Real Estate Investment Trusts

Contact:

Madan Sabnavis
Chief Economist
madan.sabnavis@careratings.com
91-22-67543489

Ashish K Nainan
Research Analyst
ashish.nainan@careratings.com
91-22-67543443

Mradul Mishra (Media Contact)
mradul.mishra@careratings.com
91-22-67543515

Overview

India is one of the more recent entrants in the Real Estate investment Trust (REIT) regime. The Securities and Exchange Board of India (SEBI) notified REIT regulations in September 2014. Owing to ambiguity in various legislations and procedural and operational bottlenecks, SEBI in November 2016 through its Official Gazette notified the SEBI (Real Estate Investment Trusts) (Amendment) Regulations, 2016, making various amendments to the previous regulation after due consultation with the industry and market experts.

With balance sheets of major realtors under heavy stress involving high debt and residential real estate undergoing a prolonged demand slump, realtors could avail the benefit of listing their commercial office spaces and meet requirements for capital. Another major reason why REITs are being considered as a potential game changer for the sector is their ability to attract foreign funds into the cash-starved sector. This is further aided by fact that, the Government and Finance Ministry has been constantly making necessary amendments in various policies pertaining to FDI and related taxation policies particularly in the real estate sector.

The popularity of REITs lies in the fact that they are seen as tax-efficient, liquid and transparent transaction mediums in an otherwise opaque sector globally. The REIT Regulations in India would gradually evolve as assets get listed.

Though it is early to say if REITs would be successful, and its ability to replace the traditional real estate market for investors. But its degree of success or failure could well be a point of inflection for the growth of real estate developers in the country and a major driver for foreign fund inflows into the real estate sector in the times to come.

Overview

Real Estate Investment Trusts (REITs) are investment instruments for real estate which are comparable to a mutual fund. REITs allow anyone to invest in portfolios of large-scale properties the same way they invest in other industries – through the purchase of stock. In the same way shareholders benefit by owning stocks in other corporations - the unit holders of a REIT earn a share of the income produced through real estate investment – without actually having to buy or finance property. REITs own underlying assets in the form of commercial properties such as office spaces, hospitals, warehouses, hotels and special economic zones, convention centers etc.

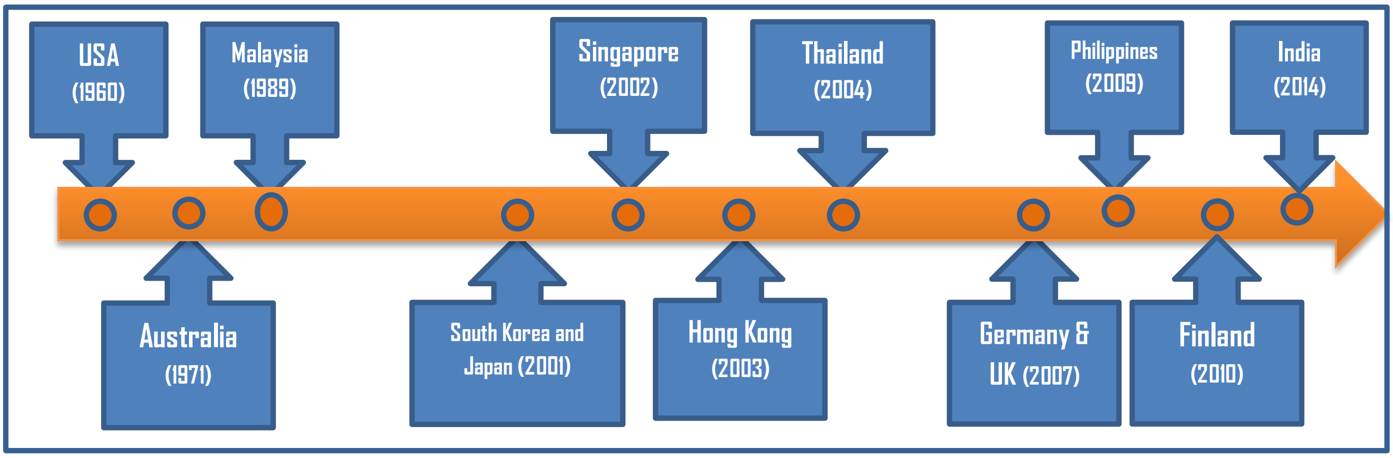
For investors, REITs are an interesting investment avenue as REITs are required by law to maintain high dividend payout ratios of (90%), making them a favorite for income-seeking investors. REITs can deduct these dividends and avoid most or all tax liabilities, though investors still pay tax on the payouts they receive.

