REITs in India

Evaluating REITs in the Indian Scenario

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Introduction And Executive Summary

In a recent move to revive growth in the cash-strapped real estate sector, SEBI has finally approved the launch of Real Estate Investment Trusts (REITs) in India — the third initiative by the securities market regulator since its first attempt to bring REITs in 2008. The objective of this white paper is to educate the reader about REITs and how they have evolved and performed in other markets, with a special focus on the Indian market. The basic structure of our paper is divided into three parts:

- The first section lays out the basic introduction followed by the evolution of REITs in the global arena
- The second section focuses on the real estate outlook in India and the role of REITs in the growth of India's real estate sector
- In the last section, we have covered the returns analysis of REITs and empirically analyzed and compared its performance with other asset classes in the US and Singapore to provide insight for an investor in India

Key highlights of the report include:

- The Indian real estate sector is expected to reach $853 billion by 2028 in absolute terms, at a CAGR of roughly 14% from its current level of $121 billion in 2013
- The real estate sector stimulates demand for more than 250 ancillary industries, including steel, cement, paint, and construction material, and is at the core of the construction industry
- According to UN estimates for India, around 843 million people will live in urban areas and 300 million people will join the workforce by 2050. This will lead to corresponding growth in the real estate sector
- Private lending and banks were the major sources of funding for the sector prior to the advent of FDI in 2005. The current funding sources are largely skewed towards NBFCs and private lending. There remains a large funding gap for the cash-starved sector and hence, this creates a strong case for launching REITs as an alternative source
- REITs will also confer transparency to an otherwise unorganized sector marred by black money, by channelizing transactions through banks
- The budget 2014-15 that cleared the 'pass through' status of REITs also underscores their importance in offloading the burden of NPAs from the banking sector
- An empirical study of REITs vis-à-vis other asset classes in the US and Singapore reveals that REITs have historically outperformed both equities and fixed income. The average yield of REITs was roughly 13% in the US and 15% in Singapore for the period under consideration
- The risk reward analysis through the Sharpe ratio also highlights the ascendancy of REITs over equities and treasuries. Hence, REITs offer potential diversification benefits
- On a peer-to-peer comparison with direct real estate investment, our study shows that REITs yield similar returns compared to direct investment in real estate property. Clearly, REITs offer a hassle-free investment instrument
- With sticky inflation-hedged rental yields and the potential to offer capital appreciation, REITs offer the benefits of both bonds and stocks

Evaluating REITs in the Indian Scenario

A Real Estate Investment Trust (REIT) can be delineated as a professionally managed corporation or trust that offers investors an opportunity to invest in a portfolio of income-generating real estate or related assets. The underlying assets include offices, warehouses, hospitals, shopping centers, hotels, and mortgage loans. Based on the exemplary Mutual Fund structure, these are also referred to as Real Estate Stocks and are either publicly or privately traded.

REIT offers investors an opportunity to invest in a portfolio of income generating real estate or related assets

Similar to the securities listed on the Stock Exchange, investors from all classes of income levels get direct access to channel their savings in the real estate market through publicly traded REITs, which is otherwise available only to HNIs and financial institutions having the financial wherewithal to embark on direct investment in real estate properties. As there are no/nominal minimum investment limits, investors can buy and sell units of REITs at market-driven prices and enjoy higher returns in the form of dividends (usually coming from rental income), interest from mortgage REITs and/or capital gains from the sale of real estate assets. The trust/corporation must distribute 90% of the taxable income to the investors to qualify as a REIT and, thereby, the sponsors are allowed to deduct all of the dividends from its corporate taxable income. Since most REITs pay out 100% of their taxable income to their shareholders, they do not owe any tax.

Evolution of REITs: Global

On September 14, 1960, REITs were introduced in the US economy by President Dwight D. Eisenhower to enable small- and mid-sized investors to participate in large scale, diversified portfolios of income-producing real estate properties. According to a press release by the 'National Association of Real Estate Investment Trusts (NAREIT)', about 50 million US citizens invest in listed REITs through their 401(k) plans, leading to an average daily trading volume of about $4 billion.

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1960-1970

- **1960** - REIT Act introduced by US President Dwight D. Eisenhower
- **1965** - Continental Mortgage Investors became the first REIT to be listed on the New York Stock Exchange
- **1969** - The first European REIT legislation passed in the Netherlands

1971-1981

- **1972** - The NAREIT REIT Index debuted as the first REIT index
- **1974** - New tax rules to allow a REIT to operate a property for 90 days and then through an independent contractor after foreclosure
- **1976** - REITs to be established as corporations in addition to business trusts

1982-1992

- **1985** - The NRES Fund formed as the first open-end mutual fund devoted to REITs
- **1991** - Kimco Realty Corporation completed the first successful equity REIT IPO
- **1992** - Taubman Centers, Inc. completed the first UPREIT IPO

