

## Research

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### Executive Summary

- Favorable demographics, a large pool of educated and skilled labor, a liberalized macroeconomic policy environment and greater foreign investment and exports are accelerating India's economic growth.
- Because India is the most prominent destination for outsourcing and offshoring activities, the IT and IT-enabled services sectors are spurring office demand growth.
- A structural shift has occurred in India's retail landscape. The organized retail share is expected to rise from 2% to 10% in the next five years.
- The housing market is on a steep growth path. Rising income, population growth, decreasing household size, a housing shortage and a decline in mortgage rates will lead to extensive residential construction activity.
- Low market transparency, a lack of liquidity, a scarcity of suitable investment products and regulatory concerns are some of the risks investors need to consider.

### Introduction

India is experiencing a tremendous structural transformation. Although still an emerging market, India's demographic and economic growth prospects are very favorable; the country is expected to become one of the world's five largest economies within 20 years. India's shift to a service-based society supported by its promising growth profile is generating long-term demand across all major investment sectors in its many markets.

However, foreign investors trying to capitalize on growth opportunities and diversification benefits face typical emerging-market risks, such as low liquidity and a lack of transparency. Investors need patience and a long-term strategic approach backed by local partners to enter this key global economy and to take advantage of the increasing institutionalization of India's real estate market.

## Accelerated Economic Growth

With a GDP of US\$803 billion in 2005, India is the third largest economy in Asia, after Japan and China. Worldwide, the Indian economy ranks 10th on a nominal basis, according to a July 2005 World Bank report (it is the fourth largest economy on a purchasing power parity basis), generating about 2% of global GDP.

Between 1947 (when India gained independence) and 1990, a system of elaborate regulations known as the “License Raj,” which was dismantled in the early ’90s, stifled private-sector growth. During the early ’90s, the government also decided to shift toward greater integration with the world economy. Since then, India has gradually opened its market by reducing government controls on foreign trade and investment. Economic liberalization and structural reforms provided the foundation for strong economic growth, averaging 5.9% per year. As reforms progressed, the GDP growth rate rose from 3.5% in the ’50s and ’60s to about 6% in the ’90s. In 2005, the growth rate was 8.5%, and 1Q06 saw an even higher rate of 9.3%. Social indicators also reflect a matching improvement. According to World Bank reports, the percentage of India’s population living below the poverty line fell from more than 50% in the 1950s to about one-quarter of the population today.

Despite ongoing reforms and progress in liberalizing foreign direct investment (FDI), India remains a relatively closed economy. On the IMF’s trade restrictiveness index, India scores seven out of 10, suggesting that the country is still not as open to foreign goods and services and, more importantly, knowledge as it could be. This is partly reflected by a relatively low historic GDP correlation with the major economies (see Exhibit 2).

### Exhibit 1: A Snapshot of India

- Land area: 2, 973,190 square km
- Population: 1.095 billion (2005)
- Median age: 24.3 years
- Population 15 to 64 years: 64.3%
- Population growth rate: 1.38%
- Capital: New Delhi
- GDP: US\$803 billion (2005)
- GDP growth rate: 8.5%
- Unemployment rate: 9.9%
- Inflation: 4.2% (2005)
- Currency: Indian rupee
- Languages: English, Hindi
- Exchange rate (Rs/US\$): 46.08 as of June 30, 2006
- Industries: Textiles, chemicals, food processing, steel, transportation equipment, cement, mining, petroleum, machinery, software

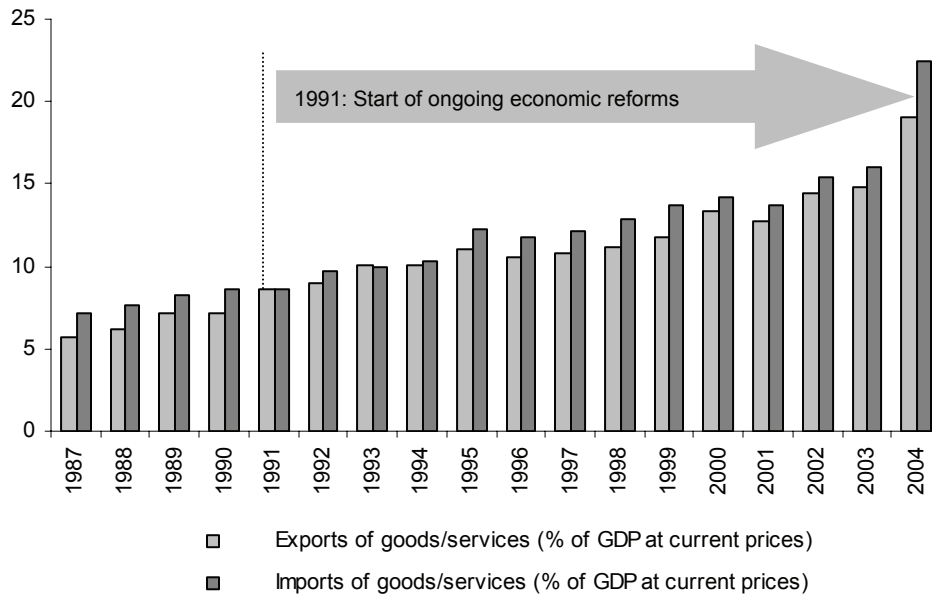
Sources: CIA World Factbook; World Bank; United Nations

