MONITOR **INCLUSIVE MARKETS**

The Recession Proof Business Opportunity in Low Income Housing

November 18, 2009

The housing market in urban India has traditionally focused on the top end of the market with the lower income segments virtually un-served. In the wake of the economic downturn however, the demand for premium homes is languishing and developers are now focusing on middle income segments – but the real area of opportunity is lower income segments.

Households earning between Rs. 7,000 – 25,000 aspire to live in and can afford to buy houses between 250-600 square feet in the suburbs at current market prices. Recognizing the viable business opportunity that this segment represents, forward thinking developers like Matheran Realty, Tata Housing, and Jerry Rao, among others, are leading the development of the low income housing sector. The economic returns on affordable housing are very attractive, with project IRRs between 30-40%.

Most importantly though, low income housing has the potential to create a new breed of home owners, and permanently improve their lives, as well as help in slum rehabilitation and urban renewal.

Monitor Inclusive Markets: An Introduction

Monitor Group is a management consulting and merchant banking group started by Michael Porter and a group of his colleagues at Harvard Business School. We have over 1,000 professionals in 25 offices across the globe and have been in India since 1996.

Recognizing that India's biggest challenges are in the area of social inequity (a large group of low income people are not benefiting proportionately from the overall economic growth in the country) and given our commitment to India and our global experience in social change, we have made this a strategic focus area.

We have identified market based solutions as a powerful route to social progress in India and have set up Monitor Inclusive Markets (MIM) to work in this area. Based on our work for numerous clients in the housing space, we felt that there was strong potential to develop a "market based solution" for lower income housing in urban India. All our findings through MIM are non-proprietary and will be actively disseminated. For more information, visit www.mim.monitor.com.

Context

Given the current economic downturn which has affected the construction industry severely, developers who capitalized on India's real estate boom by catering primarily to high income buyers are now re-evaluating their strategic focus and looking at lower income segments. The surge in global liquidity and sharp economic growth led to a doubling of real estate prices in the first five years of the decade, which in turn fuelled further investments in real estate.[1] Given the global credit crunch, developers are now finding that sales of premium apartments in large cities are negligible, but targeting middle income customers who are eager to purchase smaller houses outside city limits is proving to be more successful.

A typical example is Bangalore based Purvankara Projects, known for its luxury housing, which has set up a subsidiary, Provident Housing and Infrastructure, for its foray into 'affordable housing'. According to Ashish Purvankara, the company will 'come up with projects in Bangalore, Chennai, Hyderabad, Coimbatore and Mysore where apartments are priced at Rs. 10 lakh, R. 15 lakh, and Rs. 20 lakh, , for one, two and three bedroom houses.[2] Real estate company Keystone, which is headquartered in Mumbai, was selling one-bedroom-kitchen flats, measuring 361 square feet, for just above Rs. 13 lakh in Virar last month. 'We clocked sales of 200 apartments in just two weeks. It is mainly the salaried class from the service industry, hospitals, and back offices with an ability to pay a monthly instalment of between Rs. 7,000 and Rs. 10,000 (...that are buying these units)'' claims Boman Irani of Keystone. However, even these 'affordable' homes are beyond the reach of a majority of city dwellers. As Irani himself states, 'About 60% of the city's population earns less than Rs. 2-3 lakh a year. There are no housing projects for them.' [3]

The Business Opportunity in Low Income Housing

The commonly used definition of an 'affordable' home in the real estate sector is a home costing less than Rs. 20 lakh. According to many developers this is reinforced by the fact that housing loans below Rs. 20 lakh are in the priority sector, thereby enabling consumers to avail of a reduced interest rate. While homes in this price range are affordable to middle class salaried customers, who found themselves being priced out of the home market during the property boom, they are still unaffordable for the majority of urban Indians. Using the accepted rule that a person can afford a home that costs up to forty times his monthly income, a house costing Rs. 10 lakh is affordable to families earning at least Rs. 25,000 per month. As the urban income pyramid graph below indicates, this restricts home ownership to only 13% of India's urban population.

---

[1] 'House that for Mass Housing' – Economic Times, November 12, 2008
[2] 'No Frills, All Thrills' – Business Today, September 21, 2008
[3] 'In Realty, Smaller is Better' – The Times of India, December 10, 2008

