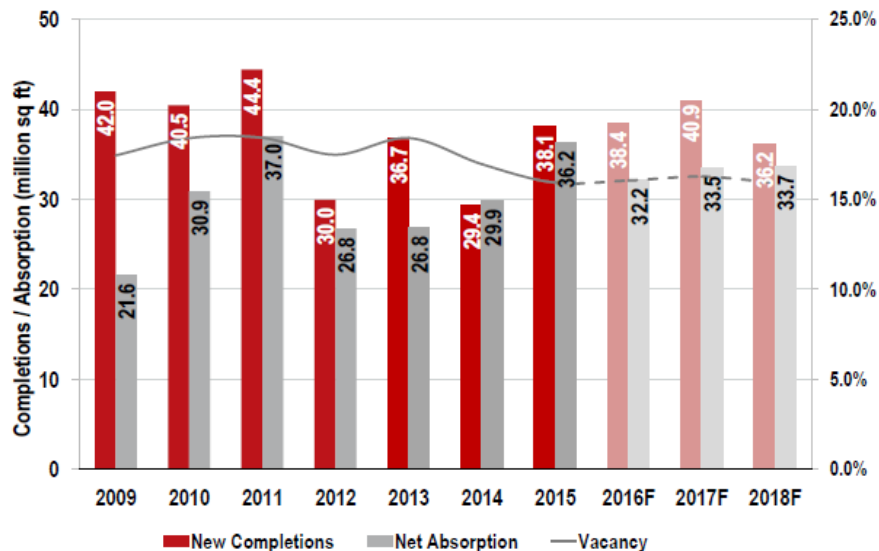


Real Estate Markets and Sources of Capital – Contemporary sources of Funding

Session By: Puneet Bhatia

Saturday, April 22, 2017

Reality of Realty

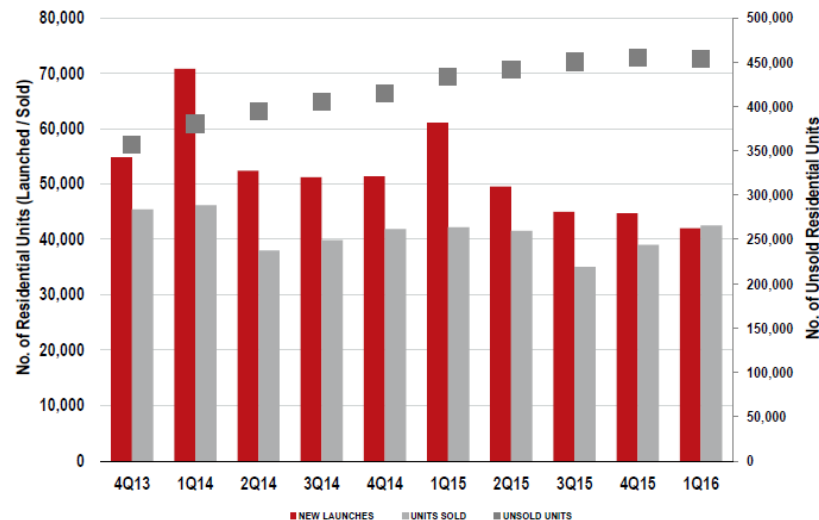


India Office

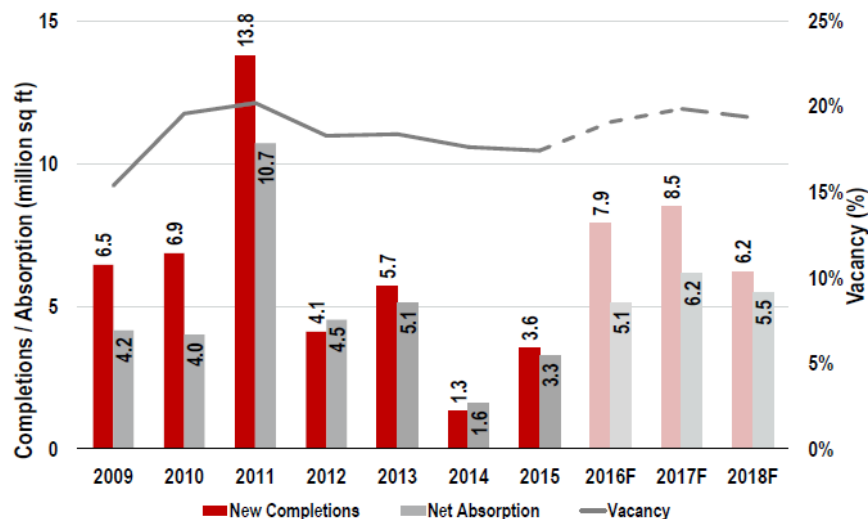
| 1Q16 | Stock (mn sft) | Vacancy (%) | Rent (INR psfpm) |
|-----------|----------------|-------------|------------------|
| CBDs | 32.3 | 10% | 124 |
| SBDs | 214.6 | 18% | 100 |
| Suburbs | 207.3 | 26% | 47 |
| PAN-INDIA | 454.2 | 16% | 78 |

There has been an addition of approximately 100 Million sqft of office space every 2 to 3 years since 2006 and approximately 500 million sft of residential space launched annually since 2010

Source: Brookfield Financial



India Residential



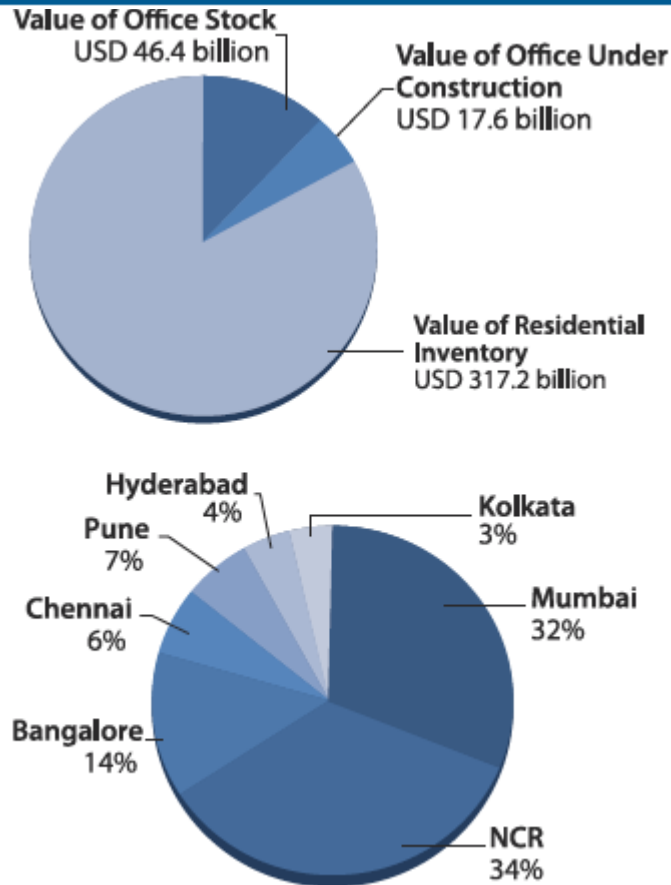
India Retail

Source: Real Estate Intelligence Service (JLL), 1Q16

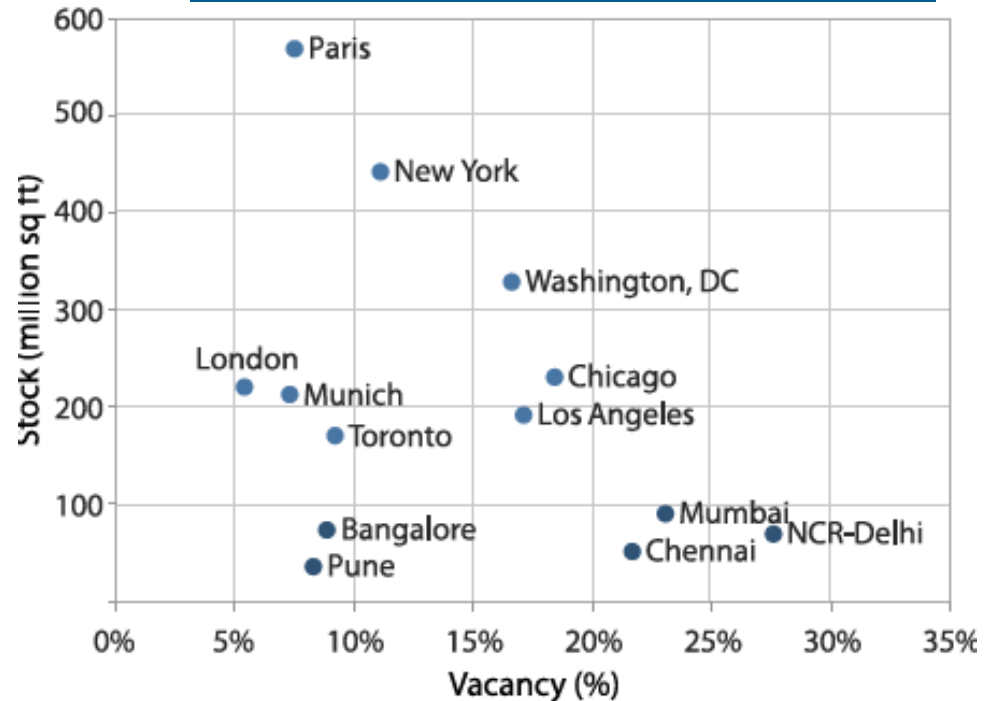
Note: Figures represent the top seven cities of India – Mumbai, NCR-Delhi, Bangalore, Chennai, Pune, Hyderabad and Kolkata.

