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Private Equity Placement in Real Sector : An Analysis

Senahe Lata : Assistant Professor, Department of Commerce,UCK, Kurukshetra (Haryana).

ABSTRACT :

A wider participation of institutional Private Equity investors in the capital intensive business beyond the traditional lenders has played a critical role in the development of Real Estate Industry in India. Private Equity investments in Indian real estate have penetrated deep into the industry, with both domestic and foreign funds fuelling the rapid growth of real estate construction in Indian cities. India is perceived as one of the attractive investment destinations globally on the back of multitude of factors such as – strong economic growth, rapid urbanization, growing middle class population, demographic advantage and increased thrust on infrastructure. The India growth story would not have been possible without the policy and strategic level support from the central and state governments. The much required impetus to the real estate sector was provided by the Government of India when the market was thrown open to foreign investment to promote Greenfield development. The combination of inherent population led residential demand, outsourcing led office and hospitality sector growth and rising income levels led retail consumption demand came together with availability of additional capital for Greenfield projects in the sector resulted in the large scale development in the last few years. The paper titled **"Private Equity Placement in Real Sector : An Analysis"** aims to gain and share a perspective on private Equity Fund involvement in the Indian realty sector.

KEYWORDS : Real Estate, Private Equity, Greenfield Projects.

Introduction : Private equity (PE) has established firm roots in India over the past decade, drawn by the nation's phenomenal growth, dynamic entrepreneurs and hunger for capital to finance opportunities in nearly every business sector. As its role increased in significance over the past decade, PE has shaped itself to the contours of the Indian economy and unique business culture. Yet, while this quintessentially adaptable industry has taken on many distinctive traits in India's hothouse growth environment led principally by domestic consumption, it is important to bear in mind that PE and venture capital (VC) are chiefly influenced by the overall health of the global economy and investment climate. That is because PE and VC fund investors are still predominantly based outside of India. The impact of this global linkage was especially salient in 2010, a year of recovery for PE worldwide from the 2008 credit meltdown that followed the bursting of the US housing bubble and subsequent recessions that hobbled the

world's biggest economies. Although buyouts play a distinctly smaller part of total deal value in emerging economies generally and the Asia-Pacific region specifically, deal making resumed its strong growth even in these markets.

As the year unfolded and credit-market conditions improved, new forces that influence PE's continued expansion—and ultimately affect PE's prospects in India—began to assert themselves. For one thing, a large and rapidly growing number of PE funds worldwide are sitting on nearly US$1 trillion in committed but uninvited "dry powder", and they are scouring the globe for attractive investment opportunities. With so many funds looking to put that money to work in today's revived deal-making environment, competition to acquire high-quality assets and the pressure to bid up prices is expected to be intense. In line with its revival in developed markets in 2010, PE activity in India, China and other leading emerging markets also recovered quickly. With India's GDP growth pegged at around 8.7 per cent over the past year on the back of increased consumer and public infrastructure spending, the confidence of global investors in India's longer-term prospects has strengthened. Including real estate, venture capital and PE investments in infrastructure, deal values in the Asia-Pacific markets rose to US$51.4 billion in 2010, approximately 20 per cent of which was invested across 380 deals in India. Along with other fast-growing Asian markets during the past year, India's economy continued its uninterrupted expansion, while those in the US and Europe slumped. That gave PE investors fresh reasons to look to the subcontinent as an attractive destination for investment capital. Including investments in infrastructure and real estate the total value of new deal activity in India rose to US$9.5 billion in 2010, more than double the US$4.5 billion PE funds had invested a year earlier. This record of impressive growth makes it clear that PE is becoming more integral to India's business landscape. It is also a testimony to the many lessons learned both by PE investors and India's entrepreneurs through the experience of working together through the peak and trough of the business cycle. Through the end of 2010, the number of international and home-grown PE firms has increased to some 450, according to Venture Intelligence, an industry data provider. Since 2005, more than 1,900 Indian companies have accepted venture capital and private equity investments, including nearly 340 in the past year alone. While these healthy indicators bode well for the next wave of PE growth, India's PE industry stands at a major inflexion point as it enters a new decade.. Despite having compelling stories to tell, PE firms will need to continue working hard to win over the skeptics, both in 2012 and beyond. To realize their full potential, PE firms must continue to demonstrate how they help management of start-up and fast-growing enterprises formulate and execute on agreed strategies and operational plans.

