Real Estate Investment Trust - REITs

- Valuation
- Investment Banking
- Advisory Services

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RESEARCH

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Table of Contents

1. Background

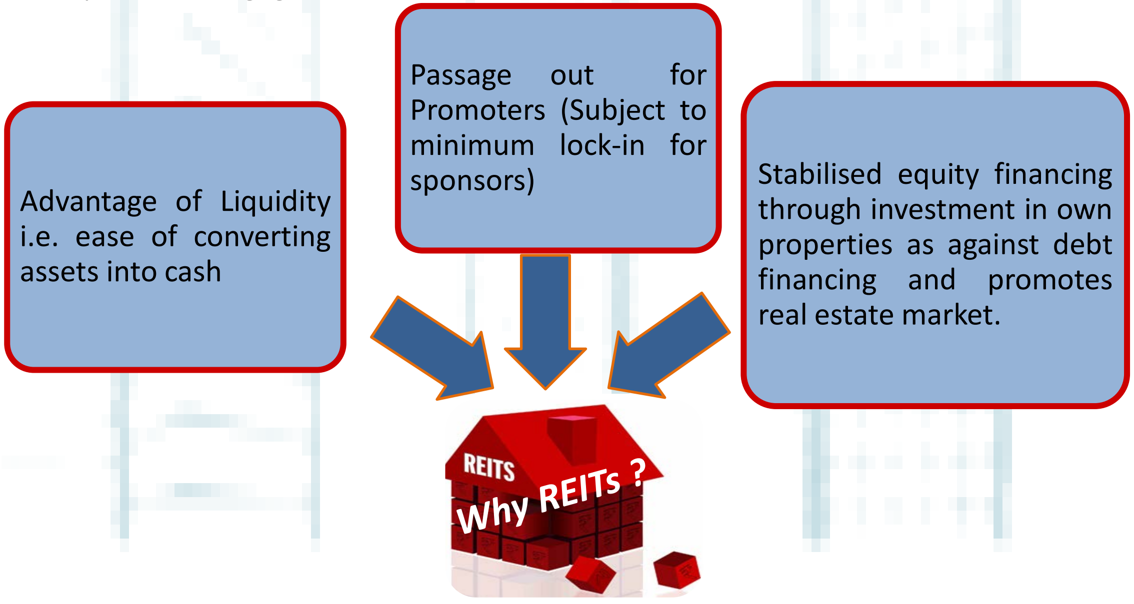
❖ REITs are collective instruments schemes that invest in a portfolio of completed and revenue generating real estate assets such as shopping malls, offices, hotels or serviced apartments, usually established with a view to generate income for unit holders.

❖ Assets of REITs are professionally managed and revenues generated from assets (Primarily rental income) are normally distributed at regular intervals to the unit holder.

