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INDIAN REAL ESTATE MARKET

DEVELOPING OPPORTUNITIES IN INDIA

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Real estate development is scaling up dramatically in India. Favourable regulations, heightened end user demand, the need for private funding of basic infrastructure and availability of large tracts of development land are contributing to an increased willingness by developers to commit to larger projects.

Whilst the economic and demographic fundamentals support robust growth in the country's commercial real estate market – which, according to Deutsche Bank, is expected to expand by 20% (US$60 billion) to US$360 billion over the next four years – a confluence of tightening domestic monetary conditions and underdeveloped capital markets could pose a threat to these ambitious growth targets being met. Given this background, is Foreign Direct Investment (FDI) the solution by which Indian developers can overcome restrictive domestic monetary constraints?

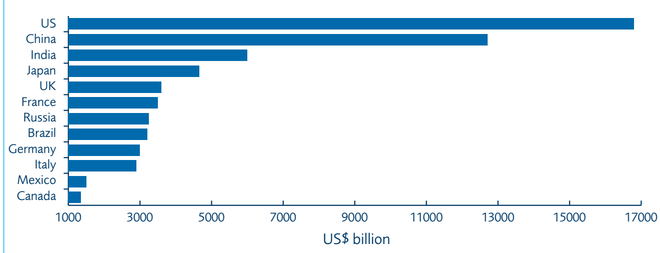
India is following a well trodden path of consolidation and enhanced scale in its real estate development industry. What is unique, relative to other emerging real estate markets, is the pace at which this is taking place. Large-scale Indian developers have significant land banks which, on average, are equivalent to eight years' supply. This compares to an average of seven years for Chinese developers.

"Off-shore private equity is expected to invest in excess of US$10 billion over the next four years into the Indian real estate market."

The favourable regulatory environment partly explains why scale has increased at such a rapid rate. Government legislation in the form of Special Economic Zones (SEZs) has encouraged developers to acquire large tracts of land for future development. Land classified as an SEZ enjoys favourable tax incentives and flexible labour policies aimed at attracting Foreign Direct Investment (FDI). In addition to promoting international competitiveness, SEZs are viewed as a means by which the government can redirect the cost of infrastructure development to the private sector. Developers within SEZs will be responsible for the development of basic infrastructure within the zones. This will partly offset the required US$425 billion of investment needed in Indian infrastructure over the next five to 10 years. SEZs have long gestation periods, with the development stage averaging four to five years and payback periods of up to eight years.

Whilst most developers' land banks have being acquired at low prices relative to today's market values and enjoy significant economies of scale in terms of development, the costs associated with large scale infrastructure works to facilitate development could place funding pressure on developers.

World's Largest Economies in 2010 (GDP, US$bn, purchasing power parity)



Source: EIU (December 2006)

Historically, Indian developers have relied on traditional debt funding from domestic banks to finance projects. This source of debt funding accounts for 60% of all commercial real estate investment. This is broadly in line with other emerging real estate markets. Bank lending for commercial real estate currently equates to US$2.5 billion or some 4% of the estimated US$60 billion in capital required over the next four years.

Bank lending is under pricing and capacity pressures. The Reserve Bank of India (RBI), concerned about inflationary pressures associated with strong credit growth, has sought to quell domestic bank lending to developers. It continues to demonstrate a strong bias towards monetary tightening, increasing interest rates to a four and a half year high of 7.75% in March and enforcing stricter prudential guidelines for lending to the real estate sector.

In anticipation of the pressure on funding, developers have been actively seeking to diversify their sources of capital in order to build out their land banks. Domestically the options are limited. India's capital markets are underdeveloped, particularly in relation to real estate equity and debt markets. The limited depth of the domestic public equity market, coupled with recent stock market volatility, make equity raisings of significant scale difficult. This has been evident in the delay of the US$2 billion initial public offering of DLF which was expected to list on the market in mid-2006 and remains on hold. Legislation enabling the introduction of unitised, tax advantaged real estate investment products, such as Real Estate Mutual Funds (REMFs) and Real Estate Investment Trusts (REITs), is yet to be

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ratified, making the mobilisation of institutional and retail capital for indirect investment into real estate inefficient, both in terms of time and cost. In response, developers are turning to international public and private equity to fill the funding void. To date, the response from international investors has been positive.

