Private Equity and Debt in Real Estate

Research Paper

2013

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Abbreviations

Abbreviation	Meaning/Full Form
AAR	Authority for Advanced Rulings
AIF	Alternate Investment Funds
AIF Regulations	SEBI (Alternative Investment Funds) Regulations, 2012
CCDs	Compulsorily Convertible Debentures
CCPS	Compulsorily Convertible Preference Shares
DCF	Discounted Cash Flows
DDT	Dividend Distribution Tax
DIPP	Department of Industrial Policy and Promotion
DTAA	Double Taxation Avoidance Agreements
ECB	External Commercial Borrowing
FATF	Financial Action Task Force
FDI	Foreign Direct Investment
FDI Policy	Foreign Direct Investment Policy dated April 10, 2012
FEMA	Foreign Exchange Management Act
FIPB	Foreign Investment Promotion Board
FII	Foreign Institutional Investor
FVCI	Foreign Venture Capital Investor
GP	General Partner
HNI	High Net worth Individuals
IPO	Initial Public Offering
IPO	Initial Public Offering
Land Acquisition Bill	Proposed Land Acquisition, Rehabilitation and Resettlement Bill
LP	Limited Partner
LRS	Liberalized Remittance Scheme
NBFC	Non-Banking Financial Services

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Abbreviation	Meaning/Full Form
NCD	Non-Convertible Debenture
NRI	Non-Residential Indian
PE	Private Equity
PIO	Person of Indian Origin
PIS	Portfolio Investment Scheme
PN2	Press Note 2 of 2005
QFI	Qualified Foreign Investor
RBI	Reserve Bank of India
RBI QFI Circular	RBI vide A.P. (DIR Series) Circular No. 66
REITs	Real Estate Investment Trusts
REMF	Real Estate Mutual Fund
SEZ Act	Special Economic Zones Act, 2005
SBT	Singapore Business Trust
SEBI Debt Limit Circulars	SEBI vide Circular No. CIR/IMD/FIIC/1/2012 dated January 3, 2012 and November 7, 2012
SEBI QFI Circular	Circular No. CIR/IMD/FII&C/3/2012 dated 13 January, 2012
SEBI	Securities and Exchange Board of India
TISPRO Regulations	Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000

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1. Background

As an industry, the real estate sector has grown and transformed more than it ever has in the past decade, especially after the opening up of the sector to foreign direct investment ("**FDI**") in 2005. The sector which was perceived to be closed and lacking on governance has largely shed that perception. With the wider participation of institutional private equity ("**PE**"), particularly offshore real estate funds, the sector is now rapidly moving towards enhanced transparency and governance standards.

Whilst the Indian real estate investment outlook dampened post 2009, the sector continued to attract interest and 2013 should see an increased number of domestic and offshore pools of capital dedicated to Indian real estate. Whilst real estate as an asset class delivered quite a few success stories and more than expected investment multiples, cases of promoter defaults and investor – promoter expectation mismatch have also become manifest, especially in the past few years as funds approached their maturity. However, due to cases where the funds haven't been able to deliver the expected returns to their LPs, there is an apprehension to invest in funds managed by new GPs, and sometimes a keenness to invest even directly. Accordingly, the focus of most fund managers seems to have shifted towards demonstrating successful exits, and attempts by some of the established players to raise global capital for real estate were not as successful. The current phase is in many senses the 'monetisation' phase for most such real estate funds typically having a life of 5 – 7 years[1] and is likely to set the tone for future fundraises by the GPs.

Per a recent Jones Lang LaSalle report, "In most cases the objective was to achieve diversification through a portfolio of projects with a particular developer and eventually exit through the IPO route in 3-5 years. Real estate investment trusts ("**REITs**") were widely expected to be the exit options for most investments in the IT and commercial office sector and were expected to be prevalent over the next 2-3 years. Large 100 acre plus townships also received a fair amount of interest from PE investors as developers were keen to de-risk and seek capital on the larger projects."[2]

On the flipside, things have panned better on the domestic side and several of these funds have

1. In study by Grant Thornton, close to 86% of the total PE investments in RE during 2005-2010 took place in the period 2006-2008.

2. Id.

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been more successful in raising domestic high net worth individuals ("**HNI**") money through wealth management and private banking channels. With interest rates peaking towards second half of 2011, some of these funds also raised debt funds for real estate promising high yields to investors.[3]

More recently, with the introduction of the new Alternative Investment Fund ("**AIF**") regime which under Category II funds allows for 'debt funds', the raising of domestic funds may change. Since the AIF regime requires a minimum investment of INR 1 crore (approx USD 200,000) per limited partner, on one hand, it may exclude a large base of small investors from the reach of PE funds; however on the other, it may ensure that the investor base now is primarily sophisticated.

From the perspective of choice on instruments, the flavour of investments changed from preferred equity to structured debt, and several funds today are keen to act pure play lenders. There is also keen interest to look at real estate focussed non-banking financial companies ("**NBFCs**") and few players like Xander, Red Fort and others have set up their NBFCs, while few of the other larger players are gearing up to set up the NBFCs. The listed non-convertible debenture ("**NCD**") route that allows foreign institutional investors to purchase listed debt securities issued by a private real estate company has become increasingly popular and to some extent gained further favour with the qualified foreign investor ("**QFI**") route now being introduced.

In this paper, we shall discuss the legal framework governing the real estate sector in India along with the exchange control regulations, the key investment routes, important tax considerations and some of the challenges which are being faced by PE players off late.

3. Id.

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2. Legal And Regulatory Framework For Foreign Investment

Foreign investments into India are primarily regulated by primarily three regulators, the Reserve Bank of India ("**RBI**"), the Foreign Investment Promotion Board ("**FIPB**") and the Department of Industrial Policy and Promotion ("**DIPP**"). In addition to these regulators, if the securities are listed or offered to the public, dealings in such securities may also be governed by the Indian securities market regulator, Securities and Exchange Board of India ("**SEBI**").

Foreign investment into India is regulated under Foreign Exchange Management Act, 1999 ("**FEMA**") and regulations thereunder, primarily Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000 ("**TISPRO Regulations**"). Keeping in view the current requirements, the DIPP (an instrumentality of the Ministry of Commerce & Industry), and the RBI makes policy pronouncements on foreign investment through Press Notes / Press Releases / Circulars which are notified by the RBI as amendment to the TISPRO Regulations. These notifications take effect from the date of issue of Press Notes / Press Releases / Circulars, unless specified otherwise therein.

In order to bring clarity and certainty in the policy framework, the DIPP for the first time issued a consolidated policy relating to FDI in India on April 1, 2010, which is now revised annually and represents the current 'policy framework' on FDI. The latest policy as of the date of this paper is dated April 10, 2012 ("**FDI Policy**").

Foreign investment can be classified into the following investment regimes –

i. FDI;

ii. Foreign Venture Capital Investment regime, for investments made by SEBI registered foreign venture capital investors ("**FVCI**");

iii. Foreign Institutional Investment regime, for investments made by SEBI registered foreign institutional investors ("**FII**");

iv. QFI regime, for investments made by certain qualified non-residents; and

v. Non Resident Indian regime, for investments made by non-resident Indians and persons of Indian origin ("**NRI**").

Separately, external commercial borrowings ("**ECB**"), which essentially mean borrowings in foreign currency, are not permitted to be procured by any Indian entity if the end use of the proceeds of the ECB will be utilized towards acquisition of real estate. However, recently, the ECB norms were relaxed to allow ECB in low cost housing. Please see **Annexure I** hereto for details.

We now discuss each of the investment routes together with their attendant regulatory challenges. Tax issues are dealt with later on under a separate taxation head in this paper.

I. Foreign Direct Investment

As per the FDI Policy, no Indian company that has FDI[4] can engage in "**Real Estate Business**". The term, 'Real Estate Business', though not defined in the current FDI Policy, was defined in the erstwhile FDI policy[5] under para. 3.3.2 as *"dealing in land and immoveable property with a view to earning profit or earning income there from."* In spirit, FDI in real estate is permitted only if the FDI is used for developmental purposes and not for speculative purposes.

While the prohibition on FDI in real estate business has long been the case, the process of deregulating foreign investments into real estate was initiated in 2001 and the turning point for foreign investments into the real estate sector came in 2005 with the issue of Press Note 2 of 2005 ("**PN2**") by the DIPP.

PN2 permitted FDI in townships, housing, built-up infrastructure and construction-development proj-

4. FDI policy refers to FDI as "a category of cross border investment made by a resident in one economy (the direct investor) with the objective of establishing a 'lasting interest' in an enterprise (the direct investment enterprise) that is resident in an economy other than that of the direct investor. The motivation of the direct investor is a strategic long term relationship with the direct investment enterprise to ensure the significant degree of influence by the direct investor in the management of the direct investment enterprise. Direct investment allows the direct investor to gain access to the direct investment enterprise which it might otherwise be unable to do. The objectives of direct investment are different from those of portfolio investment whereby investors do not generally expect to influence the management of the enterprise." It further mentions that it is the policy of the Government of India to attract and promote productive FDI from non-residents in activities which significantly contribute to industrialization and socio-economic development. FDI supplements the domestic capital and technology.

5. FDI Policy issued vide Circular 1 of 2011 dated March 31, 2011.

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ects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure) subject to fulfillment of certain entity level and project level requirements. PN2 required that real estate companies seek foreign investments only for construction and development of projects, and not for completed projects.

Per the FDI Policy, FDI in real estate is permitted under the automatic route in (i) housing, built-up infrastructure and construction-development projects (which would include, but not be restricted to, housing, commercial premises, hotels, resorts, hospitals, educational institutions, recreational facilities, city and regional level infrastructure); and (ii) serviced housing plots, subject to fulfillment of the following requirements:

1) Minimum area: Minimum built-up area[6] to be developed under each project should be at least 50,000 square meters[7] or 10 hectares in case of serviced housing plots;

2) Minimum capitalization: Company seeking foreign investment for construction development projects must be capitalized to a certain extent (USD 10 million for wholly owned subsidiaries and USD 5 million for joint ventures with Indian partners) by the foreign investor. Also, such capitalization should be brought in within six months of commencement of business[8] of the company.

3) Lock-in: Original investment[9] is not permitted to be repatriated before a period of three years from

6. The concept of "built-up area is not clearly defined nor is the term standardized within the industry so as to allow for clear guidance. In particular, the ambiguity pertains to whether the area includes only floor-space index (FSI), as licensed by a relevant local authority, or whether it also includes garage and other below grade areas, which are not considered FSI. In either case, a clear system of measurement on how the minimum area should be calculated is important to refine the process of vetting potential projects for FDI compliance.

7. Majority of realty players have had difficulty finding land parcels that meet the 50,000 square meter built-up area requirement, especially in the Tier I metro cities such as Mumbai and Delhi. Also, since valuation of land in these cities is very high, acquiring such land parcels is critically dependent on the ability of the acquirer to raise money. Consequently, this requirement acts as a severe stumbling block in attracting FDI. Conversely, saleability of a 50,000 square meter project in a Tier II or Tier III city may not be feasible, especially if the plot is for commercial use.

8. The policy document does not clarify whether the term "commencement of business is to be reckoned from the date of incorporation of the company; the date of commencement of business of the Indian company; the date of the investment agreement signed by the investor; or from the date the funds are credited into the account of the company. However, based on regulatory advice received in specific cases, commencement of business for the purpose of infusion of FDI has been interpreted to mean the infusion of first tranche of investment into the company, or the date of execution of the investment agreement for the infusion of FDI into the company, whichever is earlier.

9. FDI Policy has clarified that each tranche of investment made by the foreign investor shall be subject to the three year lock-in from the date it was invested, or from the date of completion of minimum capitalization, whichever is later. This has created tremendous issues for offshore realty funds that are willing to fund the project at a later stage, or in cases where the funding is construction linked as their investment may happen to be locked-in for a time span that exceeds the life of the fund itself. There is news that the term original investment is being reconsidered to mean the amount of minimum capitalization; however that proposal seems to be under discussion as of date.

the date of completion of minimum capitalization. If the foreign investor sought to make an early exit[10], he is required to obtain prior approval of the FIPB.

4) Project Completion: At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor/investee company is not permitted to sell undeveloped plots[11] and is required to obtain a completion certificate from the concerned local body/service agency before being allowed to dispose of serviced housing plots.[12]

5) Local Requirements: The project should conform to the norms and standards, including land use requirements and provision of community amenities and common facilities, as laid down in the applicable building control regulations, bye-laws, rules, and other regulations of the State Government / Municipal / Local Body concerned. S tate Government / Municipal / Local Body concerned would monitor the project to ensure compliance with the above conditions.

Companies / projects that meet the above requirements are referred to as "**FDI Compliant**" projects.

The FDI Policy under paragraph 6.2.11.2 Note (i) provides that *"The conditions at (1) to (4) above would not apply to Hotels & Tourism, Hospitals, Special Economic Zones (SEZs), Education Sector, Old age Homes and investment by NRIs."* Such assets are also for the purpose of this paper referred to as "**FDI Compliant**" projects. However, investments in these assets, though exempt from the onerous requirements of minimum area, minimum capitalization, lock-in etc., still have to comply with the following requirements:

1) Condition mentioned in point (5) *(Local Requirements)* above.

2) The investor shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure

10. The term used here is "exit and not "repatriation. Accordingly, there have been cases where the regulator has taken a position that any sale by a foreign investor to another foreign investor, prior to the expiry of the lock-in period, amounts to an exit, and to that extent, such sale cannot be consummated prior to the lock-in period without prior approval of the FIPB.

11. Under the FDI Policy "undeveloped plots" has been defined to mean "where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available."

12. There is currently an ambiguity on the meaning and extent of the term 'all statutory approvals', and reckoning of 50% project completion. Earlier, the 50% completion was to be reckoned from the date of land acquisition, which was later changed to obtaining 'all statutory approvals'. While there is no clarity on the provision, and the provision has seldom been invoked by the regulator, there were in recent times a few cases, per newspaper reports, where the regulator required the foreign investor to evidence that such condition was satisfied before its exit.

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facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules / bye-laws / regulations of the state government / municipal / local body concerned.

3) The state government / municipal / local body concerned, which approves the building / development plans, would monitor compliance of the above conditions by the developer.

SEZ's in addition to the above are also governed by the Special Economic Zones Act, 2005 ("**SEZ Act**") and the rules framed thereunder. Thus an investment in SEZ though exempt from the conditions imposed under the FDI Policy, is subject to the requirements prescribed under the SEZ Act and rules.

Further, the FDI Policy under paragraph 6.2.12 allows 100% FDI under the automatic route in Industrial Parks. See **Annexure II** for details of the conditions applicable to foreign investments in Industrial Parks.

1) Instruments for FDI

As per the FDI Policy, FDI can be routed into Indian investee companies by using equity shares, fully compulsorily and mandatorily convertible debentures ("**CCDs**") and fully compulsorily and mandatorily convertible preference shares ("**CCPS**").[13] Debentures or optionally convertible instruments are considered to be external commercial borrowings ("**ECB**") and therefore, are governed by clause (d) of sub-section 3 of section 6 of FEMA read with Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 as amended from time to time.

Since, these CCPS and CCDs are fully and mandatorily convertible into equity, they are regarded at par with equity shares and hence the same are permissible as FDI. Further, for the purpose of minimum capitalization, in case of direct share issuance to non-residents, the entire share premium received by the Indian company is included. However, in case of secondary purchase, only the issue price of the instrument is taken into account while calculating minimum capitalization.

