As Real Estate Regulatory Authority bites, PE investment returns to fall: The Financial Express

Return on private equity (PE) investments is set to decline as the Real Estate Regulatory Authority (RERA) takes effect, according to industry experts. Making projects RERA compliant will erode profit projections, forcing PE fund managers to re-calibrate potential income from their investments. “RERA will put a stop to diversion of funds, expenditures that are often passed on to end users under covert heads will stop so IRRs will temper down along with profitability,” said Sunil Rohokale, CEO and managing director at ASK investment managers. Current estimates suggest structured debt investments now command approximately 18%-25% interest cost on residential projects.

Equity investments, which are more rare at the moment can give 15%-18% return on investments. Of course, the upside of having taken an equity position can also fetch around 30%, depending on market conditions, sector experts said. Rohokale said while lower profits will mean lower returns for fund managers, there will be more predictable returns so over a period of time, the industry will adjust. “I would prefer the lack of ambiguity and resultant lower risk compared to higher returns.” Rohokale added. Although ASK has stuck to its core strategy of investing in projects through equity investments of smaller ticket sizes, almost 80% of PE investments made last year was in the form of structured debt or mezzanine financing. This is especially rampant in the residential piece. Back in 2005-2008 when opportunities were being discovered by PE funds in the first phase, after FDI norms were relaxed, majority of investments made were pure equity transactions.

This trend overturned after 2009, when in order to protect their exposure, leading funds started lending through structured debt, which means companies need to repay in regular intervals and exit routes, collateral obligations etc are clearly defined and in favor of funds. But now, the RERA legislation is expected to once again shift the focus towards equity transactions. “The main reason why PE funds who had made equity investments back in 2005-2006 period burnt their fingers is because projects were either not completed on time or permissions were inadvertently delayed; both these conditions get taken care of by RERA so the perceived risk has to be reassessed,” said Neeraj Bansal, head of real estate at KPMG. So PE funds will once again be more keen to pump in equity, which is the need of the hour for the debt-heavy sector. In the absence of demand, companies are saddled by high cost of debt.