Objectives :

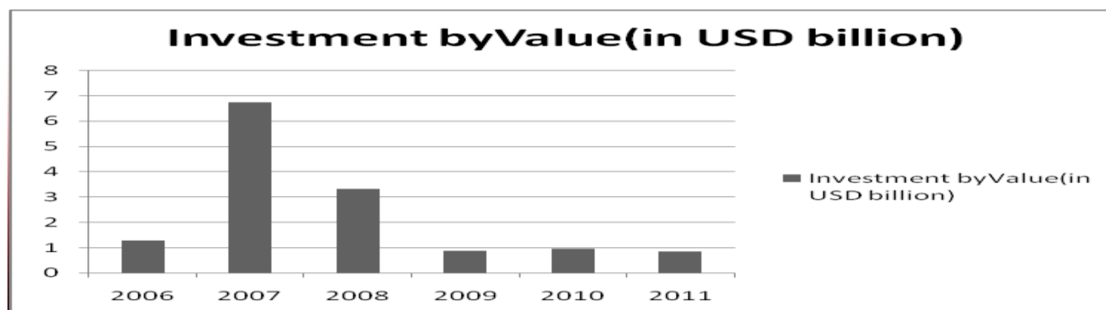
1) To analyze the trend of Private Equity in Real Estate Industry.
2) To know the pattern of exit of Private Equity from Real Estate Firm.

Research Methodology : Present study is empirical in which conclusions have been reached on the basis of secondary data. Secondary data have been collected from various Journals, Magazines, periodicals and newspapers.

Investment Trend 2005-11 : In the first three years of the sector opening to foreign investment a large number of global financial giants allocated money from their books to be invested in the Indian real estate

sector followed by multiple rounds of funds rising for their third party capital fund management business. Flush with funds, and looking for an early start fund managers invested aggressively in projects across asset classes and cities. In the early days, there were few FDI compliant projects that did not find foreign capital for investments. Domestic financial institutions raised and invested capital from domestic and international sources, the domestic capital having the added benefits of to being restricted by conditions of FDI rules. Seemingly endless capital availability pre 2008 was well capitalized by fund management business through investment fund raising investment cycles. As indicated in the recent study by Grant Thornton, close to 86% of the private equity investment in Real Estate during 2005-10 took place in the period 2006-08. While a substantial number of transactions with developers were project specific, appetite for larger ticket size investments was provided by global financial institutions that targeted holding companies of developers involved in multiple large FDI compliant projects. The likes of Morgan Stanley, Goldman Sachs, Citigroup, Wachovia etc. invested capital in unlisted developer entities. In most cases the objective was to achieve diversification through a portfolio of projects with a particular developer and eventually exit through the IPO route in 3-5 years. Real estate investment trusts (REITs) were widely expected to be the exit options for most investments in the IT and commercial office sector and were expected to be prevalent over the next 2-3 years. Large 100 acre plus townships also received a fair amount of interest from PE investors as developers were keen to de-risk and seek capital on the larger projects. Residential sector though generated huge interest from investors, but due to buoyancy in sales, developers rarely required external capital to execute prime projects. Promoter 'cash-outs' were fairly common in this period as the developer sold part of their project equity at market value to PE players. Post cash-out, projects were then dependent on funding through pre-sales, external debt or additional capital infusion by equity holders. While many investments were through pure equity route, structured products containing downside protection with an upside share, structured waterfall (sequence & terms governing capital take out by developer and investor) and preferred return structure to investors were not uncommon. This was also the period that saw substantial investment interest from investors out of some smaller European nations, Canada, South Korea, Israel and Middle East. Most of these funds were unable to conclude a significant amount of investment in the country due to lack of dedicated India focused investment managers who understood the dynamics and regulations in the Indian markets. These investors soon disappeared in the post 2008 era. In 2008, Press Note 3 (PN3) was introduced permitting 100% FDI under automatic route in operating Industrial Parks, thereby providing a window for investment in completed IT Parks that were PN3 compliant. This was a much needed regulation in the absence of REITs and with no visibility on their introduction. Given these were early years for PE investments, very limited PE exits took place in this period. At best, a few residential projects with highly successful launches may have seen some capital flow back to the investors.

