April 2013

The Guide to

INVESTING IN INDIA 2013

hubbis

FOREWORD

Global investors today have plenty of cash and limited opportunities. India presents a wealth of potential, but to harvest this, the country needs capital. And while it does have a decent savings rate, it falls short on capital formation; it therefore needs long-term foreign capital.

Investors can find information about such opportunities everywhere – books, TV, the internet, broker reports, etc. Indeed, there is too much information but perhaps not enough organised analysis that helps long-term investors make sound decisions.

While investors know that India and China are the most populous, and the fastest-growing of the larger economies in the world, they are probably not sure about allocating part of their portfolio to these markets directly. They have allocations to global or emerging market equity funds, part of which gets invested in these markets. However, the fund managers of such funds usually have shorter-term objectives and invest accordingly. Their funds move in and out of stocks (or other securities) on a daily basis, making them "hot money".

Investors may wish to consider whether these markets deserve to be a "separate asset class" like their own home equity market, in which people tend to invest disproportionately higher allocations as part of their "home bias" because of familiarity and the rationale that their liabilities are in that economy. Should they consider higher allocations to the two largest economies because increasingly the products and services they consume may come from these places?

To do so, investors will have to understand the market better. Apart from high GDP growth, what does the economy look like? What are its long-term drivers? What road-blocks does it face? Even if investors are convinced about the long-term fundamentals of the economy, are there shorter and medium-term factors that could de-rail the secular trend? How balanced are the economic and political factors?

Assuming investors are convinced about the economy, how can they leverage the fundamentals? What asset classes are available? For each asset class, what are the fundamentals? And risk/return equations?

And if investors are ready to buy, how do they access the investments? Should they invest through globally recognised fund managers or do the local investors have some competitive advantage? How can they access the local fund managers? Are there are restrictions or disincentives that change the risk/return equation for the investors?

These are some of the questions we have attempted to answer. We hope you find this Guide a useful starting point.

Hansi Mehrotra
Managing Director, India
Hubbis

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Feature article

FUNDAMENTALS – DEMOGRAPHICS, URBANISATION AND CONSUMPTION

India's huge population – considered a curse a few decades ago – has just started paying its "demographic dividend" as an unprecedented number of people enter the workforce, move to cities and consume more.

A few decades ago, both China and India were struggling to cope with their burgeoning populations. In a desperate attempt to control its population growth, China introduced a one-child policy.

India opted for a more democratic path – endorsing the merits of a small family with various incentives and in some areas and disincentives for families which have more than two children. Even as recently as the early 1990s, the Indian government made concerted efforts to combat the issue of population explosion.

The modus operandi ranged from setting up a population clock in New Delhi displaying a real time population prediction (a visual warning of the country's fast progression towards the alarming 1 billion mark), to emotional and creative advertisements on television and billboards promoting the small family concept.

> "The BRIC nations are at the peak of their advantageous demographic profiles."

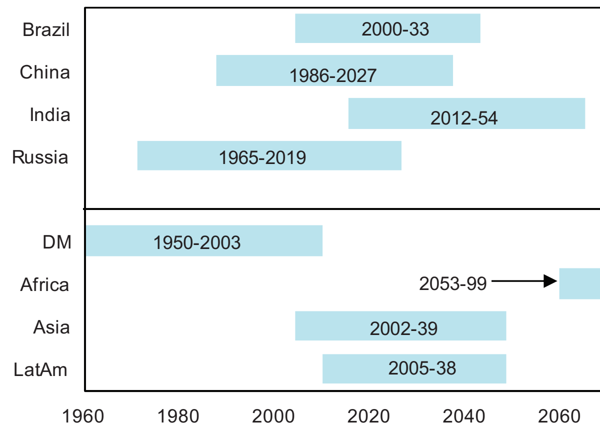
In the last decade, the very size of their populations has made both nations forces to be reckoned with. China and India's need-to-be-controlled baby booms have become "demographic dividends".

DEMOGRAPHICS

According to a Goldman Sachs study, the BRIC nations are currently at the peak of their advantageous demographic profiles, and will most likely remain in such a position for a couple of decades.

The demographic window occurs when a population "bulges" – the result of a rapid fall in mortality rates and a more gradual fall in fertility rates – surpasses the working age bracket. More labour means more people earning and saving money, which naturally boosts economic growth.

The BRICs' Demographic Windows* Have the Potential to Boost Growth



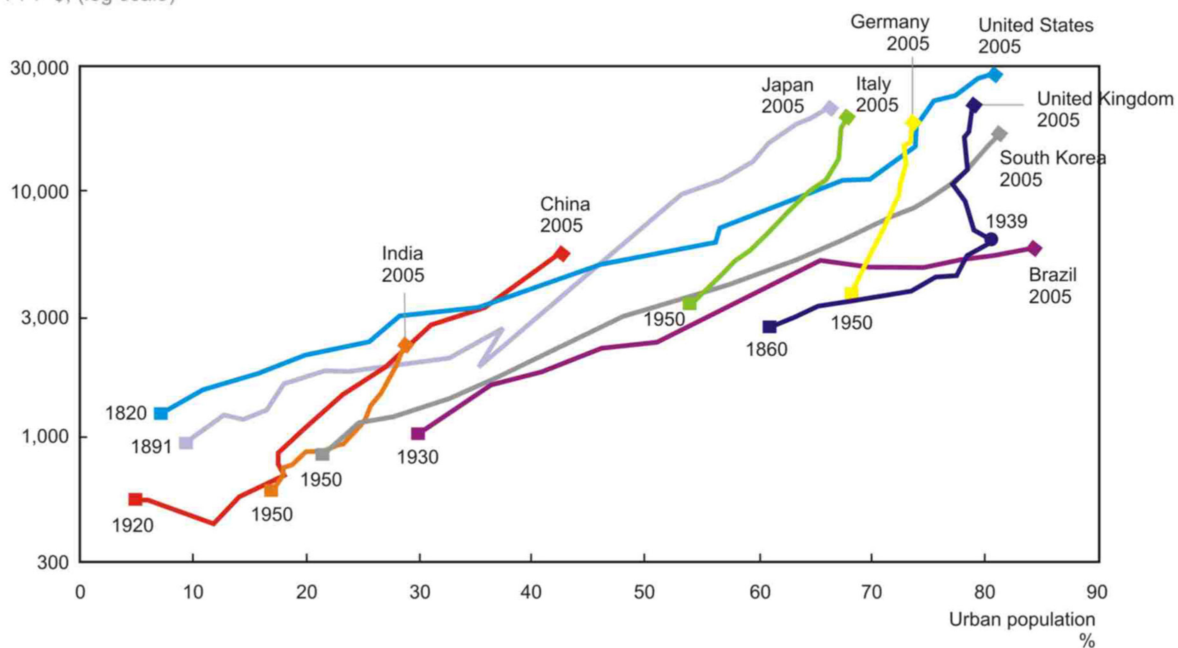
*proportion of children under 15 falls below 30% and proportion of elderly over 65 is still below 15%
Source: UN, GS Global ECS Research

India entered this demographic phase in 2012. The country's 1.2 billion population is still growing and is expected

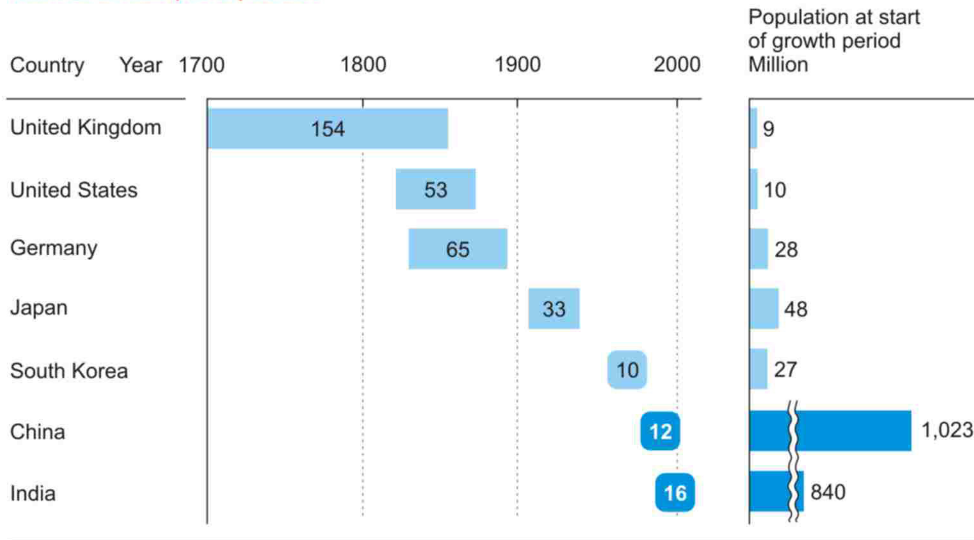
Exhibit capita GDP has risen in tandem with increases in the urbanization rate

per capita and urbanization[1]

Per Capita GDP
1990 PPP $, (log scale)[2]



1 Definition of urbanization varies by country; pre-1950 figures for the United Kingdom are estimated.
2 Historical per capita GDP series expressed in 1990 Geary-Khamis dollars, which reflect PPP.
SOURCE: Population Division of the United Nations; Angus Maddison via Timetrics; Global Insight; Census reports of England and Wales; Honda in Steckel & Floud, 1997; Bairoch, 1975



1 Time to increase per capita GDP in PPP terms from $1,300 to $2,6000.
SOURCE: Angus Maddison; University of Groningen: *Resource Revolution: Meeting the worlds's energy, materials, food, and water needs*, McKinsey Global Institute, 2011

to peak at nearly 1.7 billion by 2060. India is also currently experiencing an optimal demographic phase, whereby the working-age population is disproportionately large, even compared with other BRIC countries.

URBANISATION

Urbanisation is another factor un-derpinning growth in emerging markets, and India in particular. It was industrialisation and urbanisation that vaulted Europe and the US into prominence in the late 18th and early 19th century. Asia and Latin America are now undergoing urbanisation at unprecedented scale and speed.

One way to understand the link between urbanisation and GDP growth is to consider economies of scale. According to McKinsey's April 2010 report, "India's urban awakening: Building inclusive cities", sustaining economic growth, while the US and Germany, with their respective initial population sizes of 10 million and 28 million, took more than 50 years to double their per capita GDP, India has managed to do so in just 16 years from an initial population size of around 840 million.

The McKinsey report predicts that India's cities will account for half of the nation's GDP by 2025. There is a large body of literature on urban economics, and many experts have noted the nature and size of the urban economies of scale. Most estimates put average urban incomes at roughly three times that of their rural counterparts. McKinsey's research in India suggests that it is 30% to 50% cheaper to deliver basic services such as water, housing and education in cities, than in sparsely populated rural areas.

CONSUMPTION

In addition to expanding geogra-phies, urbanisation is also accompanied by rising incomes, and therefore, increased consumption. The growth in cities gives rise to a middle or "consuming" class, as the McKinsey report puts it. The consuming class is defined as individuals with a disposable income of more than US$10 per day on 2005 Purchasing Power Parity terms.

This growth in consumption is not just limited to middle income households. Within India's cities, 6% of the growth will come from higher income households - defined as those with annual incomes of more than US$70,000.

Such increases in disposable income inevitably boost demand for various goods and services, although the "take off" points and penetration rate will vary across categories and also across geographies.

Private consumption remains one of the strongest pillars in the Indian growth story, facilitated by the rise of the small town consumer.

