Investments in Real Estate

Trends in private equity investment (2020)
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EXECUTIVE SUMMARY

The term VUCA - volatile, uncertain, complex and ambiguous - has been common parlance post the 2008 Global Financial Crisis (GFC). Events such as the taper tantrum, Eurozone crisis, Brexit and Fed rate hikes warranted its use during the corresponding period. However, if we were to juxtapose those events with the COVID-19 pandemic, then the COVID-19 crisis would dwarf them all. None of the crisis including the dreadful 2008 GFC, has ever brought the entire world to a standstill and restricted movement of people the way COVID-19 has done.

The COVID-19 pandemic has affected almost all businesses without exception, as most major economies have had to adopt a national lockdown to tackle the crisis. Economists across the globe have predicted a global recession in 2020 and expect it to be far more severe than 2008. Valuations across asset classes and businesses are expected to plummet in 2020.

In the past decade, India has taken repeated hits to its beleaguered financial system, and in 2020 the nation narrowly avoided a systemic collapse and financial meltdown by the bailing out of Yes Bank. The COVID-19 crisis could not have come at a worse time for India. The nation has adopted one of the most stringent lockdown measures globally and hence the economic impact is expected to be acute.

While the financial system of India, from banks to Non-Banking Financial Companies (NBFCs) have had their share of problems in the previous decade, private equity (PE) had emerged as a major source of capital for the real estate sector attracting investments of over USD 45 billion from 2011 till date (May 2020). The residential segments were performing exceptionally well during the initial half of the decade and commercial segments saw pick up in the second half.

The saga of Indian real estate sector in the last decade has been similar to A Tale of Two Cities, where the residential segment has gone downhill while the commercial segment (office, retail and warehousing) has enjoyed some of its best years in terms of demand and investments in the same period.

India’s office market has grown by leaps and bounds in the last decade and is at its peak – with 6 out of 8 Indian cities featuring on the list of top 10 cities in the Asia Pacific (APAC) region based on annual transaction volumes in 2019 and finding a place ahead of cities such as Beijing, Singapore, Kuala Lumpur, Hong Kong, etc. Some of the Indian cities have very low single digit vacancy levels and have been witnessing strong double digit growth in rentals in recent years, which has allured investors. The strong demand of Indian office space in the recent years was majorly driven by companies in IT/ITeS and BPO/KPO sectors and also by co-working players. The vast availability of Science, Technology, Engineering and Mathematics (STEM) talent pool and the associated cost arbitrage make India an attractive destination for companies to have their off-shore units in. Strong PE investments of over USD 13.6 billion are a testament to the strong fundamentals of the India office market. While work from home will pose a serious threat to demand for office space in the post COVID-19 era, the enforcement of GDPR norms globally would acts as a major hindrance to this transition.

The low per-capita availability of malls across cities, favorable demographics, rise in disposable incomes, rising consumer demand and the transformation of malls into a modern entertainment and destination centre make a strong case for growth in retail revenues in malls. 2019 was the best year for PE investments in retail with the investment volumes touching a historic high of USD 922 million.

Propelled by reforms such as granting infrastructure status to the logistics industry including warehousing, implementation of GST, development of multimodal corridor and many more, the warehousing sector in India has reached its inflection point. Identifying the potential for growth investors have committed equity investments of over USD 6.5 billion since 2017, which is the second highest after office in that period. Though COVID-19 has cast it shadow on the warehousing sector in the first 5 months of 2020, however, the pandemic is likely to have a positive impact on warehousing due to a significant shift in supply chain management methods and renewed growth of e-commerce.

The COVID-19 pandemic has brought all businesses across the globe back to the ground level. It would be interesting to assess the flow of private equity (PE) capital in Indian real estate in the next 12-15 months. For private equity capital, as the flow of money is not restricted by any border, the capital chases the asset class or country offering the highest risk adjusted returns. This report assesses the flow of PE in Indian real estate in the last decade and throws light upon how things would pan out in the near term (next 12 months).
FRAGILITY IN THE INDIAN FINANCING ECOSYSTEM

The Indian banking sector has been undergoing a painstakingly long and overdue clean-up process since 2014. The measures adopted by the Reserve Bank of India (RBI) along with the Government of India (GOI) has ensured that banks identify NPAs, make sufficient provisions, write-off bad debts, initiate the process of recovery/liquidation and improve their lending standards. The Insolvency and Bankruptcy Code (IBC) 2016 and the pumping of INR 2.5 lakh crore (INR 2.5 trillion) into public sector banks were some of the major steps taken in this direction.
While banks were busy undergoing a rigorous NPA clean-up process, the Non-Banking Financial Companies (NBFCs) which include Housing Finance Companies (HFCs) went from a cycle of boom to bust in the same period. The NBFCs had jumped at the lending opportunity that emerged due to banks going soft to clean up their books. They had started lending aggressively and often to high risk segments. Due to the lower regulatory supervision and lower lending restrictions as compared to banks, the NBFCs could also lend to unorganized segments which form a large share of India’s economy and are not catered to by banks. The market opportunity both in organized as well as unorganized segments was huge. Within a short span of time, the NBFCs became an important pillar for financing India’s consumption growth. They financed a gamut of activities from individual aspirational purchases to sectors that needed long term financing like real estate and infrastructure. To expand their margins along with rapid growth in topline, a large number of NBFCs adopted the model of borrowing short term and lending long term without paying much heed to the asset-liability mismatch which was building up in their books. They were able to roll over the short-term debt but fell victim to the fallacy that they could continue operating in this manner.

The bull run of NBFCs culminated with the IL&FS default in September 2018. With this, investors lost confidence in the business model of NBFCs, and as a result, the cycle of rolling over short term debt stopped abruptly. The sector has been in turmoil ever since. A few large NBFCs went out of business while others started to wind down their operations. India’s GDP growth started to go downhill and the country recorded its lowest growth rate in 6 years during the quarter of December 2019.

