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Budget small print may hold key to REITs opportunity

Ahead of the Union budget, some real estate developers are in the process of appointing advisors while PE funds are busy acquiring more assets

Real Estate Investment Trusts (REITs) have emerged as the silver bullet for developers and private equity (PE) firms trying to cash in on their assets in a tepid market. Photo: Ramesh Pathania/Mint

Bengaluru: Real Estate Investment Trusts (REITs) have emerged as the silver bullet for developers and private equity (PE) firms trying to cash in on their assets in a tepid market, but the key to this opportunity, valued at $20 billion by some experts, will be the small print on these trusts in the Union budget that will be presented on 28 February.

While they wait, some developers are in the process of appointing advisors and PE funds are busy acquiring more real estate assets so as to build a sizeable, mature portfolio of properties.

Global private equity fund **Blackstone** Group Lp and its partner Embassy Property Developments Pvt. Ltd have lined up an office asset portfolio which is valued at around $2 billion, and may look at an end-2015 date for a possible listing of their REIT if the budget has the right kind of tax incentives, said a person directly involved in the process.

“The plan is to raise around $800 million in the first round. But we will see what are the tax benefits that are announced in the budget and take a call accordingly,” added this person, who asked not to be identified.

A Blackstone spokesperson declined comment.

The Embassy-Blackstone duo has been working on a possible REIT for some time now, and has also appointed advisors. The two also plan to increase their annual rental income from `800 crore from 24 million sq. ft of space to around `1,000 crore.

“We are watching the budget with great interest to know more on the REIT issue,” said Mike Holland, chief executive officer, Embassy Office Parks, the entity under which the duo holds many of the assets.

REITs are listed entities that primarily invest in leased office and retail assets, allowing developers to raise funds by selling completed buildings to investors and list them as a trust. REITs will also give foreign investors a chance to invest in lease rental generating assets, an asset class otherwise prohibited for foreign investments.

Last week, the country’s largest developer by market value, **DLF** Ltd, spoke about its plans more elaborately, saying it would form two REITs to monetize almost 30 million sq. ft of commercial assets, thereby increasing cash flows and reducing debt. Besides office assets, it will create a REIT for retail too, and is targeting its first filing for such a trust sometime in 2015-16.

A committee of independent directors, which has been set up to conduct a strategic review of the rental business to arrive at the best value from the investment assets that have been created over the last six-seven years, has appointed two investment banks—**JPMorgan** Chase and Co. and **Morgan Stanley** —to advise the company on the possible way forward.

DLF chief financial officer **Ashok Tyagi** and senior executive director, finance **Saurabh Chawla**, in a call with analysts last week, indicated that while the company is hoping for some tax incentives from the upcoming budget, it will anyhow look at a REIT possibility for its numerous assets.

According to audit and consulting firm **KPMG**, India has an estimated 350 million sq. ft of so-called “Grade A” office space, valued at about $65-70 billion, of which about 80-100 million sq. ft is estimated to be eligible for REITs in the next 2-3 years and valued at about $15-20 billion.

If REITs use the regular equity structure, the attendant special purpose vehicle (SPV) may attract corporate tax and dividend distribution tax, and this would result in a large tax deduction from the income earned from the property even before it reaches the unit holders, said **Sriram Govind**, senior member, international tax practice, at Nishith Desai Associates.

Additionally, the sponsor could be charged capital gains tax, even though the tax may be deferred.

“From a REIT taxation perspective, although a pass-through of tax liability to investors for REIT income was promised, since the SPV is required to pay full corporate and dividend distribution taxes, where is the pass-through? What is even worse is that no foreign tax credit may be available for distribution taxes paid in India,” he said.

“A complete pass-through can be achieved only if the REIT infuses money into the SPV by way of debt, which may require structuring of the SPV by the sponsor prior to transfer.”

Bengaluru-based realty firm RMZ Corp., backed by sovereign wealth fund Qatar Investment Authority, has been working on a potential REIT listing in India or Singapore for the past six to seven months, said managing director **Raj Menda**.

The company is looking at an end-2015 or early next year listing even as it tries to deploy funds to acquire large office assets. “There needs to be conducive platform for Indian REITs that should have minimum tax impact. The budget will be a deciding factor in where and when we do our listing,” he said.

“Fundamentally, the big expectations from REITs are that it creates a taxation framework and a new asset class for investors to create liquidity in illiquid assets,” said **Bobby Parikh**, chief mentor and partner, BMR and Associates Llp.