A number of factors support the rise in consumption:

- Higher disposable income
- Higher aspirations and therefore higher demographic dividends of the younger generation
- A growing number of nuclear families

Marketers have mainly concentrated on the 10 metros and 40 mini-metros in the last decade. The 100 million strong population of "middle India" comprises about 400 towns.

The remainder of the urban population lives in 7,500 small towns, with populations of less than 100,000.

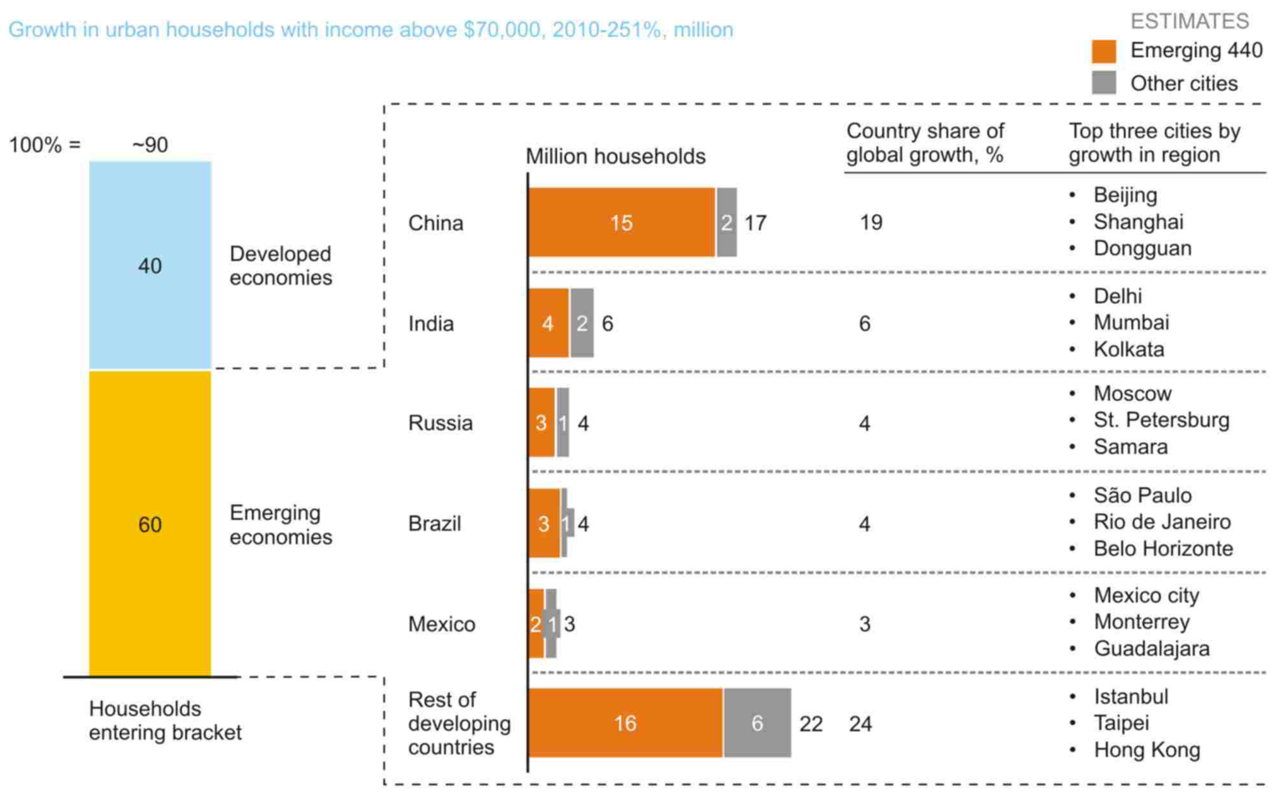
Increased exposure to the media and a gradual improvement in infrastructure have played a substantial role in introducing the middle India population to what was previously only a "metro" lifestyle.

For example, the fast moving consumer goods (FMCG) sector has become a broad and prosperous market.

Out of 81 categories, 49 varieties of personal care goods, household care goods and over-the-counter drugs outgrew the "all India rate".

Over 30 categories saw growth rates of 1.15-times the national rate, with consumers showing a preference for health, hygiene, personal grooming and convenience items.

The annual turnover of the top 10 FMCG players from this segment grew more than 42% between 2009 and 2011.



Private/ Public Sector Participation
Infrastructure Demands

Source: Avendus Capital

However, only a few major players with adequate capital and distribution networks have been able to cash in on this opportunity thus far.

Another driver of Indian growth is demand for infrastructure. This represents a US$100 billion opportunity. Providing education, healthcare and other services for a burgeoning population that has surpassed the 1.2 billion mark is a big task.

CONCLUSION

Today, a resilient demographic dividend, rapidly increasing urbanisation and a steep rise in purchasing power present India with a plethora of challenges, but also opportunities.

India's vast pool of working age citizens constitutes a labour force that may be retrained and re-skilled to meet these changing demands. ■

Cause	Effect	Possible Ramifications	
Rapid Economic Growth	Higher Family Incomes	More Consumer Spending	Emerging Market Opportunity
High Savings Rates In Asia	Low household debt	Ready supply of domestic capital	Emerging Market Opportunity
Urbanization	Infrastructure build out	Demand for commodities	Emerging Market Opportunity
Desire for social stability	Policies for peace and prosperity	Focus on creating jobs	Emerging Market Opportunity
Natural Resources Wealth	Exploration, development & production	Revenue stream for governments	Emerging Market Opportunity
Corporate Transparency	Easier to attract overseas investment	Market liquidity	Emerging Market Opportunity

Source: Avendus Capital

Feature article

INDIANOMICS

While very few people doubt India's long-term economic potential, the shorter-term report card doesn't look as rosy. Investors need to assess how India adjusts its fiscal and monetary policies to tackle a dangerous current account deficit and stubbornly-high inflation.

It is hard to ignore India's economy. Its nominal GDP nearly trebled from less than US$500 million in 2000 to US$1.3 trillion in 2010, and it is estimated that India could reach the US$2 trillion mark within the next

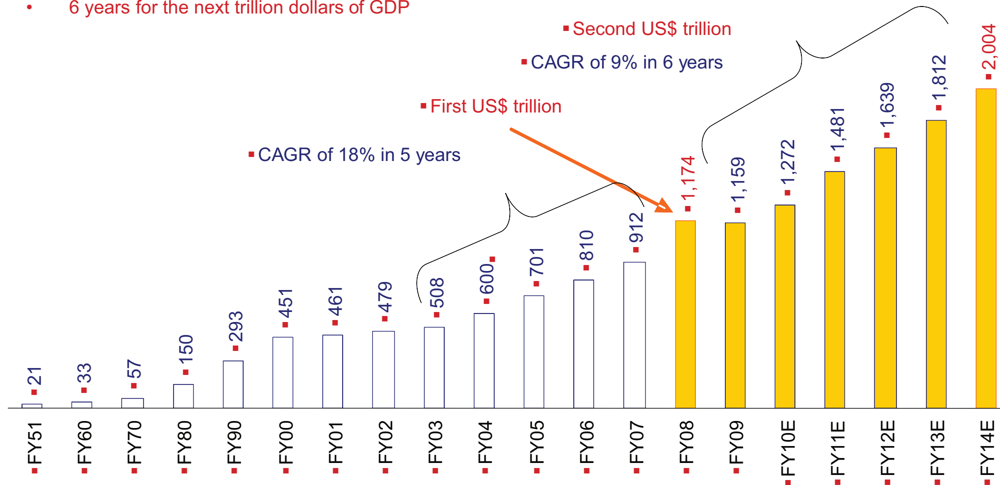
Economic profile

Indicators	Amount		
GDP (At constant prices 2004-05) 2010-11 GDP (At current market prices) 2010-11	USD 1,084 billion USD 1,750 billion		
GDP Composition by sector (%) 2010	Services	Agriculture	Industry
	54.7	19.0	26.3
Per Capita Income (2010-11)	USD 1211.7		
Forex Reserves (As on July 8, 2011)	USD 314.6 billion		
Exports (April 2010-March 2011)	USD 245.8 billion		
Imports (April 2010-March 2011)	USD 350.7 billion		
Cumulative FDI inflows (April 2000 to April 2011)	USD 1,97,935 million		
FDI Inflows (April 2010-March 2011)	USD 30,380 million		

Source: India in Business, Sept 2011, Ministry of External Affairs, Government of India

India - Next trillion dollar era

- 60 years for first US$ 1 trillion of GDP
- 6 years for the next trillion dollars of GDP



Source: Motilal Oswal Securities

couple of years. Indeed, it is already the fourth-largest economy in terms of purchasing power parity (PPP).

The services sector currently contributes to a staggering 54.7% of India's GDP, whilst industry accounts for 26.3% of the total, and agriculture just 19%.

In recent months, India's economic growth rate has actually slowed down, and was estimated to be as low as 5% in February 2013.

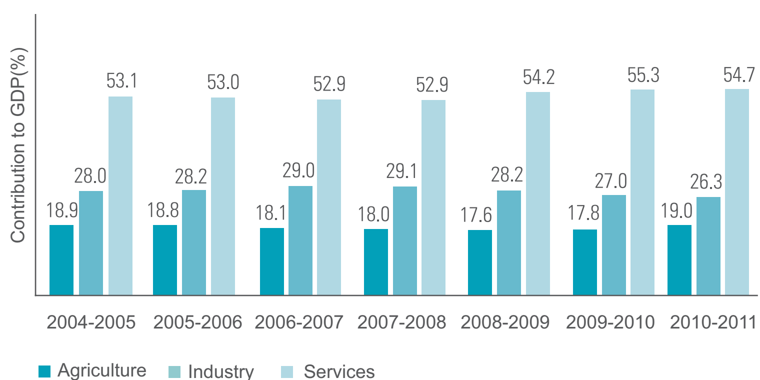
Despite this, inflation has remained stubbornly strong.

The country has seen a sharp fall in public savings. A deteriorating current account balance has resulted in a drag on the Indian rupee.

The current period of slower economic growth is something that is common to almost all economies, given the global circumstances. However, India's story is different.

Unlike other global economies, India's slowdown is more a function of policy inertia than structural, although some initiatives have been announced since September 2012.

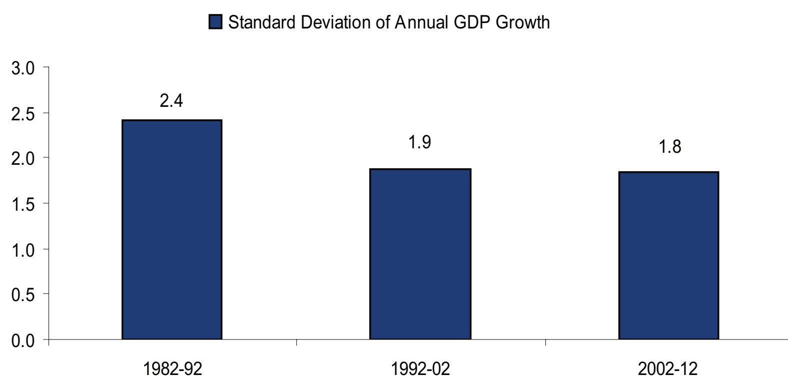
Service Led Growth



Source: India in Business, Sept 2011, Ministry of External Affairs, Government of India

Changing the way in which the majority of Indians work, live and manage their money.

India - A Sustainable, High Growth Economy



Source: India Ministry of Statistics and Programme Implementation Annual Report 2010-2011

GAME-CHANGING PROJECTS

Between 2008 and 2011, the Indian government launched a number of game-changing projects, assigning them to individuals with proven track records. The execution of these projects is changing the way in which the majority of Indians work, live and manage their money.

