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ECONOMY & REALTY

Knight Frank

Desperate times call for desperate measures! Amidst faltering economic growth, battling the perception of policy inaction and procrastination, the Indian government has geared up to at least initiate policy changes even though implementation will be a challenge. After introducing a slew of reforms relating to foreign investment in retail, aviation, broadcasting and power, the government has reshuffled its cabinet of ministers to further improve the perception. The impending general elections are due in 2014 implying the government has limited time in hand to prove its candidature for the next term.

While initiating action is the prerogative of the government, expectation from the central bank is also high to help in arresting the faltering economic growth. Notwithstanding high expectation to reduce interest rates, the RBI has kept the key repo and reverse rate unchanged in its second quarter (July-September) monetary policy review. Only the Cash Reserve Ratio (CRR) has been cut by 25 bps in a bid to increase liquidity in the system. However, this move is not expected to yield much respite because of the muted credit growth in the current scenario. The non-food credit growth rate has decelerated from 19.5% in October 2011 to 15.5% in October 2012. The biggest concern today is the high cost of capital which is delaying investments eventually leading to a supply side shortage. Thus reducing repo would have helped corporates and households alike. But, the actions of central bank are influenced by the high inflationary expectations than anything else, implying rejuvenating growth will remain the second priority of the bank for quite some time.

Weak economic situation has crippled investment and muted expansion plans of the

BEING A DERIVED DEMAND, THE FATE OF OFFICE SPACE DEVELOPMENTS DEPENDS HEAVILY ON THE PERFORMANCE OF DOMINANT OFFICE OCCUPIER INDUSTRIES

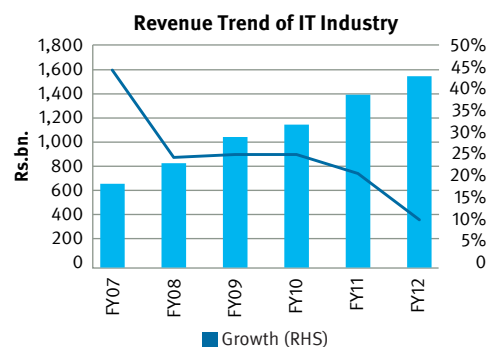
corporate sector. If the situation worsens it will eventually take a toll on the commercial real estate developments in the country. Being a derived demand, the fate of office space developments depends heavily on the performance of dominant office occupier industries. Banking, Financial Services and Insurance (BFSI) and Information Technology and Information Technology Enabled Services (IT/ITeS) sectors are the dominant office occupiers in Mumbai. Bangalore, Chennai Hyderabad and Pune are driven mainly by IT/ITeS sector. Hence, understanding the driver industries is essential to foretell the fate of this segment of the real estate industry.

The Indian IT/ITeS industry, the most dominant consumer of commercial real estate, had witnessed a multi-year high double-digit growth rate for major portion of the last decade. However, the status quo has been weakening in the last few years. In the most recent five year period i.e. 2007-12, the combined revenue of the CNX-IT index companies, a set comprising 20 leading IT companies, has grown at a rate of 18% annually, implying a 2.3 time increase in five years.

A significant portion of this revenue comes from exports and although the Indian IT industry has expanded to all the major global markets, America and Europe remain

its largely targeted geographies. In terms of the sectoral distribution, Indian IT companies have traditionally focused on core verticals such as BFSI, retail, telecom and manufacturing, with the BFSI sector contributing to as much as 35-40% of their total revenues.