After the IL&FS default in 2018, fissures in the financial system were seen again towards the start of 2020 with Yes Bank - one of the top 5 private banks in India - coming to the brink of collapse. However, proactive action by the Reserve Bank which got the State Bank of India (SBI), along with other banks to bail out Yes Bank helped avert a financial disaster. The bailout was successful and it helped calm investors’ nerves and the nation avoided a financial meltdown.

Even as the Indian economy was recovering from these back-to-back hits on its financial system, the COVID-19 pandemic erupted. In order to tackle this new threat, the Government introduced one of the most stringent lockdown measures seen globally, with most businesses coming to a complete standstill for over 65 days from March 25th to May 31st. Due to the lockdown, many companies have resorted to salary cuts, deferred wages, freezed hiring and halted all expansion plans to tide over the crisis and conserve cash. While it is too early to estimate the damage to economy due to the lockdown, it is definitely going to result in job losses, pay cuts and a huge slowdown in demand across industries. Many businesses will be pushed to the verge of bankruptcy and will find it difficult to honor their debt obligations. Therefore, the NPA mess in the Indian banking system which was showing early signs of abating is likely to remain.

As per RBI’s Financial Stability Report (FSB) released in December 2019, the NPAs in the Indian banking system is expected to touch 9.9% by September 2020 in the worst case scenario projections. However, this forecast did not take into account the COVID-19 impact and the eventual figure may be higher. Such a situation would erode the capital buffers of several financial institutions and cripple the beleaguered financial system.

2020 will be a challenging year for India. Several rating agencies and banks have cut India’s GDP growth forecast for FY21 and expect the country’s growth to contract in FY21. With the economy coming under severe stress, the financial institutions may not be in a position to provide the requisite capital required to support growth.
INVESTMENTS IN REAL ESTATE

PE INVESTMENTS IN INDIAN REAL ESTATE

The Indian real estate sector was earlier perceived by global investors as developing in terms of quality of assets across segments. However, several developments have changed this perception. Some of the biggest path-breaking reforms in real estate became a reality in the past few years which include the Real Estate (Regulation and Development) Act, 2016 (RERA), the Benami Transactions (Prohibition) Amendment Act, 2016, infrastructure status to affordable housing projects, demonetization, relaxation of norms to encourage Real Estate Investment Trust (REIT) listings, and the Goods and Services Tax (GST). These reforms collectively set a new order, changed perceptions and led to a reduction of the associated risk premiums. This was reflected in the investments in real estate which has been on an upswing after 2014.
• The Indian real estate sector has attracted over USD 45 billion of private equity capital in the last decade from the start of 2011 till date. About 80% of this amount was invested over the past five years, i.e. 2015–19 when the reforms started coming in.

• The PE investments in real estate peaked at USD 8.8 billion (bn) in 2018 which had been the best year for real estate in the previous decade. In 2019, the investments declined by 23% YoY to USD 6.8 bn. This decline is primarily attributable to the decline in investments in residential and office. While the residential sector has been passing through tumultuous times, dearth of mature assets has led to a decline in investments in office.

• In 2020 (YTD), the investor activity dropped sharply with only 5 deals getting concluded, adding up to a meagre USD 238 million and dropping by 93% YoY compared to USD 3.4 billion during same time period last year. The drop can be attributed to both the COVID-19 pandemic which impacted investor sentiments as well as the slowdown of the Indian economy in 2019.

• The COVID-19 outbreak started in Wuhan in China during November 2019 and started spreading first within China and then to other countries. Many investors who had invested in China took a big hit on their real estate portfolio as their tenants started demanding rent free periods and other concessions to mitigate the COVID-19 impact. While the COVID-19 induced lockdown in India started towards the end of Q1 2020 (March 25th onwards), investors expected a similar scenario to play out in India and preferred to go on a wait-and-watch mode.

• Private equity (PE) by virtue, is risk capital, which is generally invested in purchasing equity of a company or a project in order to make the maximum returns from the upside. In India, however, PE has been scouting for relatively risk-free opportunities like rent-yielding commercial assets, where the development and occupancy risks are largely mitigated. Hence, since 2015, the investors took up equity positions in rent yielding commercial assets (office, retail and warehousing) and their share in overall investments zoomed from 2011 to 2019 (refer chart 2) as compared to residential which involved greater risk.
Due to low investor appetite to undertake development risk, the share of residential in the overall investment pie has consistently shrunk, from 60% in 2011 to 57% in 2015 to 11% in 2019. Office, Retail and Warehousing have witnessed significant growth in investor interest and activity in the same period.

Source: Knight Frank Research, Venture intelligence

Note: YTD 2020 represents investments till 31st May 2020
Outlook

for near term (next 12 months)

Currently, there is a lot of uncertainty regarding how COVID-19 will impact business and economy. It is not known how long the virus will last or if there will be a second wave, how much time it will take to develop an effective vaccine, what will be the loss in economic activity, etc.

India has enforced one of the most stringent lockdown measures globally to combat the virus outbreak. This makes the uncertainty in case of India even higher.

For PE, the flow of capital is not confined to any particular border and money chases the asset class/country offering the highest risk-adjusted returns globally. The world economy is expected to plunge into recession in 2020 and this will lead to a sharp drop in valuations. This drop would entice investors to scout for opportunities in their home country and other developed nations over emerging markets. As investing in their home country does not entail any currency risk, they would prefer it to investing elsewhere. Further, the sovereign funds and pension funds, which were actively invested in India in recent years may face pressure from their sponsors to return the capital which has not been deployed. The sponsors want to use this money to give stimulus and for bailouts. Given this backdrop, the private equity activity in Indian real estate is likely to be subdued in 2020.
During the early years of the previous decade, the residential sector was the preferred destination of PE investments. At that time, the residential segment was witnessing a strong sales momentum and prices were appreciating every year, as demand exceeded supply. However, the tide started to turn towards the end of 2014 as the residential sales started to decline and prices became stagnant, starting to correct in subsequent periods. As the decade progressed, problems and flaws in the residential development business became apparent. The reforms which the Government implemented since 2014, exacerbated the crisis for developers forcing several of them to quit the industry altogether. The last nail in the coffin for the sector was the liquidity crisis in the NBFC sector which started with the default of IL&FS in September 2018. The decline in PE investments in residential in the later years of the previous decade can be seen as a direct consequence of these events (chart 4).
INVESTMENTS IN REAL ESTATE

• Residential prices have been stagnant for several years now and have even corrected at certain locations. However, the cost of input for developers has not corrected to the same extent, and has, in fact, increased for many items. Land prices are yet to correct; the cost of labour, cement and steel have gone up; the construction charges and approval costs have also increased over the years. On the other hand, the sales velocity has come down significantly compared to the heydays of the earlier period. This has significantly dented the profit margins of developers and lowered the Internal Rate of Return (IRR) from residential projects. The removal of Input Tax Credit (ITC) for input items in the GST regime has reduced the developer margins even further. On account of all these factors, investors have refrained from investing in residential projects.