Types of REITs (Global)		
Equity REIT	**Mortgage REIT**	**Hybrid REIT**
Equity REITs are the most common type of REIT and purchase, own and manage income-producing real estate properties. Equity REITs may be beneficial for long-term investors because, in addition to potentially earning dividends from rental income, investors also receive any capital gains from the sale of properties.	Mortgage REITs lend money directly to real estate owners and their operators, or indirectly through acquisition of loans or mortgage-backed securities. They do not invest in properties, but generate revenue through the interest paid on their mortgage loans.	Hybrid REITs are a combination of equity and mortgage REITs. The REIT portfolio consists of both income producing real estate properties as well as money directly lent to owners and their operators. They offer better risk adjusted returns.

Global perspective

Globally, REITs have been in existence since 1960 with its introduction in the United States of America. REITs have offered all kinds of investors an alternative investment instrument with exposure solely in real estate which are income producing in nature. As an investor centric action, regulators have made it mandatory for the REITs to distribute 90% and above income generated from these assets.

There are over 400 REITs listed in over 12 countries with market capitalization of over $ 1.5 trillion in 2016 (as per private sources). Two of the fastest-growing markets apart from the U.S. have been Australia and Japan, which have overtaken developed markets like France and UK. Though the US accounts for almost 2/3rd market capitalization for REIT globally, early adopters like Australia, New Zealand and the Netherlands have also grown significantly. Apart from the five countries mentioned above, other developed markets for REIT are Canada, Germany, Hong Kong and Singapore.



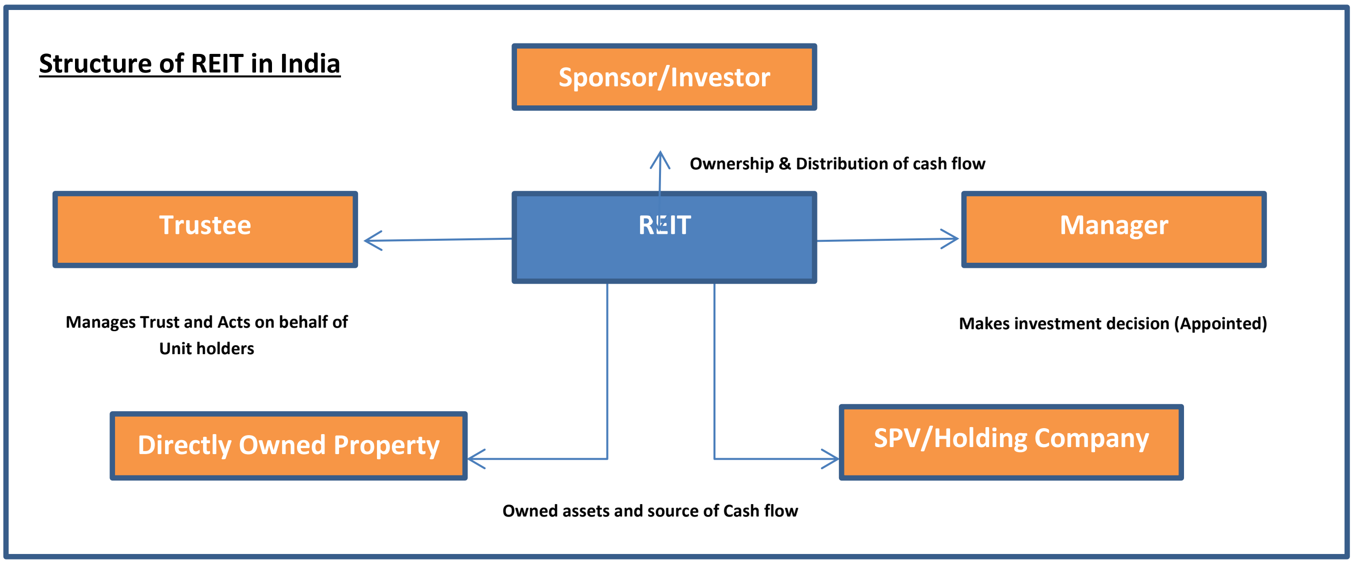
Indian story

India is still in its nascent stage of REIT implementation and is yet to see any listing owing to regulatory, legislative and taxation related issues. The size of REIT list-able A-Grade commercial real estate property is around Rs. 2.75-3 lkh crore in the Indian markets. If one were to look at factors like country risk, ease of doing business and transparency in the sector, Regulators and Government of India have been consistently trying to make them favorable for the investor community.