Figure-1
Private Equity investment in Indian Real Estate By Value (2006—2011)

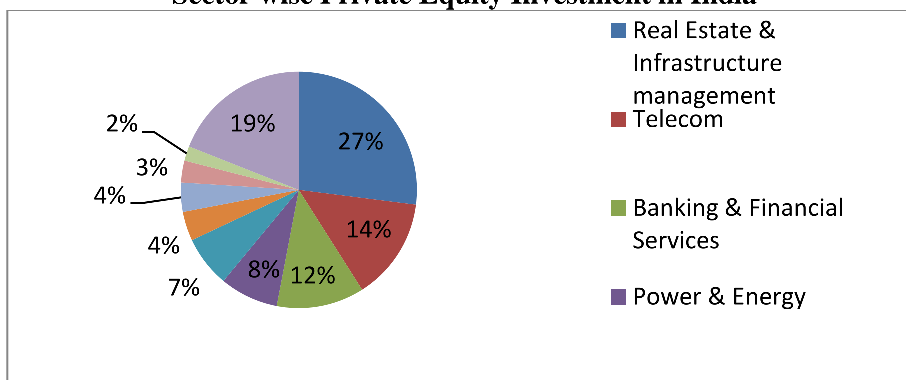


Source-ventureinteligence

In 2008-09 as a result of the market correction due to the global financial crisis, the project underwriting assumptions made by developers, fund managers, analysts, advisors and other participants suddenly looked unrealistic. Project timelines, sales assumptions, debt availability, and more visibly sentiment just seemed wrong. Some of the largest investors shut shop overnight and the others had an investment freeze from their management committees till at least their survival was secure. Many funds defaulted on their capital calls from the developers, and considered themselves lucky to have only signed term sheets for some of the largest deals the market had seen. Though, investments wherein the assumptions had been conservative got away with just project delays and some minor price corrections. This was also the period in which there was unexpected pressure on funds to evaluate exiting their investments for various reasons such as restoring confidence in their LPs, liquidity pressures from parent company, recovering scrap value from investments gone bad or just demonstrating exit track record for a potential fund raising exercise. Discussions of GP platform sale of many failed investment banks were prevalent in the market. The year 2009 also saw some of the PE funds with local decision making and Indian parentage step forward to take advantage of the liquidity crunch in the market and spot opportunities. These funds were able to capitalize on the distress in the market by offering capital to the cash- starved developers to acquire prime projects at discounted values. Despite keen interest ability to invest in such projects, many FDI funds couldn't compete with speed of local decision making by some of the domestic funds. Most of the transaction volumes in 2009-10 were generated by such PE funds. Given that the residential demand is local with almost no impact of global factors, residential sector saw a quick recovery in 2009-2010 while other asset classes lagged. Also being an asset class where liquidation of investment happens through sale of units to retail buyers, with no dependence on other institutional buyers to provide an exit , most fund managers realigned their investment focus towards residential. Many Brownfield projects with shell structures in place and substantial sales of units completed were stuck as the developers had used all the capital available with them for debt repayments or faced many cancellations by apartment buyers. Some such developers did not have enough capital to continue construction to call for subsequent construction linked installments from buyers. Many such projects received capital for last mile funding of the project from PE investors. Such projects offered a low risk and quick exit opportunity to investors. Post-recession, as the dust settled, in 2010-2011, funds were already in the 5th to 6th year of fund life that were launched