1993-2003

- **1993** - "Five or Fewer" rule introduced for pension plans to invest in REITs
- **1999** - NAREIT Index Adds Real-Time Pricing, European Public Real Estate Association (EPRA) formed
- **2001** - Through a JV, NAREIT, EPRA, and Euronext launched the EPRA/NAREIT Global Real Estate Index

2004-2014

- **2005** - The Asia Pacific Real Estate Association (APREA) is founded
- **2008** - NAREIT along with REESA modified the OECD model tax treaty for cross-border REIT investments
- **2009** - Emerging markets added to the FTSE EPRA/NAREIT Global Index

Following a series of regulatory changes, more than 31 countries have adopted different variations of the US REIT. Furthermore, 4 more countries — China, Indonesia, Vietnam, and Nigeria — are considering the adoption of REITs.

Evolution of REITs: India

SEBI introduced the first draft of REIT in 2008, which it withdrew later to make way for the Real Estate Mutual Fund (REMF). The stock market regulator released a revised draft on October 10, 2013, which was open for public comments until October 31, 2013. Due to the ambiguity in the tax structure, SEBI held back the final approval of the draft structure.

During the 2014-2015 budget session, the present finance minister (Mr. Arun Jaitley) declared the pass-through status for the trusts/sponsors of REITs, by which they were exempt from paying taxes on their income. Instead the tax will be levied on the investors. On August 10, 2014, SEBI finally approved the setting up of REITs in India.

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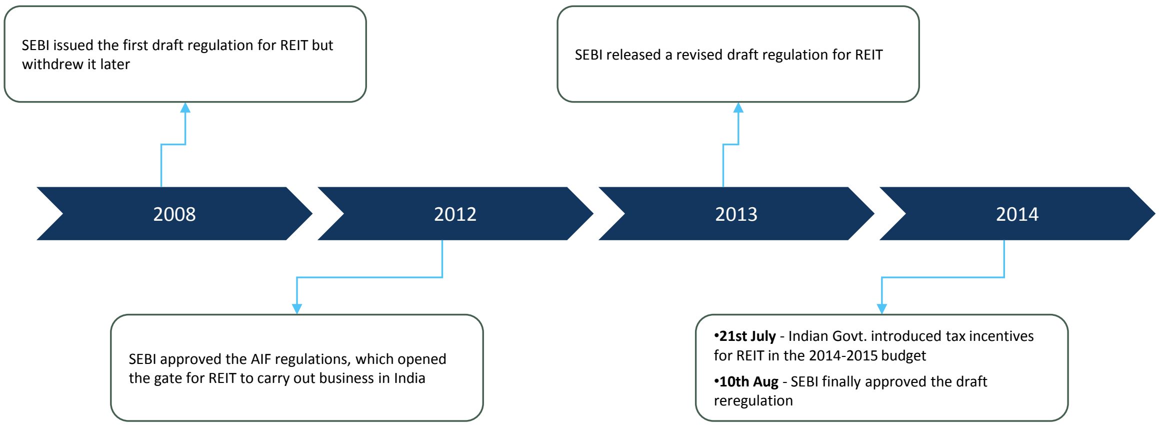

Indian Real Estate Sector Outlook

The Indian economy witnessed annual average growth of ~7.2% during 2000-2012, supported by increased consumerism, higher investment activity, and productivity gains. According to CEBR's[1] World Economic League report, India is likely to become the world's third largest economy with a GDP of roughly $7 trillion by 2028, after China and the US. Parallel to the GDP growth, both the service and manufacturing sectors have also posted positive growth to meet the growing demand and increasing consumption level during the last few years. Notably, the real estate sector was estimated to contribute 6.3% to India's GDP and generate 7.6 million employment opportunities during 2013[2].

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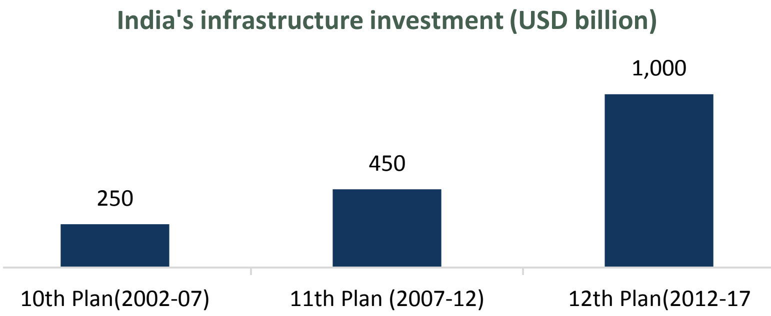
[1] *Centre for Economics and Business Research*

[2] *Source: Assessing the economic impact of India's real estate sector, CREDAI, 2013*



The Indian real estate sector is expected to reach $853 billion by 2028 in absolute terms, i.e., a CAGR of 13.9%, from its current level of $121 billion in 2013. The sector is primarily driven by the rising income levels, demographic changes, growth of the manufacturing and service sectors, and, last but not the least, the growing number of nuclear families. The sector can be broadly categorized into Housing (Residential and Commercial), Retail, and Hospitality.

