REIT - IDEAL WORKING MODEL FOR INDIAN CONTEXT

SIRISALA CHANDRUSHA 1*, Dr. HARISH KUMAR 2*

1 Student, Dept of CIVIL, SHRI SHIRDI SAI INST OF SCIENCE AND ENGINEERING, VIDYAMPETA, ANANTAPUR.
2 Head - Dept of CIVIL, SHRI SHIRDI SAI INST OF SCIENCE AND ENGINEERING, VIDYAMPETA, ANANTAPUR.

ABSTRACT

Study on 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.

Mutual Funds (MF) industry in India has been growing fast in the ongoing reforms era, particularly since the 2000s when the MF industry has witnessed many innovations. In spite of this, instruments which are very similar to MFs viz. Real Estate Funds (REFs), and its variants like Real Estate Investment Trusts (REITs) are yet to pick up momentum in India. In fact, REFs and its variants like REITs have tremendous growth potential in India; given the very low mortgage penetration in the country. Investments in REFs or REITs can offer significantly higher returns in India as against similar investment in developed nations. Hence, if properly developed REFs or REITs can significantly support the growth of residential real estate sector in India by attracting greater investment into this sector. Securities and Exchange Board of India (SEBI), the regulatory authority in respect of securities market, has been trying to develop these innovative models for financing over the last few years. Its first attempt to bring in REITs in 2007 was not complete. Likewise, the second attempt of SEBI in 2008 to bring in a REIT regime in the REMF format was also not very successful for want of adequate response from the investors. The third attempt of SEBI in 2013 has been successful in releasing the Draft of the REIT Regulations 2013 and gathering the public comments on this Draft. Accordingly, SEBI flagged off the REIT Regulations in 2014, but still the investors were unenthused unlike the property developers and lenders to the real estate sector. Of late, the recent SEBI regulations 2016 seek to relax the norms and make REITs more attractive for the investors. The Union budget 2016 has removed the Dividend Distribution Tax (DDT). Government of India has unleashed the second wave of FDI reforms in June 2016 which in turn may benefit the REITs and the real estate sector. These measures give an impetus for the growth of REITs. SEBI has done a commendable job by considering international models, views of the stakeholders etc. while redefining its regulations. As SEBI goes ahead with the promotion of REITs, this paper closely looks into the features of the REITs,

SEBI regulations and its implications, and suggests strategies for faster and sustainable development or real estate and housing sector in India through the REIT route.

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

INTERDICTION

The Real Estate Investment Trust Act of 1960 led to the formation of Real Estate Investment Trusts (REITs). REITs were created as a passive investment vehicle with a goal to enable small investors to make investments in large-scale, significant income-producing real estate. The primary benefit of a REIT status is the exemption of shareholder dividends from the double taxation that applies to dividends of traditional corporations (Graff 2001). In addition, REITs generate further savings from not having to engage in costly tax-minimizing strategies that are often employed by taxable firms (Gyourko and Sinai, 1999). REITs are particularly attractive as a way to invest in real estate because REIT shares are traded and thus offer liquidity (Beals and Singh, 2002).

However, these benefits are not without restrictions. To maintain tax exempt status, REITs are required to distribute 90% of their taxable income to their shareholder. In addition, REITs have to satisfy other regulatory requirements related to asset composition, income source and ownership diversification. These characteristics of REITs have given rise to a distinct organizational structure that is different from the traditional corporations (Tang and Jang, 2008).

Through the legislative actions and clever strategies used by some firms, the REIT has evolved to become more than just a passive investment vehicle. Companies have been finding ways to use REIT status as a strategic option to improve profitability. The hospitality industry is the most noticeable example of this practice. The value creation in the hotel real estate sector depends on the successful management of a complex operating business with leasing, operating, franchising of assets. Therefore, a corporate structure that distances the owners of lodging assets from the day-to-day operation of their holdings is detrimental to shareholders (Beals and Singh, 2002). Consequently, lodging companies have devised ways to work around the regulatory constraints of REIT and use it as more than a passive investment vehicle. As a result, the gap between a hotel REIT and a hotel C-Corporation has narrowed. One of the goals of this thesis is to observe whether the stock market perceives hotel REITs differently than their C-Corporation counterparts, and whether it favors one organizational structure over another.

REITs typically seek growth through acquisitions and it is argued that their tax exempt status allows REITs to pay higher acquisition premiums over their C-Corporation counterparts. In the lodging industry, mergers and acquisitions have long been dominated by hotel REITs. For instance, in 2011 public lodging REITS were the most active buyers of hotel real estate, with $7.2 billion of acquisitions representing 37 percent of commercial real estate transaction activity by dollar value1. However, it is not all rosy for REITs. REITs have to distribute 90% of their income and therefore, to sustain growth REITs rely heavily on debt and equity offerings. On the other hand, C-Corporations have higher free cash flow at their disposal, which allows them to take quick investment decisions. Given the importance of acquisitions to REITs, this thesis conducts a comparative analysis of hotel REITs and hotel C-Corporation to understand whether a REIT status really has advantages in mergers and acquisitions.