Comparison – Office stock

Size of Indian Real Estate – An Investment Perspective



Comparison of Global Business Hubs



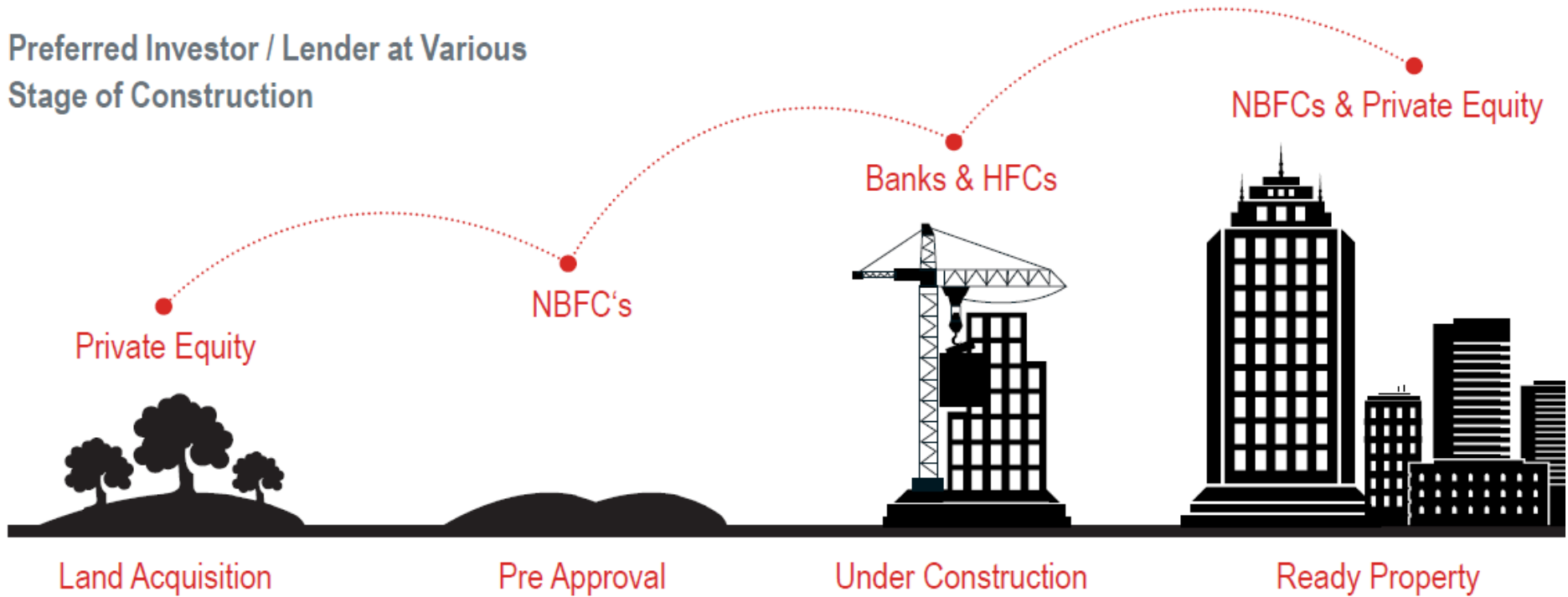
Source: Jones Lang LaSalle-REIS, Brookfield Financial

The market value of investable RE in office and residential sector is circa USD 381.3 billion; of which 83% is the market value of unsold residential inventory and remaining is market value of operational stock (USD 46.4 bn) and under construction projects (USD 17.6bn) in office sector.



Sources of Institutional capital - various stages

Preferred Investor / Lender at Various Stage of Construction



Source: JLL, REIS & Capital Market Research

Forms of Investments in Indian Real Estate

Private Investors/ HNIs

Partnership of risk and return

No value add and erratic

Private Equity

Pure Equity - partnership of risk and return

Investment horizon of 5- 7 years

Mezzanine Finance

CCDs (Pre 2008 - call and put options)

NCDs (offshore investments (listed), creation of security)

Structured debt- expensive, generally done for a short term period- 2-5 years

Bank/ NBFC lending

Security cover - 1.75x to 2x

Creation of charge and standard debt covenants. Generally done for 1-3 years.

IPOs/ QIPs/ AIM Listing/REITs

Institutional and general public

Higher Compliance

Participation in yield generating asset class

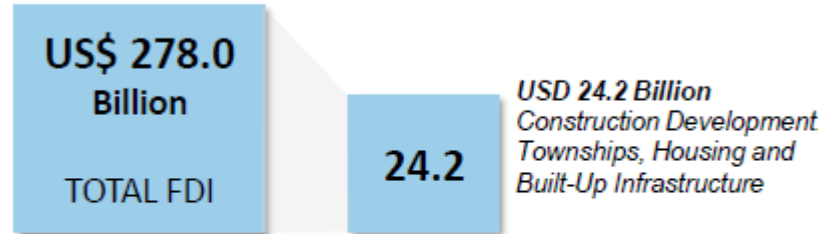
Real Estate Capital Markets

Bank Credit to Real Estate*



Source: Reserve Bank of India

FDI into Housing and Real Estate

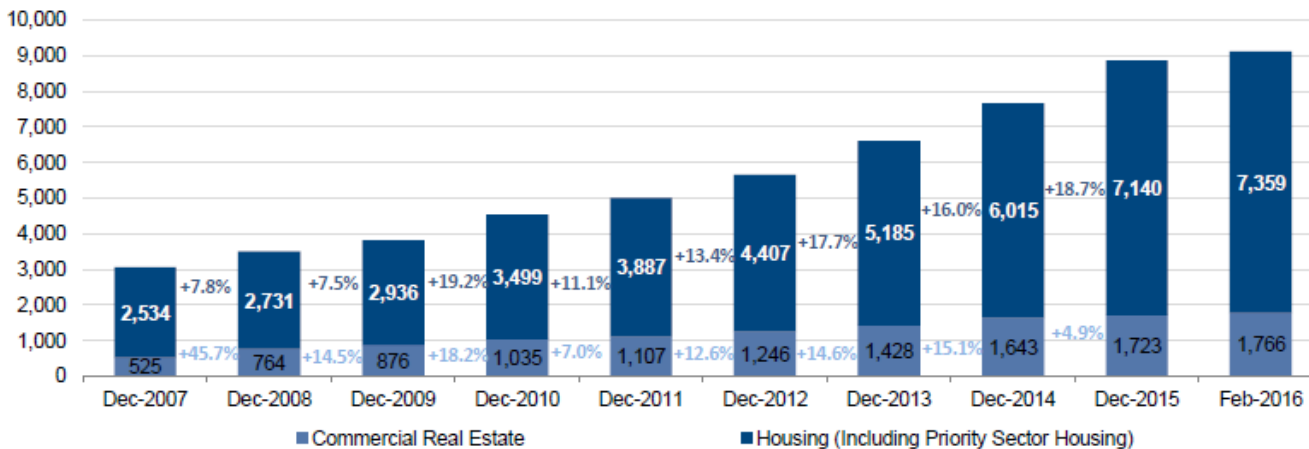


The Construction Development sector accounted for **8.7% of the total FDI inflows** during April 2000 – Dec 2015

Source: Department of Industrial Policy and Promotion

Bank Credit to Real Estate in India

(Bank Credit to CRE in INR Bn)