- For greater transparency in the sector, the Government through legislation passed the Real Estate Regulation and Development Act 2016 (RERA), which puts accountability on the developers in terms of financial disclosure, timely development of projects and maintaining good corporate governance practices.
- When it comes to ease of doing business especially for foreign investors, there have been a number of foreign investor centric measures as given below which were notified in November 2015:

Proposed changes in the FDI policy	Existing Policy
Foreign Direct Investment	100% under automatic route.
Removal of minimum land development stipulation	Minimum floor area was earlier at 20,000 sq. meters for construction development.
Removal of minimum capitalization requirement	Minimum capitalization of USD 5 million to be brought in within 6months of the commencement of project.
a)Easing lock-in restrictions where investor can exit (i) after 3 years from the date of each tranche of foreign investment or (ii) on the completion of the project/development of trunk infrastructure.	Permitted to exit only in case of (i) development of truck infrastructure or (ii) completion of the project.
No lock-in on transfer of stake by a non-resident investor to another non-resident investor without the repatriation of investment.	FIPB approval required before transfer or any similar transaction.
In case of multiple phases of project, each phase to be considered as a separate project.	No clarification.

One major factor which could hamper the REIT specifically to Indian markets would be the relative return compared with the competing avenues of investment. REITs rental yield could be in the region of 6-8% on a nominal basis which needs to be compared with returns on equity, debt, bank deposits, GSecs etc. depending on the risk profile of the potential investor. The possibility of a capital gain would also have to be considered depending on how the market moves which will vary depending on the state of the market, property prices and rentals etc. The Government may need to initially provide better tax-incentives for the investors so that the markets could develop.



Advantages of investing in REITs:

- **Income/Dividends:** 90% of distributable cash once or twice in a year
- **Transparency and accountability:** REITs will have to disclose the full valuation on a yearly basis and half-yearly basis while they operate under the same rules as other public companies for securities regulatory and financial reporting purposes.
- **Diversification in realty portfolio:** As per guidelines, REITs will have to invest in a minimum of two projects with 60% asset value in a single project. This makes the portfolio fairly diversified looking at the nature of underlying asset, i.e. real estate.
- **Lower risk:** At least 80% of the capital will have to be invested into revenue-generating and completed projects. The remaining 20% could include properties like under construction projects, equity shares of the listed properties, mortgage-based securities, Government securities, money market instruments, cash equivalents and real estate related activities. With 80% of the assets being revenue generating, the value of these assets as well as the revenue would continue to appreciate depending on the demand-supply scenario and the quality of the real estate space.

<u>Making REIT a Reality: Government's Policy initiative</u>

Real Estate Investment Trust Regulations notified in September 2014 are yet to see a listed REIT on the Indian bourses owing to legislative and taxation hurdles for these trusts. After public consultation and stakeholder deliberations, the Securities and Exchange Board of India (SEBI) on 30th November, 2016 issued the SEBI (Real Estate Investment Trusts) (Amendment) Regulations, 2016 amending the SEBI (Real Estate Investment Trusts) Regulations, 2014 (REIT Regulations). The REIT Regulations post amendments which would be applicable on REIT listings are given in a brief below:

<table>
<tr><th>Regulatory requirement for REIT</th><th colspan="3">Details</th></tr>
<tr><td>Minimum Holding of Sponsors</td><td colspan="3">Minimum of 25% of the total units on a post issue basis, with each sponsor holding of 5% of the outstanding units of the listed REITs at all times.</td></tr>
<tr><td>Minimum value of assets owned by REIT</td><td colspan="3">Not less than Rs. 500 crores</td></tr>
<tr><td>Asset Holding Structure</td><td colspan="3">Concept of holding company allowed with two-level entity structure, and limited liability partnerships included in holding companies.</td></tr>
<tr><td rowspan="2">Minimum Unit holder Requirements</td><td>Issue Capital< Rs. 1600 cr. minimum of 25% or Rs. 250 crore, whichever is higher.</td><td>Issue capital between Rs. 1600-4000 cr, minimum Rs. 400 crore.</td><td>Issue capital > Rs. 4000 cr, minimum 10%.</td></tr>
<tr><td colspan="3">Public float shall be increased to a minimum of 25% within a period of three years from the date of listing.</td></tr>
<tr><td>Listing requirement</td><td colspan="3">To be mandatorily listed on major exchanges.</td></tr>
<tr><td>Minimum Subscription Percentage Requirements</td><td colspan="3">90% of the issue has to be subscribed.</td></tr>
<tr><td>Minimum Dividend Distribution requirement</td><td colspan="3">100% from SPV cash flows, 90% of all other cash flows</td></tr>
<tr><td>Maximum sponsors in the REIT</td><td colspan="3">No limit on maximum number of Sponsors of an REIT.</td></tr>
<tr><td>Investment conditions</td><td colspan="3">Definition of "real estate" and property widened to- hotels, hospitals and conventional centers, industrial parks and SEZ, and commercial office spaces as already included; and removal of investment sub-limit of 10% from under-construction properties and completed and not- rent generating properties.</td></tr>
</table>

