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A Study on Private Equity in Real Estate Sector in India

B. GirijaKalyani — Research Scholor, Department of Business management, Sri Padmavathi MahilaVisvavidyalayam, Tirupati.

Dr. B. Vijaya Lakshmi — Professor and HOD, Department of Business Management, Sri Padmavathi MahilaVisvavidyalayam, Tirupati.

ABSTRACT

India, as it stands today, is on the trajectory of becoming the world's 3rd largest economy by 2020. Real Estate continues to form a key ingredient for the success of India's raising economy. However, one would need an association of true intellect and expertise to unravel India's true potential.

As global institutions rediscovered their appetite for private equity real estate in India, it has fared better compared with other property markets. With renewed interest in India, along with a more pressing intent to exit among exiting stake holders, they will also lead to more volume of deals in the secondary market.

The paper deals with the above aspects and is divided into two parts. Part I is all about the Private Equity in India, its investments and exits on an overall. Part II deals with the Private Equity investments specific to the Real Estate sector in India, the investment strategies, attractive factors of investments in the sector, exits, drivers and modes of exit, challenges and trends.

KEYWORDS : Private Equity, Portfolio companies, Limited and General Partners, Investment Strategies.

Introduction

In finance, private equity is an asset class comprising of equity securities in operating companies that are not publicly traded on a stock exchange. A private equity investment will generally be made by a private equity firm, a venture capital firm or an angle investor. Each of these categories of investor has its own set of goals, preferences and investment strategies; however, all provide working capital to a target company to nurture expansion, new product development, or restructuring of the company's operations, management, or ownership.

A private equity firm is an investment manager that makes investments in the private equity of operating companies through a variety of loosely affiliated investment strategies including leveraged buyouts, venture capital and growth capital. Often described as a financial sponsor, each firm will raise funds that will be invested in accordance with one or more specific investment strategies. Typically, a private equity firm will raise pools of capital, or private equity funds that supply the equity contributions for these transactions. Private equity firms, with their investors, will acquire a controlling or substantial minority position in a company and then look to maximize the value of that investment. Private equity firms generally receive a return on their investments through one of the following avenues:

An Initial Public Offering (**IPO**) — shares of the company are offered to the public, typically providing a partial immediate realization to the financial sponsor as well as a public market into which it can later sell additional shares;

A Merger or a Acquisition — the company is sold for either cash or shares in another company;

A Recapitalization — cash is distributed to the shareholders (in this case the financial sponsor) and its private equity funds either from cash flow generated by the company or through raising debt or other securities to fund the distribution.

PRIVATE EQUITY IN INDIA

Overview of India's PE landscape

In the year 2015, the inflows in the first three quarters indicate that this will, by far, be a record year for private equity investments (table 1.1). And it will easily beat the $10 billion invested in 2014. Since 2000, private equity has invested nearby $100 billion in India. This is from the 1500 private equity and venture capital firms tracked by IVCA prime Database. This includes those who have invested or are planning to invest.

"Despite the domestic gloom around growth, India stands out as an oasis on the global investment horizon," _ Amit Chandra, Managing partner, Bain Capital India.

Bain Capital is amongst the largest investors in India having invested close to $1.4 billion over the last four years. The highest has been Singapore-based government-sponsored fund Tamasek Holdings. Post 2012-13, confidence is steadily being, rebuilt, and longterm-term investors are gaining confidence in the measures taken by the new government in kick starting the economy.

Table 1.1

Year	Deals (No.)	Equity invested ($ Million)
2005	149	1989
2006	334	4354
2007	481	8078
2008	508	6505
2009	315	3224
2010	411	5353
2011	644	6584
2012	643	6347
2013	597	4470
2014	564	10063
2015*	530	8501

***Year till Aug. Source: Thomson Reuters**

Portfolio management and exits

The year 2015 has seen record exits of over Rs 5000 Million, the highest in the last several years. The largest exits were through trade sales. Bain Capital sold off its investment in HeroMoto Corp for Rs 4000 crore. Baring Asia sold off its investments in Lafarge India back to the company for $300 million.