INDIAN IT COMPANIES HAVE TRADITIONALLY FOCUSED ON CORE VERTICALS SUCH AS BFSI, RETAIL, TELECOM AND MANUFACTURING, WITH THE BFSI SECTOR CONTRIBUTING TO AS MUCH AS 35-40% OF THEIR TOTAL REVENUES

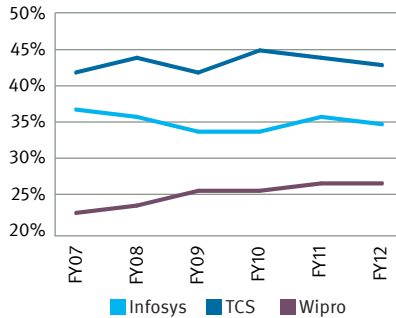


Looking back, the period between 2003 and 2008 was the golden era for the Indian IT companies wherein they registered high double-digit growth in revenues. Large IT budgets were earmarked by the banks in US which categorically fuelled the growth of this industry. Global economy along with all the major asset classes like equity, debt and commodity were thriving until the few financial intermediaries maneuvered highly



complicated business models. This financial engineering backfired in 2008 which led to the failure of more than 322 banks in US during 2008-10. This financial crisis had a ripple effect on all the economies across the globe consequently leading to a halt on the dream run of the Indian IT industry.

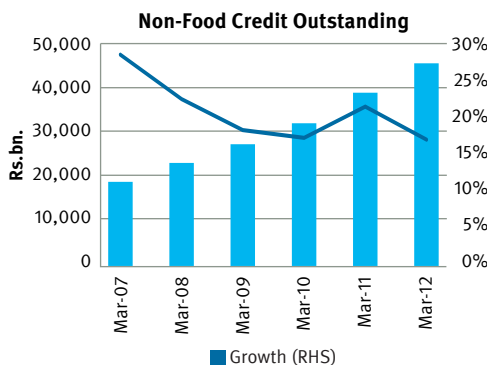
Revenue Contribution of BFSI sector



Source: Capitaline, Company

At present, the growth of the IT sector globally has been adversely impacted on account of subdued global economic growth, stagnancy in the IT budgets of the US banks and unfavourable economic climate in US and Europe. These macro parameters make us believe that spending on IT would be sporadic in the short term. Empirical evidence indicates high correlations of global GDP with IT services spend. Hence, unless there is meaningful improvement in these macro factors, returning to the high growth trajectory would be a distant dream for the Indian IT industry.

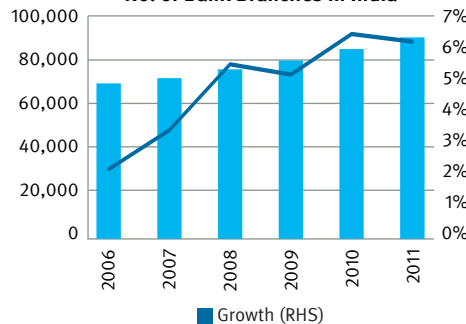
The BFSI sector is another dominant consumer of commercial real estate in cities like Mumbai. An assessment of this consumer group can be undertaken by understanding the fate of the banking sector in the country. The numbers for Non-food credit, which constitute almost 98% of the total credit of the banking sector, aptly capture the performance of this sector.



Source: RBI

Non-food credit grew by 28% in 2007 and 22% in 2008, displaying the upbeat investment climate as reflected in the Gross Fixed Capital Formation (GFCF) numbers for these years. The Positive outlook of the corporate sector, high capex plans combined with availability of cheap credit fueled this growth momentum. However, the Global Financial Crisis (GFC) of 2008 had a severe impact on the Indian economy also resulting in tapering of the non-food credit growth, which came down to 16.9% as on March 2012.

No. of Bank Branches in India



Source: RBI

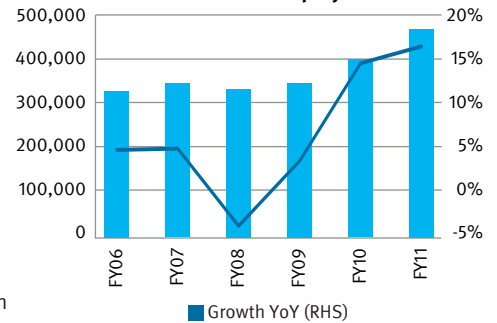
Notwithstanding the decline in credit growth rate, a silver lining has been witnessed in the growth of bank branches and employment in the sector. These parameters put together provide an all-inclusive view on the demand of commercial real estate emanating from the BFSI sector.