soon after opening of the sector for PE investments. As a result, the focus of most fund managers shifted towards demonstrating exits from their investments. Plenty of activity was seen on the exit front from PE funds, an aspect we have covered in much detail in later sections of this report. Global rounds of fund raising were prevalent but not hugely successful. Funds like Indiareit, Kotak, Milestone and ASK were more successful in raising domestic HNI money through wealth management and private banking channels. With interest rates peaking out towards second half of 2011, some of these funds also raised debt funds for real estate promising high yields to investors. The real sector has always been watched closely by policy makers and regulators as an indicator of sentiment, liquidity and speculation in the economy. RBI has consistently discouraged banks to lend to the sector by assigning higher provisioning weight ages to real estate loans and banning lending for land acquisition. To an extent some of the cautions measures taken be the banking regulator kept the Indian banking sector insulated from the global financial crisis. The focus of the regulators is clearly to encourage financial institutions to provide capital for development of real estate and not to fuel trading and speculation. FDI regulation for real estate investments was also in line with the philosophy of the regulators. In essence, directing the FDI participants to take equity participation in large projects, invest in development of new projects and lock in capital for three years rather than trade on quick profits. Since then, the real estate and infrastructure sector has attracted close to 27% of all private equity.

Figure-2
Sector wise Private Equity Investment in India



Source-venture intelligence

India is perceived as one of the attractive investment destination globally on the back of multitude of factors such as – strong economic growth, rapid urbanization, growing middle class population, demographic advantage and increased thrust on infrastructure. The Indian growth story would not have been possible without the policy and strategic level support from the central and the state governments. The much required impetus to the real estate sector was provided by the Government of India when the market was thrown open to foreign investment in 2005 to promote Greenfield development. The combination of inherent population led residential demand, outsourcing led office and hospitality sector growth and rising income levels led retail consumption demand came together with avai8lability of additional capital for Greenfield projects ion sector resulted in the large scale development in the last few years. AS per Jones Lang La Salle estimates the market value of investment grade real estate in India under

construction has increased from US$ 69.4 billion at end 2006 to US$ 160.1 billion at end 2Q 11, which is equal to 9.85 of India's GDP in 2010.

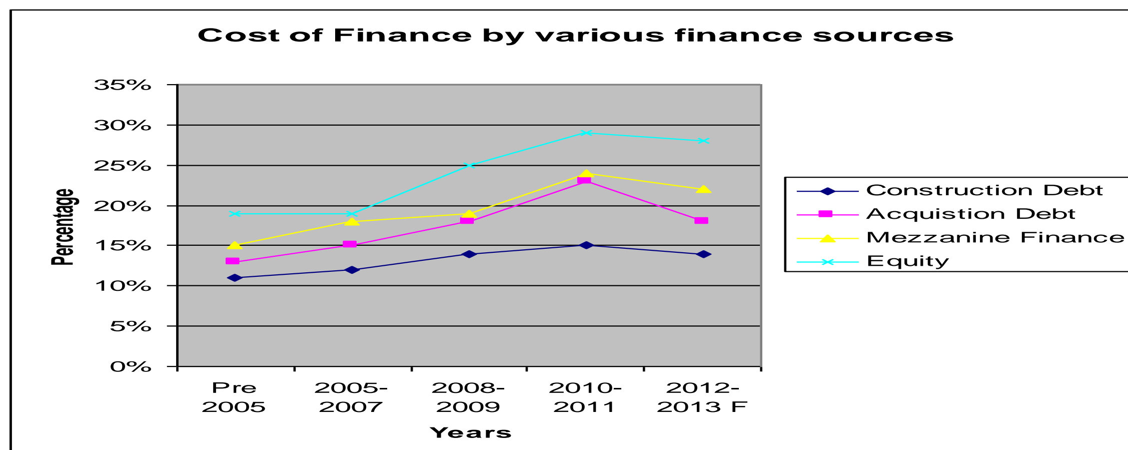
Major Channels of financing real estate : Traditionally real estate was financed in an unstructured manner through a set of high net worth individuals that each developer closely worked with fund acquisition or construction of a project. These could either be in the form of debt or equity. Over the past decade, new channels of sophisticated real estate financing from institutional sources have emerged in India that exists with the unstructured ones, only reducing the over dependence on a particular means of financing. Availability of capital through a spectrum of instruments gives the ability to borrowers to calibrate their capital structure based on market conditions and their risks averseness. It also suggests an increasing maturity and depth in the financial markets of the country.

