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Rebounding GDP positive for real estate sector

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The Indian economy, as measured by growth in Gross Domestic Product (GDP), accelerated by 6.3% in calendar Q3 2017. This is an improvement from 5.7% in Q2 and suggests that the economy is recovering from the impact of demonetisation in 2016. Most economic forecasters predict average annual GDP growth of over 7% till 2020, which will make India one of the fastest-growing economies in the world. The government's thrust towards 'Make in India' and improvement in infrastructure spending should support demand in the industrial property sector in coming years. We expect Industrial space to emerge as the next organised property asset class in India, giving a decentralisation push, which should unlock land values in areas outside major cities and stimulate business activity. We, thus recommend that developers take account of the ample opportunities outside the traditional asset classes (offices and prime residential) and make room in their portfolios for other categories such as industrial, warehousing and affordable housing, in order to gain an early mover advantage.

Indian Economy: the silver lining

After almost two-quarters of weakness, India's real GDP growth bounced back from 5.7% in calendar Q2 2017 (Q1 FY2017) to 6.3% in calendar Q3 (Q2 FY2017). According to many economists, a sharp economic recovery is underway with growth likely to exceed 6.7% for the rest of FY2017 and 6.9% to 7.4% for the next three years. GDP expansion is likely to be driven by improvement in industrial production, a pick-up in consumption and increased infrastructure spending. The low real interest rates and improving exchange rate scenario should also support investment growth. Based on Oxford Economics' forecast, real interest rates (i.e. inflation-adjusted interest rates) should stay low at about 1.5-1.6% till 2020, compared to a range of about 3.0-4.3% over the first three quarters of 2017.

We believe that steady economic expansion, persistent loose real monetary conditions and improvement in infrastructure spending ought to support the Indian investment property market.

India: Key Economic Indicators*

	2016	2017	2018	2019	2020
Private consumption	9.2	7.0	8.8	6.5	6.7
Fixed investment	5.1	1.0	5	6.9	7.7
GDP	7.9	6.4	7.4	7.1	6.9
Consumer prices index (CPI)	4.9	3.3	5.1	5.7	5.8
Short-term interest rate (%)	7.2	6.5	6.7	7.3	7.3
Real interest rate (%)	2.3	3.2	1.6	1.6	1.5
Exchange rate (Rupee per USD)	67.2	65.2	63.6	64.1	65.9

Source: Oxford Economics, * Refers to Calendar year

Furthermore, recent government reforms, e.g. the implementation of the Goods and Services Tax (GST), the Real Estate Regulation and Development Act (RERA) and various checks on cash transactions, have resulted in short-term turmoil in the market, but may be considered as beneficial for the economy in the long run.

Indeed, the impact is already visible, and India has witnessed an improvement in various international ratings. For example, the debt ratings agency Moody's has just upgraded India's sovereign credit rating for the first time in 14 years, while India's ranking in the World Bank's 'Ease of doing business' index has jumped to 100 in 2017 from 130 in 2016. India has seen a noteworthy jump of 85% in property Investments in the first nine month of 2017 as compared to the same period last year. The deal volume is recorded at USD 2.6 billion[1] in the first nine months of 2017, in comparison to 1.4 billion last year.

[1] Source: RCA (as reported in APAC Q3 2017 report, 7 Nov. 2017 with estimates by Colliers. Land development sites are excluded)

India's bank recapitalisation plan (under which the government is planning to inject INR 2.11 lakh crore (USD 32 billion) worth of capital in to the banking sector) has further boosted domestic as well as foreign investor confidence in the economy. Other factors such as the USD 59.2 billion infrastructure spending plan announced in Union Budget 2017-18 and digitisation of tax payments which is expected to gradually widen the country's tax base indicate a positive scenario.

Looking forward, in comparison to the traditional property asset classes such as office and premium residential, we expect industrial warehousing and affordable housing to grow much faster. We believe that the recent implementation of the GST and the 'Make in India' drive will attract significant investment in the Industrial sector. Similarly, the government's agenda of 'Housing for All by 2022' and the policy reform for affordable housing ought to boost demand for affordable housing in coming years. We recommend that developers consider the ample opportunities outside the traditional asset classes (offices and premium residential) and make room in their portfolios for other asset classes such as industrial space, warehousing and affordable housing in order to gain an early mover advantage.

What Challenges remain?

Slow implementation of recent reforms and delays to new infrastructure projects still represent threats to the Indian economy. According to Oxford Economics report (Country Economic Forecast India - 23 Nov 2017):

"More progress is needed on key reforms dealing with power, land and labour, if India is to see the rapid rise in investment that will be required for sustained long-term growth."

