Real Estate Investment Trusts (REITs) – An Innovative Approach to Real Estate Sector

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ABSTRACT

Indian real estate is undergoing through a phase of evolution in the process of its development. The Indian real estate sector is slowly moving from an unorganized sector to a more organized one. If India is to magnificently compete with other real estate markets, it has to take an innovative approach but at the same time not lose the sense of urgency. The new stimulus behind the development of REIT regime is a welcome positive step.

The Government of India gave priority to real estate sector because of its potential to boost economic growth significantly. In view of the crucial role that REITs could play as an investment vehicle, the SEBI came out with the draft of REITs regulations in December, 2007 in order to encourage and facilitate a healthy growth of REITs in India. However, these regulations could not be finalized for various reasons including the global economic slowdown. In a welcome move, SEBI once again taken out draft REITs Regulations, 2013, which were approved and announced by SEBI on 26th September, 2014.

Keywords: Real Estate Sector in India, REITs, SEBI Regulations

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Introduction

A REIT, or Real Estate Investment Trust, is a company which owns or finances income-producing real estate. REITs are *investment trusts* that work similar to mutual funds with the only big difference being that instead of using the money collected from investors to buy stocks and bonds. It's like a pooling vehicle through which capital is deployed to own real estate assets. REITs provide investors of all types regular incomes, diversification and capital appreciation in the long term. REITs usually pay out all of their taxable income as dividends to the shareholders. In turn, shareholders are supposed to pay the taxes on those dividends.

REITs allow investments in portfolios of large-scale properties as the investment is made in other industries by purchasing the stock. In the same way shareholders are benefited by owning stocks in other companies, the holders of a REIT can earn a share of the income created through real estate investment – without actually having to go out and buy or finance property.

Today, REITs are existing in almost all aspects of the economy, including apartments, hospitals, hotels, industrial facilities, infrastructure, nursing homes, offices, shopping malls, storage centers, student housing, and timberlands.

There are internationally three types of REITS. In India however, a beginning is made with the third type, the hybrid one.

Equity REITs: These REITs own and operate income-producing real estate and perform leasing, development, and construction activities.

Mortgage REITs: Such REITs hold mortgages on real property and make mortgages i.e. lend money usually on existing property or buy mortgages.

Hybrid REITs: Hybrid REITs syndicate both the investment strategies of owning properties and making loans. REITS in India will be primarily of the Hybrid type.

Sector-Specific Types of REITs

Housing REITs – Such REITs purchase, revamp, lease and manage housing properties located in the markets to generate rental income. They hold properties over the long term and generate virtually all revenue by leasing the properties. The income generated is used to pay for operational costs and distribute among shareholders as dividends.

Industrial REITs – Industrial REITs procure, own and manage industrial properties, such as warehouses, buildings, undeveloped land, business parks and high-tech space. The tenants of industrial REIT properties are wide ranging and cut across all kinds of businesses.

Hotel REITs – Hotel REITs own hotel, lodging or resort properties and could include different types of properties such as limited service, resorts, conferences center, suite and airport properties. Hotel REITs derive price from the underlying value of hotel properties the REIT owns and from the income generated by those properties.

There are also private, non-listed and public REITs. Majority of the REITs are dealt on the most recognized stock exchanges. Individual investors are allowed to invest in REITs either by purchasing their shares directly on an open exchange or by investing in a mutual fund that specializes in public real estate sector. An added privilege in investing in REITs is the fact that many are accompanied by dividend reinvestment plans (DRIPs). The utmost benefit will be that of quick and easy liquidation of investments in the real estate market unlike the traditional way of disposing of real estate.

An Innovative Approach to Real Estate – REIT

According to CREDAI (2013) The Indian economy witnessed annual average growth of 7.2% during 2000-2012, due to the rise in the interest of consumers, higher investment activity, and productivity gains. As per CEBR's World Economic League report, it is expected that India may become the World's third largest economy with a GDP of around $7 trillion by 2028, next to China and the US. Both the service and manufacturing sectors have also posted positive growth to meet the growing demand and increasing consumption level during the previous couple of years. Notably, the real estate sector was estimated to contribute 6.3% to India's GDP and provides employment opportunities to around 7.6 million during the year 2013.

