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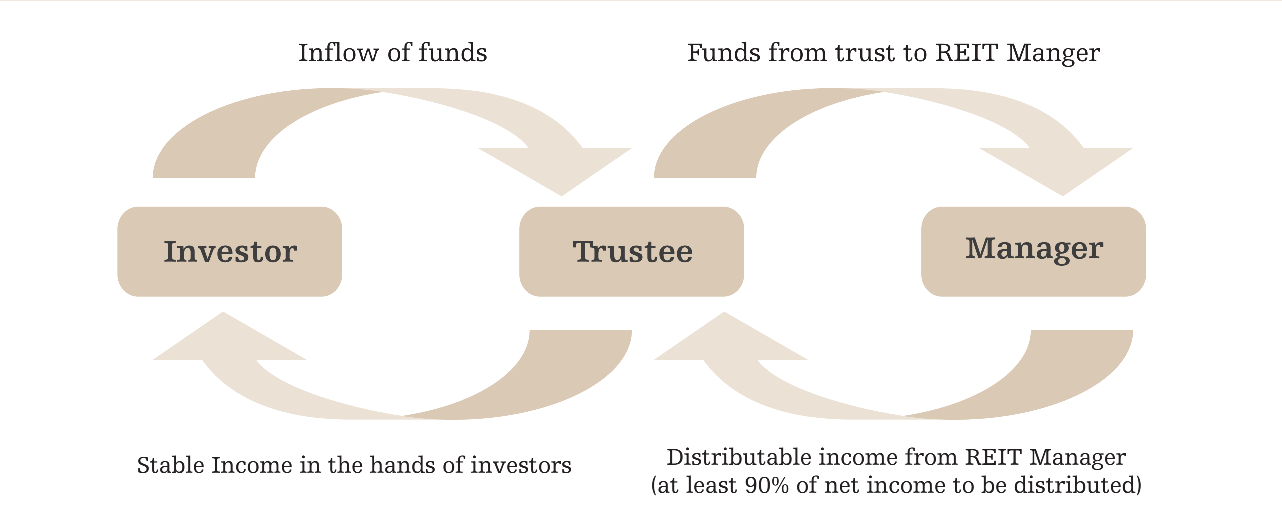
Professional Risk Opinion

Real Estate Investment Trusts in India *Challenges and Impact*

Recently the capital markets regulator, Securities Exchange Board of India (SEBI) has announced the draft consultation paper on Real Estate Investment Trust (REIT) Regulations, 2013. Previously in 2008, SEBI had issued draft regulations for introducing REITs. I-REITs (REITs in India) would issue securities, which would be listed on stock exchanges and REITs will invest in completed rent generating properties in India (to comprise minimum 90% of net asset value) and mortgage backed securities. Initially I-REITs are planned to be available only to high net worth individuals and institutions to develop the market.

Previous attempt to introduce REITs did not materialise, perhaps due to global slowdown and challenges in property markets in India. Moreover, proposed REITs then (and now), being primarily passive (cannot invest in development or mortgages) may have induced policy makers to focus and directly channelize capital in infrastructure development. Though, at present none of the major challenges faced previously appears to have subsided; there is an immense need to provide an alternate investment avenue to retail investors and asset monetisation avenue to real estate players. Success of I-REITs may also enable to lower the demand for gold, which is an idle asset, by Indians and attract the much needed long term foreign capital in India.

Structure of I-REIT



According to the draft consultation paper, REITs shall be set up as trust and registered with SEBI. A sponsor (minimum shareholding 25%) will set up the REIT, appoint manager to manage the operations and trustee to oversee the operations. REIT will issue shares for ownership in one or multiple real estate projects which can be traded by investors. Globally REITs function on a similar principle.

Objective

I-REITs will offer an additional investment avenue to investors. At present the retail investors in India with limited corpus cannot take exposure to prime real estate properties. With introduction of I-REITs investors can take exposure of prime quality properties available through it. The benefits could be stable income stream (investment in completed rent generating properties and managed by professionals with relevant experience) and diversification of portfolio, high liquidity (as I-REITs will be listed on stock exchanges), exit to existing investors and thus availability of risk capital for other productive purposes, and long term inflow of funds (funds seeking stable income such as pension funds, insurance companies).

REITs versus other investment avenues in real estate in India

In India the investors can invest in real estate through individual property, listed stock of real estate developers, private equity funds and through real estate mutual funds. Though real estate mutual funds were recently introduced by SEBI in 2008, there are not many active real estate mutual funds.

Investment in individual real estate property offer benefits such as tax advantage, leverage and control over the property. Neverthless, while considering individual real estate one has to consider factors such as unique nature of property, high transaction costs, and restricted market knowledge (which is often local and restricted). Control over the property comes with a cost of drain on time to manage properties. Moreover, for commercial real estate, as major transactions are executed in private domain, detailed knowledge of rent rolls, maintenance expenses and other critical data is not widely available. Furthermore, these assets are illiquid and smallest possible purchase unit is likley to be above the means of many investors and this also results in concentration risk.

Another avenue to take exposure of real estate as an asset class is through traded equity stock of real estate developers. This is relatively efficient way of taking exposure of real estate than investing directly in properties, however this is much more riskier. The stock in a concern is highly correlated to market risk (as compared to individual property) and this also exposes the investors to business and project risk of a single real estate developer.