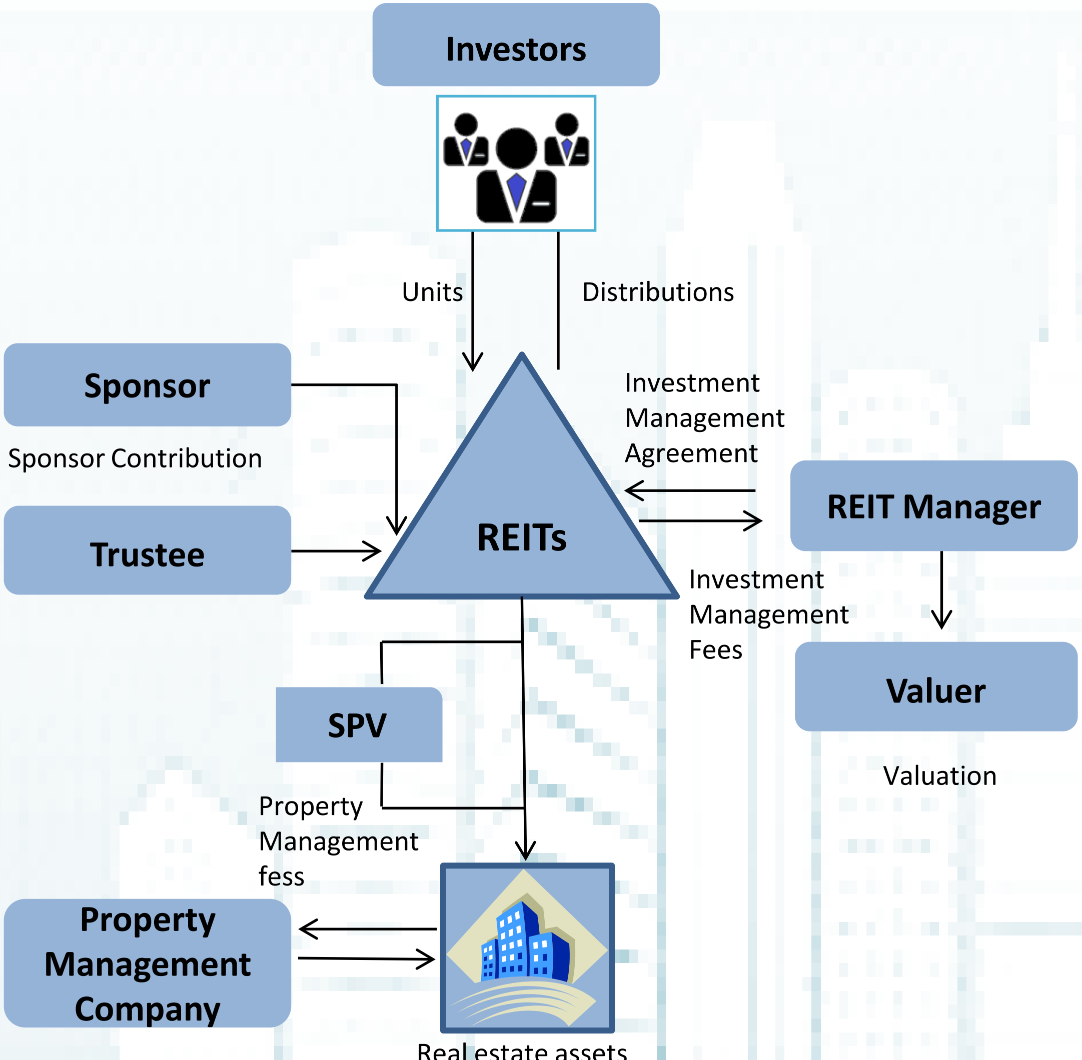
❖ Investment goals of REITs are much the same as the goals of an investment in stocks- current income distribution and long term appreciation potential.

❖ Securities and Exchange Board of India (SEBI) issued draft guidelines for Real Estate Investment Trusts (REITs) on 10th October 2013 which were kept open for public comments. The final regulations have been issued on 26th September 2014 .

❖ There are 3 types of REITs – Equity, Mortgage and Hybrid. US regulation permit REITs to be either Equity, Mortgage or Hybrid. Unlike US regulations, India does not permit mortgage assets at all.



2. Structure of REITs



REITs are set up as trust under the provisions of the Indian Trusts Act, 1882 and are registered with SEBI. Like a mutual fund, it has following parties to avoid any conflict of interest issues.

- **The Trustee** is an independent third parties appointed to ensure that the right & the interest of Unit holders are protected

- **Sponsor(s),** collectively hold atleast 25% in the REIT for atleast 3 years and 15% thereafter. This is to ensure skin in the game. Sponsor's responsibilities are to set up the REIT and appointment of the Trustee.

- **Manager** means a company or LLP or body corporate incorporated in India which manages operational activities of the REIT. In short, the manager assumes the operational responsibilities pertaining to the REIT. A manager needs to have at least 5 years of related experience coupled with other requirements

- **Property Management Company** acts as facility management company to ensure that the standard & quality of assets are maintained. Generally not required under regulation but are appointed for adequate management of property

3. Global Evolution of REITs

1960s

- United States (1960)

1970s

- Australia (1971)

1990s

- Canada (1994)
- Brazil (1995)

2000s

- Japan (2000)
- Singapore (2002)
- Hong Kong (2003)
- Malaysia (2005)
- UK (2007)