### Exhibit 2: Long-Run Historic GDP Correlation Between India and Other Major Economies

	China	France	Germany	Japan	UK	USA	India
China	1.0						
France	-0.6	1.0					
Germany	-0.2	0.1	1.0				
Japan	0.1	-0.1	0.4	1.0			
UK	-0.1	0.4	-0.6	-0.2	1.0		
USA	0.1	0.4	-0.5	-0.2	0.7	1.0	
<b>India</b>	<b>0.1</b>	<b>0.0</b>	<b>-0.6</b>	<b>0.0</b>	<b>0.5</b>	<b>0.6</b>	<b>1.0</b>

Source: EIU

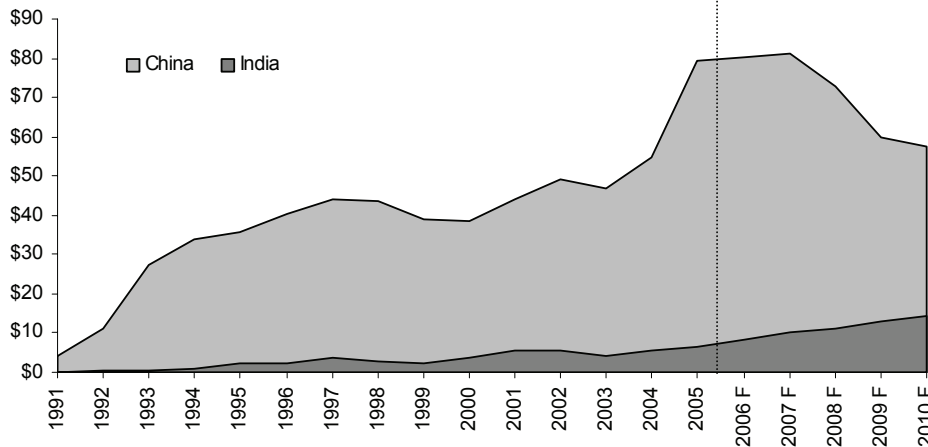
**Exhibit 3: Global Economic Integration**



Source: ADB

In spite of this, exports and imports more than doubled from roughly 9% of GDP in 1991 to about 20% in 2004, demonstrating India’s progress toward more openness (see Exhibit 3). India is the second most attractive FDI destination for global investors, according to an A.T. Kearny study, surpassed only by China. Approximately 20% of all the Fortune 500 companies have already set up R&D facilities in India. However, with an FDI volume of US\$6.7 billion in 2005, India still attracts relatively little FDI. Given that China received US\$79 billion in FDI, inflows into India should increase as long as reforms continue. Forecasts from EIU suggest that FDI should double within five years (see Exhibit 4).

**Exhibit 4: Foreign Direct Investments in China and India (US\$B)**



Source: EIU

Another proxy for improved macroeconomic policy and stability is India's inflation rate. Even though a slight rise in consumer prices is expected during the next five years, inflation should remain at roughly half the level of the 1990s.

Forecasts by EIU suggest that India's economy should grow by 6.7% per annum over the next five years. From 2006 to 2030, the annual growth rate is projected to average 5.9%. Compared with current levels, GDP per capita should more than double by 2013 and should increase about 10 times by 2030. As a result of above-average growth, India will likely become one of the five largest economies worldwide in less than 20 years (see **Exhibit 5**).

**Exhibit 5: The World's Top-15 Largest Economies, 1995-2030**

Rank	1995	2000	2005	2010	2015	2020	2025
1	USA	USA	USA	USA	USA	USA	USA
2	Japan	Japan	Japan	Japan	Japan	China	China
3	Germany	Germany	Germany	China	China	Japan	Japan
4	France	UK	China	Germany	Germany	Germany	Germany
5	Italy	France	UK	UK	UK	UK	<b>INDIA</b>
6	UK	China	France	France	France	<b>INDIA</b>	UK
7	China	Italy	Italy	Italy	Italy	France	France
8	Brazil	Canada	Spain	Spain	<b>INDIA</b>	Russian Fed.	Russian Fed.
9	Canada	Brazil	Canada	Russian Fed.	Russian Fed.	Italy	S. Korea
10	Spain	Spain	<b>INDIA</b>	Canada	S. Korea	S. Korea	Canada
11	S. Korea	Mexico	S. Korea	<b>INDIA</b>	Spain	Canada	Italy
12	Netherlands	S. Korea	Mexico	S. Korea	Canada	Spain	Spain
13	Australia	<b>INDIA</b>	Australia	Brazil	Brazil	Brazil	Brazil
14	<b>INDIA</b>	Australia	Brazil	Mexico	Mexico	Mexico	Mexico
15	Switzerland	Netherlands	Russian Fed.	Netherlands	Netherlands	Netherlands	Netherlands