• During YTD 2020, there was only one PE investment in the residential sector worth USD 40 million. The investments in 2020 witnessed a 91% YoY drop compared to USD 469 million during same time period last year. The residential sector has been plagued by the above set of challenges for several years now, and COVID-19 pandemic will act as another nail in the coffin. The lockdown induced by COVID-19 is likely to lead to pay cuts, job losses, bankruptcies, slowdown in GDP growth in India, and recession in several countries. This will impact homebuyer sentiments adversely and considerably slow down the already low sales velocity. Thus, the residential sector will find it more challenging to attract private equity capital.

• Traditionally, the PE funding route in residential was via entity-level equity as well as project-level equity. However, during the last decade, a number of projects got stuck due to the flawed business models of developers. Investors who had taken up equity in such projects burnt their fingers terribly and there was no reprieve from their anguish. Many investors were not able to recover their initial investment, leave alone record any gains. These instances forced the PE investors to shun the risk associated with investing equity in development projects and instead in recent years, pushed them to invest via debt or structured debt instruments for residential (refer chart 5).
Transformation in how NBFCs lend to residential real estate

The NBFC crisis has cast a long shadow on the Indian real estate sector, particularly on the residential segments as they were heavily reliant on NBFCs for their funding requirements. Very few NBFCs are presently lending to real estate and the large ones are almost out of the market. In such a scenario, we are witnessing a drastic change in the way that they are lending to real estate.

- **Thinking inside the box**

  There are a few NBFCs that are still willing to lend to real estate. However, the risk appetite which was witnessed earlier in the pre-IL&FS days has entirely vanished. The covenants have become more stringent and they are willing to lend only to smaller projects with disbursements not exceeding INR 300 - 500 million, provided the track record of the developer is good. The rationale is to minimize exposure to a particular project and to make it easier for the lenders to dictate terms to the developer. Further, the earlier mistake of – the same lender financing project construction as well as the home buyer - is not being repeated.

- **Mega launches no longer possible**

  There are very few lenders left in the market who have the ability to write large cheques. The ones who are still capable, are not willing to take that risk. This is forcing developers to divide their projects in multiple phases. Further, if a particular phase has not achieved a good sales position, then the funding for the next phase is put on hold. This has forced developers to alter their business models and focus more on getting their product right.

- **No or limited refinancing opportunities**

  Earlier, NBFCs engaged in refinancing loans and other obligations of developers. This had helped the developers stay afloat in recent years of slow sales velocity, particularly when sales had slowed down considerably. Now the refinancing opportunities by NBFCs have almost dried up making it harder for developers to survive this carnage.

  While this was the situation of NBFCs before the COVID-19 induced lockdown, post the lockdown, the NBFCs themselves will struggle to survive. RBI, in its March 26, 2020 directive, had asked all financial institutions to offer a 3 month moratorium on all term loans. Later the moratorium was again extended by RBI for 3 months ending August 31st. Following this directive, banks and NBFCs started offering moratorium to their customers. Many NBFCs had borrowed from banks for their funding requirements, but banks were reluctant to extend the same to their NBFC borrowers. This caused cash flow problems for many NBFCs. Despite the Supreme Court’s order to the banking regulator to ensure that all borrowers get the moratorium benefit, the RBI has left the decision to extend moratorium to particular NBFCs at the discretion of banks. The banks’ decisions are based on the NBFCs credit and liquidity profiles.

  To help NBFCs tide over the cash flow issues, RBI announced on April 17, 2020 a 3 year special INR 500 billion Targeted Long Term Repo (TLTRO) window for banks to lend to NBFCs and Micro Finance Institutions (MFIs). However, the first tranche of INR 250 billion auction by RBI received a tepid response from banks with only INR 128 billion or a little over 50% being subscribed. Banks are associating higher risks with NBFCs and the larger part of the INR 128 billion was loaned to top rated NBFCs with strong parental backing (generally a diversified conglomerate). This special financing window provided by RBI has failed to enthuse the NBFC sector and their concerns have remained unaddressed.

  The finance minister has announced an INR 750 billion special funding window for NBFCs of which INR 300 billion would be through investments in debt papers issues by NBFCs in primary and secondary markets and the other INR 450 billion was in the form of partial credit guarantee scheme. This will help NBFC to solve their short term liquidity problem and also bring down the cost of funds for them. However, more measures need to be undertaken to ensure this liquidity infusion reaches real estate sector.
INVESTMENTS IN REAL ESTATE

Outlook

for near term (next 12 months)

The residential sales had already slowed down compared to its heydays, and the demand from homebuyers is expected to dwindle further in 2020. The lockdown is expected to have a devastating effect on the economy with associated pay cuts, job losses and businesses closing down becoming the new order of the day. This will significantly dent homebuyer sentiments. When individuals are not sure about their future stream of income and job situation, the tenacity to make to a big ticket purchase like real estate which involves a long term commitment goes down. Thus, residential sales velocity will slow down significantly in the near term and the recovery in residential segment which has not happened in the past 4 years will get further delayed.

