN AND PENSION FUNDS INTO THE INDIAN REAL ESTATE SECTOR HAS COME DOWN DRASTICALLY IN THE LAST THREE YEARS

Type of investors in real estate



- The share of sovereign and pension funds, which accounted for close to one-fourth of the total PE funding in 2013, has come down drastically to under 8% in 2016
- Sovereign funds such as GIC, Temasek, and Qatar Investment Authority, which were actively participating in the Indian real estate market till 2015, have taken a back seat and are replaced by PE players such as Piramal Fund, APG Asset Management, Brookfield and Blackstone, among others
- ADIA's investment in partnership with Hines of around USD 60 mn in a Gurgaon residential project of IREO Management is the largest deal by a sovereign fund during the year

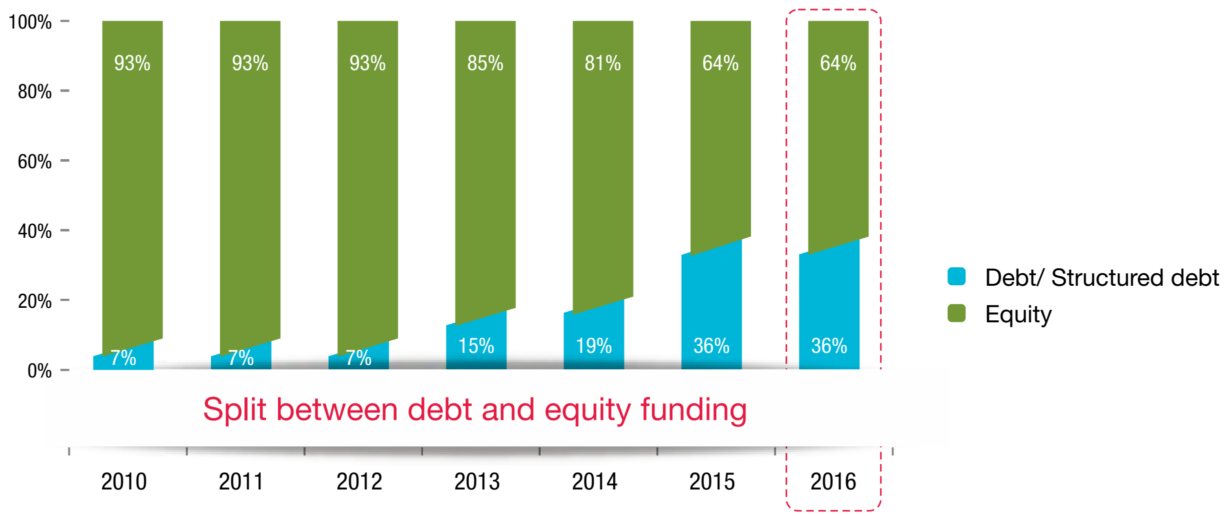
FOREIGN INVESTORS ACCOUNTED FOR MORE THAN 70% OF THE TOTAL PE INVESTMENTS IN THE INDIAN REAL ESTATE MARKET DURING 2016



Share of domestic and foreign investors

- During 2016, foreign investors accounted for more than 70% of the total PE investments in the Indian real estate market
- Share of domestic investors, which was more than the share of foreign investors in 2010, has been gradually decreasing over the years as foreign investors such as Blackstone, Brookfield, GIC and Warburg Pincus have been aggressively purchasing real estate assets in the country
- Among the domestic investors, funds such as Piramal Fund Management, Kotak Investment Advisors, ICICI Prudential and ASK Fund have been the major players who have been actively investing in the realty sector since 2014

