Easing of REIT investment norms to hike returns, but up risks too

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MUMBAI | BENGALURU: The Securities and Exchange Board of India's (Sebi) proposed relaxation in investment norms for Real Estate Investment Trusts (REITs) is likely to boost retail investors' returns even as it increases their risk too, experts said. In a bid to attract realty developers to list their portfolios and with a view to smoothen the REIT registration process, Sebi has now proposed allowing REITs invest up to 20% in under-construction projects. Earlier, investments into under-construction projects were capped at 10%. It has also proposed change in the number of sponsors and removing the restriction on the special purpose vehicles (SPVs), when the REIT's holding company is to invest in other SPVs holding the assets.

"Allowing REITs to invest more in under-construction projects would help in improving overall returns for investors. Today, analysis and estimates show that traditionally returns from REITs in mature markets range between 8-11%.

REITs in India will be able to match those kinds of returns with the proposed change," said Neeraj Sharma, director, Grant Thornton Advisory. However, experts are also of view that the proposed change in the norm will also lead to higher risk owing to investments in under-construction projects. "Permission to invest a larger chunk in under-construction assets may improve the returns for a REIT, but the risk also accentuates substantially.

REITs are stabilized instruments and developmental risk should ideally be limited to ensure investor confidence," said Ruchir Sinha, Co-Head, Private Equity and M&A, Nishith Desai Associates. "Certain other proposed measures like allowing REITs on private placement basis, relaxing stringent sponsor criterion etc will also be required to give the necessary thrust to potential REIT listings," Sinha said.

While the investment norm has been eased, proponent of REIT will also have to apply caution when choosing to invest in under-construction projects. "There needs to be caution while making such an investment decision, because if the under-construction asset overshoots completion schedules, then the potential ROIs will start dipping due to delayed occupancy by tenants & thus delayed yields kicking in. Having said that, while investing with a proven developer, under-construction status is viable, due to his delivery track record.

Also under-construction assets will fetch lower capital valuation, hence allowing the REIT to get a higher yield when leased," said Rubi Arya, Executive Vice Chairman, Milestone Capital Advisors, one of the first funds to start REIT-like structure funds, which managed and exited 4 million sq ft commercial assets in India. Most properties, even in under-construction stage, will have their key tenants already signed on, leading to either a parallel establishment of tenancy or quick post construction lease activation, Arya said, adding basing such pre-leases in place, a good developer can also lock in the balance areas for lease much before he hands over the asset, thus ensuring yield income from day one.

Realty developers are for now cheering the proposed changes in the norms governing REITs and say this will allow room for further growth potential. "More changes are good for the system. Step to align minimum shareholding in REITs with Securities Contracts Regulation Rules (SCRR) will create better platform and make it healthier. There will be more potential for development with 20% limit for investment into under-construction projects," said to Raj Menda, Corporate Chairman of RMZ.

Grant Thornton's Sharma said that increasing the number of sponsors will broaden the stakeholder base and add credibility to the venture. Indian commercial real estate offers investment opportunity worth \$43-\$54 billion across top eight cities, including Mumbai, Delhi-National Capital Region, BENGALURU and Pune through REIT-eligible ready stocks, a report by RICS and Cushman & Wakefield said.

With the removal of Dividend Distribution Tax (DDT) through a proposal in the Union Budget 2016-17, REITs were expected to kick off in India. The move was expected to offer commercial developers a liquidity option and retail investors a chance to participate in office realty market growth. However, none of the real estate developers and private equity players with large commercial asset portfolio came forward to list REITs so far.

RICS-Cushman & Wakefield report estimates that around 315 million sq ft of office inventory is eligible for REIT across the cities. The REIT-eligible inventory includes existing nonstrata sold Grade A inventory, wherein Bengaluru, Mumbai and Delhi-NCR cumulatively account for over 67%