13. Please refer below to paragraph (4)(1) on put options

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Herein below is a table giving a brief comparative analysis for equity, CCPS and CCDs:

Particulars	Equity	Equity	NCD-FII/QFI
Basic Character	Participation in governance and risk based returns	Assured Dividend–Convertible into Equity	Assured Coupon–Convertible into Equity
Liability to Pay	Dividend can be declared only out of profits	Fixed dividend if profits accrue	Fixed Interest payment -not dependent on accrual of profits
Limits to Payment	No cap on dividend	Dividend on CCPS cannot exceed 300 basis points over and above the prevailing SBI prime lending rate in the financial year in which CCPS is issued. No legal restriction on interest on CCD, however in practice it is benchmarked to CCPS limits.	
Tax Efficiency	No tax deduction, dividend payable from post tax income - Dividend taxable @ 15%[14] in the hands of the company		Interest expense deductible – Withholding tax as high as 40% but lower if investment done from favourable jurisdiction
Liquidation Preference	CCD ranks higher than CCPS in terms of liquidation preference. Equity gets the last preference.		
Others	Buy-back or capital reduction permissible	CCPS and CCDs need to be converted to equity before they can be bought back or extinguished by the Indian company.	

2) Pricing Requirements

FEMA also regulates the price at which a foreign direct investor invests into an Indian company. Accordingly, shares in an unlisted Indian company may be freely issued or transferred to a foreign

14. All tax rates mentioned herein are exclusive of surcharge and education cess.

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direct investor, subject to the following conditions being satisfied:

- The price at which foreign direct investor subscribes / purchases the Indian company's shares is not lower than the floor price computed on the basis of the discounted cash flows ("**DCF**") method;
- The consideration for the subscription / purchase is brought into India prior to or at the time of the allotment / purchase of shares to / by the foreign direct investor.

If any of the above conditions is not complied with, then the prior approval of the FIPB and/or the RBI would be required. If the foreign investor is a Foreign Venture Capital Investor registered with the SEBI, then the pricing restrictions would not apply. Also, if the securities are listed, then the appropriate SEBI pricing norms become applicable.

3) Exit options/Issues

One of the largest issues faced by private equity investors investing in real estate under the FDI route is exit. Following are some of the commonly used exit options in India, along with attendant issues / challenges:

i. Put Options

Put options in favour of a non-resident on FDI instruments are not seen favorably by the RBI, which regards such options as an ECB, and worse still regarding any option as an over-the-counter derivative contract which can be traded in only by an FII.

Though there were isolated incidents[15] where the RBI qualified put options granted to non-residents by either the investee company or the promoters of the investee company as ECB, regulatory aggres-

15. The differentiation between an FDI Instrument and an ECB was essentially on the ability of a non-resident to draw out fixed returns from the investee company. This differentiation became manifest in the DLF Case. In that case, US-based private equity investor DE Shaw had invested $400 million as convertible preference shares into DLF Assets (DAL), the company floated by the promoters of DLF Ltd, in 2007 with assurances from the developer of a public listing in 2008. However, with the worldwide real estate market collapsing in 2008, the investor negotiated with the cash-strapped DLF promoters to provide them an exit at fixed return of at least 27% IRR. RBI, reports suggest, issued a show cause notice on why the investment (even though through FDI Instruments) be classified as an ECB on the ground that it carried a fixed rate of return. Whilst the DLF Case did indicate the regulatory perspective to fixed price exits for non-residents, there is no update on what ultimately transpired. However, as it happens, FDI Instruments continue to be issued with a fixed rate of return and regulatory intervention seems to be on a case to case basis. We understand there have been cases where the RBI has qualified put options without a fixed IRR also as ECBs.

sion to foreign debt was manifested by the introduction of Clause 3.3.2.1 of the FDI Policy issued on September 30, 2011, which read as follows:

"Only equity shares, fully, compulsorily and mandatorily convertible debentures and fully, compulsorily and mandatorily convertible preference shares, with no in-built options of any type, would qualify as eligible instruments for FDI. Equity instruments issued/transferred to non-residents having in-built options or supported by options sold by third parties would lose their equity character and such instruments would have to comply with the extant External Commercial Borrowing guidelines."

The provision had the effect of nullifying the equity character of an equity instrument when such instrument was issued or transferred with an in-built optionality (a put option or a buy back provision, for example). Having lost their equity character, such instruments were required to comply with the extant ECB regulations. The regulatory chaos that ensued had led the legal community also to express its discomfort.

Clause 3.3.2.1 received categorical and unequivocal opposition from the industry. Representations were made to the DIPP by industry associations pointing out the severe implications that such a provision could have on legitimate foreign investments in India. Clause 3.3.2.1 cast a cloud of uncertainty over a host of options, including call options, put options, or even tag along and drag along rights or any right that the investor could exercise at a future date, even though these "standard" investor rights were contractually agreed between sophisticated parties. The ban on put options denied private equity players a safe exit in the event the promoters of the investee company failed to deliver as per the projected business plans. It also adversely affected the "options" available to joint venture partners to consolidate or alienate its stake in the joint venture, in case of a fall-out between the joint venture partners.

Though Clause 3.3.2.1 was deleted within 30 days of it being introduced, the ambiguity over the inclusion of put options continues to haunt. While there is one school of thought that interprets the deletion to mean that options on equity instruments are now permitted, we are of the view that deletion of Clause 3.3.2.1 merely restores the status quo. RBI had in the past issued notices, on a case to case basis, with respect to put options being granted to non-resident investors on the following two counts:

(a) The ECB Perspective: RBI has issued notices to several private equity investors in the past on

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the ground that equity investments with a put option attached qualified the instrument as a redeemable instrument, which was akin to a debt instrument. Interestingly, RBI was indifferent if such a put option was exercisable on the company or on any of its shareholders; if there was a put option, the regulatory approach was to look at such instruments as ECB. Pertinently, RBI's objections to options were rather absolute. It had no nexus to the question whether the options warranted the investor an assured return, thus arguably diluting his commitment to the "risk" capital. It also did not treat options differently on the basis of their trigger event. An option available to an investor as an exit mechanism whether on the occurrence of a material event of default or on the failure of the investee company to initiate an initial public offer was treated alike. In our interactions with the regulators, RBI re-emphasized that FDI Policy refers to FDI as "lasting interest" in the company, and a put option divorces such lasting interest from the commitment to risk capital by allowing the foreign direct investor an assured exit.

(b) The Derivative Perspective: Another regulatory approach to options that did not find a mention in the FDI Policy is the RBI's perception of such options being regarded as derivative contracts separate from the underlying equity security. RBI, in its notices issued to a few private equity investors, regarded any kind of option attached to equity securities as a derivative contract, which are not permissible under the FDI route, as only FIIs and non-resident Indians are allowed to invest in exchange-traded derivative contracts where the underlying securities are equity shares of an Indian firm.

This view was taken by the RBI notwithstanding representations that in the first place, no separate consideration over and above the purchase consideration for the securities was paid by the foreign direct investor to secure these options, and more importantly such options were not independently tradable contracts to qualify as "derivatives".

Accordingly, even though Clause 3.3.2.1 has been deleted, the debate on put options is far from being put to rest. The risk of enforceability and the likelihood of RBI penalizing the grant of options to a non-resident (on a case to case basis), cannot clearly be ruled out for reasons mentioned above. Considering that private equity funds have limited life, put options are crucial and such regulatory overhang concerning such options happens to be very discouraging for investment under the FDI route.

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ii. Buy-Back

In this exit option, shares held by the foreign investor, are bought back by the investee company. Buy-back of securities is subject to certain conditionalities as stipulated under Section 77A of the Companies Act, 1956. A company can only utilize the following funds for undertaking the buy-back (a) free reserves, (b) securities premium account, or (c) proceeds of any shares or other specified securities.

Further, a buy back normally requires a special resolution passed by the shareholders of the company unless the buyback is or less than 10% of the total paid-up equity capital and free reserves of the company. Additionally, a buy back cannot exceed 25% of the total paid up capital and free reserves of the company in one financial year, and post buy-back, the debt equity ratio of the company should not be more than 2:1.

From a tax perspective, traditionally, the income from buyback of shares has been considered as capital gains in the hands of the recipient and accordingly the investor if from a favourable treaty jurisdiction, could avail the treaty benefits. However, in a calculated move by the Government to undo this current practice of companies resorting to buying back of shares instead of making dividend payments the Budget 2013-2014 has now proposed to levy a tax of 20% on domestic unlisted companies, when such companies make distributions pursuant to a share repurchase or buy back.

The said tax at the rate of 20% has been proposed to be imposed on a domestic company on consideration paid by it which is above the amount received by the company at the time of issuing of shares. Accordingly, gains that may have arisen as a result of secondary sales that may have occurred prior to the buy-back will also be subject to tax now.

The proposed provisions would have a significant adverse impact on offshore realty funds and foreign investors who have made investments from countries such as Mauritius, Singapore, Cyprus etc. where buy-back of shares would not have been taxable in India due to availability of tax treaty benefits. Further, being in the nature of additional income tax payable by the Indian company, foreign investors may not even be entitled to a foreign tax credit of such tax.

Additionally, in the context of the domestic investor, even the benefit of indexation would effectively be denied to such investor and issues relating to proportional disallowance of expenditure under Section 14A of the ITA *(Expenditure incurred in relation to income not includible in total income)* may

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also arise. This may therefore result in the buy-back of shares being even less tax efficient than the distribution of dividends.

*iii. Initial Public Offering (“**IPO**”)*

Another form of exit right which an investor may have is in the form of an IPO. However, looking at the number of real estate companies which have listed in the previous decade in India, this may not be one of viable exit options. The reason why real estate companies do not wish to go public in India is due to several reasons.

For instance, real estate companies are usually self-liquidating by nature. Thus, unless the flagship or the holding company goes public, there may not be enough public demand for and interest in such project level SPVs. There is also some reluctance in going for an IPO due to the stringent eligibility criterion (for instance 3 year profitability track record etc.) and the level of regulatory supervision that the companies (usually closely held) will be subjected to post listing.

iv. Third Party Sale

In this option, the investor sells its stake to a third party. If the sale is to another non-resident, the lock-in of 3 years would start afresh and be applicable to such new investor. Also, since FDI in completed ‘assets’ is not permitted, the sale to a non-resident can only be of an under-construction project.

In a third party sale in real estate sector, it may also be important to negotiate certain contractual rights such as ‘drag along rights’. For instance, if the sale is pursuant to an event of default, and the investor intends to sell the shares to a developer, it is likely that the new developer may insist on full control over the project, than to enter a project with an already existing developer. In such cases, if the investor has the drag along rights, he may be able to force the developer to sell its stake along with the investor’s stake.

v. GP Interest Sale[16]

A private equity fund is generally in the form of a limited partnership and comprises of two parties the

16. Reaping the Returns: Decoding Private Equity Real Estate Exits in India, http://www.joneslanglasalle.co.in/ResearchLevel1/Reaping_the_Returns_Decoding_Private_Equity_Real_Estate_Exits_in_India.pdf.

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General Partner ("**GP**") and the Limited Partner ("**LP**"). The GP of a fund is generally organized as a limited partnership controlled by the fund manager and makes all investment decisions of the fund. In a GP interest sale the fund manager sells its interest in the limited partnership ("**GP Interest**") to another fund manager or strategic buyer. While technically sale of GP Interest does not provide exits to the LPs as they continue in the fund with a new fund manager, it provides an effective exit to fund managers who wish to monetize their interests in the fund management business.

vi. Offshore Listing/Flips

Another mode of exit could be by way of rolling the real estate assets into an offshore REIT by flipping the ownership of the real estate company to an offshore company that could then be listed. Examples of such offshore listings were seen around 2008, when Hiranandani setup its offshore arm 'Hirco PLC' building on the legacy of the Hiranandani Group's mixed use township model. Hirco was listed on the London Stock Exchange AIM market. At the time of its admission to trading, Hirco was the largest ever real estate investment company IPO on AIM and the largest AIM IPO in 2006. Another example is Indiabulls Real Estate that flipped some of its stabilized and developing assets into the fold of a Singapore Business Trust that got listed on the SGX. However, both Hirco and Indiabulls have not been particularly inspiring stories and to some extent disappointed investor sentiment. Based on analysis of the listings, it is clear that there may not be a market for developing assets on offshore bourses, but stabilized assets may receive good interest if packaged well and have the brand of a reputed Indian developer. Hence, stabilized assets such as educational institutions, hospitals, hotels, SEZs, industrial parks et al may find a market offshore. Please refer to **Annexure III** for a detailed note on exit by rolling assets to offshore REITs.

vii. Domestic REITs

One of the most common mechanism of rollover of assets to a REIT is not existent in India as India does not currently have a REIT regime. In 2008, the SEBI came out with the Real Estate Mutual Fund ("**REMF**") Regulations. However, due to ambiguity in the regulations from a legal and tax perspective, no real estate mutual fund has been registered as of date. Please refer to **Annexure V** for our analysis of the draft 2008 REIT regulations and the REMF Regulations. We are currently working with an industry body to develop the REIT regime in India, and it does appear that the regulator may consider reintroducing the draft 2008 REIT regulations in an amended form.

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II. FVCI Route

FVCI regime was initiated keeping in mind the stifling effect that the DCF pricing norms may have on opportunistic investors. This regime provided that if a foreign investor was registered as an FVCI with the SEBI, then investments made by such investor will not be subjected to the DCF valuation. Interestingly, while there is nothing in the law to prevent an FVCI from investing in real estate, the SEBI while granting the FVCI registration requires an undertaking that such FVCI shall not invest in real estate.[17]

III. FII Route

1) Listed Equity

FII regime was initiated to bolster foreign portfolio investments in listed securities. A SEBI registered FII can buy and sell listed securities on the floor of a stock exchange without being subjected to FDI restrictions.

Schedule 2 of the TISPRO Regulations permits registered FIIs to purchase listed shares and convertible debentures under the portfolio investment scheme. However, the regulations prescribe the following limits on the investment by FIIs: 10% of the total paid up capital of the company by an individual FII, and 24% of the paid up capital of the company by all the FIIs in aggregate. This limit of 24% can be increased up to the sectoral cap prescribed under the FDI policy with a special resolution of the company.

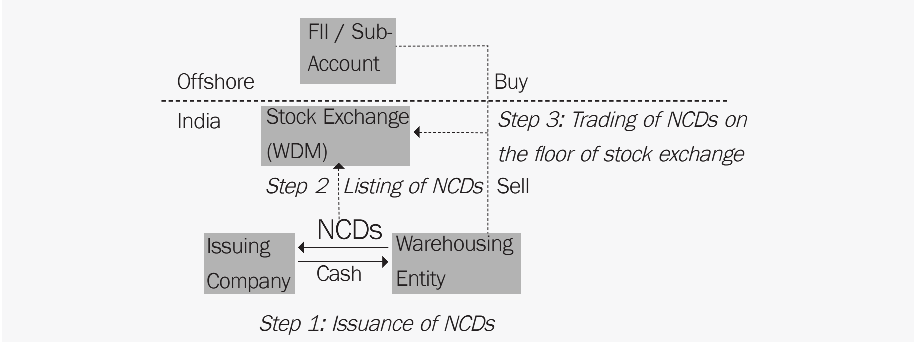
Since, the number of real estate companies that are listed on the stock exchange are not high, direct equity investment under FII route is not very popular. Instead, most of the FII investments in real estate sector is through subscription / purchase of non-convertible debenture ("**NCD**"), as discussed below.

2) Listed NCDs

Under Schedule 5 of the TISPRO Regulations, FIIs are allowed to invest in listed / to be listed non-con-

17. SEBI's reluctance to allow FVCIs from investing in real estate is based on the premise to regulate the forex outflow as FVCIs are not subject to any pricing restrictions.

vertible debentures. Herein below is a structure chart detailing the steps involved in the NCD route:



Under this route, any private or public company can list its privately placed NCDs on the wholesale debt market segment of any recognized stock exchange. An FII or any sub-account of an FII entity can then purchase these NCDs on the floor of the stock exchange from the warehousing entity. Entities of offshore realty funds may have their own FII registration or register as a sub-account to an existing FII to purchase the NCDs. For an exit, these debentures may be sold on the floor of the stock exchange[18], but most commonly these NCDs are redeemed by the issuing real estate company. So long as the NCDs are being offered on private placement basis, the process of offering and listing is fairly simple without any onerous eligibility conditions or compliances.

