

Real Estate Update

June 20, 2017

REITS: WILL THEY BE ATTRACTIVE ENOUGH?

This article was originally published in the 15th June, 2017 edition of 

Whilst the markets have given a warm reception to infrastructure investment trusts (InvITs) and a spate of InvITs are in the pipeline, the fate of real estate investment trusts (REITs) remains to be seen. REITs still haven't taken off and there is a degree of morbid scepticism around the success of a REIT. The reasons could be as follows. First, from an investor perspective, the investor base in a REIT is likely to be offshore insurance companies, pension funds, sovereigns etc., which would want to hold the asset for long term and earn stable income. For such investors, the prospect of capital growth may be a consideration, but not a driver. The average yield in prime commercial real estate in India can range 7-9.5% on an optimal tenancy basis with an annual escalation or capital growth of about 5% year-on-year. Together with capital growth, the annual return expectation can be in the region of 12-14% on a gross basis in rupee terms.

In dollar terms, considering the hedging cost (roughly 6%), the number comes down to about 1-3% for yield and 6-8% on an overall return basis. These numbers don't look so attractive to global capital when compared with other developed markets, which offers comparable returns in dollar terms, but without the regulatory risk, tax risk, litigation risk and business risk that India poses.

Second, a developer is still grappling with the difference between a REIT and lease rental discounting (LRD). Since LRD is typically available in the range of 9-11% for reputed developers, many developers are not able to appreciate the merit of going for a REIT and subject themselves to public and regulatory scrutiny. Indeed, a REIT offers the opportunity of full monetization, liquidity and brand recall, but that may in itself not be a driver. A developer may be willing to defer monetization until the expiry of the LRD, or may be content with regular LRD top-ups.

Third, even though capital gains, minimum alternate tax and dividend distribution taxes have been exempted, the tax issues are not entirely sorted out for a REIT. Since capital gains tax exemption is only applicable if the shares of a company holding the real estate asset SPV are transferred to a REIT, interposition of an SPV between the asset and a REIT is inevitable. Such SPV is subject to corporate income tax of 30% on the rentals received, which could be reduced to the extent of interest expense in the SPV. Hence, it becomes imperative for the REIT to invest into the SPV substantially by way of debt and purchase equity at nominal value, which could work in the current construct since most such assets are anyways about 60% leveraged. Whilst there is no withholding on the interest income received by the REIT, when the REIT distributes such interest income to its unit holders, the non-resident is subjected to a mere 5% tax (creditable in home jurisdiction), whereas an Indian resident is subjected to tax at the maximum marginal rate, usually 30%. This is another issue which could dissuade domestic investors, including the developer/sponsor since post transfer to the REIT they will have to bear heavy income tax on the income received from the REIT units.

Fifth, there are certain regulatory hassles that may need to be creased out. For instance, REITs unlike InvITs cannot raise funds on a private placement basis, and must make a public offering. The Securities and Exchange Board of India (Sebi) regulations for REITs require the sponsor to have real estate experience. Typically, such eligibility criterion is only limited to the investment manager, and never to the sponsor who should only be seen as the anchor investor. As a result, several entities such as banks, airlines and other large organizations that have grade A fully tenanted commercial real estate cannot float their REIT and adopt the typical sale and lease back structures. Whilst such companies can club with someone with real estate experience to form a "sponsor group", there may be some degree of challenge and financial contribution required since each sponsor is required to hold 5% of the REIT units.

Having said that, with all the challenges set out above, we still hope that REITs are well received on the back of shrinking credit rates, unflinching faith in the growth of Indian real estate and tax free exits on the bourses after a holding period of two years. With 90% income to be mandatorily up streamed and government allowing banks, insurance companies and pension funds allowed to invest in REITs, it remains to be seen if REITs are able to kick start monetization of stabilized assets on the back of right mix of security, liquidity and tax optimization.

Ruchir Sinha

DISCLAIMER

The contents of this hotline should not be construed as legal opinion. View detailed disclaimer.

This Hotline provides general information existing at the time of preparation. The Hotline is intended as a news update and Nishith Desai Associates neither assumes nor accepts any

This is not a Spam mail. You have received this mail because you have either requested for it or someone must have suggested your name. Since India has no anti-spamming law, we refer to the US

Research Papers

Fintech

May 05, 2025

Medical Device Industry in India

April 28, 2025

Clinical Trials and Biomedical Research in India

April 22, 2025

Research Articles

2025 Watchlist: Life Sciences Sector India

April 04, 2025

Re-Evaluating Press Note 3 Of 2020: Should India's Land Borders Still Define Foreign Investment Boundaries?

February 04, 2025

INDIA 2025: The Emerging Powerhouse for Private Equity and M&A Deals

January 15, 2025

Audio

CCI's Deal Value Test

February 22, 2025

Securities Market Regulator's Continued Quest Against "Unfiltered" Financial Advice

December 18, 2024

Digital Lending - Part 1 - What's New with NBFC P2Ps

November 19, 2024

NDA Connect

Connect with us at events, conferences and seminars.

NDA Hotline

Click here to view Hotline archives.

Video

Vyapak Desai speaking on the danger of deepfakes | Legally Speaking with Tarun Nangia | NewsX

April 01, 2025

responsibility for any loss arising to any person acting or refraining from acting as a result of any material contained in this Hotline. It is recommended that professional advice be taken based on the specific facts and circumstances. This Hotline does not substitute the need to refer to the original pronouncements.

directive, which states that a mail cannot be considered Spam if it contains the sender's contact information, which this mail does. In case this mail doesn't concern you, please unsubscribe from mailing list.

**Vaibhav Parikh, Partner, Nishith
Desai Associate on Tech, M&A, and
Ease of Doing Business**

March 19, 2025

**SIAC 2025 Rules: Key changes &
Implications**

February 18, 2025