

# Developer Due Diligence - a key part of real estate investment process

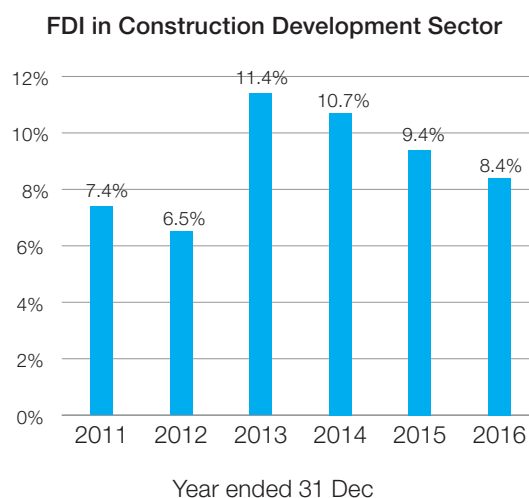
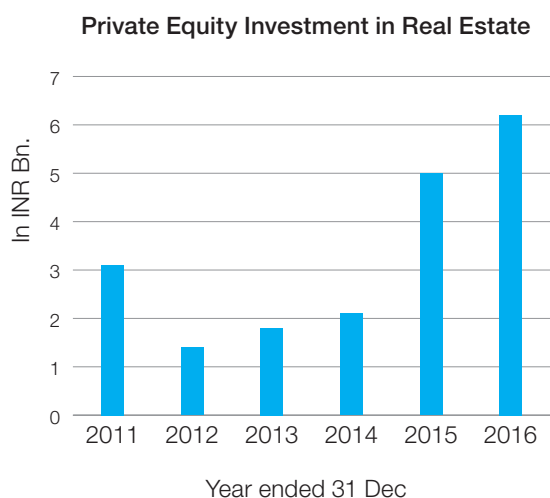
RERA already influencing investor decision making

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**THE INDIAN REAL ESTATE SECTOR IS ESTIMATED TO APPROACH A MARKET SIZE OF**

USD 200 billion by 2021. This sector has been witnessing continuous investments, especially from global investors. According to recent data released by the Department of Industrial Policy and Promotion (DIPP), during the period from April 2000-December 2016, the construction development sector in India received equity inflows of USD 24.28 billion through the Foreign Direct Investment (FDI) route. From April 2000-March 2016<sup>1</sup>, the total FDI in the construction sector, stood at USD 24 billion. For the same period, the total cumulative inflows in the sector accounted for 8.4 per cent of total inflows into the country<sup>2</sup>. In 2016, the real estate sector in India also witnessed private equity investments to the tune of INR 400 billion<sup>3</sup> (USD 6.1 billion). While banks have shied away from this sector over the last 2-3 years, NBFCs (Non-Bank Finance Companies) have been aggressively lending to the developers and have built a sizable book.



While the pace and quantum of investment in this sector has been consistently rising, investors remain wary of the risks. Real estate, even today, remains one of the least transparent sectors in India. While, RERA (Real Estate Regulation Act) is expected to change the landscape, it is still early days and we are yet to see how this Act will influence the operating style of the developers. Further, there continues to be muted demand. Demand for housing, the largest component of the real estate sector, remains poor despite interest rates remaining low. However, despite weakened demand and a wide expectation that home prices will fall, they have largely held up (with some exceptions such as Gurgaon where prices have fallen). Other than some of the large and reputed names, most real estate developers continue to struggle and have witnessed limited sales. Given the high leverage in the sector, developers that were facing risk of default have been saved by the influx of funds. A recent report<sup>4</sup> by CRISIL (India's leading rating agency) indicates that over the past few years, the residential real estate sector in India has been facing headwinds due to weak demand. For four years in a row, the downgrades have outnumbered the upgrades in the real estate sector.

High liquidity has resulted in refinancing opportunities for developers who have been shifting from one lender to the other. Also, with increased supply of funds, the yields available for the investors is constantly under pressure. In this backdrop, institutional investors have become extremely careful and are extending funds only where they feel comfortable with the developer

and not just the project. Over the last 18-24 months, a large number of private equity firms and NBFCs have introduced reputation and integrity due diligence on the developer as an integral part of their assessment process. In Kroll's experience, investors are keen to gain credible insights about the developers and their governance, operations, quality and compliance.

