Importance of REIT and InvIT in India

Current Scenario in the Real Estate and Infrastructure Sectors in India

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The dynamics of Indian demographics is evolving very fast with a rapid shift towards urbanization. According to industry chamber CII and realty consultant Jones Lang LaSalle, more than 300 million people are expected to get added to the working age population by 2050, and an estimated 843 million people are expected to populate Indian cities by 2050, almost the combined population of the USA, Brazil, Russia, Japan and Germany. This will lead to a growing demand for real estate, which continues to be higher than the supply. The capital intensive real estate sector is in need of adequate and structured financing options. According to a report by FICCI and EY, Indian real estate market needs approximately US$42 billion of investments (excluding economically weaker section housing) by 2015. However, in the current scenario, the real estate developers don't have sufficient avenues to liquidate their holdings and so, free up capital for new projects. Moreover, over-dependence on the term loans from banks and the rising costs of capital are crippling the real estate sector in India.

The need to improve India's weakness in the infrastructure sector is also pressing with the rapid urbanization and burgeoning middle class. Though following the economic reforms in the 1990s, there has been a steady growth in private investment in the infrastructure sector, yet the success of these reforms has been mixed with private participation falling short of expectations. Infrastructure project delays have become bottlenecks to India's GDP growth, which is getting exacerbated by the official redtape, corruption and lower returns on the public-private partnerships. As part of the 12th five year plan, the Government of India had a target of US$1 trillion investment in infrastructure by 2017, with half of it expected to come from the private sector. However, the critical question is how to finance the trillion-dollar infrastructure bill. With India having one of the highest interest rate regimes among the BRICS (Brazil, Russia, India, China and South Africa), the infrastructure sector is also in dire need of alternate modes of financing. Indian infrastructure sector has suffered through the state-centric approach and its inefficiencies. As per the World Economic Forum's Global Competitiveness Report 2013, India ranked 85 out of 148 surveyed countries for its infrastructure. India' two biggest metros, Delhi and Mumbai rank much below its regional peer capitals such as Beijing and Bangkok in terms of urban infrastructure. The chronic power shortage, less than satisfactory standards of the national and state highways, and the inefficient port and aviation sectors have impaired the economic growth of India, which is in sharp contrast to the al-round growth achieved by its regional rival China. The optimistic infrastructure investment plan of US$1 trillion during 2012-17 would require a shift from the traditional bank financing mode to inclusive public financing.

In order to increase investor interest in these sectors to facilitate the necessary growth and capital inflow, the market regulator Securities and Exchange Board of India ("SEBI"), along with the Government of India, is in discussions with industry participants including counsels and investment bankers to proceed towards introducing a Real Estate Investment Trust ("REIT") and Infrastructure Investment Trust ("InvIT") structure in India.

Real Estate Investment Trust

REIT is an investment vehicle that invests, and in most cases operates income-producing real estate. A REIT is similar to a mutual fund in the way it collects money from the retail or institutional investors in return for shares in the property and its managers then deploy the funds into real estate projects. The income – which is usually the rent or lease from the commercial properties - is then distributed as dividend among the investors. Primary difference between a REIT and a mutual fund is that a REIT directly buys properties instead of investing in property stock. REITs provide all types of investors an opportunity to invest in income-producing real estate such as offices, retail or hotels. Key features of a REIT are

(a) It largely owns completed (usually 75%+) real estate projects and earns rental income, dividend yield or interest income from these assets
(b) It is required by the regulation to distribute as dividend a significant (usually 90%) portion of its distributable cash flows to the unit holders
(c) It receives tax exemption / tax relief

Since introduction in the USA in 1960, all major economies across the world have encouraged the development of REIT markets by formulating conducive regulations including tax exemptions. REITs have offered investors an alternative instrument for investment in real estate by holding units in income producing assets. As per the European Public Real Estate Association Global REIT

Survey 2013, the total global REIT market capitalization is close to US$1.1 trillion, account for more than 50% of the total market capitalization of listed real estate companies in most of the markets.

