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Offshore real estate funds seek to set up NBFCs

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Mumbai: Despite the deletion of the new clause in the foreign direct investment (FDI) policy prohibiting put options, offshore real estate funds are looking to set up non-banking financial companies (NBFCs) to actively invest in the sector.

"We are currently advising several offshore clients on setting up realty specific NBFCs," said Ruchir Sinha, co-head of real estate investments practice at law firm Nishith Desai Associates. He declined to reveal the names of the firms because of client confidentiality issues.

"Our clients still continue to receive notices from the Reserve Bank of India (RBI) on put options," said Sinha. Under the put option, a promoter buys back the investors' share at a pre-determined price at a particular date in future. Typically, such an option is part of a shareholders' agreement when investors put money in unlisted entities. They exit when the firm floats its initial public offering, or IPO, but if market conditions are not conducive for a share sale, as is the case now, promoters buy back the shares to protect investors.

RBI has maintained its stand on put options as it was prior to the change in the FDI policy. "They still don't consider it favourable and they have taken the view that such options are derivatives," said Sinha.

According to RBI, a put option is a futures contract and such contracts can be traded only on a stock exchange and not between shareholders of a company, said Sinha. A futures contract is a contractual agreement to buy or sell a particular commodity or financial instrument at a pre-determined price in the future.

The advantage of setting up an NBFC is that it's a domestic entity. For a domestic loan there are no FDI restrictions and it is immune from any sort of regulatory uncertainty.

Two other law firms that *Mint* spoke to are advising offshore funds on setting up NBFCs to invest in real estate. "We have got a couple of inquiries from offshore funds who want to set up NBFCs to invest in the real estate sector," said Dina Wadia, partner at Mumbai-based J Sagar Associates. "However, all these plans are at initial stages."

Haigreve Khaitan, senior partner at Khaitan and Co., said "since RBI has taken a view on put options, several structures are being contemplated by offshore PE funds. A lot of them are looking at setting up NBFCs not just for investing in real estate but also for promoter funding and mezzanine funding."

In 2011, PE firms invested $1.3 billion in the sector, up from about $1 billion in 2010, according to VCCEdge, a financial research platform. Red Fort Capital Advisors Pvt. Ltd, a real estate focused fund, is also looking to start an NBFC, said two people familiar with the development. Subhash Bedi, managing director, Red Fort Capital, declined to comment on the development.

“There are a lot of funds with equity money that have become risk averse and, hence, the preference for debt investments is on the rise,” he said. “Given the state of the market today we look at it as a good time to make equity investments in the sector.”

Most of the investments in real estate are through structured debt instruments in the form of non-convertible debentures (NCDs). However, with a limited overall corporate debt limit, which will now expire on redemption or maturity of the debt instruments, the NCD route seems to be losing its sheen, say experts.

Red Fort isn’t the first fund to start an NBFC. Xander Group Inc., an investment firm with more than $2 billion under management, set up an NBFC, Xander Finance, in 2010. Xander Finance focuses on providing liquidity to new borrowers, banks with legacy commercial real estate exposure as well as liquid real estate debt investments.

Last year, Ashmore Group Plc, **Everstone Capital Management** and the private equity (PE) arm of Goldman Sachs set up an NBFC, Indostar Capital Finance Ltd. The NBFC signed its first real estate deal in August 2011, lending around Rs 150 crore to two Mumbai-based developers.

The NBFC route cannot be adopted by all funds, according to some people. “You need to be a player of a reasonable size to set up an NBFC,” said Sunil Rohokale, chief executive and managing director, ASK Investment Holdings Pvt. Ltd, which manages a real estate fund. “It is more of a stop-gap solution.”

According to Sinha of Nishith Desai, with the Securities and Exchange Board of India now mandating the expiry of foreign institutional investor (FII) debt limits on redemption or maturity, the role of NBFCs is likely to get enhanced. Overseas investors may park funds with NBFCs (by way of subscribing to their NCDs) and use such institutions in turn for debt deals, thereby retaining their debt limits until they exit from the NBFC, he said.

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