Source: Brookfield Financial

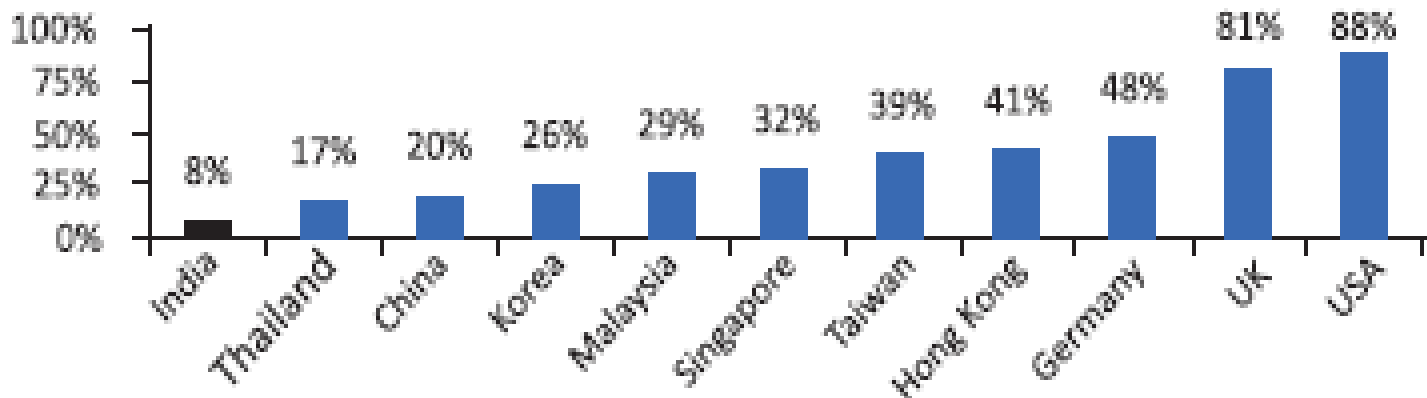
As of February 2016, Banks have an outstanding credit of INR 1,766 (USD 25.9 Billion in Commercial Real Estate and INR 7,359 (USD107.7 Billion in the Housing Sector (including priority sector housing).

*Assuming an exchange rate of USD 1 = INR 66.31

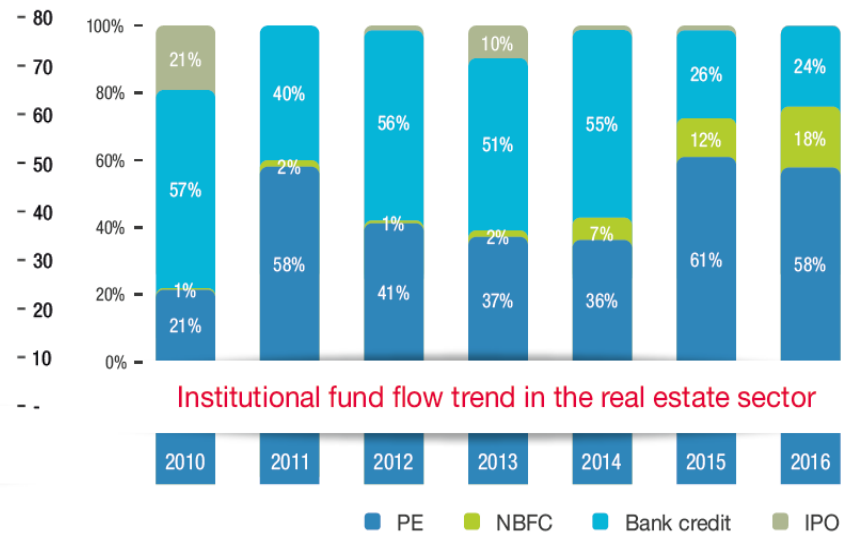
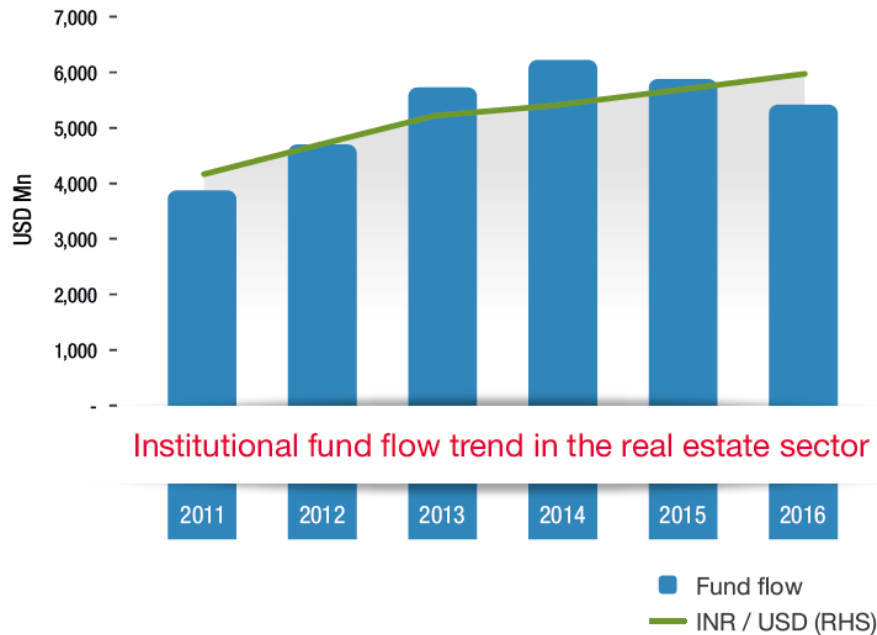
Bank Credit- a tip of iceberg ~compared to mature markets

- During the last year the outstanding bank credit increased by 4.9% and 18.7% in the commercial Real Estate and Housing sectors respectively.
- Due to the sensitive nature of the commercial real estate, the central bank has prescribed high standard asset provisioning norm for such loans.
- RBI has discouraged advance disbursal products such as 80:20 and 75:25 schemes that are likely to expose the bank as well as home loan borrowers to additional risks.

Mortgage as a % of GDP



Sources of Institutional Funding



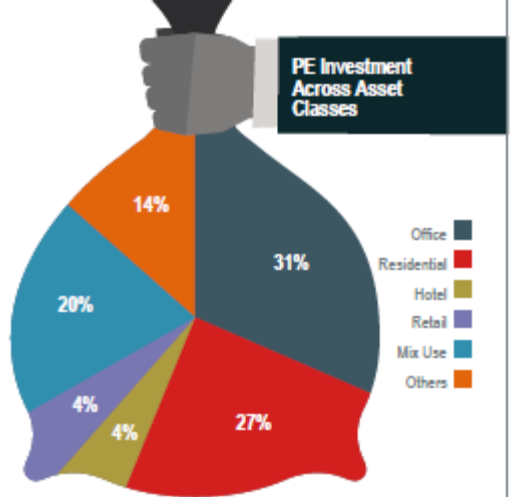
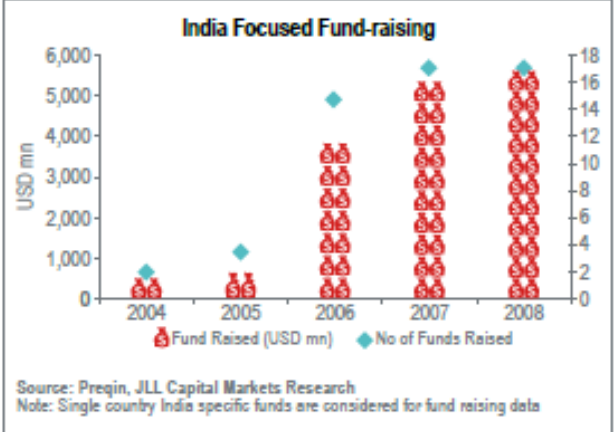
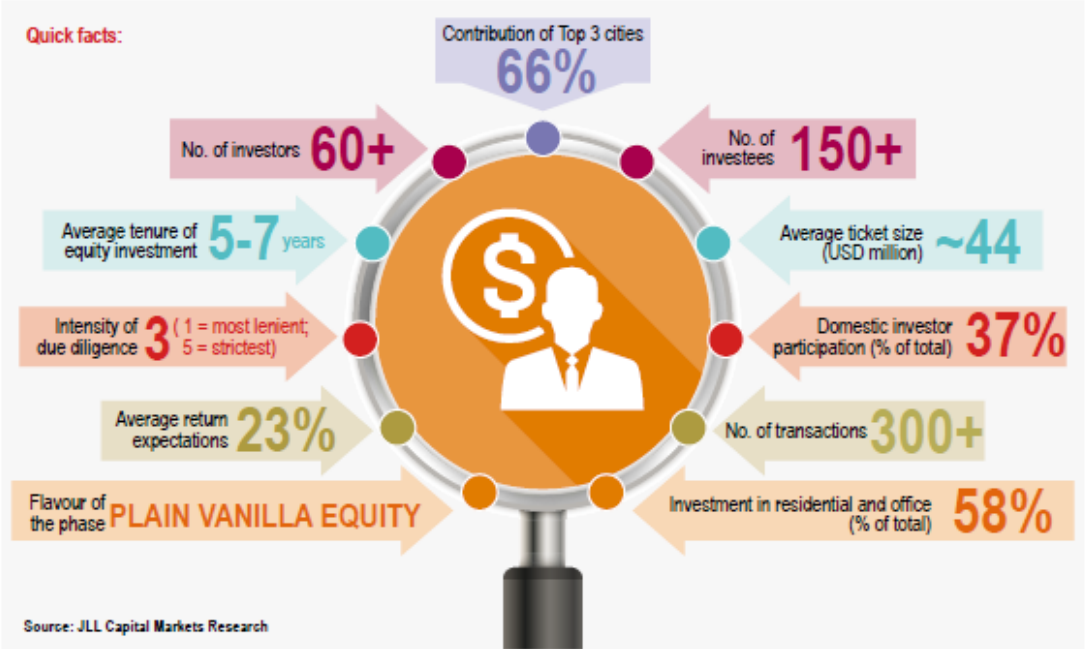
Source: Knight Frank report 2017

