Research

Investments in Real Estate

Trends in private equity investment (Q3 2020 update)

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CONTENTS

SECTION

1

PSU REIT BY GOVERNMENT OF INDIA : AN OPPORTUNITY TO RAISE OVER INR 1.2 TRILLION

1.1 Introduction

The COVID-19 pandemic has affected businesses across the board and left them struggling in search for capital to survive this crisis. Not just the private sector, the business of Public Sector Units (PSUs) in India have also been adversely affected.

Given the already stretched finances, the Government will have to look beyond the traditional means for sourcing capital for our PSUs.

1.2 PSUs need equity capital to survive this crisis

The public sector banks need capital for making provisions towards new NPAs and writing-off bad debts caused by the pandemic. The Financial Stability Report (FSR) released by RBI in July 2020 estimated the Gross Non-Performing Assets (GNPA) ratio of all Scheduled Commercial Banks (SCBs) to increase from 8.5% in March 2020 to 12.5% in March 2021 under baseline scenario and can worsen to 14.7% under a severely stressed scenario. PSBs also need money for shoring up the capital buffers to meet the capital adequacy norms.

Not just banks, several non-banking PSUs will require capital infusions in the form of fresh equity capital to survive and cover the losses incurred due to the pandemic.

The Government of India's (GOI) finances are strained and the Government is not in a position to provide the requisite capital to PSUs. In the budget of February 2020, the Finance Minister (FM) had to use an escape clause provision under the Fiscal Responsibility and Budget Management (FRBM) Act to relax the fiscal deficit target by an additional 0.5% of GDP for FY20, from 3.3% (targeted) to 3.8% (revised), citing a slowdown in GDP. The fiscal deficit was budgeted to be 3.5% for FY21. However, these budgeted numbers did not take into account a pandemic or a lockdown-like scenario.

In the month of May 2020, the Government announced a stimulus package of over INR 20 trillion to revive the economy. This package is estimated to have a fiscal impact of 1.5-2% of GDP. This package may not suffice and there are talks of more stimulus measures later during the year.

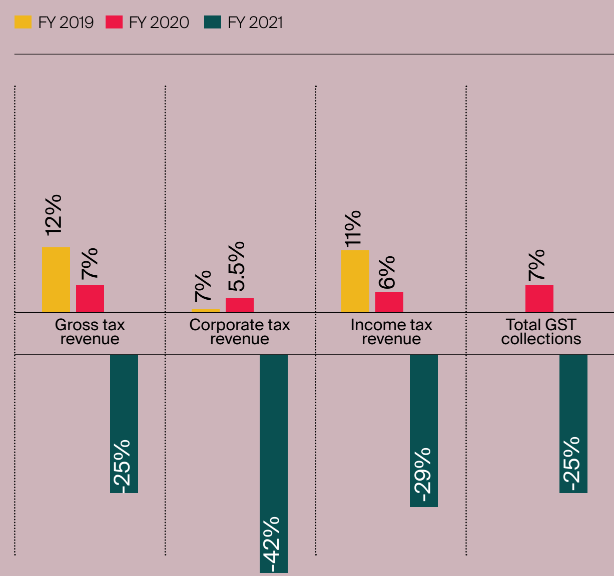
The tax collections under various heads during the April-Aug 2020 period were lower by 25-40% compared to same period last year (refer chart 1). Hence, the fiscal deficit is likely to swell much beyond the budgeted 3.5% for FY21. The Government has recently indicated that the disinvestment target of INR 2.1 trillion would be difficult to achieve. Given, the tight fiscal situation, the government will find it challenging to pump capital/ bail out PSUs during this crisis period.

1.3 Can the REIT model help GOI raise requisite capital for PSUs?

There may be a way out through Real Estate Investment Trusts (REITs) where the Government can raise funds for the PSUs that too without losing ownership control at the company level. REITs in India have proved to be an immensely successful instrument for raising funds

Chart 1:

Growth in tax collections during April-Aug period (YoY)



Source: Controller General of Accounts

using income generating real estate assets as underlying, and the two recent Commercial Real Estate REITs have witnessed strong demand from investors.

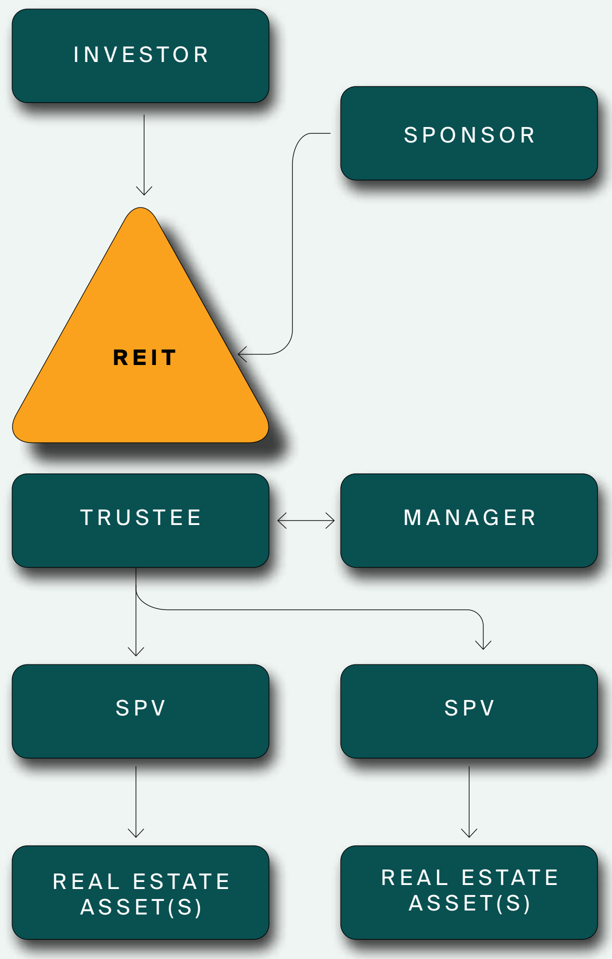
The Embassy Office Parks REIT had witnessed successful listing in April 2019 and has provided significant capital appreciation to investors along with a good dividend yield of 8% in its first year, for investors who had subscribed for the units during the IPO. Despite correction in REIT prices during the global market correction in the March-April 2020 period, the Embassy REIT never fell below the issue price and is currently (as on 9th Oct 2020) trading ~20% above the listing price.

Even during the uncertain times of the pandemic and consequent lockdowns, India witnessed the successful listing of a second REIT- 'Mindspace Business Park REIT'. Amidst a lot of speculation of Work From Home (WFH) replacing the need for having an office space, the 'Mindspace Office Parks REIT' was oversubscribed 13 times and listed at 11% premium. The performance of the two REITs has put to rest all apprehensions and is likely to encourage more REIT listings.

It is an opportune time for the Government to use this appetite for rent yielding office assets for raising funds for PSUs. The Government of India owns a large number of companies (PSUs), some of which are listed while others are unlisted and under its sole ownership. Amongst the ones listed on stock exchanges, the Government has controlling stake in a majority of the PSUs. PSUs often have their office buildings-headquarters, regional offices, back-offices, etc. in some of the prime business districts of that particular city and most of its assets are on ownership basis and not on lease.

