Real estate is a cash-hungry business, and in India, where the industry is in the developing stage, the importance of funds further increases. Apart from traditional institutions such as banks and nonbanking financial companies (NBFCs), private investors have also been highly active over the years. While a few have earned good returns from real estate investments, others have suffered losses. Our thorough analysis of investments over the years suggests that the key difference between profits and losses is a combination of the type and timing of the investment. Typically, there are three modes of investment: 1) equity, 2) debt and 3) mezzanine.

<table>
<thead>
<tr>
<th>Type of Investment</th>
<th>Lender / Investor</th>
<th>Cost of Investment</th>
<th>Usage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt</td>
<td>Banks</td>
<td>14-15%</td>
<td>Construction finance only</td>
</tr>
<tr>
<td></td>
<td>Housing Finance Companies</td>
<td>14.5-15.5%</td>
<td>Construction finance only</td>
</tr>
<tr>
<td></td>
<td>NBFCs</td>
<td>17-20%</td>
<td>Multipurpose</td>
</tr>
<tr>
<td></td>
<td>Private Equity</td>
<td>23-26%</td>
<td>Multipurpose</td>
</tr>
<tr>
<td></td>
<td>Private Lenders</td>
<td>24-48%</td>
<td>Multipurpose but ultra short term</td>
</tr>
<tr>
<td>Equity</td>
<td>Private Equity</td>
<td>20-27%</td>
<td>Multipurpose</td>
</tr>
<tr>
<td></td>
<td>Public Equity</td>
<td>16-18%</td>
<td>Multipurpose</td>
</tr>
<tr>
<td>Mezzanine</td>
<td>Private Equity</td>
<td>18-28%</td>
<td>Multipurpose</td>
</tr>
</tbody>
</table>

An important aspect of funding is the attached cost. Highly dependent on the source of funds and its usage restrictions, the attached cost varies from less than 14% to as high as 45-48%. While a bank debt is the cheapest mode of funding, the fund use is restricted to construction only. A more lenient funding option is private equity—which can be used for any purpose—but it comes at a much higher cost. Public equity, on the other hand, is comparatively cheaper than private equity; however, it requires a lot of processing and cannot take place at the special purpose vehicle level. Another option is private lender funding, which is very costly and works best as bridge capital for a very short term.
Debt versus Equity

With the funding options varying in cost and usage restriction, which route is most preferred? To understand this in detail, we conducted a thorough analysis of the four major routes of funding in real estate—bank debt, primary listing, private equity investment in equity, and private equity investment in debt. The period under consideration is 2005–2013, which witnessed an investment of INR 2,47,100 crore (USD 41.18 billion). Within the period, there is little difference between debt and equity, as the later contributed 42% and the former contributed the rest.

The state of the economic scenario plays a key role in the selection of funding mode. From 2006 until 2008, while the economy was booming, equity investment was highly preferred over debt; however, the demand reduced drastically following the global financial crisis (GFC) period, when exiting became difficult. This reflects the psychology of developers and investors that when the going is good, both sides don’t mind high-cost funding, but when the condition turns the other way, they prefer the one with cheaper cost and higher restrictions.

In this report, we will go through the four phases (periods) of the previous decade and analyse the options preferred by investors and developers—with regard to asset class, geography and mode of investment—which resulted in either gain or loss.

**Note:** Investment/ Funding refers to different sources of funds including Bank Debt, Primary Listing, Private Equity Investment In Equity and Private Equity Investment In Debt

Source: JLL, REIS & Capital Market Research
Residential Capital Value Index and Office Rental Value Index (2005-2013)

Net Absorption Pattern

Asset Class wise PE Investment Breakup (2005-2013)

Geography wise PE Investment Breakup (2005-2013)

Source: JLL, REIS & Capital Market Research
Economic and Political Situation

After recovering from the Asian financial crisis, India started to regain its momentum from 2003 onward. The United Progressive Alliance (UPA) government had returned to the centre a year before and was taking decisions that were mainly investor-friendly. With the government opening up foreign direct investment (FDI) in real estate in 2005, the first batch of India-positive foreign investors entered the country in 2005 and 2006. This helped many businesses along with real estate, where capital values started to rise faster than usual.

Investment Preference of PE Investors

Compared with traditional means of financing, private equity investment is faster and greater in value. Developers, focusing on fast track growth, preferred this funding source because of the flexibility on the end use of the funds. Investors were seeking returns in the range of 23–26%, which was reasonable, and developers—earning healthy margins—were happy to share that. Office and residential were the most-favoured asset classes, with the majority concentrated in the top seven cities in the country.