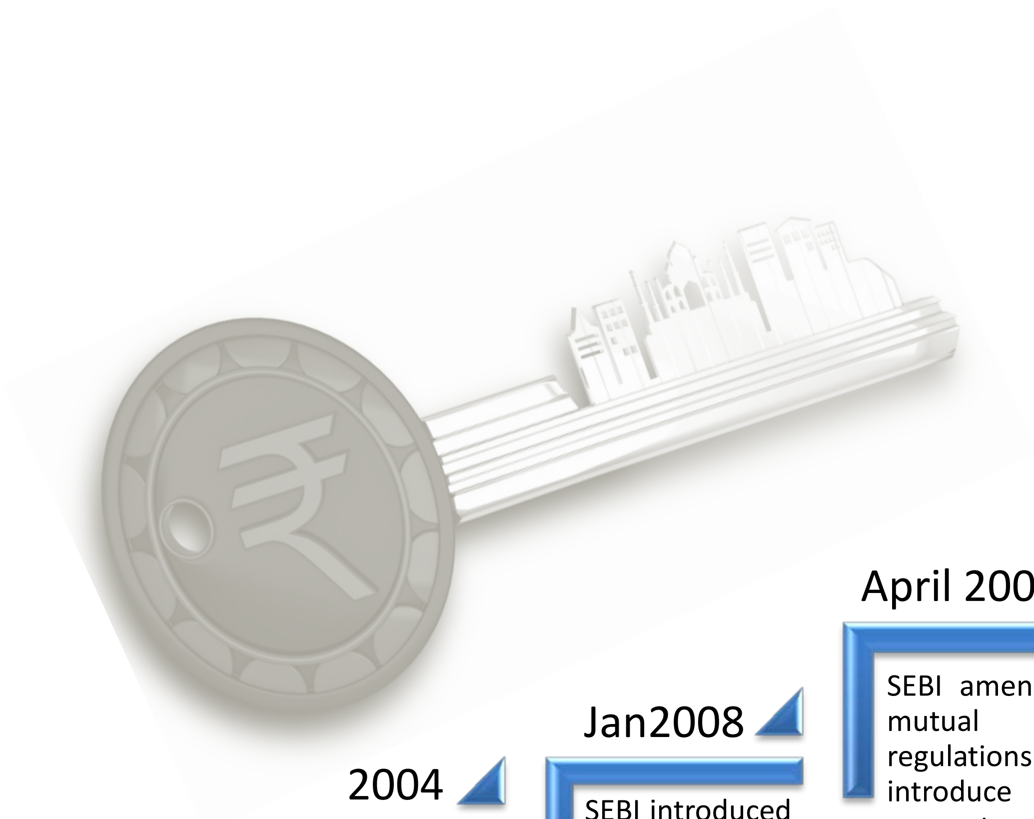
2010s

- Mexico (2011)
- Pakistan (2013)
- South Africa (2013)

Legislative Framework in place :

- China
- India,
- Spain

4. Evolution of REITs in India



2002
Recommendations of the Satwalekar Committee on Real Estate Funds

2004
Venture Capital funds permitted to invest in real estate” removed from negative list

Jan2008
SEBI introduced first draft of the regulations for public comments

April 2008
SEBI amends the mutual fund regulations to introduce the concept of real estate mutual funds.

2013
After extensive interactions by SEBI with various constituents in the market over the last several months, it released second draft of the regulations for public comments.

August 2014
After taking industry inputs, amendments to regulations were made and the draft was approved allowing setting up and listing of REIT’s. Post the clarification provided in the budget, a final draft was introduced by SEBI in August 2014.

5. Global Comparison of REITs in Key Economies

A comparison of Return on REIT across major countries is presented below:

Country	Listed REITs	Risk free rate (Government Bond 10Y) May 2015	Return on REITs	Spread
United States	172 listed at NYSE and 24 listed at NASDAQ	2.15%	4%	1.85%
United Kingdom	26 listed at LSE	1.87%	6.2%	4.33%
Singapore	37 listed at SGX	2.42%	6.5%	4.08%
Hongkong	11 listed at Hongkong stock exchange	1.69%	4.7%	3.09
India	Nil	7.98%	Expected rate:14% - 15%	Expected Spread:6% to 7%