REIT: An Extension of the Indian Real Estate Market

The real estate sector stimulates the demand for more than 250 ancillary industries, including steel, cement, paint, and construction material, and is at the core of the construction industry. Being the second largest generator of employment opportunities next to agriculture, the sector is one of the key drivers of the Indian economy.

However, the real estate industry has seen many highs and lows in the last couple of years. Swelling input costs, rising financing costs, insufficient funds, the absence of a single-window approval system, etc., are some of the principal/fundamental issues that are hampering the performance of the Indian real estate industry.

To fully exploit the sector's potential, the Government of India (GOI) has implemented some regulatory changes across all aspects of the real estate business, starting from land acquisition, regulating the industry, and taking care of customer interests to re-considering the liberalization of the FDI policy (after its introduction in 2005). To bring better corporate governance, more liquidity, and financial transparency, the GOI finally introduced the concept of REITs.

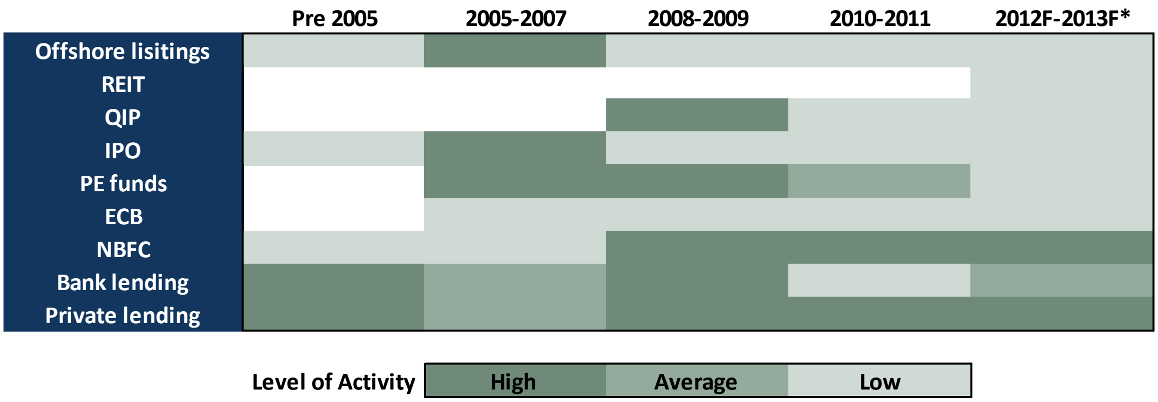
The real estate industry has seen many highs and lows in the last couple of years. REITs have been introduced to bring better corporate governance, more liquidity, and financial transparency

Why REITs could boost the real estate sector in India

1. Investment Gap:

Prior to FDI investment in 2005, bank and private lending were the major sources of funding in real estate. Since then, through major policy changes, Private Equity funds, foreign developers, hedge funds, etc., have been dangled before traditional investors to invest at the project or entity level. Exhibit 1 captures the primary source of funding in the real estate business.

Exhibit 1: Major channels of Funding the Real Estate Sector in India



Traditionally, real estate assets were kept out of the financial market in India.

According to EY estimates, the residential sector alone will require $29 billion in funding by 2015

As evident from the heat map above, over the years, NBFCs along with private lending became the major source of funding for the Indian real estate sector. According to EY estimates, the residential sector alone will require $29 billion in funding by 2015.

Asset	Excluding EWS* Housing (in $ billion)	Including EWS* Housing (in $ billion)
Residential	29	244
Retail	4.8	4.8
Office	8	8
Total	**42**	**257**

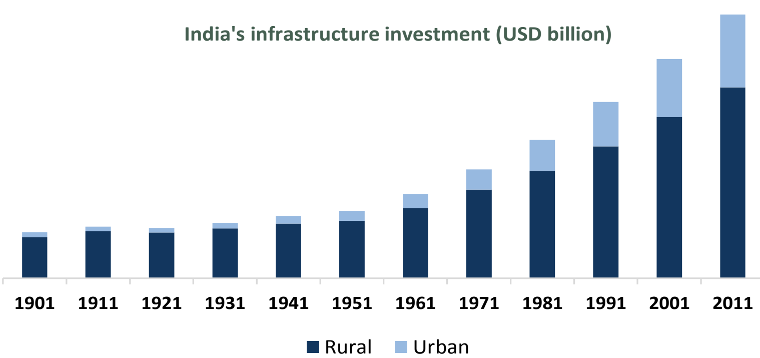
**EWS – Economically Weaker Section*

Traditionally, real estate assets were kept out of the financial market in India. On August 10, 2014, SEBI approved the regulations for REITs and Infrastructure Investment Trusts (InvITs). The approval will provide the cash-strapped realty sector access to the public market, which in turn is expected to help them retain and operate assets with a long-term view, improve liquidity, and ease the reliance on lending from banks.