Sources: EIU 2006; Prudential Real Estate Investors

### **Stable Political and Regulatory Environment**

India is the largest democracy in the world, in stark contrast to its neighbors. The Indian legal system has deep historical roots and is more robust than systems in other emerging markets. According to the World Bank's governance indicators, India's rule of law is more established than in the rest of the "BRIC" (Brazil, Russia, India and China) countries, and foreign investors' ratings of India's overall legal framework and regulatory mechanism are improving, noted a survey by the Federation of Indian Chambers of Commerce & Industry. In 2005, 87% of respondents rated the overall legal framework and regulatory mechanism "average to good" versus 75% in the 2004 survey.

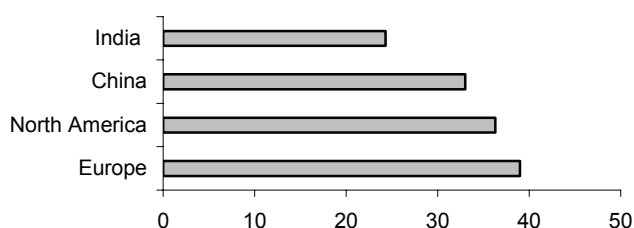
Indian accounting standards have their foundation in global best practices. The Indian stock market is well developed. The Mumbai (Bombay) stock exchange, which accounts for more than 80% of all trades in India, has a market capitalization of US\$625.9 billion. A strong, independent regulatory body, the Securities and Exchange Board of India and banking supervisors oversee the capital market.

## Favorable Demographics

India has a large and young population. With 1.1 billion people, India is the world's second most populous country after China. India's population is rising at a rate of 1.4% and should expand by 157 million over the next decade, or 16 million per year. Around 2030, India should overtake China as the most populous country.

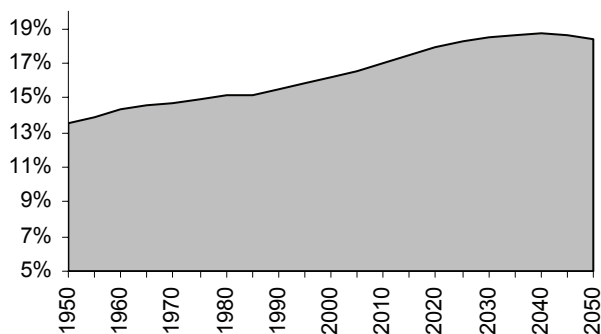
For a long time, India's population was thought to be a burden on the economy, but now it is seen as a strength rather than as a weakness. This is because India's population is young, with a median age of 24.3, compared with 39 in Europe, 36 in North America and 33 in China (see **Exhibit 6**). As of 2006, only 4.9% of India's population is 65 years of age or older, and a massive 64.3% of the population is within the working-age range of 15 to 64 years. This advantage is expected to continue for the next 15 to 20 years, since more than 30% of India's population is under 14 years old. They will be joining the working-age group in the coming years, ensuring a significant increase in the labor supply. India's global share of the working-age population should rise from 14% today to more than 18% from 2025 onward (see **Exhibit 7**). Hence, this young and growing population could lead to significant economic growth as the labor force expands – provided its potential is effectively used.

**Exhibit 6: Median Ages, 2005**



Source: United Nations

**Exhibit 7: India's Working-Age Population (% of world)**



Source: United Nations

Although only 5% of India's work force of 485 million has at least a college degree, on an absolute basis, India's young talent pool is very large. According to a study by the McKinsey Global Institute, India's pool of young university graduates is estimated to be 14 million – 1.5 times the size of China's and almost twice the size of the U.S. pool. Furthermore, India's 380 universities and 1,500 research organizations generate 2.5 million new graduates, including 200,000 engineers, 300,000 non-engineer technicians and about 400 Ph.D.s each year. India's higher education institutions are among the world's best. The Indian Institutes of Technology (IIT) and the Indian Institutes of Management (IIM) enjoy excellent reputations globally. Despite these impressive figures, surveys show that only 10% to 25% of university graduates are considered suitable for work in multinational companies (due to a lack of English skills, the inadequacy of their knowledge of world economics or poor academic performance), meaning that skilled workers will likely be in short supply. Therefore, to stay competitive in skill-intensive sectors, India must improve the quality of its human capital and must expand its access to higher education.