6. Taxation Implication

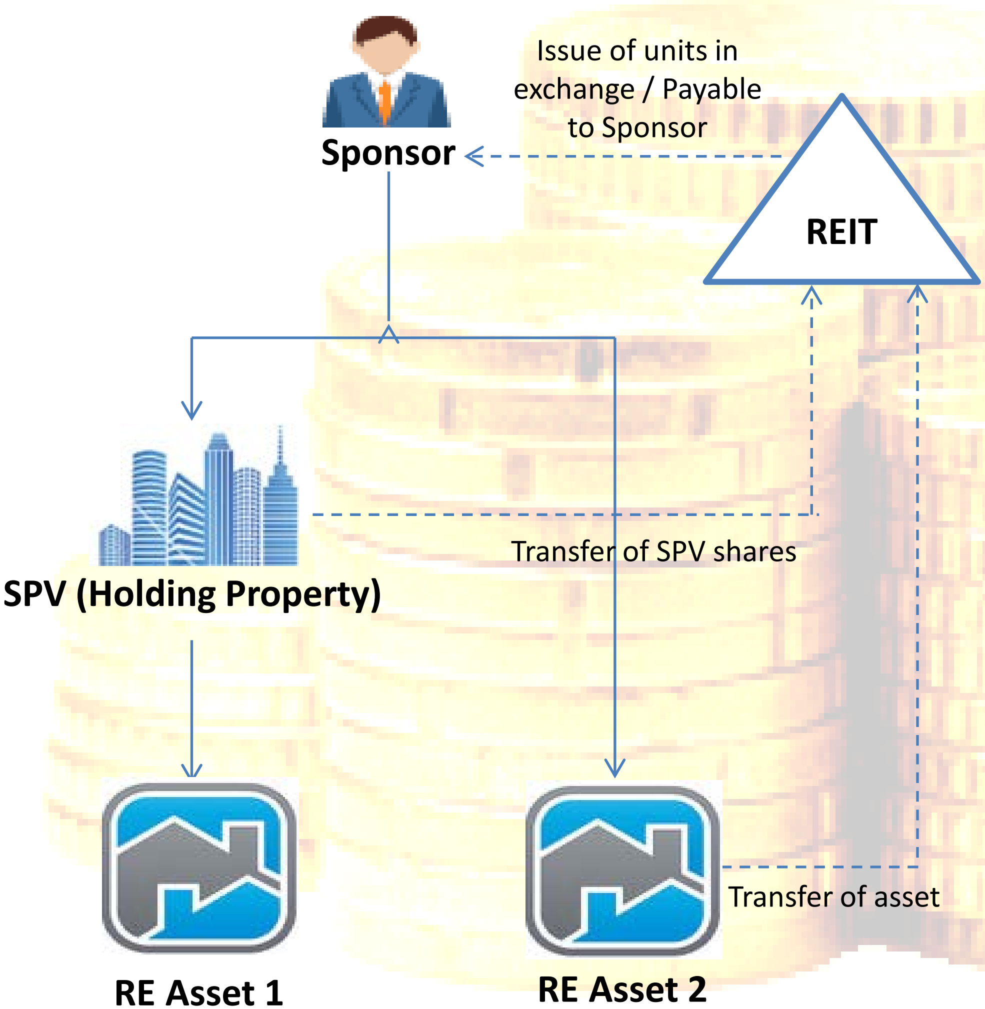
Bird's eye view of taxability at various levels in a REIT structure is tabulated below:

Entity	Income Streams			
	Dividend/ Profit	**Interest**	**Capital Gain**	**Rental/ Other income**
SPV	(DDT paid while distribution of Dividend)	Not required to deduct tax	On sale of asset: Tax on capital gains on applicable rates, as per holding period.	Taxable at maximum marginal rate
REIT	No tax on receipt or distribution	In case Received from SPV - exempt u/s 10(23FC). In case of distribution; tax to be withheld by REIT @ : ❑ 5% – NR ❑ 10% – R	On sale of SPV's shares/Capital Assets: Tax on capital gains on applicable rates, as per holding period.	Taxable at maximum marginal rate
Unit-holder	Exempt	Taxable at applicable rates ❑ 5% – NR (tax withheld would be available as credit) ❑ At applicable rate– R	❑ On sale of units: • LTCG – Exempt so long STT is paid • STCG – 15% ❑ Holding period for LTCG: 36 months	Exempt

Note: DDT=Dividend Distribution Tax, R=Resident, NR=Non Resident, LTCG= Long Term Capital Gains, STCG= Short Term Capital Gains

6. Taxation Implication

Sponsor



On setting up a REIT

- **(A)Direct Holding** Transfer of Requisite assets in exchange of REIT units
  - Liable to pay Capital gains tax
- **(B)Indirect Holding(SPV)** : Transfer of SPV shares in exchange of REIT units
  - No Capital gains at the transfer stage but applicable on subsequent transfer of REIT units
  - In case Sponsor is a Company MAT @18.5% would be applicable on its book profits.
- **(C)Indirect Holding (LLP)**: Transfer of interest in LLP holding Real Estate in exchange of REIT units
  - Liable to pay capital gains tax **Exit from REIT**

(A) & (C)- LTCG Exempt subject to STT;STCG – as applicable

(B) LTCG Applicable at 20% /10%: STCG-as app.