For example, **The Unique Identification Authority of India** was set up in 2009 to address the significant issue of fake and duplicate identities in government and private databases. The authority maintains a database of individuals' basic demographic and biometric information, and issues Indian residents with 12-digit unique identification (UID) numbers on a voluntary basis.

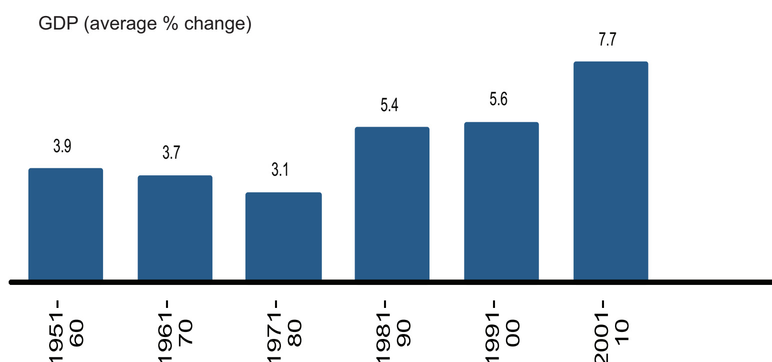
This "Aadhaar" number, Hindi for "foundation", is intended to improve efficiency in elections, subsidies, immigration, and anything else that requires identity-based system checks.

The idea is to provide a form of identity to members of society who do not have official identity documentation.

Also, **Bharat Broadband** was set up in 2011 by the Department of Telecommunications with a mission to implement an optical fibre cable network that can serve all 250,000 "gram panchayats" or local self-governments at village level thus connecting every Indian village to the internet by December 2013.

The government hopes to have 600 million internet users in India by 2020,

India - A Sustainable, High Growth Economy



Source: India Ministry of Statistics and Programme Implementation Annual Report 2010-2011

with half of the people coming from rural areas.

Broadband access enables more efficient delivery of services like education, healthcare, e-transactions and entertainment. It is estimated that for every 10% increase in broadband penetration, India's economic output increases by 1.38%.

At an average of 2km of fibre per village, the project requires around 500,000km of fibre. All of India's telecoms companies are contributing 5% of their revenues to the Universal Service Obligation Fund, which is financing this project.

In 2009, the **National Skills Development Corporation (NSDC)** was tasked with up- or re-skilling 150 million young people by 2022. Its mandate is to create an ecosystem of vocational training institutions that deliver both quantity and quality, to make the youth of India "job ready".

> Up- or re-skilling 150 million young people by 2022... to create an ecosystem of vocational training institutions that deliver both quantity and quality, to make the youth of India "job ready".

Through loans, equity and grants, NSDC funds private companies to deliver hard and soft skills to employees. The aim is to provide short-term courses for free or at subsidised rates, thereby drawing in candidates from underprivileged backgrounds.

The **National Payments Corporation of India (NPCI)** was set up in 2009 by the banking regulator, along with 10 banks, with the hope that is would make banking easier, faster and cheaper, by streamlining inter-bank transactions.

The organisation has set up an Aadhaar-based (UID) payment gateway, through which welfare payments may be verified before being transferred from government entities to individuals' bank accounts.

The next step will be to bring mobile banking systems onto a common platform, meaning money can be transferred from one bank to another via a mobile device; part of the body's aim to increase utility of mobile wallets (transferring pre-loaded money to a bank via a mobile device).

NPCI also plans to convert cheque clearing from a physical process to a digital one, reducing turnaround time from three days to one.

Further, **the Delhi-Mumbai Industrial Corridor Development Corporation** was formed in 2008, with the aim of establishing, by 2019, seven "smart cities" along an the planned rail-freight corridor between Delhi and Mumbai. This idea was formed in response to the problematic gas and water shortages that prevent new cities from growing, as older, more established cities have done.

Services such as power, water, safety, and transportation systems will be provided from a central command room within each city, with real-time governance and control systems.

The project is estimated to cost around US$90 billion, and the special purpose company plans to fund about 65% of this through public-private partnerships. The rest will rely on state funding.

Accenture and Cisco are already engaged as technology partners, while global companies like Halcrow, Jurong and Aecom, as well as some others, are working on city planning. ■

Feature article

EQUITY MARKETS

While the Indian equity market gives investors plenty of opportunities for stock-picking, a large chunk of it is held by promoters, both the entrepreneur families and government. This often leads investors to question the rights of minority shareholders. The market also follows daily inflows and outflows from foreign institutional investors as there are not enough large domestic players.

The Indian share market is a lot like India – deep and diverse. Ranked second only to the US, it consists of one of the largest universes of listed stocks in the world, with more than 5,000 listed companies. More than 150 stocks have market capitalisation of more than US$1 billion.

Investors can gain exposure to a wide range of sectors, from automotive to banking to pharmaceuticals. This diversity exists in few other emerging markets; many of which focus heavily on just one industry (oil in Russia, for example, or technology in Taiwan).

One of the widely-quoted indices, the S&P CNX Nifty (Nifty 50), comprises stocks from financials, industrials and energy companies, giving investors exposure to the key drivers of domestic growth – domestic consumption and infrastructure capital expenditure.

"This diversity exists in few other emerging markets."

Corporate profitability growth has been strong, and more importantly, consistent. The volatility of earnings per share growth for Indian companies has been much lower than that of its emerging market peers.

Quality of disclosure in India's top 200 companies is considered to be good, accounting standards are in line with global best practices, and the rule of the law is sound.

India's market trading infrastructure has set global standards with its paperless trading, settlement periods of T+2 and low transaction costs.

Consistent implementation of reforms in the industry by India's securities regulators have resulted in a turnover ratio of 93.1%, comparable with that of developed markets.

MARKET PECULIARITIES

The Indian market does, however, have some peculiarities, due to the types of investors that participate in securities activities.

These are principals of the companies, called "promoters" in India, and foreign institutional investors.

Promoters may be family members or indeed the Indian government in the case of Public Sector Undertakings.

In many companies, the promoters hold the majority of the stock, and therefore do not always take the interests of minority shareholders into account in terms of the way they run the business.

Promoters hold roughly 55% of the market, thereby lowering the overall free float of a stock. The Securities and Exchange Board of India (SEBI), India's capital markets regulator, is aware of the issues that arise due to promoter holdings. In 2010, for example, the regulator called for all listed companies to raise public shareholdings to 25% by mid-2013.

At the other end of the spectrum are the foreign institutional investors (FIIs). FIIs hold a higher proportion of shares and perform more trading activities than domestic institutional investors. FIIs are usually fund manager intermediaries investing in retail, or institutional investors moving money in and out, based on short-term movements in the stock market, making stock prices very volatile.

High holdings by FIIs, combined with the diversity and ease of securities trading in India, makes the Indian market move up and down in sync with global emerging market averages.

RETURNS AND VALUATIONS

While there is little or no evidence for a strong correlation between GDP and equity market returns, market experts forecast Indian corporate profitability and therefore, equity market returns to also be in the range 13% to 15%.

In the short to medium term, valuations clearly play a role. The valuation range for the Indian market is 10- to 30-times forward price equity multiples. In terms of relative valuations, Indian equity tends to trade at a premium to other emerging and Asian markets' stocks.

When asked about alpha potential of the Indian markets, local fund managers estimate average alphas to be in the 3% to 5% range after fees over rolling five-year periods. The average fee for a mutual fund is around 2%, giving a gross alpha expectation of 5% to 7%.

INVESTMENT ROUTES

Investors can access the Indian share market directly, through exchange traded funds (ETFs) and mutual funds, or through managed accounts. Investors who wish to access market returns can get exposure to broad market indices as well as specific sectors through ETFs. The expense ratios for ETFs are around 100 basis points, about half that of active funds.

Investors, who prefer to rely on fund managers, can invest in a wide range of local mutual funds. There are about 50 asset management companies in India, most of which offer a selection of equity funds that offer diversified, large cap, and mid-cap exposure, in addition to sector funds.

Local managers naturally have a knowledge advantage, which is important for smaller to mid-cap stocks with high promoter holdings.

Promoters are not always minority-shareholder friendly, and thus local insights can be helpful.

Fees for local mutual funds are tightly regulated, with ceilings being based on fund size, and a policy whereby institutional and retail investors must pay the same fees.

Foreign investors can also access the Indian equity market though a number of "offshore" funds, where fees structures and investing styles are more diverse. However, such funds

are restricted to investing within the FII shareholding ceilings, which could limit the alpha potential.

Larger investors can also invest through managed accounts with various providers of portfolio management services (PMS). But it is difficult to evaluate the performance of these providers, as they are not required to publish representative performance.

DOES ECONOMIC GROWTH TRANSLATE INTO EQUITY RETURNS?

Many retail investors are of the opinion that higher economic growth leads to higher equity returns, based on the assumption that the faster an economy grows, the better companies will perform. However, institutional investors question this belief. Mercer addressed this question at its 2011 Asia Pacific Investment Forum.

Mercer's analysis of the relationship between real GDP growth and real equity market returns in various markets showed a fairly flat regression line – showing no to weakly positive relationship between these variables.

The analysis also compared real GDP on a per capita basis with equity market returns, and produced similar results, suggesting that a higher GDP does not necessarily lead to higher equity market returns.

Equity market returns are usually a result of earnings growth and re-rating of price earnings multiples. There are various reasons why earnings growth does not always correspond to economic growth.

The first is simply dilution due to new share issuance.

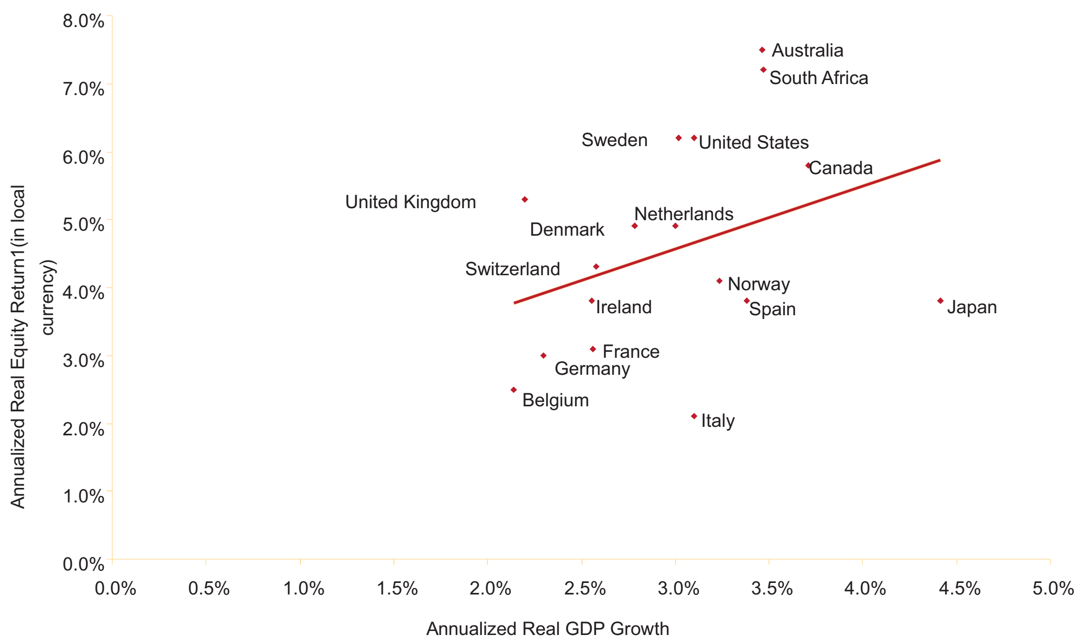
Secondly, equity markets are not fully representative of the economy – corporate profits may be earned outside of the listing country. There may also be conflicts of interest or corporate governance issues.

