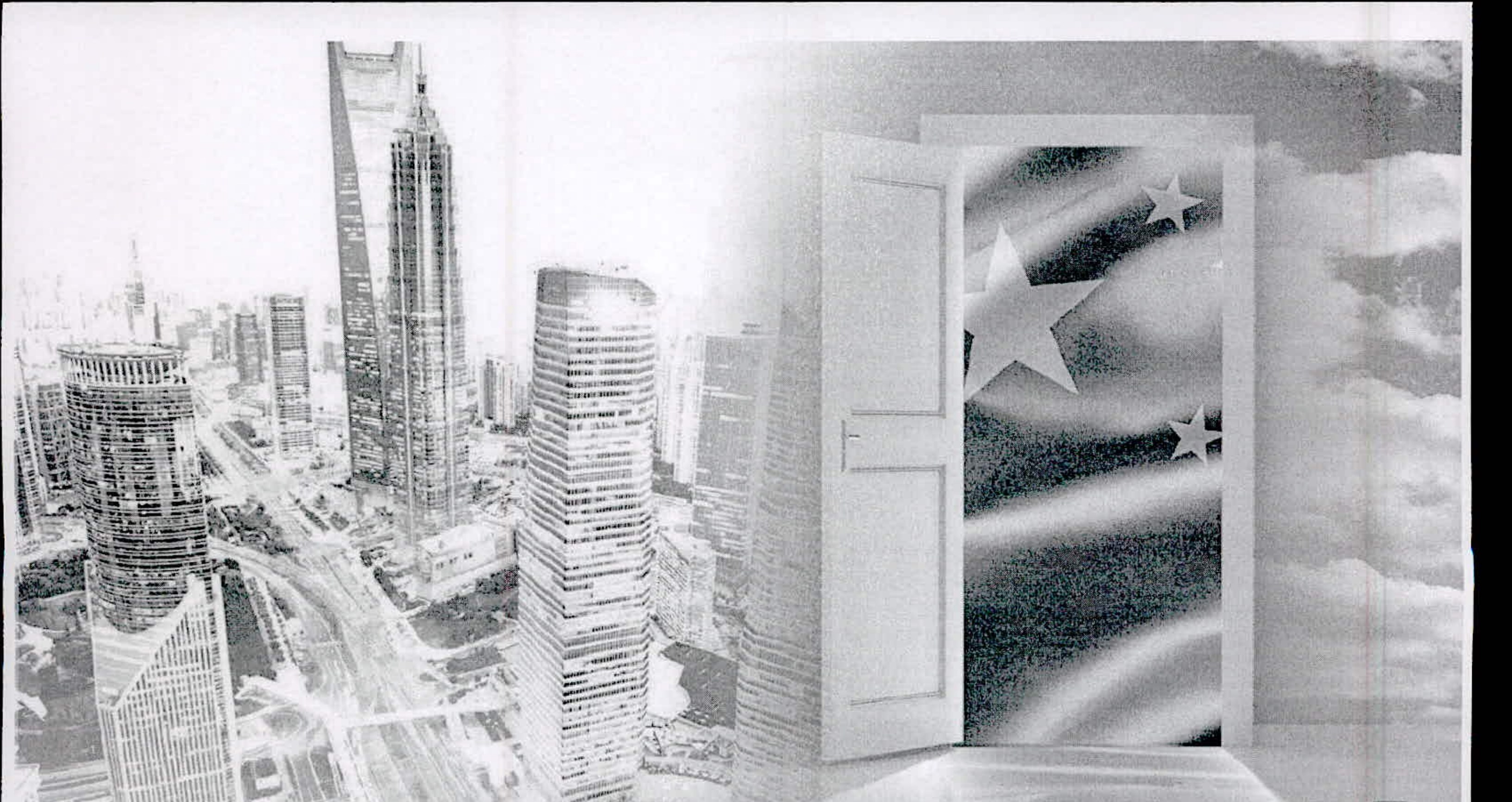


AWAKENING GIA

Opening Doors to REITs in China and India

By Charles Keenan

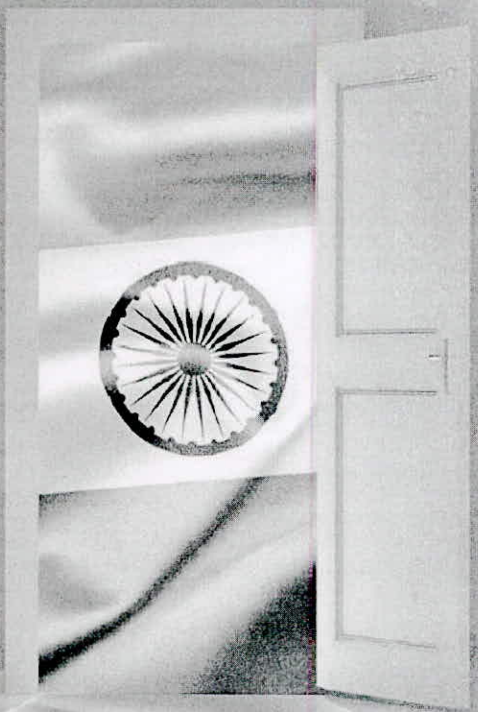
While institutional and retail investors have had a sampling of Asian real estate through REITs, in a sense they still have been shut out of the continent's most significant economies, China and India. That could change in the coming years, as each country has taken steps to open up its market to outside capital.

At this point, it's more about potential. In China, Penghua-Qianhai-Vanke "REIT" listed on the Shenzhen Exchange in July, a move marked more by symbolism rather than something investors will flock to. India has made recent key policy changes to allow REITs, which are expected to first hit the market next year.

It's a start. Just by looking at the numbers, both countries offer tremendous potential in part due to their massive populations. As of mid-2014, China had a population of 1.4 billion, and India, 1.2 billion, according to the CIA World Factbook. Both of these countries have witnessed growth in gross domestic product (GDP) much greater than their developed counterparts. Real GDP in India is predicted to grow by 7.6 percent in 2016, up from a pace of 6.9 percent in 2015, according to the Organization for Economic Cooperation and Development. In China, though the pace of real GDP growth is expected to edge downward, annual expansion is expected to be 6.7 percent in 2016, compared with 6.8 percent in 2015. Those compare with 2016 growth rates in the United States of 2.8 percent and Germany, 2.3 percent.

The growth rates and the need for outside capital mean China and India could eventually offer investors enticing options such as the REITs popular in Japan, Australia, and Singapore.

"We see development of REIT markets in these countries adding to the depth of the overall REIT market in the region and attracting



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significant investment into Asia," says Neil Raheja, group president of K Raheja Corp., a developer of office parks, malls, hotels and luxury residences, based in Mumbai, India.

China and India still need to work out a few kinks in terms of REIT tax structures, but the moves in each country point to progress.

CHINA: EDGING TOWARD REITS

Today, investors can obtain a degree of REIT exposure in China by investing in Singapore REITs and U.S. REITs with holdings there.