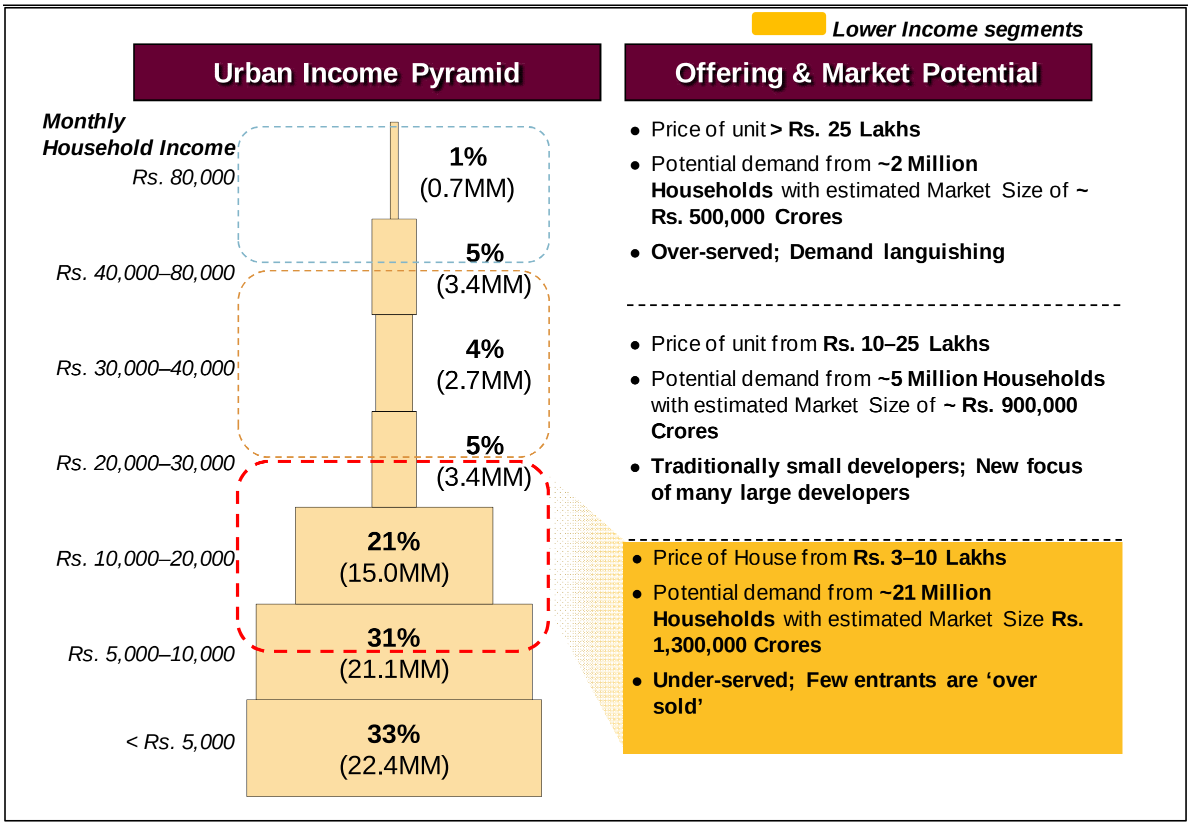

Figure 1: Low Income Housing in India is a Rs. 1,300,000 Crores Opportunity[4]

Monitor's study of the affordable housing market in India has identified a target segment of over 21 million households[5] who earn between Rs. 7,000 - 25,000 per month and currently rent rooms in slums and low income neighbourhoods. These people live in poorly constructed, small cramped houses with deplorable sanitary conditions and lacking basic neighbourhood amenities. This segment of low income individuals aspires to live in and can afford to buy houses between 250 - 600 square feet in the suburbs at current market prices. However such houses, especially at the sub-Rs. 7 lakh range, are not being built. Our research indicates that it is possible to build for lower-middle class urban customers given prevailing land prices and construction rates. A few private sector developers are currently building housing at Rs. 800 to Rs. 1,200 a square foot in vibrant neighbourhoods within an hour of the city centre in many cities and towns. However, with a few exceptions, the smallest units are too large to be affordable for the majority of the low income segment. By using the same elements of design and merely making flat sizes smaller, it is possible to sell apartments in the Rs. 3 – 10 lakh range in cities across India like Ahmedabad, Mumbai, Hyderabad, Kolkata, Kolhapur etc. Not only does catering to this low income housing segment serve a huge social need, it also presents a lucrative commercial opportunity worth Rs. 1,300,000 Crores, which is almost as big as the potential opportunity in middle and high income housing combined.

---

[4] Affordability is defined as households which have EMI / MHI Ratio of 40% of a Home loan which has a 20% down payment on Home value. EMI level of Rs. 1,200 per Lakh (at 12% interest for a 15 year loan). Of the approximately 34 Million addressable households in the target segment, it is assumed that 60% live in rented housing or in multi-family units and would be interested in buying their own homes.
Source: NHB Trends in Housing; CRIS Infac Report; Monitor Research

[5] Please refer to Figure 1

The economic potential that this segment represents is now being validated through the entry and success of developers and entrepreneurs in the low income housing market. At a time when the real estate sector is experiencing a slowdown, the low income housing projects being constructed are massively over-subscribed.