Another interesting aspect of the lodging industry is that some firms have changed their corporate structure from REIT to a C-Corporation or vice-a-versa. For example, Starwood gave up its REIT status and became a C-Corporation while Host Marriott made an exactly opposite move. Since the research objective of this thesis is to see if one form of organizational structure (i.e. REIT) is more efficient than the other (C-Corporation) for ownership of hotels, these cases provide an excellent resource to understand whether such moves were (a) motivated by the prospects of improved profitability; (b) forced due to legislative changes; or (c) made necessary by the change in a firm's business strategy.

Based on the above discussion, this study intends to address the following research questions:

1.In the lodging industry, do the tax benefits of a REIT status offset the regulatory constraints it imposes? Is one corporate structure more competent than the other?

2. Does the stock market perceive hotel REITs differently than hotel C-Corporations and if so, which organizational structure does it favor?

REIT Regulatory Requirements

In order for a company to qualify as a REIT, it must comply with certain provisions required by the Tax

Code2:

• Be an entity that is taxable as a corporation and managed by a board of directors or trustees

• Have shares that are fully transferable

•Ownership Requirement

- Have a minimum of 100 shareholders

- Have no more than 50 percent of its shares held by five or fewer individuals during the

last half of the taxable year

•Distribution Requirement

- Pay annually at least 90 percent of its taxable income in the form of shareholder

dividends

•Asset Test

- Invest at least 75 percent of its total assets in real estate assets

- Have no more than 25 percent of its assets consist of stock in taxable REIT subsidiaries

•Income Test

- Derive at least 75 percent of its gross income from rents from real property or interest

on mortgages financing real property

•Limitations on Activities3

- A REIT cannot ordinarily provide services to its tenants or manage its properties except through an independent contractor from whom the REIT does not derive any income. REITs can directly provide "customary services" to their tenants.

A REIT cannot hold property primarily for sale to customers in the ordinary course of business. There is an exception to this rule if the

•REIT has held the property for rental purposes for at least four years

•total expenditures for the property did not exceed 20% of its purchase price during the previous four years

•REIT sells no more than five properties during a given taxable year

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. I 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.

OBJECTIVES OF THE STUDY

(i) To study the significance of housing and real estate sector for the economic development of India and the role of REITs;

(ii) To study the REIT regulations prescribed by SEBI in 2014 in light of the proposed changes in June 2016 and to assess the implications of the proposed REIT regulations 2016 of SEBI; particularly from the perspective of investors;

(iii) To suggest strategies for the growth of housing and real estate sector in India through REIT route, and a suitable model

Tax Benefits

In their discussion on the cost-benefit tradeoff of electing REIT status as compared with a C-Corporation, Gyourko and Sinai (1999) estimated that the net benefits of tax exempt status contribute 2%-5% to REITs equity market capitalizations after considering shareholder dividend taxes, external financing costs, and the savings from forgone tax-minimizing strategies. The authors also argued that the net benefits are higher for the firms with lower pay-out ratios. Graff (2001) observed that in addition to the corporate tax exemption, when hotel REITs sell their properties, they don't have to pay capital gain taxes and that this tax-free capital gain from sale of properties gives REITs economic advantages when competing with C-Corporations. However, Graff also noted that the tax exempt status sometimes lead to higher debt costs due to the loss of interest tax-shelter benefits.

Regulatory Constraints

The asset composition constraint requires a REIT to invest at least 75% of its total assets in real estate assets. Graff (2001) contended that this requirement closely ties REIT's value to real estate market than to the broader capital market. However, Tang and Jang (2008) argue that the requirement preventing REITs from owning more than 10% of other companies or investing more than 5% of its assets in other companies helps to a certain extent by forcing REITs to diversify in various assets and companies.

The income source constraint requires REITs to derive at least 75 percent of its gross income from real property. Tang and Jang (2008) argue that one of the main drawbacks of the income source requirement on hotel REITs is the increase in agency costs because hotel REITs need to lease hotels to third party companies that actually manage hotels. This process induces extra costs related to structuring, monitoring and enforcing contracts with third party companies.

Per the income distribution requirement, REITs have to distribute 90% of taxable income. Kim and Jang (2012) observed that hotel REITs experience investment constraints due to this mandatory dividend payout requirement. Along the same lines, Mooradian and Yang (2001) maintain that the high level of income distribution results in lower retained earnings and can lead to higher financing costs as firms have to depend on more costly external financing options. In addition, the capital intensive nature of real estate and low levels of retained earnings can limit the ability of REITs to grow Gyourko and Sinai (1999).