7. Issues / Recommendations

Tax related :

- **Provisions** are made **to exempt the transfer of shares of the SPV by the sponsor in exchange of REIT units** and not direct transfer of the property to the REIT. Holding property can be beneficial as it saves on SPV level distribution taxes, however **the lack of exemption to sponsors is likely to deter direct holding of properties by REITs.**

- The **exchange of shares of the SPV for units of REIT** would happen at the market value and could result in profit in the hands of the Sponsor, which **could entail** tax liability in the hands of the **Sponsor** under the provisions of **Minimum Alternate Tax ('MAT').** Since exchange of shares for REIT units is merely to set-up the REIT and is not per se a commercial transaction, the **Government may consider exempting the same from MAT.** In order to create similar platform to all kinds of Sponsors, Tax deferral scheme available to a Sponsor of SPV shares should also be extended to other types of transfers (Requisite assets and interest of LLP).**Also, as per recent statement released by finance minister on 30 April 2015, MAT exemption is given for REITs at the time of SPV – business trust unit swap.**

- In a case where the SPV is primarily funded by share capital, normal corporate taxes would be applicable at the SPV level and any distribution of profits by the SPV would entail distribution taxes. **Exemption from distribution taxes should be provided to the SPV to the extent it distributes dividends to the REIT.**

- Requirement of **holding the REIT units** for more than **36 months** to qualify as long-term capital asset **(LTCA)** may act as a disincentive for investors to invest in the REIT **vis-à-vis listed equity shares** where the period of holding to qualify as long term capital asset is more than **12 months. Parity** is required to make it lucrative for investors to invest in units of a **REIT.**

- The **REIT should be made a complete pass-through vehicle** as against the current provisions which allows pass-through only with respect to interest income from SPV and rental income which is taxed in the hands of the investors directly while **capital gains and other income is taxed at a REIT lev**el and exempt in the hands of the investors.

7. Issues / Recommendations

Stamp Duty related:

- **Holding the properties directly** may **not** be **feasible** for REITs in India given **the high state stamp duties and registration costs** applicable in various states on acquisition of properties.

- The **transfer of assets** at the **initial stage** of setting-up a REIT could be **regarded as a transfer**, which may **attract stamp duty** thereon, which, ranges from **approximately 5 per cent to 10 per cent** depending upon the state in which the property is located.

- In this regard, the government ought **to consider making the stamp duty uniform across the states or** consider **waiving the stamp duty** where a REIT holds property over a specified period of years, in line with Singapore REITs or alternatively, the state governments **could consider a one-time waiver of stamp duty on transfer of assets to REITs or SPVs owned by REITs.**

Other Regulations:

- **Inclusion** of units of **REITs** set-up as a trust in the **definition of 'security**' as per the Securities Contract (Regulation) Act, 1956

- **Changes in the SEBI** Foreign Portfolio Investors **(FPI)** regulations and Foreign Exchange Management Act **(FEMA)** to **allow foreign investment** in units of REITs at the time of an **IPO or listing** on the stock exchange. It **should be clarified** that a REIT with majority foreign ownership **would not be subject to downstream conditionalities related to FDI.**

- Insurance Regulatory and Development Authority's **(IRDA)** investment regulations to be tweaked to allow insurance companies **to invest in REITs**, thereby enabling REITs to have **a wider investor base**. Similarly, changes should be brought about **in the provident fund regime**, by notifying **REITs as an eligible investment** in the prescribed pattern of investment.

8. Valuation of REITs-Methodologies

- **Net Asset Value Method:** Under this Method, Variables required are:-
  - Net Operating Income (NOI):

NOI = *Rental Income of fully occupied property + Other income – Loss from Vacancies & Collections*

  - Growth Rate (g) in Rental Income which depends on:
    - Future prospects for rental rates and no of tenants
    - Level of occupancy rates and any losses incurred from collection of rental payments.
    - Degree to which a REIT can upscale through an inorganic route eg. Acquire low end property and upgrade it.
    - The % of profits that REITS are required to distribute.
  - Capitalisation Rate:

$$Cap\ Rate(\%) = \frac{NOI(1+g)}{Property\ Value}$$

  - To compute the value of the REIT, find value of underlying property, add assets and deduct liabilities:

$$\textbf{Value of REIT} = \frac{\textbf{NOI}(1+g)}{\textbf{Cap } Rate} + \textbf{Assets} - \textbf{Liabilites}$$