Table-1
Financing Channels of Real Estate

				Off-shore Listing
		Off-shore Listing	Off-shore Listing	REIT/REMF/AIF
	Off-shore Listing	QIP	QIP	QIP
	IPO	IPO	IPO	IPO
Off-shore Listing	PE Funds	PE Funds	PE Funds	PE Funds
IPO	ECB	ECB	ECB	ECB
NBFC Lending	NBFC Lending	NBFC Lending	NBFC Lending	NBFC Lending
Bank Lending	Bank Lending	Bank Lending	Bank Lending	Bank Lending
Private Lending	Private Lending	Private Lending	Private Lending	Private Lending
Pre 2005	2005-2007	2008-2009	2010-2011	2012-2013F

Cost of various sources of Finance of Real Estate Development : Traditionally debt was available from nationalized banking channels for acquisition of land. With RBI restricting use of bank debt for land acquisition, equity and mezzanine capital became the favored options for such use. Prior to the global financial crisis in the liquidity surplus era, equity capital was so freely available that it was priced closer to debt return levels. In the last year, the pre-recession perpetual optimism has turned to irrational fear for the capital providers resulting in debt being priced at equity levels. Unfortunately for the developer community, the slowdown in sales has only increased their dependence on external capital for acquisition of new projects and repayment of pre-existing debt liabilities. This demand for capital, combined with a sharp spike in interest rates compressed the spread between debt and equity, increasing the prevalence of high cost mezzanine debt and equity structures. Non-Banking Finance Companies (NBFC) are primary sources of such capital and have been instrumental in providing capital to developers for exiting.

Figure-3



Exits of Private Equity in Real Estate in India : Private Equity Investing is all about getting out. Real estate sector is no exception to this quote. Successful private equity investments require planning for an exit at the deal stage itself. The principal mandate of any General Partner (GP) of a PE fund is to generate returns through successful monetization of the investee companies and to distribute cash flows back to the Limited Partners (LPs). This becomes even more important in light of the restrictions for foreign investments in India as well as the lack of depth in a secondary market for transactions. The credit crisis of 2008- 09 created an added pressure on fund managers to demonstrate returns through cash flows rather than through Net Asset Value (NAV) updating .Private equity investments in real estate have reached the Exit Phase. Most Fund Managers today have either hit the Exit Phase already or are readying themselves for exits. Our discussions with leading tax and legal advisors also have re-confirmed that "Exits" and not "Investments" seem to be the principal area of activity for most industry participants currently. Out of private equity investments of circa USD 13 billion that were made in Indian RE, our analysis reveals that about USD 3.2 billion of exits have been recorded so far out of over 80 transactions. Our data sample covering about USD 3.2 bn of exits includes a variety of asset classes, geographies and fund types .There can be various drivers for exits by a private equity fund:

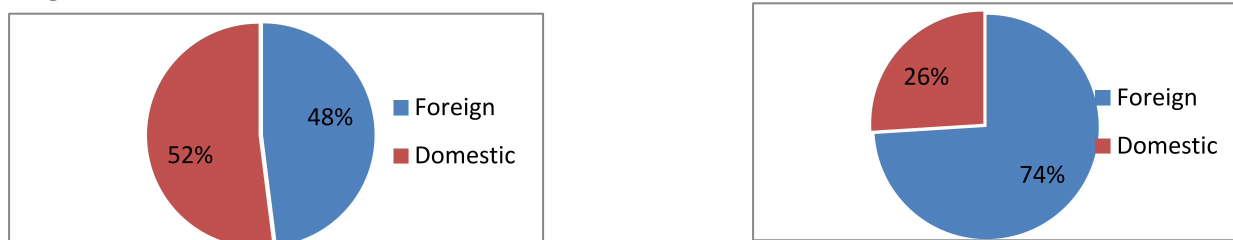
a) Completion of Project life cycle
b) Market driven opportunity
c) Distressed sale
d) Fund raising activities
e) Completion of fund life

The Indian market has so far seen all of the above drivers in play, nut the dominant driver for exists in the near term will be clearly the end of the fund life. India has witnessed US$ 3.2 bn of investors exits over 80 deals from the Real Estate in the last 4 years. In comparison to the global scenario, where the distributions by real estate private equity funds of 2006-07 vintage have been approx. 1.5%5 of the capital called, Indian RE investors have returned close to 24% of the capital invested. This indicates that Indian RE performance has been, to some extent, less affected by

global events than other countries. Contrary to the industry perception that most PE investments in Indian realty market reaped lower returns than that envisaged during entry, our study unearthed that PE in real estate industry, like any other industry, had examples of both good and bad exits from a return point of view. While a good number of PE exits were executed upon completion of their natural investment cycle, the market witnessed fewer forced exits resulting in lower returns as compared to that of a fund manager's expectation.

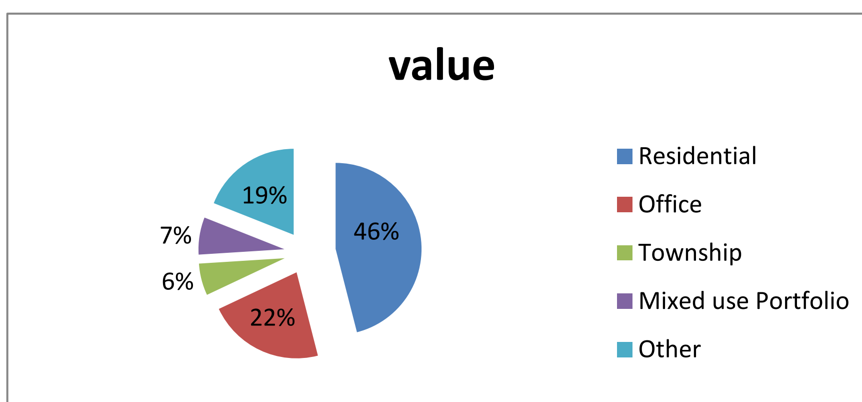
Larger Exit Values by Offshore Funds largely due to higher ticket size : The level of exit activity between domestic and offshore investors/PE Funds has been almost equal in terms of the number of deals. However in terms of value 74% of total exits were attributed to foreign funds. This is primarily because of the larger deal size in case of offshore investors.

Figure-4 (Number of Exits & Value of Exits)



With nearly 69% representation of the total exits in terms of value promoter buy backs dominates the PE exit landscape as the most prevalent exit route for investors even in terms of number of transactions. Promoter buy back are more prevalent in the commercial segment. As over 33% of all promote buy backs are for this asset class. If we exclude large ticket transactions which have seen exits through promoter buy backs, commercial assets are close to 45% of the total promoter buy backs. Also 625 of all commercial exits take place through the promoter buyback route. Project cash flows and third party exits together constitute nearly 40% of the total exist in terms of volume.