In 2007–08, the Indian economy was impacted at large due to global economic crisis and the real estate sector in particular. The real estate industry in India faced the heat of the global crisis in terms of a demand slowdown and a severe liquidity crisis. In spite of the substantial impact of the global slowdown, the Indian real estate sector managed to develop without too much distress due to the sound fundamentals of the economy.

The real estate sector encourages the demand for more than 250 ancillary industries, including steel, cement, paint, and construction material, and the focus is at the construction industry. The sector is one of the key drivers of the Indian economy as it is considered as the second largest generator of employment opportunities next to agriculture.

The Real Estate Investment Trusts (REITs) were announced in the Union Budget 2014–15 to enable investors to collectively invest in commercial properties and earn a profit from such investments.

The draft consultation paper on Real Estate Investment Trust (REIT) Regulations, 2013 was announced by Securities & Exchange Board of India (SEBI) On October 10, 2013. However, in 2008, SEBI had issued certain draft regulations for introducing REITs. I-REITs (REITs in India) would issue securities, which will be listed on the 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 supposed to be available only to high net worth individuals and institutions to extend the market. Eventually, it will be opened to retail investors.

The demographic dynamics in India are changing fast, leading to an ever growing demand for quality real estate that continues to be higher than supply. REITs can help bring the needed investments for meeting this increasing demand.

Significant Reasons for Introducing REITs in India

1. *Rise in demand due to changing demographics and growing urbanization:* As per UN estimates, India has the highest rate of change of urban population among the BRIC nations. It is projected that 843 million people will reside in Indian cities by the year 2050, which is the

same if we combine the population of the Japan, Brazil, Russia, US and Germany.

More than 300 million persons are expected to be added to India's working age population by the year 2050. Needless to say, this will add to growing urbanization and the need for providing housing/ accommodation facilities for this section, which includes the increasing number of women in the work force as well.

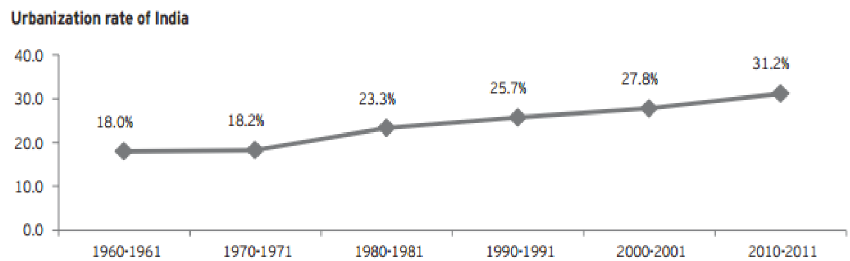


Figure 1: Urbanization Rate of India
Source: Census of India, 2011.

2. *REITs will bring transparency* – REITs will assist to streamline the real estate sector by creating a transparent mechanism for raising finance in the real estate market. REITs will have to be registered with SEBI in India which will have stringent regulation and monitoring by the regulator.

3. *Improvement in debt-equity proportion* – There will be an improvement in the debt-equity proportion in the real estate market with the introduction of REITs as it is the source of the pure equity capital. This will bring in the growth in more stable and mature real estate market.

4. *Medium for addressing non-performing assets (NPAs)* – REITs can be used as a medium to wipe out NPAs/sick or defunct companies holding large values of real estate mostly in the form of land. Disposal of such NPAs/companies to REIT's will have a dual effect—realization of true value for the real estate and ease in liquidating the sick company after removal of the high value of real estate from its books.

5. *A new avenue for investment* – REITs are suitable for those investors who wish to diversify their assets beyond gold and equity markets. REITs would be able expected to provide a safe and diversified investment option at the lower risk, all under professional management, which ensures the highest return on the investment. An investor can earn two types of income from REITs. One is through the capital gains when the units of REITs are sold on stock exchanges and the other is through dividend income.

