

News Articles

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NAVIGATING THE REGULATORY LANDSCAPE: SMALL AND MEDIUM REITS' PATH TO COMPLIANCE AND GROWTH

- On March 08, 2024, SEBI notified amendments to the SEBI (Real Estate Investment Trusts) Regulations, 2014 vide the SEBI (Real Estate Investment Trusts) (Amendment) Regulations, 2024.
- In a significant change, SEBI has permitted the establishment of SM REITs, having an asset value of at least INR 25 crores (Indian Rupees twenty-five crores), compared to the minimum asset value of INR 500 crores (Indian Rupees five hundred crores) required for existing REITs.
- The amendment is expected to initiate a growth pattern to encourage investors to invest in REITs, with a decreased threshold and increased viability of options.

OVERVIEW

Over the past 2-3 years, fractional ownership has become increasingly popular in India. Fractional ownership is a method of property ownership where multiple unrelated parties can share in, and mitigate the risks of, ownership of a high-value asset. Investors who were unable to buy the whole property due to cash limitations could invest in real estate properties via fractional ownership. However, without proper regulations and governance, there was always a question whether such fractional ownership of investments was safe.

The Securities and Exchange Board of India (“SEBI”) issued a consultation paper¹ on May 12, 2023, titled ‘Regulatory Framework For Micro, Small & Medium REITs (MSM REITs)’ laying down a proposed regulatory framework for Small and Medium Real Estate Investment Trusts (“SM REITs”) which would make real estate investment more accessible and facilitate fractional ownership platforms (“FOPs”) to be governed under the ambit of SEBI (Real Estate Investment Trusts) Regulations, 2014 (“REIT Regulations”), (“Consultation Paper”). Our detailed analysis of the Consultation Paper can be accessed [here](#).

In a board meeting conducted on November 25, 2023², SEBI approved amendments to the REIT Regulations paving way for a regulatory framework for facilitation of Small and Medium REITs (“SM REITs”). The amendments were notified *vide* the SEBI (Real Estate Investment Trusts) (Amendment) Regulations, 2024 on March 08, 2024³ (“Amended Regulations”).

AMENDMENTS

■ Definition and conditions on asset value of the SM REIT

The acceptance of the introduction of a new asset class has led to a change in the definition of Real Estate Investment Trust (“REIT”) in the REIT Regulations.

REIT has been defined to means a person that pools INR 50 crores or more for the purpose of issuing units to at least 200 investors so as to acquire and manage real estate asset(s) or property(ies), that would entitle such investors to receive the income generated therefrom without giving them the day-to-day control over the management and operation of such real estate asset(s) or property(ies). Further, the term REIT shall include SM REITs⁴ as defined in the Amended Regulations.

As per the Amended Regulations, SEBI has permitted the establishment of SM REITs, having an asset value of at least INR 25 crores (Indian Rupees twenty-five crores), compared to the minimum asset value of INR 500 crores (Indian Rupees five hundred crores) required for existing REITs. The minimum number of members for the SM REITs shall continue to be 200 investors (other than investment manager).

However, Amended Regulations clarifies that any company which acquires and manages real estate asset(s) or property(ies) and offers or issues securities to the investors, shall not be deemed to be construed as a REIT under the REIT Regulations.

■ Structure and Parties to the REIT

The SM REITs are to be set up as a trust and the trust deed shall be required to be registered under the provisions of Registration Act, 1908. The main objective of the trust deed should be to undertake the activity of SM REIT through one or more schemes in accordance with the Amended Regulations.

A Special Purpose Vehicle (“SPV”) will be a company which is wholly owned subsidiary of the scheme of the SM REIT. The SM REITs shall be required to exercise absolute control and hold 100% (one hundred percent) stake in

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the shareholding of the SPV. Further, the ownership and control of the underlying properties to the SM REITs shall be vested in the SPV.

As part of the structure, the investor / applicant shall be required to appoint a trustee (who is registered with SEBI under SEBI (Debenture Trustees) Regulations, 1993) for the SM REITs. The trustee, in turn, will have the power to appoint such investor / applicant as the investment manager of the SM REIT by entering into an investment management agreement with the trustee of the SM REIT⁵.

The investment manager shall mean a company incorporated in India, which sets up the SM REIT, manages assets and investments of the SM REIT and undertakes operational activities of the SM REIT. The minimum net worth requirement for the investment manager shall be at least INR 20 crores (Indian rupees twenty crores), out of which at least INR 10 crores (Indian Rupees ten crores) should be in the form of liquid assets.

The investment manager for the SM REITs may also act as the sponsor, and is required to have prior experience of at least 2 (two) years in the real estate industry and/or fund management in real estate (subject to certain exceptions⁶). Further, at least half of the directors of the investment manager should be independent and are not directors of the manager or investment manager of another SM REIT.. If such an investment manager is not able to meet the requirement of prior 2 (two) years, they are required to appoint 2 (two) key managerial personnel, with not less than 5 (five) years' experience each in the real estate industry and/or real estate fund management.

There are additional guidelines on the minimum unit holding for Investment Managers, which is as follows⁷:

S. No.	Time Period from initial listing of scheme's units	Minimum Unitholding of Investment Manager
1.	0-3 years	<p>(a) in a scheme with no leverage as per disclosures in the scheme offer document for initial offer - 5% of the total outstanding units of the scheme</p> <p>(b) in a scheme with leverage as per disclosures in the scheme offer document for initial offer - 15% of the total outstanding units of the scheme</p> <p><i>Holding of the investment manager in excess of minimum 5% or 15% of total outstanding units shall be held for at least 1 year (from the date of listing of units issued in the initial offer).</i></p>
2.	Up to 5 years	5% of the total outstanding units of the scheme
3.	6-10 years	3% of the total outstanding units of the scheme
4.	11-20 years	2% of the total outstanding units of the scheme
5.	Post 20 years	1% of the total outstanding units of the scheme

■ Other Key Conditions

- Mandatory listing

In order to ensure a wider scope of participation from the investors in SM REITs, and to ensure that ample exit rights are provided to the unitholders, the SM REITs are proposed to be mandatorily listed on a recognized stock exchange.