2. **Urbanization:**

High urbanization estimates indicate growth opportunities for the real estate sector in India

Indian demographics have been evolving rapidly over the last few decades. According to UN estimates, around 843 million people will live in urban areas and 300 million people will join the workforce by 2050. With a greater number of people transitioning from rural to urban areas, increasing purchasing power, labor mobility, and growing demand for higher living standards will lead to corresponding growth in the real estate sector.



3. **Greater Transparency:**

REITs could contain the investment of black money into the real estate sector

REITs can help improve the transparency level in the following ways:

- Since all transactions would take place through normal banking channels, it will help curb the creation/investment of black money into the sector
- According to one of the mandatory requirements laid down by the regulator (SEBI), REITs have to comply with financial reporting standards and disclosure of information in the public domain, which will lead to greater transparency. As per the mandate from SEBI, REITs have to undergo a yearly valuation and declare their net asset values (NAV) within 15 days of the exercise
- The title risks and other cumbersome paperwork related to direct property investment will also be borne by the sponsors, which will add credibility to this source of funding for the sector

4. **Lower NPA:**

With the introduction of REITs in the Indian real estate market, there will be more liquidity available to the sponsors or developers in the form of equity capital. Consequently, it will not only help the defunct companies in the immediate repayment of their debt but will also improve their Balance Sheet position. Being an alternative source of funding available to the debt-heavy construction sector, REITs provide an exit avenue and hence a mechanism to offload NPAs from the books of lenders, especially banks. In fact, the 2014-15 budget, which gave the 'pass-through' status to REITs, underscored the benefit of this channel to banks reeling under higher NPAs in India.

5. **Opportunity for the common investor:**

The trust/corporation distributes more than 90% of its profit to the investors as dividends. In this context, REITs provide a better opportunity to the investors as a fixed income instrument with more liquidity and a good hedge against inflation since rental income corresponds to inflation. Besides, unlike corporate dividends, income from REITs is taxable in the hands of investors, which could result in higher after-tax yields depending on the tax slab of the investors. Separately, REITs also provide an opportunity to invest in a diversified portfolio of properties with token investment amounts. These are run and managed by professionals, and mirror the benefits of mutual funds.

REITs provide a better opportunity to investors as a fixed income instrument with more liquidity and a good hedge against inflation

Why REITs could be a better investment opportunity in India

1. Outperformance compared to other asset classes:

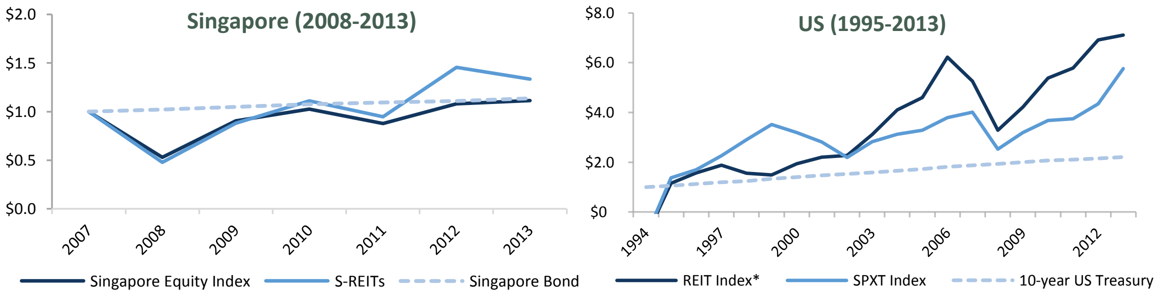
Since the average investor is risk averse, it is his/her basic investment tendency to look for higher returns at a lower risk. Most investors generally park their savings in traditional financial instruments such as stocks, fixed deposits, bonds, gold, and real estate property. Historically, returns from these investments have always been impacted by the volatility and risk in the financial market, lower historical interest rates, and other domestic/macro factors, which entice investors to look for alternative sources of investment.

Over the past few years, REITs have gained worldwide acceptance with better and credible returns among various investors who are looking to increase their risk-adjusted returns and diversify their portfolio at the same time. To give additional weightage to our analysis, we have measured the performance of REITs vs. stocks and bonds through historical returns. Though past performance does not guarantee future results, an examination of the REIT performance in both the US (a mature market) and Singapore (a relatively smaller market) may help the reader understand the market scenario.

For the US market, we consider January 1, 1995 as the starting point of our analysis, i.e., just after the beginning of the new REIT era when the US REIT market reached a market capitalization of more than $600 billion in late 1994. For Singapore, we examine our return analysis from January 2008, i.e., just after the revamp and re-launch of the FSSTITR Index comprising the top 30 SGX Main board listed companies on the Singapore Stock Exchange.