Graff (2001) argues that the ownership test that requires no more than 50 percent of REIT's shares held by five or fewer individuals; creates "a safe harbor for underperforming REITmanagers". Ghosh and Sirmans (2003) concede with Graff's observation and add that increased managers' bargaining power due to the dispersed shareholder base can result in fewer outsiders on Board and weak corporate governance.

Ott and Van Ness's (2002) event study of the Taxpayer Relief Act (TRA) of 1997 on the equity valuations of 125 publicly traded REITs found no significant price effects on the day the legislation was signed into law. This result, the authors argued, was probably due to the lower reduction in capital gains tax, and the improved management flexibility provided to REITs in the TRA, which relatively lowered future REIT returns because of the increase in costs for uninformed investors.

Howe and Jain (2004) examined the impact of the REIT Modernization Act (RMA) of 1999 on REIT shareholder wealth and found a modest positive wealth gain on the day the bill was introduced into the House and the day the bill was signed into law. The authors indicated that their results probably underestimated the true wealth gains because of the partially anticipated nature of the legislative process. This study also documented a significant reduction in the systematic of REITs subsequent to the passage of the RMA. Howe and Jain also observed the market reaction for five broad categories of equity REITs: retail, residential, industrial and office, healthcare and lodging and others. The authors found retail REITs to be the substantial beneficiaries of the RMA.

Impson and Conover (2011) extended Howe and Jain's study and conducted a "dribs and drabs" hypothesis in addition to the "new information" hypothesis to observe the price reactions to both, formal announcements and information leakages into the stock market during the series of legislative actions that eventually led to the passage of the RMA.

REAL ESTATE IN INDIA

As discussed in chapter 1, investors are increasingly looking to the emerging markets as alternate global avenues for real estate investments. Chapter 3 described why India has emerged as a favorable investment destination. India's favorable demography and strong economic impetus have made the country an attractive place for property investors. This does not mean, however, that investment in Indian real estate is risk-free. In light of the overall economic picture and the rapid escalation in prices in real estate over the last few years, many real estate markets in India are currently undergoing a price correction. However, there still exists a fundamental demand-supply imbalance and real estate remains an attractive longer- term investment prospect. Now that India is on the radar of global investors, it is important to understand the opportunities and challenges of Indian real estate investments.

India has been attracting global real estate investors primarily on account of the following:

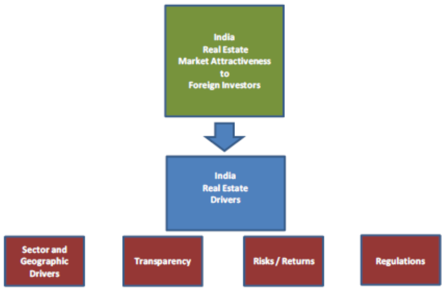
•Long term demand drivers in all real estate sectors;

•Improving market transparency;

•Attractive risk – return trade-off; and

•Liberalized government regulations.

Exhibit 20 : *India Real Estate Attractiveness*



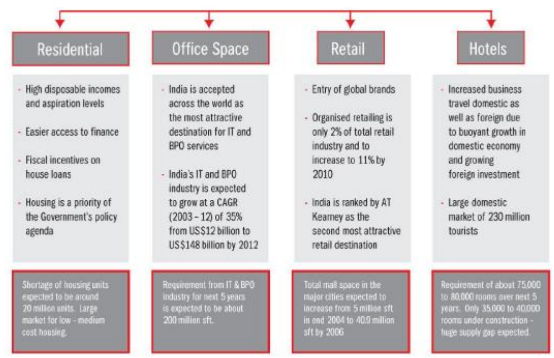
Sector and Geographic Drivers

Cities form the hub of all development in India. According to the last official estimate by the Census of India, there were a total of 27 cities with more than one million inhabitants in 2001, in which nearly 75 million people lived. By 2005 this had risen to 35 cities with a population of more than one million and almost 500 cities with at least 100,000 inhabitants. The Mumbai and Delhi regions alone are home to almost 20 million people each. But these staggering figures must not be allowed to detract from two facts. First, India is still a predominantly rural society. While more than 300 million Indians now live in an urban environment, this means that nearly 800 million people are still at home in rural areas. The United Nations Population Division (UNDP) expects the degree of urbanization to grow over 40% by 2030, implying that urban population will grow by 2.5% per annum in the next 25 years. Hence, while the rural population increases only marginally, urban population will double by 2030 to around 600 million people. Land is a scarce resource in India – driven by very high population density. India's population density more than 10 times that of U.S. and more than twice that of China. Projected population growth of 54% in next 43 years (CAGR. 1%) and growing urbanization are expected to continue to drive the property price increases in India

Country	Population (mn)		Area of Country	Population Density	Urbanization
	2007	2050	square km.	per sq km.	
China ex HK	1,318	1,437	9,571,785	138	44%
India	**1,132**	**1,747**	**3,287,576**	**344**	**28%**
Indonesia	232	297	1,904,561	122	42%
United States	302	420	9,629,047	31	79%
France	62	70	551,497	112	77%
United Kingdom	61	69	244,878	251	90%