Secondary sales were also witnessed in 2015. New silk Route sold off its stake in Destimpny to Carlyle Capital netting around $200 million. The year also saw several IPOs hitting the capital market. VRL Logis-

tics, OrTel Communications, two New Silk Route backed companies, Power Mech Projects, a MotilalOswal backed company, Manpasand Beverages, with Saif Partners were amongst a dozen or so companies coming out with IPOs. This allows the private equity player to exit partially or fully.

Taking advantage of robust capital markets, funds like Chrys Capital, one of India's early private equity funds currently managing $3.2 billion through six funds, sold its 3 per cent stake in ING bank in open market transaction for Rs675 crore, prior to its merger with Kotak Bankearly in this year. It also sold HCL technologies earlier in 2014 and 2015. Percentage wise, its biggest gain was in Mankind Pharma, a Delhi-based company, where it saw returns of over 10X on an investment of an estimated $11 million. It sold its 11 percent stake to Capital International. Chrys Capital, which has seen several marquee exits in the last two years including the sale of IntaasPharma to Tamasek for $160 million, is launching another fund, expecting to raise $500 million.

Table 1.2

Exits through IPOs in 2015	
Issuers	**Private Equity**
UFO Movies	3i Group, Providence Equity Partners
SyngeneInt	ICICI Ventures, GE India Value Fund Advisors
PG Infratech	Jacob Ballas Capital
Manpasand Beverages	Saif Partners
Adlabs Entertainment	ICICI Ventures, Jacob Ballas
Power Mech Projects	MotilalOswal PE
Ortel Communications	NSR, CDC Advisors
VRL Logistics	NSR

Table 1.3

Other notable Exits in 2015		
Issuers	**Private Equity**	**$ million**
Indus Ind Bank	G Atlantic	109
Tirumala Milk	Carlyle Asia Growth	69
Medreich Holdings	Tamasek Holdings	95
Hero Motocorp	Bain Capital	250
Idea Cellular	Providence Capital	233
Lafarge Industries	Barings Asia	304
Shriram City Union	TPG Capital	386
ING Vysya Bank	Chrys Capital	108
Destimoney	NSR sold to Carlyle	200

PRIVATE EQUITY IN INDIAN REAL ESTATE SECTOR

Realty has seen some mega investments with private equity finding valuations pretty attractive. Piramal Realty saw investments of $150 million from Goldman Sachs in August. This is on top of $284 million received from Warburg Pincus in July. ADB invested $200 million in Drashti Developers, to Develop water and other infrastructure for ShapoorjiPalonji group's affordable housing project.

What does India offer to foreign corporates?

Over the years, we have watched various MNCs setting up their offices in India and, despite the challenges; these companies have managed to grow. Various companies in banking &financial services, IT & ITES, pharmaceuticals, retail, food & beverage,telecom sectors have entered India and spread their presence throughout the country, expanded their staffing levels and grown their revenue multiple times.

Top five attractions for foreign corporates

EmergingIndia

India is the world's second largest populated country, with a high percentage (65%) of which are income earning. When combined with the growing urbanisation rate, an increasing number of nuclear families and an increasing concentration on spending, the consumer market potential is clear. The diversity in spending patterns, lifestyle changes and eating habits (focussed on higher spending) in various parts of the country offer a sizable market for a range of industries wanting to set up their office in India.

Easy availabilityof talent

Identifying and retaining a workforce is not a big task for various industries in India. Personnel are available to carry out each and every job, from the execution of tough work in difficult circumstances to formulating country level business strategies sitting in a smart office. Across various industries, manufacturing in particular, labour cost continues to be the key area. India scores well on this, as it offers a wage cost that is lower than most comparable nations in the world. There is also a noticeable increase in labour mobility. A decade ago, the percentage of Indians ready to relocate from their city of origin was small. This has increased considerably, providing a lot of flexibility for employers.