Apart from the regulations and amendments discussed above, SEBI has made few operational and procedural changes in the REIT regulations. This includes powers granted to the regulator (SEBI) to relax on a case to case basis, the enforcement of certain regulations in the interest of the investors or for the development of the securities market. At the same time, the regulator would be wary of deviating from the broader regulation/guidelines and causing any kind of loss to the investors. Also, with the latest amendments, even insurance companies have been allowed to invest into REITs.

<u>REIT in 2017- Outlook and expectations</u>:

- With the latest amendments and the policy initiatives ushered in by the Regulator and the Government respectively, the onus would lie with the industry to come forward and participate by listing assets under REIT.
- Though the industry had cited the lack of legislative and taxation support as the reason for staying away from listing REITs, the latest amendments seem to have given enough head room to accommodate every participant without hampering the core characteristics of REIT.
- Exemption from paying dividend distribution tax for special purpose vehicles was announced during the Union Budget 2016, which was another major hiccup for the trusts in the implementation of REIT. But exempting the REITs alone would not be enough. Long term investors much like equity investors should be encouraged by giving tax exemption to remain invested. This would help in developing REIT as an investment class and create a larger pool of investors.
- Around 5-8 international real estate portfolio managers and private equity funds who have been acquiring commercial/office real estate properties in the country for the past few years, are in the process of filing documents with the SEBI for listing of their assets under REIT. The country could expect to see its first REIT to be listed by the end of 2017 or early 2018.
- ***With the net asset size of A-grade offices pegged at Rs. 3.6 lac crore and the same growing with the increasing demand due to rapid industrialization across tier-II cities, one could expect at least 25% of these office spaces to be listed in the next 3-4 years*** in order to fund the addition of new office spaces as well as providing exit for portfolio managers from their existing investments. This could well mean, ***REIT to the tune of up to Rs. 1 lac crore being listed by 2020.***
- Also, few developers who have been exclusively into Commercial office space development would look to move to other segments like affordable housing due to good policy support for development of the same from the government and the high demand for affordable housing in most markets. This could mean they would either look to sell some of their commercial space to foreign investors or simply list their spaces under REIT to raise funds which could see.

Particulars	Current Regulation		Possible Regulatory Relaxation	
Type of investment	Rent yielding Real Estate including retail spaces, hotels, hospitals and warehouses.	Debt, mortgage and under-construction properties.	Rent Yielding Real Estate including retail spaces and warehouses.	Debt, Mortgage and under-construction properties.
Yield/Returns	6-8%	12-14%*	6-8%	12-14%*
Permissible investment limit	Min 80%	Max 20%	Min 60%	Max 40%
Blended returns	8-8.5%		9.5-10.5%	

*Based on Cost of borrowing incurred by major realtors in the country.

To conclude, Real Estate Investment Trusts as an investment avenue have been much awaited in the Indian market and it's only a matter of time before asset listings takes off. Even though the Amendment brought in by the regulator is intended towards encouraging the industry, much more is expected with respect to relaxation of investing in various real estate asset classes by the trusts so that it could benefit both the REITs to help churn out better risk-adjusted returns and the investors find the returns comparable to other investment classes.

CORPORATE OFFICE:
CREDIT ANALYSIS & RESEARCH LIMITED
Corporate Office: 4th Floor, Godrej Coliseum, Somaiya Hospital Road,
Off Eastern Express Highway, Sion (East), Mumbai - 400 022.
Tel: +91-22-6754 3456 I Fax: +91-22-6754 3457
E-mail: care@careratings.com I Website: www.careratings.com

Follow us on /company/CARE Ratings
/company/CARE Ratings