Table : Population Density

Exhibit 23 : *India Real Estate Drivers[20]*



	Residential		Office		Retail		Hospitality	
	Rank	Estimated Demand (mln sf)	Rank	Estimated Demand (mln sf)	Rank	Estimated Demand (mln sf)	Rank	Estimated Demand (mln sf)
Bangalore	3	107	1	51	3	11	2	14
NCR	1	114	2	48	1	19	1	17
Chennai	2	108	3	33	5	6	4	8
Mumbai	5	41	4	23	2	15	3	12
Pune	4	67	5	21	7	8	6	4
Hyderabad	7	61	6	21	6	10	4	8
Kolkata	6	30	7	7	4	10	6	4

Table: Cumulative Real Estate Demand

(2008 -12) by Sectors

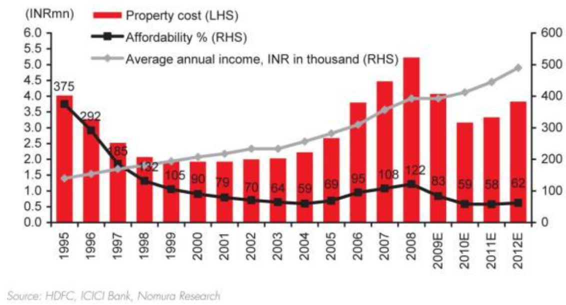
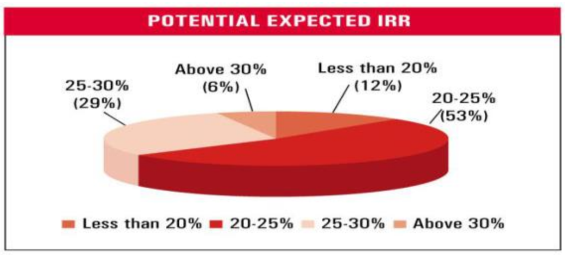
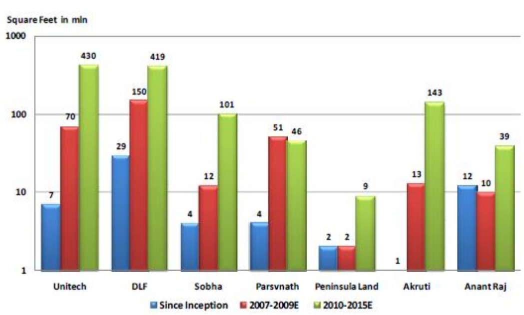


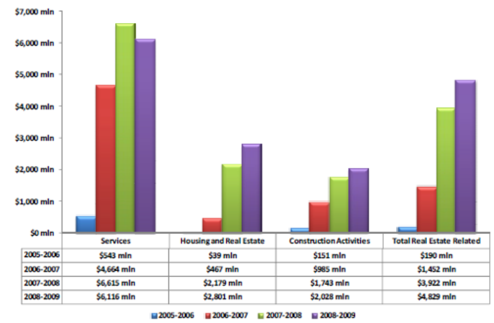
Table: JLL Transparency Index



Graph: IRR Expectations



Graph: Inadequate Execution Capability



Graph: FDI in Indian Real Estate

RESEARCH METHODOLOGY

The methodology adopted is descriptive-analytical and exploratory. The study is descriptive to the extent that it describes the developments in the field of real estate sector in India with a focus on the role of REITs in the faster development of this vital sector, and the role played by SEBI in promoting REITs. The recent relaxations in the norms of REITs so as to make them more attractive are focused in the study. The paper is analytical too as it seeks to analyze the weaknesses of the SEBI Regulations on REITs 2014, particularly the reasons for poor investor preference towards REITs etc. and accordingly to suggest remedial strategies. The study is based primarily on the secondary data from authentic sources.

SIGNIFICANCE OF HOUSING AND REAL ESTATE SECTOR IN INDIA: NEED FOR MORE LIQUIDITY

The problem of housing shortage is very acute in India, indicating the need for higher investments in the housing and residential real estate sector, particularly in the affordable housing segment or housing for the low income populace. As as of 2012 the housing shortage in India was at the level of 18.78 million (urban areas) and 43.90 million (rural areas) (NHB, 2013) [34]. Though India's position in respect of Mortgage to GDP Ratio (MGR) has improved significantly from 3.4 percent (2001) to nearly 9.00 percent (2012), its status is still very poor when compared with other major nations of the world. (Table I).