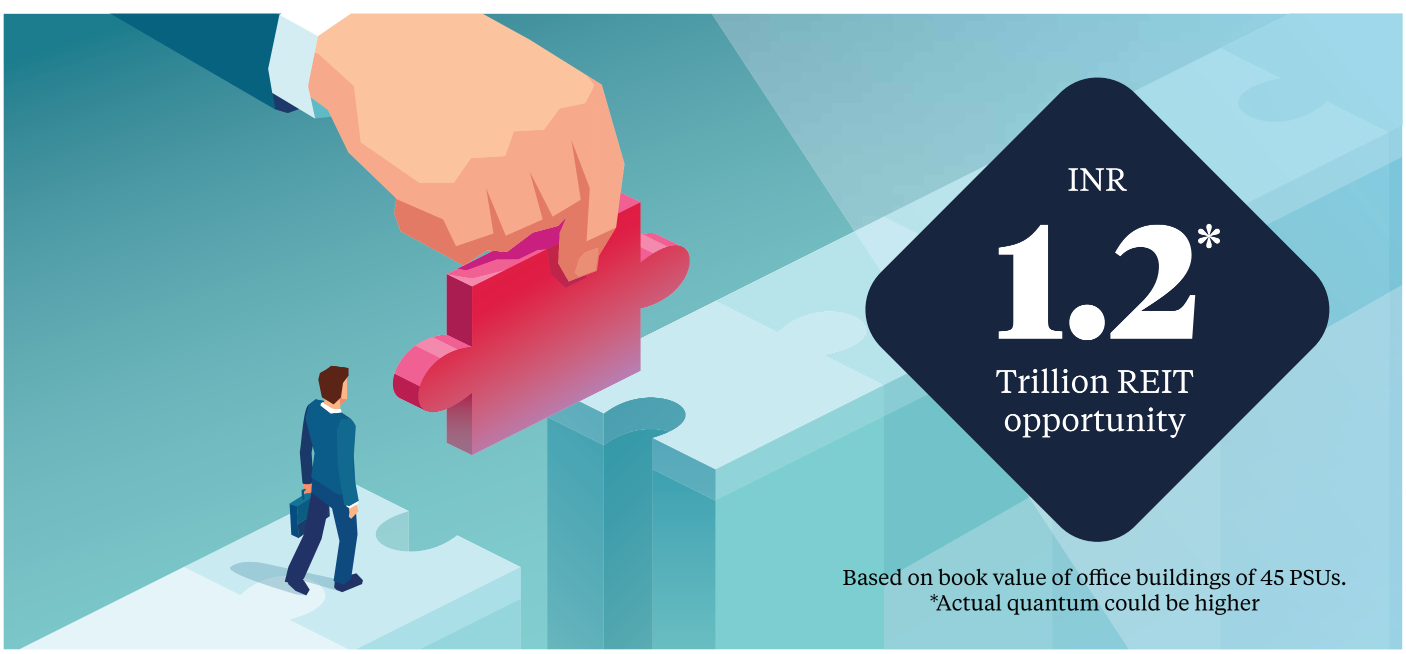
A REIT structure similar to chart 2 can be made using these office assets. The office buildings owned by the PSU can be transferred to a separate SPV. The transfer can be done through a sale and lease-

Chart 2:
Structure of a traditional REIT



back arrangement with the SPV. The PSU can sign a long-term lease (>20-25 years) with pre-defined rental escalations, with scope for marking the rents to market rate every 8-10 years. The Government of India would float (sponsor) a REIT which would take control of these SPVs. This amount owed to PSUs due to the sale and lease back, can be transferred in the form of proportionate equity stake in the REIT. The Government can list this REIT on the stock market and raise the necessary funds for the PSUs. In case of financially healthier PSUs, a part of this money raised through REITs can also flow back to the Government in the form of dividends.

In this arrangement, there would be no change in ownership status at the company level and the employees can continue work from the same premises. The difference in this arrangement would be change in the status quo of PSU from an asset owner to a tenant of the building on their balance sheet. The operating cost of PSUs would go up to the tune of rent outgo every year, but the PSU would get balance sheet headroom, which will help reduce their financial leverage. This route can also emerge as an alternative source of raising funds at a competitive cost compared to debt.



1.4 GOI PSUs sitting on REIT potential of over INR 1.2 trillion based on book value of office assets of 45 listed PSUs; actual quantum significantly higher

We did a bottom up approach to find out the value of buildings owned by large, listed PSUs. In our analysis, we added the book value of buildings owned by 45 listed PSUs which includes some of the top Maharatnas, Navratnas, Miniratnas, Public Sector Banks (PSBs) and other large PSUs based on the value of buildings in their balance sheet. We excluded the value of residential buildings and plant buildings (buildings located inside manufacturing/generating plants) owned by these companies from this number to arrive at an estimated value for their office buildings.

As per our estimates, the REIT potential comes to INR 1.2 trillion (or INR 1.2 lakh crore) based on the latest book value of the buildings in their balance sheet. Many buildings owned by PSUs were purchased or constructed several decades ago and may have very low book value. If these assets were to be valued on market value basis then the REIT potential would be significantly higher than INR 1.2 trillion.

While the above analysis only includes the 45 large listed PSUs, there are several smaller listed PSUs and many other larger PSUs under the direct ownership of the Central Government that are not listed on stock exchanges. We have not considered the value of office buildings of those PSUs in this study. However, if the value of the office buildings of those unlisted PSUs and smaller listed PSUs are also added to the above sum of INR 1.2 trillion on market value basis, the REIT potential would jump multi-fold.

1.4.1 Possible yield for PSU REIT

The Embassy Office Park REIT had projected yields in the range of 7.4-8.3% during the IPO in April 2019 which was based on the projected FY20 cash flows in Draft Red Herring Prospectus (DRHP) and actually delivered ~8%. The Mindspace Office Park REIT has projected a yield of 7.5% for FY22 and 8% for FY23 in its DRHP. The Embassy REIT declared a dividend pay-out of INR 5.84 per unit for June quarter and if we annualise this pay-out, then based on the current REIT (as on 9th Oct 2020) prices of ~360/unit, the yield works out to be 6.4%.

Some of the Maharatnas, Navratnas and Miniratnas in the PSU REIT are AAA rated along with Sovereign backing, this improves the tenant profile of the REIT. As these assets are important for running the core business, the risk of vacancy goes down.

Also, due to heightened risk averseness and uncertainties, there is a flight of global capital to safety towards Sovereign or Sovereign-backed instruments. Therefore, the REIT floated by the Government of India can also be capitalized at yields similar to the two REITs are trading currently (as on 9th Oct 2020) i.e. ~6.4%.

1.4.2 REIT can emerge as an alternate source of finance

For the listed PSUs, this REIT can become an alternate source for funds and that too at lower costs. If we look at the table below, PSUs have raised funds at higher rates through bonds/NCDs over the past two years compared to the yields offered by the two REITs during IPO and much higher than the levels the REIT are trading at presently. Some of the bonds raised by banks in the below table are perpetual bonds which gives the prescribed yield till eternity unless the call option is executed. This REIT can be compared to a Bharat Bond ETF (Exchange Traded Fund). Moreover, the REIT has the inherent advantage of having a real estate asset as underlying.

