Exit strategy

Understanding and de-risking investment exit from India

by Ashok Kinha and Prashanth Koppula

India is a large and robust economy on a fast growth trajectory, but not every investor who has entered the market has had success. Having experienced the initial wave of foreign capital flows into India's property markets, collective wisdom now focuses on finding the appropriate balance of risk and reward in this emerging market.

The pre–global financial crisis period of 2006 and 2007 saw private equity investments in Indian real estate peak. During this period, economic growth was robust, and favourable demographic factors resulted in an increase in demand for residential and other commercial projects. This induced a lot of foreign private equity funds to invest in emerging economies such as India, and predominantly in nonresidential commercial real estate.

> ***The focus in India on exits and distribution of profits is greater than ever before. But challenges remain.***

Ashok Kinha
Athamus Venture Management

After the financial crisis, foreign flows contracted and, as a result, investments declined considerably. Though the impact on India was limited vis-a-vis developed economies, an overall decline in economic activity resulted in decreased demand for residential and commercial units. Many real estate developers faced difficulty in completing existing projects because additional funds were not forthcoming, and so delayed launching new projects.

As domestic demand subsequently improved, the residential sector recovered as well. Many private equity funds realigned their focus to residential projects. Those funds that invested at the height of the market in the precrisis period are now actively looking for exits because they have completed their holding periods. As such, the focus in India on exits and distribution of profits is greater than ever before. But challenges remain.

Issues involved in Indian investments

Illiquid investments: Real estate investments in general are illiquid and, in many cases, a private equity fund may have to wait until the developments and sale are carried out by the developer before a return is realised. Private equity funds need the ability to withstand fluctuations in the value of investments and be able to hold investments over long periods.

Difficulty in valuation: Real estate investments in unlisted firms are not quoted on any stock exchange, and the values of such investments during their holding periods are not known. No other cash flows into the fund during the period of investment except the amount realised on sale. This, in turn, depends on market forces of demand and supply, specific requirements of buyer and seller, and their respective negotiation positions. Thus, unlike public equity, a general lack of clarity exists both on the amount that could be realised on sale of investments and the impact made by private equity funds on the value of the investments until they are sold.

Lack of transparency: Until recently, the real estate sector was unorganised, with numerous small regional players financed by high-net-worth individuals who lack expertise. With the advent of institutional finance in 2005, the sector evolved into an organised one. Still, the sector is affected by lack of clear land titles, absence of title insurance, challenges in obtaining regulatory approvals, and procedural difficulties. This increases the difficulty in execution of projects. Private equity funds must depend on legal experts and consultants to evaluate specific problems involved in each project before taking the investment calls.

Increase in input costs and delays in execution of projects: Rising input and labour costs result in shrinkage of profit margins, thereby straining cashflows.

Effect of economic cycles: Demand for retail, office and hotel assets depends on economic conditions. Accordingly, more private equity funds are required during boom periods when more construction activity takes place and vice versa. In periods of low economic activity, the real estate sector faces the problem of oversupply, where exits for private equity funds become difficult.

Exit challenges: Exit planning is required to return capital to investors after the end of the investment-holding period. Residential projects are self-liquidating, as the units are sold to householders on their completion, hence exits happen naturally. With nonresidential commercial projects, however, exits require more careful planning. The most prominent real estate exit modes are: Sales through IPO, or public market sales, which involve trading of secondary stock after listing, and constitute only 5 percent of total exits of private equity funds in India; third-party exit, which involves exit through sale to a strategic buyer or to another private equity fund, and is only 19 percent of total private equity exits because of regulatory restrictions on the sale of completed units; project-generated cashflows (more than 20 percent); and promoter (or company) buyback, the most predominant form of exit, at 51 percent, illustrating a lack of other avenues for exit.

Regulatory issues: The following regulations have caused hurdles in investment and exit by private equity funds: a three-year lock-in for foreign direct investments in real estate, affecting natural exit through project cashflows during that period; exit for certain commercial projects is permitted only through sale to domestic investors/end-users; and the dispute-settlement procedure is unsatisfactory.

Increasing urbanisation, driven by rapid migration from rural areas, is driving strong demand for housing in India.

Prashanth Koppula
Athamus Venture Management

Measures to overcome challenges

By focusing on thorough due diligence and active monitoring of investments, private equity funds are in a better position to address delays in project execution and issues related to transparency. Due diligence aids the determination of project viability, asset quality, promoter/developer credibility, and track record of successful project execution. Active, hands-on project monitoring is vital because it contributes to the timely completion of projects, which in turn keeps input costs in check and helps better manage profitability and cashflow prospects. All this requires the private equity fund manager to have knowledge of local conditions/environment, domain knowledge, and expertise in deal sourcing and deal execution.

It is also important to diversify investments across different property development cycles, locations and subsectors, as this helps with generating adequate liquidity for the private equity fund. Traditionally, most investments by private equity funds have been in Tier 1 metropolitan cities, such as the National Capital Region (NCR) Delhi and Mumbai, but these are now expanding to other urban areas.

Market conditions and the cyclical nature of real estate have a bearing on the ability to successfully exit from investments. Careful study of market conditions and longer-term prospects can give private equity funds an opportunity to enter local markets at opportune times and lower valuations compared with historical trends. This also makes it easier to exit when market conditions reverse and periods of lower demand are accompanied by oversupply in the market.

With regards to regulatory hurdles, The Real Estate (Regulation and Development) Act, 2016, which came into effect last year, has helped set up a real estate regulatory authority in each state and to arm state bodies with the right to impose penalties on defaulters, thereby helping protect homebuyers. By bringing much needed transparency and discouraging delays in project completion, RERA is already having an impact by making developers more accountable. This said, a lot of work still needs to be done in the area of arbitration and settlement of disputes between fund managers and developers.