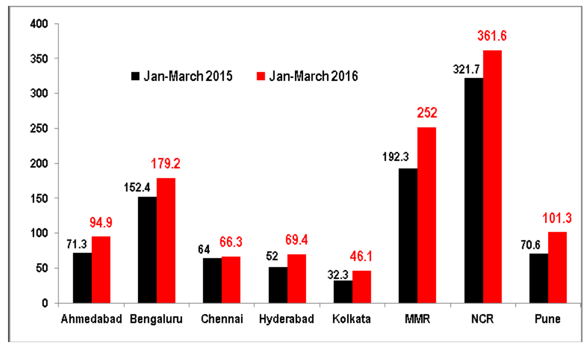
In India, because of (i) the very low percentage of MGR, (ii) the huge housing shortage, and (iii) the well recognised fact that housing and real estate investment has got immense potential for economic development because of the vast 'linkages' (both forward and backward) effects of housing investments with over 269 other industries. The real strength of the housing sector lies, in its not only direct contribution to the economy but also its 'multiplier' or, 'ripple' effects i.e. ability to stimulate economic activity in other industries. While generation of revenues and employment opportunities form some of the direct contributions to the economy, indirect benefits include the increased activity of firms, which supply materials like cement, steel, wood etc., and other allied services. Many studies have conclusively proved the positive impact of housing on economic development of nations. In short, housing and real estate sector plays a pivotal role in the development of economies across the globe, both developed and developing, and India is no exception. Many studies have pointed out the positive economic as well as social impacts of housing.

Table II: Growing Unsold Real Estate with the Builders in Major Cities in Kerala

(In Million Sq.Ft)

	Ahmedabad	Bengaluru	Chennai	Hyderabad	Kolkata	MMR	NCR	Pune	Total
Jan-March 2015	71.30	152.40	64.00	52.00	32.30	192.30	321.70	70.60	6.60
Jan-March 2016	94.90	179.20	66.30	69.40	46.10	252.00	361.60	101.30	70.80
Growth (Percent)	33.10	17.59	3.59	33.46	42.72	31.05	12.40	43.48	22.39

Source: "Builders strapped with unsold real estate", *The Times of India*, Kochi Ed., dt.23 June 2016. Print, p.10. [41]



Graph: Growing Unsold Real Estate with the Builders in Major Cities in Kerala

A survey undertaken by National Buildings Organization (NBO) (Government of India) revealed that 2 million housing units per year would lead to creation of an additional 10 million man-years of indirect employment. Housing results in raising the real purchasing power of the economy which in turn results in development of many an industry, like, consumer durables, domestic appliances, household utensils etc. It may be noted that in the Indian context, rural housing should be promoted and developed into an additional growth engine for ensuring fast rural prosperity, through the income effect. Because, as already noted, rural housing shortage is quite severe in India and is estimated at the level of 43.90 million as against 18.78 million in respect of urban housing as of 2012. More importantly, irrespective of the geographical segments like rural or urban, housing for the poor needs to be given added thrust because vast majority (more than 90 percent) of the housing shortage corresponds to the poor. Thus, specialized schemes like 'affordable housing', 'low income housing', 'budget housing' etc. need to be encouraged so that development becomes equitable and balanced also. The 'National Goal of Housing for All by 2022' that is applicable in India has given another dimension to the need for faster development of housing and real estate sector in India.

It may be noted that there has been huge accumulation of real estate stock across various cities in India. As is evident from Table II and Figure I, the growth is across all major urban centres, though such accumulation has been maximum at locations like Pune (43.48 per cent) and Kolkata (42.72 per cent). Taking all the eight major cities together there has been a growth of as high as 22.39 per cent as of March 2016 as against March 2015. (Table II). Offloading the accumulated real estate stock as above in various urban centres required better liquidity in the market. REITs offer one effective means of enhancing liquidity in the market; other means include attracting more Foreign Direct Investment (FDI) into this sector.

Real estate funds (REFs) or real estate mutual funds (REMFs) are often known, as real estate investment trusts (REITs) internationally. The essential difference between a REIT and a REF (or REMF) is that investments made in REIT are traded in real estate stocks and not invested in stock of companies. It provides a heavier liquidity than MFs. As per an earlier guideline by SEBI, the NAV of REMFs were required to be disclosed daily but a recent proposal of a quarterly disclosure of NAV is drawing serious speculations from the realty segment. In India, REFs were initially launched in the REMFs format and later on in the form of REITs. At present, the Securities and Exchange Board of India (SEBI), the regulatory authority for REFs and its variants, has been in the forefront for the regulation of REITs in India. Most funds operating in India have a lock-in period of 3 to 7 years. At the end of this period, the fund exits the holding by selling it in the secondary market. If the investment is in a commercial property, the fund may rent it out within the lock-in period and exit later. Most funds invest in residential projects and those commercial projects that are nearing completion. While residential projects move faster in the market, there is a rental yield attached to commercial projects. Because of the improved demand for housing and low capital requirement, often REFs focus on residential and income-generating commercial projects. A few funds invest in projects that are still in the initial stages of construction, based on saleability and track record.