Central time zone

The geographical location of India positions it in almost a central time zone, which enables it to offer services through the regions of the world. While an early start in India can match the timing of Singapore and Hong Kong, a late evening shift can service clients in the UK, and a night shift can work well for corporates in the US. This helps corporates across the world to set up offices in India and provide all-in-one working across offices in different countries.

Unorganised to organised

India was traditionally considered as an unorganised market. However, over the past decade, various industries transformed from unorganised to organised. The retail, real estate sectors and hospitality are a few eminent examples of sectors that have undergone this shift.

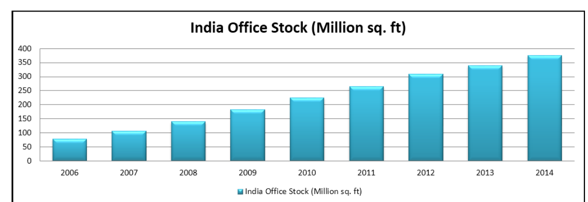
Low cost real estate

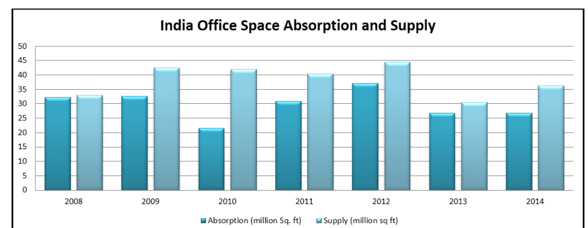
While the cost of real estate in India has grown-up over the past decade, it is still much lower than most other developed nations. A swift look at the cost of real estate in various cities around the world suggests that Delhi and Mumbai stand at number 10 and 11 in the list of the costliest office spaces in the APAC, and they are more than 55% cheaper than the table topper, Tokyo. Bangalore, one of the fastest growing office markets in the country, is at number 21 and is more than 85% cheaper than Tokyo.

Indian Office market assessment

Not only has the pace of construction picked up, but the quality of office space - optimal design, building specifications and overall work place environment - has undergone a makeover. Indian developers are now able to churn out office spaces that match the level of international occupier anticipations. Therefore, office take-up in terms of square foot leased per year has increased incrementally over the past decade.

The chart below gives annual absorption volumes for the top seven Indian cities from 2006 till end of 2014





The activity peaks of 2007 and 2008 reflect the pace of space take up by corporates indicative of the pre-crisis ecstasy around the world in terms of business growth and the potential of a country like India. Thereafter, when the Global Financial Crisis happened, the impact on the leasing volumes was intense. While the demand for office space had increased by the end of 2010, the trend amongst real estate occupiers has shifted to adopting a more conservative space acquisition strategy. As of end-2013, pan-India net absorption persisted stable at 2012 level of 26.8 million sq ft. New completions have raised from

30.4 million sqft in 2012 to 36.3 million sqft as at end 2013, causing the vacancy rate to raise marginally by 130 bps in a stable demand scenario. Mumbai and Bangalore continued to be the major contributors to India's total net absorption in 2013 while NCR-Delhi witnessed healthy pre-commitments in projects that were in the advanced stages of completion.

Drivers for Exit
Private Equity Investing is all about Getting Out – Anonymous

There Can be Various Drivers for Exits by a Private Equity Fund:
Completion of Project Lifecycle
Natural exits through the completion of the project lifecycle have been demonstrated in residential projects, which by their very nature are self-liquidating. Our analysis reveals that over 21% of the exits recorded so far classify under this category.

Market-driven Opportunistic Exits
Opportunistic exits are driven by buoyant market conditions or attractive unsolicited bids which compel the fund to exit well before the planned exit from the investment. A majority of the third party exits were driven by such positive market factors. Key transactions in this category include Trinity's sale of stake to SachsenFonds, sale of interest in a Delhi residential project by Redfort Capital to JP Morgan, etc. Market factors have also been reflected in "sell-downs" by mezzanine providers such as Deutsche Bank.

