

How can you buy property for Rs 2 lakh? REITs to help investors

By [Narendra Nathan](#), ET Bureau | 18 Aug, 2014, 10.20AM IST

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If you have Rs 2 lakh to invest, your bank may roll out a red carpet, your stock broker may inundate you with hot tips and the friendly neighbourhood jeweller may even offer a discount on making charges. However, you will probably get laughed out of the estate agent's office. Not anymore. With [Sebi](#) issuing final guidelines for [real estate investment trusts \(REITs\)](#), you will soon be able to get a piece of the action in the property market with as little as Rs 2 lakh.

REITs are just like mutual funds, but instead of using the money collected from investors to buy stocks and bonds, they invest in property. After more than a decade of discussions, this unique form of mutual fund is finally taking shape in India. Last month, the Union Budget removed an important hurdle by giving pass-through taxation status to REITs.

Last fortnight, market regulator [Sebi](#) issued final guidelines for REITs, settling several of the concerns raised by the real estate industry. Industry watchers claim that the launch of REITs will increase the flow of funds to the cash-starved real estate industry. "Even if half of the currently available Grade A office space gets converted to [REIT](#) and is listed in the next 2-3 years, it can mean an inflow of Rs 60,000-72,000 crore," says Anuj Puri, chairman and country head, [JLL India](#).

High entry barrier

The problem with real estate as an investment is that it either occupies no place or a lot of it in a portfolio. Whether you invest in a residential property or commercial space in a metro or tier I city, the minimum investment is normally upwards of Rs 30-40 lakh. [Sebi's](#) guidelines for REITs have pegged the minimum investment at Rs 2 lakh, which will allow retail investors to participate in the real estate market. In the secondary market, the minimum holding could be even lower at Rs 1 lakh. "REITs allow even middle income individuals to invest in real estate. Without this, they can't participate in real estate because of the huge entry barrier," says Keki Mistry, vice-chairman and CEO, [HDFC](#). The low ticket size means that investors can diversify their portfolios by including real estate without investing huge amounts in the asset class.



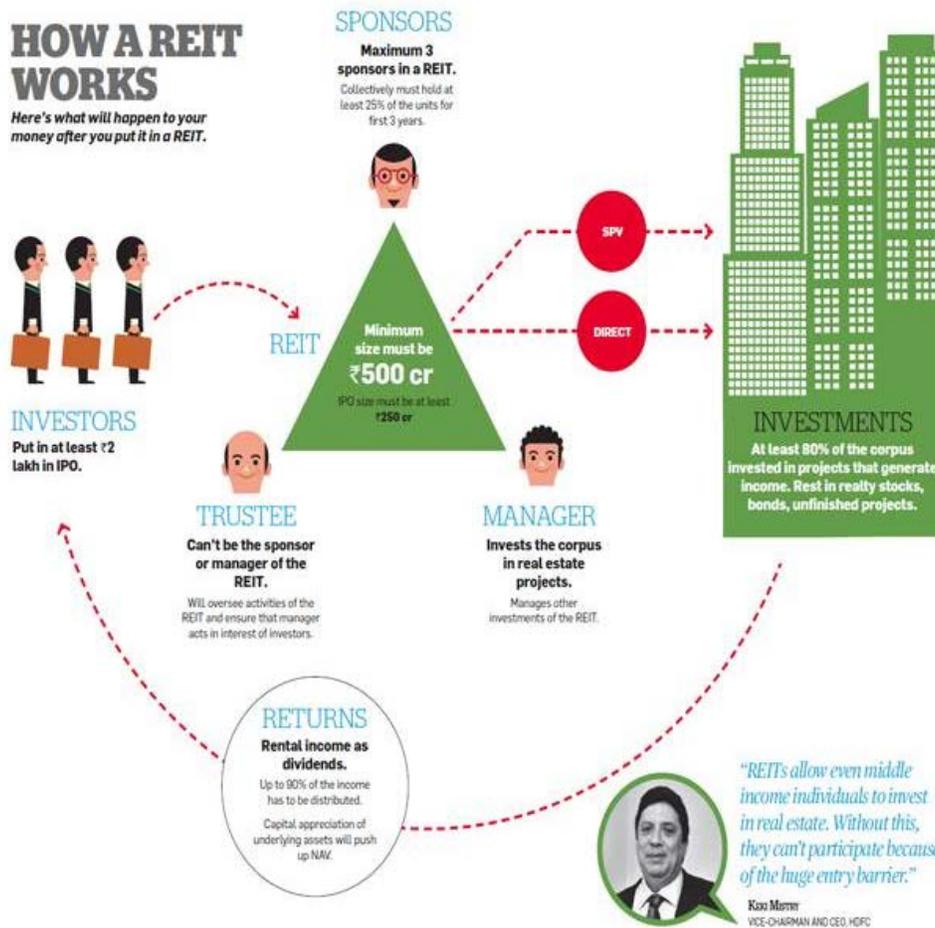
Now, you don't need deep pockets for investing in property. REITs will allow middle-class investors to participate in the real estate market.