Kotak Realty Fund established in May 2005, is one of India's first private equity funds with a focus on real estate and real estate intensive businesses. It operates as a venture capital fund. Leading banks, domestic corporate, family offices and high net worth individuals have contributed the fund's corpus. The fund is close ended and has a life of 7 years. The Fund has raised around $ 100 million from domestic investors. The strategy of the fund is to make investment at project level with developers and at an enterprise level in realty development companies. The fund has the mandate to invest in retail, hotels, healthcare, education etc. HDFC Property Fund is a 7 years' close ended real estate venture fund called HDFC India Real Estate Fund. The fund has been launched in association with SBI. HDFC holds close to 80 per cent and SBI the remaining stake while HDFC Venture Capital Ltd. manages the fund. The scheme had a minimum contribution of Rs 5 Crores per investor. AnandRathi Real Estate Opportunities Fund (AR REOF) is a close-ended fund, for domestic and overseas investors. The fund focuses on growing markets such as Pune, Bangalore, Chennai, Hyderabad and other cities that are witnessing substantial urban development. The fund's investment strategy is to focus on acquiring secured rental income producing real estate assets with quality blue chip tenants and picking up equity stakes in specified real estate projects being developed by reputed developers. IL&FS Realty Fund is a private equity fund. The fund seeks to achieve a gross investment-level leveraged annual internal rate of return in excess of 25 per cent. In addition, the fund will target a cash-on-cash stabilized yield on equity exceeding 8 per cent per annum for income-generating projects. ICICI Ventures has also launched a property fund, the funds seeks to invest in the commercial, residential, retail and other world-class real estate assets, both in developed and development projects, in the potentially growing cities of India. The fund seeks to deliver a compounded annual rate of return in excess of 20-25 per cent per annum over a 7 years tenor.

GOVERNMENT INITIATIVES TO ATTRACT FUNDS IN TO THE REAL ESTATE SECTOR THROUGH REFS

In the recent years, the supportive policies of the successive Union governments in India have further encouraged the liquidity flow into the country's real estate sector. For instance, Government of India has allowed non-resident Indians (NRIs) to invest upto 100 per cent as Foreign Direct Investment (FDI) in housing and real estate sector. This policy of 100 per cent FDI in the real estate sector in India, setting up real estate mutual funds (REMFs) coupled with other fiscal reforms like rationalization of stamp duty, property taxes etc. initiated by the Government are steps directed at making the real estate a promising investment option in India. As an outcome of these policies, the foreign contributions to REFs in India have witnessed a steady rise of 40 to 45 per cent per year. The domestic financial institutions have also built up their investments in REFs like their foreign counterparts. This combined participation from both along with contributions of the corporate houses has accelerated the growth of REFs in India. Securities and Exchange Board of India (SEBI), the regulatory authority of securities market in India, has been trying to develop various innovative models for financing real estate market over the last few years. SEBI's first attempt to bring in REITs in 2007 was not successful. So SEBI went ahead with its second attempt to bring in a REIT regime in the REMF format. But, this was also not very successful for want of adequate interest from the investors. SEBI approved the guidelines for the real estate mutual funds (REMFs) according to which all the schemes having an objective to invest directly or indirectly in real estate property will be governed by the provisions and guidelines under SEBI (Mutual Funds) regulations. SEBI made it clear that the structure of the REMFs, initially, would be close ended. The units of

REMFs would be compulsorily listed on the stock exchanges, and NAV of the scheme would be declared daily. The scope of the REMFs was kept wide open, as the guidelines allow these schemes to invest in (i) directly in real estate properties within India, (ii) mortgage (housing lease) backed securities, (iii) equity shares/bonds/ debentures of listed/unlisted companies which deal in properties and undertake property development, and (iv) other securities.

According to SEBI guidelines, REMFs need to appoint a custodian who would grant the certificate of registration to carry on the business of custodian of securities by the Board. The custodian would keep safely the title of real estate properties held by the REMFs. Earlier, in the absence of REMFs, companies setting up REFs had to restrict themselves to financial institutions, corporate sector and high net worth individuals for creating their investor base. The REMFs were supposed to offer the real estate developers another source of funds, as the SEBI guidelines allow the funds to invest in the equity of public listed or privately held real estate developer companies as much as 65 per cent of the fund size. The minimum investment norms stipulated in the SEBI guideline were thoughtfully designed to promote pure investment in the sector rather than speculation. SEBI guideline said that the REMF would invest at least 35 per cent of the assets in real estate properties that were already completed and usable. Under construction projects, vacant land or properties specified for agriculture use would not be considered as "real estate property" for satisfying the above 35 per cent norm. In addition, minimum 75 per cent investment was earmarked for real estate properties, mortgage-backed securities, equity or bonds or debentures of publicly listed or privately held companies dealing in real estate and in other securities. Here, the other securities would mean only debt and money market instruments. Clearly, SEBI wanted the REMFs to abstain from investing in under-construction projects or vacant land, as such investments were supposed to take a longer period to produce a decent yield and the retail investors were not often willing to wait for that long. In addition, such investments were perceived to have higher risks attached and gray areas about valuations. There were mixed views on the efficacy of REMFs in raising funds for the real estate sector and improving the liquidity of the players, and the impact of such developments on real estate prices. Anyway, the response from the investors towards REMFs was not as impressive as expected by SEBI. Hence, the second effort of SEBI to bring in REFs in the form of REMFs was also not successful as in the first case.