1. Total funding in Indian Real estate increased by 40% from USD 3.8 bn in 2011 to USD 5.54 bn in 2016. This takes to account the fund flows of Private equity, NBFC, Bank credit and IPO.
2. In the current scenario close to 60% of real estate sectors institutional funding requirement is met through the PE route, which is in sharp contrast to 2010; when less than one fourth funding came through this channel.
3. Bank credit which used to be 50-75% of the sectors Institutional funding in 2014, has witnessed sharp reduction in last two years to 24% to 26% range.

The RE investment saga- Its been 12 years!

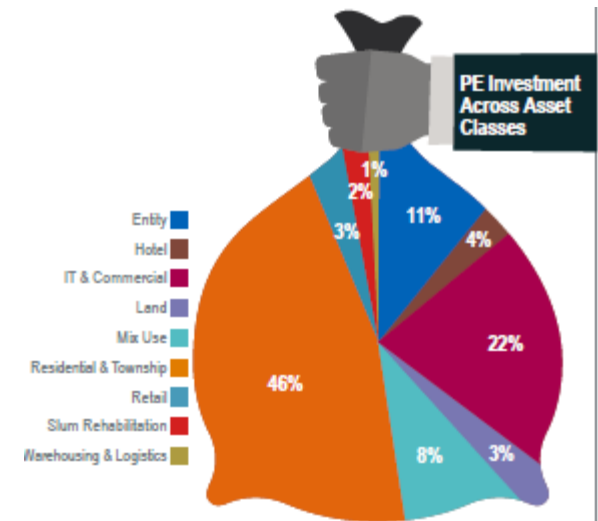
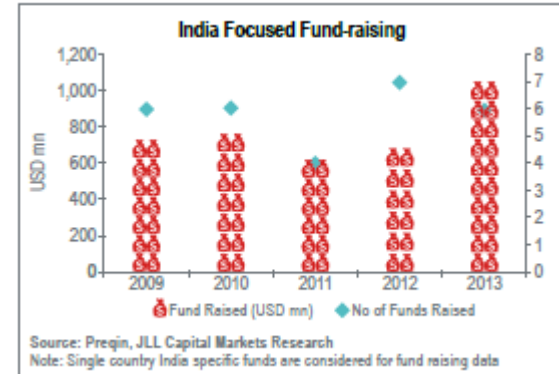
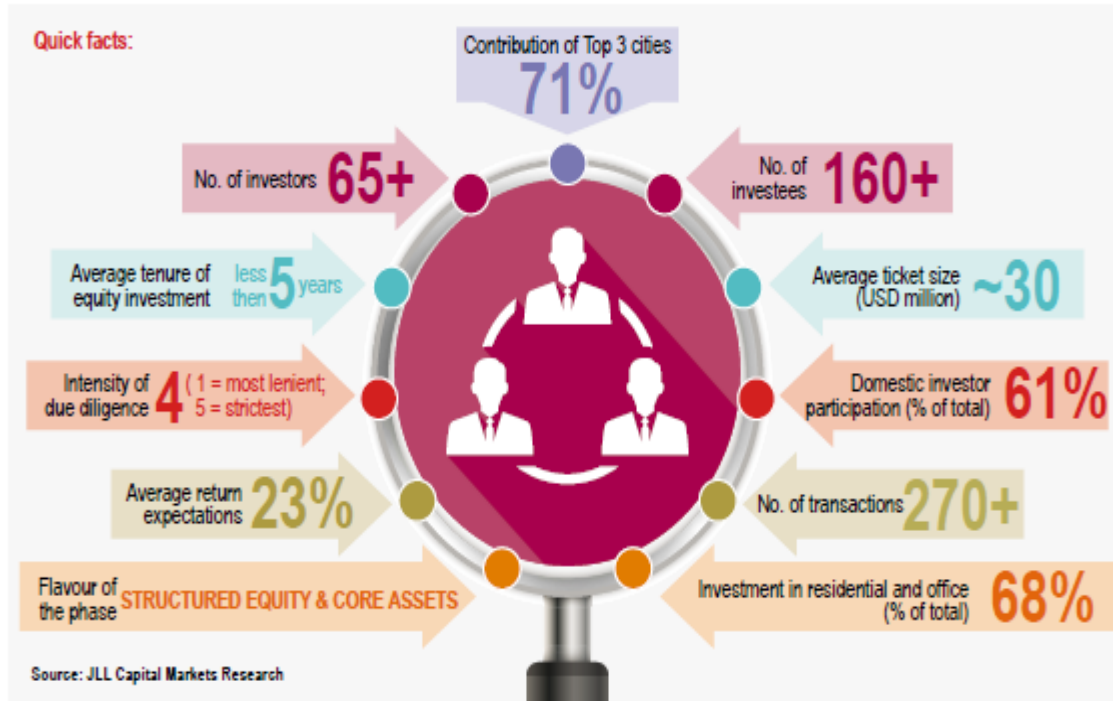


Phase 1- Mann rey tu kahey na dheer dharey.....



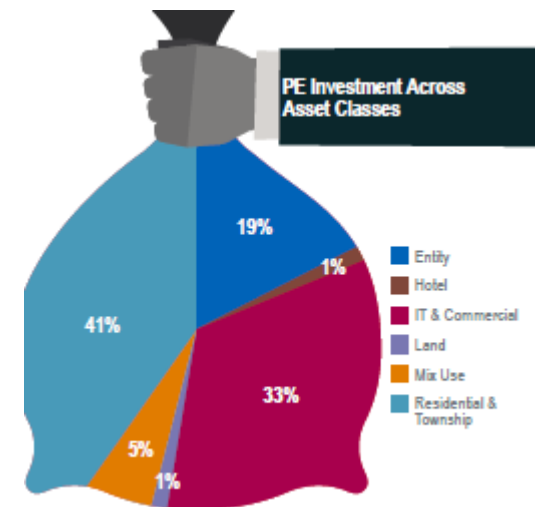
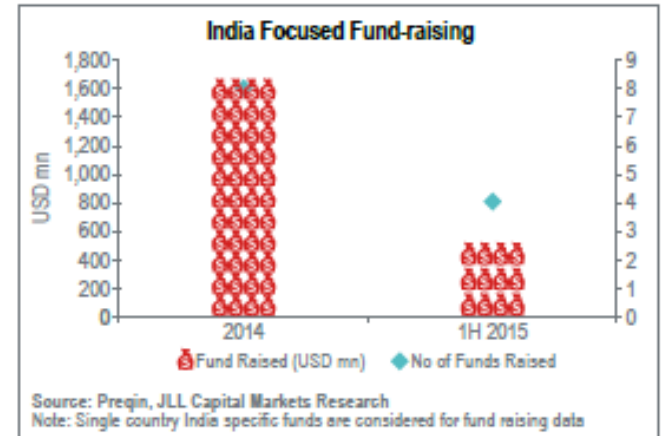
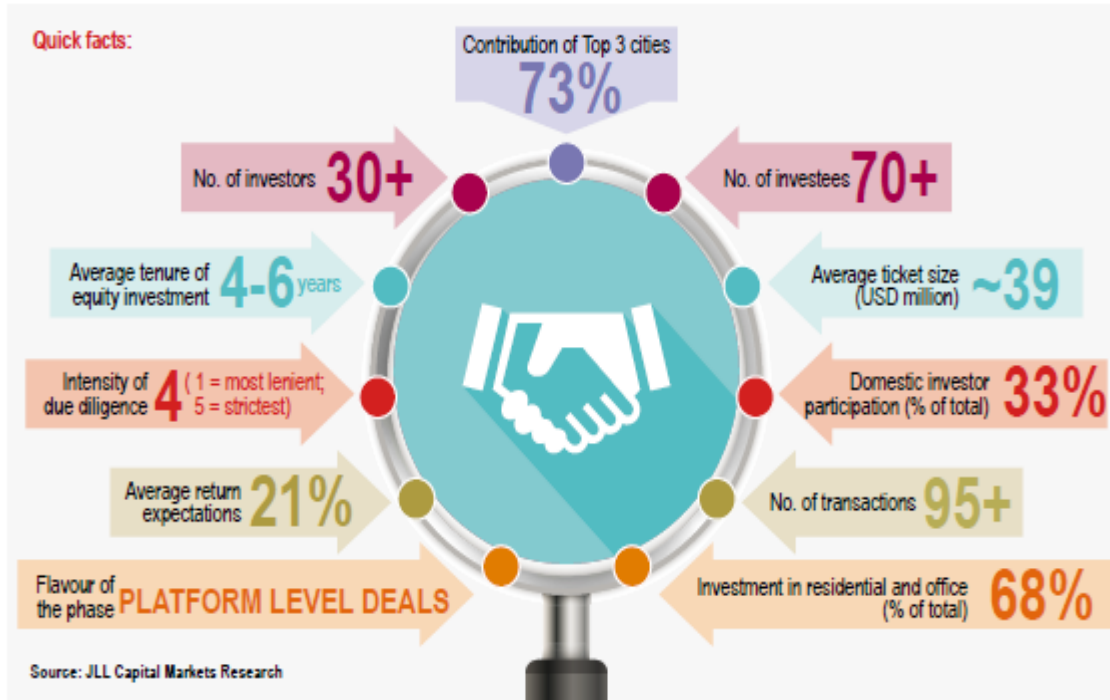
Chalo ek baar phir sey ajnabi bann jayein...