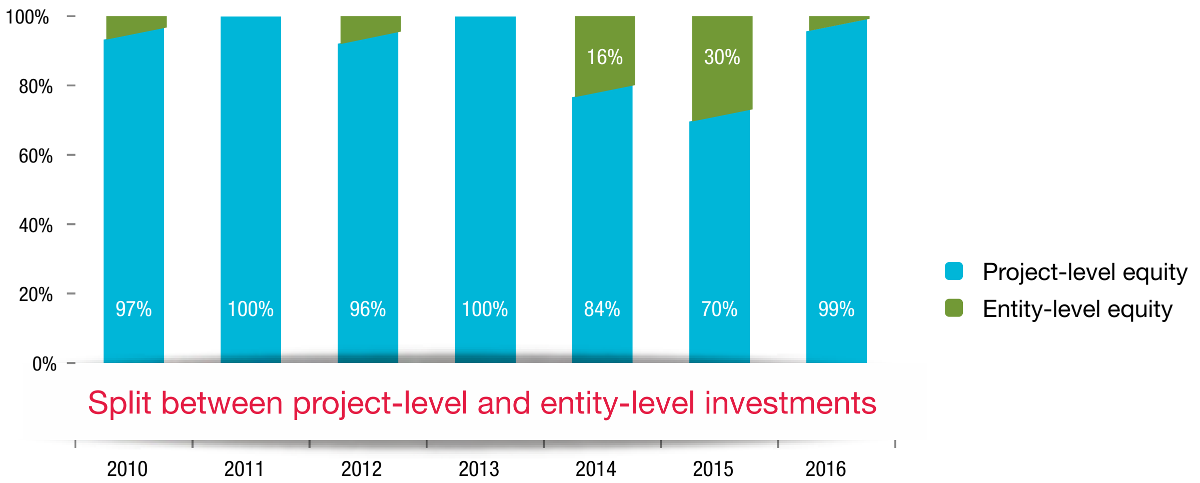
THERE IS A CLEAR SHIFT IN THE PREFERENCE OF INVESTORS TOWARDS DEBT/STRUCTURED DEBT TYPE OF FUNDING



Note:
Equity includes entity-level and project-level investments

- Preference of investors towards debt/structured debt type of funding has been increasing since 2012 and currently accounts for more than one-third of the total funding
- Higher execution risk, compression in profit margins, stricter regulatory oversight and slowdown in sales volume are some of the reasons for PE investors to shift from equity to debt

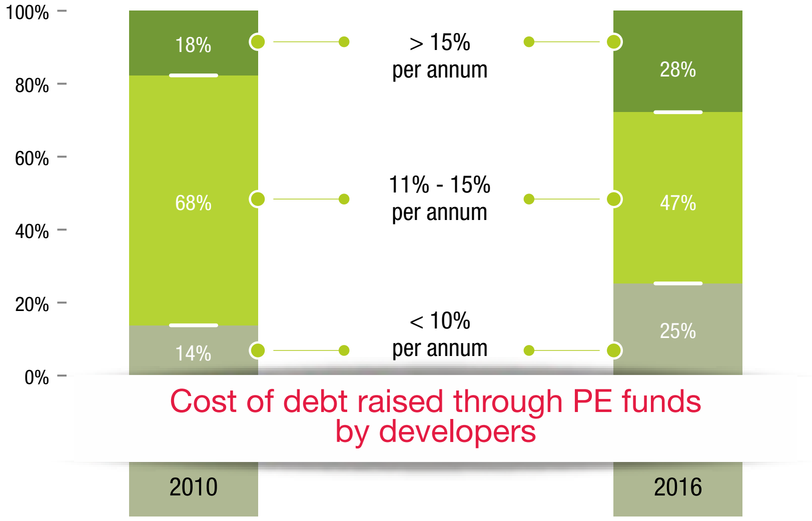
WITHIN EQUITY FUNDING, PROJECT-LEVEL INVESTMENT CONTINUES TO BE THE PREFERRED MODEL, WITH LESS THAN 1% OF TOTAL PE INVESTMENTS WITNESSED AT THE ENTITY LEVEL DURING 2016



Split between project-level and entity-level investments

- Within equity funding, project-level investment continues to be the preferred model, with only 1% of total PE investments witnessed at the entity level during 2016
- This is significantly lower than 16% and 30% share of entity-level investment in 2014 and 2015, respectively
- CDC Group's USD 25 mn investment in Tata Value Homes was the only major entity-level investment during the year, compared to over 14 deals in excess of USD 640 mn in the previous year

