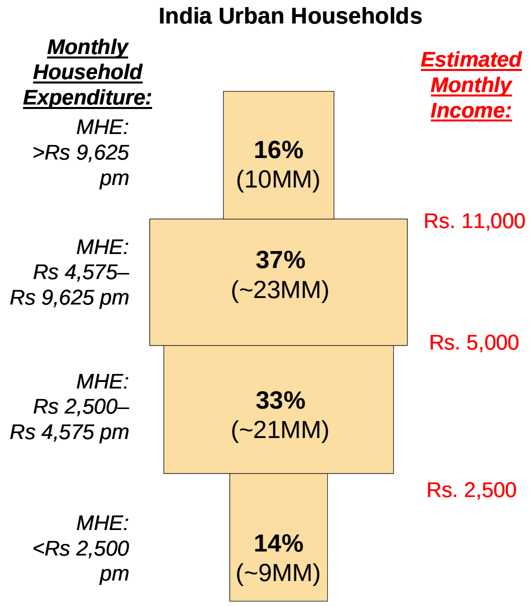
BRICK BY BRICK – MAKING A MARKET IN LOW-INCOME HOUSING

Monitor Group, India

The current market is not reaching lower income households

There is a vibrant housing market in urban India as illustrated by housing finance growing at a CAGR of over 36% for the past decade. But the smallest flats being built are around 500 square feet and cost over Rs 500,000 (USD 10,000). A household earning Rs. 11,000 or 12,000 per month can just about afford[1] such housing if they get financing. As seen from the income pyramid alongside, ***over 80% of India's urban households*** earn less than this and hence cannot afford housing in the current housing market.



The housing situation for most lower income urban households (families earning Rs 5000 to 11,000 per month) is quite poor. While they pay 20-25% of their income as rent, they typically live in dingy small single room units with shared toilets, have poor living conditions, are subject to constantly rising rents, harassed by landlords, etc. The current deficit of urban housing is estimated at 24.7 million units (mostly the poorest segments of society), but given this deficit, the continued migration into urban areas, and its limited resources, it is unlikely that the Government can provide housing for lower income urban households.

Monitor Group is using market based solutions to create social change in India

We are a management consulting group started by Michael Porter and a group of his colleagues at Harvard Business School. We have over 1200 professionals in 30 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.

The Monitor Group's Inclusive Markets Practice which was instituted in 2006, has been working extensively in the area of developing market based solutions for social issues. Through its work for private sector clients, National Housing Bank (NHB), International Finance Corporation (IFC) and the World Bank, Monitor has identified low income housing as a major gap in the market and one that can be addressed through a market based solution. It has developed innovative solutions to address this opportunity and is currently facilitating pilots to demonstrate the viability of the solutions and incubate new players to implement these solutions at scale.

[1] Using a price to annual income ratio of around 3.5.

A project by Monitor Group for National Housing Bank - with active support from the World Bank - explored the commercial opportunity to serve low income households.

Inadequate housing for low income households is a key priority for NHB and it is actively working in multiple ways to address this issue. One potential solution is through market mechanisms and this led to a project by us (Monitor Group), funded by FIRST Initiative with active support from the World Bank. The project recognized that current models are not working for low income households and hence conducted extensive field research across urban India and involved international and local experts to develop innovative solutions. The fieldwork included investigation of property prices, interviews with over 1000 customers, 50 developers, 20 Financial Institutions, 10 micro-finance and specialized lending organizations and a broad range of over 100 stakeholders.

Even with current land prices and construction rates, it is possible to build housing that lower middle urban customers can afford. Private sector developers are currently building housing at Rs. 900 – 1,200 per sq. ft. in vibrant neighbourhoods within one hour of the city centre in most metros, Tier I and Tier II towns. The smallest units they are currently building are 500-600 sq. ft. flats costing Rs. 500,000 (USD 10,000) and above. However, many developers in cities like Ahmedabad, Jaipur, Mumbai, Hyderabad, Kolkata, Kolhapur and Vizag confirmed that they could build smaller flats of 250- 350 sqft at Rs 250,000 to 320,000 (USD 5000-6500) which lower middle income customers could afford provided financing was available.

