BUILDING, CONSTRUCTION & REAL ESTATE

Investment opportunities in India, Russia and CIS and Brazil

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In the wake of the credit crisis, investors are hopeful that emerging markets can help sustain the worldwide demand for real estate. China was very much in the spotlight as we approached the 2008 Olympic Games, but what of the other three markets that make up the 'BRICs' – Brazil, Russia and CIS and India? This article takes a look at the prospects.

Investors proceeding with caution in Russia and CIS

Having borrowed prudently on the world markets, Russian banks (and indeed the nation as a whole) appear to have been to a certain extent protected from the worst effects of tightening global credit. In spite of double-digit inflation, Russia has experienced strong growth in both GDP and real income in recent years and this healthy domestic market has attracted a surge of foreign investment into real estate, with the value of such capital trebling between 2005 and 2007 to US$9 billion.

The center of attention is of course Moscow, which is still seeing excessive demand for property leading to rises in office rent of as much as 40 percent a year. St Petersburg is also thriving, with yields approaching similar levels to Moscow and a major PPP development for the airport. On the back of the aggravated global economic situation and increased political risks due to the conflict with Georgia, the boom has slowed down; however GDP growth for 2008 is still expected at close to six percent.

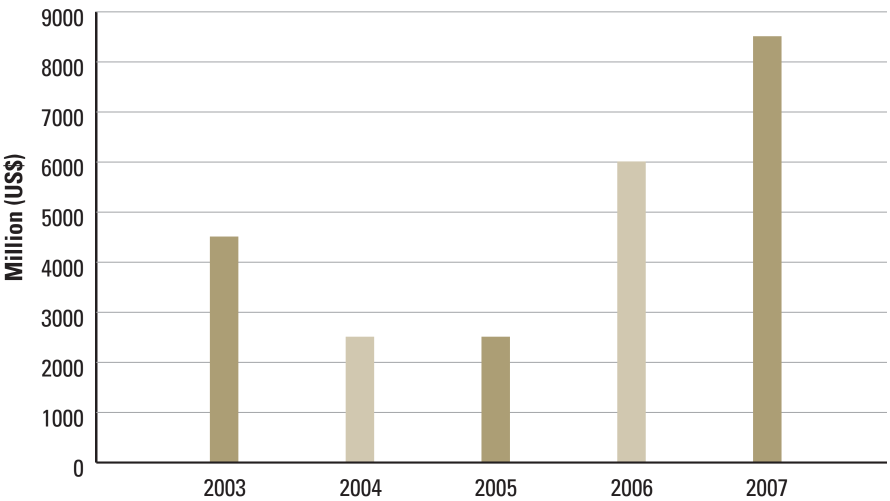
Those considering investing in Russian real estate should however be aware of the inherent political, legal and regulatory risks. The state authorities have a history of interfering in business, with the government keen to gain the authority to expropriate land at any time in specific areas. Much of the legislation is new and subsequently open to varying interpretations.

For example, in Moscow it's common to get only a 49-year lease for land, whilst in other regions such restrictions do not apply. A further challenge facing developers is the shortage of construction materials.

