Understanding and Mitigating Direct Investment Risk in the Indian Real Estate Market

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Abstract

This paper seeks to extend the findings regarding factors that affect Canadian propensity to undertake direct investment abroad by examining the perception of risk factors that may hinder direct investment in the Indian real estate market. This study utilized survey research (a non-experimental field study design). 226 Canadian investors were surveyed and reported their perceptions of various risk factors regarding investing in the Indian real estate market. The findings suggest that perceptions of political and legal nature, corruption, confiscation, and economic risk can hinder investments and may lead to capital losses on investments in the Indian real estate market. We also found that investors' foreign direct investment behavior does not differ based on their age and the level of education. This paper discusses several techniques by which investors can mitigate foreign direct investment risk in India. It also points out how real estate investors can implement these techniques and the challenges that they might face through this implementation process. Finally, some suggestions to overcome these challenges are provided.

Keywords: Investors; foreign direct investment-risk; capital losses; real estate market.

Introduction

Foreign direct investment (FDI) in India has long been recognized to be instrumental in the economic development of the country. India's FDI has increased exponentially with gradual liberalization of the economy post-1991, culminating in a boom post-2000. With the paradigm shift in its foreign investment policy, India has become one of the most attractive FDI destinations in the world, drawing nearly $99 billion in investment from 1991 to 2008 [2].

India, the world's largest democracy, has a very diverse population and geography. India is the world's second most populous country [3], and the world's seventh largest country in area. This may be one of the reasons for an increase in FDI.

Although India is a big country and provides a lot of scope for FDI, foreign investors may have real or perceived concerns regarding the risk of undertaking such investments. Such concerns might hinder FDI in the Indian real estate market. Growing importance of FDI has generated interest and research of foreign investment decisions of multinational corporations [4]. Among the main impediments to such investments one cannot ignore country risk factors such as political, legal, economic, corruption, and confiscation. These sources of risk, real or perceptional, might lead to foreign aversion to undertake direct investments.

Indian real estate market is one of the fastest growing markets among many less developed countries [5]. The Indian economy has been growing very rapidly in recent years – at an average annual rate of over 6% and is likely to continue to grow at similar rates in the years to come [6]. The Indian minister of commerce has stated on several occasions that foreign direct investments in India are safe [7].

FDI, in the context of this study, is direct long-term investment by a foreign investor in the real estate market to build and rent houses and commercial buildings. In the late 1990s, the rate of return on FDI in India was among the highest in the world and much higher than in other Asian markets [7]. Several years later, the Chief Economist of Export Development Canada suggested that the exporters must consider investment in the Indian market [8].

Despite the statements of the Indian minister of commerce, most Canadian investors are reluctant to undertake investments in the Indian real estate market. They probably perceive potential capital losses. One of the reasons of low FDI inflow is the perceived risk of such investments. Investors might believe that such investments can yield high returns but it may also result in loss of capital.

Since the Indian real estate market is one of the emerging markets in the less developed economies and real estate investors play an important role in the development of the global economy, it is important to understand different types of risks before investing in capital property (land and building). Hence, the purpose of this paper is to investigate the perceived factors that cause potential foreign individual investors not to undertake investments in the real estate market in India, and some possible techniques to mitigate these factors.

Importance of Foreign Direct Investment-Risk

All business transactions involve some degree of risk. When business transactions across international borders take place, they carry additional risks not present in domestic transactions [9]. These additional risks are called country risk and include risks arising from differences in the foreign country economic structures, policies, political and legal system, unexpected changes in the exchange rate, changes in tax policies and codes, and other factors. Such risk factors have negative as well as positive impact on real estate business. It is important to understand and then take actions to mitigate the adverse risk factors. This paper, therefore, concentrates on the foreign direct investment-risk factors on possible techniques and methods to mitigate these factors. The results of this study can be generalized to the real estate industry.

Capital Losses

Capital loss is created when investors sell, or are considered to have sold, a capital property (e.g., land and building) for less than its adjusted cost base plus the outlays and expenses involved in selling the property. The business risk and economic uncertainty are actual sources of risk [10] that cause capital losses. Therefore, real estate investors must understand risk of capital losses.

