Investing in India:
Rewards Await Investors With A Long-Term View

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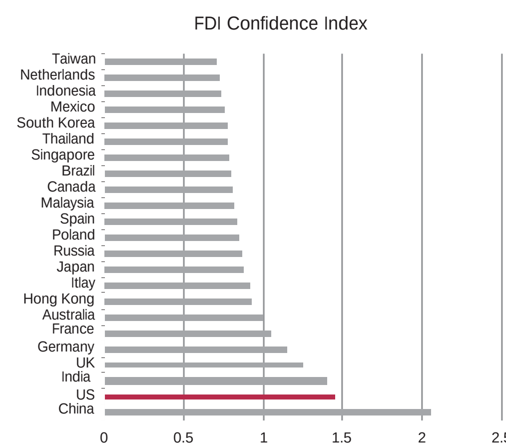
Much like the miners of '49 and the VCs of '99, real estate investors of '07 seem to have found their dream destination – India. But, unlike euphoria-past, investors are asking hard questions about India and the opportunities it presents. The complexities of Indian markets are difficult to grasp. With that in mind, we thought it would be helpful to share our views on key topics that clients are (and should be) considering before venturing into India.

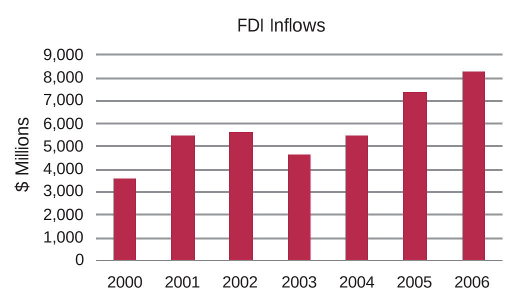
India will experience many bumps along the way, and growth will not be a steady rise. But, India's stature in the global economy will be far higher in the future than it is today.

India is a good long term economic bet. India's economic progress has been driven by 'development.' Many countries experiencing rapid growth often show reduced growth in the following period. However, this does not appear to be the case with India, which has a current growth rate of approximately 8.5%. Of course, India will not grow at this rate forever and investors' should expect more moderate long-term growth with bumps along the way. In addition, government policy is taking a proactive approach to addressing more "inclusive growth," by looking beyond growth for the sake of growth. As such, the Indian government is attempting to restrain growth imbalances.

The ruling Congress party, under the leadership of Prime Minister Manmohan Singh and Finance Minister P. Chidambaram, have pushed economic reforms and liberalization. Legislative measures include opening various industries to foreign investment and ownership, while also addressing rural employment guarantees, rural credit, health, education, water, sanitation and infrastructure. These programs are designed to ensure that the rural masses are not left behind.

The twin forces driving growth in the Indian economy are increases in both domestic consumption, fueled by rising worker productivity, and investment. There is an emerging middle class in India, which has resulted in greater buying power and a significant increase in consumption. With the manufacturing and service sectors contributing to approximately 70% of the current GDP, foreign direct investment (FDI) is on the rise, reaching US $7.7 billion. This number, while large, is only 8% of China's FDI, meaning there is room for further growth. In addition, India's FDI calculation fails to include deposits into non-resident Indian (NRI) accounts, which accounted for US $2.2 billion in fiscal year 2005-2006.





location, location, location

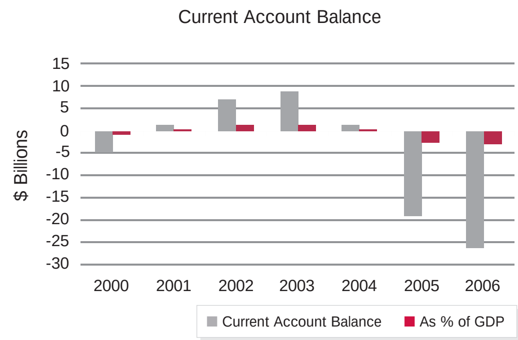
Look beyond the short term. Although India's development appears sustainable, short-term volatility will occur. Bulls often point to foreign exchange reserves, which reach a new high every week ($151.6 billion), and inflation, which has been controlled. However, there are concerns about India's widening current-account deficit as the newly rich spend their money on foreign goods, and oil imports continue to run approximately US $24 billion. More troubling, the combined deficit of the central and the state governments stands at greater than 8% of GDP.

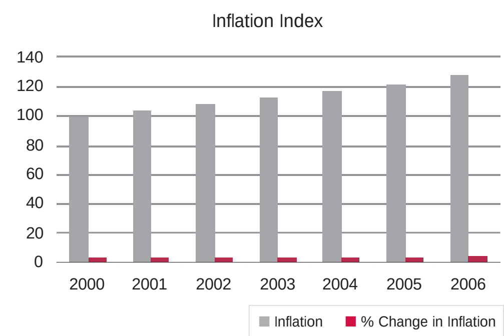
In the short term there are numerous hindrances to growth, including a lack of potable water, poor roads, corruption and insufficient educational institutions. However, the political reforms are addressing these matters. These changes take time in any economy, but in the world's largest democracy – with coalition governments at the national and most state levels – these are very long-term fixes.

India will experience many bumps along the way, and growth will not be a steady rise. But, India's stature in the global economy will be far higher in the future than it is today. The long-term growth potential of the economy is positive. Therefore, investment decisions must be made with a long-term view.