Phase 2- Yeh raastey hain...chalna sambhal key!



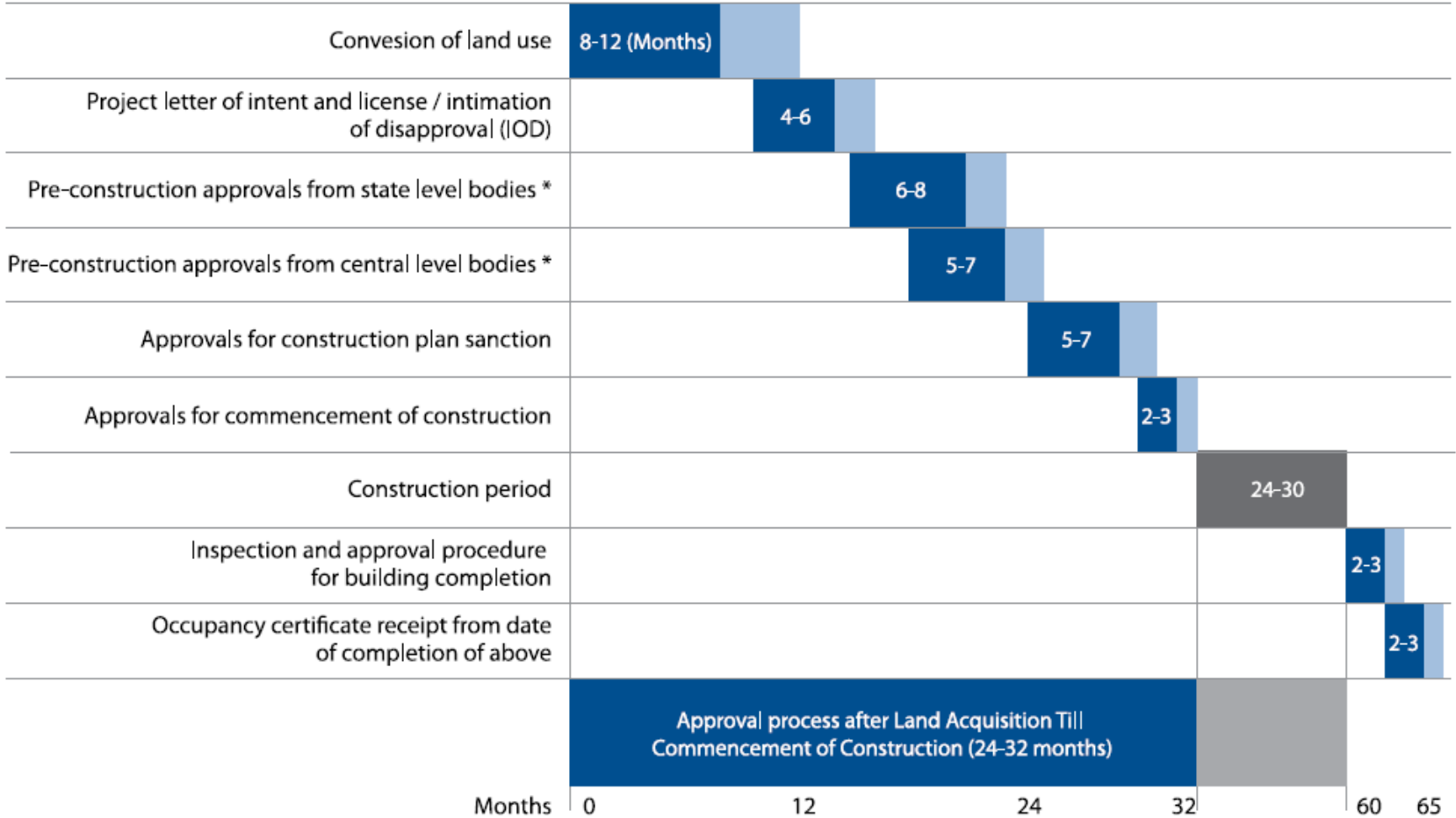
Jo waada kiya who nibhaana pareen

Phase 3- Saathi haath baddana..ek akela thakk jayegga...mil kar....



Inefficiencies in the process of Project life cycle

Figure 6: Approval Process for Real Estate Development in India



Source: CREDAI-Jones Lang LaSalle Real Estate Transparency Survey 2011

What happened in PERE- Challenges

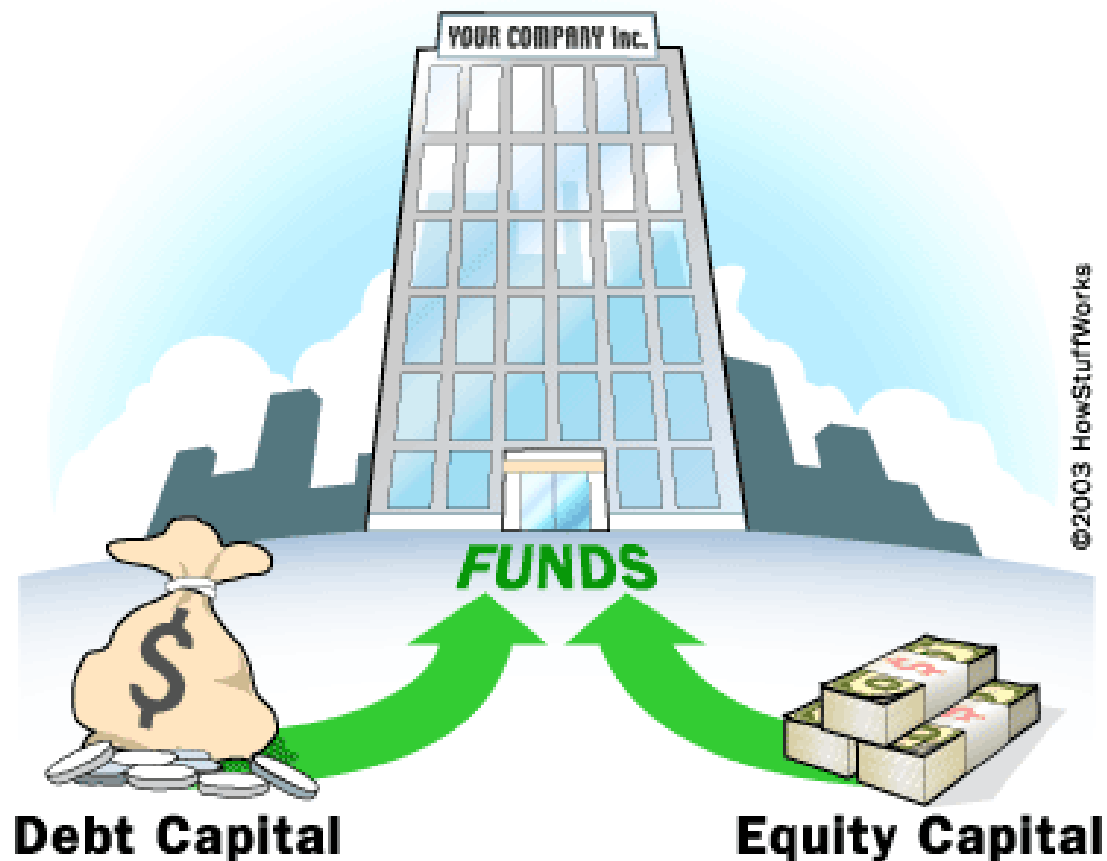
- Approvals have taken a long time resulting in delay of Projects
- Large projects have taken a long time to come to market
- Money has been impatient- the time value of money
- Delay has hurt the bottom line
- Local Partners have valued their existing land bank in excess to the market
- Cash-out to the landholder leaving no skin in the game
- Restricted management bandwidth
- Large Projects have not been very successful
- Funds have been diverted from the project
- Slow sales combined with large capital outlay and fund diversion have made some project financial un-sustainable
- Title insurance

