

Real Estate Update

September 22, 2017

SEBI FURTHER LIBERALIZES THE REITS REGIME

- Allows REITs to borrow by issuance of debt securities
- Allows REITs to lend to holdco/SPVs
- Ability to list single asset
- Introduction of strategic investors

Securities Exchange Board of India ("SEBI") notified the Securities Exchange Board of India (Real Estate Investment Trusts) Regulations, 2014 on September 26, 2014 ("REIT Regs"). At the time of the notification of the REIT Regs, it was stated that the Real Estate Investment Trusts ("REITs") will change dynamics of the real estate sector in India as (a) it will provide a platform to the real estate developers and investors with core assets to monetize the same; (b) provide an alternative platform to the investors to invest in the real estate without being exposed to plethora of issues which surround real estate sector in India; and (c) also bring higher standards of transparency and governance in the way real estate developers managed their assets.

It has been three years since the REIT Regs were notified, but REITs have not taken off in India. It was on account of multiple regulatory and tax related issues that REIT regime did not take off in India. However, since 2014, SEBI and the government has ironed out those issues, but only one developer backed by one of the largest private equity player in the world has registered REIT with SEBI, but there is no clarity when will the public issue be launched and units of the REITs will be listed on a recognized stock exchange in India.

In order to further liberalize the regime for the REITs, SEBI in its board meeting dated September 18, 2017 ("SEBI Board Meeting") has made the following tweaks in the REIT Regs.

1. *Proposal:* Allowing REITs to raise debt capital by issuing debt securities

Background

Currently, a REIT can raise debt by way of borrowing other than by way of issuance of debt securities. This is because debt instruments issued by REIT would not qualify as a 'security' under the Securities Contracts (Regulation) Act, 1956. Hence, debt investments from entities such as AIF, FPI and FVCI were not permitted in REITs, since such entities could only invest in securities and not lend in any other manner.

Implications

- a. SEBI, Central Government and RBI will need to make necessary amendments in the SCRA, Foreign Exchange Management (Transfer or issue of security by a person resident outside India) Regulations, 2000 etc. in order to facilitate the debt investments in REITs.
- b. Substantial pool of investment avenues can now be tapped by a REIT.
- c. Since banks were restricted under prudential norms in terms of exposure to commercial real estate, an important domestic source of funding was not fully available to REITs. Pension funds and insurance companies typically are primary source of funding, but they are also substantially limited in their ability to invest in REITs. Hence, there was a need to provide REITs with the ability to raise funds in order to meet capital requirements from time to time, which may now be possible based on SEBI's proposal. Please click [here](#) for our analysis on the funding by banks, pension funds and insurance companies to REITs.

2. *Proposal:* Allowing REITs to lend to underlying holdco¹/SPV²

Background

Though the REIT Regs at several places permitted REITs to invest as debt, however, a close reading of regulation 18 sub-regulation (13) of REIT Regs manifest that such investments in debt should be in the form of debt securities as lending by a REIT is prohibited.

Implications

- a. It appears that SEBI has allowed REITs with the flexibility to advance loans to the holdco/SPVs, which technically is not available as of date.
- b. This will allow REITs to lend to non-corporate entities such as LLPs, partnerships etc. which was not otherwise possible as the debt securities can only be issued by a body corporate.

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3. **Proposal:** Introducing the concept of strategic investor³ for REITs on similar lines of infrastructure investment trusts

Background

Even though the regulatory framework for the REITs and infrastructure investment trust is quite similar, there are few differences in their regulatory framework; one of them is that certain institutional investors i.e. strategic investors are permitted to invest in the units issued by infrastructure investment trusts in preference to the general public at the time of the public issuance, which is currently not permitted under the REIT Regs. Such issuance of the units to strategic investors act as a safeguard to the issuer by minimizing the risk of undersubscription of the units. The two infrastructure investment trusts which have gone public had utilized this provision and had issued units to strategic investors.

Implications

- Introduction of 'strategic investor' may help REITs to raise money by mitigating the risk of relying only on public to subscribe to the units as REITs can only undertake public issuance of units for listing of such units on the recognized stock exchange and is not permitted to undertake preferential allotment to specific investors.
- Accordingly, the requirement of having disperse unit holders can also be eased to the extent of issuance of units to strategic investors, which may be of comfort for the sponsor who are considering listing their assets.