Continued structural and economic reforms, appropriate investment in human capital, infrastructure improvements, as well as increased openness to trade and investment, are essential to sustain high economic growth. But the shift to a service-based economy is one of India's biggest opportunities, and with so much scope to catch up to developed economies, combined with very sound demographics, India's economic growth prospects are quite favorable.

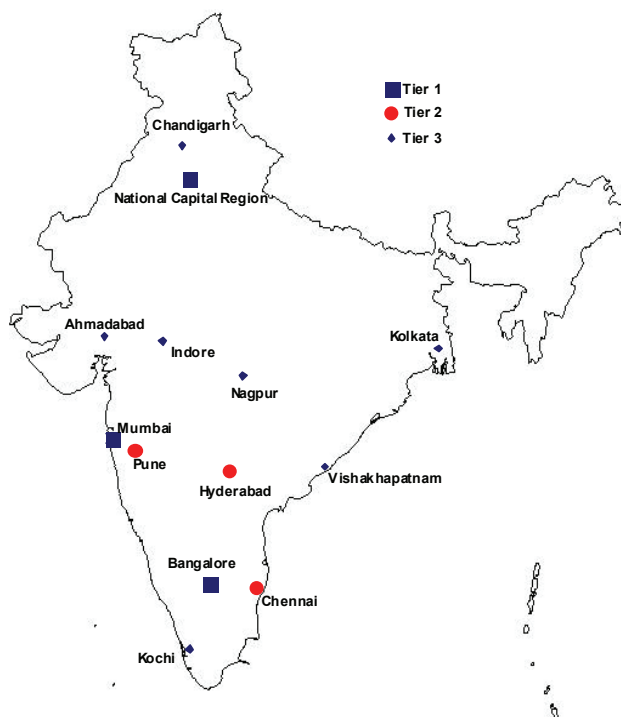
#### **Office Demand Growth Spurred by the IT Industry**

India is the world's back office, currently commanding 44% of the global market for IT and business process outsourcing (BPO) services, according to the National Association of Software and Service Companies (Nasscom), India's IT industry association. In 2006, service and software exports amounted to \$17.1 billion and hardware export another \$6.9 billion. Since fiscal year 1999-2000, the Indian IT and IT-enabled services (ITES) industry has expanded at a compound annual growth rate of 28%. The industry's contribution to India's GDP has risen from 1.9% in 1999-2000 to a projected 4.8% in 2005-06. This has led to strong demand in the office sector, with most occupier demand coming from the growth of IT and ITES, along with BPO, as multinationals try to capitalize on the young, educated and inexpensive work force.

The global demand for Indian outsourcing and offshoring activities stems from a need to reduce production costs. Wage levels in the IT sector have been steadily rising since 2000, but they are still low compared with developed countries. A young IT employee in India still earns about US\$8,000 per year, much less than a Western counterpart, who makes about US\$50,000-\$70,000. Even when the costs of power, telecommunications, office set-up and other infrastructure are included, India retains its cost advantage. A Deutsche Bank report, estimating the per employee cost per year in several offshore locations, showed India's advantageous position, with a cost of US\$5,300. China and Russia trailed at US\$7,700 and US\$14,450, respectively. Other factors driving the growth of the IT-ITES-BPO sector are a large pool of English-speaking professionals, government policies actively promoting IT export, good quality-control systems and the presence of cybersecurity and privacy laws.

The growth in offshoring has led to the classification of Indian cities into three tiers in terms of their attractiveness (see Exhibit 8). Tier I cities provide the largest and most qualified labor pool and better infrastructure and real estate formats. They include Bangalore, Mumbai and the National Capital Region (Delhi and surrounding satellite towns such as Gurgaon and Noida). Tier II cities provide relatively smaller work force pools but offer similar quality labor at a cost advantage of 15% to 20% over Tier I cities. They include Hyderabad, Chennai and Pune. Tier III cities provide more cost advantages than Tier I and II cities through lower labor and real estate costs and lower staff attrition but are riskier in terms of much smaller labor pools and somewhat lower-quality infrastructure. They include Kolkata, Ahmadabad, Chandigarh, Indore, Nagpur, Vishakhapatnam and Kochi.

**Exhibit 8: India's Major Cities**



Source: About.com

Nasscom estimates that the IT and BPO industries will create one million additional jobs in the five major hubs (New Delhi, Bangalore, Hyderabad, Chennai and Mumbai) and about 600,000 jobs in other Tier II and III cities by 2010. This should result in office space demand of roughly 21 million m<sup>2</sup> (226 million square feet), which compares with the total office stock in Central London, for example, of 19 million m<sup>2</sup> (205 million square feet). Corresponding to the high demand-side dynamics, development activity is extensive and is mainly focused on secondary locations. The combined total office stock in the major cities is estimated to stand at about 10 million m<sup>2</sup> (108 million square feet).