Singapore Property Trust Market – An Example

Singapore is the largest and the most recognized market in Asia ex-Japan to list a property trust. As of May 2014, there are 37 property trusts - 31 REITs and 6 Business Trusts ("BTs") listed on Singapore Exchange with a total equity market capitalization of approximately US$48 billion. Singapore Trust market provides platform to the issuers with assets across Asia-Pacific. Market consists of large and well-covered peer universe across asset classes with established property trust investor base such as real estate focused investors (APG, Cohen & Steers, AEW), insurance companies/pension funds (NTUC) and other institutional investors (Fidelity, Capital Group, European Investors). Singapore Exchange listing regulations ensure a well-accepted model separating economic ownership and control – sponsors retain control with relatively low ownership of the property trust. Regulations also provide certain tax exemptions (for Singapore assets) to make the listing lucrative. Structuring alternatives such as REITs and BTs allow issuers to tailor the vehicle according to its funding requirements and portfolio mix. Couple of Indian asset based BTs such as Ascendas India Trust and Religare Health Trust are also listed in Singapore, thereby diversifying its investor base.

Drivers Pushing Acceptance of REITs in India

Success stories of REITs in the global markets and the growing need for additional sources of funds in the Indian real estate industry are reasons, compelling enough to introduce REITs in India with requisite adjustments, keeping in perspective the unique dynamics of the Indian economy.

1) Indian investors have always been enthusiastic about real estate sector. REITs will provide investors an alternative to direct real estate investment with increased flexibility to invest in highvalue institutional quality real estate assets.
2) REITs are long term buy-and-hold investments, hence, acting as a stabilizing factor in an otherwise volatile real estate market. It provides capital growth and income stability to investors as income is underpinned by legally enforceable lease agreements, significant portion of net income is distributed and there is minimal to no development risk to investors.
3) Low transaction costs in buying/selling REIT units vs. trading underlying assets: Individuals would be able to "redeem" small investments quickly by selling the units in the open market, incurring little cost. REITs allow institutional funds to make incremental investments in lumpy real estate as and when new investment funds are received. Income-generating investment grade property is a "safe haven" during uncertain times.
4) Increased GDP contribution: Increased capital flowing into the real estate sector through REITs can be expected to produce increased real estate development activities. This increase in activity has "flow on" benefits for the construction industry and related services.
5) Inflation indexed investment opportunity: Periodic rent revision as per contractual agreement and inflation linked maintenance charges ensure that income from assets of the REIT are inflation adjusted.
6) Lastly and importantly, REIT provides transparency of structures and a high level of corporate governance, which currently seems lacking in the real estate sector in India.

A REIT structure will provide various advantages to the issuers and developers of real estate:

a) Firstly, it will segregate risk profiles as the separation of an integrated property company into a REIT and a property development/management company would lower market discount applied to the assets, thereby increasing valuation and liquidity. Driven by the certainty of future cash flows, REITs typically trade at a tighter discount on a standalone basis than the same portfolios retained on the balance sheet of the respective companies, thereby creating value for both the issuer and the investors.
b) Secondly, the asset-light business structure increases the return on assets as developers can monetize an investment portfolio while retaining a deconsolidated investment in the REIT and full control over the manager.
c) Thirdly, it provides access to cost effective third party equity and a favorable "mark to market" equity analysis valuation on the retained investment in the REIT. It will act as an alternative capital source – a substitute to traditional banking finance, thereby helping to avoid property related loans becoming a disproportionately large component of banks' lending portfolios. This freed up capital from the banks' loan books can be used in other sectors.
d) Fourthly, it will provide a source of funds for capital recycle as REITs can act as a ready buyer of future development assets, allowing a property developer to re-cycle its development capital without the loss of control over the asset.

Current Status of REIT in India

There are several challenges to overcome before the successful implementation of REITs in India. Firstly title certification in India is an ambiguous and cumbersome process, and this complexity discourages many potential foreign and domestic investors from buying into income-yielding properties. Secondly, the real estate valuation in India is largely unregulated and lacks a standard code of practice or ethics. And most

importantly, the government will have to provide tax benefits to the REIT structure to incentivize the developers and investors alike.