Across the country over 14,400 new branches were added post 2008, registering a 5.9% annual growth rate during a three year period from 2008-11. Moreover, when the global banks were downsizing their staff, the Indian banks added 135,260 employees as officers during 2008-11 registering a 12% annual growth rate.

WHEN THE GLOBAL BANKS WERE DOWNSIZING THEIR STAFF, THE INDIAN BANKS ADDED 135,260 EMPLOYEES AS OFFICERS DURING 2008-11 REGISTERING A 12% ANNUAL GROWTH RATE

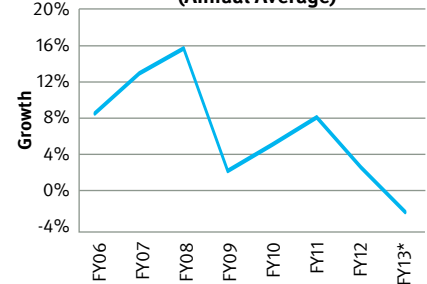
Besides, the BFSI and the IT/ITeS sector, the manufacturing sector is another important consumer group for the Indian

No. of Bank Employees



Source: RBI

Index of Industrial Production (Annual Average)



* Until Aug'12

Source: GOI

commercial real estate segment. The fate of the manufacturing sector can be gauged by analyzing the trend of Index of Industrial Production (IIP) an indicator of manufacturing activity in the country. During the last seven years, the average annual IIP index growth had topped 16% in FY2008. In the last two years it decelerated on account of weak demand scenario. However, positive signals have started to emerge with the monthly data for August 2012 registering a growth of 2.7% in comparison to the same period last year. This development augurs well for the economy as a whole.

Going forward, the revival in revenue growth for these three major industries viz. IT/ITeS, BFSI and manufacturing will be crucial for the growth of commercial real estate industry. In the case of the IT/ITeS sector while we are witnessing near term headwinds from weak macro factors, we believe the sector could still deliver an acceptable sales growth rate. We base our hypothesis on the growth in the traditional markets (US), under the penetrated European market and emergence of new verticals such as utilities, media and healthcare. We believe the Indian IT sector has achieved scale and moved ahead into the mature stage of the industry lifecycle. Combined revenues of the CNX-IT companies have increased 11x to Rs.1,537 bn. during



the last nine years. Even at a subsidised rate of 12% per annum the Indian IT industry is estimated to double in the next 6 years. This growth would translate into a steady demand for office space in the foreseeable future.

In case of the banking sector, the RBI has targeted a credit growth of 16%, which is a tad lower than the current scenario. The focus on increasing the banking penetration in the country, akin to the last few years, augurs well for the commercial real estate market. However, credit growth along with control over the rising non-performing assets would be the key indicator for a sustainable demand for property.

The manufacturing sector follows the service sector in terms of output growth. This has been a widely acknowledged status quo. After a period of decline, a growth of 2.7% in the latest monthly data (August 2012) for IIP is a positive signal. Further, the core sector, an important constituent of IIP has witnessed a growth of 5.1% in September 2012. The core sector index, comprising eight infrastructure sectors, is signaling a revival in the industrial activity in the country. The importance of IIP stems from the fact that the manufacturing sector has strong linkage with the BFSI and IT/ITeS sectors as well.

Further, policy actions to encourage investments in the sector will be guided by the National Manufacturing Policy of the Government of India, which aims to increase

THE UP MOVE IN THE INDUSTRIAL OUTPUT GROWTH RATE HAS INCREASED HOPES OF REVIVAL IN MANUFACTURING SECTOR

the share of manufacturing from the existing 16% to 25% by 2025. While it is a long road map, even a small progress in this direction will lead to substantial gains for the commercial real estate sector.

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