Table 1:
Fund raising by PSU through bond and NCDs in the recent years

Date	Company	Bond/NCD	Amount (INR mn)	Coupon
11-Sep-20	Canara Bank	Basel III bonds	10,120	8.30%
07-Sep-20	SBI	AT1 Bond	40,000	7.74%
29-Jul-20	PNB	Basel III bonds	9,940	7.25%
11-Mar-20	BPCL	NCD	10,000	8.02%
22-Dec-19	PNB	Bonds	15,000	8.15%
29-Nov-19	BOI	Basel III bonds	16,500	8.70%
28-Nov-19	Bank of Baroda	Basel III bonds	16,500	8.70%
28-Feb-19	Indian Railway Finance Corp	NCD	28,450	8.55%

Source: Media reports

1.5 Value proposition for investors

REITs are a stable product and have a proven track record of offering stable returns across business cycles globally and are used as a portfolio diversification tool. The dividends from REITs in India are exempt from tax, provided the REIT adopts the old rate of Corporate Tax. Further, REITs provide scope for capital appreciation and any gain through capital appreciation is taxed similar to debt.

There are several mutual funds, pension funds and insurance funds which invest a significant percentage of their Assets Under Management (AUM) in G-secs or bonds/NCDs floated by Sovereign entities. REITs would serve as a credible alternative for this set of investors and the tax free proposition of dividend further improves the value proposition which is not available for bonds/NCDs/G-secs except for certain specific tax free bonds.

For retail investors, it can serve as a credible alternative to other sovereign backed saving schemes like Public Provident Fund (PPF), National Savings Certificate (NSC), etc. For the purpose of analysis, it may also be compared to the 5-year Fixed Deposit (FD) by nationalised banks. Presently, PPF is giving an interest of 7.1% p.a., SBI's 5-year Fixed Deposits offers 5.4% p.a. and National Savings Certificates (NSC) offers 6.8% p.a., and these instruments have their unique tax advantages under Section 80-C of Income Tax (IT) Act. Even if investment in the GOI backed REIT is not put under a similar category of the IT Act, the REIT still offers an attractive value proposition for the retail investors. The above mentioned instruments offer less liquidity, have their own lock-in period: 15 years in the case of PPF and 5 years for NSCs and FDs, besides having a set of restrictions over early redemption. On the other hand, REIT offers greater liquidity compared to these instruments and can be sold at any time without restrictions. Further, the dividends are tax free and most importantly, the REIT also provides scope for capital appreciation which these instruments don't. Hence, such an instrument floated by GOI is bound to be a success amongst investors.

1.6 Other avenues for raising funds

A similar approach can also be used to monetize rent yielding assets of Airport Authority of India (AAI), Indian Railways, Metros, Ports, Bus terminals, etc. who receive monthly rent from occupiers of their premises. The same can be monetized through InvITs/REITs following a similar model and the money raised can be used for new infrastructure development.

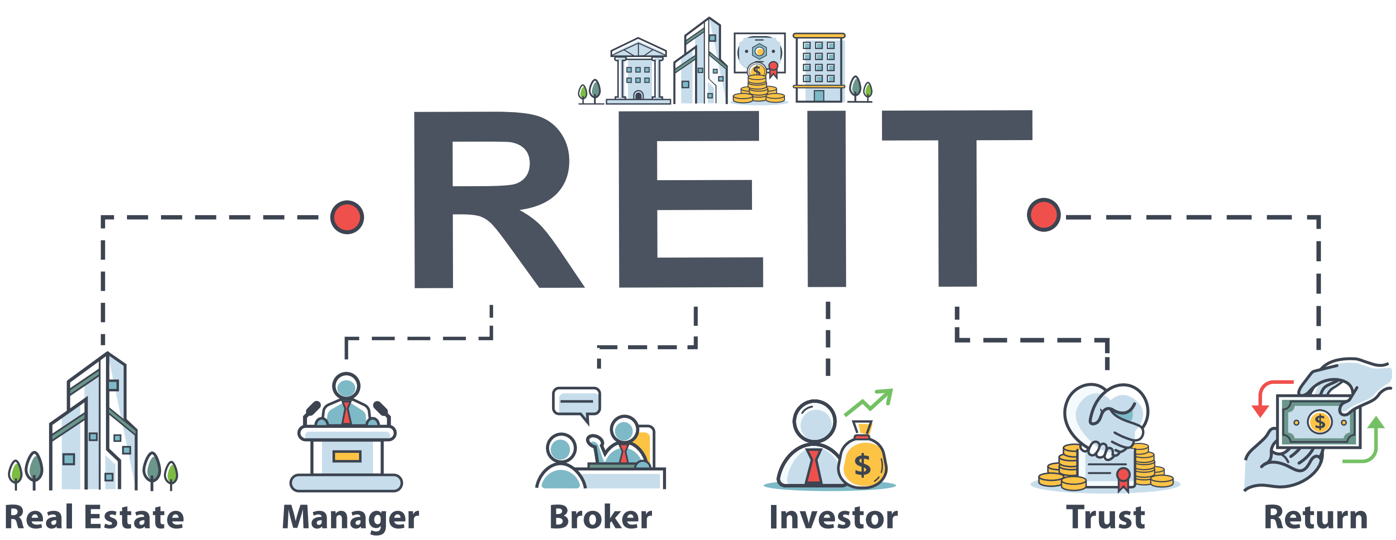


Table 2:
Comparison between the different instruments

Instrument	PPF	NSC	SBI 5-year FD	GOI REIT
Annual returns	7.1%	6.8%	5.4%	~6.4%* (Assumed)
Tax on interest/ dividends	No tax	Taxable	Taxable	No Tax (on dividends)**
Lock-in period	15 years	5 years	5 years	None
Scope for capital appreciation	No	No	No	Yes
Liquidity	Very low	Low	Mid	High

Source: Knight Frank Research

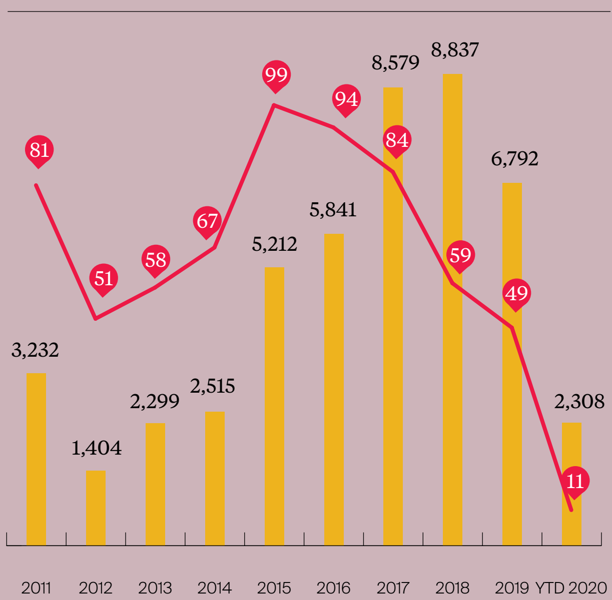
Note: *- Assumption as mentioned in section 1.5.1 above, **- provided REIT follows old rate of corporate tax