Distressed Sales
Post the financial crisis of 2008-09, several non-India dedicated funds with global pools of capital were under pressure from their Limited Partners to liquidate their investments and distribute returns. Largely US based private equity funds, investment banks and hedge funds led this phenomenon in India. With the markets being more stable and with more maturity now in the private equity exits segment, we expect this factor to be less prevalent going forward.

Fund Raising Activities
Priming for exits to demonstrate a track record prior to moving into the next round of fund raising is one of the key drivers for fund managers. LPs, both institutional and retail, look for a fund manager who has a demonstrated track record of success. Funds like Redfort Capital, HDFC, Kotaketc aggressively moved into Exit mode prior to hitting the market with their next round of fund raising. With over 15 funds currently either in fund raising mode or preparing for it, we expect exits to dominate the fund management business in 2012.

Completion of Fund Life
Most real estate private equity funds in India have been set up with a 5 to 7 year investment horizon. Funds would typically initiate their exit phase between 4 to 5 years from the date of investment, in order to be able to wind up the fund well within the fund life without any distress sale pressures. The Indian market has so far seen all of the above drivers in play, but the dominant driver for exits in the near term will be clearly the end of the fund life.

Mode of Exits
The exit strategies for private equity funds could take a range of forms. While in more developed markets, where "core" and "core plus" style investing is more predominant, exit routes are largely through third party exits of income generating assets or by sale to REITs. In India, as with the case of other emerging markets, given that the majority of the investments are in greenfield transactions, a broader array of exit options has emerged.

Project Cash flows: A project or investee company could produce sufficient cash flows, which are then used to return the capital and necessary returns to the private equity fund. Again, residential projects or commercial projects with strata-title sale lend themselves well to this exit strategy. With a 21% representation, only a small part of exits have taken place through this route.

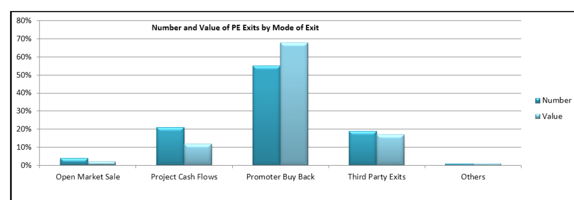
Promoter Buybacks: Promoter Buybacks have been the dominant trend in the exits viewed till now. Over 54% of all exits till date have been through this route. Indian promoters are typically keen to provide an exit to private equity funds for a variety of reasons:

a. Under contractual obligations of put/call options
b. Mismatch of investment horizons between the fund and the promoter
c. Difference in expectations of the valuation of the project, where the promoter expects a more optimistic market going forward
d. Deficiency of a large secondary market for trading investment position to other PE funds Promoter buybacks typically get structured either as company buybacks through the Investee Company or as purchase of shares through a group company of the Promoter / developer. In most cases, a combination of both these methods is used given the Indian Companies Act restrictions on company buybacks being restricted to only 25% of the net worth of the company.

Public Market Sale/ IPOs: Sale through IPOs or through trading of listed stock has not been a very significant trend in the Indian context and has been just 5% of the total exits. This is a function of the performance of the stock markets in the last 2 years, where real estate IPOs as well as stock has lost favour with the many development companies trading substantially below their listing price. While 2009-10 saw multiple DRHPs filed by large developers like Lodha Developers, Oberoi Realty etc, few companies managed to successfully list. Many investors like Deutsche Bank, HDFC Property Fund etc who were banking on public listings for their exits had to opt for promoter buybacks instead. Once the REIT regime in India is in place, this trend should become stronger.

Third Party Exits: Trade sales or third part exits are also a small component of the exits at 19% of the total exits. Third party exits have been visible largely in land or in office projects. This market has had little or no depth so far due to the lack of REITs, PN2 restrictions on purchasing completed assets as well as the lack of core funds in the market. The buyer profile for these opportunities have been either opportunistic funds like Tata Realty and Blackstone who indulged in "core-style" investing or funds who were more risk-averse and chose to enter into projects which were approved and under development and already diligence by another fund.