Lower middle income customers can afford, and are very interested in, purchasing the type of housing described above. A majority of such families live in poor quality rental housing (typically a single room of 100-250 sq. ft. with a shared toilet and bath, often poorly ventilated and lit, and in "bad" neighborhoods). They face constantly rising rents, unreasonable demands from landlords and pressure to move every two or three years. While some of these households prefer to stay in the same neighborhoods, many are very interested in moving to more distant suburbs if they can buy the 250 - 350 sq. ft. flats described above - flats that will have safe common spaces and will be in neighborhoods that have schools, shops, access to health care and most importantly are well connected by public transport. The customers see this as an economic opportunity to convert rent to ownership and as a chance to significantly improve their quality of life. They can afford such housing if they get financing at current mortgage rates[2].

THE CHOKE POINT: FINANCE While conceptually financial institutions like banks and housing finance companies recognize the potential of this segment, most of them are concerned about giving housing loans to such customers. First of all, they feel that since each individual transaction is small, the cost of serving them will be too high. Second, they are worried about higher credit risk, especially for the customers in the informal sector (both salaried informal[3] and self employed). Many NBFCs were interested in serving this market, but they were concerned as the SARFAESI Act of 2002 that allows one to recover a mortgaged property without going to court does not apply to them. MFIs were very interested, but they do not have the long tenor funds that are required for such loans and most of them did not have the capital base required (most said that given their own high growth trajectories, they needed all the money they could access for their core business).

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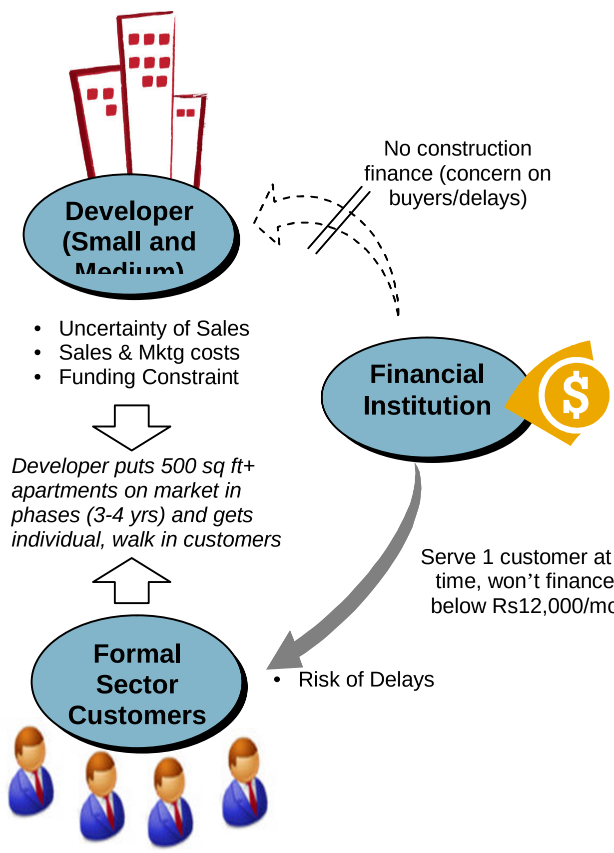
[2] Current mortgage rate for the retail customer is 12%

[3] Salaried informal includes customers working in firms with less than 100 employees