Different factors such as political, economic, social, and legal may lead to capital losses in the global market. The largest risk for foreign investors in India is the complexity in dealing with bureaucracy, political interferences, high cost of capital, and a poor infrastructure [11]. Other problems are potential corruption and inadequate legal system related to protection of property rights [12]. Such systems might lead to threats of confiscation and may adversely affect upon liquidity of the business (the ability of an investor to sell property on short notice without appreciable loss) for real estate investors.

Bureaucratic risk comes in the form of red tape issues in India [13]. The neutrality of bureaucracy has been tampered rather heavily since the mid-1970s by the political masters [14]. Business owners often complain, and perhaps rightly so, that they are more the victims than the perpetrators of economic crimes in a regime of government controls and bureaucratic stickiness [14]. Therefore, it is important to consider bureaucratic issues before taking final decisions to invest in the Indian real estate market.

Political risk is defined as negative perceptions emanating from internal instability, intergovernmental relationships, anticipated or unanticipated government actions, or government discontinuities all brought about by social, economic, or political imperatives that exist in a country's internal or relevant external environment [4]. Political risk also refers to the risk of a change in political institutions in India stemming from a change in government control.

Investment observers have been worried about political developments that have been taking place just as the country is trying to shake off its history of tight government control on all aspects of the economy [15]. In addition, political events do not merely have a potential to cause losses, but actually do cause losses in Asia [16]. Property investors in Asia have to contend with high political risk factors in their search for returns [17]. Typical risks for foreign investors in Asian markets relate to business interruption following political actions [18]. Wirth [19] also indicates that the politics of India has been topsy-turvy because of cultural and religion diversity. Thus, Political risk covers the potential for internal and external conflicts and expropriation risk. Therefore, foreign investors should be concerned about political risk in India and conduct risk assessment analysis of many factors such as the relationships of various groups and decision-making process of the Indian government. In addition, it is important for real estate investors to understand foreign direct investment risk before making investment decision.

Corruption and poor legal system of India are other risk factors that foreign investors should consider before buying land and buildings. Since increasingly expensive elections are not state-financed, the stimulus to politics-business corruption remains strong in an otherwise remarkably resilient Indian democratic system [14], which in turn, leads to poor legal system. In addition, a number of laws and regulations, of which the most important are those concerning the retrenchment of employees, restrict the labor market. Companies employing more than 100 workers need government's permission to lay off workers, and the corrupt government officers often withhold this permission. Such restrictions have hindered foreign investment in India [20].

Indian legal system is notoriously slow. The regulatory system is not immune from policy reversals due to pressure from vested interests and inter-ministerial rivalries. Disputes often take decades to resolve and many foreign companies build in clauses allowing for international arbitration. Labor relations are poor, but the incidence of strike action in the private sector has declined in recent years [20].

McClearn [12] also argues that corruption and poor legal system are serious problems in India. In its latest corruption perception index, Watchdog Transparency International gives India an appalling rating of 2.8 out of 10. A score below 3 indicates "rampant corruption" [12]. These corruption and poor legal system risk factors can lead to capital losses in the Indian real estate market. Therefore, corruption and poor legal system risk factors should be understood by real estate investors and mitigated carefully.

Economic risk refers to a significant change in the Indian economic structure or growth rate that produces a major change in the expected return on foreign direct investment. The macroeconomic factors are significant risk factors in commercial property returns. Economic risk arises from the potential for detrimental changes in fundamental economic policy goals (fiscal, monetary, international, or wealth distribution). Thus, macroeconomic risks in India arise from three factors - inflation, interest rates, and fiscal stance of the government [21].

Economic risk often overlaps with political risk because both deal with policy of the Indian government. Although, there are political and economic risk issues in the Indian economy, the rate of economic growth has jumped from the former 0-2 percent to 4-10 percent per year [19]. It is clear from literature review that there are political, social, and economic risk factors in the Indian real estate market that should not be ignored by foreign investors before investing in the Indian real estate market.