Recently, the RBI and SEBI have permitted direct subscription of 'to be listed' NCDs by the FII, thus doing away with the requirement of warehousing entity. These 'to be listed' NCDs have to listed on a recognised stock exchange within 15 days of issuance, else, the FIIs are required to dispose-off the NCDs to an Indian entity / person.

The NCDs are usually redeemed at a premium that is usually based on the sale proceeds received by the real estate company, with at least 1x of the purchase price being assured to the NCD holder.

Whilst creation of security interest[19] is not permissible with CCDs under the FDI route, listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee that acts for and in the interest of the NCD holders.

18. There have been examples where offshore private equity funds have exited from such instruments on the bourses.

19. Security interest is created in favour of the debenture trustee that acts for and on behalf of the NCD Holders. Security interest cannot be created directly in favour of non-resident NCD holders.

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Also, since NCDs are subscribed to by an FII entity under the FII route and not under the FDI route, the restrictions applicable to FDI investors in terms of pricing are not applicable to NCD holders. NCDs, in fact, are also in some situations favored by developers who do not want to share their equity interest in the project. Further, not only are there no interest caps for the NCDs (as in the case of CCDs or CCPS), the redemption premium on the NCDs can also be structured to provide equity upside to the NCD holders, in addition to the returns assured on the coupon on the NCD.

The table below gives a brief comparative analysis for debt investment through FDI (CCDs) and FII (NCDs) route:

Particulars	CCD-FDI	NCD-FII/QFI
Equity Ownership	Initially debt, but equity on conversion	Mere lending rights; however, veto rights can ensure certain degree of control.
ECB Qualification	Assured returns on FDI compliant instruments, or put option granted to an investor, may be construed as ECB.	Purchase of NCDs by the FII / sub-account / QFI from the Indian company on the floor of the stock exchange is expressly permitted and shall not qualify as ECB.
Coupon Payment	Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.	Arm's length interest pay out should be permissible resulting in better tax efficiency. Higher interest on NCDs may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.
Pricing	DCF Valuation applicable	DCF Valuation applicable
Security Interest	Creation of security interest is not permissible either on immoveable or movable property	Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who acts for and in the interest of the NCD holders

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Particulars	CCD-FDI	NCD-FII/QFI
Sectoral conditionalities	Only permissible for FDI compliant activities	Sectoral restrictions not applicable.
Equity Upside	Investor entitled to equity upside upon conversion.	NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore or Cyprus.
Administrative expenses	No intermediaries required	NCD listing may cost around INR 10-15 lakh including intermediaries cost. In case of FII / sub-account, additional cost will be incurred for SEBI registration and bidding for debt allocation limits. In case of QFI, there may be additional cost as fees charged by the QDP.

Prior to April 1, 2013, for an FII / sub-account to invest in corporate debt or debt securities, the FII / sub-account was required to first acquire debt allocation limits from SEBI which were issued or auctioned by SEBI from time to time. Also, previously an FII / sub-account which had acquired or obtained investment limits from SEBI, had the flexibility to reinvest into debt securities after the initial investment had been sold off or had matured, subject to certain restrictions as stipulated in SEBI Circulars No. CIR/IMD/FIIC/1/2012 dated January 3, 2012, No. CIR/IMD/FIIC/22/2012, dated November 7, 2012 and No. CIR/IMD/FIIC/1/2013 ("**SEBI Debt Limit Circulars**").

However, post April 1, 2013, SEBI[20] and RBI[21] have allowed FII / sub-account, along with QFIs (defined in section IV below) to invest in corporate debt without purchasing debt limits till the overall investment reaches 90% of USD 51 billion (i.e. USD 45.9 billion) after which the auction mechanism would be initiated for allocation of the remaining limits. Further, it is provided that the facility of re-

20. SEBI Circular, CIR/IMD/FIIC/6/2013, dated April 1, 2013

21. A.P. (DIR Series) Circular No. 94, dated April 01, 2013

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investment and the restrictions thereon as per SEBI Debt Limit Circulars shall not apply to the limit held or investments made by FII / sub account within the initial 90% of the available debt investment limit of USD 51 billion for Corporate Debt (USD 45.9 billion).

Separately, purchase of NCDs by the FII / sub-account from the Indian company on the floor of the stock exchange is excluded from the purview of External Commercial Borrowing ("**ECB**") and hence, the criteria viz. eligible borrowers, eligible lenders, end-use requirements etc. applicable to ECBs, is not applicable in the case of NCDs.

IV. QFI Route

On January 1, 2012, the Ministry of Finance issued a Press Release proposing to allow Qualified Foreign Investors ("**QFI**") to invest directly into the Indian equity market. In pursuance of this, on January 13, 2012 the SEBI vide Circular No. CIR/IMD/FII&C/3/2012 ("**SEBI QFI Circular**")[22] and the RBI vide A.P. (DIR Series) Circular No. 66 ("**RBI QFI Circular**")[23] formalized the scheme for investment by QFIs in equity shares of Indian companies. With this a new avenue has now opened up for foreign investors to invest into Indian entities.

QFI is defined by SEBI[24] as follows:

"QFI shall mean a person who fulfills the following criteria:

i. *Resident in a country that is a member of Financial Action Task Force ("**FATF**") or a member of a group which is a member of FATF[25]; and*

ii. *Resident in a country that is a signatory to IOSCO's MMOU (Appendix A Signatories) or a signatory of a bilateral MOU with SEBI:*

Provided that the person is not resident in a country listed in the public statements issued by FATF

22. http://www.sebi.gov.in/sebiweb/home/list/1/7/0/0/Circulars

23. http://www.rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?Id=6937

24. SEBI circular CIR/IMD/FII&C/18/2012, dated July 20, 2012.

25. The inclusion of member of a group which is a member of FATF was brought about pursuant the MoF Press Release. Thus now, along with residents of 34 member countries of FATF, residents of 6 member countries of Gulf Cooperation Council ("**GCC**") and 27 member countries of the European Commission ("**EC**") can also invest under the QFI regime.

from time to time on - (i) jurisdictions having a strategic Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) deficiencies to which counter measures apply, (ii) jurisdictions that have not made sufficient progress in addressing the deficiencies or have not committed to an action plan developed with the FATF to address the deficiencies:

Provided further that such person is not resident in India:

Provided further that such person is not registered with SEBI as Foreign Institutional Investor or sub-account or Foreign Venture Capital Investor.

Explanation - For the purposes of this clause:

1) *The term "Person" shall carry the same meaning under section 2(31) of the Income Tax Act, 1961;*
2) *The phrase "resident in India" shall carry the same meaning as in the Income Tax Act, 1961;*
3) *"Resident" in a country, other than India, shall mean resident as per the direct tax laws of that country.*
4) *"Bilateral MoU with SEBI" shall mean a bilateral MoU between SEBI and the overseas regulator that inter alia provides for information sharing arrangements.*
5) *Member of FATF shall not mean an Associate member of FATF."*

Thus, a QFI is a person resident in any of the member countries of FATF, GCC or EC and is not registered in India with SEBI as an FII or sub-account or FVCI.

On May 29, 2012, the Ministry of Finance issued a Press Release[26] to make further liberalizations in the investment regime by QFI under portfolio investment scheme ("**PIS**") wherein it was proposed to allow QFIs to invest in debt securities. The intent behind issuance of the Press Release was to attract foreign inflows under this route as the foreign inflows under this route was NIL since its introduction in August 2011. In pursuance of this, the RBI issued a circular dated July 16, 2012[27] and the SEBI also released a circular dated July 18, 2012[28] among few other circulars to govern the

26. F. No. 10101/2011-ECB, available at http://finmin.nic.in/press_room/2012/Rational_QFI_Scheme.pdf

27. RBI circular RBI/2012-13/134 A.P. (DIR Series) Circular No. 7, dated July 16, 2012.

28. SEBI circular CIR/IMD/FII&C/17/2012, dated July 18, 2012.

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debt investment by QFIs in India.

Debt investment in an Indian company through the QFI route can be made by using the following securities[29]:

- Corporate debt securities (including NCDs and bonds) listed / 'to be listed' on any recognized stock exchange;
- Corporate debt securities, through public issues, if the listing on a recognized stock exchange is committed to be done as per the relevant provisions of the Companies Act, 1956;
- Listed units of mutual fund debt schemes;

(collectively referred to as "**eligible debt securities**").

The provisions relating to FIIs in case of non-listing of 'to be listed' corporate bonds within fifteen days as per the extant SEBI and RBI circulars[30] shall also be applicable to QFIs, which would imply that if the 'to be listed' eligible debt securities could not be listed within 15 days of the issue, then the holding of QFIs has to be sold only to domestic participants/investors until the eligible debt securities are listed.

The investment by QFIs in eligible debt securities shall be within the corporate debt limit of USD 51 (fifty one) billion available freely to FIIs and QFIs ("**Eligible Debt Investors**") and such investment shall not be subject to any lock-in or residual maturity clause.

Of the abovementioned limit of USD 51 (fifty one) billion, the QFIs may invest in eligible debt securities without any permission until the aggregate investment by all the Eligible Debt Investors reach 90% of the debt limit of USD 51 billion (i.e. USD 45.9 billion) post which the remaining limits would be auctioned.

Thus a foreign investor, who qualifies as a QFI, can directly invest under these routes into debt securities and the listed equity shares of a company engaged in the development of real estate. This route provides foreign investors direct access to the Indian equity and debt markets especially

29. SEBI circular CIR/IMD/FII&C/17/2012, dated July 18, 2012 read with RBI circular RBI/2012-13/134, dated July 16,2012.

30. SEBI circular CIR/IMD/FIIC/18 /2010, dated November 26, 2010. RBI circular A.P. (DIR Series) Circular no. 89, dated March 1, 2012.

to the high net worth individuals, who do not wish to pool their funds with others. However, SEBI has provided that for the investment in listed equity shares of the company the ultimate beneficiary would be looked at and such ultimate beneficiary details would have to be obtained by the depository participant to fulfill the KYC requirements. The said condition is applicable for QFI investment via debt route also. Further, the investment by QFIs is subject to an individual investment limit of 5% of the paid up capital of the Indian company and an aggregate investment limit of 10% of the paid up capital of the company.

The table herein below brief compares subscription to NCDs under the FII route and QFI route:

Issue	FII	QFI
Eligible Investors	Institutional Investors (AMCs, Pension Funds, Mutual Funds, Investment Trusts as Nominee Companies, Portfolio Managers etc.)	Persons resident in FATF member country or member of group which is FATF member, and signatory to IOSCO MMOU or SEBI bilateral MOU.
SEBI Registration	Required	Not Required
Aggregate Debt Limits	USD 51 billion. No debt limits required to be purchased. Investment automatic till overall limit reaches USD 45.9 billion (90% of the aggregate USD 51 billion limit).	
Listing	Mandatory (within 15 days)	Same as FII
Pricing	No guidelines	No guidelines

V. NRI Route

1) Investment in Listed Securities

Similar to the FIIs, the NRIs can also purchase the shares of a real estate developer entity under the portfolio investment scheme. Under Schedule 3 of the TISPRO Regulations, NRIs are permitted to invest in shares and convertible debentures on a stock exchange subject to various conditions prescribed therein. The regulations prescribe the following limits on the investment by NRIs:

- The total investment in shares by an NRI cannot exceed 5% of the total paid up capital of the company and the investment in convertible debentures cannot exceed 5% of the paid up value of each series of convertible debentures issued by the company concerned; and

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- The aggregate of the NRI investments in the company cannot exceed 10% of the paid up capital of the company. However, this limit could be increased up to the sectoral cap prescribed under the FDI policy with a special resolution of the company.

2) Direct Investment in Unlisted Securities

Investment on repatriation basis

Investment by NRI in unlisted securities on repatriation basis is in a manner similar to any other investment allowed under Schedule 1 of TISPRO; however, as stated earlier the onerous requirements of minimum area, minimum capitalization, lock-in etc. applicable for FDI in construction development projects are not required to be met by NRIs per paragraph 6.2.11.2.

Investment on non-repatriation basis

Under Schedule 4 of TISPRO, NRI's on a non repatriation basis are permitted to purchase shares or convertible debentures of an unlisted Indian company without any limit and permission to purchase. The above permission is not available to NRI's for certain prohibited companies.[31]

3) Direct Acquisition of Immovable Property

The Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations, 2000, deal with direct acquisition of immovable property by 'a person resident outside India'. Under the regulations a 'person resident outside India' has been classified into two sections:

1) A person resident outside India, who is a citizen of India i.e. an NRI.

2) A person resident outside India, who is of Indian origin i.e. a person of Indian Origin[32] ("**PIO**").

Both NRI's and PIO's have been under the regulations allowed to directly purchase or sell immov-

31. Prohibited companies means - company which is a chit fund or a nidhi company or is engaged in agricultural/plantation activities or real estate business or construction of farm houses or dealing in transfer of development rights

32. A 'Person of Indian Origin' means an individual (not being a citizen of Pakistan or Bangladesh or Sri Lanka or Afghanistan or China or Iran or Nepal or Bhutan) who
    1. at any time, held an Indian Passport or
    2. who or either of whose father or mother or whose grandfather or grandmother was a citizen of India by virtue of the Constitution of India or the Citizenship Act, 1955 (57 of 1955).

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able property other than agricultural property, plantation or a farm house in India. However there are certain conditions imposed under the regulations on the payment of the purchase price and on repatriation of the sale consideration received.

Purchase Price Conditions

The payment of the purchase price can be made only by the following means:

- Funds received in India through normal banking channels by way of inward remittance from any place outside India; or
- Funds held in any non-resident account maintained in accordance with the provisions of the FEMA and the regulations framed by RBI from time to time.

Repatriation of Sale Proceeds

NRI's/PIO's are allowed to freely repatriate the sale proceeds provided:

- The immovable property was acquired in accordance with the regulations;
- The amount remitted outside India does not exceed the amount paid for the acquisition of the immovable property;
- In case of residential property, the repatriation is not for the amount received on sale of more than two residential properties.

However, any upside that is obtained on sale of such property after being subject to applicable capital gains tax and withholding can be remitted outside India through a Non-Resident Ordinary Rupee Account. However, the amount so repatriated cannot exceed USD 1 (One) million a year.

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3. Taxation Framework

I. General

Taxation of income in India is governed by the provisions of the Income Tax Act, 1961 ("**ITA**") as amended by the Finance Acts, from time to time. The ITA lays down elaborate provisions in respect of chargeability to tax, determination of residency, computation of income, et al. Residents are subjected to tax in India on their worldwide income, whereas non-residents are taxed only on Indian source income, i.e. incomes received in India, income that accrues or arises to them in India or is deemed to accrue or arise in India.[33] Section 9 of the ITA stipulates the types of income, which under certain circumstances are deemed to accrue or arise in India, such as interest, royalty, income from any capital asset situated in India, etc. However, in case of a non-resident taxpayer being resident of a country with which India has signed a tax treaty, he has the option of being taxed as per the ITA; only to the extent the provisions of the ITA are more beneficial to him.[34]

II. Taxation of dividends

An investee company being a company incorporated in India is regarded as a tax resident of India and is subject to taxation in India on its worldwide income. Currently, domestic companies are taxed at the rate of 30 percent on their net profits. Every Indian company distributing dividends to its shareholders is required to pay a dividend distribution tax ("**DDT**") of 15 percent. The dividends so paid by the Indian company are tax-exempt in the hands of the shareholders, irrespective of their residential status. The DDT is payable by the Indian company despite the fact that the profits from which the dividends are being distributed may be enjoying tax holiday/exemptions except in the case where the dividends are paid by a developer of special economic zone.