SECTION

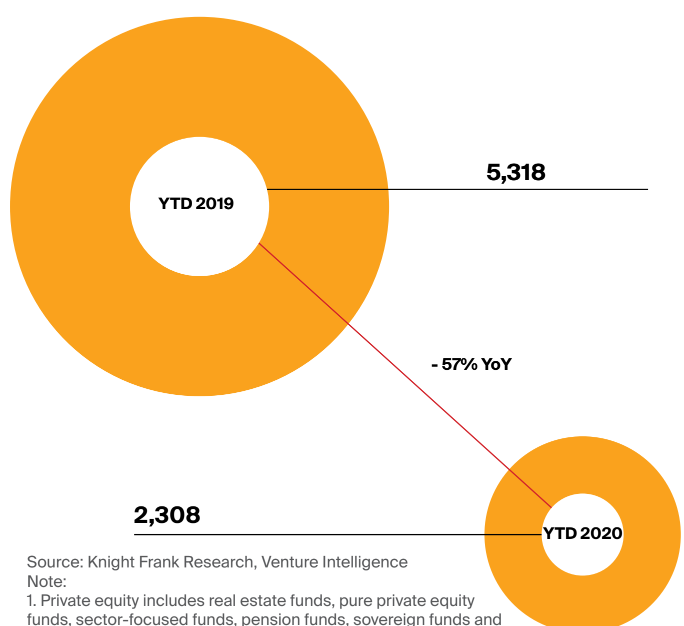
2

TRENDS IN PRIVATE EQUITY INVESTMENTS IN REAL ESTATE

Chart 3:
USD 47 billion invested across debt and equity in Indian real estate since 2011



Amount invested in YTD 2020 vs YTD 2019 (in USD mn)

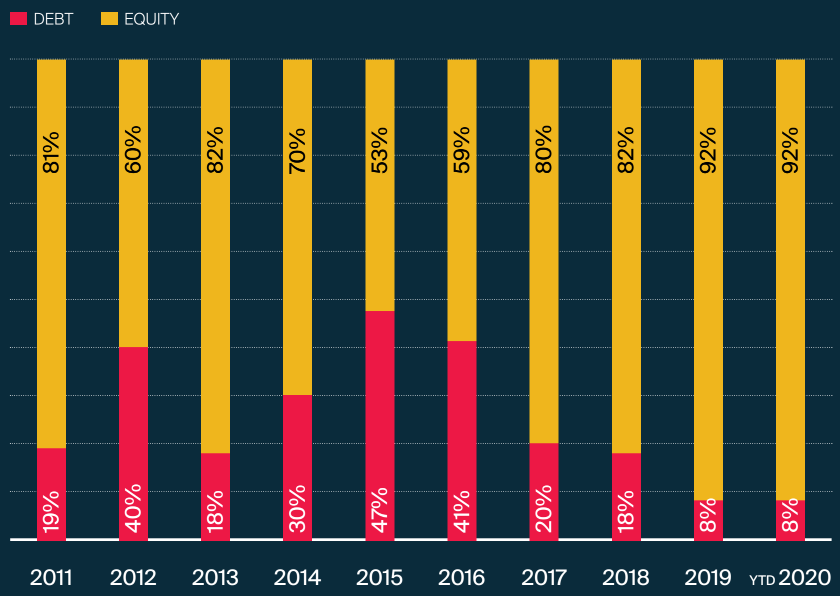


Source: Knight Frank Research, Venture Intelligence
Note:
1. Private equity includes real estate funds, pure private equity funds, sector-focused funds, pension funds, sovereign funds and Alternate Investment Funds (AIF).
2. YTD 2020 represents investments till Q3 2020. YTD 2019 represents investments till Q3 2019

- *The PE investments in real estate peaked at USD 8,837 million (mn) in 2018 which had been the best year for PE investments in Real Estate in the previous decade. In 2019, the investments declined by 23% YoY to USD 6,792 million. This decline is primarily attributable to the decline in investments in residential and office. While the residential sector has been passing through tumultuous times, a dearth of mature assets has led to a decline in investments in office.*
- *In 2020 (YTD), the investor activity dropped sharply with only 11 deals getting concluded, adding up to USD 2,308 million. The value of transactions was lower by 57% compared to the same period last year.*
- *The overall drop in 2020 can be attributed to the COVID-19 pandemic which impacted investor sentiments and the resultant economic slowdown.*
- *In 2020, of the USD 2,308 million invested, USD 1,635 million was due to a single large deal in the office segment.*

Chart 4:
Share of investments by asset class

Chart 5:
Big ticket investors bullish on annuity assets, commit substantially higher risk capital



Source: Knight Frank Research
Note: YTD 2020 represents investments till Q3 2020.

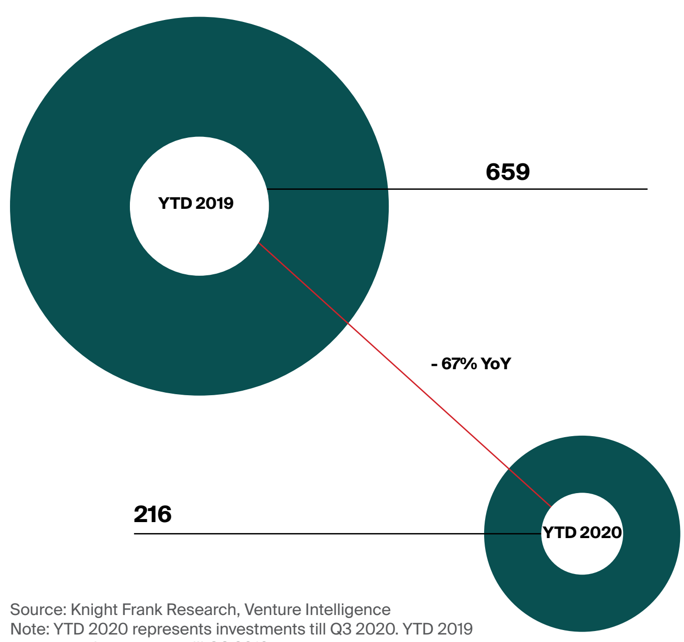
SECTION

3

PRIVATE EQUITY INVESTMENTS IN RESIDENTIAL

Chart 6:
PE investment in Residential

Amount invested YTD 2020 vs YTD 2019 (in USD mn)