4. **Proposal:** Allowing single asset in a REIT

Currently under the REIT Regs, a REIT should have minimum 2 (two) assets which cumulatively should be more than INR 500 crores (Rupees Five Hundred Crores) in value. Such diversification requirement was mandated with a view to assuage asset specific risk that may occur in certain pockets due to tenancy shortfall or other issues. However, the limited availability of Grade A fully tenanted assets that could be rolled into a REIT was becoming a challenge for many sponsors, particularly in light of limited interest from the investors. Hence, there was an industry request to do away with the diversification requirements to give the necessary support to the fledgling REIT regime, which seems to have been accepted by the SEBI.

5. **Proposal:** Amending the definition of valuer for REITs

SEBI Board Meeting also proposes to amend the definition of valuer who is entrusted with the responsibility of undertaking the periodical valuation of the assets. However, the press release of the SEBI Board Meeting does not set out changes that will be made in the definition.

6. **Proposal under deliberation:** The Board, after deliberations, decided to have further consultation with the stakeholders on a proposal of allowing REITs to invest at least 50% of the equity share capital or interest in the underlying Holdco/SPVs, and similarly allowing Holdco to invest with at least 50% of the equity share capital or interest in the underlying SPVs.

Background:

In 2014, when REIT Regs were originally notified, it mentioned that SPV means any company or LLP in which the REIT holds or proposes to hold controlling interest and not less than 50% (*fifty percent*) of the equity share capital or interest. However, this underwent a change in 2016 when SEBI extensively amended the REIT Regs, pursuant to the amendment SPV now means any company or LLP in which either the REIT or the holdco holds or proposes to hold controlling interest and not less than 51% (*fifty one percent*) of the equity share capital or interest. Further, amendments also provided for a definition of a holdco which provided for similar test i.e. holding or proposing to hold controlling interest and not less than 51% (*fifty one percent*) of the equity share capital or interest.

Implication

- Ideally, threshold for shareholding and interest in holdco/SPVs should be 51% (*fifty one percent*) and not 50% (*fifty percent*) in order to eliminate any potential conflict between the shareholders as a shareholder with a substantial shareholding of 50% (*fifty percent*) can create operational issues whereas, a shareholder with a majority shareholding of 51% (*fifty one percent*) enjoys lot of power in terms of the decision making under Companies Act, 2013.
 - Further, it remains to be seen whether SEBI will retain the '*controlling interest*' test for the investment by REIT in the holdco/SPV as the test provides additional safeguard to REITs.
- Whilst the exact text in relation to the above mentioned proposal remains to be seen, it is fair to say that SEBI has made another honest attempt to encourage REITs which have still not taken off. Changes proposed by SEBI are positive in nature and should enable more movement in this sector and titillate the industry players to list their assets and monetize their assets.

For the better and comprehensive understanding of the REIT regime, please refer [Economic Times](#), [LiveMint_Opinion](#), [LiveMint_Money](#).

– Dipanshu Singhal & Ruchir Sinha

You can direct your queries or comments to the authors

¹ Under REIT Regs, "holdco" means a company or LLP:

(i) in which REIT holds or proposes to hold controlling interest and not less than fifty one per cent. of the equity share capital or interest and which it in turn has made investments in other SPV(s), which ultimately hold the property(ies);
(ii) which is not engaged in any other activity other than holding of the underlying SPV(s), holding of real estate/properties and any other activities pertaining to and incidental to such holdings.

² Under REIT Regs, "SPV" means a company or LLP:

(i) in which either the REIT or the holdco holds or proposes to hold controlling interest and not less than fifty one per cent. of the equity share capital or interest;
(ii) which holds not less than eighty per cent. of its assets directly in properties and does not invest in other special purpose vehicles; and
(iii) which is not engaged in any activity other than holding and developing property and any other activity incidental to such holding or

development;

³ "strategic investor" under Securities and Exchange Board of India (Infrastructure Investment Trusts) Regulations, 2014 means –

a) an infrastructure finance company registered with Reserve Bank of India as a Non-Banking Financial Company;

b) a Scheduled Commercial Bank;

c) an international multilateral financial institution;

d) a systemically important Non-Banking Financial Companies registered with Reserve Bank of India;

e) a foreign portfolio investors,

who together invest not less than five per cent of the total offer size of the InvIT or such amount as may be specified by the Board from time to time.

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