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Balancing ROIC and Growth to Build Value

Growth is the lifeblood of any business, as indeed, possibly its raison d'être, but a sole focus on growth isn't always the most sustainable way to create value for shareholders. Return on Invested capital (ROIC) is often just as important – and in times like now, perhaps even more so – as a measure of value creation. When ROIC is high, growth typically generates additional value. But if ROIC is low, the blind pursuit of growth can often be counterproductive. A balanced approach would ensure growth investments successfully translate to higher shareholder value. This month's lead story in *CFO Connect* shares two successful stories – of the CFOs of Majesco and Future Group – of balancing capital investments and growth to create sustainable value for shareholders. Farid Kazani, MD and CFO of Majesco, and winner of the 'Excellence in Mergers and Acquisitions' category in IMA's Tenth India CFO Awards, architected the most innovative M&A deal which led to four times increase in company' market cap. Sanjay Jain, Group CFO, Future Group, and winner of the Award for Capital Restructuring, is a wonderful example of a CFO who successfully balanced the short-term need to deleverage and the longer-term agenda of growth, both organic and inorganic. Through his initiatives, the company's market cap jumped more than three and a half fold in just two years.

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The Indian Real Estate Investment Landscape: In Transition

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The latest macroeconomic data reinforce India's position as not only the world's fastest-growing large economy, but also, a leading investment destination. GDP growth last fiscal was 7.6 per cent, and – with indications of a good monsoon, the likely passage of the GST Bill, and a pick-up in both consumption and infrastructure spending – it could touch 8 per cent this year. Meanwhile, buoyed by government efforts, including a clampdown on corruption, FDI inflows set a new record in 2015: USD 40 billion, a 29 per cent year-on-year increase. The real estate sector saw USD 2.8 billion in PE investment, a 32 per cent increase over 2014. Significantly, too, the structure of investments in the sector is undergoing a marked shift, with the focus shifting from debt to equity.

From structured debt...

Over the last few years, investments in the real estate sector have predominantly been in the form of structured debt. This is unsurprising, given that most developers were over-leveraged, that new bank funding was not forthcoming (owing to stricter RBI norms), and that, unlike with equity, a structured debt model allowed investors an exit route at a pre-determined return, with the investment itself backed by a minimum 2x asset cover from the developer. Although the returns are relatively lower than with a pure equity model – 16-18 per cent, compared to 25 per cent or more – on a risk-adjusted basis, they were good enough to make structured debt the 'flavour of the season' for the last 4-5 years.

In 2015, GIC (the Singapore government's investment arm) and PE giants Blackstone and Warburg Pincus were the biggest investors in the real estate PE segment, with an aggregate of approximately USD 750 million. Last year also saw a number of leading private equity funds and other institutional players scouting for operational assets, be it shopping malls, corporate parks, or even warehouses. Domestic funds and NBFCs also continued their funding spree but, expectedly, they mainly stuck to the structured debt model.

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...to equity

However, this investment tide now appears to be turning towards the equity model – mainly the result of a host of recent government measures to liberalise investment in the sector. To start with, the new Real Estate (Regulation and Development) Act will bring greater transparency, accountability and maturity to the sector, improving its attractiveness to both foreign investors and Indian consumers. Added to this, the government has relaxed certain FDI norms, including waving the existing minimum project-size requirements in terms of both area and capital. This will make the country's real estate stock more accessible to foreign investors.

Another important change is the recent notification of the Real Estate Investment Trust (REIT) Regulations, and the subsequent relief granted to REITs from a taxation perspective. Primarily, this includes the waiver of dividend distribution tax (DDT) on dividends paid by the investee company to a REIT, and the exemption given to developers from Long Term Capital Gains Tax on the sale of REIT units held for at least 36 months. Further, the RBI has notified its policy on FDI under the automatic route in Alternative Investment Funds (AIFs). One of the most noteworthy changes here is that downstream investments from an AIF that has foreign capital will be treated as domestic investment if the AIF is either sponsored or managed by an entity that is Indian-owned or controlled.

These measures, coupled with an upturn in consumer demand, bode well for equity investment in the real estate sector. Moreover, general investor sentiment is starting to improve, and a recent EY survey found that more than twice as many senior global executives would pick India over China as their top investment destination for the next three years.

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Towards recovery

The real estate sector went through a turbulent few years, but it is now moving into recovery mode. Developers, having learnt from their mistakes, are focusing more on project execution and delivery. Meanwhile, with the government easing FDI norms in the construction sector and relaxing the REIT regulations, more offshore investors, including ones with smaller ticket sizes, are likely to buy into Indian real estate. A number of exclusive partnership platform transactions between Indian developers and investors are also expected to take place, giving fund managers greater control over investments and decision-making. Several institutional investors are also willing to partner with developers at a land stage, and unlike in the past, such investments are being executed at par. From an overall project-viability perspective, this ensures financial closure, avoids the need to carry expensive debt, and enables better alignment amongst shareholders.

The upshot is that quite a few PE funds – seeking better returns through long-term commitments, as well as a say in the developer's business plan – are either already investing in or ready to infuse equity capital into projects. Tellingly, including what is already committed, PE funds are expected to garner approximately USD 4 billion from abroad for real estate investments in 2016. On the whole, then, the recent slowdown is ending, and green shoots are becoming evident. Equity investments, which had dropped to a lull in the past few years, is finally set for an uptick this fiscal, riding on the back of regulatory reforms and the sector's improving credibility. ■

(The views expressed are personal)