Sale of General Partners Interest: This refers to the sale of the Fund Management or Investment Advisory Company to another fund manager or strategic buyer. While technically sale of GP Interest does not provide exits to the LPs, it certainly has become popular with fund managers wishing to monetize their interests in the fund management business. Kicking off this trend in India was IL&FS Investment Managers Ltd (IIML) acquiring Saffron Asset Advisors Pvt Ltd in 2010. The transaction gave IIML, a listed entity, access to additional Assets under Management (AUMs) of Euro 220 mn (committed Euro 160 mn) of Yatra Capital and USD 103 mn (committed of USD 24.7 mn) of Saffron India Real Estate Fund - I. Following close on the heels was Blackstone buying out Merrill Lynch's Asia investment platform with assets of over USD 2 bn. The acquirer typically looks for increased AMC fees and a larger AUM as well as immediate access to the uncommitted funds of the target. With valuations of typically 3-5% of the AUM, only a small amount of capital is required for this play. We expect this trend to become much stronger as funds near the end of their fund lives.



Exits: Challenges
Key Challenges and its Effect on PE Exits in Real Estate
"The general regulatory / tax environment is getting harder for exits to take place smoothly. For e.g. change in regulation on the 3 year lock-in period to the entire capitalization (rather than just the minimum capitalization) is one of the biggest dampener to PE exits from the sector."

- Mr.AbhishekGoenka, BMR Advisors

"A key regulatory challenge is the 3 year lock-in period which restricts buy back within 3 years of investment. The intention behind lock-in is to ensure capital is available for development and not trading. So, if the project has generated cash flows through its natural life cycle, such cash flows should be permitted to be used to repatriate, whether it is within the 3 year period or otherwise. RBI should restrict only outside capital being used to repay the investor."

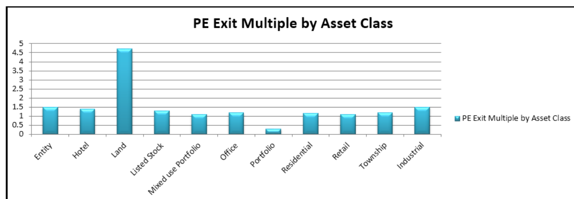
Mr.Sriniwasan, Kotak Realty Fund

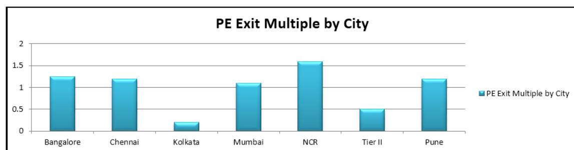
Reaping the Returns

The Indian Real Estate story has been a mixed bag while decoding the returns provided by the sector.The exits have been logged at an average multiple of approximately 1.24x. The investments have been broadly in- the-money at the time of exit; however, the returns have been depressed by the global recessionary trends.

Further, commercial sector has demonstrated positive return multiples of 1.2x on an average, whereas the returns on residential have mostly been close to 1.1x.

Within commercial office sector, non-IT office assets have displayed a multiple of 1.9x as compared to IT and SEZ which have made subdued returns. SEZs have largely been troubled with regulatory issues surrounding change in ownership which have dipped their performance. Land shows a multiple of 4.7x largely skewed primarily owing to outlier transactions recorded and therefore, the recorded returns does not necessarily reflect the expected return. Of the cities, Mumbai has displayed better equity multiple of 1.6x followed by Chennai and Bangalore. Of the metros, only Hyderabad has shown negative returns, whereas other cities have lagged behind the top seven metro cities.





Looking forward

The changing dynamics of the real estate sector in India has transformed the way the stakeholders of real estate have operated in the past five years. The bull run of the Indian real estate market during 2005-2007 followed by the recession hit years of 2008-2009 and a phased recovery during 2009-2011 and finally a pre-boom stage for the past two years now summarises the India real estate story in brief. The learning from such short industry cycles of the sector has been enormous. While the market dynamics has offered excess of opportunities for the developers and private equity investors to invest and reap higher returns, such opportunities have come with a significant risk to the stakeholders given the challenges to exit from an investment in the country's real estate sector.