Maturity has emerged in the developer/fund relationship

An insight into Mezzanine Finance

Investment flavor

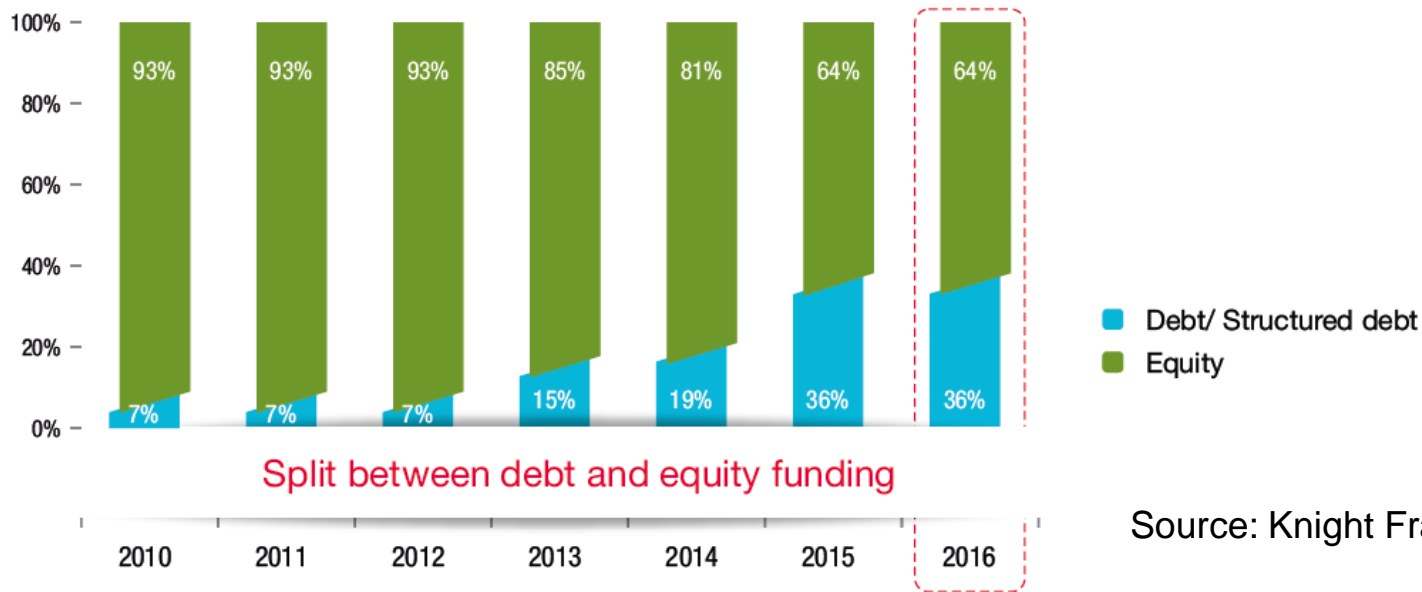
Mezzanine Finance(Structured Debt) and/or Private Equity



Mezzanine /Structured Debt Financing

- Mezzanine finance typically is a structured debt-like instrument, earning mid/high yields, through a combination of cash coupon and terminal yield and/or equity linked components, such as warrants and convertibles.
- It bridges the financing gap in a company's capital structure and occupies a place between senior debt and equity, both in security and total returns
- The Mezzanine Finance done through CCDs in pre Lehman-era has been replaced with NCDs which provide better security/charge creation. The CCD deals were done with a call/put options where the coupon was serviced regularly and the exit was structured through call option premium (conversion at minimum DCF value).
- Some of the PE players have set up an NBFC arm to undertake mezzanine finance and debt deals.
- Mezzanine funding generally provides for a coupon/preferred return of 19% to 22%. Most transactions provide for a waterfall structure on the Equity component now.
- The collateral backing where finance is done through NCD route is through collateral of land and project receivables along with standard covenants of debt.

Economic Times- June 4, 2015



Source: Knight Frank report 2017

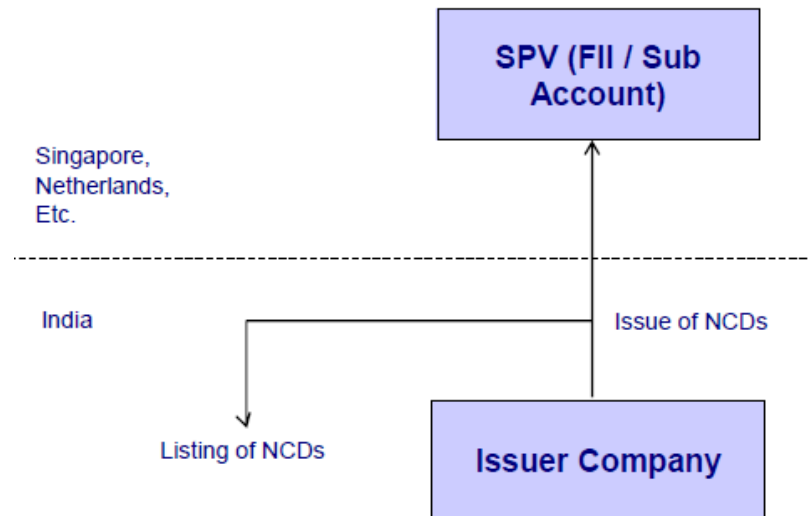
There is a clear shift to invest in Debt/Structured debt

Non Convertible Debentures

- **In NCDs factors affecting lending to projects**
 - good location
 - saleability,
- **Tenure**
 - Fixed tenure of three to five years
- **IRR**
 - Coupon payable at regular intervals
 - Back-ended redemption premium, if any, to provide the investor with an overall commercially agreed IRR in the range of 18-24 per cent .
- **Security**
 - Issuances are secured through a charge on the asset being funded with a security cover of around twice the size of the investment.
- **Options**
 - May include a put option permitting the investor to exit prior to completion of tenure of the NCDs on achievement of certain conditions (in cases where all apartments are sold or completion certificate is received prior to completion of the tenure of the NCDs).

Non Convertible Debentures Issuance Procedures and Regulations

- NCDs are Rupee denominated instruments, hence ECB regulations won't apply as ECB regulations deal with foreign currency
- No prior approval of RBI is required to remit principal, coupon and redemption premium payments to the FII or sub account which holds the NCDs
- Prior approval of RBI may be required for making any payments pursuant to the enforcement of the security by which the NCDs are secured



Commercial pre-leased yield assets

- **Constant and stable yields i.e. fixed annual return on investment in the form of rental yield**
- **Expectation of capital value appreciation**
- **Guaranteed returns**
- **First Institutional deals in India in early/mid 2000s done by HDFC in Bangalore and ICICI Limited in Hyderabad**
- **Perfect for IT parks and special economic zones.**
- **Safer investment though not giving high returns like residential developments**
- **With REITs in India, private equity investments in these assets is expected to grow significantly**