WHILE DEVELOPERS WITH A GOOD TRACK RECORD ARE ABLE TO RAISE FUNDS AT LOWER COST, THE COST OF FUNDING FOR A LARGE SECTION OF DEVELOPERS WITH POOR SALES VOLUME HAS INCREASED SUBSTANTIALLY



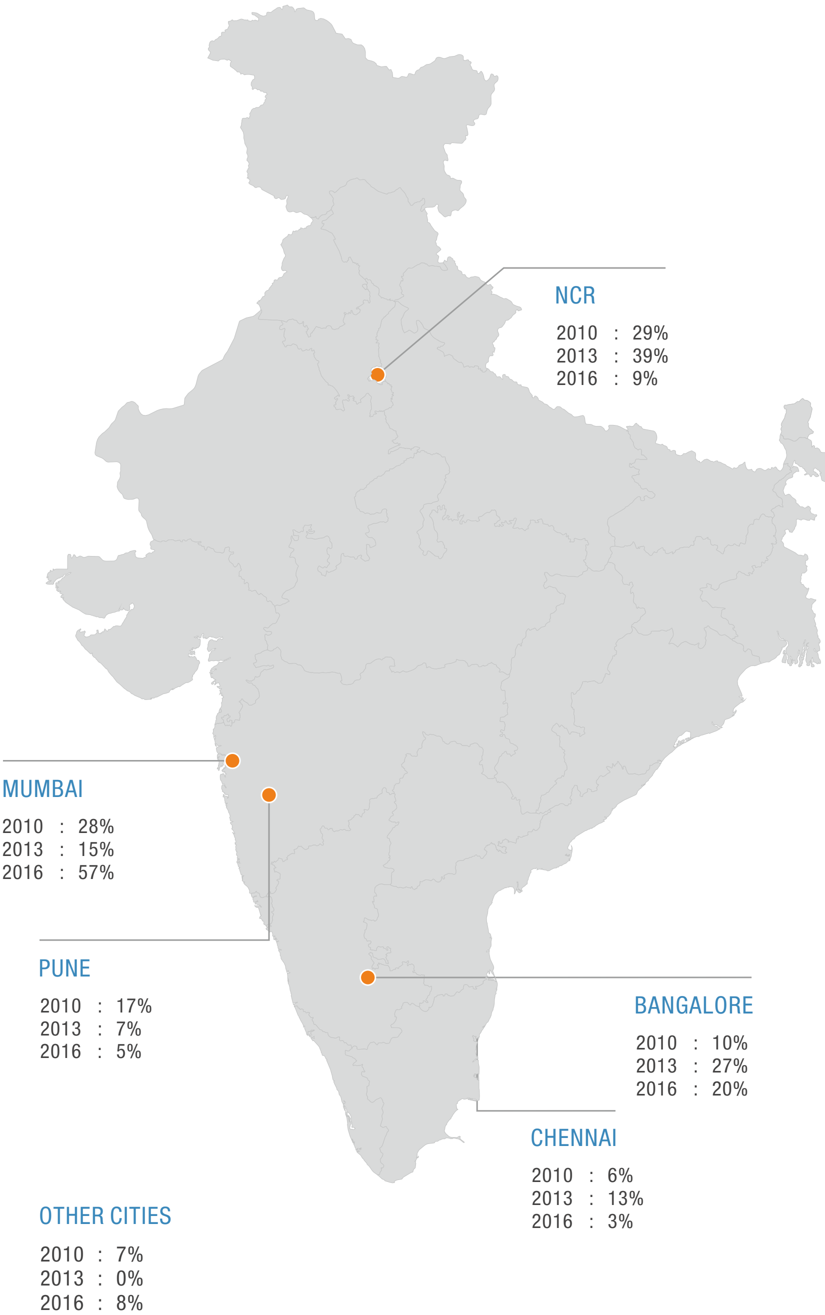
Cost of debt raised through PE funds by developers