III. Taxation of interest income

Any interest that accrues to an offshore fund is subject to a withholding tax of 10 percent in case of

33. Section 4 and 5 of the ITA Section 90(2) of the ITA

34. Unless specified otherwise or if the domestic or foreign companies income does not exceed Rupees One Crore, all income tax rates mentioned in this article are inclusive of the currently applicable surcharge at the rate of 5 percent on domestic companies and 2 percent in case of foreign companies and the education cess of 3 percent on tax and surcharge, provided that Surcharge is payable at lower of the following :
- applicable rate of surcharge on the total income tax or
- the income tax payable on the total income reduced by Rupees One Crore

interest on Foreign Currency Convertible Bonds issued by the investee company under the Issue of Foreign Currency Convertible Bonds and Ordinary Shares (through Depository Receipt Mechanism) Scheme, 1993 (the "**Scheme**"), or 20 percent on loans made to investee company in non-Indian currency not under the Scheme (e.g. under the ECB route) and at the rate of 40 percent in case of loans made to the investee companies in Indian currency. The withholding tax rates could stand reduced under the tax treaty, if any, between India and home jurisdiction of the offshore fund. Interest payments to investors in a domestic fund would attract interest withholding at varying rates depending on the tax classification of the investor in the domestic fund.

IV. Capital Gains

Currently, under the ITA, gains are classified as short-term and long-term depending upon the period of holding[35]. Long-term capital gains earned by an investee company upon sale of any property would be taxed at the rate of 20 percent. However, if the income from sale of property is characterized as business income as would be in the case when the investee company sells the property before it can be treated as long term capital asset, then the tax rate would be 30 percent. Accordingly, one would need to pay attention to the characterization of the gains as business income or capital gains which would again depend on the facts and circumstances of each case.

V. Minimum Alternate Tax

Where the tax payable by the investee company is less than 18.5 percent of its book profits, the tax will be deemed to be 18.5 percent (excluding surcharge and education cess) of such book profits as Minimum Alternate Tax.

VI. Wealth Tax

Buildings, residential and commercial premises held by the investee company will be regarded as assets as defined under Section 2(ea) of the Wealth Tax Act, 1957 and thus be eligible to wealth tax in the hands of the investee company at the rate of 1 percent on its net wealth in excess of the base exemption of INR 30,00,000. However, commercial and business assets are exempt from wealth tax.

35. Gains earned on sale of assets (other than shares) if held for 36 months or less are classified as short term capital gains, whereas gains earned on sale such assets if held for more than 36 months are classified as long term capital gains.

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VII. Service Tax

The service tax regime was introduced vide Chapter V to the Finance Act, 1994. Subsequent Finance Acts, (1996 to 2003) have widened the service tax net by way of amendments to Finance Act, 1994. Service tax is levied on specified "**taxable services**" at the rate of 12.36[36] percent on the "**gross amount**" charged by the service provider for the taxable services rendered by him. The Finance Act, 2004 has introduced "**construction services**" as a taxable service and thus such services provided by the investee company would be subject to service tax in India. Further, the Finance Act, 2007, has brought services provided in relation to renting of immovable property, other than residential properties and vacant land, for use in the course or furtherance of business or commerce under the service tax regime.

VIII. Stamp Duty and other taxes

The real estate activities of the VCU would be subject to stamp duties and other local/municipal taxes, property taxes, which would differ from State to State, city to city and between municipals jurisdictions. Stamp duties may range between 3 to 14 percent.

IX. Taxation of Offshore Fund

The dividends earned by an offshore fund would be tax exempt in its hands. Interest income would be taxed at the rates mentioned under the heading "**interest**" above. Capital gains would be taxed at the rate of 0 percent/10 percent/20 percent/30 percent/40 percent depending on the nature of security, period of holding and type of investor. As stated above, under certain treaties, capital gains are given partial or complete exemption from capital gains tax. On the other hand, if the income from investments are taxed as business income in the hands of the offshore fund set up as a company, then as stated above, such gains would not be subjected to tax in India in the absence of a PE/BC in India or would be taxed at the rate of 40 percent on the gains attributable to the PE/BC in India.

X. Intermediate Jurisdictions

Foreign investors may invest in India via an intermediate jurisdiction to mitigate tax leakage. Of the

36. Excluding currently applicable education cess of 3 percent on service tax

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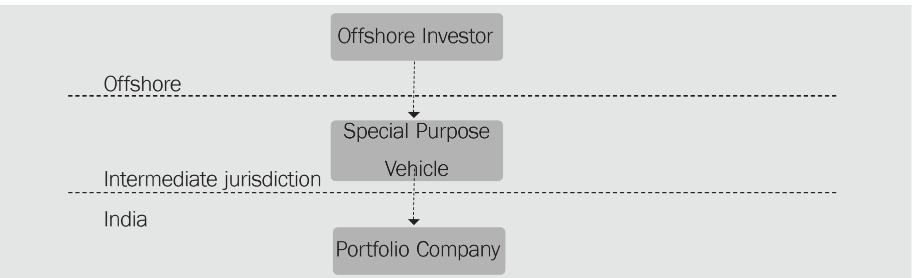
various double taxation avoidance agreements ("**DTAAs**") which India has entered into across the globe, some of them contain beneficial provisions with regard to capital gains tax and tax withholding on interest payments. Favourable legal and regulatory environment, coupled with a lower domestic tax regime in few of these jurisdictions, including Mauritius, Cyprus, Singapore and Netherlands, have made them, over the years, a popular choice for an intermediate jurisdiction. The diagram below illustrates the use of intermediate jurisdiction for investment into India:



Since taxation on business income in most jurisdictions is higher, and repatriation of dividends from India is not tax effective[37], returns to foreign investors from India are generally structured as capital gains or interest income, which can reduce the effective tax liability of foreign investor to 0% or 10% respectively, with the use of appropriate intermediate jurisdiction. Herein below is a comparison of three key jurisdictions – Mauritius, Singapore and Cyprus from the aspects – (i) corporate and regulatory framework in the intermediate jurisdiction; (ii) protection for investments; (iii) flexibility for restructuring; and (iv) ease of exit.

INCOME STREAM	TAX TREATMENT		
	MAURITIUS	SINGAPORE	CYPRUS
Sale of shares	Income from the sale of shares of an Indian Company by a Mauritius Company is only taxable in Mauritius. Mauritius levies no capital gains tax. Hence,	Income from the sale of shares of an Indian Company by a Singapore Company is only taxable in Singapore. There is no capital gains implication in Singa-	As per the India-Cyprus tax treaty, income from the sale of shares of an Indian Company by a Cyprus entity is only taxable in Cyprus. Thus,

37. There is a dividend distribution tax ("DDT") of 15% (exclusive of surcharge and cess) payable by the Indian company on the dividend distributed to its shareholders; further, since DDT is a corporate level tax and not a tax in the hands of the shareholder, credit for DDT is usually not available

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INCOME STREAM	TAX TREATMENT		
	MAURITIUS	SINGAPORE	CYPRUS
	there will be no tax incidence.	pore if the income is characterized as capital gains. To avail the capital gains exemption, the entity claiming the tax benefit must have incurred an annual expenditure of 200,000 Singapore dollars in Singapore, on operations, in the immediately preceding 24 months prior to the date the gains arise (LOB). However, Singapore tax authorities may construe capital gains to be in the nature of business income unless (a) the Singapore Company holds 20 % of the ordinary shares in the Indian Co. and (b) the shares are held for a continuous period of 24 months.	Cyprus tax residents are exempt from capital gains tax in India. There is no capital gains tax in Cyprus. Hence, no tax incidence.
Buyback	Tax shall be payable by the Indian company at the rate of 20% on the total consideration it pays to buy back the shares *minus* the amount at which the shares were issued by the Indian company.	Tax shall be payable by the Indian company at the rate of 20% on the total consideration it pays to buy back the shares *minus* the amount at which the shares were issued by the Indian company.	Tax shall be payable by the Indian company at the rate of 20% on the total consideration it pays to buy back the shares *minus* the amount at which the shares were issued by the Indian company.

INCOME STREAM	TAX TREATMENT		
	MAURITIUS	SINGAPORE	CYPRUS
Dividend	Dividend Distribution Tax shall be payable by the Indian Company prior to distribution of profits at the rate of 15%*. Dividend Income received by the Mauritius Company shall be taxable as business income in Mauritius at the rate of 15%. However, the Mauritius Company should be eligible to avail deemed foreign tax credit of 80% or underlying tax credits, which will reduce the effective tax incidence to 0%-3% .	Any dividend distributed by a company in India is subject to dividend distribution tax @15%. The dividend received by the Singapore Company should be exempt from tax in Singapore.	Any dividend distributed by a Company in India is subject to dividend distribution tax @15%. The dividend received by the Cyprus Company should be exempt from tax.
Interest	Interest income would be subject to 40% withholding tax for Indian rupee borrowing (including CCDs). In case of ECB, the withholding rate is 5%.	Subject to a 15% withholding tax in India. Further, interest income should be characterized as business income in Singapore and be subject to tax @17%. However, due to tax credit available in Singapore, the effective tax rate in Singapore is likely to be 2%. In case of ECB, withholding rate will be 5% in India. LOB provision may not be complied with to avail treaty benefits for interest income.	Interest income earned by a Cyprus company from an Indian company shall be taxable in Cyprus, though a withholding tax of 10 % is payable in India. Further, as the local tax rate on such income in Cyprus is 10% and Cyprus gives tax credit for the taxes paid in India, no tax is payable in Cyprus. Hence, interest income attracts a net tax inci-

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INCOME STREAM	TAX TREATMENT		
	MAURITIUS	SINGAPORE	CYPRUS
			dence of 10%. In case of ECB, the withholding rate will be 5% in India.

Herein below are some of the key pros and cons of each intermediate jurisdiction mentioned above:

i. Mauritius

Advantages	Disadvantages
• Minimal business income tax in Mauritius • No tax implication for the sale of shares of the Indian Company by the Mauritius entity. • No exchange control or thin capitalization requirements and therefore provides flexibility with funding to the Mauritius entity. • Investments from Mauritius into India are protected under the India- Mauritius Bilateral Investment Treaty. • More corporate operational flexibility than Singapore for any potential restructuring exercise • Most preferred for investment into India.	• In case of debt investments, interest income received by the Mauritius entity from the Indian Company would be subject to a high tax incidence. • India-Mauritius tax treaty may be re-negotiated to introduce a LoB provision.

ii. Singapore

Advantages	Disadvantages
• Singapore does not have thin capitalization rules and hence there is flexibility with respect to funding. • No tax implication for the sale of shares of an Indian Company by a Singapore Company or	• Less corporate restructuring flexibility as against Mauritius and Cyprus in terms of buy back, cross border mergers etc. • Issues surrounding characterization of capital gains as business income continue to exist –

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Advantages	Disadvantages
the buyback of the Singapore entity's share by the Indian Company. • Singapore entity may have the option to get listed on the Singapore Exchange (SGX) which is a vibrant market for Indian real estate assets. • LOB clause should provide adequate protection against the GAAR to transactions involving Singapore even if the recommendations of the Shome Committee are accepted.	Whether Rule 220 can be applied to CCDs? • The Singapore entity is required to incur an annual operating expense of 200,000 Singapore Dollars for at least 2 years preceding the date when the gains arise in order to avail the treaty benefits. • Investments from Singapore into India may not be adequately protected as there is no Bilateral Investment Treaty between India and Singapore. However, the India Singapore Comprehensive Co-operation Agreement inter-alia provides protection against expropriation of investments.

iii. Cyprus

Advantages	Disadvantages
• There is no exchange control restriction or thin capitalization rules under the local laws of Cyprus and thus there exists flexibility with respect to funding. • The interest income received by the Cyprus entity from an Indian entity is subject to lesser tax incidence as compared to Mauritius or Singapore. • Investment from Cyprus into India are protected under the India-Cyprus Bilateral Investment Treaty. • Benefits of European Union ("**EU**") Directives available particularly when investors are from EU.	• Cyprus not seen as favorably as Singapore by the revenue authorities and may be subject to scrutiny. • In the past we have seen the Cyprus tax authorities deeming income at arms length rate and thereby taxing such deemed income at 10% even when no interest was accrued / paid to the Cyprus entity.

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4. Domestic Pooling

Domestic pools of capital may be structured primarily in two ways:

I. AIF

In May 2012, SEBI notified the (Alternative Investment Funds) Regulations, 2012 ("**AIF Regulations**") to regulate the setting up and operations of alternate investment funds in India. As provided in the AIF Regulations, it replaces and succeeds the erstwhile SEBI (Venture Capital Funds) Regulations, 1996. The AIF Regulations further provide that from commencement of such regulations, no entity or Person shall act as an AIF unless it has obtained a certificate of registration from the SEBI. The AIF Regulations define 'Alternate Investment Funds' as any fund established or incorporated in India in the form of trust, company, a limited liability partnership or a body corporate which is a privately pooled investment vehicle which collects funds from investors, whether Indian or foreign, for investing in accordance with a defined investment policy for the benefit of investors, and is not covered under the SEBI regulations to regulate fund management.

The real estate funds shall be registered with SEBI as a Category II Alternate Investment Fund and shall be governed by the provisions of the AIF Regulations. The AIF Regulations prescribe that the raising of commitments should be done strictly on a private placement basis and the minimum investment that can be accepted by a fund from an investor is INR 1,00,00,000 (Rupees One Crore Only). The AIF Regulations also prescribe that a placement memorandum detailing the strategy for investments, fees and expenses proposed to be charged, conditions and limits on redemption, risk management tools and parameters employed, duration of the life cycle of the AIF should also be issued prior to raising commitments and be filed with the SEBI prior to launching of a fund. Further, the AIF Regulations also prescribe that the manager or a sponsor of an AIF shall have a continuing interest in the AIF of not less than 2.5% of the corpus or INR 5,00,00,000 (Rupees Five Crore Only), whichever is lower, in the form of investment in the AIF and such interest shall not be through the waiver of management fees.

The AIF Regulations provide that a close ended AIF may be listed only after the final closing of the fund or scheme on a stock exchange subject to a minimum tradable lot of INR 1,00,00,000 (Rupees One Crore Only). Accordingly, the Fund will not be in a position to list its securities without complying

with the above conditions. The AIF Regulations lay down several investment restrictions on Category II AIFs. These restrictions are as follows:

- A Category II AIF cannot invest more than 25 percent of its corpus of the fund in any one investee company.
- A Category II AIF may invest in units of Category I and II AIFs but not in the units of fund of funds.
- An AIF may not invest in its 'Associates' except with the approval of 75% of the investors by value of their investments in the AIF. For this purpose 'Associates' means a company or a limited liability partnership or a body corporate in which a director or trustee or partner or sponsor or manager of the AIF or a director or partner of the manager or sponsor holds, either individually or collectively, more than 15% of its paid-up equity share capital or partnership interest, as the case may be.

An investee company has been defined to mean any company, special purpose vehicle or limited liability partnership or body corporate in which an AIF makes an investment. A registered AIF will be subject to investigation/inspection of its affairs by an officer appointed by SEBI, and in certain circumstances the SEBI has the power to direct the AIF to divest its assets, to stop launching any new schemes, to restrain the AIF from disposing any of its assets, to refund monies or assets to Investors and also to stop operating in, accessing the, capital market for a specified period.

However, a Category II AIF is not permitted to receive foreign investment under the extant exchange control regulations without prior approval of the FIPB. Though in a few cases, such approval has been granted in cases where the investment was required for the purposes of making the sponsor commitment, no approval has thus far been granted for LPs willing to invest in the AIF. Based on reports, SEBI is in discussions with the RBI and FIPB to allow foreign investment beyond sponsor commitment in AIFs, but as we understand the RBI and the FIPB are not yet comfortable with such permissions on a policy level.