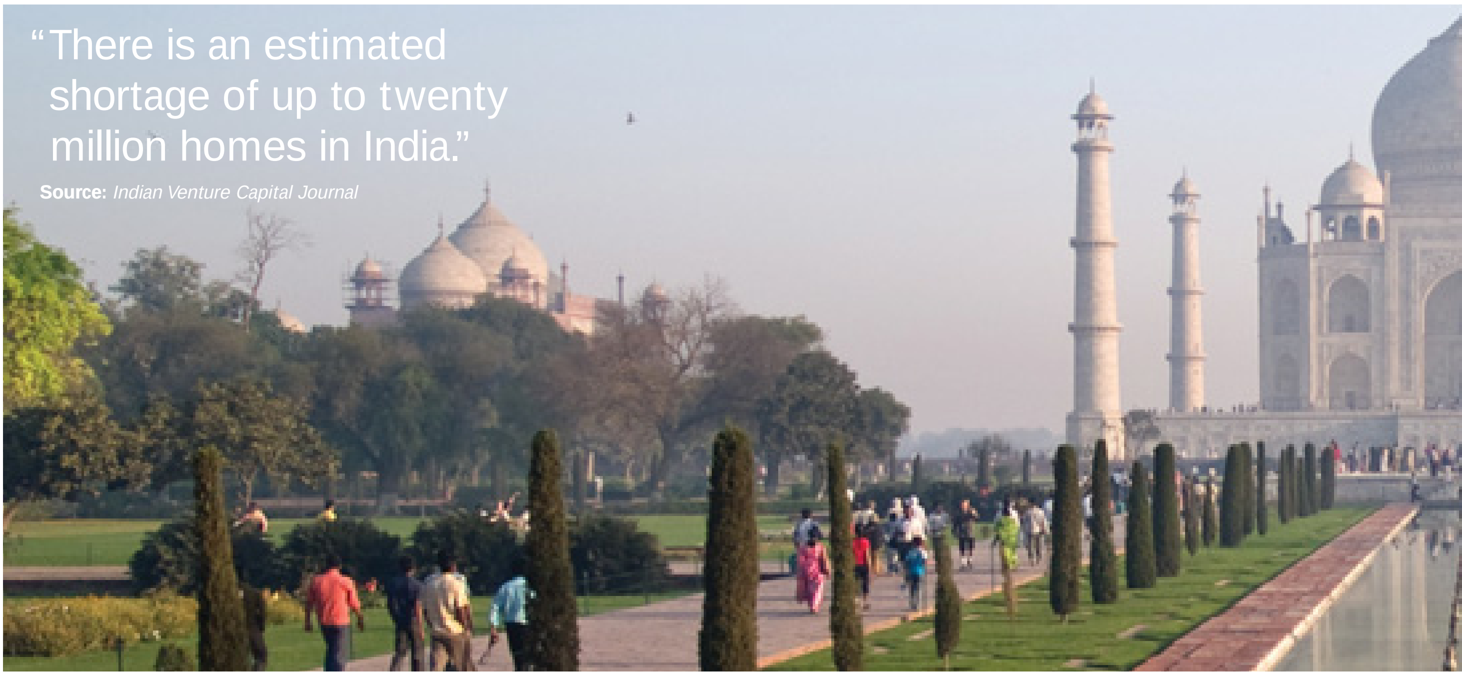
> "Foreign investment in Russian real estate has trebled between 2005 and 2007 to US$9 billion."

Source: KPMG International analysis, 2008.

Foreign investments in Russian real estate



Source: KPMG International analysis, 2008.



> ”India is likely to add 131 million people to its urban population between 2007 and 2020.”

Source: UN Population Division, HSBC estimates.

The other main real estate markets in the region are Ukraine and Kazakhstan. Following several years of political turmoil, stability is hopefully returning to Ukraine, creating a strong demand for office, logistics and retail space. Kazakhstan has opened its doors to global capital, but more than any other country in the region has been hit hard by the US sub prime collapse, as its banks were far more highly leveraged. Despite this, retail development is fairly strong although such growth also brings the danger of saturation.

Markets such as Azerbaijan, Armenia, Georgia, Kyrgyzstan, Turkmenistan and Uzbekistan are emerging more slowly.

Potential investors in Russia and CIS have been fairly cautious, due to concerns over the security of their money. However, with high returns, developments in residential, infrastructure and recreational facilities and favorable tax regimes the region should continue to draw interest from investors. Further, the difficulties developers are currently facing in financing their projects, opens more opportunities to potential investors.

India continues to enjoy a fast pace of change

With a young, aspiring population of over a billion, a proactive government and increasingly liberalized policies, India continues to be an attractive proposition for real estate investment. Strong growth is helping to trigger a rise in disposable income and the property market has enjoyed an annual growth rate of 20 percent, which should take its total value up to US$100 billion by 2010.[1] Millions are migrating to the cities, creating an estimated shortage of up to twenty million homes, and this urbanization is in turn driving developments in infrastructure such as transport, logistics, health and education.

Underpinning all this are the ambitions of a growing, educated middle class.