- The quantum of PE funds raised through debt/structured debt by developers above 15% pa interest rate has jumped considerably since 2010. However, the share of funds raised below 10% pa interest rate has also jumped in the same period
- This indicates that while developers with a good track record are able to raise funds at a lower cost, the cost of funding for a large section of developers, who have not been able to sustain sales volume, has increased substantially
- Some developers have raised funds for as high as 20%-21% pa during 2016

CITY-WISE TREND OF PE FUND FLOW

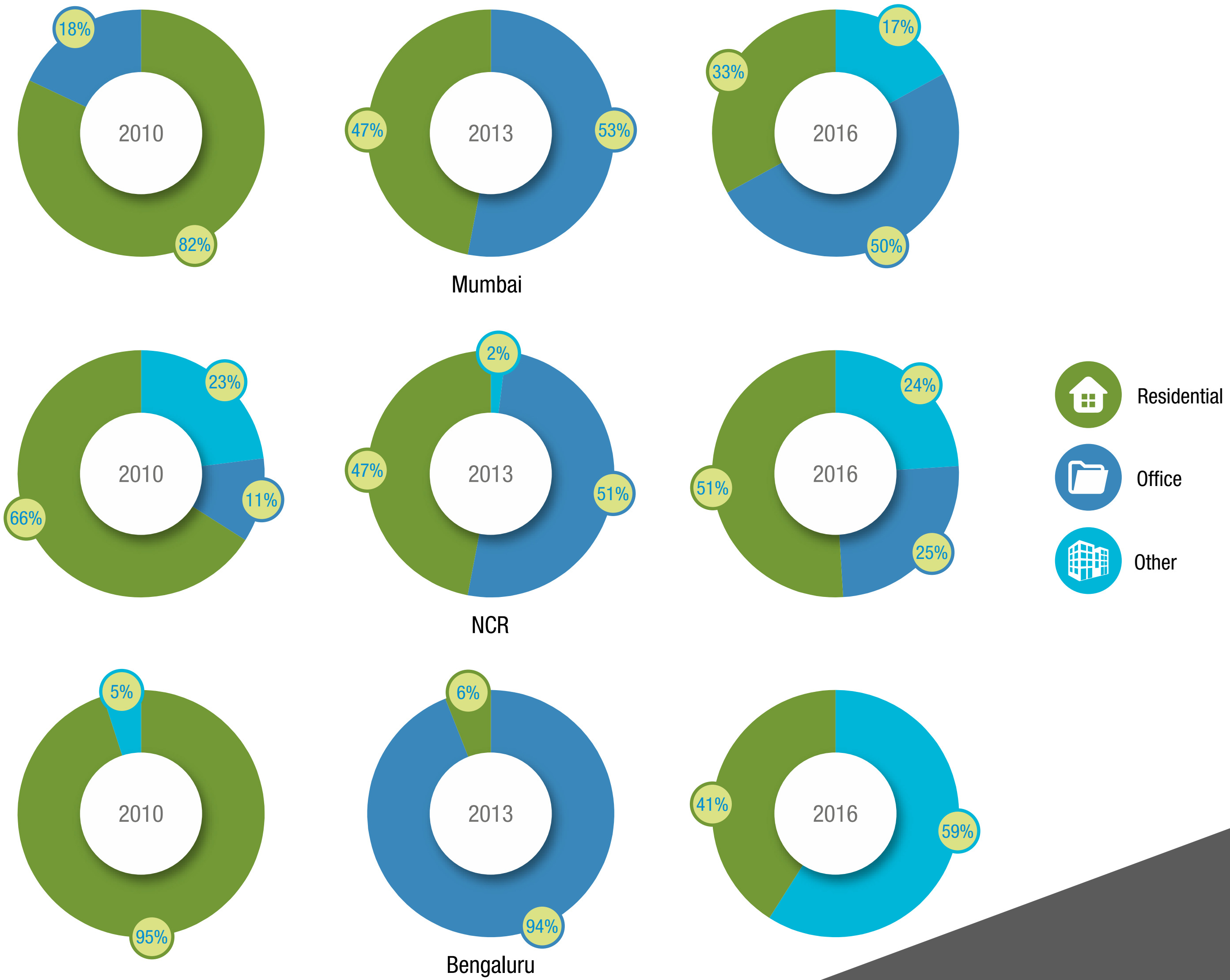
NCR, WHICH USED TO LEAD IN TERMS OF VALUE SHARE OF PE DEALS IN 2013, HAS DROPPED SHARPLY FROM 39% TO JUST 9% IN A SPAN OF THREE YEARS