The SM REIT shall be permitted to launch schemes and the units of each scheme shall be in dematerialized form. The minimum offer and allotment to the public in each scheme of SM REIT shall be at least 25% (twenty five percent) of the total outstanding units of such scheme. The minimum price of each unit of the scheme of the SM REIT shall be INR 10 lakhs (Indian Rupees ten lakhs) or such other amount as may be specified by SEBI.

- Investment conditions

Each scheme should invest at least 95% (ninety-five percent) of its assets in completed and revenue-generating properties. An SM REIT is not permitted to invest in under-construction or non-revenue generating real estate. Further, each scheme can invest up to 5% (five percent) of the scheme's assets in unencumbered liquid assets.

The SPV must solely own all assets acquired or intended to be acquired by the SM REIT scheme, as it is a wholly owned subsidiary of the REIT. Additionally, the scheme is prohibited from lending to any entity except its own SPV, and the SPV itself is not allowed to lend to any entity⁸.

- Valuation

The investment manager of the SM REIT must ensure annual comprehensive valuations of each scheme's assets by a qualified, independent valuer and submit such report within two months after the financial year ends to the investment manager.

If significant events impact asset values, a fresh valuation must be done within 2 (two) months from the date of such event. The valuer must have at least 5 (five) years of real estate valuation experience and must not be affiliated with the investment manager or trustee. Valuations must include physical property inspections and adhere to specified disclosures. Any property acquisitions or sales require a full valuation, and the same valuer cannot reassess an asset within 12 (twelve) months of acquisition, unless involved in its initial valuation.

Prior to any issue of units to the public and any other issue of units, the valuer shall undertake full valuation of all the REIT assets and include a summary of the report in the offer document. The valuation report cannot be more than six months old from the date of such issuance.

- Distributions

The investment manager of the SM REIT must ensure that at least 95% (ninety-five percent) of the SPV's net distributable cash flows must be distributed to the SM REIT scheme, subject to adherence to the Companies Act, 2013, with retained amounts used as specified by SEBI.

Each scheme must distribute 100% (one hundred percent) of its net distributable cash flows to unit holders. Distributions must be declared at least once in a quarter within fifteen working days from the end of a quarter, and paid to unit holders within seven working days from the date of such declaration. If payments are delayed, the investment manager shall be liable to pay 15% (fifteen percent) annual interest for the delayed period, without recovering this excess interest from the SM REIT.

- Mode of funding

The SM REIT scheme can raise funds from both Indian and foreign investors through unit issuance, with foreign investments subject to guidelines from the Reserve Bank of India and the Government of India. If leverage is disclosed in the scheme's initial offer document, both the scheme and its SPVs may undertake leverage.

The scheme must raise capital by issuing units specific to the scheme, and if leveraging, it may do so through borrowings or debt securities issuance under SEBI regulations. SPVs shall raise capital from equity investment from the SM REIT scheme and may borrow from the scheme. For schemes that have opted for leveraging, the SPV of the scheme may also undertake external borrowings or issue debt securities under applicable SEBI regulations.

The total borrowings and deferred payments, net of cash equivalents at the scheme level, shall not exceed 49% of the scheme's asset value. If these exceed 25% (twenty five percent) of the value of the scheme, then for further borrowings a credit rating from a SEBI-registered agency and approval from unit holders as specified in Amended Regulations shall be required.

- Taxation

The Income Tax Act has set out a special regime for taxation of income arising through a 'Business Trust' (which includes REITs and SM REITs) and its unitholders under Chapter XII-FA of the Income-tax Act, 1961.

- Migration

Applicants can apply for the registration of existing entities or structures owning real estate assets as SM REITs as of the notification date of the Amended Regulations within 6 (six) months of this date or within a timeframe specified by SEBI.

For migration under the Amended Regulations, the applicants must include details of the existing entities or structures and a migration plan with their registration application. The migration must be completed within 6 (six) months of receiving registration or as specified by the Board.

■ Differences from the consultation paper

Some of the provisions set forth in the Consultation Paper to be implemented on the SM REITs schemes, were not notified in the regulatory framework for SM REITs introduced in the board meeting held on November 25, 2023 as well as the Amended Regulations. Some of these are as follows -

- the SM REITs scheme shall raise funds from at least 20 (twenty) investors that are unrelated to the sponsor, its related parties and its associates;
- maximum subscription from any investor cannot be more than 25% (twenty-five percent) of the total unit capital;
- the Amended Regulations have done away with the requirement of appointment of two separate individuals as the sponsor and the investment manager respectively; and
- the Consultation Paper provided for the minimum net worth of the investment manager to be not less than INR 10 crores (Indian rupees ten crores) while the Amended Regulations prescribe for the net worth to be not less than INR 20 crores (Indian rupees twenty crores).

CONCLUSION

The introduction of SM REITs into the REIT Regulations has come in as an awaited and welcome change in the industry. The scheme is expected to initiate a growth pattern to encourage investors to invest in REITs, with a decreased threshold and increased viability of options. However, as is said that each coin has two sides, we understand the limitations may lead to several hinderances and the prescribed migration of the existing REITs under the framework to SM REITs may be a path of hurdles. We await the implementation of the scheme to see the impact on the industry further.

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