Real Estate Update

December 29, 2007

SEBI ACTS SANTA: GIFTS REITS TO INDIAN REAL ESTATE SECTOR

In a move that would align the practices in the Indian real estate sector with the global real estate practices, Securities and Exchange Board of India ("**SEBI**") has announced on December 28, 2007, the draft Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations, 2008 ("**REITs Regulations**") dealing with the setting up and functioning of a Real Estate Investment Trust ("**REIT**") in India. The said REITs Regulations, once approved, are expected to be in effect in India from early 2008.

In recent years, India's real estate sector has experienced surge of foreign and domestic capital. REITs have become a preferred public property investment vehicle around the world and can become the investment vehicle of choice for institutional and retail investors proposing to participate in real estate ownership, management and development. REITs provide a similar structure for investors buying into real estate as mutual funds provide for investment in stocks.

KEY HIGHLIGHTS

The key highlights of the draft REITs Regulations are as follows:

REITS

ELIGIBILITY CRITERIA FOR REGISTRATION

REIT shall be required to have a minimum net worth of Rs. 50,000,000 i.e. approx. USD 1,250,000. However, the REIT would also be eligible for registration, if it has a net worth of Rs. 30,000,000 i.e. approx. USD 750,000 which can be increased to Rs 50,000,000 i.e. approx.USD 1,250,000 within three years from the date of registration with SEBI. Further, the REIT should have adequate infrastructure and good professionals with requisite relevant experience.

SCHEME

The schemes offered by a REIT ("Scheme") shall be close-ended and cannot be open for subscription for a period of more than ninety days. This means that the unit holders cannot redeem their units in the Scheme, but can exit by selling the units on the stock exchange. Further, the Scheme cannot guarantee or assure any returns to the unit holders but only mention indicative return assessed by an appraising agency and stated in monetary terms. A Scheme shall be launched only upon obtaining a rating from a credit rating agency and being appraised by an appraising agency.

TRUST VEHICLE AND TRUSTEES

REITs Regulations provide that a Scheme shall be launched only by a trust registered under the Indian Trusts Act, 1882 and the trust deed shall provide for undertaking real estate investments as per REITs Regulations. The trustees of a REIT should be either a scheduled bank, trust company of such a scheduled bank, public financial institution, insurance company, or a body corporate.

INVESTMENT LIMITATIONS

A REIT shall be allowed to only invest in real estate which is generally income generating. However, a REIT shall also be allowed to invest in a building, which is unoccupied and non-income generating, or under redevelopment, provided the aggregate contract value of such properties does not exceed 20% of Scheme's total Net Asset Value. REIT shall not be allowed to invest in vacant land or participate in property development activities.

A REIT under all its Schemes shall not have exposure of more than 15% of any single real estate project and 25% of all the real estate projects developed, marketed, owned or financed by a single group of companies.

BORROWING RESTRICTIONS

A Scheme can borrow for funding investments and operating expenses but it cannot borrow more than one-fifth of the value of the Scheme's total gross assets.

DISTRIBUTION TO UNIT HOLDERS

The Scheme is required to distribute to unit holders at least 90% of its annual net profit after tax as dividends every year.

LISTING

The REITs Regulations provide for compulsory listing of the Scheme on the stock exchanges immediately after the allotment of the units to the unit holders but not later than six weeks from the date of closure of the Scheme on the stock exchange.

FEES

The application fees and registration fees payable for a REIT to SEBI shall be Rs. 25,000 (i.e. approx. USD 625) and Rs. 1,000,000 (i.e. approx. USD 25,000) respectively. Further, the filing fees for the offer document shall be Rs. 25,000 (i.e. approx. USD 625). In addition to above, the annual fees shall also be payable by a REIT depending on the Net Asset Value of the REIT.

INDEPENDENCE

At least 50% of the trustees of the REIT shall be independent persons and not directly or indirectly associated with the persons having a control over the REIT.

VALUATION REPORT

Every Scheme shall be required to appoint an independent property valuer ("Principal Valuer") who will submit valuation report on properties to be acquired or sold by the Scheme or where new units are offered by the Scheme. The Principal Valuer shall follow the valuation methodology based on the 'valuation standards on properties' published from time-to-time by the concerned Indian institute or the international valuation standards issued from time-to-time by the International Valuation Standards Committee.

REAL ESTATE INVESTMENT MANAGEMENT COMPANY ("REIM")

The Schemes shall be managed by a REIM and the REIM shall be registered with SEBI. The eligibility criteria, application and registration fees and criteria for independence for REIM are similar to criteria prescribed for a REIT.

It shall be the responsibility of the REIM to calculate the Net Asset Value of the Schemes of the REIT on the basis of the annual valuation report and disclose the same to the unit holders as per the frequencies specified by SEBI.

REIM shall prepare quarterly report on its activities and submit the same to the trustees of the Trust within one month of the expiry of each quarter. The REIM shall also have certain other reporting requirements to SEBI.

IMPLICATIONS

The following shall be implications of the REITs Regulations:

- REITs could now directly invest in real estate properties unlike a domestic venture capital fund which currently is required to invest in a venture capital undertaking which in turn can own properties. This direct investment by REITs for owning underlying properties will help in reducing taxes by eliminating one entity layer in the ownership structure.
- It remains to be seen whether a REIT would be eligible for a tax pass through under the domestic tax laws, as is currently available in developed countries, if at least 90% of its annual net profit after tax is distributed as dividends every year to the unit holders as per the REITs Regulations.
- REITs 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 four to six years till the real estate projects are completed.
- It remains unclear from the REITs Regulations and the same will unfold over a period of time as to whether the REITs regime will be open for investment by foreign investors.
- No mechanism has been prescribed under the REITs Regulations for the migration of the existing schemes registered under the SEBI (Venture Capital Funds) Regulations, 1996 to the proposed REITs regime. Accordingly, the existing domestic venture capital funds will have to wait for some more time to get a clear picture on migration of their existing schemes into a REIT Scheme.
- As per the REITs Regulations, the development risk has been capped at 20% of the Scheme's Net Asset Value which is in line with the laws in developed countries.
- For the foreign fund managers proposing to set up their REIT in India, it remains to be seen whether they will be allowed to set up their REIM in India under the automatic route as is currently available to other foreign owned asset management companies.

REITs will offer a convenient tool to retail investors, which will relieve them of the necessity to select, acquire, get registered and sell real estate properties and will help minimize the risks related to real estate investments. The announcement of draft REITs Regulations by SEBI has come at a time when India's biggest real estate developers such as DLF and Unitech have announced their plans to list their REITs in Singapore early next year. It remains to be seen whether the Indian REITs regime, once operational, will be able to garner as much interest as currently garnered by offshore REITs regimes in Singapore, Hong Kong, Australia, etc.

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Sources:

- SEBI announces guidelines for REITs, Business Line, December 28, 2007
- SEBI clears the way for REITs, Business Standard, December 28, 2007
- SEBI paves way for real estate investment trusts, Economic Times, December 29, 2007
- SEBI proposes REIT guidelines, Financial Express, December 29, 2007
- Draft SEBI (REIT) Regulations, 2008

September 26, 2024

Scope of judicial interference and inquiry in an application for appointment of arbitrator under the (Indian) Arbitration and Conciliation Act, 1996

September 22, 2024

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