Share of various cities in PE funds



- Mumbai has attracted the maximum amount of PE investments in 2016 with three marquee deals accounting for a lion's share during the year. Brookfield's purchase of Hiranandani Developer's Powai commercial office portfolio for more than USD 885 mn, Blackstone's USD 209 mn purchase of L&T Realty's Seawoods Mall in Navi Mumbai and GIC's acquisition of 49% stake in Sheth Developer's Viviana Mall for USD 49 mn were the three major PE investments in the city
- NCR, which used to lead in 2013, has dropped sharply from 39% to just 9% in a span of three years. Poor sales volume, huge amount of unsold inventory and stagnant prices in the residential segment of NCR have shifted PE investors' interest away from this market
- Bengaluru continues to hold steady in terms of attracting PE investments, although its share has dipped since 2013 due to the absence of any major deal during 2016

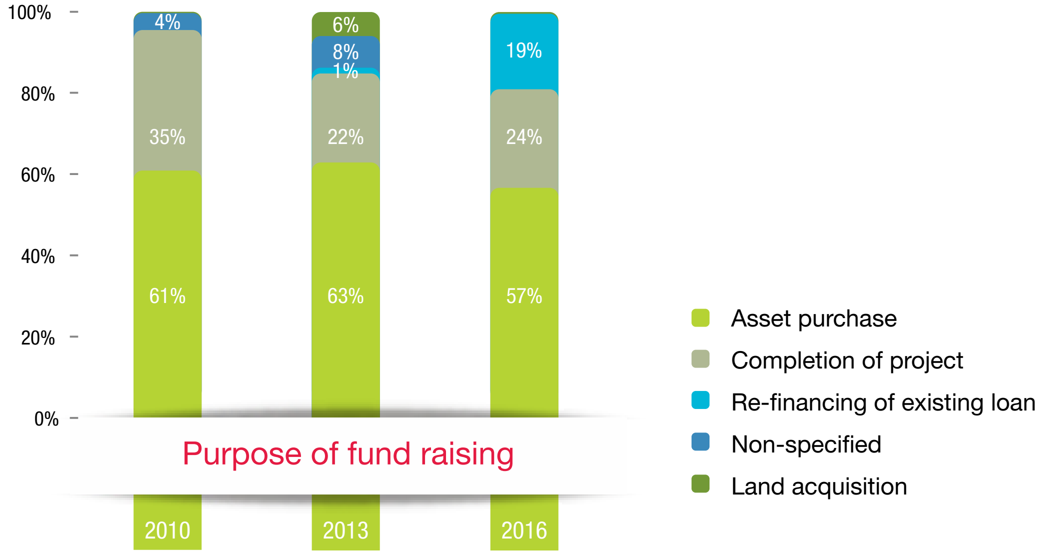
ASSET CLASS-WISE SPLIT OF PE FUNDING IN THE TOP THREE MARKETS



- Within the top three markets, PE investments in the office segment have witnessed a drastic fall since 2013. The absence of any major new launches since 2013 in the office segment has reduced the opportunity available in this segment for PE players
- While Bengaluru and NCR witnessed lower PE activity in the office segment, Mumbai observed a slew of marquee deals in this segment
- In Bengaluru, the residential sector has once again emerged as the clear preference of PE investors in 2016 with most of the developers in desperate need for funding their projects

PURPOSE OF FUND RAISING

RE-FINANCING OF AN EXISTING LOAN HAS EMERGED AS ONE OF THE BIGGEST REASONS FOR DEVELOPERS TO RAISE FUNDS THROUGH PE PLAYERS IN 2016