Finally, the real economic growth of emerging markets comes down to high savings rates and more efficient utilisation of labour.

Mercer concluded that while higher economic growth does not necessarily lead to higher equity returns, the conditions that are supportive of strong GDP growth in emerging economies are likely to have a positive impact on corporate earnings growth.

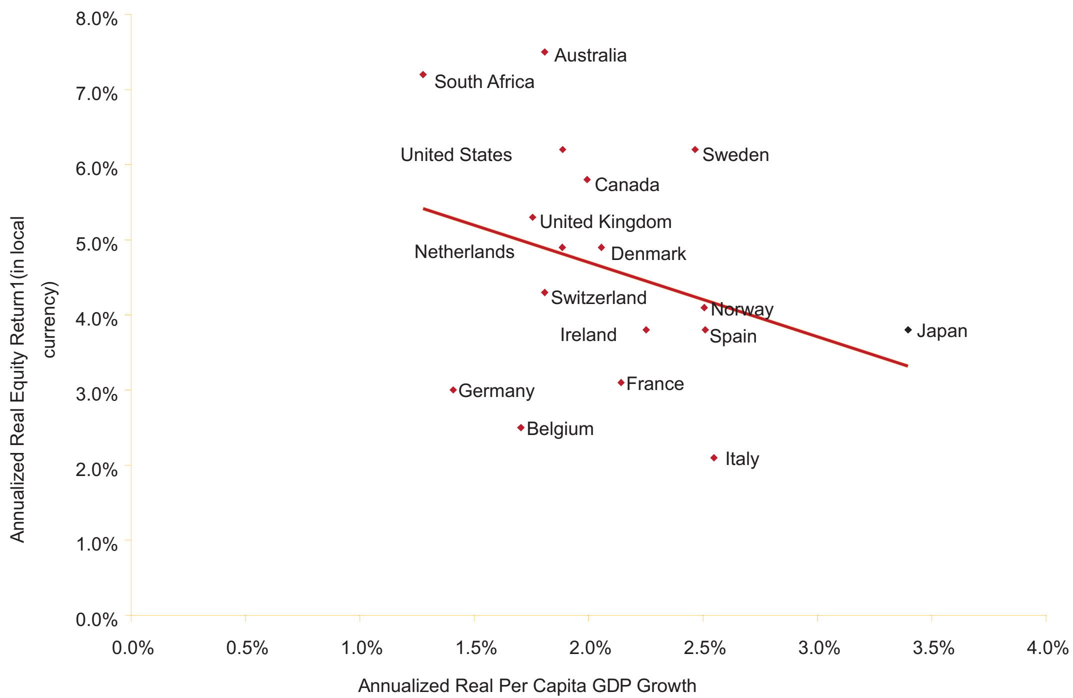
An Indian brokerage, Ambit Capital, conducted a similar study of India's GDP growth and returns of the top 30

The longest analysis of the relationship between real GDP growth and real equity market returns



Source: Credit Suisse Global Investment Returns Yearbook 2010 and Mercer analysis

The longest analysis of the relationship between real GDP per capita growth and real equity market performance

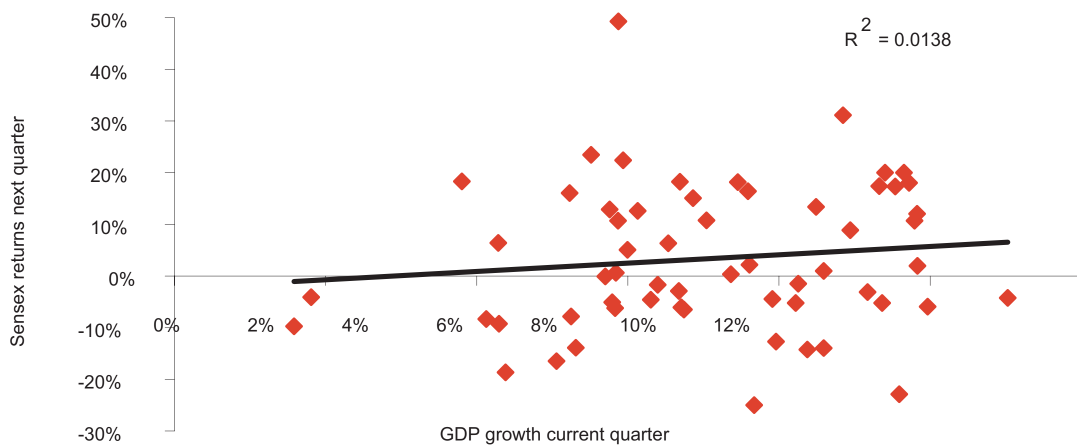


Source: Credit Suisse Global Investment Returns Yearbook 2010 and Mercer analysis

stocks. The study concluded there was no relationship between these. Ambit Capital's research also highlighted China as an example of a country experiencing strong economic growth which was not being translated into strong stock market returns.

In conclusion, investors should be study the prospects for equity markets independently, most importantly looking at valuations, rather than assume good returns based on high economic growth alone.

Sensex returns versus India's GDP growth



Source: Ambit Capital

Feature article

FIXED INCOME MARKETS

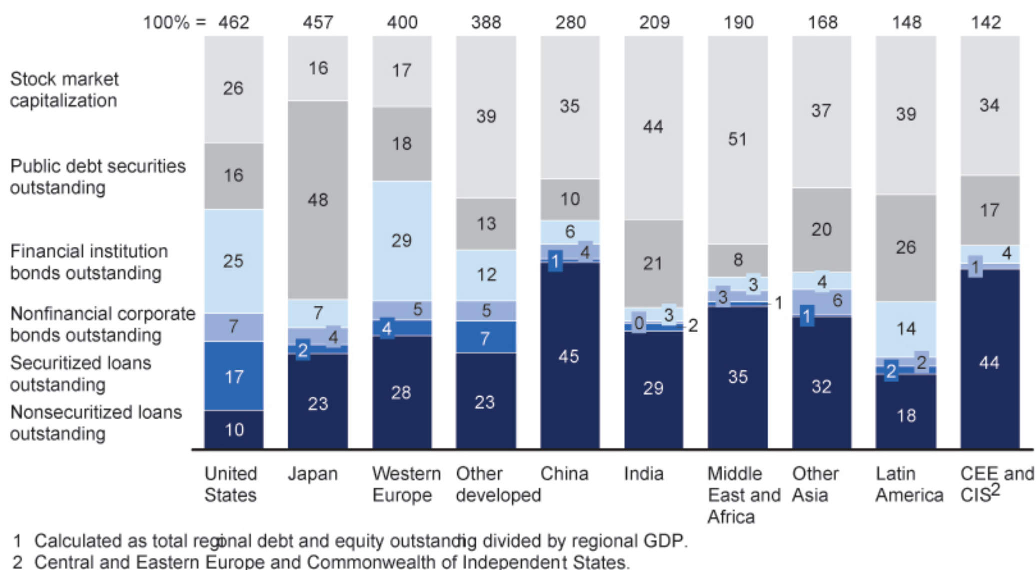
The Indian debt market is dominated by government bonds. However, as policymakers realise the massive capital requirements needed to fund infrastructure and growth generally, the corporate credit market is starting to open up. Foreign investors are looking at the high interest rates and good credit quality although the long-term prospects for the currency are still a question mark.

Although the Indian bond market remains relatively small compared with the fixed income markets of advanced economies, it is the third-largest in Asia, surpassed only by Japan and Korea.

In contrast to the capital structures of other countries, where the size of debt market tends to be several times the size of equity in that country (three to four times larger, on average), equity has a greater weighting within

> India has experienced visible growth over the last five years in both the primary and secondary market within the corporate bond segment.

The structure of capital and banking markets varies widely between countries



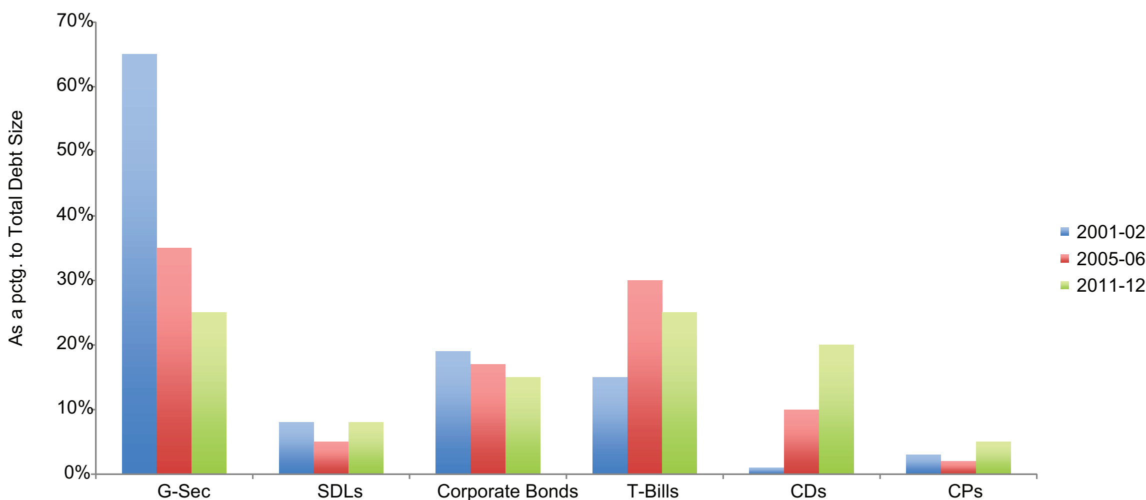
Source: Mckinsey Global Institute-Mapping capital markets update 2011

India's capital structure. Largely due to government regulation, the Indian corporate debt markets remain highly under-developed in comparison with India's mature equity markets.

The Indian bond market is largely dominated by issuances and the trading of government securities, which happens in the primary and secondary markets respectively.

The proportion of corporate fixed income debt to that of total debt is minimal, and still at a nascent stage of development. However, India has experienced visible growth over the

Evolution across the Debt Instruments - Primary Issuance



Source: RBI, SEBI, FIMMDA, AK Capital Research

last five years in both the primary and secondary market within the corporate bond segment.

Between 2001 and 2012, there was a significant decrease in the weighting of government securities issuances as a percentage of India's total consolidated debt. A marginal fall was subsequently seen in the long-term corporate bond segment.