The market regulator, SEBI is still in the process of formulating legislations for REITs in the Indian real estate market. It had first proposed a REIT framework in 2008, which was withdrawn later to make way for Real Estate Mutual Funds ("REMFs"), which eventually couldn't get materialized either. Last year, with a clear intention to deliver REIT framework, SEBI published its draft REIT regulations in October, which proposed, among other regulations, an initial offer size of at least INR 2,500 million and a public float of at least 25 per cent with a subscription ticket size of at least INR 200,000. SEBI was expected to issue final guidelines in December 2013. However, the decision seems to have been deferred due to tax-related hurdles. SEBI and the Finance Ministry are in dialogue with the Income Tax Department to deliberate on giving REIT the status of a "pass-through vehicle", as the current Income Tax Act is silent on the tax treatment of income earned by a REIT or its investors. In the current structure, income from real estate flowing to the REITs through the special purpose vehicles ("SPV") will incur corporate tax, along with tax at distribution level on dividends, capital gains or interest gains in the hand of investors, totaling to more than 40%. The primary aim of the SEBI's proposal to the Income Tax Department, and as promulgated by various industry participants is to limit this multifarious tax leakage.

Infrastructure Investment Trust in India

InvIT (similar to infrastructure business trusts) is an investment vehicle that invests in operational revenue generating infrastructure projects. Such trusts would collect money from the retail or institutional investors in return for units in the trust and then deploy the funds for acquisition of completed infrastructure projects. The income, which is usually realized through long term contracts, is then distributed as dividend among the investors. Key features of an infrastructure trust globally are:

(a) It largely owns completed infrastructure assets with long term stable contracted cash flows
(b) It is required by regulation to distribute as dividend a significant (usually 90%) of its distributable cash flows to the unit holders
(c) It has a clear acquisition mandate for expansion with a "Right to First Refusal" over the future assets of the initial seller company
(d) It receives tax exemption/tax relief

In December 2013, SEBI issued a consultation paper for a separate investment vehicle, InvIT. The objective of promoting InvITs in the infrastructure sector in India is similar to the objective of REIT regulations in the real estate sector i.e. to channelize public investments in the crippling infrastructure sector to meet the capital requirements. Under the draft norms, an InvIT would be set up as a Trust under the provision of the Indian Trusts Act, 1882.

Key features of the currently envisaged InvIT structure would be:

(a) InvIT shall invest in infrastructure projects belonging to only one sector/subsector; this condition may be relaxed in future as the market develops.
(b) Investment assets would be 1 year post commissioning revenue generating projects, with a minimum of 4 projects.
(c) InvIT shall have a maximum public shareholding of 76 percent and a minimum of 25 percent
(d) Size of the projects under the InvIT shall not be less than INR 10 billion. The size may be relaxed in future as the market develops.
(e) To ensure regular income to the investors, the InvITs shall distribute at least 90 percent of the net distributable income after tax to its investors.
(f) InvIT may raise funds from any investor with subscription amount by each investor being not less than INR 1 million.

InvITs are also proposed to raise further funds through follow-on offers, rights issues, bonus issues, preferential allotments or any other route as prescribed by SEBI. Public comments on the consultation paper were invited till 20 January 2014. Based on the comments and suggestions received, the regulator, under the guidance of the new government, is expected to come out with further guidelines on the implementation of InvITs soon.

Tax Benefits Required to Facilitate Trusts Markets in India

For the envisaged REIT and InvIT structures to be successful and attractive to investors, certain exemptions from the current tax laws are critical. Firstly, an exemption on the capital gains tax on upfront restructuring is required with tax to be applicable only at the sale of ownership of the trust. This should be in addition to the tax exemption on the long-term capital gains on sale of units of the trust (at par with the listed equity shares). Secondly, distributions by SPVs, which would be majority controlled by the trust are sought to be exempt from dividend/any other distribution tax. Thirdly, trusts would need to be exempt from corporate taxes while the income received by unit holders of a trust are also sought to be exempt from income-tax. Another important exemption would be to provide flexibility to the SPVs to distribute cash beyond the maximum permissible limits under the Companies Act to the extent of depreciation or standard deduction applicable for income from house property as applicable.