II. NBFC

For a detailed note on investment through an NBFC, please refer to **Annexure V.**

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5. The Road Forward

The Indian real estate industry is at a stage where the PE players have seen a lot of exits, with some making excellent multiples while others burning their fingers deep. However, a larger chunk of exits are expected to be witnessed in the next 2-3 years when the sector completes its first full cycle, which is where the key challenge lies. Some of the challenges that Indian real estate sector faces are as follows:

I. Partner issues

Uncooperative partner has been the largest issue for PE players. Promoter - investor expectation mismatch are now increasingly seen. Enforceability of tag along rights, drag along rights, put options or even 3rd party exits clearly hinge on the cooperation of the local partner. Besides, with exit price capped at the DCF valuation, cooperation of the investee company typically controlled by the Indian promoters is crucial as projections for DCF can only be provided by the investee company.

II. PN2 ambiguities

Issues such as transfer of shares from one non-resident to another non-resident with a fresh lock in of 3 years becoming applicable to the transferee non-resident and the permissibility of exit where 50% of the project is not completed within 5 years of obtaining all statutory approvals (with ambiguity on what constitutes 'all statutory approvals') have made investors apprehensive.

III. Unenforceability of put/call options

Typically, exits are affected either by way of taking the company public by way of an IPO, or liquidating the company, or by a put on the promoters or the company. Liquidation is not even considered as an exit option in the Indian context due to the time it takes. IPO is again fairly rare in the real estate sector as most investments are made in project specific single asset companies with the asset being self-liquidating in most cases. The only viable option that is left is either a put option on the promoters or buy-back by the company. With the RBI regarding 'puts' to be in the nature of ECB, and worse still regarding any put option as an over-the-counter derivative contract which can be traded in only by an FII, this crucial exit avenue available to offshore private equity funds is also blocked. The

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aggressiveness with which such unwritten policy has been used against private equity in the recent past has severely disappointed investors, who are concerned if it is even legitimate to expect return of (if not on) their invested capital in the country.

IV. GAAR

Though, the Finance Minister has confirmed in January 2013 (and reconfirmed again in the Budget 2013-14)that the GAAR shall be effective only from financial year beginning April 1, 2015 (and not from April 1, 2013 as proposed initially), investors would need to grapple with these new rules. GAAR gives revenue the ability to re-characterize the nature of the income, essentially regarding substance over form. Enough has been written about GAAR, but what is important are the few recent decisions of the authority for advanced rulings ("**AAR**") that depict similar tendencies already pending GAAR, even though AAR rulings are binding only on the revenue and applicant. For instance, in Z Mauritius, AAR re-characterized sale of CCDs to the promoters as interest; in XYZ India, AAR held that scheme of buy-back was 'colourable device' to distribute dividends and avoid dividend distribution tax. These rulings have only accentuated investor apprehension. The Shome Committee, constituted to review the GAAR provisions, had recommended substantial dilution of the provisions and also deferral of the implementation of GAAR, key recommendation of the said committee have not been accepted by the Finance Ministry. Although not reflected in the Budget, the Finance Minister announced in January of this year that investments made prior to August 30, 2010 would be grandfathered and GAAR shall not apply to exits from such investment. To the contrary, the Shome Committee has recommended that GAAR should only apply to investments made subsequent to the implementation of GAAR. Therefore, GAAR may retroactively apply in relation to transactions and investments taking place between August 30, 2010 and the date when GAAR comes into force, thereby creating issues for post 2010 deals where divestments take place subsequent to April 1, 2015.

V. Indirect transfers

Post budget 2012, the Indian revenue authorities have the power to tax capital gains arising from an asset or a capital asset being any share or interest in a company or entity registered or incorporated outside India shall be deemed to be situated in India, if the share or interest derives, directly or indirectly, its value substantially from the assets located in India. Consequently, sale of offshore entities having Indian assets has also become challenging. Unfortunately, much to the dismay of foreign investors and contrary to the recommendation of the Shome Committee, Budget 2013-14 was silent

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on the issue of indirect transfer provisions introduced in the Budget 2012-2013 and accordingly failed in settling the uncertainty that was unleashed from these provisions.

VI. Withholding

With the spectre of indirect transfers and GAAR looming large, foreign investors are concerned on the extent of withholding that they need to make when buying the shares of Indian companies from a non-resident. The buyer is apprehensive if he should withhold capital gains tax at the rate of 10% or 20% (as there is a debate that the reduced rate of capital gains tax for non-residents is applicable only when the shares are that of a public company), and importantly whether he should actually withhold or just take a tax indemnity, or tax insurance, or put the withholding amount in escrow, or go for an AAR ruling or procure a NIL withholding certificate from the tax authorities. Clearly, each alternative has its own set of challenges from a buyer and seller perspective, but at the end of it, such uncertainties definitely play down the marketability of Indian assets.

VII. Arbitration/Litigation

Indian courts have been known for their lackadaisical approach to dispute resolution. Hitherto, even international arbitration was not free from the involvement of the Indian courts, which was a concern for offshore investors. Now, with the decision of the Supreme Court in the Balco case, the jury is out that parties in an international arbitration can agree to exclude the jurisdiction of the Indian courts. However, enforcement of such arbitral awards in India continues to remain a challenge.

VIII. Security Enforcement

Enforcement of security interest is still a challenge in India. For instance, enforcing a mortgage in India is a court driven process and can take very long sometimes even extending beyond couple of years. Since most realty funds are structured with a fund life of 5-7 years, coinciding with a typical project lifecycle[38], this additional enforcement period may not always be feasible. Similarly, to enforce a guarantee, one has to approach the court and the protection is limited to the extent of financial wherewithal of the guarantor. The situation was better in case of pledge of listed shares which was considered the most liquid security, as it could be enforced without court involvement. However, the

38. Jones Lang Lasalle India Capital Markets Report, available at http://www.asiapacific.joneslanglasalle.com/india/Gurgaon/March2012/DecodingPrivateEquityRealEstateExitsinIndia.pdf, page 2.

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court stay on the invocation of pledge of shares of Unitech[39], in spite of a breach of the terms, has raised questions on this form of security as well.[40] Please see **Annexure VI** for an article on challenges in invocation of pledge.

IX. Title related issues

In India, tracking ownership of land with conclusive certainty is an ordeal. This is because India still follows the deed registry system, contrary to the title registry system followed in developed economies, and the land records in India are not yet in electronic form.[41] Further, title insurance as a product is still not available in India. Government is poised to streamline the land title issues by promulgation of the proposed Land Titling Bill, 2010. Please see **Annexure IV** for our analysis of the proposed Land Titling Bill.

Funding land acquisitions are always a challenge for the foreign investors as real estate transactions in India whether land aggregation, acquisition, obtaining permission for conversion of land from agricultural to non-agricultural, obtaining building approvals can at times involve unaccounted money to save on stamp duty[42] and capital gains tax;[43] or payment of bribe or facilitation fee to obtain any construction approval etc.[44] which are not uncommon. Global anti-corruption laws having significant

39. Court saves promoter pledge, http://www.moneycontrol.com/news/management/court-saves-promoter-pledge_520897.html, last visited on April 8, 2012

40. For the first time, a High Court (highest court of law in a state in India) stayed the invocation of a pledge and that too via an ex-parte (without the defending party being present or heard) injunction handed out on a Sunday.

41. Government is poised to streamline the land title issues by promulgation of the proposed Land Titling Bill, 2010. Please see **Annexure IV** for our analysis of the proposed Land Titling Bill.

42. Stamp duty is in the nature of transfer tax payable to the revenue on the instrument for transfer of real estate. It varies from state to state and is generally calculated on the consideration paid for the transfer, or the ready reckoner rate, whichever is higher. For e.g., in Maharashtra (a state in India), the stamp duty applicable on the transfer of immovable properties is 5% of the consideration value, or the ready reckoner rate, whichever is higher. To reduce the stamp duty payable, parties reduce the consideration value on the sale deed and pay the remaining consideration out of 'black money'. To discourage people from adopting such practices and reduce the usage of 'black monies', the state governments generally on a yearly basis come up with a ready reckoner containing the reckoner rates for each area in that state which forms the basis for calculation of stamp duties. Therefore, even if the parties conclude the transaction below the ready reckoner rates, the ready reckoner rate would be deemed to be the consideration, and stamp duty would be applicable on such reckoner rates. However, as it happens in most cases, the reckoner rates are still much lower than the market rates.

43. Capital gains tax is a tax on the profits or gains arising from the transfer of a capital asset made in a previous year. The rate of capital gains tax would depend on the period of holding the asset under consideration. Akin to stamp duty, to prevent use of 'black money' in transactions, the reckoner rate has also been made the basis for calculation of capital gains tax vide Section 50C(1) of the Income Tax Act, 1961. Therefore, if the parties conclude the transaction below the ready reckoner rates, the ready reckoner rate would be deemed to be the full value of the consideration received by the seller and capital gains tax would be imposed accordingly.

44. Payment of facilitation fee for the conversion of zoning of land from agricultural land to non-agricultural land is also not uncommon.

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extra territorial reach, such as FCPA and UK Bribery Act, are being rigorously enforced and adequate safeguards for foreign investors are crucial.

Notwithstanding the challenges, Indian real estate continues to hold promise and the government seems poised to bring bold and far reaching reforms to encourage transparency and growth of the sector, and is sensitized to the needs of the foreign investors. For instance, the proposed Land Acquisition, Rehabilitation and Resettlement Bill ("**Land Acquisition Bill**") and the Land Titling Bill are likely to pave the foreign investments at the land acquisition stage.[45] Rationalizing the policy on GAAR and indirect transfers, deferment of GAAR to 2015, encouraging disintermediation of the equity and the bond markets by introduction of the QFI regime, taking steps to create a vibrant debt market by streamlining regulations around portfolio debt investments are just a few examples. From private equity in real estate perspective, regulators are sensitized to the need of setting up an efficacious REIT regime, and in recent times regulatory overhang on real estate focused NBFCs seems to be abating. With that spirit, the end of 2012 did witness resurgence of Indian real estate as an attraction for global capital, besides domestic capital which did receive a shot in the arm with the introduction of the new Category II AIFs despite the restrictions it brings with it, but it remains to be seen how long does India and Indian real estate hold up to such interest.

- Mukul Aggarwal, Deepak Jodhani, Ruchir Sinha

45. From a private equity in real estate perspective, if the Land Acquisition Bill is passed, then an enhanced need for funding is likely and the demand for private equity participation may be accentuated. Due to the high price that is required to be paid under the Land Acquisition Bill, the question of unaccounted money dealings may be obviated, which is likely to encourage private equity participation at the land acquisition stage.

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Annexure I
ECB for low cost affordable housing projects allowed[46]

The Reserve Bank of India ("**RBI**") has vide A.P. (DIR Series) Circular No. 61 ("**Circular**") issued on December 17, 2012 reviewed its policy relating to external commercial borrowings ("**ECB**") so as to provide guidelines for developers/builders and Housing Finance Companies ("**HFC**")/National Housing Bank ("**NHB**") to avail ECBs upto an aggregate limit of USD 1 (one) billion in the financial year 2012-2013, for the purpose of investing in low cost affordable housing projects and financing prospective owners of low cost affordable housing units, respectively. However, the Circular has kept it abundantly clear that such ECBs shall not be utilized for acquisition of land.

The said guidelines have been issued and made effective in furtherance of the RBI Notification No. FEMA. 246/2012-RB dated November 27, 2012 ("**Notification**") which amended the Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2012 to allow developers/builders and HFC/NHB to avail ECBs for low cost affordable housing projects.

I. Eligible Purpose for availing ECB

i. Low cost affordable housing project wherein at least 60 per cent of the permissible Floor Space Index ("**FSI**") would be for units having maximum carpet area up-to 60 square meters.

ii. Slum rehabilitation projects under the low cost affordable housing scheme, provided that they meet the criteria as may be set subsequently by the Central Sanctioning and Monitoring Committee of the Affordable Housing in Partnership Scheme constituted under the Chairmanship of Secretary, Housing and Urban Poverty Alleviation which administers the slum rehabilitation projects. The said criteria are yet to be notified by the abovementioned government authority.

*(The low cost affordable units as mentioned to be constructed in point number 1 and 2 above are hereinafter referred to as "**LCHU**")*

46. Real Estate Hotline, dated January 4, 2013, available on, http://www.nishithdesai.com/New_Hotline/Real/Real%20Estate%20Hotline_Jan0413.htm

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II. Eligibility Criteria for Borrowers

While the parameter as specified under the extant ECB Policy[47] with respect to minimum average maturity period, all-in-cost ceilings etc. are same, the developers/builders and HFC/NHB have to meet certain eligibility criteria's before they can avail ECBs for the purposes mentioned above.

The developers/builders should satisfy the following eligibility criteria:

i. should have a proven financial track record,

ii. should be registered as a company under the Companies Act, 1956,

iii. should have minimum 5 years' experience in undertaking residential projects,

iv. should not have defaulted in any of their financial commitments to banks/ financial institutions etc.,

v. the project undertaken by the developer/builder should not be a matter of litigation and should be in conformity with the provisions of master plan/ development plan of the area and all necessary clearances from various bodies including Revenue Department with respect to land usage/environment clearance etc., are available on record.

Further, the HFCs should satisfy the following eligibility criteria:

i. should be registered with the NHB and operating in accordance with their guidelines,

ii. its minimum paid-up capital, as per the latest audited balance sheet, should not be less than INR 50 crore and the minimum Net Owned Funds ("**NOF**") for the past three financial years should not be less than INR 300 crore,

iii. the borrowing through the ECB should be within the HFC's overall borrowing limit of sixteen times their NOF,

iv. its net non-performing assets shall not exceed 2.5 % of the net advances. Additionally, the maximum loan amount sanctioned to the individual buyer should be capped at INR 25 lakh subject to the condition that the cost of an individual LCHU will not exceed INR 30 lakh.

47. extant ECB Policy as provided under the Master Circular on External Commercial Borrowings and Trade Credits, Master Circular No. 12 /2012-13, July 2, 2012.

The Circular permits NHB to avail of ECB for on-lending to such developers who satisfy the eligibility criteria's mentioned above so as to further aid small developers/builders who are unable to raise ECB directly.

III. Procedure for availing ECB

NHB shall act as a nodal agency between the borrower and the RBI with the responsibility to first decide if a project is eligible as a low cost affordable housing project and then forward the application to RBI for consideration under the approval route. Simultaneous with the forwarding of application to RBI, NHB will advise the borrower to approach RBI for availing ECB through their Authorised Dealer in a manner as prescribed.

Developers/builders/HFCs/ NHB are not permitted to raise Foreign Currency Convertible Bonds (FCCBs) under this scheme.

IV. Implications of the Circular

(a) Availability of cheaper construction funding

Considering that ECBs are available at significantly lower rates as compared to other sources of funds available in India vide banks, private equity funding the Circular will assist in ensuring availability of construction funding for the developers/builders venturing into the low cost housing projects.

(b) Opportunity for developers/builders in maximizing their gains

Stipulation regarding construction of LCHU upto a minimum of 60% is a positive move and will be a significant impetus for developers/builders, to engage into such low cost affordable housing projects as they have the flexibility to develop 40% of the total FSI in any manner to maximize their returns while continuing to utilize the low cost funding and accordingly help in overall development of this segment of real estate projects in India.

(c) Low cost loans for buyers of units in low cost housing project

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Availability of cheaper loans for individual buyers buying individual LCHU upto INR 25 Lakhs for the LCHU costing within INR 30 lakh assuming that the benefit of borrowing at lower rates of interest by HFCs via ECB is likely to be passed on to the buyers. However, the regulator may want to specify the limit upto which interest arbitrage can be availed by HFCs engaging in on-lending activities with funds availed though ECBs. Doing so may ensure that HFCs do not hold back the benefit of low cost borrowing to itself.

