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REITs: Will they be attractive enough?

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Real estate investment trusts (REITs) still haven't taken off in the market, and there is a degree of morbid scepticism around their success. Photo: Mint

Whilst the markets have given a warm reception to infrastructure investment trusts (InvITs) and a spate of InvITs are in the pipeline, the fate of real estate investment trusts (REITs) remains to be seen. REITs still haven't taken off and there is a degree of morbid scepticism around the success of a REIT. The reasons could be as follows. First, from an investor perspective, the investor base in a REIT is likely to be offshore insurance companies, pension funds, sovereigns etc., which would want to hold the asset for long term and earn stable income. For such investors, the prospect of capital growth may be a consideration, but not a driver. The average yield in prime commercial real estate in India can range 7-9.5% on an optimal tenancy basis with an annual escalation or capital growth of about 5% year-on-year. Together with capital growth, the annual return expectation can be in the region of 12-14% on a gross basis in rupee terms.

In dollar terms, considering the hedging cost (roughly 6%), the number comes down to about 1-3% for yield and 6-8% on an overall return basis. These numbers don't look so attractive to global capital when compared with other developed markets, which offers comparable returns in dollar terms, but without the regulatory risk, tax risk, litigation risk and business risk that India poses.

Second, a developer is still grappling with the difference between a REIT and lease rental discounting (LRD). Since LRD is typically available in the range of 9-11% for reputed developers, many developers are not able to appreciate the merit of going for a REIT and subject themselves to public and regulatory scrutiny. Indeed, a REIT offers the opportunity of full monetization, liquidity and brand recall, but that may in itself not be a driver. A developer may be willing to defer monetization until the expiry of the LRD, or may be content with regular LRD top-ups.

Third, even though capital gains, minimum alternate tax and dividend distribution taxes have been exempted, the tax issues are not entirely sorted out for a REIT. Since capital gains tax exemption is only applicable if the shares of a company holding the real estate asset SPV are transferred to a REIT, interposition of an SPV between the asset and a REIT is inevitable. Such SPV is subject to corporate income tax of 30% on the rentals received, which could be reduced to the extent of interest expense in the SPV. Hence, it becomes imperative for the REIT to invest into the SPV substantially by way of debt and purchase equity at nominal value, which could work in the current construct since most such assets are anyways about 60% leveraged. Whilst there is no withholding on the interest income received by the REIT, when the REIT distributes such interest income to its unit holders, the non-resident is subjected to a mere 5% tax (creditable in home jurisdiction), whereas an Indian resident is subjected to tax at the maximum marginal rate, usually 30%. This is another issue which could dissuade domestic investors, including the developer/sponsor since post transfer to the REIT they will have to bear heavy income tax on the income received from the REIT units.

Fifth, there are certain regulatory hassles that may need to be creased out. For instance, REITs unlike InvITs cannot raise funds on a private placement basis, and must make a public offering. The Securities and Exchange Board of India (Sebi) regulations for REITs require the sponsor to have real estate experience. Typically, such eligibility criterion is only limited to the investment manager, and never to the sponsor who should only be seen as the anchor investor. As a result, several entities such as banks, airlines and other large organizations that have grade A fully tenanted commercial real estate cannot float their REIT and adopt the typical sale and lease back structures. Whilst such companies can club with someone with real estate experience to form a "sponsor group", there may be some degree of challenge and financial contribution required since each sponsor is required to hold 5% of the REIT units.

Having said that, with all the challenges set out above, we still hope that REITs are well received on the back of shrinking credit rates, unflinching faith in the growth of Indian real estate and tax free exits on the bourses after a holding period of two years. With 90% income to be mandatorily up streamed and government allowing banks, insurance companies and pension funds allowed to invest in REITs, it remains to be seen if REITs are able to kick start monetization of stabilized assets on the back of right mix of security, liquidity and tax optimization.

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