Relatively speaking, investment in REITs has outpaced the traditional investment in bond and equity indices across both the US

Exhibit 2: Growth of $1 Investment in REITs vs. Other Asset Classes in the US and Singapore



Source: Bloomberg

As depicted in Exhibit 2, the growth of $1 investment in REITs has outpaced the traditional investment in bond and equity indices across both the US and Singapore. Since 1995, the average return for US REITs is 12.9%, compared to 11.6% for the S&P 500 Total Return Index (SPXT Index) and 4.3% for the 10-year US Treasury bond. Similarly, Singapore REITs produced an average yield of 14.8%, i.e., 6.7% higher than the FSSTITR Index and 12.7% higher than the 10-year Singapore Treasury bond.

2. Diversification Benefits:

Exhibit 3: Risk and Return Characteristics by Asset Class

Singapore (2008 -2013)

Asset Classes	Asset Classes	Volatility	Sharpe Ratio
S-REITs	14.8%	49.8%	0.25
Singapore Equity Index	8.2%	39.4%	0.15
10-year Treasury	2.2%	0.5%	0.00

US (1995-2013)

Asset Classes	Average Return	Volatility	Sharpe Ratio
REIT Index*	12.9%	20.5%	0.42
S&P Index	11.6%	20.1%	0.37
10-year Treasury	4.3%	1.4%	0.00

Source: Bloomberg

…also, its higher Sharpe ratio provides better diversification benefits

Following Markowitz's portfolio theory, it is important for investors to explicitly consider the risk and return of each asset prior to making an investment. With this in consideration, we captured the Sharpe ratio along with the volatility for each asset class separately in Exhibit 3. The Sharp ratio describes how much excess returns investors can earn by bearing the additional volatility (as measured by the standard deviation of returns) from holding a riskier asset.

* The REIT index (Dow Jones Equity REIT Total Return Index) captures both rental income and price appreciation

From the table above, it is evident that with a higher Sharpe ratio (risk-adjusted returns) REITs have outperformed both the stocks and bonds in the US as well as Singapore. Hence, the inclusion of REITs as an additional asset class could lead to an improvement of the efficient frontier by yielding higher returns with, practically, similar risk profiles like equities. Thus it seems worthwhile for investors to consider the diversification effects of REITs in a portfolio.

3. Advantage over direct investment in real estate:

Over a long period of time the returns received from US REITs are more or less similar to the returns gained from real estate properties

There are two ways in which an investor can include real estate in a portfolio as income-producing assets: by investing in REITs and through direct investment in real estate. Moreover, to expand the breadth of our analysis, we compared the alternatives on the basis of returns earned during different periods, in Exhibit 4.

Exhibit 4: Return Characteristics between REITs and Direct investment in Real Estate Property

US	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Property Index	7.0%	17.6%	13.3%	11.9%	23.7%	9.4%
REIT Index	7.0%	17.6%	13.2%	11.8%	23.8%	9.6%

Singapore	QTD	YTD	1-Year	3-Year	5-Year	10-Year
Property Index	8.5%	9.2%	8.4%	8.5%	14.5%	16.4%
REIT Index	8.5%	12.5%	11.0%	10.5%	22.0%	15.1%

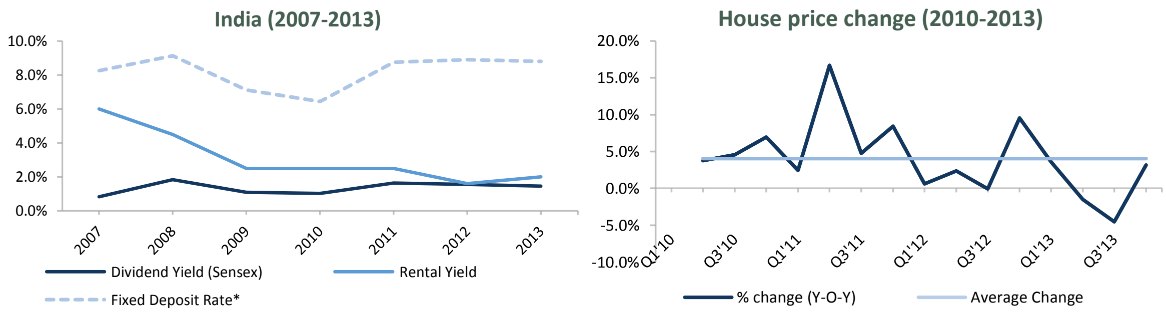
Source: S&P Quantitative Analysis Report (June 30, 2014)

The table above clearly demonstrates that, over a long period of time, the returns received from US REITs are more or less similar to the returns earned from real estate properties. However, considering different factors like liquidity, risk/return characteristics, investment amount, and the choice of investment in different property types, REITs could be a better choice than direct investment in real estate properties.

4. REITs provide hybrid options for investors who favor bonds and stocks:

The underlying property in REITs generates recurring income until it is sold. Given the nuances of the Indian property market coupled with the returns that an investor could expect from REITs in the Indian context, we performed a comparative analysis of fixed deposit rates (as a proxy for risk free return), dividend yields, and rental yields (as regular income to the investors).