Recently, though, China took its first steps toward having a REIT regime. The Penghua-Qianhai-Vanke REIT holds office properties owned by developer China Vanke and is managed by Penghua Fund Management. The key word here is "fund," as it barely resembles a REIT by U.S. standards. Half of the fund will invest in an office project built by China Vanke in Shanghai, while the other half will be invested in stocks, bonds and money market products. That puts a limit on moving properties over to the structure.

The closed-end fund went public in late June, raising about $500 million. The fund now trades on the Shenzhen stock exchange. Institutional investors were the main participants, and the good news is that it was oversubscribed by more than 100 percent, notes Fred Wang, secretary general of the China REITs Alliance, an organization lobbying for better REIT structures.

But the key missing element to REITs in China is an efficient tax structure, observers say. There's currently taxation for the transfer of assets, as well as at the corporate and investor levels. But the anticipation is there for real REIT structures, says Peter Verwer, chief executive officer of the Asia Pacific Real Estate Association (APREA), based in Singapore. "Everyone's at the party, but there are no balloons or cupcakes," Verwer says. "But these are all positive first steps."

For now, there are numerous taxes for the special purpose vehicle (SPV). Rental income is subject to a 12 percent revenue tax and a 5.6 percent sales tax, says Kai Tan, a senior analyst at Macquarie Securities Group in Hong Kong. Corporate taxes run another 25 percent.

Taxes on the transfer of properties is high too. With the transfer of properties into a REIT, developers would have to recognize the market value of the properties, which are marked with very low book values given the relatively low costs of construction. So, owners must pay an appreciation tax ranging from 30 percent to 60 percent, according to Wang of the China REITs Alliance. "To inject the properties into the REIT structure means very high taxation," Wang says.

All of the taxes are likely to dampen yields, and investors don't want to see taxes erode them, Tan says.

"People will look for a track record," he says. "People will see whether it can give a sufficient return."

Investors will also look at the quality of assets, he adds. The fear is that the owners will funnel lower-quality assets into China REITs, much like Hong Kong, where owners—mainly island tycoons—have held onto class-A properties and jettisoned lower-rated buildings into the REITs. That has led Hong Kong REITs to lag their counterparts in Japan, Australia and Singapore, Tan says. Mainland owners will probably do the same.