While this is the situation on the demand side, the challenges on the supply side are complex. The residential segment has already started witnessing consolidation, with the non-serious and over-leveraged developers going out of business. This trend is likely to continue as the policy changes have altered the structure of the industry to such an extent that it is impossible to carry out the residential business the way it was done earlier. The NBFC crisis which has left a deep lacuna in real estate funding, is further accentuating this shift.

Earlier, PE for developers came in at the land stage, the NBFCs came in at the approvals stage and the banks came in at the construction stage. Further, in the pre-RERA days, customer advances also acted as a source of finance for all these 3 stages. However, things have changed now as RERA has made it impossible for customer advances to come in before the approval stage. PE funds are not keen on residential and are focusing on the commercial segments, NBFCs do not have the requisite capital to lend to real estate and even if banks are willing to lend to real estate, by regulation they cannot come in before the construction stage. Hence, this gap which was earlier filled in by PE, NBFC and customer advances, now needs to be financed by the developers’ own equity. Very few developers have such deep pockets and going forward, it is the developers with strong balance sheets and who are willing to put in their own equity, are the ones who would be able to carry out this business. Many residential developers will start monetizing their land parcels and rent yielding assets in 2020 to build cash reserves and to strengthen their balance sheets and repay existing obligations. However, the 6 month moratorium extended by RBI would give them some reprieve till August.
The Indian office market has been on a bull run in recent times with leasing volumes touching a new high each year since 2016 driven by demand from the BFSI, Information Technology (IT) and Co-working sectors. The performance of office has been in stark contrast to that of residential in the same period. The primary reason for this is the balanced demand-supply equilibrium in the Indian office market. 2019 was a milestone year for the Indian office market with the All-India office transaction activity reaching a historic high of 60.6 mn sq ft (5.6 mn sq m). The PE investors have taken cognizance of the strong fundamentals of the Indian office market and have invested over USD 13.6 billion as equity investment in the last decade, with a large quantum of USD 9.2 billion (68%) coming in over the last 3 years (refer chart 6).
After rising from 4 consecutive years, the PE investments in office asset declined in 2019. This decline was on account of the dearth of mature office assets. The lack of mature assets is forcing investors to look at opportunities in under-construction assets and greenfield developments which garnered 10% and 13% of the investments respectively (refer chart 7).

The situation took an adverse turn in the first 5 months of 2020 with only 2 deals concluding amounting to USD 141 million. The investments reported a drop of 81% YoY compared to USD 757 million invested during same time period last year. The slowdown in investor activity can be attributed to the COVID-19 impact. The global recession forecasted for 2020 due to COVID-19 is expected to affect the demand for office space in near-term. Investors are waiting for the dust to settle before making any new purchase.
**Strong fundamentals of Indian office market**

In the short-term, investors would prefer to wait till the pandemic comes under control and would also look to gauge the impact of forecasted recession on office space demand in 2020 before investing. However, these factors would not undermine the strong fundamentals of Indian office market for long due to the following reasons:

- The Indian IT ecosystem has evolved over the last decade from providing traditional coding services to providing new age services like Artificial Intelligence (AI), machine learning and data analytics. Such services command a premium and are more remunerative, thereby increasing the rent paying ability of IT companies. While the BFSI industry within India has been growing at a considerable pace, it is the demand from global BFSI companies for their offshore centers or Knowledge/Business Process Outsourcing (KPO/BPO) units aka Global In-house Centres (GICs) that is majorly driving demand for office space in the BFSI segments. The depreciation of rupee will further aid this cause and stimulate the shift of more such offshoring units to India which would boost the office demand.

- As per Nasscom study in 2017, there are around 1,100 GICs in India and their numbers have just grown over the years. The availability of vast talent in India in the fields of Science, Technology, Engineering and Mathematics (STEM) and the cost arbitrage makes India one of the most attractive destinations for companies in the BFSI and IT sectors. In addition to this, the emergence of co-working as a major occupier segment has given a fillip to the overall demand for office space in the recent years.

- Some of the Indian cities have stepped up and stolen the limelight from other cities in the Asia-Pacific (APAC) region. 6 out of the top 8 Indian cities feature in the top 10 markets in terms of annual leasing transaction volumes in the APAC region (refer table) in 2019. Bengaluru and Hyderabad were the second and third largest office markets in APAC region in terms of office leasing transactions in 2019 followed by Mumbai and NCR, and feature ahead of cities such as Beijing, Shanghai, Singapore, Jakarta and several others in the APAC region. The low vacancy rates in these cities coupled with the double digit rental growth has further allured investors.
### Table 1: Six Indian cities feature in top 10 cities in Asia Pacific (APAC) region based on annual transaction volumes in 2019

<table>
<thead>
<tr>
<th>Rank</th>
<th>City</th>
<th>Office leasing transactions in 2019 (mn sq ft)</th>
<th>Office stock (mn sq ft)</th>
<th>Vacancy (mn sq ft)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Tokyo</td>
<td>81.0</td>
<td>287</td>
<td>0.6%</td>
</tr>
<tr>
<td>2</td>
<td>Bengaluru</td>
<td>15.3</td>
<td>165</td>
<td>4.8%</td>
</tr>
<tr>
<td>3</td>
<td>Hyderabad</td>
<td>12.8</td>
<td>75</td>
<td>7.0%</td>
</tr>
<tr>
<td>4</td>
<td>Mumbai</td>
<td>9.7</td>
<td>146</td>
<td>17.5%</td>
</tr>
<tr>
<td>5</td>
<td>NCR</td>
<td>8.6</td>
<td>166</td>
<td>17.1%</td>
</tr>
<tr>
<td>6</td>
<td>Beijing</td>
<td>6.8</td>
<td>113</td>
<td>10.1%</td>
</tr>
<tr>
<td>7</td>
<td>Pune</td>
<td>6.2</td>
<td>73</td>
<td>4.2%</td>
</tr>
<tr>
<td>8</td>
<td>Chennai</td>
<td>5.2</td>
<td>73</td>
<td>8.8%</td>
</tr>
<tr>
<td>9</td>
<td>Guangzhou</td>
<td>3.0</td>
<td>63</td>
<td>8.4%</td>
</tr>
<tr>
<td>10</td>
<td>Kuala Lumpur</td>
<td>2.0</td>
<td>93</td>
<td>22.0%</td>
</tr>
</tbody>
</table>