## UNIQUE CHALLENGES IN INDIA'S BUSINESS ENVIRONMENT

### Corporate governance standards are still evolving

- Lack of segregation of duties, absence of code of conduct, limited whistle blowing mechanism, and weak internal audit functions
- Close nexus between politicians, bureaucracy and business compromises ethical operating standards
- Several cases of investors facing 'bad faith' practices from local partners, subsidiaries and competitors

### Local accounting and auditing practices have not fully matured

- Over-reliance of internal and external auditors on management representations
- Auditing tools are not customized to the Indian operating environment (e.g., family owned businesses)
- ERP systems are often ineffective in driving transparency

### Poor regulatory oversight

- India's regulatory systems are complex and ever-changing (tax, environmental, competition laws)
- The complex judicial system makes it difficult for investors to enforce agreements and punish non-compliance
- Cannot rely on courts or arbitration to resolve disputes in a timely manner

## THE RESULT

- Lack of good quality information on business practices
- Key accounting and performance related data can be manipulated relatively easily
- Investors may be exposed to reputation-related and regulatory risks
- Good investments may not be getting done due to insufficient or conflicting information



To realize value creation, investors need objective, credible information that can be used to support negotiation of financial terms, identify areas of performance improvement and sometimes, aid in developing a clear strategy for future exit. In the context of real estate, some of the critical aspects to look at are explained below.

## The background, track record and reputation of the promoter/developer – can they be trusted?

The basic principles of knowing your investee or borrower is extremely critical and unfortunately is not generally adequately reflected in the balance sheet of the company. Having a good understanding about the background of the promoter upfront is critical and in many situations, can be a key differentiator. Getting a deeper perspective about the intentions of the promoter and their operating style is also critical as it provides strong insights as to how a promoter may act during a difficult period or at the time of exit. The due diligence exercise will also help gain an understanding as to whether representations which may be made by the company are reliable and accurate.

Further, a thorough due diligence should also include inputs from multiple stakeholders. Investors like to understand what other investors, with current or past exposure to the developer, have to say about the operating style of the promoter. Similarly, it is important to get views of other stakeholders such as contractors and architects and their experience with the developer. A potential risk in the real estate sector is the proximity of the developer to its contractors. Validating key commercial relationships and uncovering potential conflicts of interest helps to gain greater confidence that the invested funds will be used for the intended purpose and there is no leakage. Promoters' conduct with other stakeholders is an important signal of how much importance they attach to a relationship and if they are likely to honour their commitments.

## Source of funds

One of the biggest fears an investor may have in making a real estate investment is not knowing who they are dealing with. Real estate transactions often tend to have complex ownership structures and involve multiple middlemen. At times, the person at the forefront of the negotiations may not be the true owner of the business and is just a representative used to hide the real beneficiaries. Politicians, who don't like to be seen as people with significant business interests or wealth, have used this approach to hide their identity. Further, the real estate sector is well known to have a complex web of ownership weaved through multiple corporate

entities, many of which are Special Purpose Vehicles (SPVs) with no real business intent. Such structures also potentially enable the laundering of money, as it can be difficult to trace both the origin and destination of funds.

A good quality due diligence enables the investors to decipher the ownership structure and gain further clarity on the counter party. Knowing the ultimate owner also allows the investor to examine the source of funds and verify its legitimacy. Understanding the origin and source of wealth enables an investor to take a more informed decision and also potentially provides leverage during difficult times.

## Assessing developers true credit worthiness; access to unorganized financial market

As mentioned earlier, the credit quality in the real estate sector has traditionally been quite weak. However, the heavy flow of funds into the sector has enabled developers to refinance their debt. In such an environment, it becomes even more important to understand the credit worthiness of the borrower. Apart from looking at the financials and project cash flows, it is important for an investor to also gain a better understanding of the standing of the developer in the credit market, both organized and unorganized. When it comes to real estate, Indian promoters are known to borrow actively from the unorganized market – money lenders (Hundis), High Net worth Individuals (HNIs), etc. In addition, quite often borrowing is in a personal name of the developer and is unlikely to be reflected in the balance sheet of [developer or the operating company. This mode of finance is largely driven by relationships (and high interest rates) and provides relief to the developer in times of emergency or distress. However, given the nature of such borrowing, the developer would always give it the highest priority and service such debt ahead of institutional investors. In this backdrop, it becomes extremely critical for an institutional investor to understand the extent of borrowing and the developer's reliance, or potential for such reliance, on this mode of finance.

Similarly, investors can also be exposed to hidden liabilities in connection with unresolved litigation and disputes. It is important that potential investors understand how litigious the developer is and the potential liability in connection with unresolved and ongoing disputes. This will ensure there are no unpleasant surprises post investment.