SEBI INITIATIVES TO PROMOTE REITS: REIT REGULATIONS 2014 AND ITS REVISION IN 2016 – IMPLICATIONS

Failure of its first two attempts to improve liquidity in the real estate market made SEBI to float REFs in the form of REITs (Real Estate Investment Trusts) again, in its third attempt. As part of its third initiative, SEBI has been successful in releasing the Draft of its Real Estate Investment Trust Regulations (Draft REIT Regulations) in 2013 and gathering the public comments on the above draft. SEBI has so far done a commendable job in taking into account international models and views of stakeholders. Accordingly, it was envisaged that REITs should likely emerge as a preferred form of asset backed investment with established revenue streams, and will go a long way in protecting the interests of investors seeking exposure in real estate as an asset class. More importantly, REITs may infuse additional transparency and liquidity in the Indian real estate market. With Indian players showing an increased keenness to list Indian real asset listings offshore, especially in SGX, SEBI's move is likely to attract such markets onshore and increase depth of Indian real estate capital markets. From a private equity in real estate perspective, REITs will also create exit opportunities for developers and financial investors allowing them to move completed assets to REIT and provide much needed liquidity in the market.

As envisaged, SEBI formally flagged off its final version of REIT Regulations in 2014. While developers and lenders welcomed the move, the investors were still not convinced. For developers REITs offered a convenient way to offload their commercial assets and also to reduce debts, while for lenders REITs reduced their business risk and expand their exposure to real estate business further. The poor turn out from the investors was a setback for the REIT Regulations 2014. Though the launch of REIT Regulations was a positive step forward on the part of SEBI, several issues concerning taxation, stamp duty and foreign participation remained. Thus, in spite of the various benefits as contemplated by SEBI, REITs did not take off as expected because specific tax exemptions are not provided. Besides, foreign investment in REITs also did not materialize as expected, because the amendments to the extant exchange control regulations were not carried out. Here, the investors were primarily put off by the governance risks in the asset class and the low liquidity of REIT investments compared to equities or bonds. Returns on REITs depend on the demand and rents for office space, they also compare poorly to other debt instruments during the economic slump. Table III gives the basic details regarding the REITs in their current form (as per REIT Regulations 2014) and the likely changes that structure of REITs will undergo once the new relaxations as contemplated by SEBI in June 2016 are put in place.

PROSPECTS OF REITS IN INDIA IN THE ONGOING REGIME: SOME STRATEGIES FOR THE FASTER GROWTH OF REITS

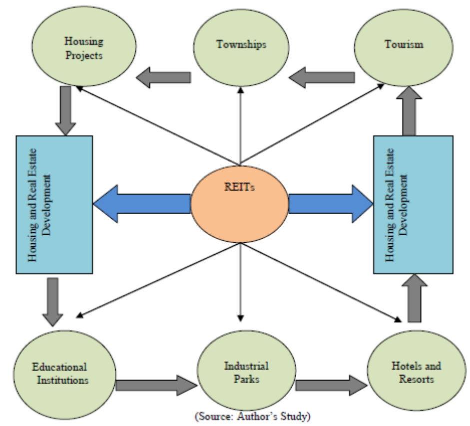
In spite of the limitations of the REIT Regulation 2016 from the perspective of investors, there are some favourable developments too that enhance their growth prospects. Firstly, REITs have obtained exemption from Dividend Distribution Tax (DDT) in the Union Budget 2015-16 and this is a step in the right direction for their growth. Accordingly, a retail investor who invests a minimum of Rs.2 lakhs in REITs would get stable income as per the extant dividend rules. Recently in June 2016, the Government of India (GOI) has unleashed the second wave of reforms in the foreign direct investment (FDI) front would also benefit the growth of FDI in India. Besides, the GOI has allowed 100 per cent FDI in civil aviation, while FDI norms in defence and pharmaceutical sectors have been relaxed and those in single brand retail have been eased. All these reforms in the FDI sector would benefit the REITs and real estate sector also because FDI in various sectors would result in demand more office space, warehouses, logistics, housing etc. which in turn results in enhanced demand for real estate and housing properties.