Source: Knight Frank Research, Venture intelligence
Threat of work from home

A serious threat that has emerged to the long term demand for office space is the concept of work from home (WFH). While WFH has been around for several years now, in India, the adoption rate was low. It is a first that companies in India have allowed most of their employees to work from home for a period extending over 40-55 days due to the COVID-19 induced lockdown. Many companies have realized the benefits of working from home and the corresponding savings in real estate and other associated costs for them as well as their employees. One of India’s leading IT company intends to have 75% of its staff working from home in the next 5 years. However, it is easier said than done and the thinking may change post the lockdown. The biggest hindrance that is emerging is the Global Data Protection Rules (GDPR), which most countries are drafting, while a few have already been enacted. These rules give paramount importance to data and penalize any misuse heavily. The rules lay out stringent guidelines with regard to the location where the data can be stored and how it can be used. Till now, only the financial/critical data of companies were handled with such sensitivity. The GDPR puts many categories of data collected in the normal course of business in this sensitive category and mandates it to be managed in the same way as financial/critical data.

The off-shore units (KPO/BPO)/back-offices of global companies located in India would have to handle all the data coming from its onshore units carefully, or else their parent company would be liable to pay hefty fines in their home countries running into several millions dollars. As a result, these companies would be reluctant to allow their employees working from home fearing the possibility of breach or theft. A few other obstacles to work from home in India are - low internet speed, lack of reliable 24-hour electricity supply besides congested homes with many people sharing an apartment which does not or rather cannot provide an undisturbed environment for work thereby reducing productivity.
INVESTMENTS IN REAL ESTATE

Table 2: 190.6 mn sq ft of office space transacted in the last decade of which 33 mn sq ft was a part of India’s first REIT

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Area of the assets transacted (sq. ft.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>5,795,000</td>
</tr>
<tr>
<td>2012</td>
<td>18,870,000</td>
</tr>
<tr>
<td>2013</td>
<td>11,635,000</td>
</tr>
<tr>
<td>2014</td>
<td>5,580,000</td>
</tr>
<tr>
<td>2015</td>
<td>5,813,000</td>
</tr>
<tr>
<td>2016</td>
<td>13,500,000</td>
</tr>
<tr>
<td>2017</td>
<td>56,700,000</td>
</tr>
<tr>
<td>2018</td>
<td>36,135,000</td>
</tr>
<tr>
<td>2019</td>
<td>33,650,000</td>
</tr>
<tr>
<td>YTD 2020</td>
<td>2,900,000</td>
</tr>
</tbody>
</table>

Grand Total: 190,578,000

Source: Knight Frank Research, Venture intelligence
Note: YTD 2020 represents investments till 31st May 2020

Table 3: City wise investments: Mumbai takes the largest quantum of investments since 2011

<table>
<thead>
<tr>
<th>City</th>
<th>Amount invested (USD mn)</th>
<th>Number of deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mumbai</td>
<td>5,015</td>
<td>19</td>
</tr>
<tr>
<td>NCR</td>
<td>2,803</td>
<td>15</td>
</tr>
<tr>
<td>Hyderabad</td>
<td>2,010</td>
<td>12</td>
</tr>
<tr>
<td>Bengaluru</td>
<td>1,744</td>
<td>10</td>
</tr>
<tr>
<td>Chennai</td>
<td>1,118</td>
<td>9</td>
</tr>
<tr>
<td>Pune</td>
<td>936</td>
<td>10</td>
</tr>
<tr>
<td>Others</td>
<td>67</td>
<td>1</td>
</tr>
</tbody>
</table>

Grand Total: 13,694 76

Source: Knight Frank Research, Venture intelligence

Chart 8: PE funds are the most active in this space followed by SWF and pension funds

Share in investment

- **83%** PE
- **13%** Sovereign / Pension Fund
- **4%** Developer

Source: Knight Frank Research, Venture intelligence
• Cap rates have come down considerably over the previous decade i.e. between 2011 and 2019 (refer table 6) due to several factors such as reduction in interest rates globally as well as in India, reduction in country risk premium for India, reduction in risk premium associated with office investment, strong rental growth and strong investor demand coupled with low availability of good quality mature assets.

• The Indian rupee has depreciated from INR 45 to a dollar to INR 75 levels in the last decade (from Jan 2011 till date). The rental growth in office assets and the cap rate compression in the same period has made up sufficiently for the losses incurred by investors due to depreciation in rupee.

• The COVID-19 pandemic has forced central banks across the globe to cut their interest rates significantly and many developed nations have brought them close to near zero levels to stimulate their economy. The RBI has followed suit and reduced its repo rates to a historic low of 4%. In an ideal scenario, this should lead to further cap rate compression. However, the risk premiums associated with India and the office asset class have gone up due to the COVID-19 pandemic. Investors are factoring in risks in the form of deferment of rentals and lower rental growth going forward, in their financial models. This would lead to expansion in cap rates in 2020. Further, the yield on G-sec has not contracted much despite the cut in policy rates, which indicates that markets are expecting the Government to borrow more to make up for the subdued tax collections. This would put upwards pressure on cap rates and keep it elevated.
The demand-supply equilibrium for office markets across India has been balanced and the scale was tilted more in the favour of asset owners. However in 2019, for the first time in 6 years, office supply across the top 8 markets exceeded demand.

The recent years of outperformance of office as an asset class has encouraged developers and investors to construct new office buildings. While in the short term, supply is expected to remain in deficit, a huge amount of office supply is expected to hit the top cities in the next 3-5 years. The lockdown will push this supply back by 12 to 18 months. Developers would also go slow on completing these projects anticipating lower occupier demand and increase in input cost due to lockdown induced disruptions. While a supply glut which led to the bubble like situation we witnessed in 2008 may not repeat, this upcoming supply had started acting as headwinds to rental growth and the rental growth tapered down in most markets in 2019.

