

# Deal Destination

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## INVESTMENT INTO COMMERCIAL REAL ESTATE IN INDIA: AN INVESTOR PERSPECTIVE

Commercial real estate space in India has been attracting increased attention from investors globally. Regulatory restrictions had hitherto restricted foreign investment into the space. However, the liberalizing regulatory framework has resulted in increased investment into the commercial space. As per recent reports, foreign investment in real estate in India (2016) was approximately US\$ 5.6bn, out of which approximately 40% of the investment was in the commercial space. This denotes a major shift in the asset allocation for funds towards commercial real estate, which stood at approximately 21% for 2015.

The increasing attention garnered by commercial assets have also been a result of a slowdown in the residential property space. Since the enactment of the Real Estate (Regulation and Development) Act, 2016 ("RERA") in 2016, the number of projects being launched substantially. As per recent reports, launching of residential projects in Q1FY2017 have fallen by 16 -24% from Q1FY2016, due to the enactment of RERA.

From an economics perspective as well, commercial assets have offered better returns to investors. Grade B commercial assets offer 7-9% returns to investors, and this goes up to 9-11% in Grade A commercial assets. Combined with modest capital appreciation of 4-6%, commercial assets offer a reasonable rate of return, with relatively lower risk than in case of residential assets.

With growing interest in commercial assets, it would be pertinent to delve upon some of the aspects which investors should delve into prior to investing in, or some of the rights investors should insist on when investing in a commercial property.

### 1. Asset

The importance of evaluating the asset / project in which the investment is to be made cannot be exaggerated. While in a residential property, the evaluating criteria is the demand for the asset upfront, which would result in sale of the units in the project, for a commercial project, the determinants are varied and depends on the asset class.

- Office space: Location, access to public transport and nearby accommodation facilities are important determinants for office spaces.
- Retail shops: While prime locations tend to have relatively smaller shops, the quality of tenants are likely to be higher. Other locations may offer relatively lower quality of tenants, but may have longer lease durations.
- Malls: The location, surrounding potential for development (if under-developed), the possibility of new malls opening up in the vicinity are the most crucial aspects for malls.
- Warehouses: Proximity to ports, access to main city, kind of usage (whether for e-commerce players or large shipments) are important determinants for warehouses.
- Hotels: Similar to malls, the determinants for investments into hotels would be the location, development potential around, competition around the hotel location.

### 2. Partner

Unlike residential real estate, where the development credentials are most significant, in case of commercial real estate, along with the development, the asset management credentials play an equally important role. The major driver for commercial real estate is the stable cash flows, emanating from rental deposits. In such cases, assets such as hotels, malls, office space, warehouses require proper operation and maintenance. This becomes more crucial where tenants of a property vacate the premises, requiring the owner to repair, renovate or refurbish properties to suit the needs of the incoming tenants. This requires expertise in the operation and management. If the developer intends to outsource these functions under a developmental agreement, the investor should ensure that the developmental agreement does not impinge on the rights of the investor vis-a-vis the project and the developer.

### 3. Revenue stream

While commercial assets are largely considered to provide stable cash flows, it may not be the same for all assets. Ensuring appropriate allocation of portfolio to stable revenue generating assets may be a prudent approach to hedge against regular cash flow issues for investors.

For rental assets with a large number of tenants, while the vacancy rate may be relatively higher, the revenues

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are considered to be stable (using appropriate vacancy assumptions). However, for assets which are leased out to single / few tenants (such as large office buildings being leased by IT companies, individual shops, warehouses rented by large conglomerates), the risk of revenues being impacted by vacancy are higher. While the lease tenure for these assets are higher, ensuring appropriate safeguards (generally in the lease agreements executed) in case any tenant vacates the premises prior to the expiry of the lease tenure would be crucial to cover for the loss during the vacant period.

However, for assets such as hotels, revenues are not stable and expenses for operation and maintenance are substantial. Investors expect to earn returns over appreciation of value and moderate revenues.

To protect themselves against revenue risks and ensuring that investors are not required to be involved intricately in the day to day operations of the asset, investors could seek to ensure that the investment agreements provide for the following:

- **Minimum lease price:** One of the most important safeguards is the concept of minimum lease price. No unit in the project can be leased out at a price below the minimum lease price, which may be reviewed periodically. This ensures that the developer/ manager has the operational flexibility as long as the leasing of units is above the minimum lease price. The minimum lease price is determined based on a number of factors, including the location of the property, the lease price of similar properties in the nearby areas, the demand – supply situation.
- **Essential terms of lease:** Investors may prefer to have drafts of lease deeds approved by them, with any deviation requiring their consent. However, practically, such rights are hardly exercised by investors. More prudent, and common, is determining the essential terms of the lease, and giving the developer a base to work out of, similar to the minimum lease price. These base terms generally include the tenure of the lease and the lock-in for the same and payment of maintenance charges, compensation in case of vacancy prior to lock-in tenure. Any deviation from the agreed parameters require the consent of the investor.
- **Bankruptcy of tenants:** Generally seen in assets with few tenants, some of the rights of the investor kick in upon the initiation of bankruptcy proceedings of a major tenant (say occupying 10% plus of the leasable area). In such cases, investors may call a default or may require the developer to evict the tenant immediately, and ensure consequences of the same follow.
- **Control over cash flows:** Compared to residential real estate projects, generally only maintenance charges and direct taxes paid by lessees periodically which may constitute 'pass through charges'. If the investor does not intend to control these pass through charges, the rental receipts should not be allocated for usual regular maintenance. Further, rental deposits or security deposits paid by tenants should also be kept separate and not used for any other purpose.