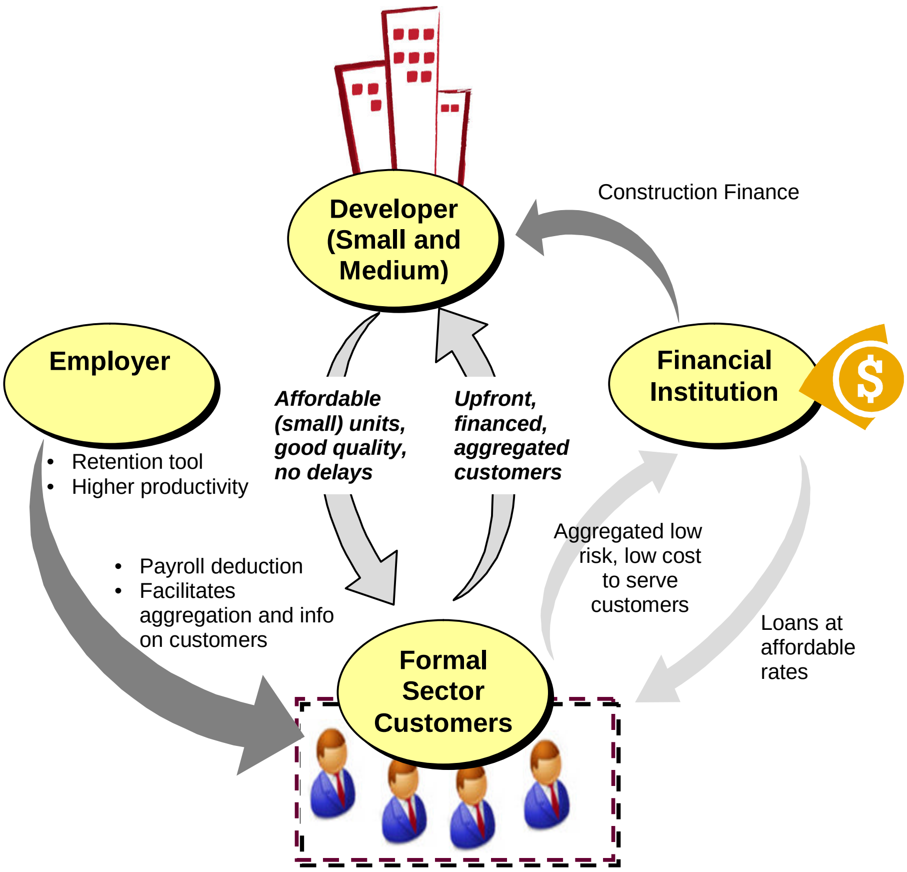
The current business model was sub-optimal for the customer. We recognized that while finance was the key issue to serving low income customers, even the current lower end of the market (as shown in the graphic below) had issues. The developer would buy a plot of land, get his clearances and start constructing. Typically, the developer would not be able to get construction finance (as there were concerns about delays) and so the developer would use his own finances to quickly put up a building and complete a sample flat to attract customers. Customers in the Rs 12,000 (USD 240) per month and above income group, would see the sample flat and if they liked it, would try to get a loan. Due to the concerns of banks and housing finance companies described above, typically only customers working in larger organizations (i.e., formal sector employees) would get a loan and hence by default this market was focused on the formal sector in this income group. The funds from these early customers would provide the developer with finance to continue construction and he would continue selling flats (at higher and higher prices, in keeping with land appreciation) to fund ongoing construction. At times the flow of new customers would not keep up with the construction and there would be delays while the developer arranged for financing (or just waited to get more customers). Also, given the unorganized nature of the developers, the quality of the finished product could vary significantly. In other words a market fraught with delays and poor quality – the consequence of which was borne by the customer.

Current bottom of the market (12-20k)



An innovative business model to serve formal sector customers. We developed a set of new business models to address the concerns of different stakeholders. The first model (see attached graphic description of Alternate Model 1 is aimed at organized sector employees and uses the employer as a nodal point to aggregate customers and facilitate processing including payroll deduction. Employers have shown a strong interest in doing this as it helps with retention and performance improvement[4]. Financial institutions like banks and housing finance companies are very interested in such groups of customers because (a) they feel these customers are inherently low risk[5] and (b) it lowers their cost to serve as the employer is facilitating the loan application process and providing payroll deduction. Developers are very keen on providing housing to these agglomerated pre-financed customers as it reduces their marketing cost, and selling risk. In fact, due to the pre-financed customers, it also enables them to get construction finance. This access to funds in turn enables the developer to keep to schedules and reduces the chances of delays. In fact, the aggregated buying power can also be used to negotiate better terms with the developer including good quality construction. In other words, it's a business model that addresses the key issues of the different stakeholders and is a win-win for all concerned.