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HOW A REIT WORKS

Here's what will happen to your money after you put it in a REIT.



The high entry barrier is not the only problem with investments in real estate. With no real estate regulator in place, individual investors are at the mercy of politically connected builders in India. If, however, they invest in a REIT, they will be able to join hands and get bargaining power against the real estate developers.

The other benefit that REITs offer is diversification. When one invests in a real estate project, the returns are dependent on how well that project is received in the market and the rental income it is able to command. On the other hand, REITs invest in several projects and, therefore, provide the benefit of diversification to the investor. With a low entry barrier of Rs 1 lakh in the secondary market when units are listed, an investor can spread his investment across 3-4 REITs launched by different asset managers.

The liquidity offered by REITs is another positive feature of this mode. Real estate is an illiquid asset, and selling a property can take weeks, even months, but REITs will inject liquidity into the investment by listing the units on the stock exchanges. The day is not far when one will be able to buy and sell property at the click of the mouse.

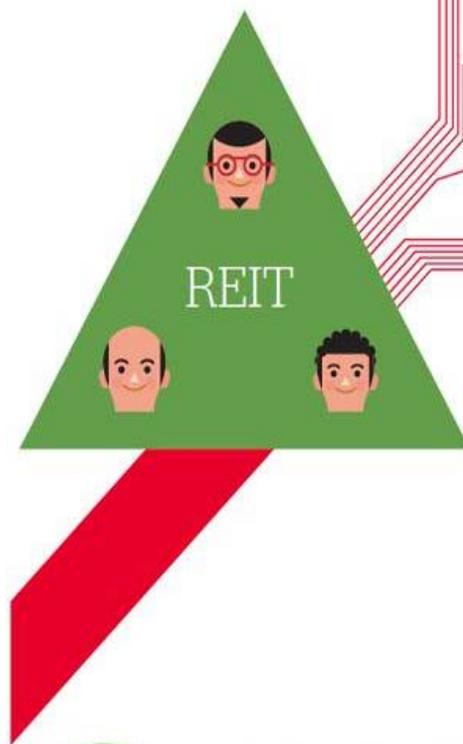
REITs also generate a regular flow of income which could move up in tandem with inflation. This explains why REITs are a hit in most developed markets. "Around 40% of the global alternative investment assets is through REITs," says Anshu Kapoor, head of Global Wealth Management, Edelweiss.

How attractive is the investment?

While Sebi has given the go-ahead to REITs, right now they can invest only in commercial real estate. This narrows the scope considerably because most of the action in the sector is in residential real estate. Even in commercial projects, 80% of the investment must be in rent-earning projects. The balance 20% can be in other assets, including projects under construction (restricted to 10% of the total REIT assets), listed or unlisted debt of real estate companies, equity shares of real estate companies having 75% income from realty activities, government securities and money market instruments.

Sebi's GUIDELINES FOR REITs

The market regulator has come out with final guidelines for real estate investment trusts. Here's what they mean for investors.



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CHAIRMAN AND COUNTRY HEAD, JLL INDIA

MINIMUM SIZE OF REIT

Though lower than original ₹1,000 crore, the minimum size of ₹500 crore will ensure that very small players don't enter this market.

IPO SIZE

At ₹250 crore, this will ensure there is ample trading activity once the REIT units are listed.

MINIMUM INVESTMENT

₹2 lakh minimum investment will keep small investors from investing in REITs.

MARKET LOT

Market lot of ₹1 lakh will ensure liquidity and wider investor participation.

PUBLIC HOLDING

Minimum public holding of 25% in REIT units will ensure sufficient liquidity.

NUMBER OF SPONSORS

Multiple sponsors will help smaller players to join hands and launch REIT, but restriction to three will avoid clutter.

SPONSOR HOLDING

Minimum 25% of the units for first three years and 15% thereafter will ensure the sponsors remain committed to the scheme.

ARM'S DISTANCE

Sponsor, trustee and manager can't be associate. This will ensure that there is no conflict of interest.

INVESTMENTS

Allowed only in commercial real estate. 80% to be in rent earning projects. Will provide safety and regular income but also muted returns.

20% IN OTHER ASSETS

Balance can be put in other assets, including under-construction projects. Though risky, this has potential to give higher returns.

DISTRIBUTABLE INCOME

At least 90% of distributable cash flows must be distributed. This will ensure regular income for investors.

NAV DECLARATION

REIT must declare its NAV within 15 of valuation or updation. This will ensure transparency.