The Securities and Exchange Board of India finalised REIT regulations in 2014, and the first REIT to be listed is anticipated later this year — sponsored by Blackstone and its Indian partner Embassy Group — and is expected to be worth US$1 billion. REITs are likely not only to provide exit options for private equity real estate funds, but also an opportunity for retail investors looking to add exposure to real estate in India.

Reforms and urbanisation

Recent reforms ushered in under the leadership of Prime Minister Narendra Modi, as well as the intact economic fundamentals that continue to strengthen, are good for investors, especially in the Indian real estate market.

Increasing urbanisation, driven by rapid migration from rural areas, is driving strong demand for housing in India. The number of cities with populations exceeding 1 million, for example, has grown from 35 to 53, an increase of more than 50 percent over the past decade. While urbanisation is on the rise in India (33 percent as of 2015, and expected to reach 50 percent by 2050), the Indian urban population share is far below global averages for developed markets, an encouraging sign. Rising household incomes are another factor driving strong demand for residential real estate.

Although strong demand is driving India's residential market, existing housing supply capability and capacity are woefully insufficient; the current backlog is 19 million homes per year, and the current delivery capacity is 1 million homes per year, with most of this in urban areas. The rapid urbanisation underway will see this backlog grow to 30 million homes per year in 10 years, with a corresponding increase in the delivery capacity to 3 million homes per year (19 percent compound annual growth rate in residential). Adding fuel to this demand is the easy availability of home loans. As a result, housing demand in India is very strong, with 40 percent of the growth coming from Tier 1 cities, and a three- or four-fold demand/supply gap in low- to mid-income segments.

Against this backdrop, the best way to balance risk and reward in an emerging market such as India would be an integrated model involving

New Delhi

both fund management and residential real estate development in end-user driven micro markets, with a time horizon of five to 10 years.

Residential versus other segments

It is far better to be in the residential segment in India than other segments, including retail, industrial, hotels and logistics, because investors have greater control over the exit timeline, which is very important in the Indian real estate market. This can be achieved by having 100 percent control over the investment assets, which provides capital protection and for multiple exit strategies. Having the ability to exit at the land-buy stage is essential. This, along with investing in opportunities where one can exit in five years or less, is key. With this in mind, investing in India with integrated funds that keep control over the assets and exits, and make investments at the land-buy stage, is a dependable way to achieve excellent returns and balance risk. In select micro markets within Tier 1 cities in India, for example, simple ownership in land results in 3x returns over five years. The key is to have experts to identify those opportunities.

Managing pricing risk and investment strategy

While there is pricing risk in any market, only one financial structure makes sense for entering the market. Pricing risk can be reduced by entering at the right stage to ensure the investment is secured with an asset that matches or is higher in value than the investment. FDI regulations in India have been successively liberalised to the extent they now allow for buying land to develop and sell. This allows for a far better entry for investors, rather than buying at the pricing stage at a premium. On a broader note, India has seen a decade or more of its capital and real estate markets opening up, with investors making returns in Indian real estate. The bottom line is, when a government has opened markets, returns soon follow. Indian real estate, therefore, presents several direct-buy opportunities, but it is necessary to have the right team with the required expertise to make investments and exit in five years. Integrated funds that do real estate development with such a team are the answer because they provide avenues for multiple exits, starting from the land-buy stage.

Over the past 15 years, a good portion of investments were with listed and unlisted developers, as well as joint ventures with developers. This period has shown exit delays from investee companies. As a result of this experience, investors have become smarter, with a greater understanding of the markets, how they function and their risks. The right team can make a difference, as long as investors have 100 percent control over the invested assets. Given zero percent risk does not exist, investors need to manage risk through control investments with the right team on the ground with the expertise required. This can achieve the baseline 3x return, and the right team can go beyond that by creating value and achieving the right valuations.

A successful exit

May private equity funds have experienced challenges in achieving a successful exit for their Indian investments made over the past decade. A market survey by Bain & Co has found, more than raising capital or finding the right investee, the biggest challenge for private equity funds has been to achieve a successful exit. This is why fund managers focused on exit modes, and those that understand all the factors associated with them will have an advantage.

Existing regulatory and market conditions are resulting in practical difficulties for traditional exit modes. As a result, private equity funds are looking at new and innovative ways to achieve a successful exit. These include: a share swap (upon receipt of necessary regulatory approvals) with a listed entity forming part of the same group as that of the investee company, and wherein the acquired shares can be easily liquidated; and private equity funds negotiating the right to require the investee company to sell its assets or its business as a going concern to obtain liquidity — depending on the ownership distribution of the investee company, this may require support from other shareholders.

Most exit modes still require cooperation from the promoters. Perhaps to counterbalance this "promoter risk", there has been increasing interest in evaluating investments in certain classes of listed companies as private investment in public equity (PIPE) transactions; although the private equity fund cannot obtain participation in control rights without making a tender offer, the fund has the additional comfort of easy liquidity because shares can be traded freely. This mode has been validated by the fact a substantial portion of the funding in the past year was through PIPE deals.

A holistic and practical approach by private equity funds toward investment and returns, and promoter identification and promoter relationship management, are key drivers for a successful exit. On the part of the promoters, their proactive participation in the exit — with the understanding a successful exit for the investor would attract better investments in the future — would enhance investor confidence in the Indian real estate market. ❖

Ashok Kinha (ashok.kinha@athamus.com) and **Prashanth Koppula** (prashanth@athamus.com) are managing directors and general partners of **Athamus Venture Management,** based in Bengaluru, India.