**Mumbai (Bombay):** Mumbai is India's financial hub and is home to the headquarters of the Reserve Bank of India (RBI), India's central bank, the Bombay Stock Exchange, the National

Stock Exchange, the Securities and Exchange Board of India, the capital market regulatory body, and many domestic and international banks and financial institutions. Hence, the IT firms catering to the financial sector also have big offices in the city. JLL estimates the office market at 33 million square feet, of which about 12 million are class A and B. The demand for offices comes mainly from the IT industry, followed by financial companies.

The CBD comprises Cuffe Parade, Fort/Fountain, Ballard Estate and Nariman Point, which is the southern tip of a peninsula (thus, it is impossible to expand in the south). New business areas are forming in the northern part of the city in the secondary business districts (SBD) of Bandra Kurla, Worli, Prabhadevi and the peripheral locations of Andheri and Thane. SBDs have become prestigious locations, and some industry members consider them part of the CBD.

High demand has also led to much new development, most of which is occurring in the SBD of Bandra Kurla. Also, the Supreme Court of India has recently allowed the use of derelict mill land (mostly textiles) for real estate development. Projects are already in place for 23 of them; six will be mixed-use, seven will be commercial and 10 will be residential.

**National Capital Region (NCR):** The NCR comprises the country's capital city of Delhi and the neighboring towns of Gurgaon and Noida. New Delhi is the seat of the central government, the Parliament, the Supreme Court and foreign embassies. JLL estimates an office stock of 30 million square feet, of which one-quarter is class A. The NCR contains many multinational companies and is one of the most important hubs for call centers and other customer services.

The CBD is in Connaught Place, in the heart of New Delhi. Security and zoning restrictions make it impossible to put up any more office buildings there. Most of the big multinational companies such as IBM, Microsoft, Hyundai and Samsung have offices in the neighboring township of Gurgaon, which provides more space and lower rents. The establishment of offices by these multinational corporations led to residential areas for their staffs, and gradually a satellite township grew up with planned infrastructure. But now Gurgaon is also facing a space shortage, which has drawn attention to other nearby townships, such as Noida and greater Noida. All of these satellite towns are planned with a mix of office, residential areas and large shopping malls. But due to demand, rents have started to climb there too, even though they are much below that of the CBD. Demand is flowing to these towns from the CBD due to the availability of larger, more modern office space, sometimes built-to-suit, with lower rent and proximity to the international airport. JLL estimates new construction in 2006 to be 7.5 million square feet.

**Bangalore:** All the important domestic and international IT companies are present in the "Silicon Valley of India," but the infrastructure of the city has not kept pace with the development of the IT market. The office market has a total stock of 28 million square feet, of which 38% is class A and B. The CBD is M.G. Road. The SBDs are Hosur Road and Whitefield. Most of the new projects in the SBD are developed as office campuses, which are often owned by the occupier company. Even most of the rented buildings are built-to-suit, i.e., with requirement input from the tenants.

**Tier II and III Cities:** With increasing labor and real estate costs and high attrition rates among skilled professionals, more IT firms are looking at Tier II cities, such as Hyderabad, Chennai and Pune, and Tier III cities, such as Kolkata, Nagpur, Chandigarh, Indore, Ahmadabad, Kochi and Vishakhapatnam, which provide a similar quality labor force but at a cost advantage of 15% to 20% over Tier I cities. The state governments of these cities are also actively wooing IT companies with quick approvals of project proposals and tax incentives.

### **Structural Shift in the Retail Sector**

India ranks as the most attractive retail destination among all emerging markets, according to A.T. Kearney's Global Retail Development Index. Total sales account for more than US\$300 billion and are projected to rise between 6% and 10% per year in the medium term, considering India's projected upward growth trend and favorable demographics.

The retail sector offers opportunities stemming from an ongoing structural change. India's retail market until recently was very fragmented. The retail scene is still characterized primarily by small, family-owned enterprises and street markets. The largest 10 retailers account just for 2% of the total market. One major reason for the underdevelopment of the retail market was government protection of local retailing from foreign competition. Only as recently as early 2006 has the government allowed 51% FDI in single-brand retail, with Reebok, Nike, Levi Strauss and Benetton opening outlets. However, multibrand retail chains like Wal-Mart have not yet been allowed entry, although further opening of the market is likely in the near future.

