TRENDS IN PRIVATE EQUITY INVESTMENTS

DECLINE OF PE INVESTMENTS IN REAL ESTATE: A REALITY OR AN ILLUSION?

The lifeline of capital movement, Private Equity (PE) investments in India, saw a slowdown in FY18 following the staggering growth trajectory over the recent past. While overall PE investments dropped by 5% YOY, funds foraying into the real estate sector declined by significant 19% YOY during this period. Investments in sectors other than realty however, held steady.

TABLE 1

PE Investment Trends (in USD bn)

Financial Year	PE investments in Real Estate	Growth	PE investments in sectors other than Real Estate	Growth	Total PE investments	Growth
FY15	3.1	-	14.8	-	17.8	-
FY16	5.3	73%	20.2	37%	25.4	43%
FY17	8.8	67%	22.1	10%	30.9	22%
FY18	7.1	-19%	22.1	0%	29.2	-5%

Source: Venture Intelligence, Knight Frank Research
Note: The above table includes PE investments across debt and equity
FY: Financial Year (April-March)

Did Investments into Real Estate Actually Decline?

At one glance, the decline of 19% YOY in investments could reflect turbulence in the real estate sector. But when we delve deeper and dissect the flow of funds, it provides a different picture. During FY17, there have been several large ticket brownfield transactions particularly in commercial real estate covering office and retail assets (malls). For example, the USD 1.4 billion DLF-GIC deal and USD 1 billion Hiranandani-Brookfield deal which elevated the total investments for FY17. Such transactions do not happen often due to the sheer size of assets that are involved in the transactions, as those assets have a long gestation period and take more than a decade to mature and become operationally efficient.

Hence, if we take a look at the investment numbers for these years excluding the major brownfield investments worth more than USD 500 million, the numbers were as follows:

The decline of 19% YOY in FY18 of PE investments could reflect turbulence in the real estate sector, but if we delve deeper and look at the investment numbers for these years excluding the major brownfield investments worth more than USD 500 million, the PE investments have been on an increasing trend since 2014 and the strong momentum which was observed in FY17 has sustained in FY18.

TABLE 2

A deeper look into PE investments in real estate (in USD bn)

Financial Year	PE investments in real estate (excluding deals > USD 500 mn)	Growth
FY15	3.1	-
FY16	5.3	73%
FY17	6.4	22%
FY18	6.4	0%

Source: Venture Intelligence, Knight Frank Research
Note: The above table includes PE investments across debt and equity

If we look at table 2, the PE investments have been on an increasing trend since FY15 and the strong momentum which was observed in FY17 has sustained in FY18.

Commercial Real Estate More Attractive For Equity Investments

The structural reforms introduced by the government over the past 2-3 years have helped the real estate sector in India to move towards a relatively transparent environment. This transformation has attracted a significant number of organised players. The process is still on and shall stabilize in short to medium term. We believe that the reforms have brought in a paradigm shift in the sector and made it more conducive for investors. Taking cognizance of these reforms, investors have invested around USD 24 billion in the form of debt and equity into real estate since FY15.

Among the asset classes, residential sector is reeling under pressure for the last 3-4 years but commercial real estate is moving from strength to strength. While the office market is maintaining its robust annual transaction volumes, retail spaces, particularly select shopping centres in tier I and II cities are catching the attention of international funds.

Warehousing is one of the most promising sectors in India. The implementation of the Goods and Services Act (GST), continued government focus on building industrial corridors and the unabated growth of the Indian consumption market have whipped up the growth potential of the sector.

While the PE investments into residential asset between FY15 and FY18 were primarily in the form of structured debt courtesy inherent risk of the sector, those into commercial assets were in the form of equity. Out of USD 24 billion, around USD 10 billion (42%) was in the form of equity investments into commercial assets such as prime office assets and select retail malls.

The last couple of years have seen unprecedented interest for good quality rent yielding office and retail assets in cities across India among global financial institutions such as the private equity giants, sovereign funds and wealth funds. This demand coupled with scarcity in supply of good quality assets, strong performance of the office sector, reduced interest rate regime, decline in risk expectations on account of reforms and a strong bench of long term investors did result in compression of capitalisation (cap) rate for good quality commercial assets from 9-11% to 7.5-9% during the last 3-4 years.

Unprecedented investors' interest is being observed for lapping up good quality rent yielding office and retail assets, which has led to compression in cap rates from 9-11% to 7.5-9% during the last 3-4 years. Investors entering the market today are expecting the cap rates to compress further up to 150 bps in the years to come.

Would The Cap Rate Compression In Commercial Assets Continue?

Despite the compression in cap rates, investors' appetite for quality space seems undeterred. Investors entering the market today are expecting the cap rates to compress further up to 150 bps in the years to come. The projections are also in sync with the estimated exit time. They are hoping to get dual benefits – primarily from the growth in rental income and secondly from compression in cap rates.

On the rental front, we are optimistic about the growth prospects, as there has been a significant crunch in the supply of good quality office space across major cities in India. Vacancy rates in some of the most sought after business districts in India such as the Bandra-Kurla Complex, Lower Parel in Mumbai, Outer Ring Road in Bengaluru and DLF Cyber City in NCR have shrunk to single digit levels. These prime business districts have limited scope for substantial new supply. The supply crunch coupled with strong occupier demand has been driving up the rentals for good quality office space. With business environment in India improving and the country's GDP growth rate expected to improve in the coming years, the occupier demand would strengthen. This would provide tailwinds for future office rental growth.

