India: Reits Regulation from 2014 to Future

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Real Estate Investment Trusts Regulations ("**Reit Regulations**") were notified by the Securities Exchange Board of India (SEBI) in 2014. Yet, until 2019, the field remained dormant. Here is a quick analysis with a hope to get a debate started.

What is a Reit?

Typically, entities with large stock of completed commercial property set up a Reit as a private trust under the provisions of the Indian Trusts Act, 1882. Soon thereafter, a Reit is registered with SEBI. Upon registration, it issues units at Rs. 50,000/- each to different retail investors which are listed on a Stock Exchange. Parallels between a Reit and Mutual Fund are, therefore, natural. However, the essence of a Reit lies in the following two fundamental features:

a. 80% of the asset value of a Reit is required to be invested in rent or income generating properties. As mentioned hereafter, the balance 20% can be invested in other real estate related securities / instruments.
b. At least 90% of net distributable cash flows of a Reit are required to be distributed to the unit holders twice a year.

An expert manager looks after the assets of a Reit and is also responsible for investment decisions. By way of checks and balances, a trustee keeps a close eye on the manager. In this respect too it is similar to a Mutual Fund.

2017 Amendments- Fixing the Loopholes:

Reits were a non-starter for various reasons. Even after the clarity regarding taxation, there were hardly any listings. They came into their own, much later, thanks to the watershed amendments of 2017 as discussed below.

At the time of notification of the Reits Regulations, in 2014, a Reit could invest in the assets either directly or through a Special Purpose Vehicle (SPV). This type of one-level investment structure was rather restrictive since real estate assets are usually held through multiple layers of investment. Today, pursuant to the 2017 Amendments (a) a Reit can have a controlling stake of 51% in the Holding Company (HoldCo.), provided that (b) the HoldCo., in turn, owns a controlling stake of 51% in the SPV which holds all the assets in its own name. The fears of a highly diluted stake in the ultimate assets and formation of a real estate bubble of sorts is, to some extent, assailed by the mandatory 26% viz: The ultimate holding interest of a Reit in the underlying SPV should be at least 26%.

Earlier, the balance 20% of the assets of a Reit could not be invested in unlisted equity shares or debt of real estate companies, mortgage-backed securities, Transferable Development Rights (TDRs) etc. However, the 2017 relaxations have opened these prohibited avenues as well. Notably, even a Reit can issue listed debt securities.

As finance to real estate becomes increasingly constrained, Reits is a readily available avenue for additional capital requirements of developers with a large overhang of completed commercial property.

However, it is myopic to take a two-dimensional view of Reits i.e. (a) as a tool of investment in the hands of retail investors, or (b) as an alternate source of funding for developers. Another natural outcome is quality management of commercial realty as highlighted below.

The Future- Professionalism in Real Estate Management:

Malls in some of the best areas of Mumbai failed on account mismatch of tenants with the sites. Spaces in purely residential areas were let out to luxury brands. Almost a decade later, when the same space was let out to retail brands its rental profile improved dramatically. As an increasing volume of commercial real estate falls under the management of a Reit, its expert manager/s shall avoid such mismatch since their very brief shall be maximizing rentals. Further, under the Reits Regulations, a manager is bound to obtain adequate insurance coverage, ensure that the title of the assets is clear of defects, the contracts are in order, and so on and so forth. Automatically, real estate shall be infused with professionalism. Most importantly, as we are nearing the budget, it shall not be amiss to say that more and more funds shall find their way straight within the taxation net. All in all, it looks like a win win situation.

The content of this article is intended to provide a general guide to the subject matter. Specialist advice should be sought about your specific circumstances.

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