Even though India continues to remain an attractive destination globally for companies to have their offices in, the prevailing business uncertainty and any event of recession forecasted in the upcoming quarters of 2020 will reduce overall demand and impede expansion plans of occupiers. Occupiers will resist any hike in rentals and look to renegotiate existing/expiring leases. As asset owners are cognizant of the supply building up in office, they would be amenable to negotiate at lower rentals for long term leases. Hence, the cycle of strong rental growth which we had witnessed over the last 3-4 years will taper down or even stagnate, impacting valuations.

The pandemic induced recession will lead to a significant drop in asset valuations across the globe. Investors are likely to get ample opportunities in their home country and such opportunities do not entail any exposure to currency risks. On account of all the above factors, in the near term, investors are likely to slow down their investments in office assets in India and the cap rates would expand from 2019 levels.

**Outlook**

**for near term (next 12 months)**

The demand-supply equilibrium for office markets across India has been balanced and the scale was tilted more in the favour of asset owners. However in 2019, for the first time in 6 years, office supply across the top 8 markets exceeded demand.

The recent years of outperformance of office as an asset class has encouraged developers and investors to construct new office buildings. While in the short term, supply is expected to remain in deficit, a huge amount of office supply is expected to hit the top cities in the next 3-5 years. The lockdown will push this supply back by 12 to 18 months. Developers would also go slow on completing these projects anticipating lower occupier demand and increase in input cost due to lockdown induced disruptions. While a supply glut which led to the bubble like situation we witnessed in 2008 may not repeat, this upcoming supply had started acting as headwinds to rental growth and the rental growth tapered down in most markets in 2019.

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The past decade has seen failure of a large number of malls across the country. The major reasons for this include strata sales by developers, poor planning with respect to design, smaller (non-optimal) size of malls, improper location selection, narrow access roads, inaccurate demand forecasting, shrinkage in catchments, advent of e-commerce and in most cases oversupply of retail spaces in the same locality. Due to oversupply of malls, the malls that were doing well initially started to suffer. A large number of instances of failure made investors shift their focus away from malls. Even developers shelved plans to build malls and the land acquired for constructing malls were either kept idle or were used for residential or office constructions.
With a large number of malls going out of business coupled with no new supply, the malls which survived and could transform as per the need of the hour started commanding a premium. Occupiers/retailers lined up to take up space in those assets. For the malls which started doing well, the revenue sharing agreements became more and more valuable. The owners were able to achieve rental growth higher than what they would achieve in the case of standard rent appreciation clauses (15% every three years) in rental agreement of office assets. This helped allure investors.

The COVID-19 pandemic has led to a temporary shutdown of malls all over the country and put tenants as well as developers in a precarious situation, but the long term growth story for malls is not over yet. Once a vaccine or a solution for the pandemic is available to the masses, there is significant potential for mall revenues to grow due to a dearth in supply of good quality successful malls, rising consumer demand, increasing levels of disposable income, India’s growth potential and demographics, besides the ongoing structural changes taking shape in select malls to accommodate new anchors and entertainment options in order to remain relevant in the face of competition from online retail.

Investors have spent over USD 2.5 billion in the previous decade to acquire retail assets. As the supply of successful Grade-A malls in India is low, many new, retail-focused investment platforms have also been created like the CPPIB-Phoenix Mills, Warburg Pincus-Runwal, etc. which have the mandate to construct new malls as well acquire retail assets.

- For a considerable amount of time post the Global Financial Crisis (GFC), a large number of malls in India struggled and some of them went out of business. Several retail assets though, were thriving and undergoing transformation to become modern day entertainment hubs. It was not clear as to which malls would undergo the transformation successfully. Thus, there was a considerable lull in transaction of retail assets between 2011 and 2015 and investors at the time became interested in acquiring rent-yielding, good quality office assets.

- The investor activity went on an upswing since 2016, and 2019 was a historic year for PE investments in retail with investments touching an unprecedented high of USD 922 million.

- In 2020(YTD) there were no investment deals in retail space. During same time period last year, the sector had witnessed investments worth USD 397 million. Investors anticipated malls in India to temporarily shut down to combat the COVID-19 crisis, similar to what happened in China. In China, tenants had started demanding rent free periods and other concessions to compensate for the shutdown. Investors expect a similar scenario to pan out in India as well.

- Many tenants in India have invoked ‘force majeure’ clause in their rental agreements and demanded exemption from payment of rents during the lockdown period. Further, the tenants are demanding a complete switch to revenue share agreements for payment of rent instead of minimum rent plus revenue share, as they fear that it will take time for things to revert to normal once the lockdown ends. The fear of contracting COVID-19 and the low propensity to spend (due to job losses and recession) may keep the footfalls low even after the lockdown is lifted. Thus, investors are reluctant to commit to retail assets.

**Chart 10:**
**PE investments in retail**

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount invested (USD mn)</th>
<th>Number of deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>2012</td>
<td>28</td>
<td>1</td>
</tr>
<tr>
<td>2013</td>
<td>37</td>
<td>1</td>
</tr>
<tr>
<td>2014</td>
<td>5</td>
<td>5</td>
</tr>
<tr>
<td>2015</td>
<td>652</td>
<td>5</td>
</tr>
<tr>
<td>2016</td>
<td>545</td>
<td>5</td>
</tr>
<tr>
<td>2017</td>
<td>388</td>
<td>5</td>
</tr>
<tr>
<td>2018</td>
<td>6</td>
<td>6</td>
</tr>
<tr>
<td>2019</td>
<td>922</td>
<td>0</td>
</tr>
<tr>
<td>YTD 2020</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Knight Frank Research, Venture Intelligence
Note: YTD 2020 represents investments till 31st May 2020
### Table 7
26.6 mn sq ft of retail assets were transacted in the last decade