- Tanaji Malusare City, a Matheran Realty project, received 66,000 applications for its phase 1 sale of 3,000 units in Karjat, a suburb about 100kms from Mumbai. The project when completed will be one of the country's largest affordable housing developments and will consist of one room-kitchen (200 sqft and 300 sqft), one bedroom-kitchen (400 sqft) and two bedroom-kitchen (500 sqft) flats in the Rs. 2-7 lakh price range.
- Jerry Rao, one of India's most successful entrepreneurs has set up a housing company, Value Budget Housing Development Corporation (VBHDC), to build homes in the Rs. 3–9 lakh range across India.
- Large corporates like the Tatas have also entered this space through an offering of a block of 1,300 flats (in phase 1) as part of their 67 acre development in Boisar, a town 98kms from Mumbai. The smallest flats in the complex include 283 sqft one-room-kitchen flats for Rs. 3.9 lakh.

The entry of scale players is providing legitimacy to this market, and also encouraging the entry of smaller players.

- For instance, Taral Bakeri, a developer in Ahmedabad is coming up with 850 low income apartments in the Vatva neighbourhood of Ahmedabad. These homes cost between Rs. 3 – 5.5 lakh and target primarily blue-collar workers and self-employed entrepreneurs who earn between Rs. 8,000 – 15,000 per month. Bakeri saw a phenomenal response to his phase 1 offering, with 400 flats being sold in the first two days.

This surge in demand for homes unequivocally validates the robustness and recession proof nature of the low income housing market. Even large international players are now recognizing the shortage of affordable housing in India and are entering this market.

- Homex, the largest home builder in Mexico with a market capitalization of Rs. 14,000 Crores, is combining its expertise in rapidly churning out affordable, low income housing, with partnerships with local developers to replicate its Mexican high growth model in India.

One of the other critical factors that is enabling the success of this market is the increased access to finance for customers. This is being done by some of the larger public sector banks and also by targeted players such as GRUH, Dewan Housing, Repco etc. There are also several new players entering the home financing space with a focus on serving informal sector customers, such as MAS Financial Services and Micro Housing Finance Corporation. The Monitor Group is actively encouraging the incubation of additional similar entities that will focus on providing home financing to low income segments.

Low Income Housing: A Distinct Business Model

They key to being successful in low income housing lies in recognizing that this is a fundamentally different business model than luxury housing. Typically, builders acquire land and treat it as a capital asset. They construct a project over several years and value to the developer accrues not only from the value of the home but also from the appreciation of land, which is tagged to the final price charged by the developer. In the low income housing model, land must be treated as working capital or inventory. [6]Down payments from customers cover land acquisition costs, and construction financing is supplied through banks and housing finance companies that have tied up with the developer to provide customers with home loan financing. While traditional housing projects typically take upwards of 3-4 years, it is in the interest of the developer to finish low income projects rapidly – typically between eighteen months to two years, and move onto subsequent projects. While this means that profit margins are lower at 25-30% as compared to high income projects, internal rates of return (or IRRs) are attractive. Also as the projects tend to be smaller and with lower selling prices, the magnitude of return is smaller than in high-end projects; the key therefore is volume - executing more projects in a fixed timeframe. Developers can expect to receive IRRs of between 30-40% in the low income housing market assuming that construction costs and project timelines are tightly managed.

Monitor modelled the economics of a representative low income housing project, which anticipated that for a 10 acre project with 1,800 flats being constructed over 24 months, the overall revenue potential is Rs. 99 crore at a gross margin of 22% and project IRR of 40%. The following assumptions were used to derive the economic potential of the project:

- The project is constructed over 3 phases - each phase consists of approximately 600 flats
- Price is constant over the duration of the project
- The value of area per square feet is enhanced using two methods:
    - Commercial space is valued more than residential space with an Average Yield Factor of 2
    - The mix of flats is such as to allow some area to be sold at a higher price point
- Cost of construction is Rs. 800 per square foot (comparable to other estimates for such projects based on our experience)
- Land is owned by the developer

Figure 2 below highlights that even with a selling price of Rs. 1,100 per sqft (for around 30% of the flats), the returns for a low income housing project are very attractive. It is further possible to enhance returns by increasing the share of commercial space on the project.