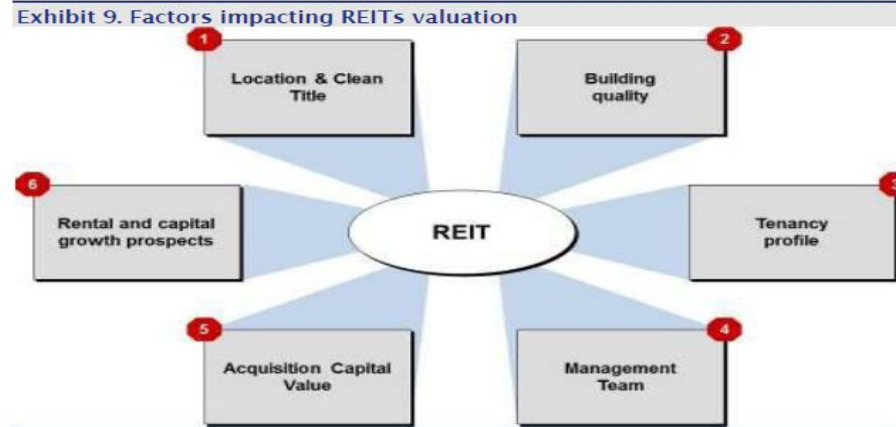
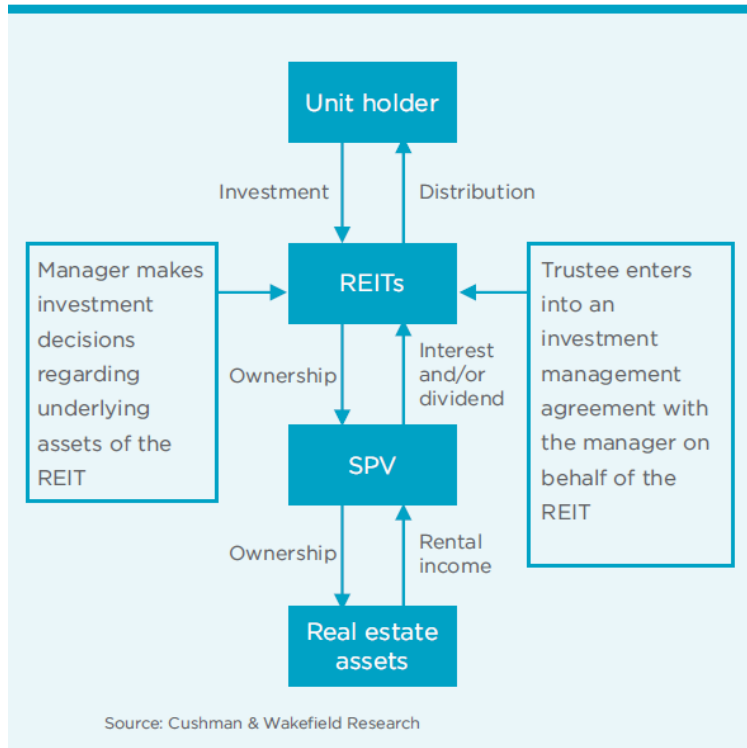
Right time to invest in commercial office asset class?

- Office markets in the top seven cities in the country, are yet to regain their peak, whilst absorption levels had gone up
- Many cities are offering lease earning office properties below replacement cost, though supply of quality leased assets still remain a challenge.
- Very interesting trends in variation on vacancies in micro-markets- What?
- For an investor, this provides an excellent investment opportunity, as these properties have reduced the key risks – land acquisition risk, approval risk, construction risk and marketing risk
- Long term investment with horizon of 7- 10 years -long term investors like pension funds
- FDI compliant stock is roughly 45% of the investable Grade A stock of 450 mn sft. However, generally there is lack of quality grade A assets with considerable leased portion available for sale.
- Concept of 'ERV- Expected Rental value' /global vacancies being factored by some of the investors in their financial models.
- Some of the players who are actively seeking to invest in commercial real estate asset class are CPPIB , Blackstone, Brookfield, Ascendas, GIC and Xander.

REIT- An idea whose time has come?

- Real Estate Investment Trust(REIT) is a company that owns and manages investment grade and income producing real estate properties such as office buildings, residential buildings, shopping malls, healthcare facilities,. Returns from REITS are primarily derived from two sources- dividend yield and share price appreciation. Most REITS are listed and traded in stock exchanges.
- REITs invest in completed, revenue generating commercial properties and distribute a major portion of the earnings among investors.
- Of the 450 msf of Grade A office market across top seven cities, ~100 msf could be up for REIT listing in medium term. Cap rates have already been compressed and it is also expected that the cap rates will compress further by 100 bps to 125 bps.
- REIT has a potential market size of USD 10 -15 Bn in medium term
- REITs bring in increased transparency in the sector by adopting better corporate governance, disclosures and financial transparency practices.
- Currently most leased assets have LRDs on them, which leaves little for distribution as dividend.
- SEBI REIT regulations allow for foreign participation provided “that in case of foreign investors, such investments shall be subject to guidelines as may be specified by RBI and the government from time to time”.

Size of REIT market/ Factors impacting REIT valuations



Source: JM Financial

| Probable REIT listing in next 3 years | | |
|---|--------|---------------------|
| REIT compliant office space in top seven cities | 203 | million sq ft |
| Expected REIT listing in first 3 years (50%) | 102 | million sq ft |
| Average rent | 60 | INR / sq ft / month |
| Total rent | 7,308 | INR crore / annum |
| Cap rate | 8% | |
| Valuation | 91,350 | INR crore |
| Exchange rate | 60 | INR / USD |
| Valuation | 15 | USD billion |

Source of table: JLL REIS

Bulk Apartments Units

- ▶ Strategic investment (equity flavoured) through this route
 - An institutionalised way of underwriting under construction projects.
- ▶ Two Approaches
 - A dedicated fund approach towards investing in bulk apartment units with a three to four year investment horizon
 - Earmarking a part of existing or proposed funds for such bulk apartment investment modules.
- ▶ Mode
 - Funds pre-purchase stock in under-construction projects at a discount (20-30%)
 - Look for appreciation in apartment values in the medium term.
 - The capital is infused either upfront or in tranches based on the construction schedule of the project.
- ▶ Developers use the funds to complete construction of the project and are required to sell the fund's stock of apartments in proportion to the rest of the apartments in the project after a stipulated time

Construction Finance in Real Estate

- ▶ Types of Products
 - ▶ Term Loan for Residential/Commercial Project – Sale Model
 - ▶ Term Loan for Commercial Project – Lease Model
 - ▶ Term Loan – General Purpose Corporate loan
 - ▶ Mezzanine Finance
 - ▶ Project Finance with Distribution

Loan criteria and parameters

| Key Considerations | Credit Evaluation Parameters |
|--|--|
| <ul style="list-style-type: none">➤ Developer's Profile➤ Industry Outlook➤ Project Feasibility➤ Financial Strength➤ Utilization of Funds➤ Means of Finance➤ Monitoring | <ul style="list-style-type: none">➤ Exposure Norms➤ Credit Parameters➤ Builder Categorization➤ Security Requirements➤ Commercials➤ Repayment Pattern➤ Approving Authority➤ Standard Formats |

Credit Parameters

- ▶ General Parameters
 - ▶ Developer Category
 - ▶ Purpose of Loan
 - ▶ Satisfactory Credit History
 - ▶ Profit making
- ▶ Financial Parameters
 - ▶ Loan amount capping - 50% of Project Cost
 - ▶ Promoter's contribution - minimum 20% Project Cost
 - ▶ Debt equity ratio
 - ▶ DSCR =>1.5 times

(It varies from company to company, as per internal Credit Policy)

Key Financial Parameters – Construction Finance

| | |
|------------------------------------|--|
| Loan to Project Cost | Maximum 50% depending on the merits of the case. |
| Promoter's Contribution | Minimum 20% of cost of the project. |
| Dependency on booking money | Maximum 50%. |
| Project Debt Equity | 2 times |
| Project DSCR | 1.5 times |
| Loan to Value Ratio | 50% to 75% of security value depending on the merits of the case. |
| Financials (Company/ Group) | Consistently profit making D/E: maximum 2 times. Current Ratio: 1 time. |
| Audited Financials | Balance Sheet: Net worth, Debt, Advances from customers (current liability), WIP (current asset). Profit & Loss: Turn over and PAT (trending and margins) Contingent Liabilities and auditor's qualifications. |

Security Requirements

- ▶ Clear, marketable and mortgage-able title of the project land/security.
- ▶ Satisfactory technical due diligence of the project.
- ▶ Forensic report- promoter, vendors, employees
- ▶ RoC check
- ▶ Asset coverage - **1.75 to 2 times**
- ▶ Hypothecation of the receivables.
- ▶ Personal guarantee of the promoters and/or corporate guarantee as per the sanction terms.