Further, in India SEBI enables the investment in real estate through private equity funds. These funds bring their expertise to earn the desired returns. These may or may not be exposed to business risk and project execution risk depending upon the strategy of investment in completed properties or under construction properties. However, minimum investments in these funds is also above the means of many investors (previous requirement; minimum investment of Rs.25 lakh, new requirement; mimimum investment of Rs.1 crore) and these inevestments typically come with some lock in period and may not be highly liquid.

REITs, on the other hand, come with benefits of listing, stable source of income for investors, diversification of assets, small initial invetment requirement (initially SEBI has proposed a minimum investment of Rs.2,00,000), professionally managed, no project execution risk (as fully completed properties are to be included in the portfolio -90% of net asset value), though rent rollover risk and market risk remains.

Each of the investment aveneus mentioned above have thier own merits and demerits. Investors should consider their background, risk apetite and invetment objectives before investing.

Challenges for REITs

The property market is highly localised and the transactions are affected by local taxes. At present the property taxes in India are on higher side. This could be detrimental to the performance of the I-REITs directly impacting its yield and thus its attractiveness to investor. Moreover, Stamp duty in India is also on higher side and is a subject matter of States. The rates and procedures are also not standardized. As a result, many a time, the property transactions are not registered and property is transferred through power of attorney. This creates ambiguity over the title of the property. Due to aforementioned reason, the assets available for I-REITs initially could be limited. Moreover, the high stamp duty structure will also affect the capital gains of the I–REITs assets.

I-REITs are similar in principle to mutual funds except the underlying security (at least 90%) would be in the form of physical property. To offer a level playing field with the existing MFs, the tax structure of REITs also needs to be made similar as applicable to mutual funds. However, there is not much clarity on the tax front for I-REITs at present and many questions remain unanswered. Any adverse tax structure is likely to be detrimental to the acceptance of this new product in the market. On the other hand, as I-REITs would be competing more with debt securities (due to the fixed income nature of I-REITs) any tax incentives similar to infrastructure bonds, will be helpful to attract investors. Similarly, at present there is no clarity on investment in I-REITs by Foreign institutional Investors (FIIs). If I-REITs have to attract significant long term capital, scope for FIIs investments in I-REITs needs to be clarified.

On the operational side, significant challenges are also likely to be faced by REITs to source trained professionals and managing custody of title and transaction documents.

Impact of REITs on real estate market

I-REITs being listed securities with stringent disclosure requirements and managed by professionals with relevant experience can bring in the much needed transparency and accountability in the real estate sector as many properties might be developed with an objective to sell them through REITs. Furthermore, I-REITs can also inflate the property prices as REITs may have significant financial power to chase the quality properties and simultaneously investors may also be willing to pay premium for quality assets.

I-REITs will provide an easy exit option to the existing private equity or other investors in real estate to free up the capital for further productive use. I-REITs can also provide relatively easy and transparent avenue for value unlocking to the existing real estate players with leveraged balance sheets, who may free up the capital to fuel further growth. At present the avenues available to such developers are distressed asset sale or part monetisation by lease rental discounting (LRD) loans. Under LRDs, the developers have to offer very high interest rate (range 11%-15%) to lenders as they are not participating in capital appreciation of the asset. At the same time, the developers' balance sheet is further leveraged limiting the financial flexibility with potential downside of credit. Moreover, depending on tax benefits offered by I-REITs, ownership of many corporate premises may be routed through REITs.

I-REITs can also be catalyst for the development of rental housing schemes in India which are needed and not meaningfully present in India. At present, not many developers are willing to develop such schemes due to lack of sufficient capital. As a result, property prices in high density areas have become unaffordable offering very low yield and have become easy avenue to attract unaccounted funds. I-REITs may provide incentives to develop well planned rental housing schemes and may enable the residential properties to offer meaningful yields and make prices of residential properties predictable over the long term. Finally upon the success of I-REITs, specialised (with underlying assets like hospitals, ware houses, Industrial units etc) REITs may flourish and offer the aforementioned benefits.

REITs and Credit Rating Agencies

Performance of I-REITs by virtue of being managed by professionals with mandate to maximise the returns will be differentiated by strategies adopted by these managers. I-REITs may perform well by attracting long term capital with very low intermittent financial and transaction cost, by channelizing retained earnings (likely to be significant for bigger I-REITs) with expertise in high quality assets, efficiently traversing through the business cycles and interest rate cycle (as a high yield investments I-REITs will be more sensitive to interest rates) by buying assets during troughs and selling during peaks. Finally I-REITs can also leverage and magnify the returns for its investors. To ensure that the investors are not exposed to risks associated with leverage, SEBI has proposed to cap the maximum leverage to 50% of value of REIT assets and mandatory credit rating in case the aggregated consolidated borrowings and deferred payments exceeds 25% of value of REIT assets. Though, mandatory credit rating beyond threshold limit would enable credit rating agencies to assess the credit risk and differentiate risks for REITs on a wider scale. Finally, credit ratings agencies can benchmark the performance of I-REITs as is done for various mutual funds.

Outlook

REITs is a new offering in the Indian capital markets. The product in India needs to be properly regulated with easy recourse to investors. Though, SEBI has taken care in its draft REITs regulations to ensure watertight regulations and necessitated high entry barrier for initial years to maintain transparency, accountability and attract serious sponsors. Any miss-governance and inadequate recourse to investors may erode the faith of investors for a long time. Notwithstanding the challenges the benefits likely to be offered by I-REITs are significant. The product with proper backing by policy makers may flourish and over the period upon successful development may offer competition to international REITs market (no restriction on location of property).

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