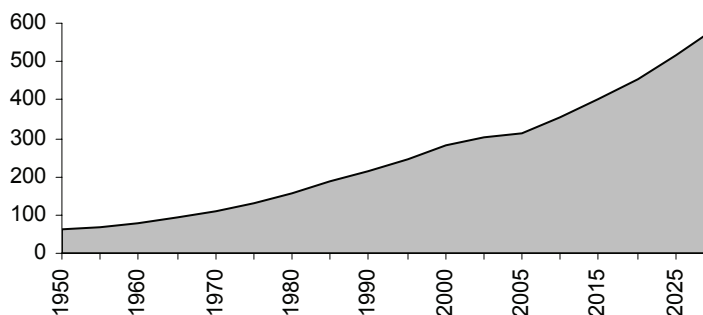
India's accelerated growth potential, the rise of a growing middle class with high disposable income and greater contact with the West have all sparked a boom in modern shopping centers that are similar to Western malls. In recent years, the trend toward larger retail formats, such as shopping malls and department stores, has grown, and the major companies likely will capture up to 10% of total market share within the next five years. Developers have started to respond to the structural shift. By 2007, India will have about seven million m<sup>2</sup> (75 million square feet) of mall space, out of which 57% will be in Delhi and Mumbai, notes a study by Knight Frank. Although this could result in pockets of oversupply in selected microlocations, the provision per capita in India overall should remain relatively low, at less than 10 m<sup>2</sup> (107.6 square feet) per 1,000 inhabitants, compared with the EU15 average of 200 m<sup>2</sup> (2,153 square feet) per 1,000.

Shopping malls are becoming more common, not only in Tier I cities, but also in other large cities (those with populations of more than one million). Based on announced development plans, at least 150 new shopping malls should appear by 2008. Mall developers are adapting quickly to the preferences of their customers. Some new types of projects are automobile malls and wedding malls, which are one-stop shopping destinations. The number of department stores is growing much faster than overall retail, at an annual rate of 24%. Supermarkets have garnered a growing share of the food and grocery trade over the past two decades.

## Housing Market on a Steep Growth Path

Strong urbanization effects are augmenting the growth potential arising from India's young, expanding population. Less than 30% of the population now lives in urban areas. But India's Planning Commission forecasts that the urban population will rise by more than 40% by 2020, meaning an increase of about 140 million over the next 15 years, or nearly 10 million per year (see Exhibit 9).

**Exhibit 9: India's Urban Population, 1950 to 2050 (millions)**

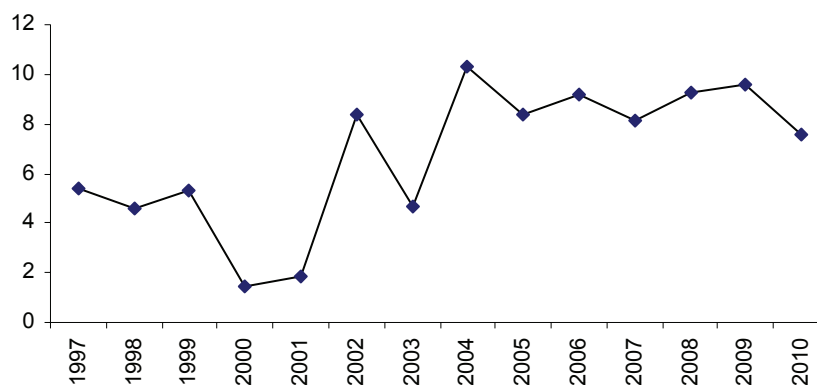


Source: United Nations

Household formation is growing due to population growth and the shift from joint families to nuclear families. The average number in each household has fallen from 5.8 in 1990 to 5.3 in 2005. According to the Tenth Five-Year Plan, a shortage of 22.4 million dwelling units exists. Additional housing needed each year from 2002 to 2007 has been estimated at 4.5 million units.

Real income growth should rise from 5.9% per year in 1991-2005 to 8.7% per year in 2006-2010 (see Exhibit 10). The percentage of households with nominal disposable incomes of more than US\$3,000 per year should rise from today's 25% to 56% in 2010. Also, India has moved to a lower-interest-rate environment, with easier availability of home mortgages. Prime lending rates fell from 16.5% in May 1996 to 11% in May 2006. Government action has also helped to raise housing demand via greater tax incentives. Now, more interest and debt service can be deducted from income taxes than in the '90s. Positive demographics, rising income, growing urbanization and lower interest rates bode well for demand in the residential sector.

**Exhibit 10: Real Personal Disposable Income (% change per year)**



Source: EIU

India's homeownership today is estimated at about 30%, compared with roughly 69% in the U.S. Additionally, the availability of financing choices, including the development of a mortgage market, is increasing to meet pent-up demand. Even then, mortgages currently equal less than 3% of India's GDP, compared with more than 30% in other South Asian countries.