Financing Real Estate Development in India

Channels of Financing Real Estate Development in India:

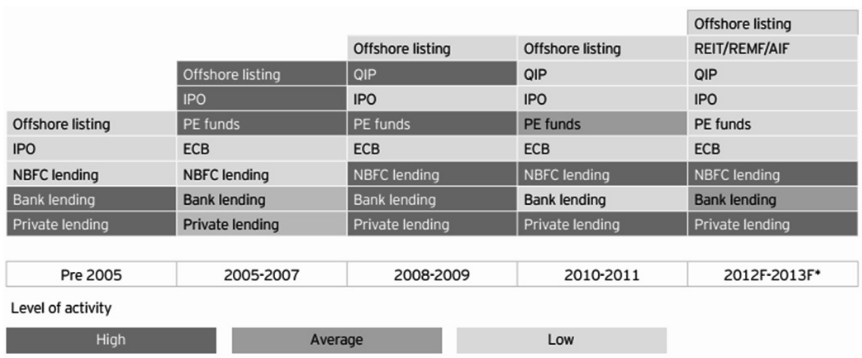


Figure 2: Channels of Financing Real Estate Development in India

Source: Real Estate Intelligence Service (Jones Lang LaSalle)

* F - Forecast.

From the above figure, we come to know that for the period pre 2005 bank lending and private lending were the major channels for real estate development in India. Consequently followed by offshore listing, IPO, PE funds for the period 2005-2007, QIP, PE funds, NBFC lending, bank lending and private lending were the major sources of finance for the development of real estate sector in India for the year 2008-2009. However, for the year 2010-2011 NBFC lending and private lending could prove to be the major contributors in Indian real estate sector. Eventually, in the year 2012F-2013F*, NBFC lending and private lending were expected to have major contribution in real estate development in India.

Literature Review

According to the Securities Exchange Commission (2008), "REITs principally invest in different kinds of real estate or real estate related assets, including shopping malls, office buildings, hotels, and secured mortgages by real estate". Bodie et al. (2008, pp. 97-99) currently define a REIT similar to a close-end fund. In other words, investors who "wish to cash out must sell their shares to other investors".

Real estate has traditionally been identified as one of the main asset classes for investment in portfolio planning (Geltner, Miller, Clayton & Eichholtz, 2007). Its status as an inflation hedge and consistent cash flow generator, plus its ability to diversify investors' portfolios due to their low correlation of returns with other asset classes, have made this particular asset category attractive to portfolio investors (Geltner et al., 2007). However, direct investments into the real estate market also usually entail large capital outlays, lengthy lead time to acquire and dispose of the properties as well as intensive involvement in property management activities (Imperiale, 2006; Sing & Ling, 2003).

On the overseas continent, the regulated form of real estate investment trust is not new. Originally, the essence of REITs was born back in the 1880s. The concept already consisted of tax-exempt in the case that beneficiaries received trusts income. REIT specificity resides in their legal status meaning that Real Estate Investment Trusts are not like traditional corporations but benefits from financial advantages. After the World War II, the US Congress judged necessary to encourage investments in real estate, to promote its interest and to aspire for reconstruction (Brueggman and Fisher, 2008, p. 621).

In some of the Asian countries such as China, India, Philippines, Indonesia, Pakistan and Middle East that has REITs-like structure. These countries have got draft REITs law and have planned to launch REITs in the future. However, due to the current economic environment and market structure, REITs do not exist for the moment. Thus, it is quite important for global investors to give some attention to real estate markets in these countries as well (Guannan YU, 2009).

Compared with REITs of United States and European countries, Asian REITs start relatively late. However, the Asian REITs market is growing and expanding rapidly. Most institutional investors increase allocation to Asian real estate as part of global portfolios. In the global REITs market's prospect, Asian REITs have learnt the pattern from the U.S. REITs; however, have their own unique regulations and structures. Furthermore, the probability of creating a portfolio with less risk under the same return by adding Asian REITs seems an attractive idea to global investors. After all, the topographical differences are likely to cause a small correlation between assets.

In the context of such scenario the need is felt to take the review of real estate sector in India, REITs and the potential for REITs development in India.

Challenges and Opportunities of Investment in REITs

The real estate industry is at the centre of construction industry which in turn encourages the demand for more than 250 ancillary industries, including steel, cement, paint, and construction material. It also provides the huge employment opportunities and it is considered as the key drivers of the Indian economy.

But, this industry has faced many ups and downs in the last few years such as increase in input costs, rising financing costs, inadequate funds, etc., are some of the serious concerns that are impeding the performance of the Indian real estate industry.

REITs will offer another opportunity to the investors. It will offer dividend which is comparatively higher than other investments. Thus, the investor can earn high annual dividends as well as there will be capital appreciation in the value of the properties.

