

Real Estate Developers And Private Equity Investors: Is The Relationship Set To Get Rocky?

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In attempting to empower real estate buyers against construction delays and erring developers, the Real Estate (Regulation and Development) Act, 2016 (RERA) has turned the screws not only on developers but also their predominant source of funding - private equity.

Private equity constitutes almost 60 percent of the institutional funding requirement of India's real estate sector, according to a 2017 report published by property consultant Knight Frank. Bank credit, which accounted for anywhere between 50-57 percent of the sector's institutional funding requirement till 2014, has witnessed a sharp reduction in the last two years to 24-26 percent, the report points out.

With higher stakes, private equity investors have enjoyed a big say in how their investments are put to use by developers. But, according to industry experts, this is set to change because of RERA.

Though the new law was notified by the central government last year, most states are expected to finalize the rules only by April-end. Once the law comes into effect in its entirety, it will prompt new terms of engagement between real estate developers and private equity investors, said experts to BloombergQuint.

They identified three key areas of impact

- Rights included in private equity agreements
- The investor-cum-developer model
- Investment returns

Indian real estate has attracted \$32 billion in private equity since 2005 and inflows in 2016 were the second highest at \$5.7 billion, according to real estate services firm Jones Lang LaSalle India.

When making these investments, most private equity investors, especially foreign ones, insist on certain specific

rights, Ruchir Sinha, co-head of real estate practice at law firm Nishith Desai Associates, pointed out. For instance, he said, in the event of a default by the developer, the investor typically has a *step-in right*.

“ *The private equity investor has the right to step into the shoes of a developer and run the project or appoint a third-party developer. This will become a challenge going forward and is a concern for our clients.*

Ruchir Sinha, Co-Head-Real Estate Practice, Nishith Desai Associates

The challenge Sinha is referring to stems from a condition under the Act that any change in promoter requires the approval of two-thirds of the allottees and the Real Estate Regulatory Authority.

Step-in rights will be the first casualty of this law, concurred Sai Krishna Bharathan, a partner specialising in private equity investments in the real estate sector at law firm AZB & Partners. RERA puts many other rights and control measures at risk too, he added.

“ *There is a cross-default provision that says if the developer defaults under the development management agreement, it will become a trigger for terminating the shareholders’ agreement as well. This allowed the investor to get an alternate project manager. Since the Act won’t allow this anymore, the investors would want the agreements to say that RERA issues would ultimately be the developer’s problem which will obviously be indemnified by him.*

Sai Krishna Bharathan, Partner, AZB & Partners

The loss of such rights will have further collateral impact. For instance the unfeasibility of the step-in right will make it tough for a private equity investor to take over the project in case the developer defaults. Instead, the investor will have to work with allottees to achieve completion, said Amit Bhagat, managing director and chief executive officer at ASK Property Investment Advisors.

“ *RERA is a protection to the customer; it’s not a protection to the high-cost lender. This is particularly relevant for those lending at 20 percent. Who borrows at high cost? To whom low-cost money is not available. So now, as a private equity investor, you have to ensure that you deal with a partner whose brand and reputation is solid, there is good governance and the track record is good. So, you have to choose your partners with far more due diligence.*

Amit Bhagat, MD and CEO, ASK Property Investment Advisors

Investor Or ‘Promoter’?

The Act defines promoter as ‘a person who causes to be constructed an independent building... and such other person who constructs any building or apartment for sale to the general public.’

The explanation to the definition of promoter says that in situations where the person who constructs/develops the buildings and the person who sells the apartments are different persons, both of them shall be deemed to be promoters.

Bhagat said that ultimately, a private equity investor making an equity investment is also the owner of the asset

along with the developer.

“ *When you are the owner, you have to take responsibility of completion and delivery. If you're a debt investor, you may be outside the ambit.*

Amit Bhagat, MD & CEO, ASK Property Investment Advisors

Sinha added that today there is a hybrid breed of investor-cum-developer and more and more private equity players are keen to take controlling stakes to achieve stability.

“ *The challenge is will they qualify as promoter and if yes, then the entire responsibility of the project is pinned on them. The important point is in whose name the marketing and sale happened. Today, if you market the project in the name of some of the investors that are good brands, it sells well. But then under RERA, they will qualify as a promoter.*

Ruchir Sinha, Co-Head-Real Estate Practice, Nishith Desai Associates

The Xander Group, Hines, Temasek-owned Mapletree Investments are some examples of the investor-cum-developer model.

If a private equity investor qualifies as a promoter, it will have to fulfill obligations relating to registration, meeting project timelines, and penalties in case of a default.

Bharathan said these developments have prompted the addition of a new covenant in shareholder agreements currently under negotiation - that under no circumstances can a project be marketed in the name of the investor. Other lawyers are also suggesting caution.

“ *It's being made very clear that in no case can an investor be shown as a developer or a promoter or in any manner in control of the special purpose vehicle (SPV) set up for the project or in charge of the day-to-day decisions of the SPV.*

Sai Krishna Bharathan, Partner, AZB & Partners

Returns In Jeopardy?

The Act mandates that the promoter must deposit 70 percent of the amount received from the allottees in a separate account. This amount can only be used to cover the **cost of construction** and land cost as per the Act, with the states having the leeway to specify what constitutes cost of construction. For instance, the draft rules for Maharashtra allow the 70 percent amount to be used to repay and service debt, but Karnataka doesn't.

Sinha pointed out that most private equity - developer agreements have veto rights that require the developer to repay the investor first using whatever cash flow comes in. Such vetoes now face extinction because the developer's priority will be to meet delivery timelines, he added.

Bhagat views this as a positive for private equity investors as this and other provisions push the developer to complete the project on time.

The balance 30 percent of the money received from allottees will be used to service investors and this will lead to

an increase in the internal rate of return, Bharathan opined.

The payback to investors is going to be higher since repayment will take a longer amount of time as most of the money will be cash-trapped.

Sai Krishna Bharathan, Partner, AZB & Partners

Despite the new limitations, experts said RERA will benefit private equity investors too. Default rates will fall as a project can't even be marketed until all approvals, leading up to the commencement certificate, are in place. And the 70 percent escrow condition reduces the risk of fund diversion by the developer.

In balance private equity investors may not be at a big disadvantage, but like with any new law, that depends on implementation. Experts wonder if the new law, coupled with a new regulator, will succeed in achieving better outcomes for buyers and investors, given the competing interests at stake.

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