Real Estate Update

April 29, 2008

WILL REMFS OUTSHINE REITS?

INTRODUCTION

The real estate sector, which received its most recent shot in the arm early this year with the introduction of the draft Real Estate Investment Trust ("**REIT**") Guidelines (yet to be notified), can now expect enhanced investor interest and participation with the Securities and Exchange Board of India ("**SEBI**") finally notifying on April 16, 2008, the amendments to the Securities and Exchange Board of India (Mutual Funds) Regulations, 1996 ("**Regulations**") to allow mutual funds to launch real estate mutual funds ("**REMF**").

KEY FEATURES

Certain key features of the Regulations are discussed below --

ELIGIBILITY

- In order to set up a new mutual fund, which will launch only REMF schemes, the sponsor should be carrying on the business in real estate for a period at least five years and fulfill all other eligibility criteria applicable for sponsoring a mutual fund.
- Existing mutual funds can launch REMFs if they have adequate number of experienced key personnel / directors.
- Interestingly, if the REMF has no key personnel with experience in finance and financial services, then 100% of the net assets will be required to be invested in real estate assets.

INVESTMENT RESTRICTIONS

- REMFs are required to invest at least 35% of its net assets in real estate assets and can invest the balance in mortgage backed securities, securities of companies engaged in dealing in real estate assets or in undertaking real estate development projects and other securities, provided that, if taken together, investments by the REMF in real estate assets, real estate related securities (including mortgage backed securities) should not be less than 75% of the net assets of the REMF. The balance 25% can be invested by the REMF in any other securities.
  Regulation 49A of the Regulations defines a 'real estate asset' as an identifiable immovable property (i) which is located within India in a specified area (to be specified by the SEBI); (ii) on which construction is complete and which is usable; (iii) which is evidenced by valid title documents; (iv) which is legally transferable; (v) which is free from all encumbrances; and (vi) which is not subject matter of any litigation. The Regulations specifically exclude projects under construction, vacant land, deserted property, land specified for agricultural use etc.
- REMFs are not permitted to transfer real estate assets amongst its schemes.
- REMFs are prohibited from engaging in the business of lending or housing finance activities.
- REMF are not permitted to invest more than (i) 30% of all its net assets in more than one city, unless disclosed in the offer document; (ii) 15% of its net assets in a single real estate project; (iii) 25% of the issued capital of an unlisted company under all schemes together; and (iv) 15% of net assets of any of its schemes in equity / debentures of an unlisted company.
- REMFs are prohibited from investing in (i) unlisted securities of the sponsor, its associate or its group company; or (ii) assets owned / previously owned by sponsor or the asset management company or their associates during the past 5 years. REMFs, may, however, invest in listed securities of such companies provided that such investment does not exceed 25% of its net assets.

VALUATION OF ASSETS

- Each real estate asset of an REMF should be valued by two valuers accredited by a credit rating agency registered with the SEBI and appointed by the asset management company.
- The valuation must take place every 90 days from date of purchase of the real estate asset, and the lower of the two values should be taken for the computation of net asset value ("NAV").
- The NAV is required to be disclosed on a daily basis.

TAX REGIME

- All income arising from the REMF registered under Section 10 (23D) of the Income Tax Act, 1961 will be tax exempt at the hands of the REMF.
- Under the provisions of Section 10 (35) of the Income Tax Act, 1961 the returns received by the unit holders from the REMF will be tax exempt.
- REMF will be liable to pay additional income tax on distributions of returns at the rate of 12.5% for individuals and 20% for others if it is not regarded as an equity oriented fund.
- Unit holder will be exempt from long term capital gains tax if the units are purchased on the floor of a stock exchange and the securities transaction tax thereon has been paid.