Further, rental receipts should be defined as broadly as possible, and should include receipts from insurance policies and lease termination charges. Further, lessees should be defined broadly, to also include agreement to lease.

- **Cost overruns:** While it is common for investors to seek protection against cost overruns, the concept needs to be looked at in a different light in a commercial real estate perspective. The costs for a commercial project (post completion) is generally for maintenance and operation. In such cases, a cost overrun may be necessitated due to some renovation work, refurbishment or structural changes required in the project. Considering such cases (unless the cost is incurred due to faulty construction earlier) as cost overrun is not reasonable, and is expected to face substantial resistance from developers. Further, as a result of such peculiarities in the commercial real estate space, restrictions on capital expenditure is also common.
- **Right to control all liquidity options:** As is common in any residential real estate transaction as well, the investor should have control over all means to liquidate the asset, be it through a strata sale of the project, discounting of the lease rentals, or a sale of the project.

#### 4. Information rights

Considering that once a commercial asset is up and running, the chances of the valuation of the property fluctuating are minimal. Accordingly, while right to receive regular/ periodic valuation report of the asset are not uncommon, practically, the valuation exercise is of little importance and resisted by developers.

Investors' information rights, on the contrary, should require information of the lessee, the payments made by lessees, the tax, pass through charges and other maintenance costs (if any) paid by the tenants, the vacancy details in the property, details of insolvency proceedings initiated against tenants, rent in arrears and details of expiring rentals.

#### 5. Exit provisions

In residential real estate investments, while rights such as step-in-rights, replacement of developer, drag along rights are common, the enforceability of the same has been challenging practically due to lack of buyers for the property. Put options on resident developers have their own challenges (valuation if the investor is non-resident, availability of funds with the developer, etc.). While these issues spill into the commercial space as well, commercial space provide better foreseeability of exit compared to the residential space.

- **Marketability of the asset:** Considering that the assets in the commercial space are up and running, and generate revenue, the risk for the purchaser is relatively lower, as in the case of a residential asset. Further, since the sale is further to the investor's exit, the asset is likely to be available at some discount to the potential purchaser.
- **Monetisation without sale:** In some cases, the developer of the asset may be able to monetise the asset without being replaced. The most common mechanism of doing this is through loan rental discounting ("LRD"). In an LRD, the developer takes a loan from a financial institution, with the rentals received from the property are used to service the loan over a period of time. The loan proceeds are used to retire the investor from the project. This ensures that the developer continues to remain in control of the asset, and the investor is provided an exit.

Parsvnath Developers offered an exit to its investors, Red Fort Capital and Proprium Capital by raising funds through LRD in 2016.

- REITs: The Securities Exchange Board of India (“SEBI”) has introduced Real Estate Investment Trusts (“REIT”). REITs offer another option for investors to liquidate the assets. Typically, if the asset is being transferred to a REIT, the REIT pays the developer (transferor) and the same may be used to retire the investor.

## 6. Regulatory concerns

Commercial considerations aside, two regulatory issues need to be considered when making any investment.

- RERA: RERA was enacted in 2016 with a view to bring about transparency and discipline in the real estate sector in India. RERA has created a number of challenges for investors in real estate projects (including challenges in the enforcement of security interest and extraction of cash flows from projects).

However, RERA does not apply to projects where units are meant for leasing only, and not for any sale. Accordingly, investors should ensure that, if units in the project are meant for sale, appropriate safeguards are in place for investors.<sup>1</sup>

- FDI restrictions: Under the extant foreign direct investment (“FDI”) norms, investment in relation to completed assets is permitted in companies involved in the operation and management of completed assets. Accordingly, foreign direct investment into companies which developed the project, but are not operating and managing the project would not be permitted under the FDI norms.

Commercial real estate is an industry where the modus operandi is to have a company undertaking the operation and management of a number of projects, each of which are housed in special purpose vehicles (“SPV”). Considering that the assets are developed in the SPVs, it is common for the holding company to enter into an operation and maintenance agreement with each SPV for the operation and maintenance of the asset. However, if the investment is sought to be made in the SPV, from an FDI perspective, this may pose challenges, since the SPV is not engaged in the operation and maintenance of the project. Hence, foreign investors should insist on ensuring that the operation and maintenance of the project occurs at the SPV level.

An increasing number of global players have shown interest in core assets in India, with players like Blackstone, Brookfield having invested substantial amounts into the space, and players like Ascendas- Singbridge entering into platforms for development of commercial assets. Better and stable returns, combined with a wait-and-watch approach being adopted by investors to see how RERA plays out (especially in the residential space), commercial assets seem to be fast becoming the preferred investment choice for inbound investors.

– Abhinav Harlalka & Ruchir Sinha

You can direct your queries or comments to the authors

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<sup>1</sup> For a detailed note on the RERA, please refer to Chapter 4 (page 20) of our paper ‘*Private Equity and Debt in Real Estate*’ available [here](#).

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