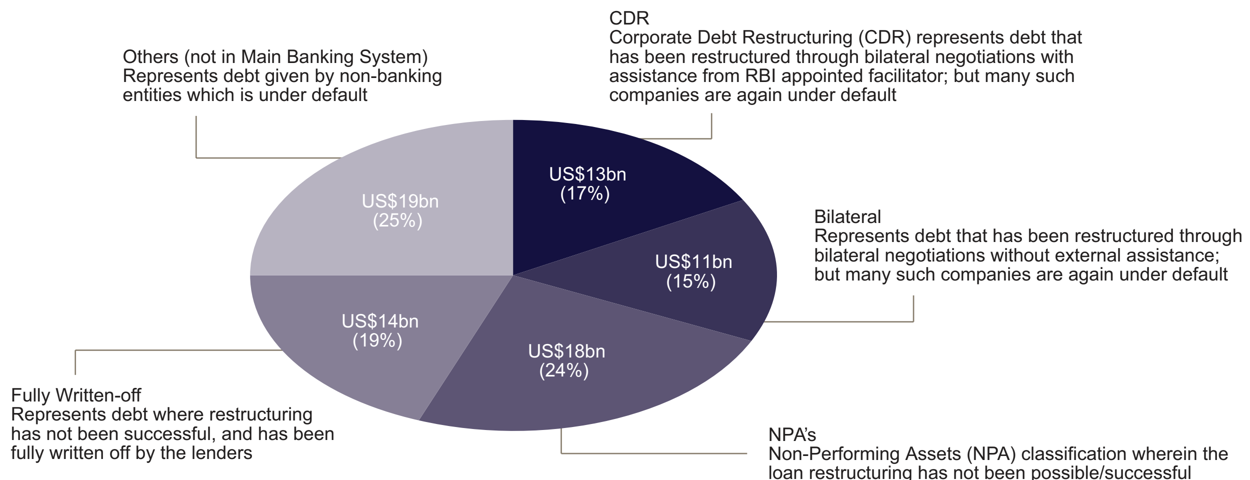
In contrast, considerable growth took place in short-term corporate debt instruments such as certificates of deposit and commercial papers.

As India's private sector bond market is relatively small, banks are the key providers of capital, with bank assets accounting for almost 60% of the financial system's total assets.

It has now become clear that India's banks and equity markets will not be able to provide sufficient capital to fund the nation's massive infrastructure requirement. In response to this, the regulators / government have now opened up the corporate debt market to domestic investors, and are further raising the corporate debt ceiling as

> "The regulators / government have now opened up the corporate debt market to domestic investors, and are further raising the corporate debt ceiling as well as relaxing restrictions on accessing credit from foreign investors."

Financial restructuring status of corporate debt in India



Source: Edelweiss Capital

well as relaxing restrictions on accessing credit from foreign investors.

India has some of the highest lending rates and credit spreads in the world, with its prime-lending rate currently at 14%. Last year, India's benchmark 10-year bond broke the 8.5% mark in yield-to-maturity.

The Indian credit market is structurally biased towards AAA and AA corporate bonds, which account for 80% of the market (Note that these are national ratings, and do not reflect India's global country rating).

Unlike those in developed countries, lenders to the high-yield market in India can enjoy security over assets. They charge high credit spreads, and face limited risk of refinancing.

OPPORTUNITIES FOR VALUE-ADD

The Indian debt market is not just a beta play. There are funds available that seek to exploit opportunities in debt restructuring. The loans under default, or restructuring segment, are estimated to be worth US$75 billion.

Lenders are ceasing to issue such loans, due to the impending higher capital provisioning norms - such as the recently implemented Basel II regulations, the increasing provision requirements for defaulted loans as stipulated by the Indian central bank, and market perceptions about the quality of bank assets. Hence, some opportunistic funds are able to capitalise on this one-time opportunity.

Foreign Currency Convertible Bonds (FCCB) – with a conversion price that is significantly higher than the market share price – are also widespread. Many issuers are currently facing refinancing pressures, and the opportunity exists to negotiate deals with issuers on favourable terms.

FOREIGN INVESTMENT

The high interest rates are attractive for foreign investors. While foreigners are not allowed to invest in certificates of deposit (CDs), they may instead invest in short term mutual funds – as these invest in CDs with high credit ratings, and maintain low duration to mitigate the mark-to-market impact on the portfolio.

Mutual funds are one way for foreign institutional investors and individual investors to access this market. This represents 10% to 20% of the total foreign investor exposure in the Indian debt market. Individual foreign investors are limited to holding no more than 25% of a total mutual fund.

The government is working on facilitating access to the fixed income market for individual foreign investors. The Qualified Foreign Investor (QFI) status was announced in January 2012, providing a direct route in for foreign investors.

Prior to this regulation, individual foreign investors were forced to invest in non-convertible debentures listed on the stock exchange, like foreign institutional investors.

FIIs are limited to investing a maximum of US$10 billion in government securities, US$15 billion in corporate debt and US$25 billion in the infrastructure sector, although these caps are reviewed from time to time. ■

"The government is working on facilitating access to the fixed income market for individual foreign investors. The Qualified Foreign Investor (QFI) status was announced in January 2012, providing a direct route in for foreign investors."

Feature article

REAL ESTATE

One of the most direct results of India's growth story is the demand for real estate, especially in the affordable housing segment which has a massive demand / supply gap. There is also significant demand for office and retail real estate.

India's growth story has many different ramifications, one of which is the increased need for real estate across various sectors.

The country's rapid urbanisation is leading to widespread demand for housing in cities and towns across the country. On top of this, growth in the services sector – including telecommunications, financial services and IT related services – is leading to increased demand for commercial real estate. The growth in household or disposable income is also pushing up demand for retail spaces.

“This sector is certainly on a rapid growth trajectory, quickly evolving from a highly-fragmented and poorly-organised market into a semi-organised market.”

The Indian real estate industry is expected to be worth US$180 billion by 2020, with the residential segment alone contributing around five to 6% of India's GDP.

This sector is certainly is on a rapid growth trajectory, quickly evolving from a highly-fragmented and poorly-organised market into a semi-organised market, with a large number of listed players.

Housing shortage in urban India

	Monthly Per Capita Expenditure	Estimated Number of Households (2007)*	Housing Shortage in million (2007)	Percentage Shortage
EWS	0 - 3,300	21.81	21.78	99.9%
LIG	3,301 - 7,300	27.57	2.89	10.5%
MIG	7,301 - 14,500	16.92	0.04	0.02%
HIG	14,501 and above			
Total Shortage		66.30	24.71	37.3%

Source: JLL Affordable Housing in India 2012

RESIDENTIAL

Residential property constitutes the bulk of the real estate segment. This sector is highly-fragmented and lacks structure. Local developers currently operate in regional silos.

More recently, there have been attempts by developers to expand and establish a national presence, achieving mixed success.

The industry divides residential into low-cost or affordable housing, mid-market housing and premium housing.

While rapid urbanisation is a growth driver across all of these categories, the major shortfall is in the affordable housing category.

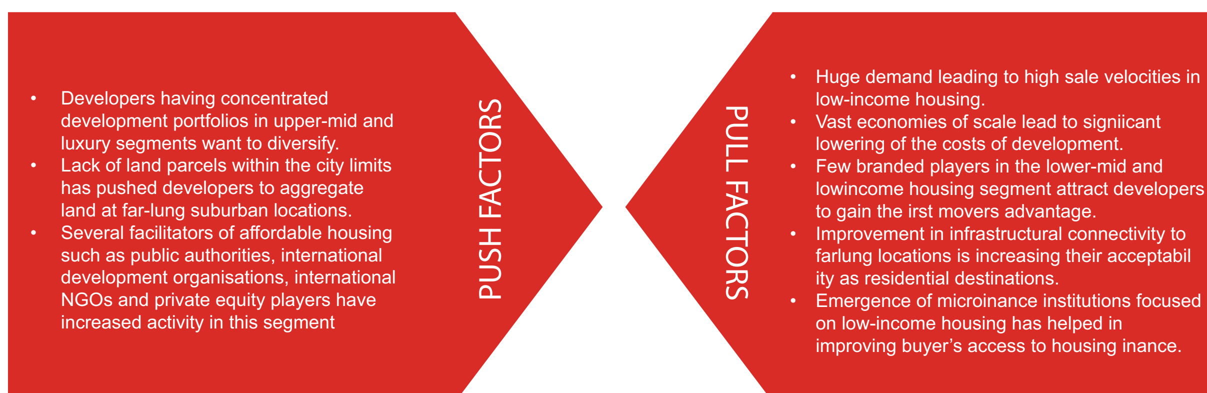
According to the Ministry of Housing and Urban Poverty Alleviation, in 2007 India's urban housing shortage was estimated to be 24.71 million, 80% of which pertains to houses for the economically weaker sections.

The group further estimated that 88% of this shortage pertains to houses for Economically Weaker Sections (EWS) and another 11% for Lower-Income Groups (LIG). For Middle- and High-Income Groups (MIG and HIG) the estimated shortage is only 0.04 million.

The urban housing shortage is expected to reach 30 million by 2020.

The main reason for this is that real estate companies continue to focus primarily on the middle and higher income segments, leaving the affordable housing problem to the government.

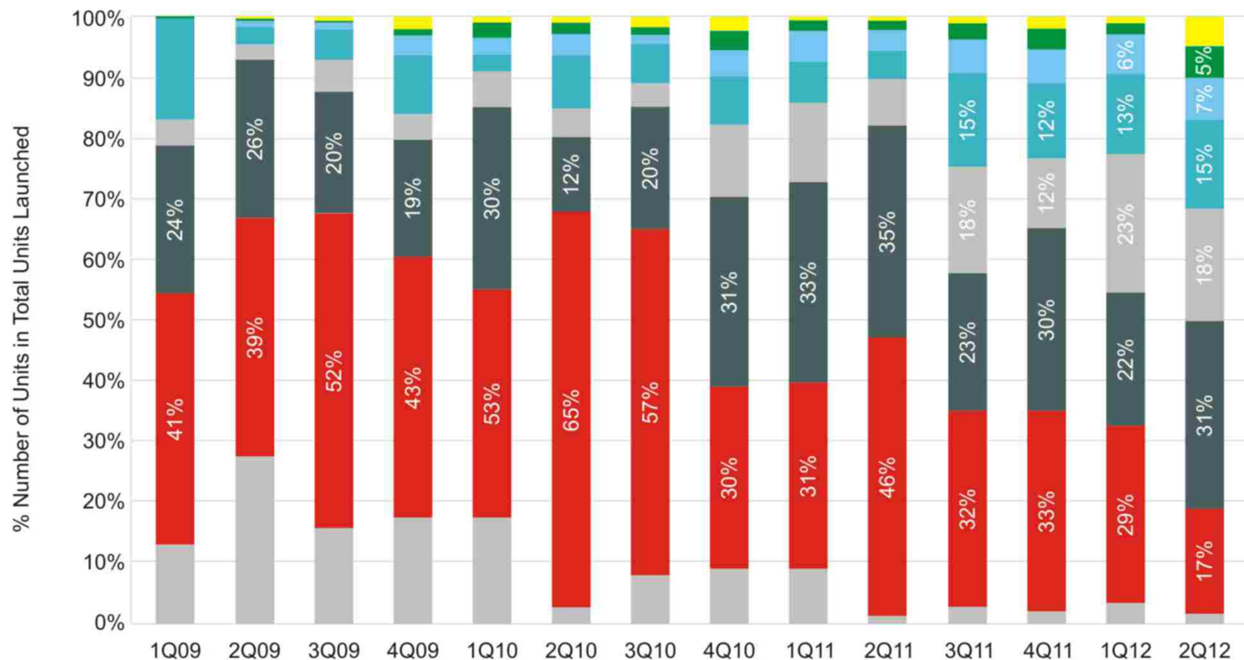
Push and Pull Factors for Entry of Private Players in Affordable Housing



Source: JLL Affordable Housing in India 2012

Residential Trends: Residential Launches 2009-2012

Share of launches in the range of INR 3,000-4,000 per sq ft dominated in 2012;
Rising input costs lead shrinking share of launches priced under INR 2,000 per sq ft.



Source: Real Estate Intelligence Service (JLL), 2Q12
Note: The range of capital values mentioned are in INR per sq. ft.
Figure are representative of the top seven cities of India- Mumbai, NCR-Delhi, Bangalore, Chennai, Pune, Hyderabad and Kolkata.