Office and residential were the key asset classes in this phase; together, they accounted for 62% of the total investments, followed by mixed-use development projects. Interest in retail assets was negligible.

95% of the investments in this phase was focused on the top seven cities, with Mumbai leading, closely followed by Pune, Hyderabad and the National Capital Region (NCR).
Debt versus Equity

During this phase, Indian real estate—through the primary and secondary routes—attracted investments worth INR 38,800 crore (USD 6.47 billion). The primary market, which had just started to pick up, witnessed limited new listings or follow-on offers, hence contributed just 11% of total investments. Private equity investment in the country also started to pick up and contributed 19% of total investments, 96% of which was through the equity route. This showed the keenness of investors to take part in the bull run. Meanwhile, bank debt was the largest contributor with 69% of loans to developers; however, the scenario changed in the phases that followed.

The economy picking up and a new mode of funding opening up helped developers to have healthy growth during this phase. Private equity investors were highly focused on equity investments returning to the 25–27% range. Residential and commercial properties in the top seven cities attracted the majority of investments.

![Investment/Funding into Real Estate (2005-2013)](chart)

In a nutshell

The economy picking up and a new mode of funding opening up helped developers to have healthy growth during this phase.

Private equity investors were highly focused on equity investments returning to the 25–27% range. Residential and commercial properties in the top seven cities attracted the majority of investments.
**Economic and Political Situation**

This two-year phase witnessed one of the most optimistic scenarios in the Indian economy. Foreign money was rapidly entering the country and Indian developers were expanding their land banks at an equally fast pace. In lieu of fast-paced growth, developers leveraged their balance sheets considerably; however, a strong investment demand backbone and easy financing supported their ambitions. The pace of project commencement in Tier II and Tier III cities was the key highlight during this phase, and valuations were extremely high. However, the dream run stopped at end-2008, with Lehman Brothers filing for bankruptcy. End-2008 was the beginning of the GFC.

**Investment Preference of PE Investors**

Investors, trying to get a larger slice of the pie in the fast-growing Indian real estate market, left no stone unturned. While they continued to focus on residential and office asset classes, in this period, they started investing in Tier II and Tier III cities as well. Deal closures were happening at a rapid pace, and developers—in the race to increase their land banks—were happy to share the returns, which were as high as 25–30%.

A higher base and the beginning of the GFC stopped the developers’ ‘dream run’. After a good increase, office rents gave up the gains and ended marginally higher. In contrast, residential capital values witnessed a sharp jump and remained almost unaffected. Office absorption remained steady at higher levels.
**Debt versus Equity**

This, being the best phase in terms of capital value appreciation and absorption, garnered huge interest. Total investment in the sector grew by more than 2.5 times and reached INR 99,700 crore (USD 16.61 bn). The contribution of bank debt reduced sharply, from 69% in the previous phase to just 31% in this phase. This was an outcome of RBI restrictions on banks to fund land as a part of project cost in real estate projects, which came into effect post 2006. PE funds therefore, came in to fill the gap created by lack of land funding by banks. On the back of a series of new listings, the primary market enjoyed a marked improvement with investment worth INR 16,700 crore (USD 2.78 billion) in this phase, compared with less than INR 42,500 crore (USD 7.08 billion) in the previous phase. With a view to riding the multiyear bull run, private equity investment in the sector grew sharply to 52%, still largely contributed by the equity route (88%). While the contribution of debt investment by private equity investors was marginal in the previous phase, it grew during this phase, from mere INR 32 crore (USD 5.4 mn) to INR 6,500 crore (USD 1.08 billion).

### In a nutshell

Investors, desperate to take part in the booming Indian real estate market, started investing in Tier II and Tier III cities along with metros. Residential and commercial still remained the key asset classes, and equity remained the most-preferred mode of investment. Developers, keen to grow their land banks and hence earn better valuations in initial public offerings (IPOs), did not mind paying returns as high as 25–30%, which were difficult to sustain. Developers promised deliveries that were considerably higher than their historical deliveries. Meanwhile, although contractors were facing resource crunch, their order books were full. Before the construction works started taking a good shape, the GFC happened and the demand evaporated, hence the promised deliveries never happened.
**Economic and Political Situation**

The GFC affected every segment of the world economy, and India was not an exception. Fast-reducing revenue and profitability margins affected the expansion plans of various industries, resulting in considerable job losses and a steep reduction in the expenditure and savings rate. Investment in real estate was a situation of the past, and end users were not in a position to take a buying call because of the uncertain economic situation. Developers—under the burden of high leverage and huge interest cost—opted to sell land that they were not planning to utilise in the near term, but there was little interest among buyers. Interest payments were not easy, and debt repayments were out of the question. Keeping the seriousness of the situation in mind, the government allowed banks to restructure debt. This gave some relief to developers, although business revamp remained their biggest challenge.