## Industry Trends

With 40 cities of more than one million residents, totaling 128 million people, India offers many potential investment locations (see Exhibit 11). Despite this, commercial sectors tend to concentrate in Tier I and II cities due to the availability of skilled human resources and adequate infrastructure. Real estate investment focuses on a few major cities, which follow their own economic and real estate agenda. The most important investment locations include Delhi (the political

**Exhibit 11: India's 10 Largest Cities by Population (thousands)**

	2005	2015	% Change
Mumbai (Bombay)	18,336	22,645	24%
Delhi	15,334	20,946	37%
Kolkata (Calcutta)	14,299	16,798	17%
Chennai (Madras)	6,915	8,092	17%
Bangalore	6,532	8,416	29%
Hyderabad	6,145	7,536	23%
Ahmadabad	5,171	6,632	28%
Pune (Poona)	4,485	6,130	37%
Surat	3,671	5,731	56%
Kanpur	3,040	3,838	26%

Source: United Nations

center), Mumbai (the financial capital) and Bangalore (the major IT hub). Moreover, Chennai and Hyderabad could establish themselves successfully as investment locations. However, as costs have risen and labor shortages have appeared, cities like Ahmadabad and Chandigarh should compete successfully due to their lower cost basis, and cities like Calcutta and Nagpur likely will take advantage of their relatively large pool of skilled workers.

Many cross-border developers plan to enter the residential sector via the emerging trend of integrated townships. With land scarce in most major cities, but large parcels available just outside the city limits, developers are moving toward large, integrated developments with commercial, retail, residential and even medical facilities. Most are joint ventures with Indian developers, and some are also in public-private partnerships, with local governments as minority stakeholders.

Developers are also showing interest in Special Economic Zones (SEZ). SEZs are specifically delineated, duty-free enclaves outside the customs territory of India. SEZs are approved by the Ministry of Commerce and can be set up by private developers or by central/state government or jointly by any two or more of these. Currently, 14 SEZs are operational. Another 60 are in various stages of planning and development. SEZs can be multiproduct or for a single sector, such as IT, pharmaceuticals or textiles. Multiproduct SEZs must be at least 1,000 hectares.

Businesses operating in SEZs enjoy a corporate tax holiday on export earnings, indirect tax exemptions and liberal exchange controls. Developers also receive many fiscal benefits. The income-tax incentives for a SEZ developer include a 10-year tax holiday; exemption from dividend distribution tax; tax-exempt interest on long-term financing; tax-exempt long-term capital gains arising on the transfer of shares in the developer's company; and no minimum alternative tax. The indirect tax incentives include no import duty; no excise duty; exemption from service tax; and exemption from tax on the sale of electricity for self-generated and purchased power.

Traditionally, India has predominantly been a developer's market, whose main source of financing was private debt. International real estate investors have played only a minor role in India, as FDI into real estate was very restricted and had high threshold requirements. Thus, foreign investment flows were very limited. But India has progressed by introducing reforms and liberalizing investment policies. In early 2005, the government relaxed FDI norms, and now FDI in "greenfield" real estate developments are automatically approved, without a cumbersome permission procedure from the Foreign Investment Promotion Board, if they fulfill certain conditions (see **Exhibit 12**). That said, FDI is still somewhat limited, and barriers to entry for foreigners are still considerable. For example, foreigner investors cannot buy existing buildings.

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**Exhibit 12: New FDI Norms**

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FDI in "greenfield" real estate projects are automatically approved, if the following conditions are satisfied:

- Commercial projects are more than 50,000 square meters; residential developments are at least 10 hectares.
- The minimum capitalization is \$10 million; for a joint venture with an Indian partner, the limit is \$5 million.
- The original investment cannot be repatriated for three years.
- Foreign investors cannot trade in undeveloped plots.
- At least 50% of the development of an integrated project must be completed within five years of all approvals.

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Source: PriceWaterhouseCoopers

We estimate that higher-quality commercial real estate in India totals about US\$100 billion, equaling about 0.6% of the global commercial real estate stock. In the long term, India's real estate share should rise to more than 3% of global commercial real estate stock and more than 12% of the Asian stock due to the structural transformation of India's economy.

So far, private debt has been the most important source of financing in this sector. The recent growing demand for real estate is driving the substantial demand for construction financing and, according to the Reserve Bank of India, loans to commercial real estate rose in 2005-06 by 84%, to US\$2.4 billion.

Since 2004, venture capital funds have been permitted to invest in real estate, allowing domestic and foreign investment managers to operate real estate fund vehicles via a private equity route. The first real estate funds are now up and running, and several are in the planning stage. Several foreign funds are exploring investment opportunities, reflecting a strong interest from domestic and international investors. Roughly US\$15 billion have been raised on behalf of foreign funds targeting Indian real estate.

Currently, real estate investment trusts (REITs) are not allowed in India, but in June 2006 the Securities and Exchange Board of India approved guidelines for real estate mutual funds.