Supply-side constraints include lack of availability of urban land, rising threshold costs of construction and regulatory issues. Lack of access to home finance remains a significant demand-side constraint.

During the demand slowdown of 2008-2009, some private market participants started dipping their toes into this sector, with various motives.

Between 2009 and 2012, real estate developers began to launch projects in the affordable segment across Indian cities, with units priced within the US$10,000 to US$20,000 range.

Typical pre-tax internal rates of return achievable in an affordable housing project, where a developer has purchased land, are estimated to be 40% to 45%, with gross profit margins of 15% to 20%.

The break-even period is usually about 24 months. However, if the developer enters into a joint development agreement with the landlord, upfront land acquisition costs may be reduced and breakeven periods shortened.

COMMERCIAL

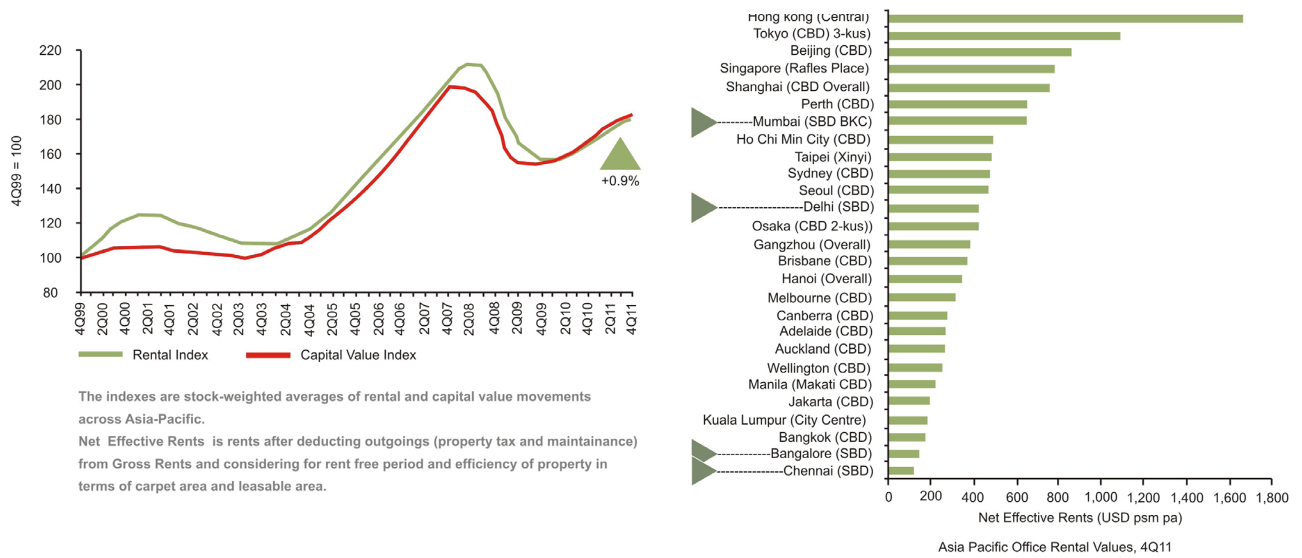
Following progressive liberalisation and rapid growth of the services sector (in particular, telecoms, financial services and IT-related services), the influx of multi-national companies entering India has driven demand for more commercial real estate. While there are a few large developers with a national presence that currently dominate the market, smaller regional players are aggressively expanding to establish a pan-India footprint.

In urban areas, business activity is shifting from central business districts to the suburban or special business districts, and also from tier-1 cities to tier-2 cities, and thus there is a greater need for additional commercial property in these areas.

Capital values in the office sector in India on average are still 25% lower than their last peak values, while the capital values in the residential sector crossed their past peak by end 2011.

Asia Pacific Office Rental Index

Average q-o-q rental growth in 4Q11was recorded at 0.9%, slowing from 2.5% recorded in 3Q11. Mumbai SBD BKC is among the expensive markets and Bangalore and Chennai are among the cheaper markets in Asia Pacific, on the basis of Net Effective Rents.



Source: Real Estate Intelligence Service (JLL), 2Q12

Occupier Traffic Lights

Rents in SBD and Suburban markets to favour the occupiers till 2013 across cities

	1H11	2H11	1H12	2H12	1H13	2H13
Mumbai CBD / BKC						
SBD						
Mumbai Suburbs						
Delhi						
Gurgaon						
Noida						
Bangalore CBD						
Bangalore SBD						
Whitefield						
Chennai CBD						
Chennai SBD						
Chennai Suburbs						
Pune CBD						
Pune SBD						
Pune Suburbs						
Hyderabad CBD/SBD						
Hitec City						
Gachibowli						

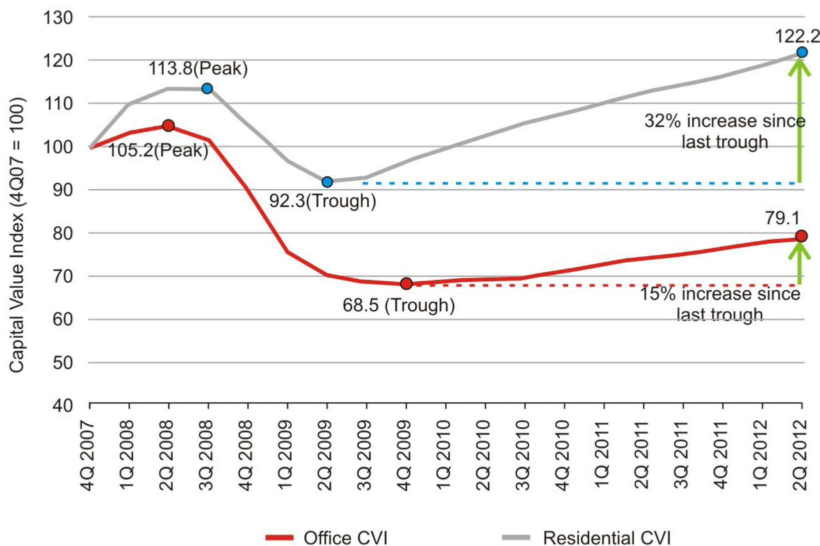
Landlord Market

Balanced Market

Occupier Market

Source: Real Estate Intelligence Service (JLL), 2Q12

Movement of Capital Values



Source: Real Estate Intelligence Service (JLL), 2Q12

The operational model is also witnessing a shift from a sale model to more of a lease-and-maintenance model.

While shopping malls are appearing all over the country, the mere existence of malls does not guarantee their success. Some malls struggle with high vacancy as they fail to garner retailer interest.

The average size of shopping malls in India has been increasing due to developer preference for larger malls.

A mall's success is related to its size; superior-grade malls are nearly double the size of average grade malls.

Indian political parties are divided over the issue of allowing foreign direct investment (FDI) to take place in the multi-brand and single-brand retail categories.

In September 2012, the government finally announced 100% FDI in single brand retail, albeit with some restrictions around equal investment in front and back-end components of retailing.

RETAIL

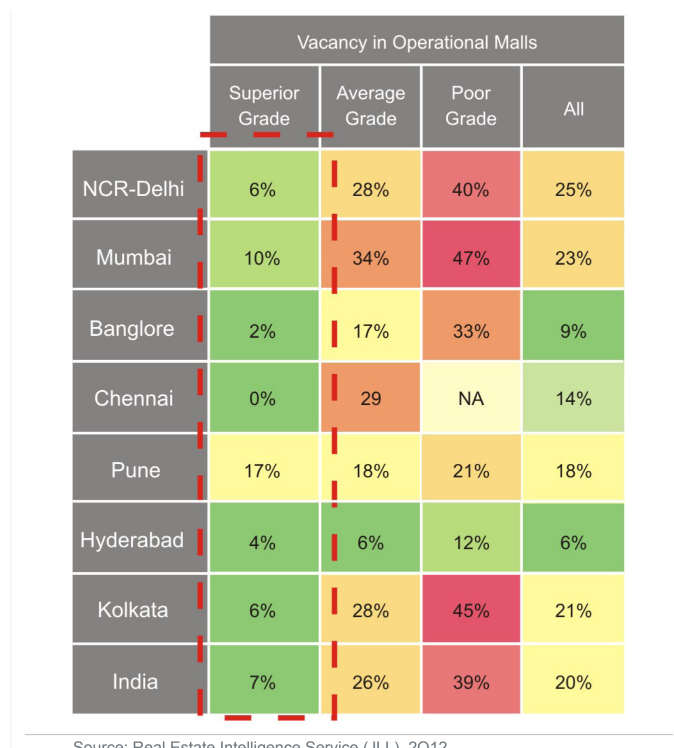
Retail real estate in India represents a significant opportunity for investment. The retail segment currently constitutes a relatively small proportion of the total real estate industry in India, due to a lack of structure and organisation in the market.

Consumers shop at tiny "mom and pop" stores found on every street, and international brands have to collaborate with Indian partners if they want to sell globally-recognised brands.

Increased disposable income is leading to increased consumerism.

The industry is also becoming better organised, with the establishment of shopping malls, and the entry of international-branded retailers.

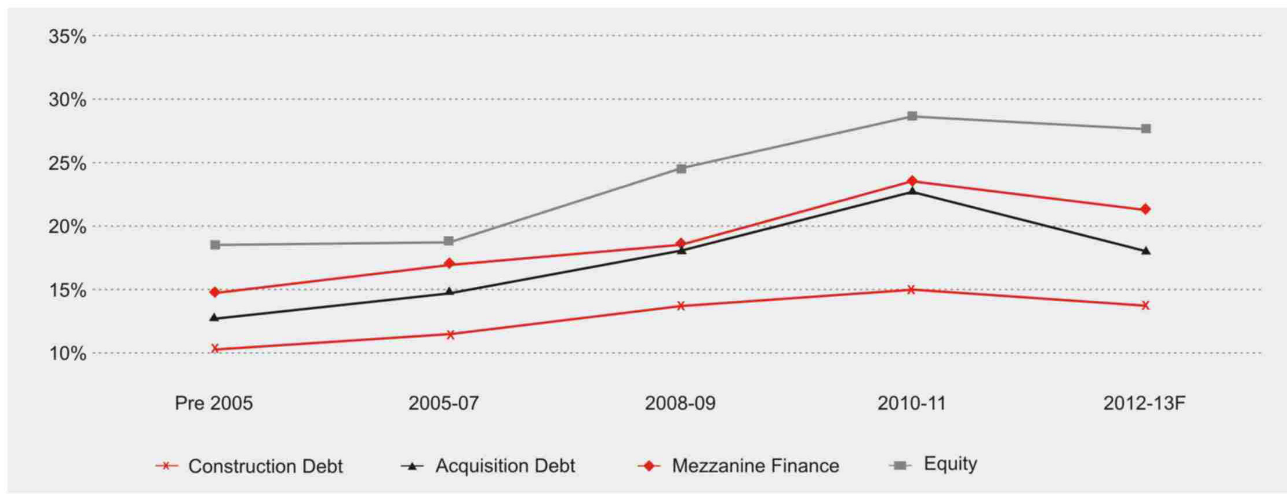
Retail Trends: Polarisation of Demand



	Vacancy in Operational Malls			
	Superior Grade	Average Grade	Poor Grade	All
NCR-Delhi	6%	28%	40%	25%
Mumbai	10%	34%	47%	23%
Banglore	2%	17%	33%	9%
Chennai	0%	29	NA	14%
Pune	17%	18%	21%	18%
Hyderabad	4%	6%	12%	6%
Kolkata	6%	28%	45%	21%
India	7%	26%	39%	20%

Source: Real Estate Intelligence Service (JLL), 2Q12

Figure3: Cost of Finance by Various Finance Options



Source: Jones Lang Lasalle, "Reaping the Returns - Decoding private equity real estate exits in India"

OTHER SECTORS

While the key trends in demographics and urbanisation are creating long-term demand for affordable housing, retail and commercial properties, opportunities also exist in other industry segments.