Exhibit 5: Return Analysis across Various Asset Classes in India



Source: Bloomberg, National Housing Bank; *SBI 1 year fixed deposit interest rate

REITs could draw investment from investors who are driven by consistent dividend income

Additionally, REITs have growth stock characteristics

As shown in Exhibit 5, across the period, rental yields are perennially lower than the FD/bank deposit rates as opposed to mature markets where rental yields are higher than the interest rates. Thus, investors in India who have a lower risk appetite may prefer FDs over REITs, at least in the short run, as the situation indicates. However, a closer look here indicates that the rental yields are marginally higher than the dividend yields. Consequently, REITs could draw investment from investors who value recurring income more than capital appreciation. Since the rental income is sticky and more stable compared to dividends that can be rolled back by corporates during times of crises, they also offer the benefit of consistent income like bonds, especially when the cycle is low or the stocks are out of favor. It is due to these reasons that REITs could draw interest from both the stock and bond investors.

Additionally, REITs have growth stock characteristics and offer the possibility of multiplying in value through escalation in property prices. According to Jones Lang LaSalle, a global real estate consultancy firm, the potential capital appreciation of REITs could be as high as 20%. Hence, in the long run, REITs prove to be a better option to invest in than FDs. Furthermore, with the economy on the mend, interest rates have likely peaked out in India. There is also a revived focus on roads and infrastructure development by the newly elected government. All these factors will help revive the property demand in India, which could trigger capital appreciation.

Conclusion

Considering the success of REITs in the global market and the growing need for additional sources of funds for the cash-strapped realty sector, SEBI has finally set the stage for the launch of REITs on October 10, 2014. This is likely to herald a new era of opportunities for the sponsors, investors, and, eventually, for financial institutions in India. According to Cushman & Wakefield, the real estate industry is eyeing the $20 billion REIT market by 2020, which will free up capital for the development of new projects.

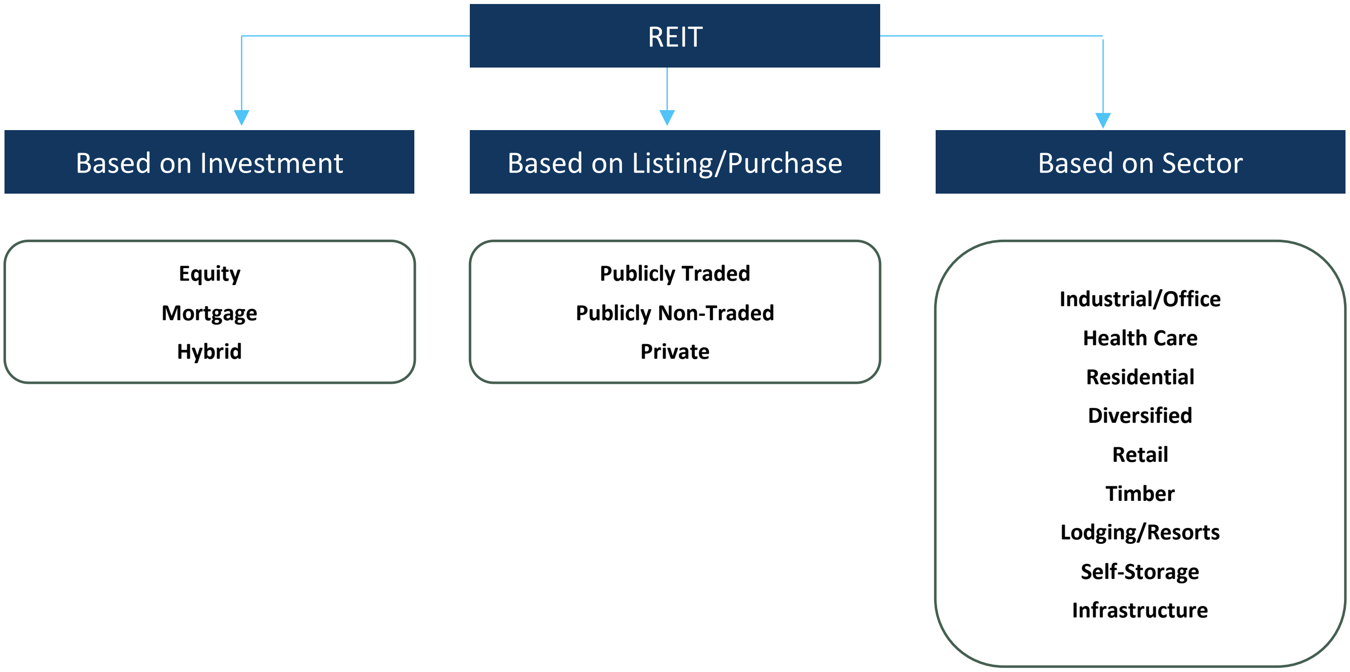
REITs provide benefits to both investors and sponsors in different ways. On the one hand, investors get to invest in the real estate sector with nominal investment and earn regular income in the form of dividends, which are comparatively less risky than investment in other asset classes. On the other hand, the sponsors get a platform to exit and provide liquidity, which would enable them to invest in other projects. Separately, REITs provide additional revenue sources in the form of tax (from investors) to the GOI.