Though some may see this as an unnecessary restriction (investors should have the freedom to select the place where they want to invest), the straitjacket of rental yielding projects is actually a blessing in disguise. First, there is major difference between rental yield from commercial and residential properties in India now. "While the rental yield on commercial property is slightly lower than the interest rate, the one on residential property is very low. So REITs will not work in the residential market now," says Mistry.

If the rental yield from commercial projects is less than the prevailing interest rate, why should one consider investing in REITs? "The rental yield is not very attractive now, but is expected to rise in the future," says Ujwala Rao, national director, capital markets, JLL. Besides, there is always the possibility of capital appreciation that will push up the NAV. "REIT will not only provide opportunity to earn regular rental income but also capital appreciation on such assets along with liquidity of listed market," says Sharad Mittal, director & head, real estate fund, Motilal Oswal Real Estate.

Bottom of the cycle

Still, there are several factors that investors need to keep in mind. As of now, the commercial real estate market is in doldrums. "In several pockets, the price of commercial real estate is around 30% cheaper compared to residential real estate," says Kapoor. Though there is an escalation clause in most commercial real estate projects, it is a users' market and, therefore, they are able to renegotiate the rents downwards.

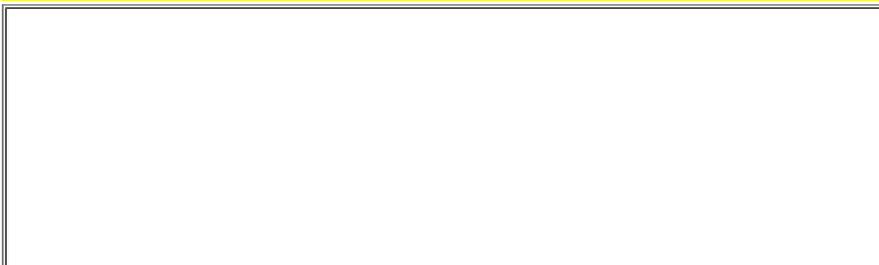
THE REIT ADVANTAGE	
REITS	DIRECT INVESTMENT IN PROPERTY
<ul style="list-style-type: none"> ■ Lower entry barrier for investing in real estate. Minimum investment ₹2 Lakh. ■ Diversified portfolio of properties reduces risk for investor. ■ Due diligence conducted by REIT manager and trustee before investing. ■ Get professional help and avoid the headache of directly managing real estate. ■ Greater liquidity. Investor can fully or partially exit REIT by redeeming units. ■ Possible to earn regular returns because 80% of corpus in finished projects. ■ By pooling investments, investors can increase the bargaining power. ■ Can invest in any city without being physically present at the location. 	<ul style="list-style-type: none"> ■ Required outlay for investment in property is at least ₹25-30 lakh. ■ Investment in single property is risky and returns are volatile. ■ Investor has to check the background of builder and property details on his own. ■ Buyer has to maintain the property and recover rent from tenant. ■ Searching for a buyer can take weeks, even months before investor can exit. ■ Investment won't give immediate returns if the project has not been completed. ■ Investor has to fight his battles alone against well-connected builders. ■ Physical presence during deals mean only accessible markets can be tapped.

This also means that commercial real estate is reasonably priced right now. There is a greater scope for appreciation. As the economy picks up momentum and commercial activity increases, things are likely to improve in the coming years. "This is the time to get into commercial real estate because it is at the bottom of the cycle," says Kapoor. Other experts join the chorus of optimism. "For the REIT to work, you need a buoyant real estate market. Nothing much had been happening in the past 3-4 years, but things have started picking up now," says Mistry.

"Commercial real estate is linked to economic recovery. Rentals may remain under pressure for the next 12-18 months given the oversupply, but with the speed of supply moderating in the coming years, the situation should improve if we get back to the economic recovery mode," says Mittal. The huge commercial real estate projects that were launched between 2005 and 2008 are being delivered now. With the builders facing financial stress, the supply of fresh real estate has moderated in recent years.