These include industrial (logistics and warehousing), healthcare and education infrastructure.

Driven by growth in industrial production, consumption and organised retail, the demand for logistics and warehousing is estimated to grow from around 391 million square feet in 2010 to 476 million square feet in 2013, according to a KPMG report.

The healthcare industry is currently estimated to be worth US$77 billion, and is growing at more than 20% per annum.

In addition to domestic demand, India is also emerging as a preferred destination for international patients to have medical treatment. The medical tourism industry is estimated to be worth around US$2.4 billion, and is growing at nearly 30%.

The education industry is another growth area. There is growing interest

> "The market value of investment-grade real estate construction increased from US$69.4 billion in 2006 to US$160 billion in 2011, at which point it represented 9.8% of India's nominal GDP."

> Since the global financial crisis, foreign capital dried up, and local real estate private equity funds have been bailing out developers.

among global educational institutions to set up campuses in India.

FOREIGN INVESTMENT

Traditionally, those wanting to acquire land would borrow from nationalised banking channels. But since the Reserve Bank of India has introduced restrictions on the use of bank debt for this purpose, developers have resorted to using mezzanine and equity capital, which until the global financial crisis, was priced at the same levels as debt.

In order to boost the real estate sector and, in particular, to promote greenfield development, in 2005 the Indian government opened the market to foreign investment.

However, regulators restricted certain investments linked to the development of large projects, and introduced a lock-in of three years, in order to prevent foreign investors using this for speculation.

During the first three years after this was introduced (2005 to 2008), a large number of global financial giants allocated proprietary capital to the Indian real estate sector, and raised additional capital from their fund and wealth management businesses.

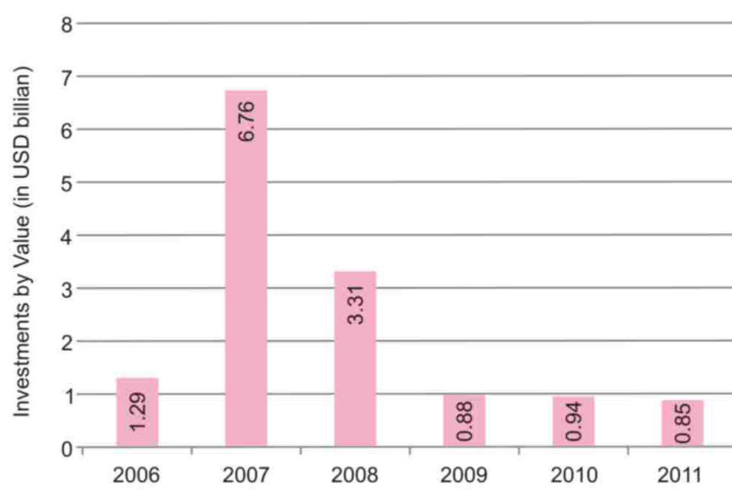
In 2008, the government passed regulation permitting foreign direct investment in industrial parks, thereby encouraging more investment into technology parks.

The market value of investment-grade real estate construction increased from US$69.4 billion in 2006 to US$160 billion in 2011, at which point it represented 9.8% of India's nominal GDP.

However, since the global financial crisis, foreign capital dried up, and local real estate private equity funds have been bailing out developers. Residential markets did recover during 2009 and 2010, owing to domestic demand and funding from individual investors rather than institutional buyers.

As the dust settled in 2010 to 2011, real estate funds still struggled to raise capital from overseas sources, forcing developers to rely on debt funding at very high interest rates, priced at equity levels. ■

Figure 5: Private Equity Investments in Indian Real Estate - By value (2005-2011)



Source: Real Estate Intelligence Service (JLL), 2Q12

Co-published article

PRIVATE EQUITY

The Indian private equity market is still quite nascent, with barely a decade of investments. Most of the deals are growth investments, with buyouts and venture capital taking a backseat. Smaller deal sizes have meant large global funds have a lot of dry gunpowder. As the first round of exits has started, the market should see continued interest and development, says Kunal Shrivastava of VCCEdge.

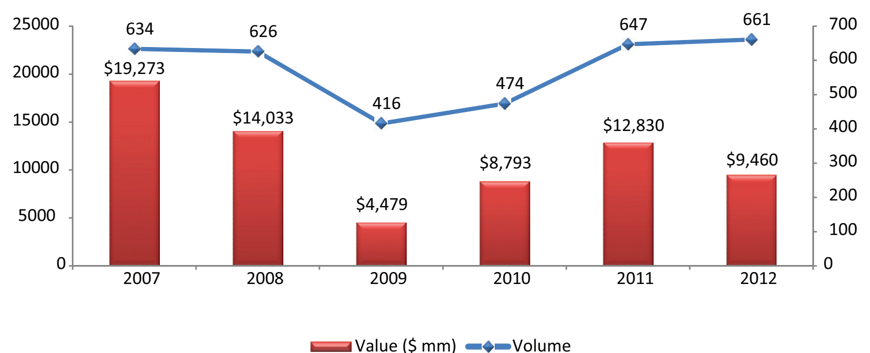
The private equity (PE) industry in India was virtually non-existent until 2004. Since then, it has grown exponentially, evolving into a staggering US$19 billion market by the end of 2007, just before the global financial meltdown.

Post-meltdown, signs of a fast recovery were evident, with over US$9 billion worth of investments made in 2010, followed by another US$12.3 billion in 2011.

In 2012, investors committed nearly US$6.3 billion of capital across 363 deals (as of 31 August 2012), representing a slowdown in overall PE activity when compared with the US$7.9 billion invested across 403 deals in 2011.

Fundraising also took a beating in 2011, with allocations from limited partners dwindling against due to the difficult exit environment and lower

Private Equity Investments



exit-returns (compared with other emerging markets).

Political and regulatory uncertainty both in India and across the macro-economic environment have also damaged investor sentiment.

PE DEAL BREAKDOWN

Unlike in established markets, the Indian PE model is largely characterised by investments through growth capital deals, with buyouts and venture capital investments taking a back-seat.

Growth capital and late stage investments have consistently accounted for over 90% of the total PE capital invested annually for the past six years.

In 2011, 92% of the deal value and 57% of the deal volume came from growth capital deals alone. Early-stage (angel and venture capital) investments accounted for the remaining capital.

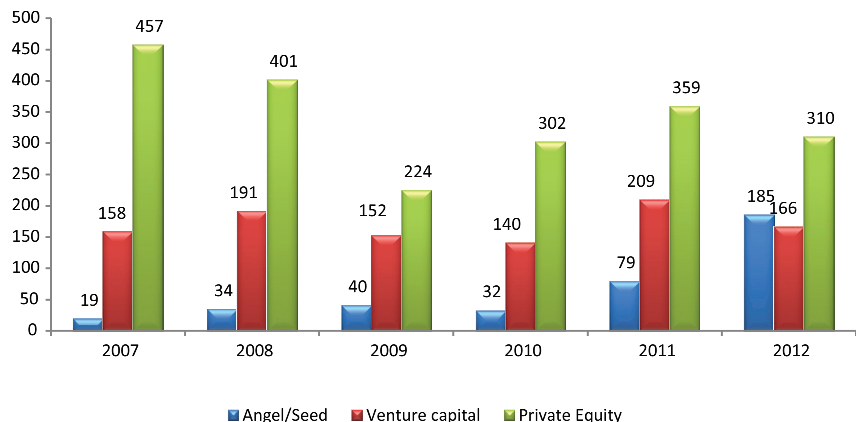
As for deal volume, early-stage investments have been rising steadily since PE activity regained momentum in 2010, increasing from 35% of total deal volume to 43% in the first year, and enjoying a further increase of 53% in the first eight months of 2012.

While buyouts continue remain sparse (largely due to regulatory restrictions), the appetite for early-stage investments is on the rise.

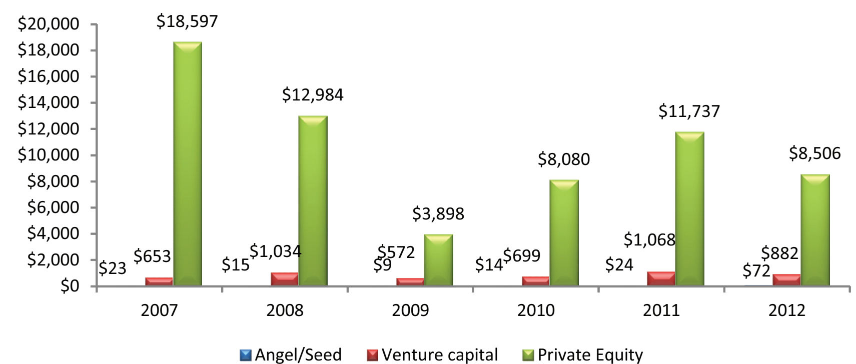
SECTORAL BREAKUP

PE capital in India has largely been channelled into the financial sector, which contains real estate and

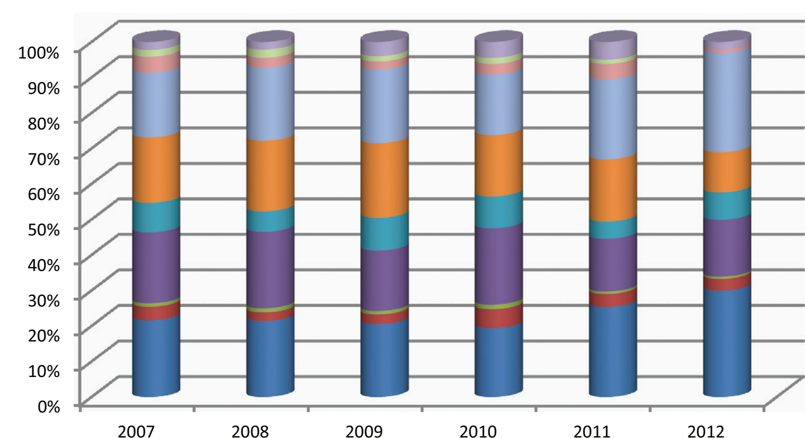
Private Equity Breakdown - Volume

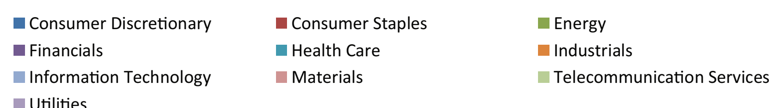


Private Equity Breakdown - Value ($ mn)

