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Real Estate Investment Trust (REIT) regime in India

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The REIT regime

On 26 September 2014, the Securities and Exchange Board of India (SEBI) notified the Real Estate Investment Trusts (REITs) regulations, thereby paving the way for introduction of an internationally acclaimed investment structure in India. The Finance Minister has also made necessary amendments to the Indian taxation regime to provide the tax pass through status, which is one of the key requirements for feasibility of REITs.

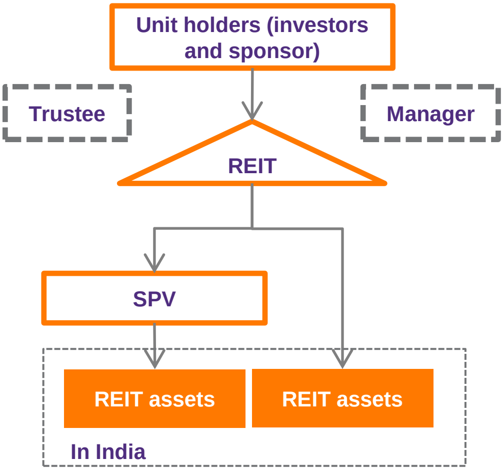
REITs have been in existence in developed economies since several years and provide a stable investment alternative for retail investors, as well as the real estate sector. Taking cue from developed economies, the Indian REIT regime echoes the internationally followed concepts, methods and principles.

The India REIT regime is aimed at providing:

- an organised market for retail investors to invest and be part of the Indian real estate growth story
- a professionally managed ecosystem that is risk averse and is aimed at protecting the interest of public
- an exit platform for the real estate sector to ease out liquidity burden

This document highlights some of the key aspects of the Indian REIT regime.

Typical structure of a REIT



Commercials aspects

- REITs offer a natural experiment in corporate governance due to the fact that they leave little free cash flow for management, which reduces the level of supervision required from the market watchdogs

Commercial aspects (continued)

- transparency is an important element in the REIT story, which can be analysed in two different ways:
  - REITs provide **tax transparency**. This means that the REIT does not pay any corporate tax in exchange for paying out strong, consistent dividends. Rather, taxes are paid by the individual shareholder only
  - Further, considering that the listed REITs will be registered and regulated by the SEBI and adhere to highest standards of corporate governance, financial reporting and information disclosure, the REITs will provide **operational transparency**

- increasingly, shareholders are scrutinising the corporate governance practices of publicly traded companies. Good corporate governance is reflected in higher valuations; companies that have high governance ratings are also those that tend to have higher valuations in the marketplace as well as stronger total returns

Commercial aspects (continued)

Listed REITs are regularly lauded by independent agencies and investment analysts for their strong corporate governance practices. REITs typically receive high marks in important areas such as executive compensation structures, the composition of board of directors and shareholders' voting rights

- while REITs has been recently introduced in India, there are other economies which have successfully implemented REITs. For many years, investors considered real estate the ultimate immovable, illiquid asset. However, the liquidity of Equity REITs listed on major stock exchanges makes real estate investing fast, easy and efficient. Listed Equity REITs also provide market transparency for investors, with real-time pricing and valuations. As with other stocks, investors can get in and out of their investments to optimise their exposure to real estate

Commercial aspects (continued)

- listed Equity REITs in the U.S. are also registered and regulated by the SEC, ensuring adherence to SEC standards of corporate governance, financial reporting and information disclosure. The resilience of listed Equity REITs in recovering from sharp declines in values during the 2008–2009 global financial market crisis also is noteworthy
- from the beginning of the equity market recovery in March 2009 through 2013, listed U.S. Equity REITs delivered an average annual total return of 28.3%, compared to 23.6% for the S&P 500 Index. However, in a recent study of the Singapore REITs (S-REITs), it is observed that there is no positive correlation with operating performance proxied by accounting measures. S-REITs, with higher corporate governance, tend to register better risk-adjusted returns but do not outperform operationally. To test for market efficiency, the study also observed that the S-REITs with the best corporate governance practices also have less information asymmetry

Indian framework

Legal form

- REIT shall be a Trust set up under the Indian Trust Act, 1882 and it must be registered under the SEBI (Real Estate Investment Trusts), Regulations 2014
- REITs to raise funds through an initial offer and subsequently through follow-on offer, rights issue, qualified institutional placement, etc
- minimum asset size, to be proposed by REITs, is prescribed as Rs 500 crore and the minimum offer size for initial offer is prescribed as Rs 250 crore
- minimum 200 subscribers required to form a REIT (excluding related parties)
- REIT units are mandatorily required to be listed on recognised stock exchanges in India. Besides, they need to be in dematerialised form
- minimum public share in initial offer should not be less than 25% of the number of units of the REIT on post-issue basis

Indian framework (continued)