(d) Entry barrier for new builders/developers

Low cost affordable housing projects are a niche segment and many new developer/builders may want to venture into this segment of constructing LCHU. However, the eligibility requirement for the builders/developers to have past experience of minimum five years and a proven financial track record may create an entry barrier for new players.

(e) Possibility that promoters financial track record and experience is not taken into account

Although it is likely that the track record of the promoters of the newly established developers/builders companies will also be considered in ascertaining the financial track record and/or experience for the companies, the Circular leaves some room for uncertainty and needs clarification.

(f) Onerous requirement for the project to be free of litigation

In the Indian real estate context, there may be very few projects which will be entirely free from litigations and may significantly narrow down the extent of utilization of ECB.

(g) Onerous requirement for the borrower not having defaulted in financial commitments

The requirement that the borrower shall never have defaulted on any of their financial commitments may substantially reduce the extent of eligible borrowers as the Circular does not provide any leeway to entities that may have defaulted but cured such defaults, and does not specify any thresholds of default. It may be helpful if the regulator further specifies the extent or thresholds for such defaults in financial commitments so as to ensure that the purpose of the Circular is not defeated.

(h) Uncertainty on the extent of clearances required

The requirement of having all necessary clearances from various bodies including Revenue Department with respect to land usage/ environment clearance etc. does not give clarity with respect to the identified benchmarks upto which approvals should be obtained. It is worth noting that for real estate projects it is a common practice that approvals from authorities are provided in different stages as the project progresses, hence, an unqualified requirement of obtaining all necessary clearances for a low cost housing project may lead to uncertainty.

(i) Non availability of ECB for acquisition of land required for the low cost housing project

Restriction on the developers/builders from utilizing the ECB proceeds for acquisition of land is likely to act as a dampener on the developers/builders since major capital requirement for execution of a low cost real estate projects is for the acquisition of land.

V. Analysis

Keeping in view the objective of providing housing for low-income groups and corresponding with the 2012-13 Budget announcement wherein the Finance Minister had proposed to allow ECB for low-cost affordable housing projects the Circular appears to fall short in meeting certain expectations with overpitched safeguards introduced by RBI. Further, Whilst regulatory intent behind some of the safeguards seems understandable, care must be taken to ensure that such safeguards do not defeat the purpose and intent of allowing ECB for low cost affordable housing projects. The onus on the regulator to safeguard government's intent can be considered to be higher considering the fact that in addition to the above announcement, in the 2012-13 Budget, government had taken certain other welcome measures for ECB in low cost housing projects. The said benefits to low cost affordable housing projects were in the form of reduced interest withholding on ECB from 20% to 5% for three years, investment linked deduction of capital expenditure at the enhanced rate of 150% as against the then existing rate of 100%. Also on indirect taxes front, service tax exemption for construction services relating to low-cost mass housing up to an area of 60 square meters was provided.

- Mukul Aggarwal & Ruchir Sinha

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Annexure II
FDI in Industrial Parks

As per the FDI Policy, FDI in Industrial Parks would not be subject to the conditionalities applicable for construction development projects etc. spelt out in paragraph 6.2.11, provided the Industrial Parks meet with the under-mentioned conditions:

i. it would comprise of a minimum of 10 units and no single unit shall occupy more than 50% of the allocable area;

ii. the minimum percentage of the area to be allocated for industrial activity shall not be less than 66% of the total allocable area.

FDI Policy defined ***"Industrial Park"*** as a project in which quality infrastructure in the form of plots of developed land or built up space or a combination with common facilities, is developed and made available to all the allottee units for the purposes of industrial activity.

Further the terms 'allocable area', 'industrial activity', 'infrastructure', 'common facilities' have been defined as following:

- "**Infrastructure**" refers to facilities required for functioning of units located in the Industrial Park and includes roads (including approach roads), water supply and sewerage, common effluent treatment facility, telecom network, generation and distribution of power, air conditioning.

- "**Common Facilities**" refer to the facilities available for all the units located in the industrial park, and include facilities of power, roads (including approach roads), water supply and sewerage, common effluent treatment, common testing, telecom services, air conditioning, common facility buildings, industrial canteens, convention/conference halls, parking, travel desks, security service, first aid center, ambulance and other safety services, training facilities and such other facilities meant for common use of the units located in the Industrial Park.

- "**Allocable area**" in the Industrial Park means:

  (a) in the case of plots of developed land- the net site area available for allocation to the units, excluding the area for common facilities.

  (b) in the case of built up space- the floor area and built up space utilized for providing common facilities.

  (c) in the case of a combination of developed land and built-up space- the net site and floor area available for allocation to the units excluding the site area and built up space utilized for providing common facilities.

- "**Industrial Activity**" means manufacturing, electricity, gas and water supply, post and telecommunications, software publishing, consultancy and supply, data processing, database activities and distribution of electronic content; other computer related activities, basic and applied R&D on bio-technology, pharmaceutical sciences/life sciences, natural sciences and engineering, business and management consultancy activities, and architectural, engineering and other technical activities.

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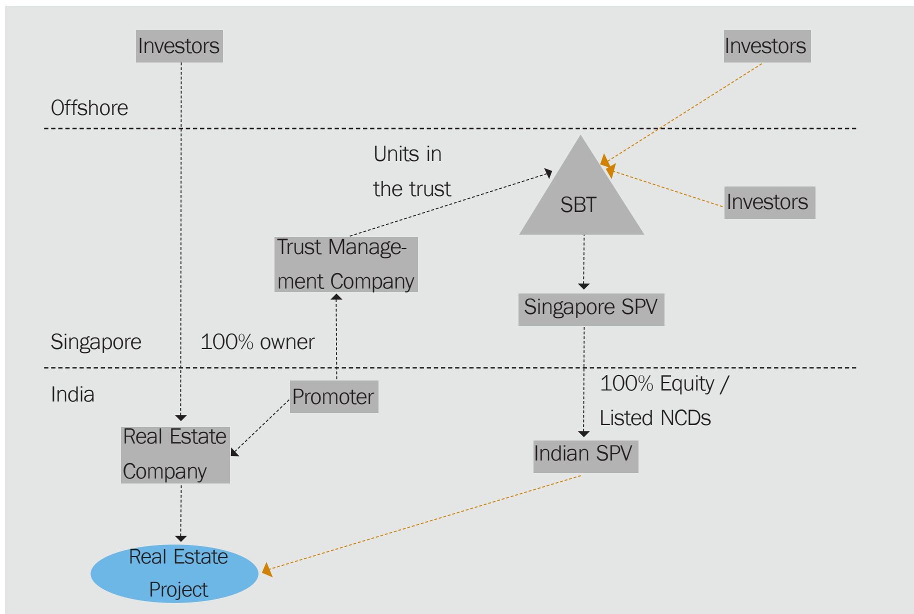
Annexure III
Flips and Offshore REITs

One of the means of exit for shareholders of a real estate company and also a way of accessing global public capital is by way of flipping the assets of the real estate company into the fold of an offshore REIT vehicle.

Herein below, is a typical structure that may be adopted for flipping the assets into REIT vehicle structured as a Singapore business trust that could be listed on the Singapore stock exchange.



In this structure the promoter flips its interest in the real estate asset in India offshore which can then be utilized to raise global capital offshore or to give an exit to offshore investors.

In this structure:

1) The individual shareholders of the Promoter entity acquires an interest in the management company in Singapore under the liberalized remittance scheme (“**LRS**”) which sets up the

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Singapore business trust ("**SBT**"). LRS permits an Indian resident individual to remit upto USD 200,000 in any financial year for most capital / current account transactions.

2) SBT in turn sets up an SPV in Singapore to invest in India. This is because a trust is not eligible to treaty benefits under the Indian Singapore tax treaty.

3) The SPV then sets up the Indian SPV.

4) The Indian SPV can then either purchase the real estate project on a slump sale basis on deferred consideration.

5) SBT can then raise monies by way of private placement or through listing of its units on the Singapore stock exchange. These monies can then be utilized to settle the deferred purchase consideration or purchase the real estate project.

6) The proceeds from the sale of the real estate project may then be utilized to provide an exit to the shareholders in India, in particular the foreign investor in the real estate company.

I. Key Considerations

Some of the key considerations that may be considered while flipping assets into an offshore entity are as follows

- Jurisdiction of the offshore entity and amenability to public markets
- Choice of Yield generating stabilized assets vs. developing assets as most offshore mar kets favor yield generating assets
- Need for on the ground presence and domestic sponsor and track record
- Appetite for Indian assets
- Tax Challenges
- Regulatory Challenges

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II. Tax and Regulatory Challenges

1) FDI Policy

A foreign company or a subsidiary of a foreign company is not permitted under the FDI Policy to acquire completed real estate assets, and can only invest in developmental assets as set out earlier in this paper. To that extent, either the SBT can acquire under construction real estate assets or other FDI Compliant assets such as SEZs, industrial parks, hospital etc. as provided in the FDI Policy and set out above. Also, other restrictions of FDI in real estate as set out earlier such as 3 year lock-in, DCF valuation and other issues as set out earlier in this paper also become applicable.

2) Holding of the Trustee Manager

Under the extant Indian exchange control regulations, only an Indian financial services company can invest in another financial services only with prior approval of the Indian financial services regulator (department of non-banking financial services in case of an NBFC investing overseas) and the overseas financial services regulator. However, based on our experience, such approval from the Indian regulator may be difficult to come through if the purpose of the overseas investment is to reinvest the proceeds in India, or manage a trust that is entrusted with investing India. Accordingly, whilst an Indian real estate company will find it impossible to invest in the asset management company overseas (referring to the trustee-manager), even if the investment were through an affiliated Indian NBFC, regulatory approval may be challenging.

Accordingly, the promoters of the Indian Promoter entity may subscribe to units of the trustee manager under the LRS, which permits an Indian resident individual to remit upto USD 200,000 in any financial year to acquire shareholding in the trustee-manager. In our experience, Sponsor brand name typically is necessary for marketing the SBT.

3) Need for Indian SPV

Typically, any fundraise initiative by the SBT may not be received well by the investors unless the SBT has the real estate project in its fold. Since the SBT may not have adequate funds to purchase the real estate project initially, it may like to purchase the real estate project on a deferred consideration

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basis. However, since purchase of Indian securities on a deferred consideration is not permitted, the SPV may setup the Indian SPV, which could purchase the real estate project on deferred consideration basis, which shall be discharged in manner set out above.

4) Transfer Taxes on Flips

Any transfer of immoveable property is subject to stamp duty to be paid to state government where the property is located. The extent of stamp duty varies from state to state usually ranging from 5 - 8% on the market value of property or the actual sale consideration whichever is higher. To determine the market value, the local authorities have prescribed the reckoner / circle rates for each area which are generally revised on an annual basis.

In addition to the stamp duty, the Seller is obligated to pay tax on the capital gains received by it from the sale of the immovable property. If however, the sale consideration is lower than the reckoner rate, per Section 50C of the Income Tax Act, 1961, the reckoner rate shall be deemed to be the consideration for the transfer of immovable property and the seller shall be taxed accordingly. Having said that, Section 50C is not applicable to immovable property which is held as stock-in-trade and not capital asset however, the Finance Bill, 2013-14 has inserted section 43CA (Special provision for full value of consideration for transfer of assets other than capital assets in certain cases) in the ITA which is a provision similar to Section 50C but applicable for assets other than capital assets, and since most developers record the real estate project as stock-in-trade, to that extent also unlike before, the seller would now be taxed on the value adopted/assessed/assessable by any authority of a state Government for the purpose of payment of stamp duty on such transfer, thus denying the tax advantage of allowing the sale of the immoveable property at book value.

5) Structured Debt Instruments

Considering the restrictions of FDI in real estate (minimum area requirement, lock - in etc.) and the limited asset classes that can be rolled into an offshore REIT (being only FDI Compliant assets), SBT may consider investing in the Indian SPV by way of acquiring listed NCDs of the Indian SPV or the real estate company under the FII / QFI route as set out earlier in this paper.

In addition to the above, NCDs may also be issued where the investors are offered assured regular

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returns and exit. This is because, the interest on compulsorily convertible debentures may be capped at SBI PLR + 300 basis points and any returns beyond that may have to be structured by way of buy-back or dividends which entails a higher tax rate.

Annexure IV
Analysis on LAND TITLING BILL, 2010: New "Conclusive" Property Title Regime Proposed[48]

The Department of Land Resources ("**DoLR**"), Ministry of Rural Development, of the Government of India has introduced for public discussion, a draft of the proposed Land Titling Bill, 2010, (the "**Bill**")[49] seeking to change the very nature of land titles in India from being "presumptive" to being "conclusive". This hotline seeks to highlight some of the prominent features of the proposed bill and analyze its impact.

I. Introduction

Due to historical and colonial reasons land regimes[50] have differed across India. Regardless of the regime there is another problem and this concerns titling. In any common law system, establishing titling is a horrendous affair, since title has to be traced back to its original roots and even title searches (with costs an additional issue) are no guarantee of ownership. Contrary to common belief, registration of sale deeds only registers the instrument and does not register titles. Thus under existing laws pertaining to land titles, in India are at best "presumptive" and not "conclusive", leading to heavy and increasing litigation and much strife.

Land is both a crucial yet complex resource required for development activities – crucial because no development is possible without land and complex because land is associated with several opportunities to use, invest and secure.[51] Thus it becomes crucial to ensure that land titling is conclusive in nature to promote development and the proposed legislation seeks to achieve exactly that.

48. Real Estate Update, dated June 11, 2010, available on http://www.nishithdesai.com/New_Hotline/Real/REAL%20ESTATE%20UPDATE_June%2011_2010.htm

49. www.dolr.nic.in/landtitlingbill_notice.htm

50. Article: Why giving land titles is hard? : Bibek Debroy, The Financial Express.

51. India Infrastructure Report , 2009, Land – related rights, Land Markets and Institutional Framework : Dr Piyush Tiwari.

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II. Existing legal framework

The existing legal framework relating to land titles mainly comprises of Transfer of Property Act, 1882, the Registration Act, 1908, the Land Acquisition Act, 1894, and the Indian Stamp Act, 1899. All the above laws were introduced in colonial times and were in severe need of a re-look which would lead to conclusive titling of immovable properties and the proposed Bill does exactly that. While this legislation would not lead to the repeal of the existing laws it would over-ride the provisions of those laws.

III. Proposed provisions

The Bill proposes to provide for a regime for establishment, administration and management of a system of "conclusive" property titles. Once property holders follow the due processes as laid out under the new law are completed, the title entered in the Register of Titles is to be considered as "indefeasible" which means title cannot be altered or voided and this title shall stand against the right of anyone else to claim that property. For the delivery of "indefeasible" and "conclusive" titles, the new legislation proposes the constitution of a Land Titling Authority ("**Authority**"). The authority shall prepare, maintain and update the Register of Titles, Register of Disputes, Register of Charges and Covenants and the Index of Maps for which it will operate through the setting up of four divisions namely Title Registry, Survey Settlement and Land Information System, Property Valuation, and Legal Services and Title Guarantee. The authority shall exercise powers as are vested in a civil court as also the Chief Controlling Revenue Authority and te Inspector General under the Registration Act.

Upon registration of a property with the Authority under the proposed Act, the Authority shall provide a unique property identification number. Also the Authority shall extend Title guarantee and indemnification against losses due to inaccuracies in property titles. The Authority will do all this through customer facilitation centers where citizens will have to report ownership or transfer of immovable property to register their titles. Once this law is promulgated, citizens will have a period of 5 years to get their titles registered for the first time and thereafter with every transfer. Non – registration of immovable property shall render the creation of right in such property and transfer thereof void *ab-initio* and any transaction thereof shall not be received as evidence as to transfer. Being a forward looking legislation it provides for digitization of documents and use of bio-metric authentication as well.