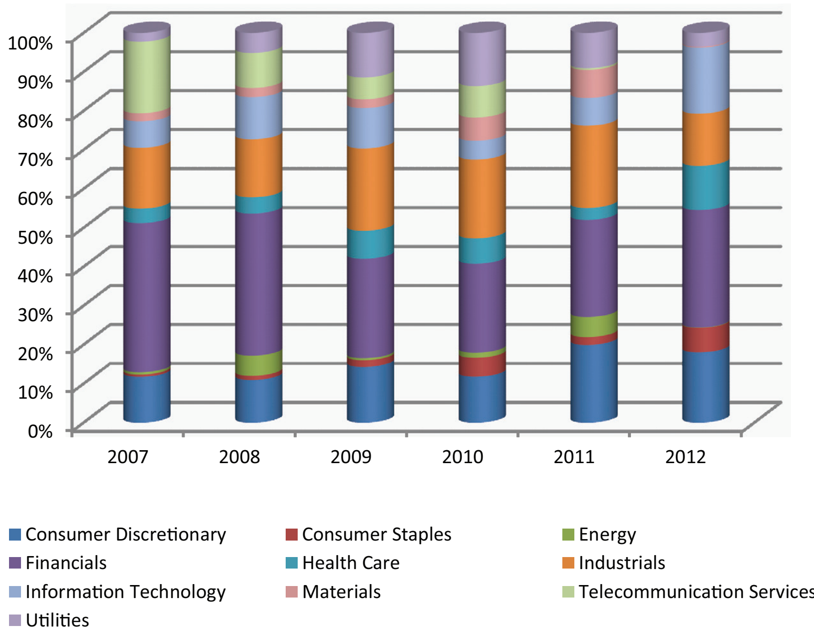


Sectorial Breakup by Deal Volume





Sectorial Breakup by Deal Volume

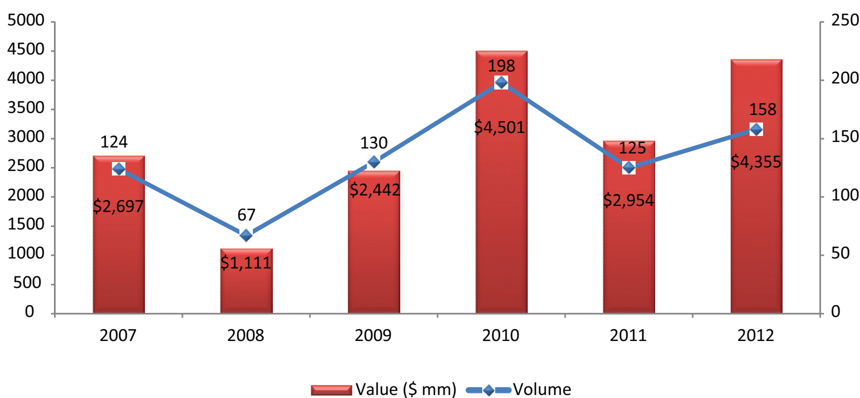


BFSI (banking, financial services and insurance). Between 2007 and 2012, this sector received over US$20 billion worth of PE investments.

The capital-intensive infrastructure sector, India's engine of future growth, also enjoyed significant investment during this period, within both industrials and utilities. The infrastructure sector is expected to experience US$1 trillion worth of investments between 2012 and 2017.

Consumer discretionary is another area that has thrived on India's growing consumption, fuelled by the country's large young population and steadily increasing income levels. Since 2007, the sector has seen investments to the tune of US$9.1 billion coming from a whopping 706 deals.

Private Equity Exits



The IT sector also continues to ride high, with investments aggregating to over US$6 billion over the last six years, spread across 624 deals.

Healthcare, too, has seen a lot of traction, as changes in consumption patterns have led to increased consumer awareness and a rise in lifestyle diseases. The industry, pegged at US$35 billion in 2010, is anticipated to grow to US$75 billion by 2012.

PRIVATE EQUITY EXITS

The year 2010 saw a record number of exits, with PE firms cashing in a big chunk of their previous investments in Indian companies, arguably bringing to an end India's first generation of PE investments.

The US$4.5 billion realised as returns by funds in 2010 was roughly half the amount of the fresh PE capital infused during the year (US$9 billion).

In August 2012, Bain Capital acquired a 30% stake in Genpact Limited – India's largest BPO – from General Atlantic LLC and Oak Hill Capital Partners for a staggering US$1 billion.

This was a milestone liquidity event for India's PE market and may become part of India's largest exit, with investors making a little over US$2 billion on their eight-year old investment. General Atlantic and Oak Hill Capital Partners made US$1.62 billion (including a special dividend) on their US$500 million investment in Genpact back in 2004. ■

(Kunal Shrivastava is Research Director of VCCEdge, India's leading financial research platform for dealmakers brought to you by the VCCircle Network)

Feature article

HOW TO ACCESS THE INDIAN MARKETS

There are three ways foreigners can invest in India – through direct stakes in unlisted investment (FDI), through registration to invest in listed equity and debt markets including managed portfolios (FII), and most recently, investing directly into listed equity and debt markets as Qualified Foreign Investors.

There are essentially three ways for foreign investors (those of non-Indian origin) to access the Indian markets.

Foreign Direct Investment (FDI) – While used primarily by companies to expand operations, the FDI route is also used by individual investors looking to buy unlisted investments, either directly or through private equity funds, as "portfolio investments".

Certain industry sectors have restrictions on FDI. Investors may perform FDI via the "automatic" route if they wish to invest in certain approved sectors. Under the automatic route, there

> Sector lists for FDI are revised on a regular basis by the Indian government, based on industry needs.

is no requirement for regulatory approval, but the Indian company must file post facto intimation forms to the Reserve Bank of India (RBI) through an authorised dealer (bank).

If the investment amount exceeds the specified sector cap, or if it is in a non-approved sector, investment may be made under the "prior approval" route. This requires government approval through the Foreign Investment Promotion Board. Proposals for issue of warrants and partly paid shares fall under this FDI route.

The sector lists for FDI are revised on a regular basis by the Indian government, based on industry needs.

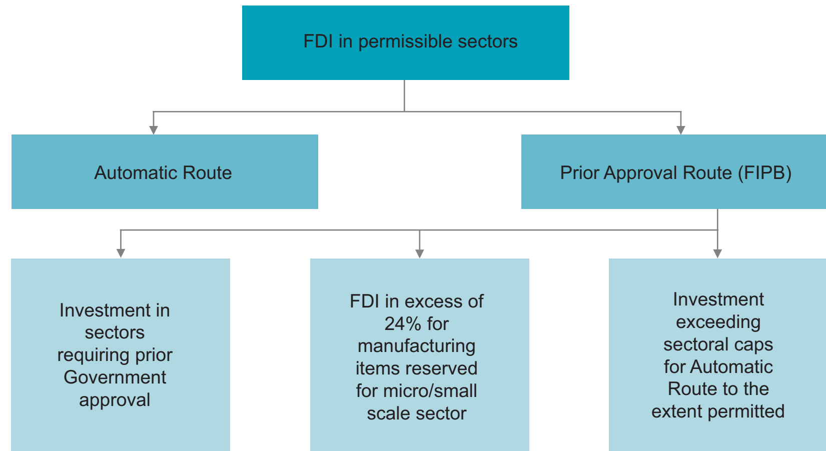
Foreign investors can invest in foreign currency debt issued by Indian companies, though these are governed by the guidelines on External Commercial Borrowings (ECB), under foreign exchange regulations. These guidelines, issued by the RBI, stipulate eligible borrowers, recognised lenders, amount and maturity period, all in-cost interest ceilings, end-use, compliance, and other details. The issue of any non-convertible, optionally convertible, or partially convertible preference shares or debentures to non-residents is considered as ECB.

An Indian company can also raise funds by issuing Foreign Currency Convertible Bonds (FCCBs) or Foreign Currency Exchangeable Bonds (FCEBs). These too are covered by the ECB guidelines.

In addition, companies that are eligible to issue shares to non-Indian residents may issue American Depository Receipts (ADRs) or Global Depository Receipts (GDRs). Unlisted companies that have not yet accessed this route for raising capital need to be listed in

FDI Routes

A diagrammatic representation of the FDI routes is given below:



Source: India in Business, Sept 2011, Ministry of External Affairs, Government of India

the domestic market either prior or simultaneously to this.

Foreign Institutional Investor (FII) – Non-Indian institutions can invest in India under the "Portfolio Investment Scheme" by registering with SEBI as an FII. Both end investors – asset owners such as pension funds, sovereign wealth funds, endowments, foundations, or banks – and intermediary institutions can use this route.

Although the Portfolio Investment Scheme was not designed for individual investors, FIIs can offer them "sub-accounts". In order to qualify for this, individual investors must have been a client of the FII for three years and a foreign citizen for five years, and must have a net worth of US$5 million. They also need to obtain a permanent account number (PAN) from the Indian income tax authorities.

FII or FII sub-account holders may only hold up to 10% of a listed Indian company. FIIs and their sub-account holders can invest in Indian equities, debentures, warrants, mutual funds, dated government securities, derivatives traded on a recognised stock exchange, commercial papers, security receipts and debt instruments – if within the prescribed ceiling and framework.

In 2011, SEBI introduced increased monitoring of FIIs, asking for details about their end beneficiaries, in order to prevent breaches of the 10% holdings cap.

FIIs and sub-account holders may also issue participatory notes (P-notes) to their clients, allowing those clients to invest in the Indian stock market while remaining anonymous. This route is popular amongst hedge funds.

By October 2007, P-notes accounted for about 50% of foreign institutional investment in India, and the Indian regulators temporarily banned them,

inviting the end investors to register as FIIs in an attempt to curb volatility. In 2008 P-notes were re-introduced.

A Foreign Venture Capital Investor (FVCI) wanting to invest in Indian venture capital funds can also register with SEBI to set up a domestic asset management company to manage the funds.

Qualified Foreign Investors (QFI) – In 2011, India introduced the QFI route, designed to encourage foreign individual investors to invest directly into Indian domestic mutual funds or the equity and debt markets, without going through an FII or registering as an FII sub-account holder.

In order to be eligible, investors must reside in a country that is compliant with Financial Action Task Force (FATF) and that is a signatory to IOSCO's multilateral memorandum of understanding.

There was some initial confusion over whether residents of jurisdictions that are compliant with the FATF standards, but are not a direct member of the FATF – such as members of European Commission and the Gulf Cooperation Council – are eligible. The legislation has now been clarified; residents of such countries are eligible to invest as QFIs.

Countries such as Cyprus, which have favourable tax treaties with India, are also eligible. However, Mauritius still remains out of bounds from a QFI perspective, despite its strong Know Your Client (KYC) and anti-money laundering laws.

QFIs are required to open a trading account with a SEBI-registered Qualified Depository Participant (QDP). QDPs perform all necessary KYC checks and other regulatory requirements. The QFI can remit money through normal banking channels in any permitted currency (freely convertible) directly to his or her QDP bank account.

The individual and aggregate investment limits for QFIs are 5% and 10% (respectively) of the paid-up capital of an Indian company. These limits stand over and above the FII and NRI investment ceilings.

The QFI route gives high net worth individuals the opportunity to invest in Indian debt, which offers attractively-high interest rates and returns. Previously, such investors were only able to invest in non–convertible debentures listed on the stock exchange (via the FII route).

There is a separate sub-limit for QFI investment in corporate bonds and mutual fund schemes, of US$1 billion.

TAX AND REPATRIATION OF FOREIGN EXCHANGE

Registered FIIs and sub-accounts are subject to tax as detailed below -

Tax for Foreign Institutional Investors

Interest	20 percent
Long-term capital gains #	NIL
Short- term capital gains #	15 percent

Subject to payment of STT

Source: India in Business, Sept 2011, Ministry of External Affairs, Government of India

There is an additional surcharge of 2% for companies and 3% for education.

The rate of tax on other short-term capital gains is 30% plus relevant surcharges.

Foreign investors have been hesitant to adopt the QFI route due to lack of clarity over how the income tax will be levied.

At present, investors who do not reside in countries that have signed double tax avoidance treaties with India have to file tax returns in India – which is not attractive.

India does not yet have full capital account convertibility.

Payments due in connection with foreign trade are considered to be current account transactions, and are generally permissible.

Dividends declared by an Indian company can be freely remitted overseas to foreign shareholders without any prior approval. ■