## Quality of delivery

For a long time, investors and lenders were only focused on sale of the project. For a majority of real estate developers it was always about finding a buyer who is willing to pay upfront. Baring a few, there was little thought put into the timeliness of delivery and providing the quality promised at the time of sale. This has been witnessed more so in the Northern India, especially in NCR (National Capital Region). However, even before RERA came into force, buyer/consumer forums (groups of aggrieved customers) had become very active in voicing their concerns with the relevant authorities. Kroll is able to identify if a particular developer and their past or current projects have been subject to such claims and the reasons behind the same. With the use of social media analytics, we can also identify the extent of consumer activism as such groups often take to social media to voice their concerns. The quantum and longevity of such complaints can be a good indicator of the real intent of a developer.

### RERA

After years of prodding and pushing, India finally had regulations and regulator for its rapidly growing real estate sector. The Real Estate Regulation Act, or RERA as it is commonly referred, came into force on 1st May 2017. While initially only a handful states were ready for its implementation, one-by-one other states are also implementing RERA. The regulation, which has been long time coming, is expected to bring transparency to the real estate sector and is expected to boost the demand for home ownership.

The biggest impact of RERA is that it allows consumers to have more information about the developer and the projects thereby helping them in the decision making process in one of the most important decisions of their life. The act requires the developer to give information about themselves, their projects, agents, architect, contractors and other stakeholders. Previously, in most projects, the buyers have limited or absolutely no information or no way to verify that the information provided is accurate. Every project, whether new or ongoing, is required to be registered with the Authorities with very little exceptions. If the project is not registered, the developer cannot advertise, market, book or sell any plot, apartment or building under the project.

With introduction of RERA, consumers have become even more aware and the extent of activism has significantly increased. In Kroll's experience, PEs and NBFCs are today very keen to know the level of compliance at the developers end, steps being taken and the potential risks that they can face due to breach in RERA norms and dissatisfied customers. Few investment opportunities which were looking very strong on paper have either been held up or let go due to developers lack of preparedness for RERA and the resultant perceived risk in project delays.

In addition to the above areas of focus in a due diligence exercise, some of the other factors which are equally relevant for the real estate sector include an understanding of the extent of political affiliations and the potential use of such relationship in connection with the project. Similarly it is good to understand the land acquisition process of the developer and if the same is at arm's length basis. Indian real estate players are known to be politically well connected and seek benefits while acquiring land parcels and subsequently at approval stage.

## Conclusion

Thorough due diligence on the reputation and integrity of the investee company and its promoters can help strengthen a deal and have a positive impact on its success through the early identification of potential problems that may be mitigated ahead of closing. The Indian real estate sector is witnessing significant investments and with the introduction of new products such as REITs, the industry is likely to see increased participation of global investors. In that context, local dynamics also should be factored into any due diligence. Segregated and regional markets, coupled with the existence of different political structures and opaque regulatory frameworks, often pose challenges to foreign investors. Similarly, local investors are also increasing their footprints from a few large cities to smaller cities (Tier I and Tier II cities) and need to equip themselves with a better understanding of the regional dynamics and the changing regulatory environment.

Kroll's pre-transaction due diligence helps provide clients with important information and intelligence to drive confident decision-making. When evaluating significant investments, acquisitions, transactions and IPOs, including multi-jurisdictional deals, where risk levels can be elevated, decision-makers can benefit from Kroll's investigative due diligence services, a consultative-based offering that can be tailored to the level of risk and regulatory scrutiny involved. Kroll delivers timely, critical intelligence regarding owners, board members, executive teams and their related entities, providing robust and thoroughly researched information to aid its clients in carefully evaluating business deals.

## KROLL CASE STUDY

### Indian NBFC

#### A NORTH INDIA BASED REAL ESTATE COMPANY AND ITS PROMOTER

##### Objective

- To understand the promoters reputation
- To understand customer reputation about the developer on quality and governance

##### Scope

- Reputation of promoters
- Credibility in the informal financing community
- Political linkages of the company and founder
- Dependence on cash transactions

##### Approach

- Indepth review of public records including corporate information, media profile, litigation records and social media
- Speak to multiple current and former employees, real estate brokers and customers
- Carry out site visits across projects in multiple cities

##### Findings

- Positive reputation of the promoters with no instances of past frauds
- Cash transactions at 10% of total sales, much below the average in North India
- Compromise on quality of material used. Discrepancy in sample flat v/s actual delivery
- Promoters have political network but does not influence the operations
- Two outstanding litigations - can have meaningful financial impact if goes against the company

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#### REFERENCES

- <sup>1</sup> Source: Department of Industrial Policy and Promotion
- <sup>2</sup> Source: Department of Industrial Policy and Promotion
- <sup>3</sup> Source: India Brand Equity foundation
- <sup>4</sup> <https://www.crisil.com/pdf/ratings/CRISIL-Ratings-Round-up-REPORT-FY17-3Apr2017.pdf>

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