Methods

This non-experimental field study utilized survey research. The current study surveyed Canadian persons who might be considered potential investors in the Indian real estate market. This method of data collection was chosen because as Gall *et al.* [22] indicate that survey research is a useful tool for studying sensitive opinions, attitudes, preferences, and behaviors of individuals, particularly when the opinions are reflections of larger underlying attitudinal constructs.

Measurement

In order to remain (for comparison and reference reasons) consistent with previous research on the subject, all measures pertaining to investors' perception on capital losses were taken from Byrne [23]. All the scale items were re-worded so that they can be applied to Canadian investors. The questionnaire was pre-tested to ensure its effectiveness. The reliability of the scale items was also re-checked. Note that investors were asked to rate each scale item on a four-point scale ranging from "None" to "Extreme".

Investors' Perception on Capital Losses was operationalized as the reasons which a respondent may perceive for future capital losses in the Indian real estate market can be i) poor political and legal system, ii) corruption, iii) the chances of confiscation, and iv) economic issues. Five items were selected to measure the variable "investors' perception on capital losses."

Sampling Frame, Questionnaire Distribution, and Collection

The current study consists of the population of approximately 5,000 Canadian real estate investors who invest in the Indian real estate market. They invest in residential and commercial properties. Canadian real estate investors in the Lower Mainland of Canada area (North Vancouver, Vancouver, Burnaby, New Westminster, Surrey, Delta, Cloverdale, and Richmond) were chosen as a sampling frame. To solve sampling frame issues, it was ensured that subjects were selected from Canadian community only.

Given that the population is "abstract" (i.e., it was not possible to obtain a list of all members of the focal population) [24], a non-probability (purposive) sample was obtained. In a purposive sample, participants are screened for inclusion based on criteria associated with members of the focal population. This method was chosen because the Canadian real estate investors were generally reluctant to participate in the research. Therefore, there was the possibility of sampling bias (the threat to representational ability of a sample). An extreme form of biased sampling occurs when certain members of the population are totally excluded from the sample (that is, they have zero probability of being selected). To avoid sampling bias, research assistants were asked to only choose research participants who are indeed representative of the population. For example, they were instructed to exclude all non-Canadian real estate investors. It was ensured that all the research participants who completed surveys were representative of the population.

By using the Lower Mainland telephone directories (White Pages), an exhaustive list of Canadian investors' names and telephone numbers in the Lower Mainland area was created to conduct telephone interviews and to complete surveys in person. In addition, to set up the data gathering, a mailing list of assistants' names and addresses were completed. Survey questionnaire bundles coupled with an instruction sheet were provided to participating research assistants for distribution.

Out of approximately 5,000 Canadian real estate investors who invest in the Indian real estate market, the sample included approximately 700 research participants. 227 surveys were completed over the telephone (approximately 32%), through personal visits, and received by mail.

Study Procedures

Issues Related to Confidentiality of the Research Participants

To solve confidentiality issues, all the subjects were assured that their names will not be disclosed and confidentiality will be assured. In addition, all the Canadian investors were requested to not disclose their names on the questionnaire. Since the research was based on the survey questionnaire, investors were not forced to respond to each specific question. All the subjects were provided with stamped envelopes so that confidentiality is assured. There was no obligation for the subjects to answer my questions over the telephone and in person. To conduct telephone interview, all the subjects were asked for their permission to participate. All the subjects had right to say no over the telephone. Therefore, no one was forced to participate. Investors' Consent Letter specifically indicated that by completing the survey, subjects have consented to participate in the study. Any information that is obtained in connection with this study and that can be identified with subjects will remain confidential and will be disclosed only with subjects' permission or as required by law.

Results

Measures of mean, central tendency, variance, skewness, and kurtosis were calculated on responses to all of the items. Skewness measures for all of the items were within the range of: -1.0 to +1.0, which is considered an acceptable range for most research that requires using statistics appropriate to normal distributions. The overall variance among five scale items is 85.83.