"These people are private developers, not state-owned enterprises," Tan says. "So if there are good assets, they will probably want to keep them for themselves and divest some of the lower-quality assets. That will be a key concern of the market."

That said, China's growth in select markets has vast potential, observers say. The country's so-called alpha cities, Shanghai and Beijing, are establishing themselves among the world's top 10 city economies in terms of scale, status and commercial attraction, according to a Jones Lang Lasalle report. Meanwhile, the country's second- and third-tier cities—dubbed by JLL as the "China60"—would be the world's second-largest economy in terms of purchasing power, the firm says.

Even with the current roadblocks to having real REITs in China, it's that kind of potential growth that fuels optimism. Wang looks down the road with the hope that the government will eliminate the corporate tax at the entity level and reduce the tax burden for transferring property ownership, similar to the UPREIT structure in the U.S.

"In the future, if we can copy the U.S. model, that will be a great benefit," Wang says.

For now, more reforms will be needed to stimulate global investor demand for a REIT in China, including making sure that REITs will be run internally by specialized property managers, not by external groups. The property owners have to make things happen, Wang says.

"We really need to have more industry players get involved in the game, especially the large developers," Wang says. "They are holding many properties. Private equity is quite an important force in helping the REIT product form."

INDIA: REITS TAKING SHAPE

For now, India has a head start on China. The election in 2014 of Prime Minister Narendra Modi helped bring REITs closer to fruition. While guidelines were issued by the Securities and Exchange Board of India (SEBI) last year on REITs and so-called infrastructure investment trusts (InvITs), some concerns of investors on the tax structure thwarted any real progress.

Recent modifications by the government include eliminating long-term capital gains tax on the transfer of REIT units by sponsors and minimum alternative tax (MAT) when it transfers shares to the REIT—and when it sells units of REITs—notes Rajesh Mokashi, deputy managing director for Credit Analysis & Research Ltd., a credit-rating agency based in Mumbai. DLF Ltd., one of India's largest developers, has applauded the moves. It stated in May that it could set up its first REIT by March 31, 2016, the end of its fiscal year.

Still, some barriers remain, Mokashi says. One is dividend distribution taxes (DDT) and stamp duty on the transfer of properties. "The lack of clarity on DDT has acted as a deterrent for the real estate players and the private equity players to launch REITs in the country," Mokashi says.

"The current tax regime for REITs in India leads to multiple levels of taxation, thereby adversely affecting the yield to investors and making REITs unattractive for investment," adds Raheja of K Raheja Corp. "For REITs to become mainstream vehicles for large pools of investors, it is essential to get the tax regime for REITs in India at par with the international tax regimes."

The potential is there. The top seven cities of India together have more than 400 million square feet of operational office space, according to Raheja. This is expected to grow by approximately 25 million to 30 million square feet annually. Of this office stock, more than 150 million square feet will be ready for REIT listing, he estimates.

Embassy Office Parks, a joint venture between Embassy Group and Blackstone, holds 22 million square feet of space in three cities, including Bangalore.

"There is no shortage of commercial office stock for REIT programs," adds Mike Holland, chief executive officer at Embassy Offices Parks. "There remain some small details which remain to be ironed out to make the overall structure tax efficient for investors and owners. We are looking forward to seeing REITs launched in India in the coming year".

Industry-wide, there will be limits on what assets can be transferred to REITs, Holland adds. "A significant part of that needs to be discounted for quality," he says. "We don't see the opportunity for significant non-office REITs, particularly residential, as the rental market is quite informal and fragmented."

REITs and InvITs will also free up capital for real estate and infrastructure, attracting long-term investors such as sovereign wealth funds, pension funds and insurance companies. Also, they will discourage flight of capital out of the country, Raheja notes. "We see REITs and InvITs contributing immensely to the growth of capital markets in India through wider investor participation," he says.

By tapping an alternate source of capital, developers can also improve their balance sheets and free up funds for investment in new projects, Raheja says.

"India needs infrastructure investments to further economic growth," he says. "Availability of capital with infrastructure companies will spur the investment cycle. This will also open up a new avenue for the Indian government to monetize its infrastructure assets like toll roads, ports, airports, power transmission assets and railway assets."

GROUNDWORK FOR A BRIGHT FUTURE

While India and China REITs have yet to mirror their counterparts overseas, observers remain hopeful that they'll eventually have structures and tax transparency similar to other successful REIT regimes in Japan, Australia and Singapore. In particular, global sources of capital would prefer that REITs in China and India have the ability to be self-managed.

If the two countries create stable REIT platforms, it could open up vast new options for investors in real estate globally.

"The race is on," says Verwer of APREA. "These are monumental growth markets." ◆