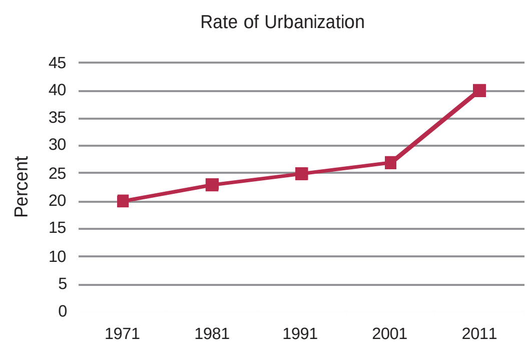
Pick a location carefully. In India, not all places are the same in terms of economic and political risk factors, stability and infrastructure, making geography a critical part of the investment decision. For example, Mumbai real estate prices are high due to the "Paris" effect. In fact, 70% of the country's GDP is generated within 100km of the city. Land constraints dictate a linear city expansion. As a result, in Mumbai's 'elite' residential areas such as Malabar Hill, it is not unheard of for apartments to sell at Rs.35,000-Rs.45,000 per square foot (approximately US $800 to $1,000) simply because it is a prime location with growing demand and virtually no new supply. We are more concerned about secondary and tertiary cities, where speculation has, in some cases, far exceeded the discipline of realistic supply and demand. For example, cities like Coimbatore (in Tamil Nadu) will see value growth due to favorable geographic constraints, as well as the presence of over 50 educational institutes ready to train the much-needed talent for companies relocating from Bangalore. However, similar price speculation on plots of land located 50km outside of Gurgaon (in the middle of nowhere), should not reasonably trade for US $100,000 to $200,000 per acre.

All real estate is ultimately local. Real estate remains a local business, and having a knowledgeable, legitimate and aligned local partner is a prerequisite. It would be advisable to enter India with the best and most reputable local developers to exploit their knowledge of the land, the market and the laws. However, the best developers generally have sufficient access to funds and do not need your financial backing. The key is to find local partners who are under capitalized and are value-add operators.





The 'high' returns may not be so high. While many developers present plans advertising 40-50% investment returns, the projects often involve significant asset mark-ups. While high returns are not impossible in the long run, they represent the exception rather than the norm. Many developers report such returns because they purchased the land many years ago and are now reaping the returns. Simply acquiring land at today's lofty prices with the intention of flipping it to another speculative investor or to a developer (as many are attempting to do) will not provide consistent returns, and possibly no return at all. Ultimately, the infrastructure and the value-added improvements made to the land will be the key to generating significant long-term returns.



Another aspect to be aware of is the sale value of the land. There are two major issues to consider. The first is the estimated value, and the second is timing. For instance, the case of Bangalore is one that illustrates how these concepts factor into an investment decision. Recently, developers have been constructing a large number of IT buildings speculatively with the intention of selling or renting out the buildings. However, education in Bangalore is limited and there is a limited talent pool. As a result, Bangalore runs the risk of many shiny new vacant buildings, while firms continue to set up in other cities where the supply of talent meets demand.

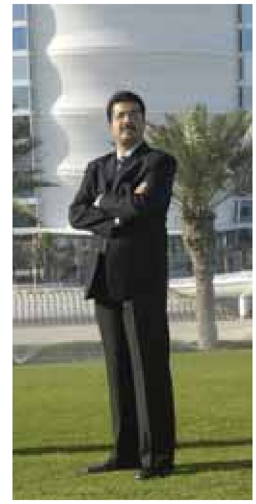
FDI norms and local laws are still tricky. Even though the Indian government has vastly expanded opportunities for foreign investors by loosening the FDI restrictions, the rules and restrictions remain a significant impediment.

Limitations exist in the form of:

- Minimum holding periods (typically three years) on repatriation of any of the initial investment unless with the prior approval of the Foreign Investment Promotion Board.
- Minimum capitalization requirements of US$10 million for wholly owned subsidiaries of foreign companies and US$5 million for joint ventures with an Indian partner.
- Capital must be brought into India within six months of incorporation of the subsidiary or joint venture.
- Size and type of projects (e.g., development is generally allowed, but acquisition of income-producing assets outside of certain sectors, such as IT and hospitality, remains limited).
- In addition, the judicial system in India is appreciably different from those of the U.S. and Europe. While India is a common law country, it can take years for claims to be processed. In addition, corruption is prevalent, though after long and tedious processes, the rule of law will prevail for those with patience and tenacity. The question for foreign investors is: How much is one actually willing to bear?

That said, once one is up the learning curve (in terms of process and contacts) with one or two investments, further investments will be less "painful."

investment opportunities



Leverage is tricky. Most foreign investors find the cost of debt in India to be high. Interest rates are often 9-11%, and amortization periods range from five to 10 years, creating a scenario where short-term cash flows are negative. The positive side is that this debt environment has made it difficult to over leverage, thereby making a "bubble" scenario (with many asset holders forced to sell due to loan maturity or interest coverage violations) less likely.

There are some very good investment opportunities. As FDI regulations continue to evolve, the result has been the entry of a broad range of foreign real estate investors. Key opportunities exist in large scale residential development, hospitality, IT parks and infrastructure.

Indian real estate presents an attractive long term investment proposition. In a land of 1.1 billion people (nearly 4x the size of the U.S.), and an economy growing at 8-10% per annum, but with 25% of the land mass of the U.S., good land is an important asset, and one which will appreciate significantly in the long run.

Indian real estate remains attractive due to the country's long-term economic story. Population growth and purchasing power growth are fueling both residential and retail demand, both of which are further fueled by the increased use of credit (in the form of mortgages and credit cards). Finally, the growth of the service sector has given rise to special economic zones, IT parks and real assets designed to support India's increasing presence as a global leader in services. Thus, while investment in India is not for the faint of heart or the risk averse, it offers the potential of attractive long-term returns.

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