REITs – Guidelines

As per the guidelines given by SEBI, it is obligatory for REITs to invest at least 90% of the value of the REITs assets in revenue generating properties. Flexibility has been given to invest the remaining 10% in other assets such as property development, listed or unlisted debt of companies, mortgage-backed securities, and equity shares of companies deriving not less than 75% revenue from real estate activities, securities issued by government, money market or in cash.

Securities and exchange board of India (Real Estate Investment Trusts) Regulations, 2014 were recently announced for the creation of real estate investment trusts (REITs) in India. This announcement of rules regarding setting up of Real Estate Investment Trusts (REITs) is likely to spur $20 billion property development in India, also allowing the investors to participate in the country's real estate market.

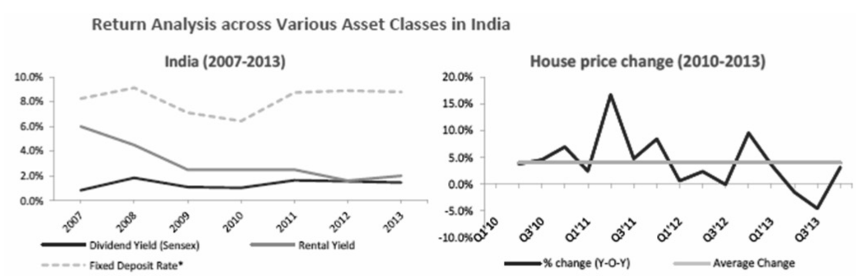
The crucial aspect that has to be resolved is tax transparency, which is out of SEBI's realm and has to be addressed by the Union Finance Ministry. According to Anshuman, the Chairman of CBRE South Asia addressing media, REITs may find it difficult to launch in India unless the country's tax code is revised. He also stated that if these issues are not resolved, property developers cannot presume incentives to take the trust route. REITs may be launched about six-nine months after Budget 2015.

REITs will probably provide a new source of funding to the debt loaded developers in India. But the tax rules are making it unappealing to sell securities within 3 years and it may result in delay for greater transparency.

Potential for REITs in India

REITs provide mix options for investors who errand bonds and stocks:

The underlying property in REITs generates recurring income until it is sold. Given the nuances of the Indian property market coupled with the returns that an investor could expect from REITs in the Indian context, we performed a comparative analysis of fixed deposit rates (as a proxy for risk free return), dividend yields, and rental yields (as regular income to the investors).



Source: Bloomberg, National Housing Bank; *SBI 1 year fixed deposit interest rate.

As shown in the above figure, across the period, rental yields are continuously lower than the FD/bank deposit rates as against to mature markets where rental yields are higher than the interest rates. The figure indicates that investors in India who prefer to have a lower risk may prefer fixed deposits over REITs, at least in the short run.

However, it is clear that the rental yields are slightly higher than the dividend yields. Therefore, REITs could draw investment from those investors who value recurring income more than capital appreciation. Since the rental income is more persistent as compared to dividends that can be moved back by the corporate sector during the times of crises. Hence, REITs could draw interest from both the stock and bond investors.

Moreover, REITs have characteristics of the stocks which grow and there is the possibility of increase in value through escalation in the prices of properties. Jones Lang LaSalle, a global real estate consultancy firm, has observed that the potential capital appreciation of REITs could be as high as 20%. Thus, in the long run, REITs may prove to be a better option to invest in than FDs. Furthermore, Indian economy is recovering; interest rates have likely peaked out in India. The major focus of new government is on roads and infrastructure development. This will in turn lead to the property demand in India which could generate capital appreciation.

Conclusion

Though the real estate sector in India is remarkable, but it still suffers from great complication in generating funds from banks and the major hurdle is REITs cannot lift off until the changes are made in the tax rules. Even real estate IPOs at this instant are tormenting. So REITs also provides very vigorous machinery for funding of real estate projects.

REITs in India may emerge as a new source of investment for the investors. The listed real estate and real estate investment trusts (REITs) may prove to be efficient and effective investment opportunities due to their transparency and liquidity. REITs have been implemented worldwide, and, in some markets, they have become very successful as investors look for investments which produce systematic income. The apparent choice of investors is the dividends associated with REITs. At the end, India has the entire gradient to witness a successful REIT regime in the long-term. All that is required is a well-organized regulatory system framed which ensures the best interest of the investors, the market and the nation.

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