The Case for Tier-II Real Estate

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Is real estate in India in a bubble? In parts of it, certainly. Some recent transactions in posh areas in Delhi have pegged the value of residential land at approximately Rs. 11 lacs per sq. yard. Even in not so posh areas, transactions have apparently gone through at valuations of Rs. 4 lacs per sq. yard. This is in Delhi. I have little anecdotal evidence from Bombay. In comparison, rates in several Tier-II cities in India sound distinctly subdued. However, it is my opinion that over a 10 year period, a significant shift in demand growth is bound to happen as demographic, social, technological and economic factors converge to make the Tier-II cities attractive locations to live.

The Social Imperative

India's fertility rate has been dropping consistently for the last 5 decades and has dropped from 5.7 in 1966 to 2.7 in 2009. What this means is that families are getting smaller and fewer children are available to support their parents in old age. At a time when it was common to have 3 or often even more children within a family, it was possible, even imperative, for some children to move to bigger commercial centers to make their living. On the other hand, India critically lacks infrastructure for supporting the elderly. With fewer children per family in a generation now beginning to retire, this means that children are under pressure to live close to their parents. While so far this has meant looking for job opportunities in the general region of parents' cities (residents of Agra or Jaipur look to work in Gurgaon or Noida), other forces will push it to the next step, viz. living in the cities of the parents.

Technology Makes It Possible

The way I look at it, a very significant part of the migrant high value-add workers in the large economic centers of India today are in the IT/ITeS sector. A fair bit of local spending is also driven by these workers. Nasscom expected India's outsourcing industry's exports for the year ending in March 2012 to be between \$68B and \$70B. That's a little under 30% of the 2010 estimates of about \$225.6B of total exports. Of the total exports, a large part of is petroleum products, which have low value-added relative to software exports. In sum, a large part of the retail spending the software cities is driven by workers in the IT/ITeS industry.

However, by its very nature, a lot of these jobs can easily be migrated to smaller cities provided there is supporting infrastructure in those cities. If one realises that the "chosen cities" (Hyderabad, Bangalore, Chennai, Pune, Gurgaon) were chosen at a time when IT infrastructure in India was much more flaky and almost non-existent in other cities, one realises that the barriers to setting up such businesses in Tier-II cities are now much lower than in the early 2000s. The infrastructure, therefore, now exists in smaller cities too. Indeed, the likes of Wipro, Infosys and TCS have already begun to set up shop in these smaller cities – such as Jaipur, Chandigarh, etc. The scarcity of engineering talent (Nasscom has famously declared that no more than 25% of India's IT graduates are readily employable) coupled with the social pressures mentioned above means that it makes sense for the IT majors to diversify their geographic presence.

The side-effect of such a diversification would be to jump start the local economies in these cities. As spending capacity within the Tier-II cities rises, other businesses will become viable – right from coffee shops and pizza joints to high-end clothing retail and fitness centers.

The Economics Make Sense

Tier-I cities and metros have seen a rapid rise in cost of living as retailers have caught on the fact that youngsters working in the IT/ITeS are less price sensitive than their parents. Anecdotal evidence suggests that goods and services that are particularly attractive to youngsters are priced significantly higher in there cities. For instance, movie tickets easily range between Rs. 150 and Rs. 250 in a city like Gurgaon, compared to Jaipur with ticket prices up to Rs. 200 for comparable class. In such a scenario, companies can easily get away with offering lower salaries in Tier-II cities while still keeping employees there above parity compared to their Tier-I peers. Cost of housing also would be mitigated as youngsters could live with their parents, in homes often owned by them.

What Could Go Wrong

The biggest risk, to my mind, is policy and infrastructure failure. State governments and city administrations need to pro-actively attract high-tech enterprises to their cities. Streamlining of processes for granting of relevant licenses and registrations, electricity connections, land and improvement of general governance would go a long way in making any given state an attractive destination. Gujarat has already demonstrated what better governance can do for industry and the local economy. However, narrow-mindedness amongst the political elite can hamper this process destroying the prospects of growth in these cities and states, and lead to an exodus of talented and productive workers.

The Investment Idea

In light of all the above, unbuilt land in Tier-II cities appears to be an attractive investment. These cities, of course, would have to be chosen carefully based on mindset of the political leadership, general education level, availability of basic infrastructure like medical facilities, schools, etc. The process outlined above, though, could take several years to unfold. Built properties, then, run the risk of losing value as newer construction comes up by the time the real demand kicks in. On the other hand, unbuilt land does not face this issue. Even amongst the unbuilt land, smaller pieces of up to 250 sq yards should afford greater liquidity as the core demand should come from the demographic that can afford only such sizes.