REITs is a good avenue for investment for investors who are averse to invest in physical purchase of property due to risks involved in investments in physical assets. Here, investors can invest in REIT units which in turn can be traded in the stock exchange (like, other securities like shares, bonds etc.) as against transactions involving purchase of physical properties. Thus, REITs are ideally supposed to be very liquid unlike the investments in physical assets. Here are some suggestions to make REIT market in India more effective and also to ensure their faster and sustainable growth in the days to come:

- The relaxations proposed in REIT Regulations 2016 of SEBI are primarily intended to attract the sponsors of REITs and not the investors. For the long term growth of REITs SEBI should instead focus on investors. SEBI should devise a more transparent mechanism with better exit routes for luring the investors.

- SEBI should ensure a more frequent mark-to-market valuation for the vehicle concerned would result in better acceptance of REITs. At present, SEBI insists on compulsory listing to facilitate anytime liquidity. But, to what extent the investors can liquidate their REIT units is doubtful, because the valuation of real estate portfolios will be done only once in six months. Only through more frequent valuations can we ensure better liquidity in the REIT market.

Figure II: Effective Use of REITs for the Development of Housing and Real Estate Sector in India – A Model



(Source: Author's Study)

- Focus on commercial real estate is preferred in India at this stage, because investment in residential assets (e.g. rental housing schemes) requires a more mature market; rental housing schemes are still not prevalent in India. The current SEBI guidelines on REITs permit investments only in rent-yielding assets.

- The current policy of the Government of India (GOI) of attracting FDI into housing and real estate sector needs to be continued to attract maximum investment of foreign capital into this sector. The launching of the Real Estate Regulation Bill by the GOI is laudable move. More recently, in June 2016, the GOI has released the Draft rules Real Estate (Development and Regulation) Act, 2016 applicable to the five Union Territories (UTs) in India, for public comments. Once such national policies are in place, the investor confidence will go up and they will invest in real estate, both in the physical properties and in REITs or equivalents (like REMFs).

• Two other critical issues: (i) Exemption from capital gains tax, and (ii) State governments' stamp duty while transferring assets to REIT's holding company, would be key to REITs' success,". Exemption from stamp duties has helped support the expansion of REITs in other financial markets, including Singapore. The removal of DDT, as already noted, has attracted the institutional investors who view India as an untapped market for this asset class. "

• Special schemes for faster development of residential real estate in the country (on the lines of Special Economic Zones) namely Special Residential Zones (SRZs) be promoted by giving tax and other concessions and incentives to real estate developers who are ready to develop residential (housing) units as per Governmental guidelines. Free or subsidized land may also be provided to such developers.

• Last, but not the least, is the special significance of inclusionary housing development. Given the fact that over 90 percent of housing shortage corresponds to people in the low income group and economically weaker section (EWS) sections, insisting on earmarking a specific per cent (say 20 per cent) of the total housing property developed by every developer to the LIG and EWS or budget category customers would ensure that housing development is balanced and sustainable in the long run. It is advisable to encourage specialized REIT schemes by the GOI and offer them privileges.

CONCLUSION

There are a number of limitations and handicaps for the housing and real estate sector in India. Primarily these are the low level of penetration of the market, significantly low investments by public and private sectors, poor liquidity and resources of the players in the market, and inadequate regulatory and legal system in the country. In this context, the entry of the innovative schemes like REITs can provide the much desired liquidity and dynamism to this vital sector of the economy. Side by side, other innovative instruments and schemes such as Residential Mortgage Backed Securitization (RMBS), Reverse Mortgage Loans (RML), Housing Micro Finance (HMF), FDI in real estate, Special Residential Zones (SRZs) etc. need to be promoted further by the Government for the faster development of the housing and real estate sector and hence the overall development of the economy as a whole. REITs are particularly suitable to the current Indian scenario, because of the rising real estate prices in the past few years making investments an expensive proposition for smaller investors. When the investor sentiments are adversely affected by the capital market developments and poor macro economic conditions, launching of REITs could ensure better liquidity in this sector, which could address the demand-supply gap also. In addition, REITs are useful as they provide an exit option to real estate developers. As REITs develop, healthcare, infrastructure and other stabilized yield generating assets may also be rolled into REITs. Such a framework was initially considered by SEBI. This should ideally be the next progressive step of SEBI in this regard.

Because of its vast potential for socio-economic development, housing occupies a prominent place in the policy decisions of the Governments worldwide, particularly in the developing nations like India. In India, the vital significance accorded to housing is reflected in the policies and budget outlays of the Government, particularly since the late 1970s. Governmental concessions by way of tax benefits to the beneficiaries and lenders of housing finance, refinance at low rates to the lenders etc. are examples. The favourable policies of the RBI and the Governments continue even now and the present housing policy of the GOI seeks to attain 'Housing for All by 2022'. RBI, 2014 [21] (b) in its policy report has observed as follows: "Development of housing and mortgage markets has an important role in growth and employment. As the government is committed to a policy of 'Housing for All by 2022', the housing sector has immense potential to grow; so do the mortgage markets". A vibrant REIT market would act as an enabler for the faster growth of the housing and real estate sector and hence the economy as a whole.

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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