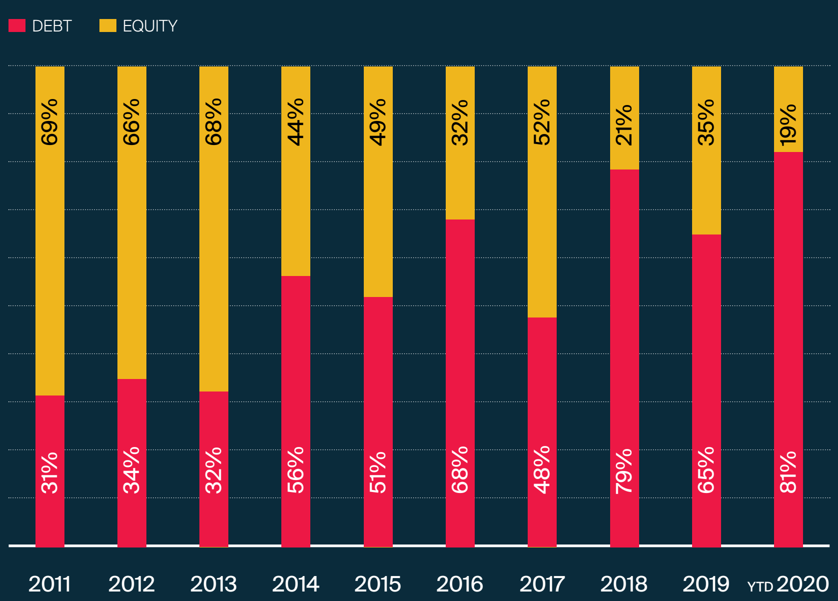


Source: Knight Frank Research, Venture Intelligence
Note: YTD 2020 represents investments till Q3 2020. YTD 2019 represents investments till Q3 2019

- *Residential prices have been stagnant for several years now and have corrected at certain locations. However, the cost of input items for developers have not corrected by 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; construction charges and approval costs have also increased over the years. On the other hand, the sales velocity has come down compared to the heydays of the earlier period. This has 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 these factors, investors have refrained from investing in residential projects.*
- *In 2020 (YTD), there were 3 deals in the residential sector worth USD 216 million. The investments were down 67% YoY compared to USD 659 million during the same period last year.*

Chart 7:

Change of investors' preference in residential from equity to debt



Source: Knight Frank Research
Note: YTD 2020 represents investments till Q3 2020

- *To avoid the risks associated with development projects, investors have been reducing their equity exposure to residential real estate and invested through debt or structured debt instruments.*

SECTION

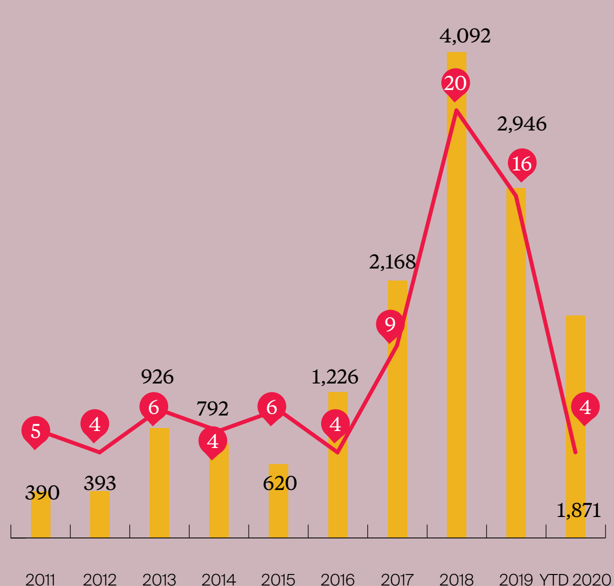
4

PRIVATE EQUITY INVESTMENTS IN OFFICE

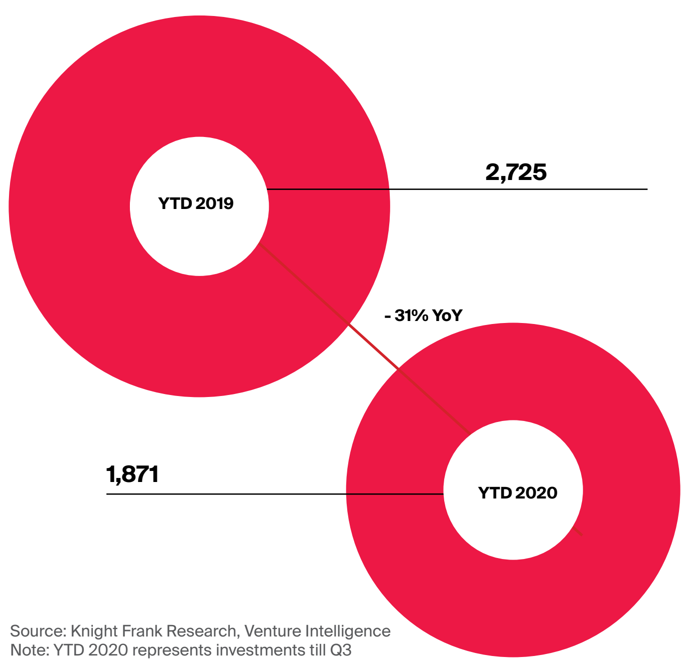
Chart 8:

PE investment in Office

Amount invested (USD mn) Number of deals



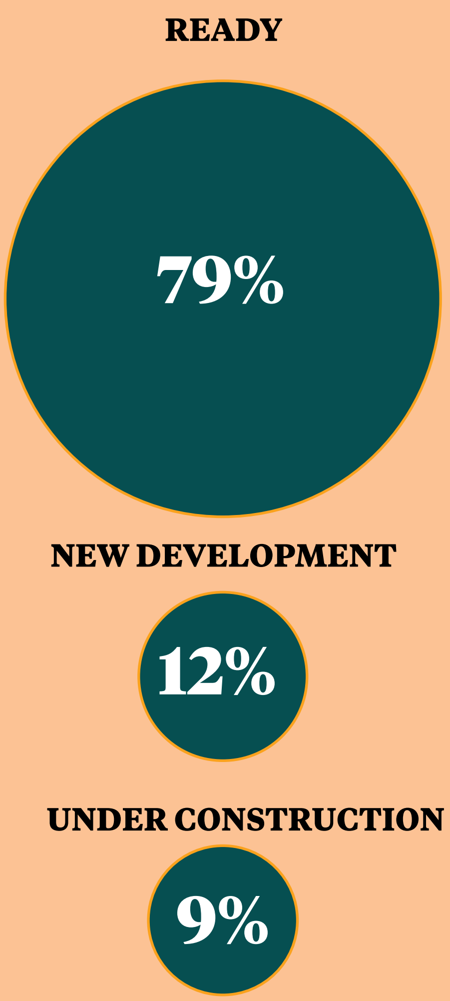
Amount invested YTD 2020 vs YTD 2019 (in USD mn)



Source: Knight Frank Research, Venture Intelligence
Note: YTD 2020 represents investments till Q3 2020. YTD 2019 represents investments till Q3 2019

- *The office sector continues to be the blue-eyed boy for investors due to the strong fundamentals of the India office market. The segment has garnered USD 15.4 billion of equity investments since 2011. During YTD 2020, the segment garnered 81% share of total PE investments.*
- *Of the USD 1,871 million of investment in 2020, USD 1,635 million was part of a single large deal. The PE investments in office segments were down 31% YoY in YTD 2020 compared to USD 2,725 million during same period last year.*

Chart 9:
Share of PE investments in office since 2011



Despite a slowdown in overall PE investment, we continue to witness strong investor appetite for rent yielding office assets. The PE investments in office in 2020 may surpass the previous year numbers if the deals in the pipeline are concluded.