- **Market Approach Method:** Commonly used **market multiples for REIT shares are Price/Funds from Operation (FFO) & Price/ Adjusted Funds from Operation (AFFO).**

$$FFO = NPAT + Depreciation + Deferred\ Tax\ Liability - Deferred\ Tax\ Assets - Gains/+Loss\ from\ sale\ of\ property + Loss\ from\ Debt\ Restructuring$$

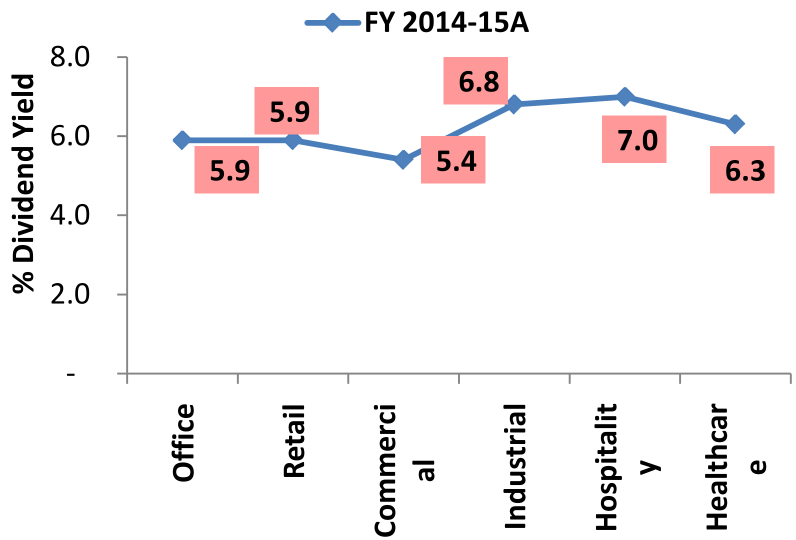
$$AFFO = FFO - Non\ Cash\ Rent - Maintainable\ Capital\ Expenditure$$

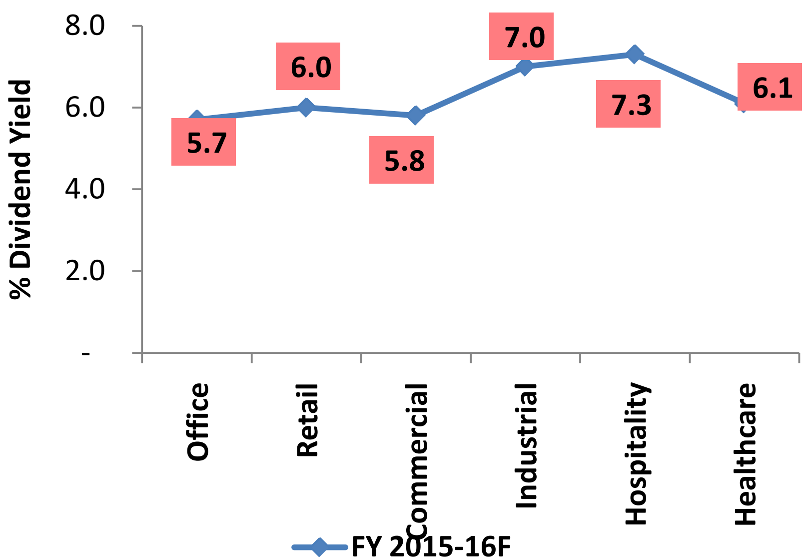
Non Cash Rent is the difference between Average contractual rent over the lease period and Actual Rent. This differential reflects contractually increasing rental rates.