In the public markets, Indian developers have been increasingly active on London's Alternative Investment Market (AIM) having collectively raised US$2.9 billion through new IPOs in the second half of 2006. Expectations are that there will be a further 20 new IPOs from Indian companies on AIM this year, which will raise approximately US$5 billion. The majority of these listings are expected to comprise Indian developers.

Off-shore private equity funds have been increasingly active in capital raising for India-specific investment vehicles. To date, off-shore funds have raised some US$5 billion in equity for investment into the real estate market. Jones Lang LaSalle estimates that some US$10 billion in privately placed FDI will enter the real estate market over the next three to four years. In pricing terms, off-shore equity is becoming increasingly competitive given recent tightening by the Reserve Bank of India (RBI). Domestic listed developers have an average cost of equity of 18% which is broadly in line with returns sought by off-shore investors at 20%.

Over the next three years, we expect that up to US$15 billion in off-shore public and private equity could realistically be invested in the Indian real estate sector. Should the government further relax FDI restrictions, we see significant upside potential to this number.

FDI Confidence Index

Country:	Rating:
China	2.20
India	1.95
United States	1.42
United Kingdom	1.40
Poland	1.36
Brazil	1.34
Russia	1.34
Australia	1.28
Germany	1.27
Hong Kong	1.21

Source: AT Kearney Report (December 2005)

With respect to debt capital, non-domestic investment in the Indian private and public debt capital markets is constrained by adverse regulatory issues. Currently, foreign bank participation in private debt markets is limited. However, the RBI, recognising the need for foreign debt capital, has set in place a "road map" which outlines the process by which the current FDI restrictions will be partially relaxed by 2009. Given the estimated US$60 billion of growth in the commercial real estate market over the next four years and assuming 50% leverage, private debt could be required to fund up to US$30 billion of development in the market over the next four years. This is a twelvefold increase from the current level of bank lending for commercial real estate. Thus, in an economy experiencing 30% year-on-year credit growth, domestic banks are faced with an impending capital shortage.

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The public debt market (i.e. Commercial Mortgage-Backed Securities (CMBS) and corporate bonds) is in its infancy in India. In 2005, total public debt secured by real estate was tiny (approximately US$6 million), all of which comprised corporate bonds. Development and growth of an active CMBS market is constrained by uncertainty over foreclosure under the Indian legal system and opaqueness surrounding the tax implications of securitisation.

What does all this mean for international public and private equity real estate investors and the Indian real estate market?

Demand for equity funding by domestic developers will undoubtedly increase in the short term. We expect to see an increase in the number and scale of off-shore equity raisings, primarily on AIM, by Indian developers. Pricing power will likely shift from issuers to investors as volumes increase, although continued strong institutional demand will result in competitive pricing for credible offerings. Non-domestic private equity funds should see increased deal flow, particularly from small and medium-sized developers with limited access to equity markets. Pricing power is moving in favour of non-domestic funds and the differential between listed developers' cost of equity and the required returns of non-domestic investors is marginal.

Accessing non-domestic public and private equity demands will undoubtedly increase disclosure requirements. This is a positive for the Indian real estate market. Recently we have seen a move by equity analysts to price the shares of listed developers on asset based or NAV valuations as opposed to price earnings multiples. This is providing a pricing framework for listed developers' land banks which will further enhance transparency in the market.

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ABOUT PRUPIM

PRUPIM is one of the leading real estate investment managers in the United Kingdom. We form part of the M&G Group of Companies which is the asset management arm of Prudential plc in the UK and Europe.We manage around US$37 billion of real estate assets, of which US$6 billion is invested internationally in North America, continental Europe and Asia Pacific. We are invested in over 1,000 properties with approximately 6,000 property occupiers. We manage real estate investments for a wide variety of clients, providing core services and expertise in fund management, asset management and property management. These services are offered individually, or on a fully integrated basis.

Our major activities are driven by powerful research, managed by the Global Property Research Team. Our considerable scale and diversified activities allow us to draw on our own multi-dimensional inputs which give us an unrivalled information advantage. We evaluate the macro-economic environment working as part of the global research capability of Prudential. We receive detailed property related data generated by our on-the-ground surveyors. This is fed into proprietary modelling systems which form the basis of our analysis. The 10-strong Global Property Research Team was formed in 1987 and is comprised of property economists and performance measurement analysts who work together to provide leading property analysis and commentary on the UK and international property markets.

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Scott has been active in Asian real estate capital markets since 2002. Previously based in Korea and Japan for Jones Lang LaSalle, he has been involved at senior levels in investments, corporate finance, research and property advisory for a wide range of clients.

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