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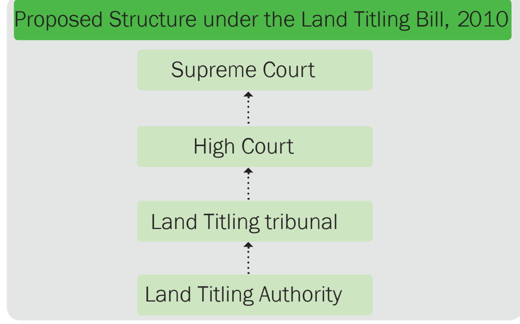

Appeals against orders passed by the Authority would lie before a Tribunal. Thereafter in turn one can appeal to the High Court and finally the Supreme Court *(see the diagram above)*

IV. Conclusion

The success of this proposed law will lie in its effective implementation. When this Bill becomes law it will have a positive impact on Infrastructure projects and Industry. The introduction of pioneering principles like strata-titles –a form of ownership of immovable property devised for multi-level apartment blocks and horizontal subdivisions with shared areas will impact housing which will become easier to promote and maybe even cheaper as clearer titles will lower speculative transactions. Even Agriculture too will benefit as land will become easily available. Transacting in real estate including mortgages and funding would be facilitated as the Bill introduces reporting mechanism both by government and private entities/ persons. With increased transperancy, frauds would decline and so will long-drawn property relate litigation.

However, on the other hand land administration is a State subject in India i.e. it is not within the purview of the Federal Government. Therefore, as of now it is proposed to be introduced for those Union Territories which do not have their own legislature and will be a suggested legislation for other states to follow. But already Delhi is adapting provisions from the Bill in its own similar proposed legislation. The key question then will be how many states will follow suit and draw from this proposed Bill and facilitate transparency and conclusiveness in land titling?

- Debargha Basu & Chittaranjan Datar

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Annexure V
Analysis of Draft REIT Regulations[52]

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:

I. 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.

52. Real Estate Update, dated December 29, 2007, available on, http://www.nishithdesai.com/Infra-update/2007/Real-Estate-Upd-Dec-30-2007.html

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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.

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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.

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Real Estate Investment Management Company ("REIMC")

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

It shall be the responsibility of the REIMC 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.

REIMC 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 REIMC shall also have certain other reporting requirements to SEBI.

II. 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.

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- 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.

III. 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

- Mansi Seth & Nishchal Joshipura

Annexure VI
NBFC Structure for Debt Funding

In light of the challenges that the FDI and the FII route are subjected to, there has been a keen interest in offshore realty funds to explore the idea of setting up their own NBFC to lend or invest to real estate.

An NBFC is defined in terms of Section 45I(c) of the RBI Act, 1934, as a company engaged in granting loans/advances or in the acquisition of shares/securities, etc. or hire purchase finance or insurance business or chit fund activities or lending in any manner provided the principal business of such a company does not constitute any non-financial activities such as (a) agricultural operations (b) industrial activity (c) trading in goods (other than securities) (d) providing services (e) purchase, construction or sale of immovable property. Every NBFC is required to be registered with the RBI, unless specifically exempted.

The Act has however remained silent on the definition of 'principal business' and has thereby conferred on the regulator, the discretion to determine what is the principal business of a company for the purposes of regulation. Accordingly, the test applied by RBI to determine what is the principal business of a company was articulated in the Press Release 99/1269 dated April 8, 1999 issued by RBI. As per the said press release, a company is treated as an NBFC if its financial assets are more than 50 per cent of its total assets (netted off by intangible assets) and income from these financial assets is more than 50 per cent of its gross income. Both these tests ("**50% Tests**") are required to be satisfied in order for the principal business of a company to be determined as being financial for the purpose of RBI regulation.

The Working Group on the Issues and Concerns in the NBFC Sector chaired by Usha Thorat ("**Working Group**")[53] has recommended that the twin criteria of assets and income for determining the principal business of a company need not be changed. However, the minimum percentage threshold of assets and income should be increased to 75 per cent. Accordingly, the financial assets of an NBFC should be 75 per cent or more (as against more than 50 per cent) of total assets and income from these financial assets should be 75 per cent or more (as against more than 50 percent) of total income.

53. The Working Group report was released by the RBI on August 29, 2009. Recommendations have not yet been accepted.

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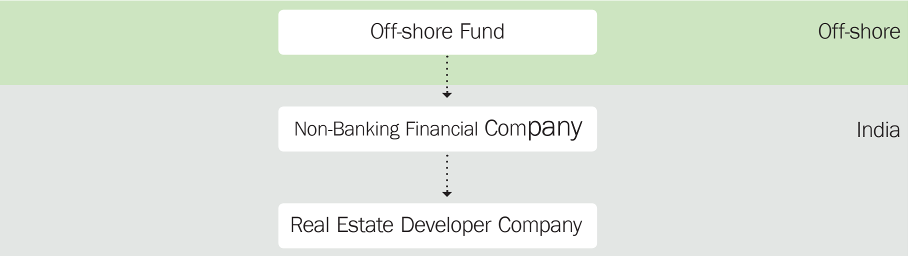
The NBFC could be structured as follows.

Structure diagram



The Offshore Fund sets up an NBFC as a loan company, which then lends to the real estate companies. The NBFC may either lend by way of loan or through structured instruments such as NCDs which have a protected downside, and pegged to the equity upside of the company by way of redemption premium or coupons.

I. Advantages of the NBFC Route

1) **Assured Returns:** The funding provided through NBFCs is in the form of domestic loans or NCDs, without being subjected to interest rate caps as in the case of CCDs.[54] These NCDs can be structured to provide the requisite distribution waterfall or assured investors' rate of return ("**IRR**") to the offshore realty fund.

2) **Regulatory Uncertainty:** The greatest apprehension for realty funds has been the fluid regulatory approach towards foreign investment. Introduction of Clause 3.3.2.1 (discussed above) has been one example. The NBFC being a domestic lending entity is relatively immune from such regulatory uncertainty.

3) **Security Creation:** Creation of security interest in favour of non-residents on shares and immoveable property is not permitted without prior regulatory approval. However, since the NBFC is a domestic entity, security interest could be created in favour of the NBFC. Enforce-

54. Exchange control regulations do not prescribe for any cap on coupon in case of CCDs, but only prescribe for a cap on payment of dividends on a CCPS, which is three hundred basis points over and above the state bank of India prime lending rate, prevailing at the time of issue of the CCPS. Nevertheless, it is market practice to restrict the coupon that can be paid on CCDs to the same extent as dividends that can be paid on CCPS.

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ability of security interests, however, remains a challenge in the Indian context. Enforcement of security interests over immovable property, in the Indian context, is usually a time consuming and court driven process. Unlike banks, NBFCs are not entitled to their security interests under the provisions of the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act.[55]

4) **Repatriation Comfort:** Even though repatriation of returns by the NBFC to its offshore shareholders will still be subject to the restrictions imposed by the FDI Policy (such as the pricing restrictions, limits on interest payments etc.), but since the NBFC will be owned by the foreign investor itself, the foreign investor is no longer dependent on the Indian developer as would have been the case if the investment was made directly into the real estate entity.

5) **Tax Benefits to the Investee Company:** As against dividend payment in case of shares, any interest paid to the NBFC will reduce the taxable income of the investee company. However, an NBFC may itself be subjected to tax to the extent of interest income so received, subject of course to deductions that the NBFC may be eligible for in respect of interest pay-outs made by the NBFC to its offshore parent.

II. Challenges involved in the NBFC Route

1) Setting up

The first challenge in opting for the NBFC route is the setting up of the NBFC. Obtaining a certificate of registration from the RBI for an NBFC is a time consuming process. This process used to take anywhere in the region of 12 – 14 months earlier, which wait period has now significantly reduced, but it may still take as much as 6 months, or in some cases, even longer.

The Working Group deliberated on whether NBFCs that fund their activities out of their owned funds should be exempt from registration with the regulator on the grounds that they do not pose any risk to any public funds. The Working Group felt that even entities that do not rely on public funds could pose systemic risks if the size of their operations are material especially in certain sensitive markets. Further, if excluded from registration requirements there could be a temptation to try to

55. SARFAESI Act facilitates enforcement of security interest without intervention of the courts.

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avoid regulatory oversight through the use of a variety of instruments that are ostensibly equity but could be quasi debt. Indeed, the Working Group is given to understand that there are a number of registered NBFCs that are apparently capitalised only with equity, but in fact the investment in their equity capital is based on funds borrowed offshore. These companies undertake investment and lending activity in India, thereby circumventing the capital controls on external borrowings. Besides, even if currently engaged in activities without any public funds in India, such large asset sized entities have the potential to take on such leverage at any point in time. NBFCs that are not leveraged or do not have any access to public funds up to a certain minimum size could however be considered for exemption from registration, but not regulation. As and when the regulator observes risks arising out of the activities of such exempted NBFCs, the exemption may be adequately modified to cover such risk generating NBFCs or may be withdrawn totally as the situation warrants. Based on these considerations, the Working Group recommended that NBFCs with asset size below Rs. 1000 crore and not accessing any public funds may be exempted from registration. Those NBFCs, with asset sizes of Rs. 1000 crore and above, need to be registered and regulated even if they have no access to public funds.

Working Group also proposed that small non deposit taking NBFCs with assets of Rs. 50 crore or less could be exempt from the requirement of RBI registration. Not being deposit taking companies and being small in size, no serious threat perception is perceived to emanate from them.

Due to the elaborate time period involved in setting up the NBFC, one of the alternatives adopted is to purchase an existing NBFC. Currently, there is a requirement of giving 30 thirty days' written notice prior to effecting a change of 'control' (the term 'control' has the same meaning as defined in the SEBI Takeover Code). The public notice needs to be published in one English and one vernacular language newspaper, copies of which are required to be submitted to the RBI. Unless the RBI restricts the transfer of shares or the change of control, the change of control becomes effective from the expiry of thirty days from the date of publication of the public notice.

The Working Group has recommended that all registered NBFCs, both deposit taking and non-deposit taking, should take prior approval from the Reserve Bank, where there is a change in control or transfer of shareholding directly or indirectly - in excess of 25 percent of the paid up capital of the company. 'Control' may be defined as "right to appoint majority of the directors or to control the management or policy decisions exercisable by a person individually or persons acting in concert, directly or indirectly, by virtue of shareholding or shareholder agreements or by any other name. Prior

approval of RBI should also be required for any mergers of NBFCs under Section 391-394 of the Companies Act, 1956 or acquisitions by or of an NBFC, which are governed by the SEBI Regulations for Substantial Acquisitions of Shares and Takeover.

In addition to the requirement to give public notice, until November 4, 2011 any transfer of shares of a financial services company from a resident to a non-resident required prior approval of the Foreign Exchange Department of the Reserve Bank of India ("**FED**"), which took anywhere in the region of 2 – 4 months. However, as per a recent RBI circular dated November 4, 2011, the requirement to procure such an approval has been done away if:

(a) *"No Objection Certificates ("**NOCs**") are obtained from the respective financial sector regulators/ regulators of the investee company as well as transferor and transferee entities and such NOCs are filed along with the form FC-TRS with the AD bank; and*

(b) *The FDI policy and FEMA regulations in terms of sectoral caps, conditionalities (such as minimum capitalization, etc.), reporting requirements, documentation etc., are complied with."*

However, there are a few ambiguities that need to be creased out. Since the Circular makes the reference to 'respective financial sector regulators', it appears that such NOCs may be required to be obtained from the relevant regulator as against the FED. For instance, for transfer of shares of a non-banking financial services company, approval of the department of non-banking financial supervision may be required as against the FED.

Requirement of procuring an NOC from the financial services regulators of all the three – the investee company, the transferor and the transferee entities does seem elaborate and leaves a few ambiguities. For instance, it is not clear whether FED approval will be required or an NOC from the regulator of the investee company will suffice in cases where the transferor or transferee are unregulated entities (say, transfer between a resident and a non-resident individual shareholder). Also, since the Circular specifically provides for NOC from the "financial services regulator / regulators of *the investee company as well as transferor and transferee entities",* an NOC from the regulator of the transferor and transferee entities will be required even if such regulator is not a financial services regulator.

Another alternative of establishing foreign ownership in an NBFC could be to let an Indian resident / partner purchase the NBFC and diluting the resident shareholder by issue of shares (regulatory

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approval is not required for issue of shares to a non-resident) to the non-resident.

2) Capitalization

The NBFC would be subject to minimum capitalization requirement which is pegged to the extent of foreign shareholding in the NBFC as set out in the FDI Policy.

Percentage of Holding in the NBFC	Minimum Capitalisation
Up to 51% FDI	USD 0.5 million, with entire amount to be brought upfront.
More than 51% FDI	USD 5 million with entire amount to be brought upfront.
More than 75% FDI	USD 50 million, with USD 7.5 million to be brought upfront and the balance in 24 months.

Considering the need for capitalization, it is not uncommon to see non – residents holding less than 75% stake in the NBFC even though a significant portion of the contribution comes from non-residents. Premium on securities is considered for calculating the minimum capitalization.

In addition to the above, every NBFC is required to have net owned funds[56] of INR 20 million (INR 2.5 million provided application for NBFC registration is filed on or before April 20, 1999)[57].

3) The Instrument

Before we discuss the choice of an instrument for the NBFC, let's discuss the instruments that are usually opted for investment under the FDI route.

The only available options under the FDI route are equity shares, compulsorily convertible preference shares ("**CCPS**") and CCDs. Typically, and naturally depending from case to case, a combination of

56. "Owned Fund" means Equity Capital + CCPS + Free Reserves +Share Premium + Capital Reserves –(Accumulated losses + BV of intangible assets + Deferred Revenue Expenditure).

57. Although the requirement of net owned funds presently stands at INR 20 million, companies that were already in existence before April 21, 1999 are allowed to maintain net owned funds of INR 2.5 million and above. With effect from April 1999, the RBI has not been registering any new NBFC with net owned funds below INR 20 million.

equity and CCDs is usually preferred to capitalize the investee company. Equity usually forms a nominal part of the investment, and a large portion of the investment is made by subscription to CCDs. CCDs essentially offer three important benefits. Firstly, any coupon paid on CCDs is a deductible expense for the purpose of income tax. Secondly, though there is a 40% withholding tax that the non-resident recipient of the coupon may be subject to, the rate of withholding can be brought to as low as 10%[58] if the CCDs are subscribed to by an entity that is resident of a favorable treaty jurisdiction such as Cyprus. Thirdly, coupon can be paid by the company, irrespective of whether there are profits or not in the company. Lastly, being a loan stock (until it is converted), CCDs have a liquidation preference over shares. And just for clarity, investment in CCDs is counted towards the minimum capitalization.

CCDs clearly standout against CCPS on at least the following counts. Firstly, while any dividend paid on CCPS is subject to the same dividend entitlement restriction (300 basis points over and above the prevailing State Bank of India Prime Lending Rate at the time of the issue), dividends can only be declared out of profits. Hence, no tax deduction in respect of dividends on CCPS is available. To that extent, the company must pay 30%[59] corporate tax before it can even declare dividends. Secondly, any dividends can be paid by the company only after the company has paid 15%[60] dividend distribution tax. In addition, unlike conversion of CCDs into equity, which is not regarded as a 'transfer' under the provisions of the Income-tax Act, 1961, conversion of CCPS into equity may be considered as a taxable event and long term or short term capital gains may be applicable. Lastly, CCPS will follow CCDs in terms of liquidation preference.