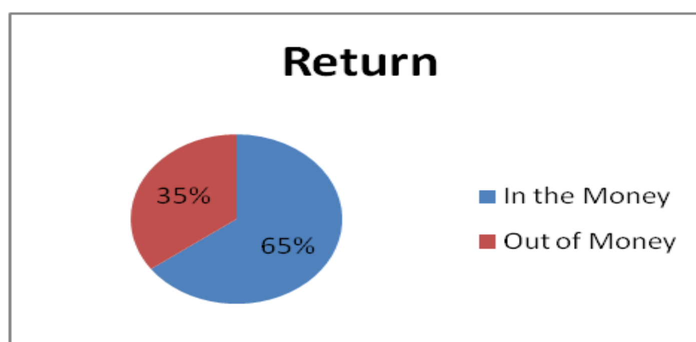
Exit by Asset class : Clearly residential segment has been able to provide a majority of the exits to investors followed by the commercial office segment. However, financial meltdown during 2008 brought in a paradigm shift in the way PE funds strategize their investment. Prospectively the focus of PE Funds going forward will be largely on residential projects. Figure 5 (Asset Class Exists)



Exit by Geography : NCR-Delhi and Mumbai together account for nearly 72% of the total value of PE exits thereby by contributing heavily to the exits recorded in North and West parts of the country. As the political and financial capitals of the country, these two large cities attracted a good proportion of the investment s since 2005. While exits in south zone was dominated by activity in Bangalore and Chennai recording close to 23% of the total exits, other cities such as Pune and Kolkata in West and East, respectively, also recorded PE exits.

Return on private equity investment in Real Estate : The Indian Real Estate story has been a mixed bag while decoding the returns delivered by the sector. The analysis revealed that the real estate investments have been largely in the money at the time of exit. This is a positive indication as the ratio is likely to improve as partial exits execute till date move towards complete divestment.

Figure-6 (Return on Private Equity)



The changing dynamics of the real estate sector in India has changed 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 summarizes the India real estate story in brief. The learning from such short industry cycles of the sector has been immense. While the market dynamics has offered plethora of opportunities for the developers and private equity investors to invest and reap higher returns, such avenues have come with a significant risk to the stakeholders given the challenges to exit from an investment in the country's real estate sector.

The key trend that will govern private equity investment include the following

a)Local market expertise and stable Asset Management Teams Valuation

b) Direct investment by LPs or Separate Account structure

c) Smaller fund and Niche fund

d) Increased execution oversight

e)Third Party exit will gain momentum

Conclusion :

The last couple of years have posed some key economic challenges internationally. India has been stable and has not witnessed critical worrisome moments, except for weak political environment which creates ambiguity and

inertia in policy making. In the medium term, we believe the outlook for RE sector and specifically from an exit perspective, will be positive. With a higher concentration of residential construction and investments, where the demand is dependent on Indian savings and consumption story, the performance is likely to be steady subject to moderation of price levels in certain geographies. The residential projects that have commenced post the global financial crisis will start churning out cash flows in the next two years offering partial to complete liquidation to several PE Funds. On the commercial front, there is likely to be more long drawn negotiation between sellers and buyers on valuation aspects due to expectation mismatch. There may be a more top down approach to buying activity in future with the global. Phenomenon impacting the valuations to some extent; however, we believe this should not be an impediment for closure of the deals for good projects. The industry is at a crossroad, where it has already witnessed a sizable number of exits and is expected to experience a larger number of exits in the near future. The exits so far has been a mixed experience for PE funds with some funds making excellent multiples while few others have bled profusely. Overall, though, one can deduce that the investor performance has been reasonable in a global economy which otherwise has been displaying brinkmanship with many investments devalued by over 50%. At this zero hour, the industry needs to forge ahead to 2012 by taking cues from the stakeholders' recent experiences, which however, may not be a thoroughly irreproachable basis for identifying future trends. As we now invert the hourglass, its a wait-and-watch until the key players checkmate and pen the conclusion of the first complete cycle of the India real estate story.

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