The real estate market is relatively immature in India and characterized by a few large national players, with much of the demand in the commercial sector serving the fast growth in IT and financial services.

Investors are witnessing healthy yields for commercial property that are considerably higher than the rest of Asia Pacific, thanks to low vacancy rates due to short supply of quality commercial space. At 10-11 percent, the asset yield trumps that of Hong Kong and Singapore.[2] Despite a recent slowdown in activity, there are still many local entrepreneurs setting up funds, with overseas investors putting up around US$10-12 billion in recent years.[3] Indeed, Indian developers are now gaining the confidence to expand overseas, which brings with it a need for greater governance and standardized operating procedures.

Foreign investors can expect to encounter a heavily restrictive regulatory environment where direct ownership of real estate is not permitted – only shares and convertible instruments are allowed. There are signs of liberalization in such policies and with draft guidelines for REITs in place, it will be hard to ignore the prospects of this vibrant economy.

[1, 3] KPMG International analysis, 2008.
[2] *JLLM Asia Pacific Property Digest*, India, Q3-2007.

Brazil: the next South American powerhouse?

Now that inflation is under control, Brazil's growing GDP, falling interest rates and rising consumer confidence make it ripe for real estate expansion. The recent upgrade of the Brazilian economy by ratings agencies should trigger an inflow of foreign capital eager to exploit what is an underdeveloped market. Indeed, with Latin America having been largely abandoned by the US in the 1990s, Brazil is in a prime position to fill the vacuum, building on its key industries of banking, agriculture and oil.

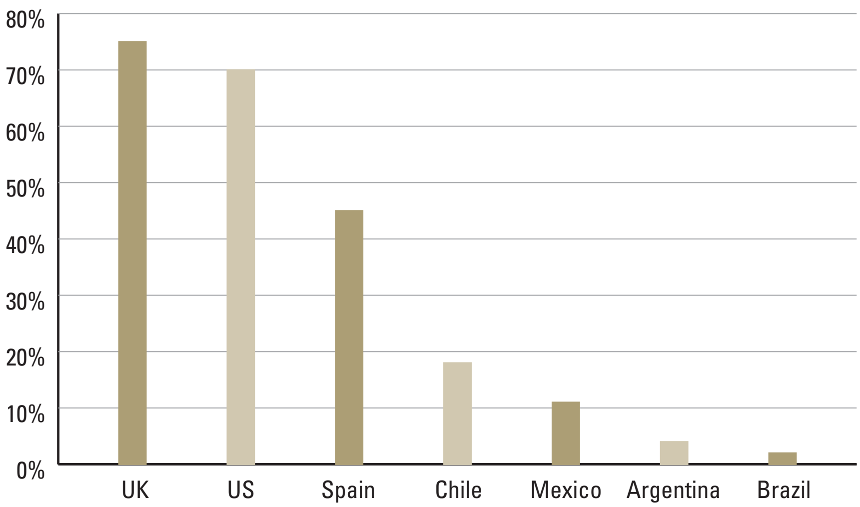
The Brazilian economy has been largely shielded from the worst of the sub-prime fall out. There has been no need for a secondary loan market as buyers are under leveraged, with typical down payments of around 30 percent of the property value.[4] Indeed, with credit hard to come by, there is relatively little debt overall, although there are opportunities for funding through equity and long-term debt.

Over the past three years, residential developers have managed to raise considerable funds, with much of this invested in land banks rather than construction projects.

A further challenge facing the Brazilian market is the sheer geographical size of the country, which is likely to lead to a period of consolidation in real estate, with smaller and mid sized players either getting swallowed up or squeezed out.

With the market clearly needing extra capital, there is a potential for high yields for either sovereign wealth or other real estate funds. Recent indicators of progress are however positive, with capital flowing in through equity, local banking and international real estate investment funds.

Mortgage lending as a percentage of GDP



Source: KPMG International analysis, 2008.

> "The Brazilian economy appears to have escaped the worst of the sub-prime fall out."

Source: KPMG International analysis, 2008.

[4] KPMG International analysis, 2008.

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