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Area of the assets transacted (sq. ft.)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>-</td>
</tr>
<tr>
<td>2012</td>
<td>924,000</td>
</tr>
<tr>
<td>2013</td>
<td>-</td>
</tr>
<tr>
<td>2014</td>
<td>-</td>
</tr>
<tr>
<td>2015</td>
<td>1,200,000</td>
</tr>
<tr>
<td>2016</td>
<td>4,720,000</td>
</tr>
<tr>
<td>2017</td>
<td>6,040,000</td>
</tr>
<tr>
<td>2018</td>
<td>4,925,000</td>
</tr>
<tr>
<td>2019</td>
<td>8,850,000</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>26,659,000</strong></td>
</tr>
</tbody>
</table>

Source: Knight Frank Research, Venture intelligence

### Table 8
Unlike office assets, investor interest in retail goes beyond major metros

<table>
<thead>
<tr>
<th>City</th>
<th>Amount invested (USD mn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mumbai</td>
<td>951</td>
</tr>
<tr>
<td>Pune</td>
<td>434</td>
</tr>
<tr>
<td>Chandigarh</td>
<td>267</td>
</tr>
<tr>
<td>Hyderabad</td>
<td>197</td>
</tr>
<tr>
<td>NCR</td>
<td>143</td>
</tr>
<tr>
<td>Ahmedabad</td>
<td>123</td>
</tr>
<tr>
<td>Lucknow</td>
<td>115</td>
</tr>
<tr>
<td>Chennai</td>
<td>106</td>
</tr>
<tr>
<td>Nagpur, Amritsar</td>
<td>100</td>
</tr>
<tr>
<td>Indore</td>
<td>61</td>
</tr>
<tr>
<td>Bhubaneshwar</td>
<td>46</td>
</tr>
<tr>
<td>Bengaluru</td>
<td>28</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>2,572</strong></td>
</tr>
</tbody>
</table>

Source: Knight Frank Research, Venture intelligence

Note: Grand total represents investments since 2011

### Chart 11
Incorrigible defunct malls and low per capita quality mall space make a strong case for greenfield investments

- 50% Ready
- 32% New Development
- 18% Under-construction

Source: Knight Frank Research, Venture intelligence
• In the top cities of India like Mumbai, NCR, Bengaluru and Pune, there can be multiple malls within the city which can do well simultaneously, as the population density is high and the catchment area of each mall is smaller. However, in the tier-II and tier-III cities of India, only one or a limited number of malls can do well simultaneously, as the population density is lower and the catchment expanse for each mall is vast. Evidence suggests that generally, in the tier-II and tier-III cities, the biggest mall of the city, if managed well, is generally the best performing mall. In some cases, these evolve into destination malls. Moreover, it is easy to identify the best performing mall in smaller cities compared to the top metros. Thus, investors who have ventured into tier II and tier III cities of India have gone for the biggest and the best performing asset of that city. As a result, unlike office assets, investor interest goes beyond major metros.

Mall ownership in India is getting institutionalized

Compared to office buildings, good performing retail assets are few and far between. A majority of these assets are now owned by funds and institutions. The retail investment platforms which are constructing new malls would again come under the ownership of institutions.

A handful of developers, who are not over-leveraged, have been able to hold on to their prized assets till date, but if COVID-19 causes a significant slowdown in real estate, very soon even those are likely to be put on the block and they would come under institutional ownership.

For customers, institutional ownership would provide better mall experience as these funds have global assets in their portfolio. They would bring the best practices adopted globally to India to maximize footfalls and their revenue potential. Over the next few years, the shopping malls are likely to transform into an entertainment destination that has everything under one roof. In certain malls, one can witness such transformation already taking place.

![Chart 12: Investor origin](source: Knight Frank Research)

Note: Grand total represents investments since 2011
Despite the fact that the complexity of operating a retail asset is higher compared to an office asset as retail assets need involvement in day-to-day management, the investors were still chasing prime retail assets. The higher rental growth on account of minimum guarantee plus revenue share helped the investors ensured that they transact the assets at a lower cap rate than office in the corresponding period.

While this was the scenario till 2019, things have changed post COVID-19. Occupier would demand for pure revenue share arrangements instead of minimum guarantee plus revenue share. Investors are now associating much greater risk with retail assets compared to office and accounting for longer periods of no rentals or lower rentals in their financial models in the near term on account of pure revenue share arrangements. Further, retail would be the last to recover as customer spends at malls would be lower on account of job losses and pay cuts. This would lead to significant expansion of cap rates for retail assets and take it much higher than office.

**Outlook**

**for near term (next 12 months)**

2020 looks to be a bleak year for the retail segment and we may not witness much investor activity over the next 12 months. The low national economic growth due to COVID-19, associated job losses coupled with global recession would adversely impact consumer sentiments and hit retail demand hard. Post lockdown, malls may have to limit entry of people to maintain sufficient social distancing and there may be long queues to get in. This restriction and the fear of contracting the virus is likely to keep people from visiting malls and opt for e-commerce instead. Some segment of retail shopping would also shift to online permanently.

Going forward, the tenants will negotiate harder and push for complete revenue share instead of the current minimum rent plus revenue share, citing loss of business due to closure during lockdown and lower footfalls post lockdown. This move by tenants will adversely impact developers and funds who had raised finance through Lease Rental Discounting (LRD). They will have to enhance collateral on these credit lines in the wake of reduced mall valuations.

The cap rates for retail will expand and go higher than office which is contrary to what was happening in the recent years. Investors investing today would have to account for a period of no or lower rentals for the next few months till a vaccine or a credible solution for COVID-19 emerges.
PE INVESTMENTS IN WAREHOUSING

The warehousing industry in India is undergoing an unprecedented transformation from a mere provider of storage space within four walls into a modern day warehousing hub similar to the ones in developed countries. A majority of warehousing operations in India are being handled by small and fragmented unorganized players, which adds to the logistics and warehousing cost. The share of large organized players is small but growing rapidly.

Over the past few years, there has already been a gradual transition in the mindset of occupiers to use the services offered by organized segments. This change in mindset was further accentuated with the implementation of GST.
A plethora of factors are driving this wave of change, such as:

- Requirement of stringent quality controls from compliance regulators (in case of the pharmaceutical industry),
- stringent enforcement of penalties on non-compliant warehousing facilities by local authorities,
- economies of scale being achieved through larger warehouses,
- safety and security of goods, efficiency in operations,
- demand for quicker turnarounds,
- need for efficient warehousing designs,
- advent of e-commerce, and
- the entry of multinational businesses in the country that prefer to occupy only complaint facilities.