Strong underlying demand helped residential capital values to jump back sharply after a steep correction in a short time. However, because of the weakening economic and business scenarios, office rents never took off after the initial correction.

**Investment Preference of PE Investors**

The challenging economic scenario and weak job market severely affected the investment sentiment. The pace of investment dropped considerably, and developers—with no encouraging demand for their noncore assets—were stuck in the debt trap. The slow pace of government approvals and high property prices, especially of residential, also affected investment decisions at all levels. Equity investments almost dried up, and debt providers were highly cautious.

On the back of the challenging economic scenario, office demand reduced drastically. The trio of residential, office and mixed-use developments still contributed more than 80%, with residential projects as the largest contributor.
Debt versus Equity

A lack of interest from buyers and investors in the physical market blocked the exit route for private equity investors; hence, new investments reduced by as much as 75%, while overall investments in the funding to the sector reduced by more than half. Private equity investments were majorly restricted to brownfield residential projects and rental yielding office assets. The appetite for new listing dried up, and many developers keen to hit the primary market withdrew their IPOs. Developers, burdened by huge debt and few sales, found a helping hand from banks, which continued to lend money to the sector.

As a result of the GFC, the investment focus returned to the top seven cities. Mumbai and the NCR remained the most-preferred zones, with Bangalore, Hyderabad and Pune sharing the majority of the rest.

The challenging economic scenario, dried-up absorption and limited exit options kept investors at bay. With sales revenue reducing drastically, developers found the going tough, with highly leveraged balance sheets. Investors moved away from Tier II and Tier III cities and preferred the ever-dependable residential asset class, which was reflected in the sharp rebound of residential capital values. Debt investments started picking up, accounting for as much as 21% of total private equity investments in the sector.
Economic and Political Situation
After two dull years, the economy started recovering during this period. Businesses started to regain momentum, and confidence in the job market was higher than in the previous period. However, the scenario was far from the ideal, and real estate was one of the highly affected sectors. Capital values, especially residential, passed their previous peaks—which took buyers away—and investment demand remained low. The debt level reduced marginally on the back of noncore asset sales and a focus on fast-selling properties, although the level was high enough to give discomfort. A lack of transparency in the sector and the political scenario remaining highly uncertain were some of the key concerns cited by foreign investors. Delay in project approvals added fuel to the fire, as this affected developers’ cash flows and the feasibility of the projects.

Investment Preference of PE Investors
By end-2010, investment activity in the sector started picking up again, although not at the peak levels achieved in the 2007–2008 phase. In commercial space, completed and leased earning properties were given higher preference; in the residential segment, the focus was on approvals. Greenfield projects were not preferred, nor were retail and hospitality projects. Tier I cities offered good investment opportunities; hence, Tier II and Tier III cities remained low in priority. Steady absorption and launches with affordable capital values brought Bangalore in the investor radar, while approval delays and high capital values pushed Mumbai to the third position. With higher focus on safety, return expectations took a back seat. The majority of deals that took place in this phase saw return expectations of 21–24%.

Caution was in the air during this phase. End-user demand helped residential capital values to rise, although closer to the inflation rate. Office rents hardly witnessed any growth over three years.

Residential demand remained stable during this phase, with a visible shift from investor-led demand to end-user-led demand. The period started with strong office demand; however, the pace could not be sustained.

Steady improvement in the economic scenario from the lows of the post-GFC phase helped improve office demand, primarily for lease-earning assets. Residential still attracted almost half of total investments; however, focus on approvals increased considerably during this period.
Investment/Funding into Real Estate

Breakup of Total Investments

Equity Investment in Real Estate

Private Equity Investment in Real Estate

On the back of steady launches, absorption and healthy capital value appreciation, Bangalore became the second most-preferred city in this phase. While the NCR came on top, construction delays and below-par absorption pushed Mumbai to the third position.

Debt versus Equity

With the economy gradually growing and the real estate leaving behind its worst performance, investment in the sector grew by 37% in this phase. A focus on safety and a regular fixed return took over the centre stage from the high return expectations witnessed during the 2007–2008 phase. While the primary market absolutely dried up, investors remained cautious despite low capital values and attractive investment options. As a result, equity contributed just 60% of total investment in this phase, majorly focussed on leased office assets. Private equity investment in debt witnessed marked growth in contribution—from a mere 1% of private equity investment in 2005–2006, it grew to as high as 40% during this phase.