REITS V. REMFS – AN ANALYSIS

- Investment Ability: Whilst REITs are required to invest only in real estate assets and cannot invest in securities, REMFs can invest in securities as well. As our head of Real Estate Investment Practice, **Nishchal Joshipura** points out "The unique ability of REMFs to make hybrid investments (in securities and real estate) will not only allow them to make high risk high return investments in securities of a company undertaking construction development projects, but will also give them the leeway to acquire such real estate projects once they are completed."
- Development Risk: REMFs are not permitted to invest in developing properties, which may mitigate the returns on real estate assets. REITs are permitted to invest in underdeveloped properties up to 20% of their corpus.
- Valuation: Unlike REITs, where the valuation of the property is required to be done by a SEBI registered valuer having a net worth of at least 5 crores, the valuers in case of REMFs are not required to be registered with the SEBI or satisfy such net worth requirements.
- Taxation: Whilst the tax treatment of REITs is still unclear, tax treatment of REMFs, in line with mutual funds, is relatively certain. It, however, remains to be seen whether REMFs will be regarded as equity oriented funds or not. This is because a mutual fund qualifies as an "equity oriented" mutual fund, only if more than 65% of its total net assets are invested in equity shares of domestic companies, and the Regulations require that only up to 65% of the net assets of an REMF be invested in securities.

IMPLICATIONS

Much in line with the REITs, REMFs are likely to have similar implications, which are as follows:

- Enhanced participation: Domestic retail investors can now participate in the growing real estate market in India, which they were otherwise unable to owing to soaring real estate prices.
- Property: The requirement of the real estate assets to be entirely free from litigation in case of an REMF may not be practical, and it would have been better if certain threshold for litigation was stipulated.
- Venture Capital: As our Funds Practice Head, **Siddharth Shah** apprehends, "the Regulations might disappoint a host of venture capital investors that were anxiously waiting for the Regulations to convert themselves into REMFs as not only do the Regulations not provide for any rollover mechanism, they also prohibit REMFs from acquiring real estate assets owned by the sponsor, or the asset management company, or any of its associates during the past 5 years."
- Exit mechanism: REMFs will help private equity investors to exit from their investments in real estate projects with a shorter payback period as against the current scenario where they have to stay invested for usually 4 to 6 years till the real estate projects are completed. However, such an exit may be impacted by the restriction on an REMF to purchase assets from sponsors or their associates as mentioned earlier.
- Valuation: Further, the requirement to value the real estate assets every 90 days may not be practical in the Indian scenario and a period of 6 months for such valuations may have better suited. Such frequent valuations will only add to the administrative costs and expenses of REMF.
- Tax mitigation: REMFs can now directly invest in real estate assets unlike a domestic venture capital fund which is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REMF for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.
- Stamp duty implication: Heavy stamp duty rates might make investments in real estate assets

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unattractive. Recently, the government was deliberating on waiving the stamp duty for REITs in accordance with international norms, and it remains to be seen if the waivers will extend to REMFs as well.

- Professionalism and transparency: REMFs will not only be instrumental in the growth and maturity of the real estate sector, they will also facilitate professional management, good corporate governance, transparency and more importantly alleviation of black money from real estate sector in India.
- FIIs: Though there is nothing in the extant Regulations to exclude Foreign Institutional Investors from investing in REMFs, it remains to be seen whether restrictions would be imposed on FII investment in REMFs.

CONCLUSION

Essentially, the Regulations will provide a platform for diversification and give investors a professionally managed investment in real estate as an asset class and result in price discovery of real estate projects as mutual funds will conduct greater due diligence and check the fundamentals (location, commercial viability and other aspects of realty projects) prior to making the investment.

Whilst REMFs are likely to go a long way in unlocking value and enhancing investor participation in real estate, especially in a country like India where real estate and gold remain the traditional investment favorites of households, it remains to be seen whether the globally successful REITs, regarded as specialized mutual funds with the ability to invest directly into real estate, will be able to outshine the newly launched REMFs in terms of investor participation and investment returns.

- **Ruchir Sinha**, **Sahil Shah** & **Nishchal Joshipura**

Source: SEBI circular PR No.101/2008 dated 25th April, 2008

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