Alternate Model 1 for 6-12k formal sector customers



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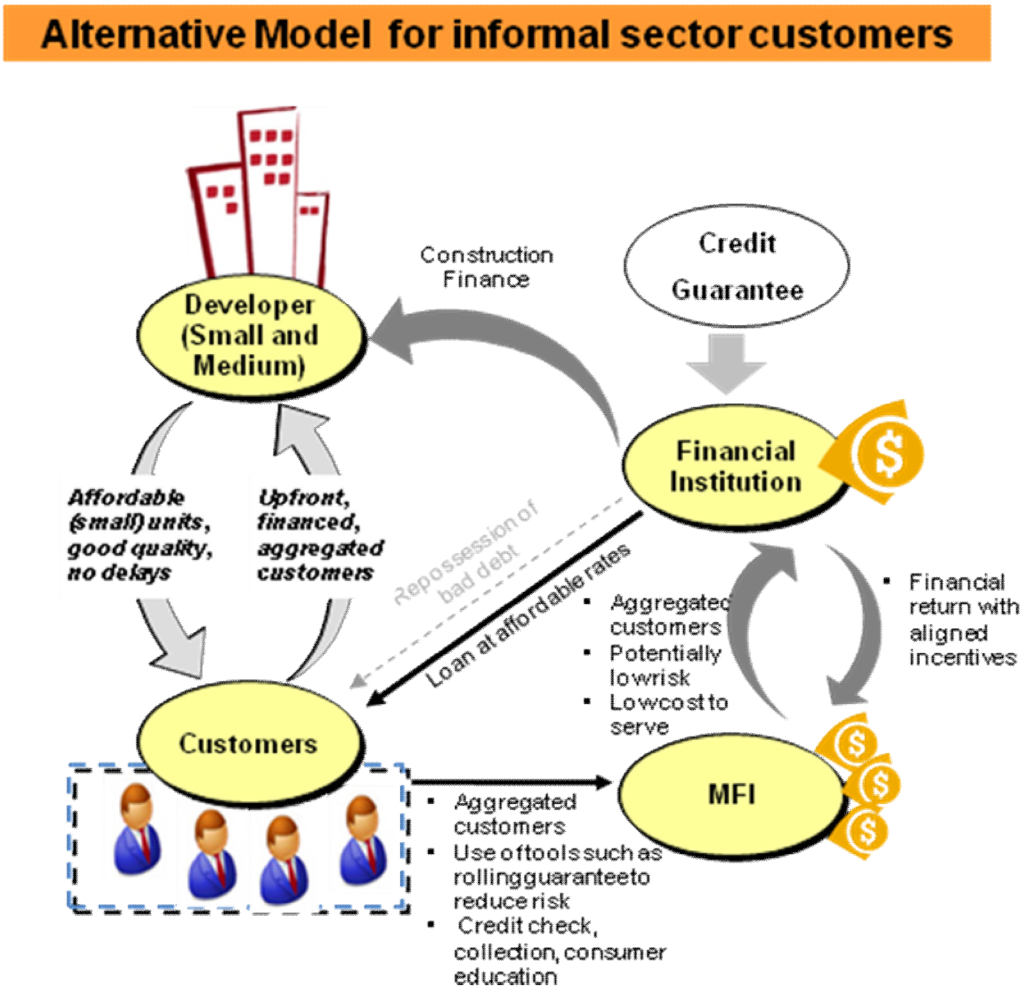
4 Employers see better housing as leading to better morale, less absenteeism, etc. They also know the interest in owning housing and hence see this as an effective retention tool.
5 FIs perceive these customers as low risk because they feel they will have a steady source of income. Since they are in a large company with a union, etc, it is unlikely that they will get fired. If they do leave their job, it is most probably to go to a better (read higher paying) employer.