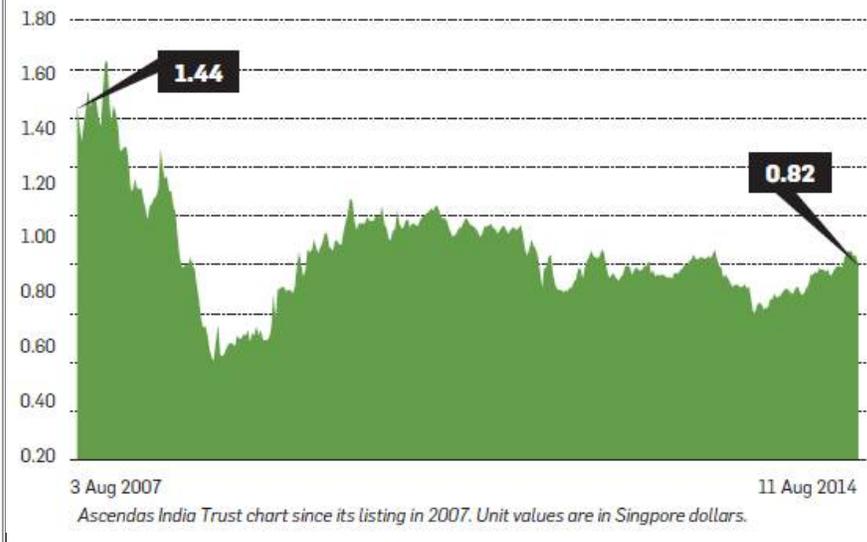
Taxation of REIT income

This was the biggest bone of contention for REITs. The recent budget offered some relief when the finance minister announced that REITs will be a pass-through vehicle. In the earlier structure, both the trust as well as the investors had to pay tax. Now, the trust will not pay tax on income. Only the investor will be taxed when he gets the income or sells the units. However, experts warn that this passthrough benefit is not applicable to all types of incomes from the REIT (see table) "The pass-through benefit is only for interest income earned by the REIT from its special purpose vehicle (SPV). As of now, there is no pass-through for rent or other income received by the REIT from property directly held by it," says Sriram Govind, core member of the international tax team, Nishith Desai Associates. He says the REIT has to pay corporate tax on such income earned by the SPV. Similarly, the REIT will also have to pay capital gains tax on sale of shares of the SPV. There is also no relaxation on the dividend distribution tax on payouts by the SPV to the REIT," says Govind. Though the dividend received from the SPV is tax-free for the REIT as well as the investor, the SPV would have already paid corporate tax and dividend distribution tax on such income. Factor this tax into the calculation of returns from REITs.



Reits have not done too well

Units of Ascendas India Trust, a Singapore-listed Reit that invests in commercial real estate in India, are trading below their issue price



Though the dividend distribution tax is a prickly problem, what more than makes up for it is the treatment of capital gains from the REIT. Since there is a securities transaction tax (STT) on the listed REITs, the longterm capital gains will be tax-free while short-term capital gains will be taxed at a concessional rate of 15%.

However, you need to hold the REIT units for at least three years to qualify for longterm capital gains. In addition, the investor has to pay tax on part of the income received during the period. "The listed pass-through vehicles are at a tax disadvantage," says Feroze Azeez, director, Investment Products, Anand Rathi Private Wealth Management.

How will income from REITs be taxed?

While some of the income will be taxed heavily, another portion will enjoy tax benefits

	Special purpose vehicle	REIT	Investors
Rent Received by SPV	Corporate tax rate	N/A	N/A
Capital gain received by SPV	Rates applicable to capital gains	N/A	N/A
Dividend from SPV to REIT	Dividend Distribution Tax	No Tax	Tax Free
Rent directly received by REIT	N/A	Corporate tax rate	Tax Free
Capital gain directly received by REIT	N/A	Corporate tax rate	Tax Free
Interest from SPV to REIT	N/A	No Tax	Taxable at slab rates on the portion of interest distributed. There will be 5% withholding tax for NRIs and 10% withholding tax for residents
Capital Gain received by investors by trading in REIT units	N/A	N/A	Tax free if the holding period is more than 3 years; Else 15%

Since some of the income from the REIT will be tax-free and some other will be taxable, the big question is, how will investors know the difference? "There will be some reporting mechanism and the break-up will come at the time of income distribution from the REIT," says Rao of JLL.

Interestingly, REITs offer a better deal to NRIs on the tax front. The withholding tax for them is only 5% compared to 10% for resident Indians. And the amount received may be tax-free for them, at least in most countries, while the Indian investors have to pay tax based on their slab rates. If the NRI has to pay tax on the income in the country of residence, he can claim this 5% as a rebate.

What are the risks?

The biggest risk can come in the form of developers keeping their prime rent-earning properties and dumping their not-so-good assets on REITs. Though there will be professional valuers, the real estate market is notorious for its opacity. It is still a builder's market and the investors don't have any access to the valuation process. Though the introduction of REITs is expected to improve the situation, the lack of transparency and the black money component in the real estate deals is another possible risk. Finally, there may be stable regular income, but the capital appreciation or depreciation depends on the market price of commercial real estate and, therefore, will be volatile.

Sebi's guidelines for REITs is only the first step. There are bound to be teething problems when the market starts functioning. However, this has paved the way for a more vibrant market for real estate. If you want to invest in real estate but don't have deep pockets, you can consider REITs as the vehicle that can take you there.

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