The approval from SEBI is a welcome step for the realty sector and should channelize much needed investments to the sector, which will bring fresh liquidity and improve the performance of the sector, thereby boosting the economy.

Annexures

Annexure 1: Classification of REITs (based on the US REIT Industry)

These can be categorized as:



Based on Investment

	Equity REITs	Mortgage REITS	Hybrid REITS
Overview	Invest in and own income-producing real estate properties	Invest in real estate mortgages or mortgage-backed securities	Combination of equity and mortgage REITs
Liquidity	~90% of the listed REIT marketplace is represented by Equity REITs	Remaining 10% is represented by Mortgage REITs	Discontinued from the FTSE NAREIT Index on Dec 17, 2010
Source of Income	Rental income and capital appreciation of properties	Interest income on mortgages	Includes rental, interest income, and capital appreciation of properties
Ownership	Own and manage the properties	No ownership position	NA

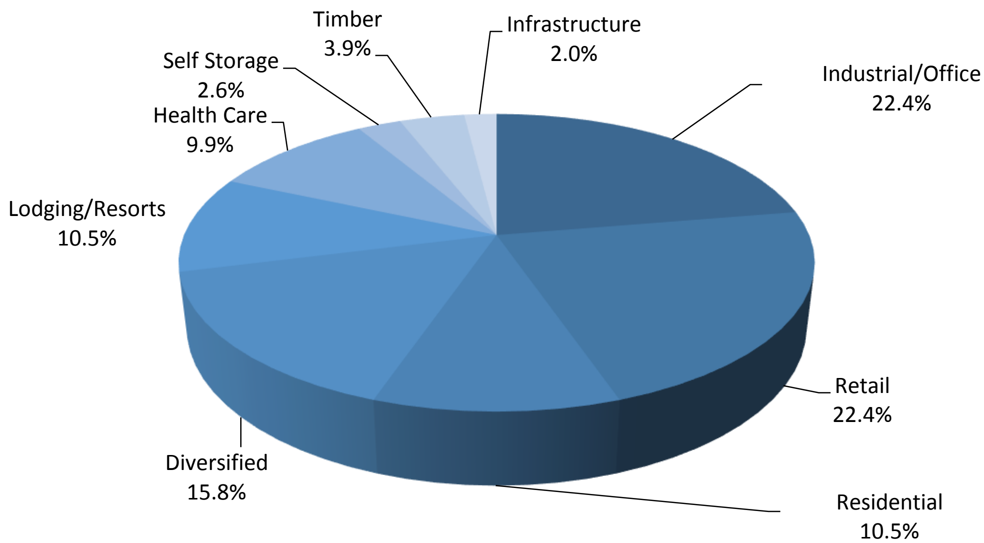
Based on Listing/Purchase

	Publicly Traded	Publicly Non-Traded	Private
Overview	File with SEC and trade shares on the National Stock Exchange	File with SEC but not traded on the National Stock Exchange	Not registered and not traded on the National Stock Exchange
Liquidity	Highly Liquid	Very limited and redemption programs may be offered by the sponsor	Limited in nature as it is privately placed
Min. Investment	One Share	Typically $1,000–$2500	Typically $10,000–$100,000
Liquidity	Specific to the Stock Exchange rules	Subject to State & NASAA regulations	Not regulated