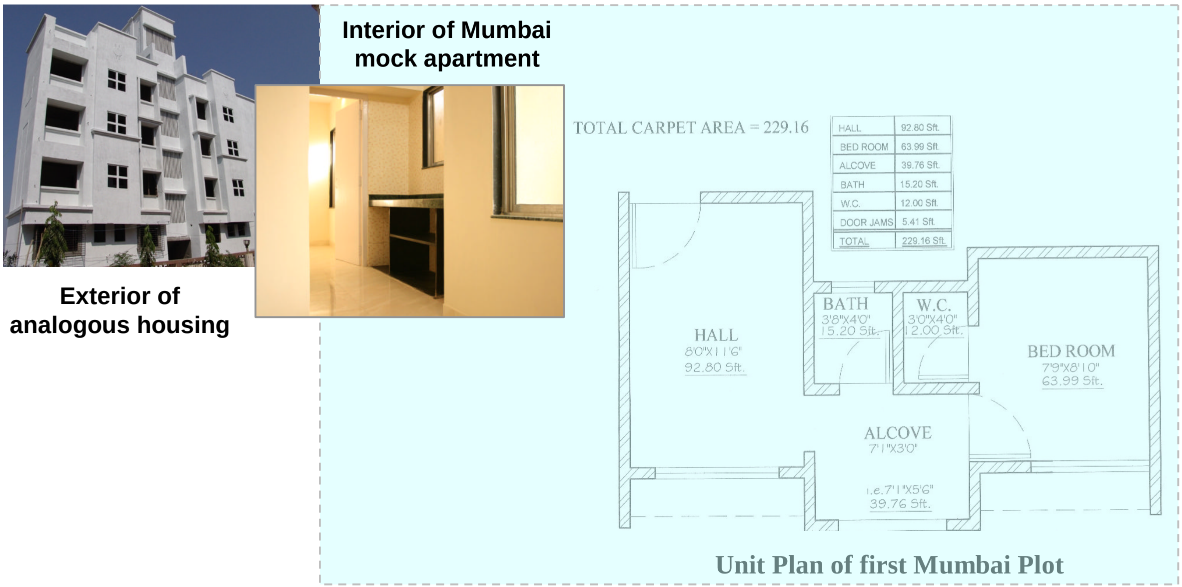
An alternate set of innovative business models to serve informal sector customers. The second model (shown below) is analogous, except that it targets the informal sector and uses a micro finance organization to do the aggregation, qualification and collection, thereby achieving the required lower cost. The actual loan is provided by the bank as it has the appropriate funds (magnitude and tenor) and the bank is also responsible for repossessing the house in case of default – a task most MFIs are not interested in performing[6]. Quite a few banks/traditional HFCs we spoke to were interested in participating in such a model but they wanted to align the MFI's incentives with theirs (i.e., ensure the MFI did not bring in customers who were poor credit risk). All the urban MFIs we interacted with could understand the FIs perspective and agreed to align incentives – they said that if any customer defaulted, for that customer they would payback all the fees and a bit more.



[6] MFIs have told us that they will be working in the community on an ongoing basis and hence they would not like to be seen as the "heartless" lender that throws a person out of their house. The bank on the other hand already has a mechanism in place to do this and is not so concerned about the adverse effects.

<u>Pilots.</u> In order to incubate and develop the low-income housing market, Monitor has taken on the role of a market-maker, working closely with various stakeholders – developers, financial institutions, MFIs, corporates, to bring the different pieces together. As part of this exercise, Monitor is facilitating a series of pilots having 200 to 1,000 flats each in Ahmedabad, Mumbai and Bangalore. In each case, Monitor has identified a developer interested in this opportunity and is supporting him through the actual process – getting him customers, getting the customers financed, helping the developer secure construction finance, facilitating development of cost- efficient unit designs and overall complex layouts, etc. One of the developers has constructed a 229 square foot mock flat (see attached unit plan and photographs), and the general reaction to the unit has been that (a) "this is much bigger than 229 square feet" and (b) "this is too good to be low income housing". The reason for these reactions is that the unit has been carefully designed (e.g., effective utilization of space, visually attractive proportions, high ceilings, good ventilation) with a few key amenities leading to a feeling of space and quality while managing costs.