- While asset purchase and completion of project continue to be the primary reasons for raising funds, re-financing of an existing loan has emerged as another major reason for fundraising. The falling interest rate in the economy since the beginning of 2016 provided developers with an opportunity to convert their earlier high cost debt into low cost debt
- The share of non-specified reasons has gradually reduced over the years, as PE investors have turned vigilant towards the end-use of the funds disbursed by them to developers.
- Funding for land acquisition, which accounted for 6% share in 2013, has dropped to less than 1% in 2016 as no major land deals occurred during the year

OUTLOOK

LAND TRANSACTIONS

- The decision by the Government of India to demonetise ₹500 and ₹1000 currency notes will have a far-reaching impact on the real estate industry in the coming months
- The biggest impact will be witnessed in the land transaction segment, where the component of cash is very high in most of the deals. This segment will observe a severe slowdown and there is likely to be emerging trends of price rationalisation
- The funding channels of developers, who used to rely on HNIs or other informal means of finance, will dry up entirely in the short term due to the demonetisation move. Since it will be difficult for such developers to raise funds through PE players for land acquisition, we expect a significant dip in land deals for the next few quarters
- This could provide an opportunity to some of the large-sized reputed developers, who could partner with PE players and acquire land at a relatively cheaper valuation for future projects
- PE funding for land transactions, which accounted for less than 1% of the total PE funding in 2016, could witness a considerable jump in the next one year period

RESIDENTIAL SEGMENT

- Investor-driven markets such as NCR, Mumbai and Ahmedabad will be the worst hit due to the demonetisation move, as parking of cash into real estate will become difficult. The sales volume in these markets will be severely hit in the coming quarters, forcing developers to offer discounts and freebies to homebuyers. We expect residential prices in these cities to witness downward pressure in the coming months
- The impact of demonetisation on end-user-driven markets such as Bengaluru, Hyderabad, Pune and Kolkata will be relatively less severe as most of homebuyers in these cities either avail a home loan or pay through banking channels for purchases
- We believe a large number of developers will be looking for refinancing their existing debt as a further slowdown in sales volume will disturb the cash flow situation of these developers in the coming months. This provides a renewed opportunity to PE funds looking to partner with developers in terms of structured debt and we expect a significant jump in such deals over the next one year period
- With the excess liquidity that will be created in the market due to the demonetisation move, the cost of debt for developers with strong credentials track will go down. However, the cost of debt for developers with a dubious track record will increase substantially as their reliance on cash funding through HNIs and other informal channels will entirely dry up in the short term
- Affordable housing is the biggest gainer in the Union Budget 2017–18. The infrastructure status given to this segment is a game-changing move and will open up more institutional sources for developers to raise funds at a competitive price. The budget has also given leeway to developers to build bigger houses and extended the time of completion of affordable housing projects from three years to five years. We strongly believe that going forward these moves will encourage leading real estate players to enter this segment, thus creating a lot of potential for institutional funds to participate

OFFICE AND RETAIL SEGMENTS

- The office and retail segments will be the least impacted due to the demonetisation move as majority of the transactions in these segments are already taking place through the formal banking channel
- However, since the demonetisation move could flush the banking system with excess liquidity in the short term, we expect a significant compression in the capitalisation rates in the coming months. This will push the capital values higher by as much as 10%-12% in the coming quarters
- Developers and PE funds holding such office assets will observe a windfall gain in the next one year period. Additionally, the case for REIT listing will become much stronger as a result of this yield compression
- In terms of PE deals, we expect these segments to become the preferred choice of PE players looking for project-level equity participation. With vacancy levels at one of their lowest levels in the recent history, a limited supply pipeline and rising rental values, investment in office space offers a significant advantage over the residential segment
- PE funding through structured debt will be minimal in these segments as bankers are still comfortable with offering construction finance to developers for such projects, unlike the residential segment

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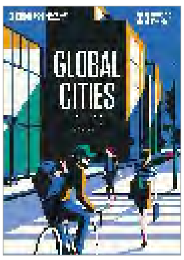

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