Findings

One of the major findings was that different risk factors such as poor political and poor legal system, corruption, chances of confiscation and economic factors could lead to capital losses in the Indian real estate investment. Overall, as shown in Table 1, Canadian investors perceive corruption, poor political and legal system, chances of confiscation, and economic issues risk factors as "high risk factors" that can lead to capital losses. From perceived individual risk factor ratings point of view, investors rated corruption as the highest risk factor (Mean Score 2.75), political system as second highest (Mean Score 2.71), the legal system as third (Mean Score 2.69), chances of confiscation as fourth (Mean Score 2.62), and economic issues as fifth risk factor (Mean Score 2.43).

Table 1: Overall Investors' Perception on Capital Losses.

	N	Minimum	Maximum	Mean
Corruption	226	1	4	2.75
Political System	226	1	4	2.71
Legal System	226	1	4	2.69
Chances of Confiscation	226	1	4	2.62
Economic Issues	226	1	4	2.43

N = Number of responses.

An ANOVA analysis was performed in order to investigate whether Age or Educational level are instrumental in affecting the risk perceptions of the respondents. The results of the analysis indicate that with respect to each one of the risk factors there were no significant differences between the mean severities of the perception towards each one of the risk sources. Thus, irrespective of age or educational level, the average risk perceptions of the respondents were all relatively high (close to 3 on a scale of 1 to 4) and thus the propensity to actually undertake investments in the real estate market in India is hindered by the perception of these risk factors.

Conclusion

Overall, all the investors perceive political system, legal system, chances of confiscation, corruption, and economic issues as “risk factors” that may lead to capital losses. If there were strong views about these risks being present in India, one would expect strong aversion regarding investments by Canadians in the Indian real estate market. Therefore, it is important to find some methods and techniques by which real estate investment risk can be mitigated.

Mitigating Foreign Direct Investment-Risk

Based on the findings related to investors’ perception on different risk factors, it is important to understand different methods and techniques to mitigate foreign direct investment-risk. Real estate investors can use the following techniques to mitigate foreign direct investment risk:

- Hire local employees; that is, hire Indian employees to run rental property business. Hiring locals might reduce the chances of confiscation and government takeover. Employees can pressurize the Indian government to avoid takeover actions. Madura [25] also explains that local employees may limit a government takeover.

- Borrow local funds and establish good relationship with lenders: borrowing local funds from Indian banks would reduce the probability of confiscation and government takeover. That is, banks would receive their loan payments promptly and they might attempt to prevent a takeover by the Indian government. Madura [25] explains that local borrowing may prevent a takeover by the host government. In addition, local borrowing would reduce exchange rate fluctuation risk because less money will be transferred back to the parent company. Establishing good relationship with lenders at banks would help to receive lower mortgage interest rates, which will lower the cost of borrowing. This, in turn, would improve the economic situation of the real estate investors.

- Finance additional rental property with other rental properties’ (if there is one) retained earnings. This way, parent company does not need to finance the new rental property project. Thus, less money of the parent company will be stuck in India, which in turn, lowers the capital losses risk. The parent company also has an option to borrow funds based on existing rental properties to finance new projects. This financing method will discourage Indian government to make confiscation or expropriation decisions because of the involvement of Indian banks.

- Purchase insurance to cover the risk of expropriation; that is, foreign rental property business owners/operators can purchase insurance through the Overseas Private Investment Corporation (http://www.opic.gov). The Multinational Investment Guarantee Agency (MIGA) also provides political insurance to protect investment in less the developed countries [25, 26].

- Once foreign direct investment takes place, parent company/foreign investors should watch for destabilizing political situations which can lead to block funds’ transfer. Periodic decisions as to sell the constructed rental properties and to determine whether further expansion should take place can be made based on forecasted political and economic changes in India. This in turn, will mitigate the capital loss risk.

- Engage in joint venture with Indian firm, which in turn, will reduce risk of government takeover, confiscation, and expropriation. In addition, real estate investors do not need to consider a substantial investment that can put much capital at risk to generate high returns. Luo [27] also describes that joint venture strategy reduces the capital losses risk in the Asian market.

- Establish good relationships with local and national politicians, which in turn, will reduce risk of government takeover, confiscation, and expropriation.

Implementation of Risk Mitigation Approaches

Many barriers (e.g., lack of skilled customer service employees, higher cost of capital and other cultural, economic, political, social factors) can make it difficult to implement risk mitigation approaches.