[6] 'Jerry Rao's Fourth Act' – Forbes India, June 5, 2009

Project details		UOM	Key Nos
Option		With Land Cost / No Revenue Share	
Total Land size	10	sq. ft.	435,600
FSI allowed			1.80
Total area available for construction		sq. ft.	784,080
Area for Commercial	5%	sq. ft.	39,204
Area for Residential	95%	sq. ft.	744,876
Land Cost FSI		INR/sq. ft.	200
Construction Cost		INR/sq. ft.	800
Average size of flat (sq.ft.)		sq. ft.	396
Number of flats		nos	1,883
Average realisation per flat (Rs)		INR	476,799
Mix of Houses - Area	% of number		
1 RMK	29%	sq. ft.	220
1 BHK – Type 1	32%	sq. ft.	300
1 BHK – Type 2	40%	sq. ft.	400
Loading Factor for Saleable Value			25%
Mix of Houses - Base Price in Phase 1			
1 RMK		INR/sq. ft.	1100
1 BHK – Type 1		INR/sq. ft.	1200
1 BHK – Type 2		INR/sq. ft.	1250
Price Rise between Phases			0%
Average Residential (Rs)		INR/sq. ft.	1,205
Average Commercial Yield Factor			2
Commercial (Rs)		INR/sq. ft.	2,410

Overall realization from project		
Revenue from different Sources		
Commercial (Rs)	INR	9.45
Residential (Rs)	INR	89.76
Overall Realization of the Project (Rs. Crores)		99.21
Costs from different Sources		
Cost of land	INR cr.	15.7
Construction Cost	INR cr.	62.7
Sales and Marketing	INR cr.	3.0
Overall cost of project (Rs. Crores)	INR cr.	81.38
Net realization (Rs)	INR cr.	17.82
Margin		21.9%
Return on Investment (IRR)		40%

Expected Return	30%
NPV at Expected Return	3.14
Calculated IRR	40%
Peak Cash without Land (Rs. Cr.)	(4.16)
Peak Cash with Land (Rs. Cr.)	(19.84)

Figure 2: Project Assumptions and Returns for a representative low income project

Customer Profile

To determine the social implications of low income housing, it is useful to look at the buyers of homes at Tanaji Malusare City.

- Almost 50,000 applicants (76% of all applicants in Phase 1) are first time home buyers
- Of the applicants that supplied their demographic information; 46.9% of households earned less than Rs. 15,000 per month, while another 20.3% earned between Rs. 15,000-20,000 per month. Only 32.8% of households had a monthly income of over Rs. 20,000 (Figure 3)

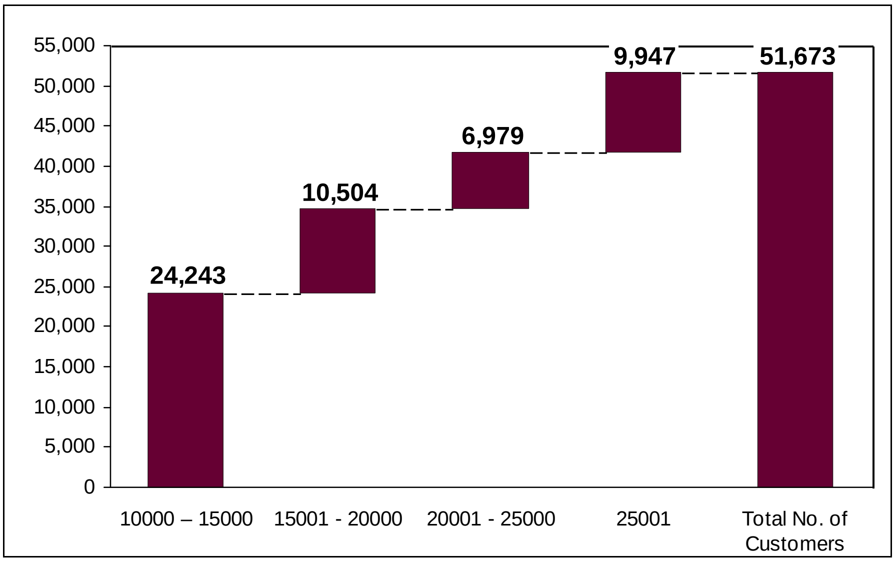

Figure 3: Net Monthly Family Income Profile for applicants at Tanaji Malusare City

It is evident that low income housing projects such TMC are creating an entirely new class of low income home owners. As Sharad Gaikwad, a TMC customer states, ‘After all – a slum is a slum and a chawl is a chawl, while a home is a home. When I went to TMC and saw the flats, I felt that my life-long dream of having my own home will be fulfilled.’ Sharad currently lives in a 90 sqft room in a Dharavi slum which he shares with his wife. As a security supervisor in an office building earning Rs. 7,000 per month, Dharavi was his only option for housing, until he learnt of the TMC project.

The successful development of this market has the potential to transform the lives of millions of individuals – not only financially, but also to enhance the quality of their lives and provide the emotional security of a home. It could also have a systemic impact on urban development by providing a potential benchmark for slum rehabilitation and options for housing that in the long term may help in slum prevention.

Nabomita Dutta, Smarinita Shetty, Bala Venkatachalam and Ashish Karamchandani wrote this paper in the course of their research for the Monitor Group.