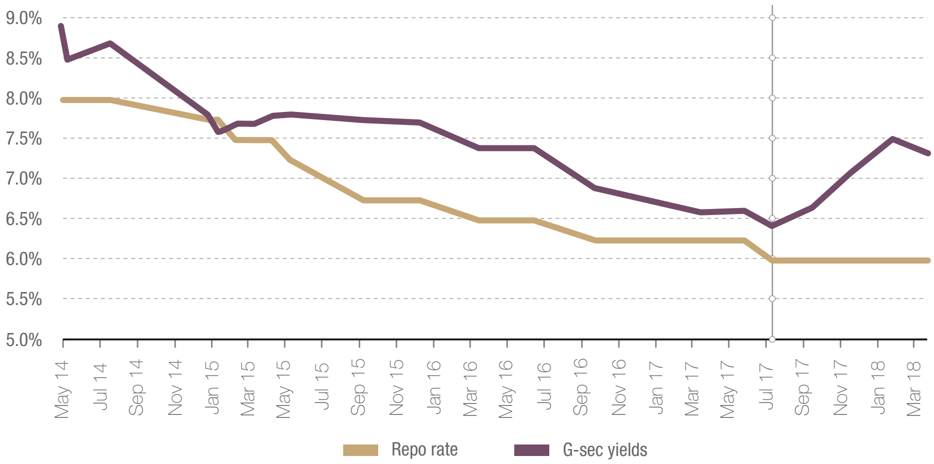
The oversupply of retail assets (malls) coupled by strata title sales of malls in India led to underperformance and closure of a large number of properties. Select retail assets which survived and were successful are witnessing strong occupier demand and rental growth. These particular retail assets are attracting investors' attention at par with or in some cases higher than that witnessed in case for office assets. The demand is primarily driven by scope for better rental growth. Unlike office assets, which generally have a standard rental appreciation clause of 15% every 3 years on the base rent, retail assets come with revenue sharing opportunities, in addition to the escalation on base rent. There is a significant potential for mall revenues to grow on account of the rising consumer demand and ongoing structural changes taking shape in select malls to accommodate new anchors and entertainment options in order to remain relevant against the competition from online retail. Hence, with respect to the expectation of rental growth in office and retail assets the investors would be able to achieve their desired objective.

However, with respect to expectations of cap rate compression, one needs to be cautious. Globally, the days of zero/low interest rates regimes are coming towards an end. The U.S. fed has ended its quantitative easing program and has already hiked the rates several times and has indicated of more hikes in the coming years. This has led to increase in cost of funds globally. Even in India the reducing interest rate regime prevailing for the last 3 years is likely to end soon and so is the case with Government Securities (G-sec) yields.

Scarcity in supply of good quality office and retail spaces in the most sought after locations coupled with strong occupier demand is providing tailwinds to rental growth.

FIGURE 1

Repo rates and G-sec yield movements



Source: RBI, Knight Frank Research

We believe that our economy is at the bottom of the current interest rate cycle and going forward the rates would start hardening. The government breaching of fiscal deficit targets currently, have already put upwards pressure on G-sec yields. Further additional factors such as expectation of higher inflation, weakened capital reserve position of banks owing to NPAs, treasury losses on bank's G-sec holdings and the early sign of pick up in credit growth have been pushing banks to raise lending rates. With election in several states and the general election approaching, the volatility would be higher in the next 2 years.

While it is too early to comment on the extent of rise in lending rates and G-sec yields, in the short term they are likely to have an impact on the current trend of cap rate compression. If the rise in lending rates and G-sec goes up beyond 100-150 bps the expectation of returns from real estate investments would go up. Thus, particularly in the short-term, the case for cap rate compression would weaken and it may hold steady or increase marginally to keep the spread constant. Overall the institutional investor may have to rely more on rental growth to make up for their expected returns from their investments in the near future.

When it comes to long-term perspective, India's macro-economic fundamentals and GDP growth outlook remain strong on the back of settling of the ongoing structural reforms and completion of mega infrastructure projects in the next 5 years. In turn, as the economy matures the perceived risk pertaining to invest in India is likely to come down. With the Reserve Bank of India's continuous focus on keeping the inflation under 4% and government's efforts for fiscal consolidation, the cap rates are going to see required compression. Hence, investors with longer investment horizons like endowment funds, sovereign funds, pension funds and insurance companies would achieve returns at par with their expectations. A note of caution: unforeseen catastrophe like global financial crisis of 2007-08 should not repeat, current low intensity trade war should not exacerbate and India should have a stable government beyond 2019.

In the short-term there are many challenges for cap rate to compress further on account of fiscal pressures and inflation expectations. However, in the long term, the strong fundamentals coupled with maturing of the Indian economy would lead to compression in cap rates.

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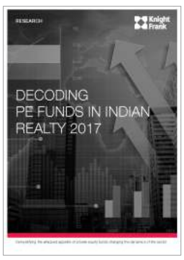

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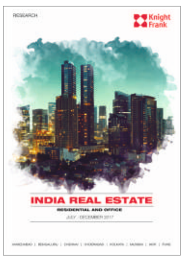

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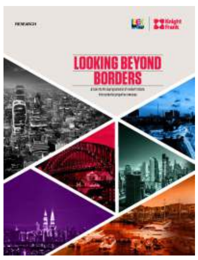

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