However, unlike other companies, a combination of nominal equity and a large number of CCDs may not be possible in case of NBFCs. Though all non-deposit accepting NBFCs are subjected to NBFC (Non-Deposit Accepting or Holding) Companies Prudential norms (Reserve Bank) Directions (the "**Prudential Norms**"), once such NBFC has 'total assets' in excess of INR 1 billion (USD 20 million approximately)[61], the NBFC is referred to as a 'systemically important NBFC'. Unlike other NBFCs, a systemically important NBFC is required to comply with Regulation 15 (Auditor's Certificate),

58. Tax credit of 10% is available in Cyprus against the tax paid in India, which can be set off against domestic tax in Cyprus which is also 10%.

59. Exclusive of surcharge and cess.

60. Exclusive of surcharge and cess.

61. Note that an NBFC becomes a systemically important NBFC from the moment its total assets exceed INR 100 crores. The threshold of INR 1 billion need not be reckoned from the date of last audited balance sheet as mentioned in the Prudential Norms.

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Regulation 16 (Capital Adequacy Ratio) and Regulation 18 (Concentration of Credit / Investment) of the Prudential Norms. The choice of instrument is largely dependent on the capital adequacy ratio required to be maintained by the NBFC for the following reason.

Regulation 16 of the Prudential Norms restricts a systemically important NBFC from having a Tier II Capital larger than its Tier I Capital.

"Tier I Capital" = *Owned funds*[62]*+ Perpetual debt instruments (upto15% of Tier I Capital of previous accounting year) -Investment in shares of NBFC and share/ debenture/bond/ loans / deposits with subsidiary and Group company (in excess of 10% of Owned Fund)*

"Tier II Capital" = Non-convertible Preference shares / OCPS + Subordinated debt + General Provision and loss reserves (subject to conditions) + Perpetual debt instruments (which is in excess of what qualifies for Tier I above) + Hybrid debt capital instruments + revaluation reserves at discounted rate of fifty five percent;

Thus, CCDs being hybrid debt instruments which fall in Tier II cannot be more than Tier I Capital. This disability in terms of capitalization is very crucial for the NBFC and its shareholder as it not only impedes the ability of the NBFC to pay out interests to the foreign parent in case of inadequate profits, but is also tax inefficient. There is currently an ambiguity on whether NCDs are to be included in Tier II Capital no as they do not qualify in any of the heads as listed above for Tier II Capital.

4) No ability to make investments

Having discussed the funding of the NBFC itself, let's discuss how the NBFC could fund the investee companies. Under the FDI Policy, an NBFC with foreign investment can only engage in certain permitted activities[63] under the automatic route, and engaging in any financial services activity other than such activities will require prior approval of the Foreign Investment Promotion Board ("**FIPB**"), an instrumentality of the Ministry of Finance of the Government of India.

62. "Owned Fund" means Equity Capital + CCPS + Free Reserves +Share Premium + Capital Reserves –(Accumulated losses + BV of intangible assets + Deferred Revenue Expenditure).

63. The activities permitted under the automatic route are: (i) Merchant Banking, (ii) Under Writing, (iii) Portfolio Management Services, (iv)Investment Advisory Services, (v) Financial Consultancy, (vi) Stock Broking, (vii) Asset Management, (viii) Venture Capital, (ix) Custodian Services, (x) Factoring, (xi) Credit Rating Agencies, (xii) Leasing & Finance, (xiii) Housing Finance, (xiv) Forex Broking, (xv) Credit Card Business, (xvi) Money Changing Business, (xvii) Micro Credit, (xviii) Rural Credit and (xix) Micro Finance Institutions.

While lending qualifies as one of the permitted categories ('leasing and finance'), 'investment' is not covered in the list above. Therefore, any FDI in an NBFC that engages in 'investments' will require prior approval of the FIPB. Such an approval though discretionary is usually granted within 3 months' time on a case to case basis. Therefore, an NBFC with FDI can only engage in lending but not in making investments.[64]

We are given to understand that in a few cases where the redemption premium of the NCDs was linked to the equity upside, RBI qualified such instruments to be in the nature of investments rather than just loan instruments. Once the nature of the instrument changed, then nature of the NBFC automatically changed from lending to investment, and FIPB approval was immediately required in respect of foreign investment in an NBFC engaged in investment activity.

CORE INVESTMENT COMPANIES

A core investment company ("**CIC**") is a company which satisfies the following conditions as on the date of the last audited balance sheet (i) it holds not less than 90% of its net assets in the form of investment in equity shares, preference shares, bonds, debentures, debt or loans in group companies; (ii) its investments in the equity shares (including instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue) in group companies constitutes not less than 60% of its net assets; (iii) it does not trade in its investments in shares, bonds, debentures, debt or loans in group companies except through block sale for the purpose of dilution or disinvestment; and (iv) it does not carry on any other financial activity referred to in Section 45 I (c) and 45 I (f) of the Reserve Bank of India Act, 1934 except for granting of loans to group companies, issuing of guarantees on behalf of group companies and investments in bank deposits, money market instruments etc.

A CIC is not required to register with the RBI, unless the CIC accepts 'public funds' AND has total financial assets in excess of INR 1 billion.

64. The FDI Policy however under paragraph 6.2.24.2 (1) provides that: *"(iv) 100% foreign owned NBFCs with a minimum capitalisation of USD 50 million can set up step down subsidiaries for specific NBFC activities, without any restriction on the number of operating subsidiaries and without bringing in additional capital.*
(v) Joint Venture operating NBFCs that have 75% or less than 75% foreign investment can also set up subsidiaries for undertaking other NBFC activities, subject to the subsidiaries also complying with the applicable minimum capitalisation norms."

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'Public funds' for the purpose of CIC include funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance but excludes funds raised by issue of instruments compulsorily convertible into equity shares within a period not exceeding 10 years from the date of issue.

5) Credit concentration norms

A systemically important NBFC is not permitted to lend or invest in any single company exceeding 15% of its owned fund[65], or single group[66] of companies exceeding 25% of its owned fund. If however the systemically important NBFC is investing and lending, then these thresholds stand revised to 25% and 40% respectively.

Exemption from such concentration norms may be sought and has been given in the past where the NBFC qualified the following two conditions – firstly, the NBFC did not access public funds[67], and secondly, the NBFC did not engage in the business of giving guarantees. Interestingly, 'public funds' include debentures, and to that extent, if the NBFC has issued any kind of debentures (including CCDs), then such relaxation may not be available to it. In the absence of such exemption, it may be challenging for loan or investment NBFCs to use the leverage available to them for the purpose of making loans or investments.

6) Enforcing Security Interests

NBFCs, unlike banks, are not entitled to protection under the SARFAESI Act. This is a major handicap for NBFCs as they have to undergo through the elaborate court process to enforce their security interests, unlike banks which can claim their security interests under the provisions of SARFAESI Act without the intervention of the courts. Representations were made by industry associations seeking inclusion of NBFCs within the ambit of SARFAESI Act, especially in the current times when NBFCs are fairly regulated.

We understand that the then RBI Governor D. Subbarao responded to the exclusion of NBFCs on the

65. Supra Note 59.

66. The term 'group' has not been defined in the Prudential Norms.

67. "Public funds" includes funds raised either directly or indirectly through public deposits, Commercial Papers, debentures, inter-corporate deposits and bank finance.

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ground that their inclusion under the SARFAESI Act would distort the environment for which Securitisation Companies (SCs)/ Reconstruction Companies (RCs) were set up by allowing more players to seek enforcement of security rather than attempting reconstruction of assets.

Subbarao mentioned that SARFAESI Act was enacted to enable banks and financial institutions to realise long-term assets, manage problem of liquidity, asset liability mis-matches and improve recovery by exercising powers to take possession of securities, sell them and reduce nonperforming assets by adopting measures for recovery or reconstruction, through the specialised SCs/RCs, which would be registered with the RBI and purchase the NPAs of the banks and FIs. According to him, two methodologies were envisaged - first, the strategy for resolution of the assets by reconstructing the NPAs and converting them into performing assets, and second, to enforce the security by selling the assets and recovering the loan amounts

Subbarao further mentioned that SARFAESI Act is not merely a facilitator of security enforcement without the intervention of Court. It is a comprehensive approach for restructuring the assets and make it work and only when it does not work, the recovery mode was envisaged.

He was apprehensive that since NBFCs have followed the leasing and hire purchase models generally for extending credit and they enjoy the right of repossession, the only benefit SARFAESI Act would extend to the NBFCs will be for enforcement of security interest without the intervention of the court, which may distort the very purpose for which SCs/RCs were created, namely, reconstruction and the inclusion would simply add a tool for forceful recovery through the Act.

Working Group recognized the anomaly that unlike banks and PFIs, most NBFCs (except those registered as PFIs under Section 4A of the Companies Act) do not enjoy the benefits deriving from the SARFAESI Act even though their clients and/or borrowers may be the same. Working Group has recommended that NBFCs may be given the benefit under SARFAESI Act, 2002.

7) Exit

Exit for the foreign investor in an NBFC is the most crucial aspect of any structuring and needs to be planned upfront. The exits could either be by way of liquidation of the NBFC, or buy-back of the shares of the foreign investor by the NBFC, (although it is tax inefficient because of changes introduced in budget 2012-13, as discussed in the main body of this paper) or a scheme of capital reduction

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(where the foreign investor is selectively bought-back), or the sale of its shares in the NBFC to another resident or non-resident, or lastly, by way of listing of the NBFC.[68]

Unlike most countries, liquidation in the Indian context is a time consuming and elaborate process in India, sometimes taking in excess of 10 years.

Buyback of securities is another alternative, however, CCDs cannot be bought back. CCDs must be converted into the underlying equity shares to be bought back. Buy-back of securities is subjected to certain conditionalities as stipulated under Section 77- A of the Companies Act, 1956. A buyback of equity shares can happen only out of accumulated profits, or proceeds of an earlier issue or out of share premium[69]. In addition to the limited sources that can be used for buy-back, there are certain other restrictions as well that restrict the ability to draw out the capital from the company. For instance, only up to a maximum of 25%[70] of the total paid up company can be bought in one financial year, the debt equity ratio post buy-back should not be more than 2:1 etc. Buy-back being a transfer of securities from a non-resident to a resident cannot be effected at a price higher than the price of the shares as determined by the discounted cash flows method, as explained in ***Annexure I.***

As an alternative to buy-back, the investor could approach the courts for reduction of capital under the provisions of section 100 of the Companies Act, 1956; however, the applications for such reduction of capital need to be adequately justified to the court. There have been certain cases such as Century Enka where the court approved a scheme for selective buy-back of 30% of its shareholding from its non-resident shareholders.

Sale of shares of an NBFC or listing of the NBFC could be another way of allowing an exit to the foreign investor; however, sale of shares cannot be effected at a price higher than the price of the shares determined by the discounted cash flow method. Listing of NBFCs will be subject to the fulfillment of the listing criterion and hinges on the market conditions at that point in time.

68. The forms of exit discussed here are in addition to the ability of the foreign investor to draw out interest / dividends from the NBFC up to 300 basis points over and above the State Bank of India prime lending rate.

69. As a structuring consideration, the CCDs are converted into a nominal number of equity shares at a very heavy premium so that the share premium can then be used for buy-back of the shares.

70. The Companies Bill, 2012, as passed by Lok Sabha on December 18, 2012, does not provide for including securities premium in afore-mentioned limit of 25%.

Annexure VII
Challenges in Invocation of Pledge of Shares[71]

Mumbai: Astay obtained by Unitech Ltd against the sale of shares it had pledged has made real estate-focused private equity (PE) funds uneasy, concerned that they could face similar opposition if they need to exercise similar rights.

Unitech said the shares were no longer under pledge.

"Promoters of Unitech obtained the injunction due to the unreasonable notice period given to them," the company said in an email release. "Outstanding loan amount was repaid in full by the promoters within a few days of obtaining the injunction and ahead of the schedule. The pledged shares got released nearly three months ago."

The pledging of shares is a mechanism through which an investor or a lender can ensure a company or a borrower delivers a promised return or repays a loan within the stipulated period. When the company defaults on the pledge, the shares are sold. PE funds that focus on real estate have got such pledged shares from their portfolio companies.

"The Unitech case has raised concerns among PE investors about the enforceability of the pledge," said Ruchir Sinha, co-head, real estate investments practice, at law firm Nishith Desai Associates. "Many funds are looking to enforce the pledge today, but are concerned if the company can take them to court and obtain a stay order."

Realty valuations have been declining as some companies have been facing allegations of wrongdoing relating to bribes given for loans and the allocation of telecom spectrum, besides falling home sales and rising interest rates.

On 30 January, Unitech's promoters approached the Delhi high court and secured an injunction

71. Article in Live Mint, Concerns among PE firms over enforcing realty share pledges, Shraddha Nair & Khushboo Narayan, May 2, 2011, available on, http://www.livemint.com/Companies/I5mzgtPyZRxqtimiq4CsxH/Concerns-among-PE-firms-over-enforcing-realty-share-pledges.html?facet=print

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against a move by debenture trustee Axis Trustee Services Ltd to sell pledged shares. The promoters of Unitech had raised Rs 250 crore from high networth individuals (HNIs) in 2010 through the issue of non-convertible debentures and had pledged their shares in the firm as security to raise these funds.

However, on 28 January, Unitech's stock price dropped to Rs 51 per share, marking a 38% decline since November 2009 and triggering the default. The same day Axis Trustee Services informed the promoters that it would sell the pledged shares on the next working day, as per their agreement. Unitech moved the high court, which said that if the stay was not granted, the company would suffer "irreparable loss".

Invoking a pledge can be challenging even in a publicly traded company, since the law requires that a fund must immediately sell the shares upon invocation; funds are often faced with the dilemma of whether to invoke the pledge or not, said Sinha.

"If they invoke the pledge, then they must ensure that the shares are sold, which may, apart from hammering the stock, earn a bad name for the fund," he said. "If they don't, and the share value falls, an argument can be made that they suffered the loss due to their failure to exercise their rights on time."

The situation is even worse in a private company as there is generally no market for such shares, Sinha said.

"Any lender who has pledged shares as collateral runs the risk of ending up in court," said a fund manager at one of the large domestic real estate funds, who declined to be identified as it was a legal issue.

Ideally, in a case where the lender decides to invoke the pledge even before the company defaults because of weak market conditions, the company should immediately provide for adequate additional security to avoid legal proceedings, he said.

There are three major forms of security that are available to lenders—mortgages, guarantees and share pledging. Realty funds are increasingly making investments through structured debt instruments and are looking at stringent security mechanisms and stock pledges are one of the most liquid form of security.

"This is a strong tool being employed by institutional investors today who are worried about their returns from their investment," said Amit Goenka, national director of capital transactions at **Knight Frank (India) Pvt. Ltd.**

According to him, what is prompting investors to enforce pledging of shares is that the risk associated with real estate has risen and investors don't believe they can get their returns on time.

There have been 10 investments worth $514 million (Rs 2,282.16 crore today) in real estate this year, according to VCCEdge, a financial research platform. Last year, there were 34 investments worth $1.16 million compared with 28 investments worth $870 million in the year earlier.

Some of the big investments in the sector include $450 million investment in DLF Assets Ltd by Symphony Capital Partners Ltd, $296 million invested in Phoenix Mills SPV by MPC Synergy Real Estate AG and $200 million invested in Indiabulls Real Estate Ltd by **TPG Capital.**

"Unfortunately, it is true that real estate funds want to invoke pledges," said the general counsel of a local PE fund that has raised foreign money. He declined to be identified considering the sensitivity of the issue.

"If you see all the real estate companies, the extent to which shares have been pledged is increasing day by day," he said. "In some of those companies, it has reached the limit and they have nothing else to leverage. So, there is no other choice for those lenders, but to invoke the pledge."

However, Sinha of Nishith Desai cautioned that enforcing a pledge will affect the reputation of the company as borrowers will become apprehensive of taking PE money.

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