- mandatory distribution of at least 90% of the net distributable cash flows to be to investors on a half-yearly basis
- mandatory distribution of at least 90% of the sale proceeds from sale of assets to unit holders, unless reinvested in another property
- onerous duties and responsibilities casted on Trustee and Manager to ensure strict adherence to the REIT regulations
- mandatory requirement for a full-fledged valuation of all REIT assets on a yearly basis through a registered valuer. Semi-annual updation made mandatory
- declaration of Net Asset Value ("NAV") within 15 days from the date of valuation/ updation of valuation of assets
- any acquisition/ transfer of REIT Assets to meet prescribed valuation guidelines

Indian framework (continued)

REIT Assets / Investments

- all assets to be situated in India
- REIT Assets to include:
  - land and any permanently attached improvements to it (whether leasehold or freehold) including buildings, sheds, garages, fences, fittings, fixtures, warehouses, car parks, etc
  - Transferable Development Rights (TDRs)
  - any other assets incidental to the ownership of real estate
- assets **Not** forming a part of REITs
  - hospitals
  - hotels, with project cost of more than Rs 200 crore each in any place in India and of any star rating. 3-star or higher category classified hotels located outside cities with population of more than 1 million
  - common infrastructure for industrial parks, Special Economic Zones (SEZs), tourism facilities and agriculture markets

Indian framework (continued)

  - convention centres, with project cost of more than Rs 300 crore each
  - agricultural land or vacant land
  - units of another REIT
- mortgages not eligible to be REIT Assets
- at least 80% of value of the REIT Assets to be invested in completed and rent generating properties. Specific conditions prescribed for investing the balance funds in other assets
- REIT shall invest in at least two projects and investment in one project should not exceed 60% of the value of assets owned by REIT
- REIT Assets could be held directly by the REIT or via Special Purpose Vehicles (SPVs)
- REIT to hold not less than 50% equity and controlling interest in SPVs
- SPV to hold 80% equity in REIT Assets
- multi-layer SPV structure may not be permitted and multiple scheme under REIT is not permitted

Key takeaways - Unit holder

- can be any person excluding the Trustee, Principle Valuer or another REIT
- foreign investors are also permitted to invest in a REIT, subject to permissions from the Reserve Bank of India (RBI) and Government of India
- minimum unit size and trading lot size of REIT is Rs 1 lakh. However, the minimum subscription amount per investor (upon public offer) is Rs 2 lakh
- all unit holders to have equal voting rights

Key takeaways - Sponsor

- responsible for setting up the REIT. Person swapping their shares of SPV for units of REIT are also regarded as Sponsors
- REIT can have maximum three sponsors, each holding at least 5% of the units of the REIT, post-listing
- Net worth requirement - at least Rs 100 crore collectively for all sponsors, and individually each sponsor to have net worth of at least Rs 20 crore
- experience requirement - at least 5 years of experience in real estate industry (per sponsor)
- where sponsor is a developer, he must have at least two completed projects
- lock-in period
  - three years from the date of listing for 25% of the total units of the REIT
  - one year in the case of units exceeding 25%
  - collectively hold minimum 15% of the outstanding units of REIT, throughout the life of the REIT

Key takeaways - Trustee

- must be registered with SEBI
- should not be an associate of Sponsor/ Manager/ Principal Valuer. If the Trustee is an associate of REIT, at least 50% of the directors of the trustee should be independent
- responsible for holding REIT assets in the name of REIT and ensuring that the assets have proper legal and marketable titles

- appointing Manager of the REIT
- given a fiduciary responsibility of ensuring proper utlisation of subscription amount, ensuring that all material contracts entered into on behalf of REIT are legal, valid, binding and enforceable and overseeing activities of Manager and obtaining quarterly compliance certificates

Key takeaways - Manager

- responsible for day-to-day operations and management of the REIT
- net worth requirement – at least Rs 10 crore
- experience requirement – at least 5 years of fund management/ advisory services/ property management in the real estate industry or in development of real estate. Manager's team to consist of at least two employees, each having at least five years of experience
- responsible for the entire management of REIT assets, appointment of auditors, principal valuer, constitution of investment committee, declaration of dividends, etc
- change in Manager requires prior approval of a majority of contributors

Key takeaways - Principal valuer

- need to be a registered valuer as per Section 247 of the Companies Act, 2013
- should have experience of at least five years in valuation of real estate
- must be engaged to provide a valuation of assets for every purchase or sale of asset by REIT
- responsible for ensuring impartial, true and fair valuation of assets of REIT
- cannot accept valuation linked remuneration

Taxation regime

- specific taxation regime has been introduced to deal with income earned via REITs. This is summarised as follows:

Nature of income	Taxation for REIT	Taxation for unit holders/ sponsor
Interest from SPV	Exempt	Taxable as interest income Withholding tax to be deducted by REIT on distribution (Non-resident – 5%, Others – 10%)
Dividend	Exempt	Exempt
Capital gains earned by REITs on sale of share of SPV	At the rates applicable to capital gains	Exempt
Capital gains earned by unit holders on sale of REIT units	Not applicable	For unit holders (other than Sponsor) - long-term – exempt - short-term – 15%
Capital gains earned by Sponsor on sale of REIT units	Not applicable	For sponsors (for units acquired on account of swap of shares of SPV for REIT units) - long-term – 20% (if units are held for more than 36 months) - Short-term – 30%; (cost of SPV shares and period of holding of SPV shares to be considered)
Other income	Maximum marginal rate	Exempt

- for Sponsors, transfer of shares of SPV to a REIT in exchange of units is not considered a transfer. The tax payable is deferred to the date when the Sponsor sells the units of REIT

Singapore REITS (S-REIT) – a comparison

Singapore, as a jurisdiction has gained tremendous importance and significance in the REIT space, especially because of the following:

- provides a wider scope of investable assets
- has clear restriction on investing in underdevelopment properties
- allows investment in real estate assets situated outside Singapore as well
- allows investment by foreign players (without specific approval)
- stamp duty exemption provided for acquiring assets

S-REITs – Taxation

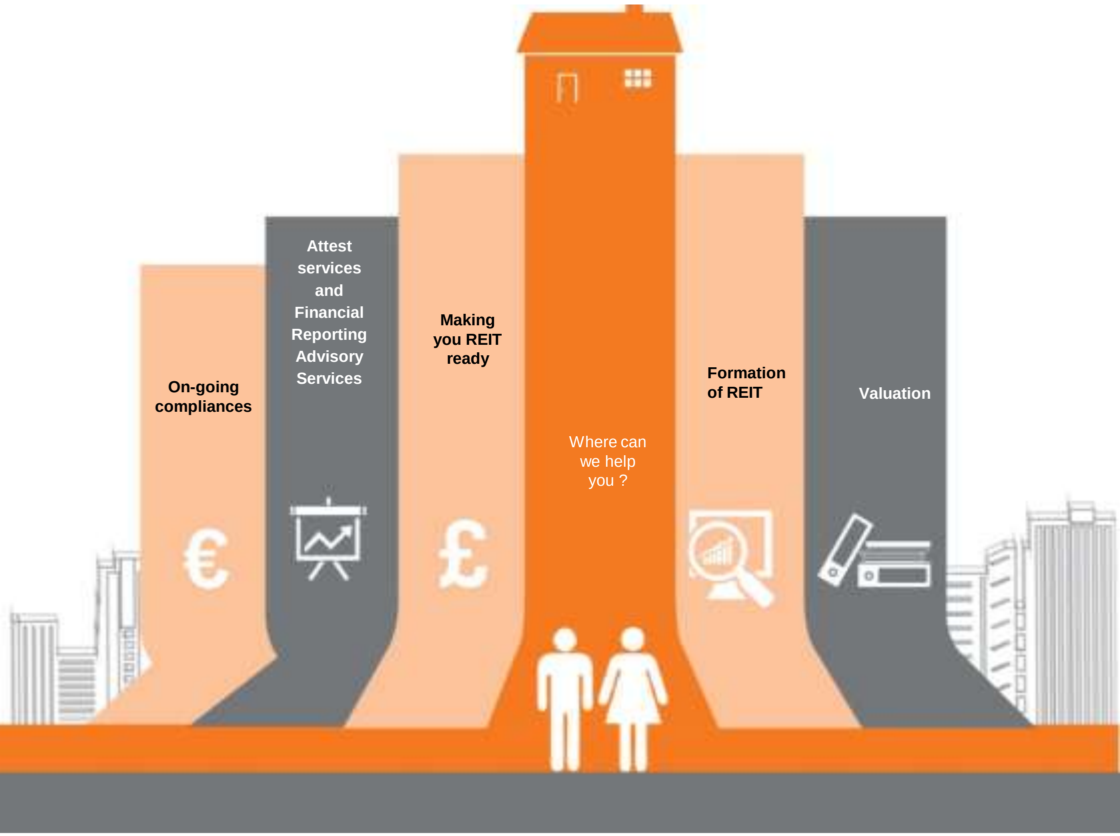
- any distributions made by S-REITs to foreign or local investors shall be exempt from tax, provided at least 90% of the taxable income is distributed
- S-REITs currently enjoy tax exemption on foreign income on fulfilling certain conditions till 31 March 2015
- individual investors are generally exempt from tax
- qualifying foreign corporate investors are taxed at 10%
- Singapore corporate investors are taxed at the prevailing corporate tax rate

In conclusion

In India, in the absence of a regulator for the real estate sector, introduction of REITs is a welcome move that will help bring in:

1. liquidity
2. transparency
3. better governance
4. organised platform for retail investment
5. an ecosystem, which is professionally managed and protects investors

Largely, the Indian REIT regime is at par with the international REIT format and seems to have what is needed to provide the right impetus to the Indian real estate sector.



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