In a nutshell

The improving economic scenario, coupled with highly attractive investment options, helped regain a portion of the investments. Investors, with a clear focus on approved residential projects and lease-earning commercial assets, started focusing on investments. Private equity investors continued to keep a considerable focus on debt deals. Developers remained silent, with limited new launches. Bangalore emerged as one of the strongest real estate markets with steady appreciation and absorption levels.
At the beginning of this phase, the Indian population gave its verdict by electing Bharatiya Janata Party (BJP) government, led by Mr. Narendra Modi. The new government, in its first budget, showcased its largely investor friendly policy by further facilitating key sectors to foreign investment. The improved focus on real estate sector is clearly visible from the pace at which government paved way for much needed REITs, modified the FDI policy to attract more investment and provided infrastructure status to affordable housing.

Initial response to these steps showcase that the investor sentiments are reviving. Leasing activities in office markets have increased along with marginal increase in rental values. Fund raising activities are also picking up pace and entry of sovereign funds is expected to provide long term funding to the sector. Stock market, which is usually the reflection of economy, has also displayed strong performance.

This study showcases that investment strategies have changed over the years depending upon the state of the economy. The “Modi Era” has brought new enthusiasm in the economy and the investors are set to work out new combinations to ride this wave. In order to get a sense we conducted a survey and asked the private equity funds about their likes and dislikes about the Indian real estate market, investment strategies and confidence in success of REITs.

The newly elected government has generated a wave of optimism in the country and if it manages to deliver as promised, the country will enjoy an improved economic environment accompanied by healthy foreign investments. So, do we believe this government will be able to deliver in next five years? The answer is YES, we believe acche din aane wale hai! (prosperous future is ahead of us)

Are we at the start of a new bull cycle?
Fresh investment in Indian real estate will meet your return expectations.

Which asset classes do you prefer the most?

Source: JLL, REIS & Capital Market Research
Which cities do you prefer the most?

What is expected return (IRR) from your investment?

Source: JLL, REIS & Capital Market Research
What is your expected holding period?

REIT will be a success in short term (next 3 years)

REIT will be a success in long term (next 10 years)
Akshit Shah has joined Jones Lang LaSalle Research team in 2013. Based out of Mumbai; he is the data custodian for Capital Markets and contributes towards incorporating Capital Markets related research into REIS.

Akshit also contributes to whitepapers. Akshit is a Chartered Accountant and has 9 years of Equity Research experience; including 6 years of Real Estate sector research. He has tracked more than 90% market capital of Indian listed real estate space and has authored several reports on the companies he tracked.
Our most important deal is yours

Despite our impressive track record, we prefer to look, not to our past, but to your future. Our Capital Markets team focus all their energy and experience on ensuring that your deal is right up there with the best of them.
About JLL

JLL (NYSE: JLL) is a professional services and investment management firm offering specialized real estate services to clients seeking increased value by owning, occupying and investing in real estate. With annual fee revenue of $4.0 billion and gross revenue of $4.5 billion, JLL has more than 200 corporate offices and operates in 75 countries and has a global workforce of approximately 53,000. On behalf of its clients, the firm provides management and real estate outsourcing services for a property portfolio of 3.0 billion square feet, or 280.0 million square meters, and completed $99.0 billion in sales, acquisitions and finance transactions in 2013. Its investment management business, LaSalle Investment Management, has $50.0 billion of real estate assets under management. JLL is the brand name, and a registered trademark, of Jones Lang LaSalle Incorporated.

JLL has over 50 years of experience in Asia Pacific, with over 28,453 employees operating in 80 offices in 16 countries across the region. The firm was named ‘Best Property Consultancy’ in seven Asia Pacific countries at the International Property Awards Asia Pacific 2014, and won nine Asia Pacific awards in the Euromoney Real Estate Awards 2013. For further information, please visit our website, www.jll.com/asiapacific

About JLL India

JLL is India’s premier and largest professional services firm specializing in real estate. With an extensive geographic footprint across 11 cities (Ahmedabad, Delhi, Mumbai, Bangalore, Pune, Chennai, Hyderabad, Kolkata, Kochi, Chandigarh and Coimbatore) and a staff strength of over 7000, the firm provides investors, developers, local corporates and multinational companies with a comprehensive range of services including research, analytics, consultancy, transactions, project and development services, integrated facility management, property and asset management, sustainability, industrial, capital markets, residential, hotels, health care, senior living, education and retail advisory.

The firm was named the Best Property Consultancy in India at the International Property Awards Asia Pacific 2014-15. For further information, please visit www.joneslanglasalle.co.in

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