Interior of Mumbai mock apartment

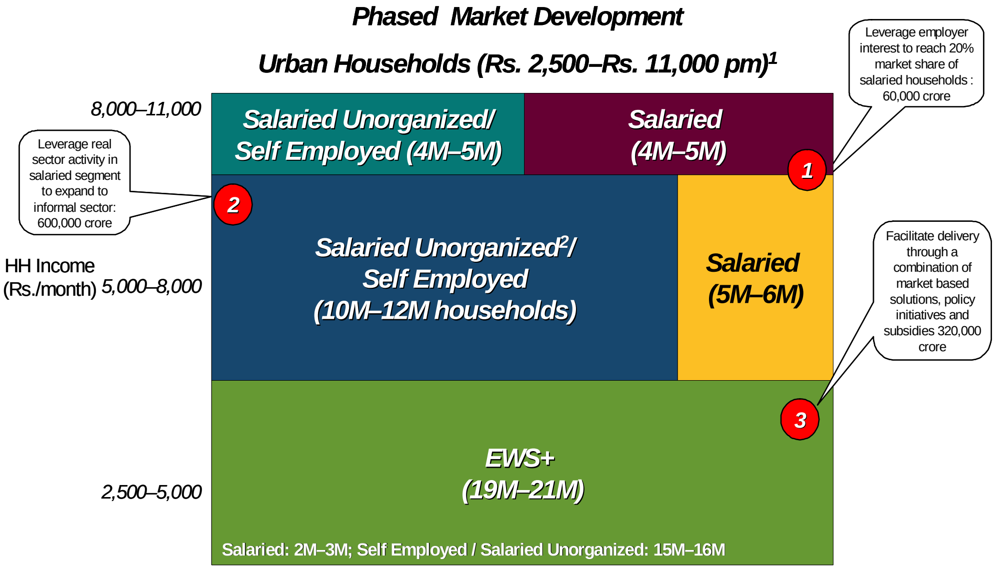


Exterior of analogous housing

Unit Plan of first Mumbai Plot

<u>Economic returns for developers.</u> In addition to demonstrating the overall feasibility of using market based solutions to meet the housing needs of low income households, the pilots are also highlighting the commercial value of the opportunity to developers. The return on investment is in the 50-75% range (pretax IRR) based on factors like time to get clearances, selling price escalations, etc.

The reason the returns are so attractive is because (1) the land cost is low and hence the customers down payment covers all or a large part of it, (2) there is no other large outgoing for the developer as construction finance has been arranged and (3) the timeframes are short (as the customers are arranged and financed before the project is even started).



Phased Development of the Overall business opportunity. About 40% of households earning Rs. 5,000 to 11,000 (USD 100-220)per month work with large employers[7]. It is estimated that 70- 90% of these households live in rented housing or in multi-family units. Given the willingness of employers to facilitate housing and the financial institutions' comfort with this segment, these will be the easiest customers to start with. Even with a 20% market share in the formal salaried segment of this income band, the business opportunity is Rs 60,000 crore. Serving this segment will lead to a significant supply of appropriately priced and located housing. It is expected, that in parallel, given the fact that this is a collateralized loan, financial institutions will get more comfortable lending to the informal sector and this combined with increasing supply could lead to the market serving the entire space of households (organized and unorganized) earning Rs 5,000 to 11,000 per month – an opportunity of over Rs. 600,000 crore (USD 12 billion).

Pure market based solutions may not be able to serve households earning less than Rs 5000 per month, but it may be possible to facilitate delivery to these segments through a combination of market based solutions, policy initiatives and subsidies – a market of over Rs. 320,000 crore (USD 6.5 billion)

Government can help facilitate market based housing for lower income households and many such interventions may not have a financial cost. *"Affordable housing for all"* is a priority for the Government and market based solutions can help make this a reality. A key long term facilitator is increasing the supply of affordable land. The government may be able to institute policy changes that provide this without any subsidies or financial support (e.g., higher FSI for lower income housing). Financing is also critical and RBI and Government can introduce guidelines/incentives – which may be bereft of subsidies/financial support - to get financial institutions to serve this market and compensate for the related entry cost. In the longer term, given the depth of the market and using customized business models such as those tested by Monitor, the profitability of providing scores of small mortgages seems ensured

[7] Organizations with more than 100 employees.

<u>Potential to create immense economic and social impact.</u> The financial impact of such market based solutions can be enormous both at the aggregate level (as mentioned earlier, it is a Rs 600,000 crore opportunity for just households earning Rs 5,000 to Rs 11,000) and at the individual level. It will not only financially transform the lives of the customers but also have huge social implications – enhancing quality of life, emotional security of a home and a safety net, etc. 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

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