The real estate investors can overcome the above challenges by using the following techniques:

Find out the availability of skilled customer service employees in certain local areas: Real estate investors can find out the availability of qualified labor by contacting local educational institutions such as schools, colleges, training institutions, universities, etc., and labor suppliers. Real estate investors must check the reputation of local educational institutions and labor suppliers.

Overcome higher cost of capital barriers: To overcome the higher cost of capital barriers, real estate investors must consider contacting different financial institutions such as Indian banks to find best interest rates. In addition, real estate investors must check the compounding of interest rates and the overall cost of borrowings from different banks because compounding makes a big difference in overall cost of borrowing. For example, overall cost of borrowing will be higher for daily compounding than the semiannually compounding.

Finance additional projects with other real estate properties' (if there is one): The retained earnings may have some tax issues. To overcome tax issues, real estate investors must use the services of local accountants/tax consultants.

Buy insurance to cover the risk of expropriation: The expropriation insurance may not be available in India. Therefore, real estate investors must contact the Overseas Private Investment Corporation (http://www.opic.gov) and the Multinational Investment Guarantee Agency (MIGA) to purchase expropriation insurance.

Overcome joint venture issues: To overcome joint venture issues, real estate investors need to check Indian company reputation, legal barriers, and internal organizational political issues.

Overcome economic and political issues time to time: To overcome economic and political issues, real estate investors may consider hiring local economic and political consultants.

Establish relationships with local and national politicians: Some donation to political parties may help to overcome the difficulties of relationship with local and national politicians.

All of the above require real estate investors to internalize the importance of showing genuine concern. Since the consequences of poor Indian political and legal system, corruption, chances of confiscation, and economic issues can lead to capital losses; and since hiring local employees, borrowing funds locally, financing additional projects with other real estate properties' (if there is one) retained earnings, purchasing insurance to cover the risk of expropriation, monitoring political changes on a regular basis, and considering engaging in joint venture mitigate the capital loss risk, it is highly advocated implementing these methods as the investors method of choice.

Limitations and Practical Implications

The present study asks for responses from fixed format, set-questions survey tools, which could direct questions to the exclusion of providing additional input. A mail/drop off survey data collection method contributed to a low response rate or response error. Some favorable techniques such as including postage paid mail, sending a cover letter, providing a deadline for returning the survey, and promising anonymity were applied in order to increase the response rate. Maturation of participants can also affect the survey response rate. Maturation of participants, in the context of this research, means that some of the research participants may be on holidays. However, a short study period (four weeks) limited any negative effects from maturation. The practical implication is that if investors perceive that the risk of capital losses is higher, their propensity to invest capital is lower than if risk is perceived to be lower. Results suggest that investors' foreign direct investment behavior does not differ much based on their age and the level of education. In addition, risk mitigation techniques may not be very successful in India due to the unique nature of political and legal system.

Future Research

This study focused on understanding country risk factors and discusses possible ways to mitigate such adverse effects in the Indian real estate market. The study's empirical section explored investor's perceptions of the risk of investment in the real estate market in India but such consideration might be common and shared by investors who consider direct investment abroad. In light of the ever-expanding economic globalization, an interesting extension to the study may explore other groups of individuals that contemplate investments abroad. Real estate investment is one of the most direct avenues for individuals to invest in assets. Such investments seem to be less complicated than investments in manufacturing facilities that are more typical to the corporate sector to be interested in. Individuals do not possess the tools that companies that expand globally may use in assessing the risk and in undertaking measures to mitigate the 'political risk' that was described in the paper. As our study has found, people's perceptions of this source of risk causes many to decline direct investment possibilities in real estate. India was one example and the survey related mostly to individuals of Indian origin and their concerns about investments in the Indian market. Other studies may examine the attitudes of other groups of potential investors to real estate investment in other countries.

Competing Interests

The authors declare that they have no competing interests.

Authors' Contributions

AG developed the framework, gathered all the data, carried out the final estimations and statistical analysis, and drafted the manuscript. NB, NM, and RT edited the final draft.

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