Construction Finance: Process

SANCTION STAGE

Stage 1: Loan Origination & Business Development

Stage 2: Documentation & Verification

Stage 3: Preparation of Credit Proposal

Stage 4: Holistic Risk Analysis

Stage 5: Appraisal & Approval Process

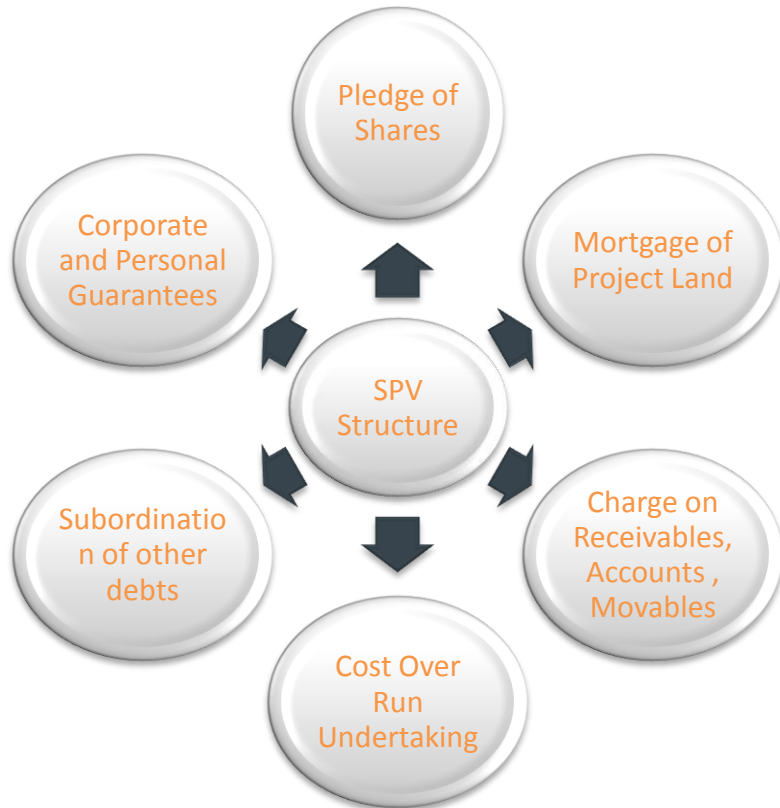
DISBURSEMENT STAGE

Stage 6: Loan Documentation & Disbursement

POST DISBURSEMENT STAGE

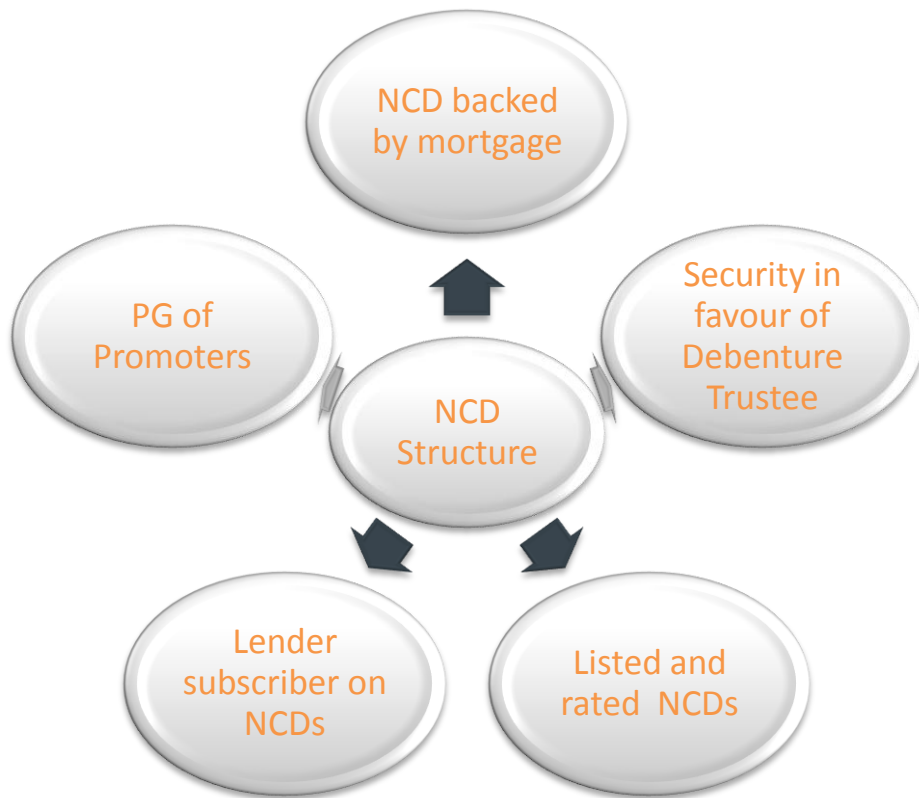
Stage 7: Loan Monitoring Mechanism

Transaction Structures - SPV



- ✓ Enforcement through sale of shares
- ✓ Project not getting completed or slow can be sold
- ✓ In case of cost overrun promoters to provide funds
- ✓ All other debts to rank junior including promoter's contribution
- ✓ No change in the capital structure
- ✓ No further indebtedness

Transaction Structures - NCD



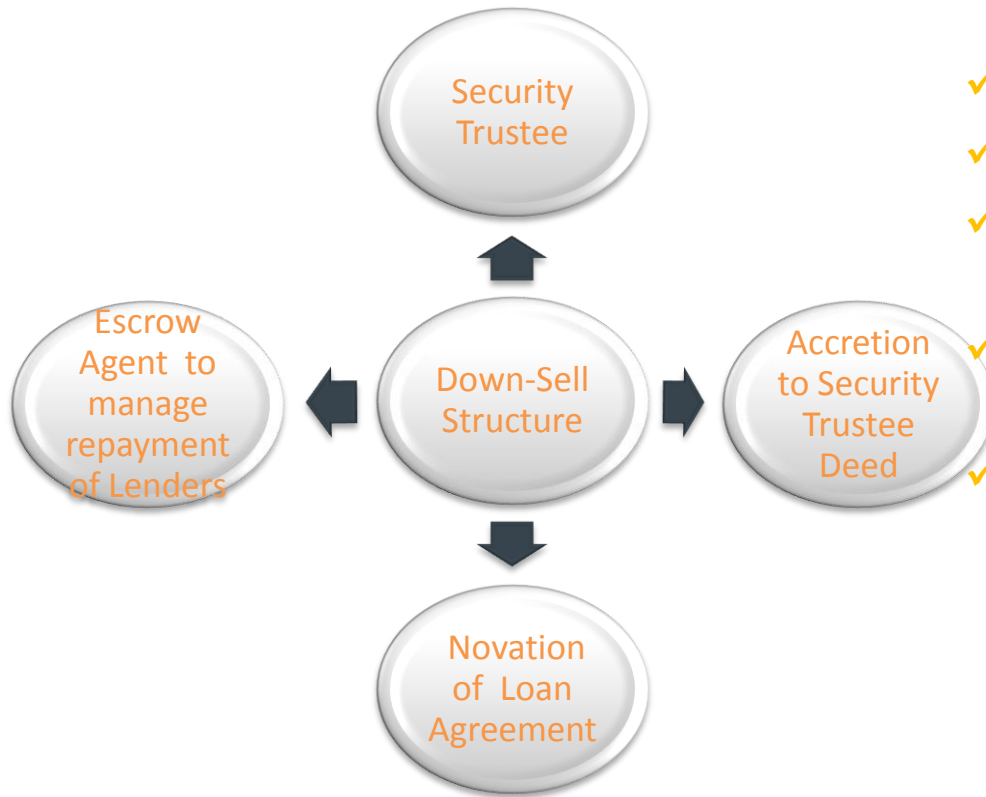
- ✓ Enforcement through sale of Debentures
- ✓ Listed and rated NCDs
- ✓ Portion of debt can be sold
- ✓ Exposure to capital market permitted up to 40 % of the net worth to HFC
- ✓ Syndication – other lenders to share the risk

Transaction Structures - LRD



- ✓ Risk of vacancy to be covered by DSRA
- ✓ Saves impairment of asset
- ✓ Portion of debt can be sold
- ✓ Any shortfall in lease rentals to be met by the Promoter / Hold Co.
- ✓ Attachment of lease rentals and bank accounts in case of default

Transaction Structures - Downsell



- ✓ Structure created to Down Sell
- ✓ Ensures Risk Sharing and Higher ROE
- ✓ Security Trustee to be holder of the security
- ✓ New Lender to Accede to Security Trustee Deed
- ✓ Escrow Agent / Security Trustee to manage repayment of Lenders

Where are we headed?



Source: Internet/ JLL Report

Disclaimer

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The views expressed are not binding on any authority, and hence, no assurance is given on its accuracy and that a position contrary to the opinions expressed herein, will not be asserted by any authority and/or sustained by an appellate authority or a Court of law.

This presentation is purely indicative and has been prepared for the benefit of and from the perspective of Institute of Chartered Accounts of India and does not address any other perspective.

Thank You

For any queries/comments, please feel free to contact:

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