Moreover, general elections are scheduled in 2019, and these may divert the government's focus from key reforms. Although, the government's economic reform programme has yielded some successes in recent past, the progress has not been as fast as had been hoped. In the real estate sector, the following key reforms have been initiated: the 'Housing for All by 2022' plan, the implementation of RERA, and amendment of the Real Estate Investment Trust (REIT) policy. While the ambitious 'Housing for All by 2022' plan started with a big bang, so far private investment has not picked up as expected. RERA has been implemented in most of India's states, and reportedly about 20,000 projects are registered under the Act up till now. However, while RERA has expedited the completion of projects across the country, it will take time to resolve buyers' problems in dealing with developers with acute financial distress.

Similarly, REITs have yet to take off even though all regulatory hurdles seem now to have been removed.

In our opinion, the delay in approval processes is still an area of concern and impacts the overall viability of real estate development projects. The government needs to consider making the approval processes simpler and faster since this will remain the key to the successful development of real estate assets in the country.

Another challenge may be Artificial Intelligence (AI). In recent months, Colliers has carried out extensive research into the impact of artificial intelligence on real estate. We believe that AI will replace many routine and replicable roles, and consider finance – in particular, commercial banks and insurance companies – as a sector are likely to be significantly impacted. Although the impact of AI in the Indian market may still seem a little distant, the field is evolving rapidly. It is entirely conceivable that a material acceleration in the rate of advances in AI creates substantial near-term disruption in the finance sector, resulting in major job losses. Such a shift could lead property investors to conclude that future office space requirements in the Indian finance sector have been significantly overestimated.

Sustained office demand expected despite disruptions

Notwithstanding the economic disruption, the commercial real estate market has remained robust in 2017. Up to November 2017, the market has recorded pan-India leasing volume of about 35 million sq ft (3.3 million sq m) excluding renewals and pre-commitments. We expect that the overall leasing volume for 2017 to be on a par with last year. The demand for Grade 'A' office space has been driven by technology companies followed by engineering, manufacturing, banking and finance, and coworking operators. Although GDP growth was dull in the middle of the year, taking cues from the positive policy initiatives, most of the large occupiers have been reviewing their long pending Corporate Real Estate (CRE) decisions. Tenants in expansion mode have relocated and locked in large office spaces at favourable lease terms.

The trend of pre-committing large spaces has picked up so far in 2017. Furthermore, as we predicted, operators of coworking or flexible working space have made their entry into the market in a big way, representing about 11% of total absorption over the first eleven months of 2017 compared to last year's share of 3%.

We expect that the office leasing market will remain robust in 2018 and over the subsequent few years, reflecting strong employment growth and economic reforms. However, we do not expect the absorption level to grow further since despite strong demand other factors such as the quest for workspace efficiency and the advent of flexible office space may push back overall absorption volumes. Flexible office space is likely to flourish further, given its convenience and cost-effectiveness. In last two years (2016 & 2017) the flexible office operators leased more than 4 million sq ft (0.37 million sq m). Our recent report "Coworking space - The New Kid on the Block" (20 March 2017) forecasts coworking operators to lease 8 to 9 million sq ft (0.7-0.8 million sq m) by 2020.

We observe that technology and e-commerce companies are exploring expansion in Tier II and III Indian cities. Given the government's push for smart cities development, we believe that firms should consider expanding in the cities where the state governments intend to spur growth by offering more fiscal and non-fiscal incentives and building crucial infrastructure projects such as airports and railways. However, we advise occupiers to consider the talent pool in each city before making such decisions since due to increased urbanisation young talent is migrating towards Tier I cities, and talent acquisition and retention can be a challenge in these cities.

Industrial space demand set to grow, driven by GST reform

With a vision to lift India amongst the top five manufacturing destinations in the world by 2020, various government initiatives are dedicating greater focus to setting up superior manufacturing infrastructure in the country. National Manufacturing Policy (NMP) has been framed with an aim of increasing the share of manufacturing in the country's GDP from 16% to 25% by 2022. The setting up of clustered developments like the National Investment and Manufacturing Zone (NIMZ) by aggregating production units, logistics, public utilities, residential areas and administrative services within the zones at strategic industrial locations, is intended to promote the emergence of promising warehousing corridors around respective industrial regions. Moreover, rapid growth in e-commerce (currently growing at an annual rate of 51[2]%) should drive demand further and hence push up warehousing volume growth.

India's ranking in the International Logistics Performance Index (LPI) (Global Ranking by The World Bank), has jumped from 54 in 2014 to 35 in 2016 with an overall LPI score of about 3.42. Colliers Research believes that one of the major factors behind this leap is GST implementation and growth in retail sector. While the fast-growing e-commerce market and implementation of GST are already acting as key catalysts for the rise of the logistics industry in India, the recent announcement on infrastructure status to logistics sector is likely to provide a further boost to momentum. The government's focus on road, rail and port development projects, coupled with initiatives like Bharatmala[3] and Sagarmala[4] Paroyojna to improve road network and seaways, should reduce the total costs of the logistics industry which is currently higher than global averages.