### **Caveats**

India is an emerging market. Although country risk is hard to measure, Euromoney's rankings of the country's creditworthiness based on political, economic and capital market risk can be used as a proxy. With a rating of 56 out of 100, India falls in the lower end of the range, implying higher investment risks. India's real estate market is opaque. Real estate related data is patchy, key time series are nonexistent or too fragmentary to allow robust analysis, and no historic reference points exist. Hence, valuations and investment decision-making in India are challenging tasks. Investors are faced with typical emerging-market characteristics, most notably low transparency, lack of suitable investment products and low liquidity.

Another major barrier to entry is the fragmented ownership structure and absence of clear land titles, restricting organized dealings. Currently, title insurance is unavailable, although, according to press reports, some Indian financial companies are looking into the issues of structuring and pricing such a product. Accessing the Indian real estate market is very difficult due to the lack of investment-grade properties. This lack is reflected by the 0.3 m<sup>2</sup> (3.2 square feet) of office space per capita in major Indian cities, which is 10 times less than in a typical Western European city. Research by the World Bank suggests that it takes five times longer to register a property in India than in the U.S. and three times longer than in the UK. Additionally, lease terms in India are rather short. While longer-term leases, up to nine years, can be negotiated, the typical commercial lease term is three years, with options to renew for two more terms of three years.

Relative underdevelopment of the capital market in the real estate arena is another drawback. The primary debt and equity markets are active, but the absence of REITs, commercial mortgage-backed securities and other secondary investment vehicles are hindering capital flows. Also, domestic institutional investors, such as pension funds and insurance companies, are prohibited by law from investing directly in real estate, even though they can invest a small portion of their total investments in publicly listed securities.

Regulatory risk is another area of concern. The Urban Land Ceiling Act, which imposes a ceiling on the maximum amount of land under individual possession, and a high stamp duty, creating a higher transaction cost, are two such examples. However progress is being made in this area, with the central government and some of the state governments liberalizing these restrictions. Also, RBI regulations concerning the repatriation of capital somewhat limit exits for cross-border funds.

Another challenge that India needs to meet is the inadequacy of its physical infrastructure. Even though India has made significant progress in telecom infrastructure, at least in the urban areas, much needs to be done to improve the quality of transport infrastructure. The quality of Indian roads, railways and airports leaves much to be desired. Moreover, each commercial property needs to have its own back-up generator due to the unreliable supply and distribution of electricity.

## Implications for Investors

India's commercial real estate stock is currently only a fraction of the global universe. However, India's weight in institutional portfolios should increase as the real estate markets mature along with the economy. A positive economic outlook, favorable interest rates, increasing purchasing power and reforms in the industry are some of the positive factors contributing to the recent growth of this sector.

Yields on commercial real estate across India's main urban hubs continue to be higher than those prevalent in the real estate markets of the developed world. In addition to the potential for higher returns, one of the most compelling arguments for investors to include Indian real estate in an international portfolio is its diversification benefit. Relatively low historic GDP correlation with major economies suggests that investors can reduce portfolio risk for a given level of return by adding India to their investment universe.

India's real estate capital market should reach a turning point in the foreseeable future. First, high economic growth in India can only be sustained if investments in both industry and infrastructure accelerate. Consequently, capital market products and investment vehicles must improve. Second, given the lack of infrastructure, a huge amount of foreign capital is needed, which should act as a catalyst for further FDI liberalization. The liberalization of FDI norms, coupled with the emergence of real estate funds, should result in a paradigm shift leading to increased competition, the introduction of global best practices and professionalism, improved transparency, and the reduction in exit risk in the medium to long term. In the short term, however, India remains a challenging market with significant investment and exit risks. Against this backdrop, investors need a clear understanding of how to structure investments to reduce such risks.

Despite India's many investment locations, one of the highest barriers to entry continues to be the lack of institutional-grade properties. Given foreign investors' high interest in India and still-low FDI levels, combined with India's ongoing progress toward opening its economy, a flood of liquidity is poised to flow into real estate. This expected flood of foreign capital chasing limited stock is likely to compress yields. Increasing demand for limited investment products is leading to a fast rise in property prices in Tier I cities and, to a lesser extent, in some of the Tier II and III cities. Thus, yields for commercial property have started to come down in most markets. With the anticipated surge in capital, further yield compression is likely. Hence, investors need to consider risk-adjusted return levels.

Additionally, differences in economic culture could lead to asymmetric information between domestic and foreign investors. To overcome the resulting information disadvantages and to access the market, foreign investors need to establish relationships for the longer term with local partners. A patient and prudent approach is needed to enable investors to capitalize on the increasing institutionalization of India's real estate market and to access this strategic market of increasingly global significance.

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