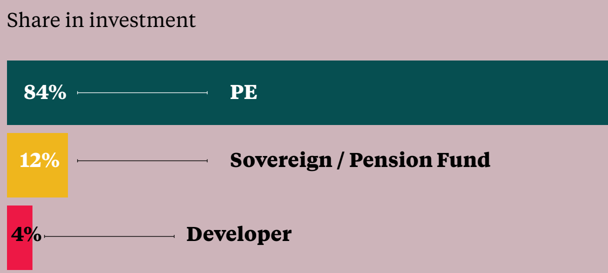
Table 3:
206 mn sq ft of office space was transacted in the last decade of which 62 mn sq ft were a part of India's first two REITs; Future REIT potential of atleast 144 mn sq ft

Year	Total area of the assets transacted (mn sq ft)	Total area of the assets transacted (mn sq m)
2011	5.8	0.5
2012	18.9	1.8
2013	11.6	1.1
2014	5.6	0.5
2015	5.8	0.5
2016	13.5	1.3
2017	56.7	5.3
2018	36.1	3.4
2019	33.7	3.1
YTD 2020	18.1	1.7
Grand Total	**206**	**19.1**

Source: Knight Frank Research
Note: YTD 2020 represents investments till Q3 2020.

Chart 10:

PE funds are the most active in office space followed by SWF and pension funds



Source: Knight Frank Research

Table 4:

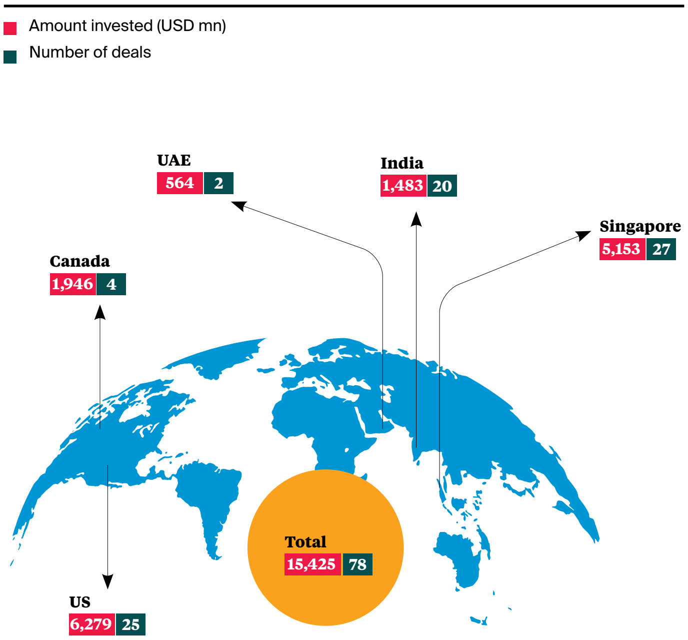
City wise investments: Mumbai takes the largest quantum of PE investments in office since 2011

City	Amount invested (USD mn)	Number of deals
Mumbai	5,015	19
NCR	2,803	15
Hyderabad	2,010	12
Bengaluru	1,839	11
Bengaluru, Chennai, NCR*	1,635	1
Chennai	1,118	9
Pune	936	10
Others	67	1
Grand Total	**15,425**	**78**

Source: Knight Frank Research
Note - * represents investments in a single deal

Chart 11:

Origin of PE investors investing in office assets



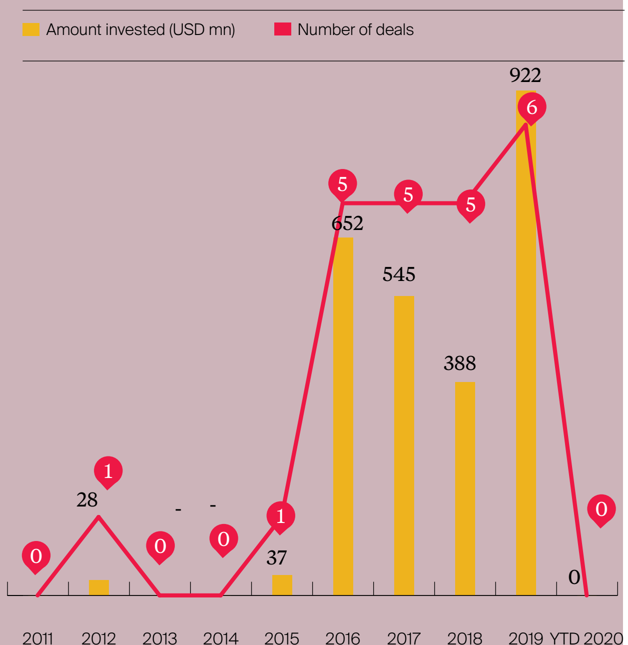
SECTION

5

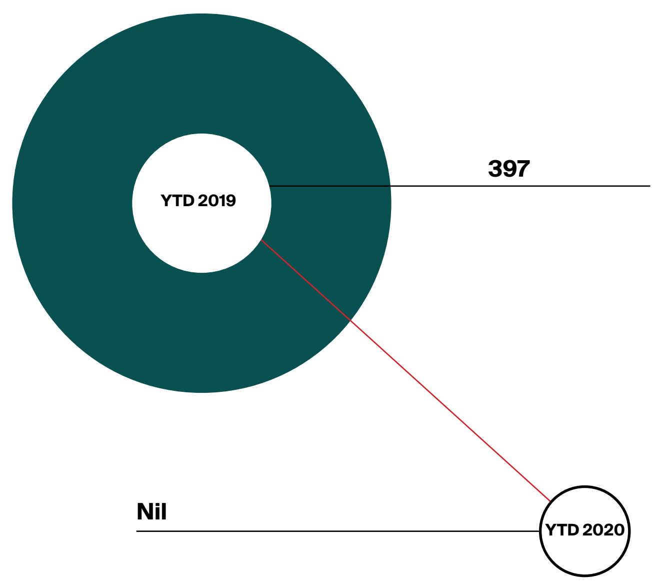
PRIVATE EQUITY INVESTMENTS IN RETAIL

Chart 12:

PE investment in Retail



Amount invested YTD 2020 vs YTD 2019 (in USD mn)



Source: Knight Frank Research, Venture Intelligence
Note: YTD 2020 represents investments till Q3 2020. YTD 2019 represents investments till Q3 2019

- *The retail sector has been the worst affected segment in this crisis. The pandemic induced lockdown had forced all malls to temporarily shut down affecting their business adversely. Malls have been amongst the last to open during the unlocking phases and the fear of virus has kept the consumer footfalls low.*
- *Any possibility of a second wave of infections in India, as witnessed in certain countries of Europe presently, may lead to future lockdowns and a shutting down of retail assets again.*
- *Several mall owners in India gave a partial/full rent waiver for the lockdown period taking a major hit on the revenues. Some have extended this partial waiver for the rest of the financial year and offered to waive off a portion of the minimum guarantee or a fixed portion of rents and shift to a higher percentage of revenue share.*
- *Such high levels of uncertainty have kept investors away from retail assets and it is expected that they will be the last to recover from the pandemic. Thus, there were no PE investment in retail in 2020.*

Table 5:

26.6 mn sq ft of retail assets were transacted in the last decade

Year	Total area of the assets transacted (mn sq ft)	Total area of the assets transacted (mn sq m)
2011	-	-
2012	1	0.1
2013	-	-
2014	-	-
2015	1.2	0.1
2016	4.7	0.4
2017	6.0	0.6
2018	4.9	0.5
2019	8.9	0.8
YTD 2020	-	-
Grand Total	**26.7**	**2.5**

Source: Knight Frank Research
Note- YTD 2020 represents investments till Q3 2020.