Based on Sector

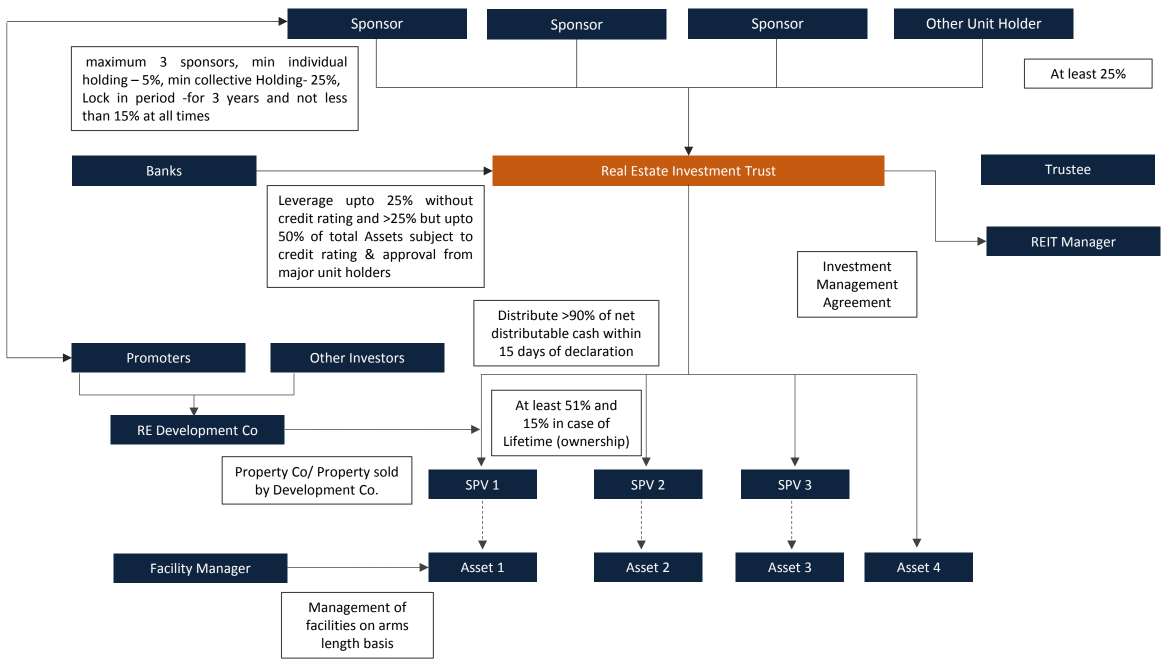
Some REITs invest or specialize in one property type only. Such REITs include Health Care, Industrial, and Timber. With each contributing 22.4%, both Retail and Industrial/Office lead the sector-specific investment in the US.

Exhibit 1: Listed REITs in All Property Types - US



Source: REIT.Com

Annexure 2: Key Regulations – Based on the Guidelines from SEBI



Some key points among the final regulations as per SEBI guidance:

1. **Eligibility Criteria:**
   - Sponsor - Minimum net worth of INR200 million and 5 years of experience in the real estate industry. Besides holding not less than 25% of the total units for a minimum period of 3 years (prior to IPO) and, in the case of units exceeding 25%, should hold for not less than 1 year from the date of listing. The sponsor should hold not less than 15% of the outstanding units of the REIT at all times
   - Trustee - Registered with SEBI under the SEBI (Debenture Trustees) Regulations, 1993 Act and not less than 50% of its directors are independent and are not related parties to the REIT
   - Manager - Minimum net worth of INR50 million and 5 years of experience in fund management/advisory/property management
   - Principal Valuer - Should not be an associate of the sponsor/manager/trustee and has not less than 5 years of experience in valuation of real estate. Besides, the Valuer should not be an investor in parties related to the REIT

2. **Listing/Delisting Criteria:**
   - Listing - Mandatory listing within 15 days of IPO and trading of units permissible only through stock exchange. For a public offer, the minimum market cap should be INR5 billion with a 25% (minimum) float size, minimum issue size should be INR2.5 billion, INR 0.2 million for the subscription size and for the trading lot, it should be INR0.1 million
   - Delisting - Mandatory if public float <25%; the number of subscribers to the IPO (other than Related parties to REIT) is <20. For voluntary delisting, subject to approval of =>75% unit holders by value and number

Source: The Securities and Exchange Board of India (SEBI)

3. **Investment Criteria:**
    - REIT Asset - At least 80% of the value of the REIT Asset should come from completed and revenue generating assets. The remaining 20% can be invested in developmental properties, government securities, listed/unlisted corporate debt (with a 3-year lock-in period from completion and lease out), etc. More importantly, the sponsors are not allowed to invest in units of another REIT.
    - Real Estate/SPV - The sponsors can invest a minimum of 51% or more in real estate properties or SPV and 15% for the lifetime of the REIT

4. **Distribution Criteria:**
    - Dividend - The sponsors of the REIT should distribute 90% or more of the net distributable cash flows, subject to applicable laws, to its investors (at least on a half-yearly basis)
    - Duration – The distribution should be made within 15 days from the date of such declaration

5. **Valuation Criteria:**
    - Timeline - Perform the complete valuation on a yearly basis and should declare the NAV within 15 days
    - Acquisition/Sale - For any acquisitions/sale of properties, valuation reports from 2 independent valuers should be obtained and the transaction value for purchase/sale of such properties should not be greater/less than the average of the two independent valuations
    - Valuation - For the sale of assets, the minimum floor price should not be less than 90% of the principal valuer's valuation and, in case of the purchase of any asset, the cap should be within 110% of the assessed value of the property

6. **Leverage Criteria:**
    - Borrowing & Deferred Payments - The aggregate consolidated borrowing & differed payments have been capped at 50% of the value of the assets and are subject to a credit rating from a credit rating agency and approval of the majority of investors in case it exceeds 25%
    - In case of market movements of the price of the underlying assets/securities, the trustee/sponsor will get a 3-month cure period

Source: The Securities and Exchange Board of India (SEBI)