Citing this potential, PE investors invested over USD 7.3 billion in warehousing industry in the previous decade with 77% of the investments going towards creating new assets. Of this investments worth USD 5.6 billion which went into new development is expected to create over 300 mn sq ft of warehousing space.

The COVID-19 induced lockdown has slowed down the leasing activity in warehousing segments. However, new trends have emerged which can give a significant fillip to the demand for warehousing space and make it attractive for investors.

- To drive the growth of the warehousing industry, the government implemented reforms such as GST and granting infrastructure status to the logistics industry including warehousing. Investors started taking cognizance of the opportunities that were emerging in this sector. Consequently, the warehousing industry has witnessed strong inflow of investments since 2016. However, in 2020(YTD) the investment volumes declined on account of the COVID-19 induced lock down and the slowdown in the Indian economy. The investments worth USD 57 million during the first 5 months of 2020 is negligible compared to the investment of USD 1.5 billion during the same time period last year.
**Investors from Singapore and UAE invest the most**

<table>
<thead>
<tr>
<th>Country</th>
<th>Amount Invested (USD mn)</th>
<th>Number of Deals</th>
</tr>
</thead>
<tbody>
<tr>
<td>Singapore</td>
<td>1,734</td>
<td>8</td>
</tr>
<tr>
<td>UAE</td>
<td>1,600</td>
<td>2</td>
</tr>
<tr>
<td>India</td>
<td>814</td>
<td>8</td>
</tr>
<tr>
<td>Canada</td>
<td>900</td>
<td>2</td>
</tr>
<tr>
<td>France</td>
<td>150</td>
<td>1</td>
</tr>
<tr>
<td>China</td>
<td>100</td>
<td>1</td>
</tr>
<tr>
<td>Germany</td>
<td>1,000</td>
<td>1</td>
</tr>
<tr>
<td>US</td>
<td>996</td>
<td>7</td>
</tr>
</tbody>
</table>

**Table 10:**

<table>
<thead>
<tr>
<th>Year</th>
<th>Cap rates for select good quality rent yielding retail assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>13 – 15%</td>
</tr>
<tr>
<td>2019</td>
<td>8.5-9.5%</td>
</tr>
</tbody>
</table>

**Chart:**

There are not many mature warehousing assets available in India as compared to office and retail assets. The high cap rates in 2011 was on account of low investor interest, dearth of mature good quality assets, unorganized structure of the industry, poor demand to use the services offered by the organized segments and lack of impetus from policymakers to support the growth of the industry. However, as the years progressed things started to fall in place and the cap rates compressed.

Investors expect the warehousing industry to emerge stronger from the COVID-19 crisis globally and expect it to outperform other asset classes in real estate in the near term. They are expecting similar trend to play out in India. Thus, despite increase in country risk premium for India, greater investor interest would keep the cap rates stable at current levels for the warehousing industry in 2020.
Outlook

for near term (next 12 months)

The forecasted slowdown of India’s GDP in 2020 due to the COVID-19 induced lockdown will affect businesses across the board and reduce their aggregate demand for warehouses. However, certain new trends are likely to emerge which will drive warehousing growth in the coming years.

- **Time to stock up over being on time**

  The COVID-19 induced lockdown of China has jolted manufacturing chains across the globe and caused significant challenges to companies employing just-in-time (JIT) system for inventory management. Going forward, companies would prefer keeping higher inventories over JIT, thereby increasing the demand for warehousing space.

- **E-commerce to spread its wings wider**

  E-commerce segments catering to grocery and daily essentials have seen a spurt in retail demand owing to the COVID-19 induced lockdown of malls and retail spaces. For standardized products like electronics, the common fear amongst consumers of buying a product from an e-commerce website vs purchasing offline, has reduced over the years. However, for groceries, given the perishable nature of items and quality of product not being standardized, many resisted ordering online. Once the lockdown ends, people may not venture out for grocery shopping at malls due to the fear of contracting COVID-19 in public spaces and also because of the convenience e-commerce offers. Even malls may limit entry of people to maintain social distancing. Thus, this lockdown may bring about a behavioral change and increase the acceptability of buying groceries and daily essentials online. Some of the big organized retailers have identified this trend and have started strengthening their e-commerce and home delivery infrastructure which was not their focus earlier. Such a shift, would give a significant fillip to the premise of warehousing industry.

- **Multistorey warehousing, next frontier:**

  With e-commerce becoming pervasive, the concept of multistorey warehouses is slowly gaining traction in densely populated and landlocked cities. However, due to high cost of land in cities, it is very difficult to get the model right and the resultant high rentals are a major deterrent to occupiers.

  When the e-commerce wave started in India, companies used to take a week or two to deliver orders. As the competition increased and sector started growing, companies started to use next day or two day delivery as the differentiating factor. As the competition intensifies, the next set of differentiating factor would be same day delivery or delivery within hours of placing the order. For offering these kind of delivery timelines, companies would need to have a warehouse or large fulfilment centres inside the city and would become amenable to bear higher rentals associated with such facilities. Moreover, the warehousing operators having warehousing parks outside city limits would offer the multistorey facility as a part of the overall warehousing package to differentiate their services. Thus, we are likely to witness an entirely new asset segment emerging within the warehousing industry.

- **Moving out of China**

  Warehousing industry is also likely to benefit from the shift in manufacturing units outside China. While there are 5-6 countries which are competing directly with India to attract these industries, each country has its own set of advantages and challenges. However, even if 1/6th of them come to India, the gains for the nation and warehousing sector would be immense.

  In the short-term the investment activity may remain subdued; however, as the dust of the pandemic starts settling and as these emerging trends start to unfold, investors would return to the warehousing sector with renewed vigour. The greater investor interest would keep cap rates in warehousing stable in the near term.
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