Table 6:

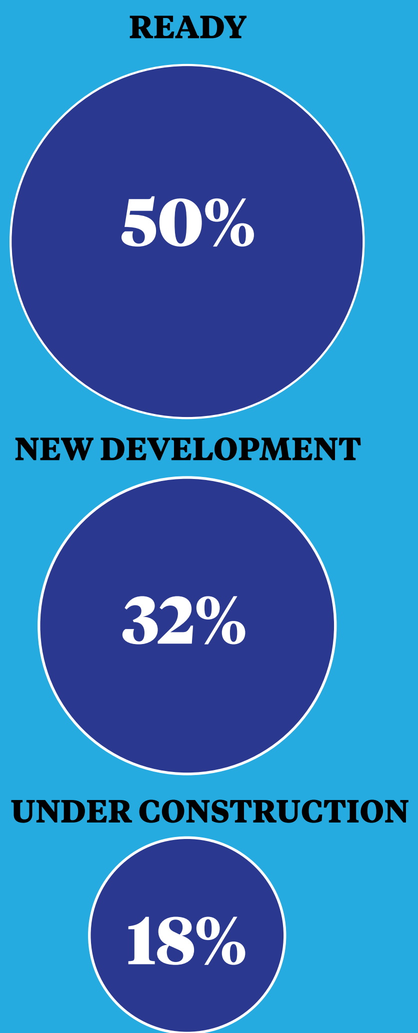
Unlike office assets, investor interest in retail goes beyond major metros

City	Amount invested (USD mn)
Mumbai	951
Pune	434
Chandigarh	267
Hyderabad	197
NCR	143
Ahmedabad	123
Lucknow	115
Chennai	106
Nagpur, Amritsar*	100
Indore	61
Bhubaneshwar	46
Bengaluru	28
Grand Total	**2,572**

Source: Knight Frank Research
Note: Grand total represents investments since 2011.
*-Investment in a single deal

Chart 13:

Lack of quality assets makes a strong case for greenfield investments

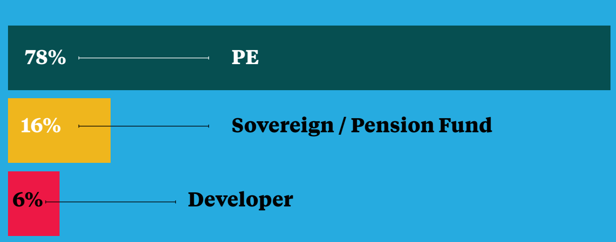


Source: Knight Frank Research

Chart 14:

PE and long-term capital providers alike actively participating in quality retail assets

Share in investment



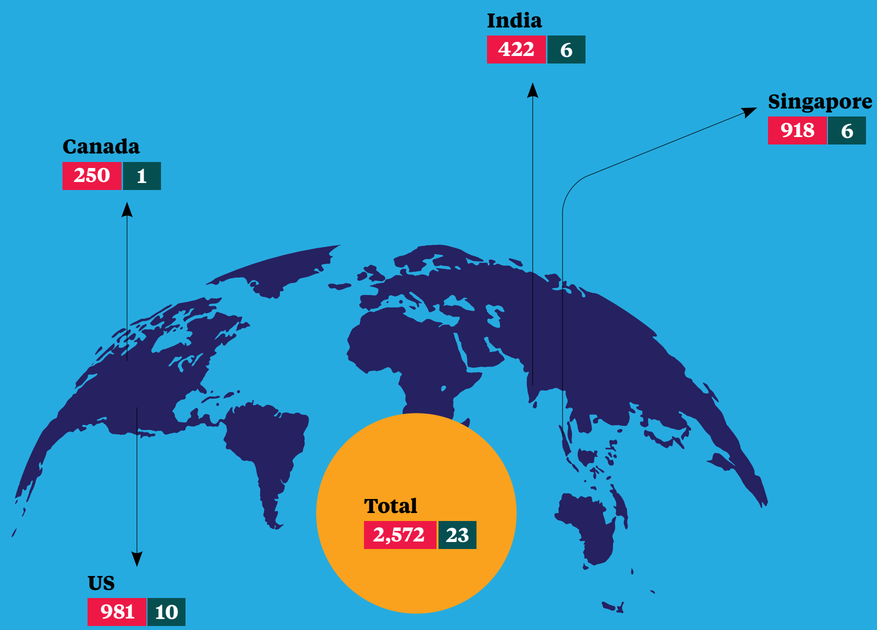
Source: Knight Frank Research

Chart 15:

Origin of PE investors in retail assets

Amount invested (USD mn)

Number of deals



Source: Knight Frank Research

Note: Grand total represents investments since 2011

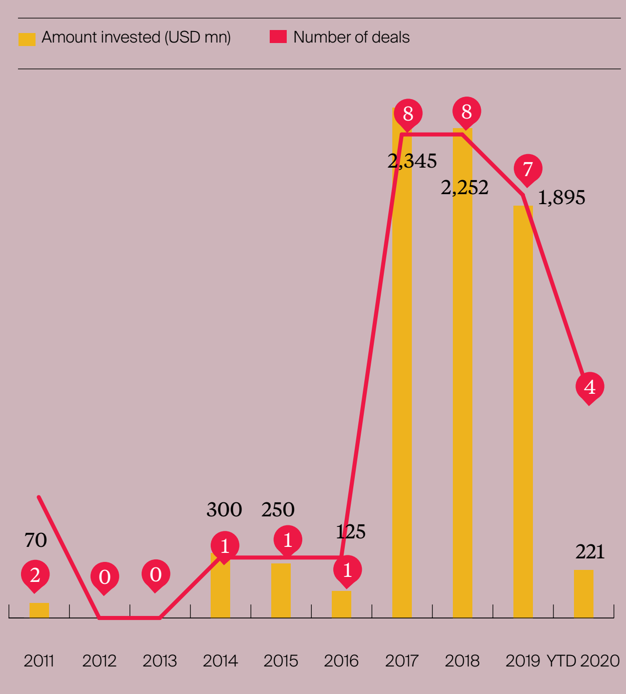
SECTION

6

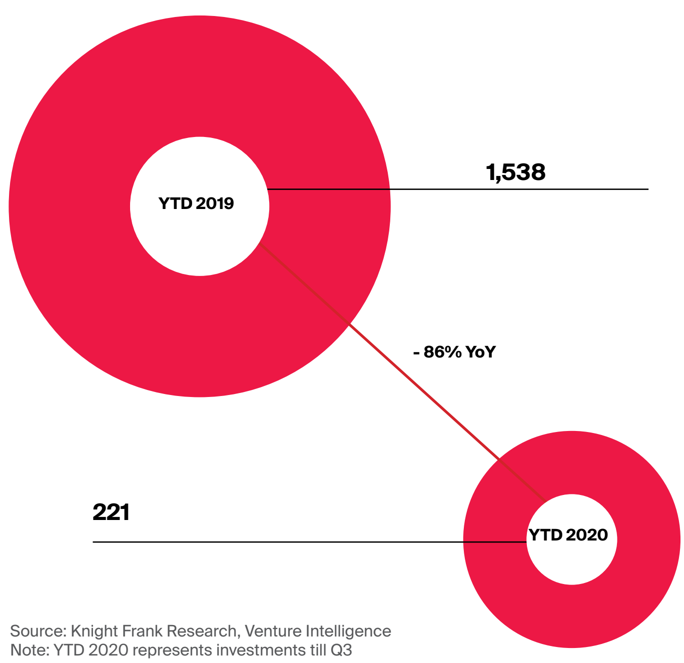
PRIVATE EQUITY INVESTMENTS IN WAREHOUSING