As per Colliers Research, e-commerce logistics businesses are highly optimistic about the rising demand for supply chain services in India. Many international companies are more hopeful about the Indian logistics market now that various global players have made announcements about increasing the capacity of transport routes between Indian cities. Companies such as FedEx, Kintetsu World Express, DHL and TNT have already entered India, through mergers, acquisitions and joint ventures with Indian logistics companies. In H1 2017, the Canada Pension Plan Investment Board's (CPPIB) acquisition of a majority stake in IndoSpace, for around SD500 million, marked one of the largest industrial and logistics deal in India. Private equity players like Standard Chartered Private Equity and Home-grown Milestone Capital have also announced plans to invest in the industrial and warehousing facilities in the country. Meanwhile, domestic developers such as Embassy are already in advanced stages of developing industrial parks in India.

In our opinion, the organised warehousing sector is poised for interesting times, since a spurt in demand for top-quality warehousing should exceed available quality supply in major cities across India.

At present, most companies have set up multiple small warehouses of 4,000-10,000 sq ft (371-930 sq m) across the country to save taxes on inter-state movement. However, the implementation of the GST has reduced the need to have several small warehouses and should drive demand for large facilities at strategic locations.

Colliers Research believes that growth in the manufacturing sector, rising interest among foreign investors, the expansion of 3PL/4PL service landscapes

[2] ASSOCHAM (The Associated Chambers of Commerce and Industry of India) -Forrester Study Paper 2016

[3] Bharatmala is the highways sector development plan focused on optimising efficiency of road traffic movement.

4 Sagarmala is aimed towards transforming the existing Ports into modern world class Ports.

and similar factors should drive the demand for large contiguous organised industrial space at strategic locations in coming years. For a developer, finding affordable land at the right locations, providing adequate infrastructure support, integration of various modes of logistics, skilled resources, standardisation of warehouse specifications, and technology will be the key factors to successfully serve the increasing demand.

Affordable housing to remain in vogue amid government policy push

The 12th five-year plan estimated that India has housing shortage of about 18.78 million houses. To achieve this mammoth task the government of India has started its mission 'Housing for All by 2022'. The key initiatives taken by the central government for affordable housing include:

i. the granting of infrastructure status to affordable housing

ii. the Pradhan Mantri Awas Yojna (PMAY) - Housing for All (Urban)

Infrastructure status should give a supply-side push to the affordable housing sector. There are two primary reasons why we expect that private developer participation will increase in affordable housing. Firstly, the cost of finance is likely to come down for affordable housing projects. Secondly, income-tax exemptions for the developers (under Section 80 IBA of the Income Tax Act, whereby profits arising from affordable housing projects are fully deductible from total taxable income) are creating optimism among developers that they should experiment with such projects. Moreover, in support of the central government's initiatives, a few state governments have announced incentives regarding an additional Floor Space Index (FSI) for affordable housing projects which should make these projects more viable financially.
So far, we have witnessed limited participation by private investors in this sector, but we have observed increased interest among developers in affordable housing. Several institutional investors like HDFC, Piramal, Kohlberg Kravis Roberts & Co Ltd (KKR) investments are also actively investing in affordable housing projects in various Indian cities. In addition, the companies like Xander Finance and Kotak Realty have been in action looking for opportunities in affordable projects.
Regarding the demand side push, the government has provided an interest subsidy of 3 to 4% under the PMAY for home loan customers under the Economically Weaker Section (EWS), Lower Income Group (LIG), Middle Income Group (MIG) I & II categories. After the recent bank rate cuts, home loan interest rates in India range between 8.3% and 8.45% depending on the borrower's gender and occupation profile. A subsidy of 3-4% pushes the effective home loan rates below 5%. The lower interest rate regime ought to boost buyers' confidence to invest in this sector. According to Colliers Research, considering both the demand and supply side factors, affordable housing should be the next major growth area in the residential sector in coming years.

According to the Ministry of Urban Development (MoUD), the urban population in India, which is nearly 377 million now, is poised to grow to up to 600 million by 2030. This rapid urbanisation will require huge-scale development in all real estate asset classes along with infrastructure support. However, we foresee that lack of adequate infrastructure will remain a concern. According to a Standard & Poor's report[5], while India's aggregate annual infrastructure investment amounts to 35% of GDP, the government estimates that it requires USD1.5 trillion in infrastructure investment over the next decade. Even this vast amount will probably only help bridge the infrastructure deficit rather than create room for future growth.

The above said, with India forecast to see a notable economic growth in coming years and Indian cities growing at a rate faster than most other cities in the world, we expect property development to continue witnessing robust growth rate in the medium to long term.

[5] The Missing Piece in India's Economic Growth Story: Robust Infrastructure" August 02, 2016

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