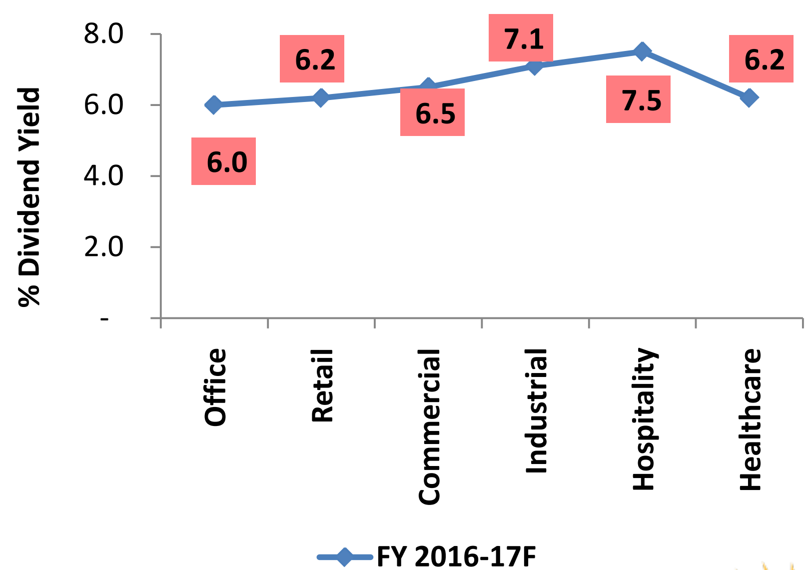
- **Income Approach Method:** Under this method, Value of REIT is sum of **Present value of Dividend per share** and present value **of Terminal value at a discount rate** which is equal to rate attributable to Investors.

$$Terminal\ Value = \frac{Dividend_0(1+g)}{Discount\ rate - g}$$

9. Yield from Singapore REITs







Source: Singapore Industry Focus Singapore REITs

10. Overview of SEBI REITs Regulation

Structure	• To be set up as trust, registered under SEBI • Relevant parties have been designated as trustee (register with SEBI), sponsor and manager.
Offer & Listing of Units	• May raise funds form both residents as well as foreign investors (subject to guidelines specified by RBI/govt.) • Minimum subscription size to be INR 2 Lakhs per investor, and the unit size to be INR 1 lakh • Minimum investors to be 200 • Mandatory listing on recognised stock exchange within 12 days of closure of offer
Valuation of Assets	• Full valuation including a physical inspection of the properties to be carried out at least once a year • Valuer need to be independent from sponsor, manager and trustee and with minimum 5 years of relevant experience in valuation of real estate. • Valuation report to be submitted to designated stock exchange and unit holder within 15 days from the receipt of such valuation report.
Manager	• Manager to have minimum net worth of INR 100 million • Manager and its associates to have at least 5 years of specified relevant experience • Minimum 2 key personnel to have at least 5 years of relevant experience

10. Overview of SEBI REITs Regulation

Sponsor

- REIT can have upto 3 Sponsors (each sponsor to hold at least 5% units).Sponsor to have minimum net worth of INR 200 million on a consolidated basis.
- Should hold at least 25% of the total units of the REIT on post issue basis, which shall be locked in for a period of 3 years from the date of listing
- Sponsor / its associates to have a minimum 5 years experience in real estate industry on individual basis

Borrowings

- Aggregate consolidated borrowings and deferred payments net of cash & cash equivalents capped at 49% of the value of the REIT asset

Investment Condition

- Shall invest only in properties / securities in India
- At least 80 % of the value of the REIT assets to be in completed and rent generating properties and prohibited to invest in vacant land /agricultural and / mortgages (other than mortgage backed securities) and other REIT's
- Permitted to invest in properties through a SPV , subject to certain specified conditions.

Income & Dividend Policy

- At least 75% of the revenue of the REIT (other than gains from the disposal of properties) to be from rental, leasing and letting real estate assets all the times.
- At least 90% of the net distributable cash flows of the REIT to be distributed to the unit holders

11. Future Prospects of REITs in India

In the near future, we expect the REIT vehicle to increase the depth of the Indian property market through enhanced transparency and governance standards along with monitoring of the REIT's performance on a regular basis by the financial media. The REIT Regulations fix the roles and responsibilities of stakeholders with respect to the underlying property in terms of valuation, structural audit, safety audit and insurance of the property at regular time periods. Besides adequate and timely disclosure on important developments relating to the REIT, it also prescribes the quantum and timelines for income distribution. Largely, the Indian REIT regime is at par with the international REIT format and seems to have what is needed to provide the right impetus to the Indian real estate sector..

Select eligible REIT property segments:-

Property type	Potential REIT-able space (million sq. ft.)	Potential Value (USD Billion)
Office	425	52
Retail	64	16
Warehouse	919	28
Total	**1,408**	**96**

Source: Industry Report

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