Chart 16:

PE investment in Warehousing

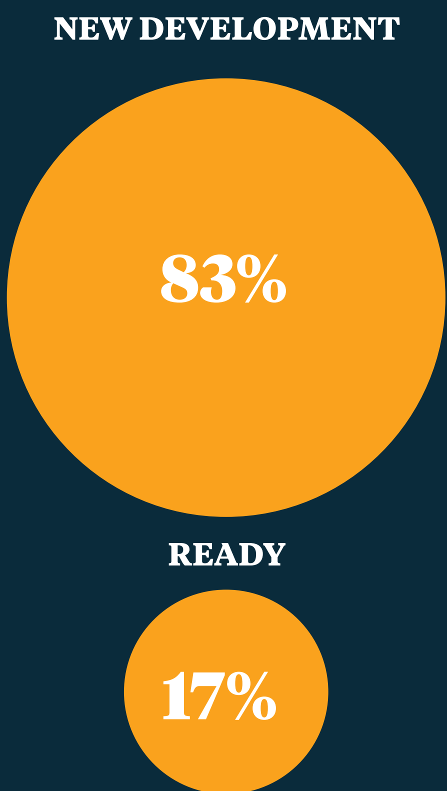


Amount invested YTD 2020 vs YTD 2019 (in USD mn)



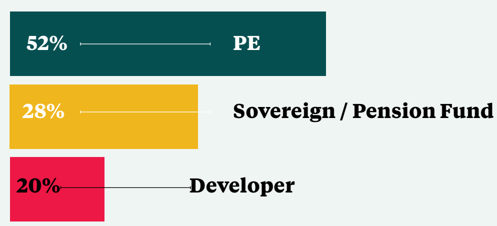
Source: Knight Frank Research, Venture Intelligence
Note: YTD 2020 represents investments till Q3 2020, YTD 2019 represents investments till Q3 2019

Chart 17:
Lack of mature assets in India and lower construction timelines make a strong case for greenfield investments in warehousing



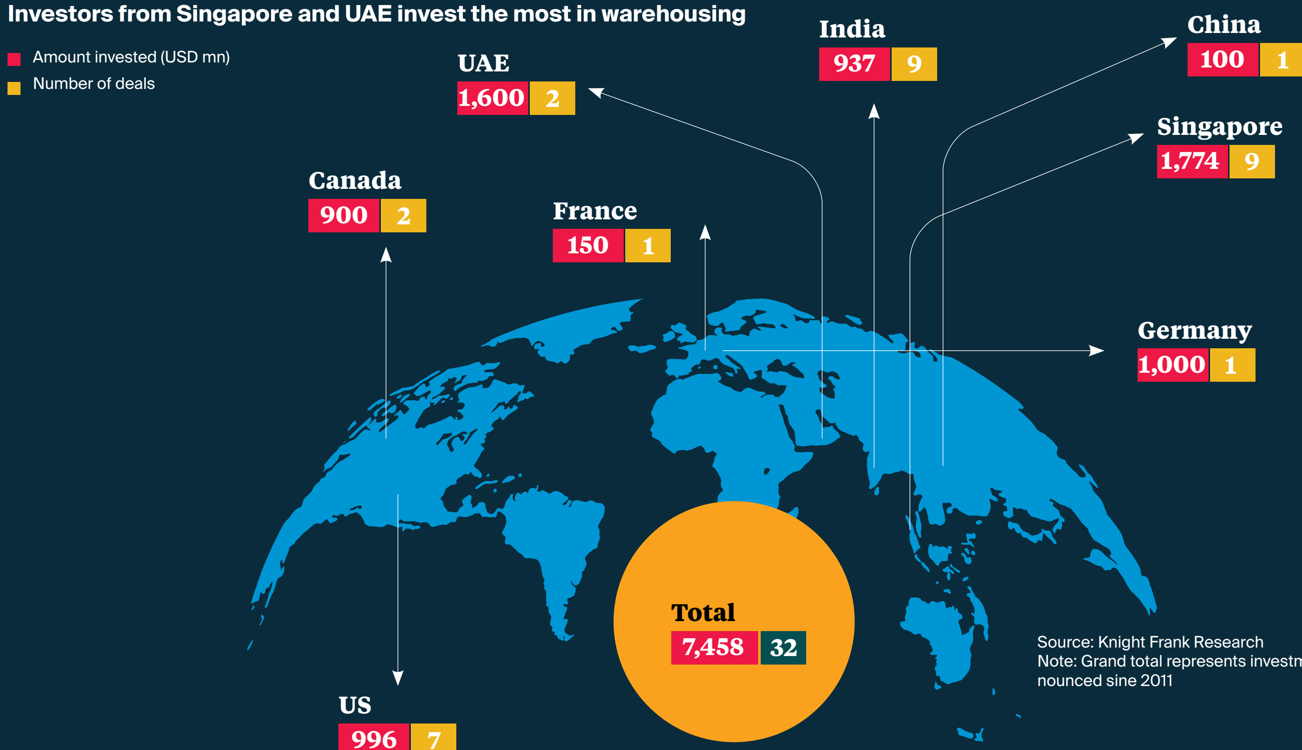
- *Globally, investors are expecting the warehousing segments to emerge stronger from the crisis driven by the renewed demand from e-commerce segments due to restrained consumer mobility.*
- *In YTD 2020, the warehousing sector attracted PE investments worth USD 221 million which was 86% YoY lower compared to USD 1,538 million during the same period last year. This drop can largely be attributed to a significant percentage of capital, which was committed for the warehousing sector in India over the past 3 years, awaiting deployment.*

Chart 19:
PE and long-term capital providers alike actively participating in creating warehousing assets



Source: Knight Frank Research

Chart 18:
Investors from Singapore and UAE invest the most in warehousing



Source: Knight Frank Research
Note: Grand total represents investments announced sine 2011

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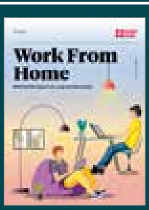
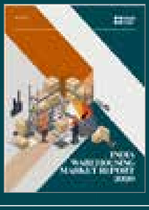


Work From Home

Co-working

Investments in Real Estate



India Warehousing

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