

Real Estate Investment Trusts Expectations and Possibilities

Over the past few years, India's commercial real estate sector has seen a sequential growth, largely driven by the continued demand traction from the country's technology sector and with new demand coming in from the rapid strides in the start-up ecosystem. Currently, the estimated size of commercial office space that can be transitioned to Real Estate Investment Trusts (REITs) is nearly 300 million square feet, translating to a potential market size of over US\$ 35 billion. The sector is looking robust with high occupancies and consistent growth in rentals year-on-year in key markets. Clearly, this sector has been an outlier in the current market scenario where things have been gloomy for the real estate sector.

Need for REITs



The developed global markets display that REITs have played a key role in ensuring liquidity and marketability for real estate and it is expected that they will continue to do so in the near future. As the Indian commercial real estate market matures in future, a REIT market is necessary to bridge the gap between developers' need for liquidity and investors' appetite for investing in structured and transparent real estate products.

Although it has been a long wait before India did witness its first REIT¹, earlier this year, the REIT's blockbuster listing and performance thereafter has encouraged many commercial real estate developers to follow suit. Currently, many Indian developers are either actively implementing or evaluating options to list their office asset portfolio under a REIT platform.

Moreover, private transactions in the commercial real estate sector continue to gain momentum with large global investors, particularly sovereign wealth funds and international private equity funds, pursuing asset acquisitions or collaborations with developers to build and expand their real estate asset portfolios in India. Again, the robustness of REITs as a platform is key for investors as they look at eventual exits from their investments.

Near-term possibilities



With the overall growth of commercial real estate market in India and the impending success of REITs, some of the expectations and possibilities are as follows:

1

Success of the first REIT to be the trendsetter

It was the joint effort of Embassy and Blackstone that resulted in the launch of India's first REIT—Embassy Office Park REIT with an asset portfolio of nearly 33 million square feet, in April this year. While the initial response to the REIT was not very overwhelming, the sustained performance of the scrip over the past eight months has brought in a sense of optimism for prospective developers and investors with a large commercial portfolio. Currently, the units are trading at a premium of about 37 percent (although with limited liquidity) to its allotment price and this is a huge attraction to lure large commercial asset owners into the REIT market.

Some developers who also operate in the residential real estate segment may prefer to partially monetise their rent-yielding portfolio to fund their other businesses, in the current market that is starved of funds. Similarly, the listed companies can use the REIT platform for a value discovery with the hope of rerating their stock prices.

As this trend surges, it is expected that other rent-yielding assets such as retail malls, warehousing assets, hotels, etc., will eventually join the REIT bandwagon either through standalone specialised REITs or as an addition to existing REITs, which may be relatively concentrated on commercial properties.

2

Investors' interest in REITs to increase disproportionately

A majority of institutional investors worldwide perceive rent-yielding quality commercial assets as attractive and relatively less risky investments. Foreign investment in this sector has been growing for the past five years. The absence of liquidity and lack of a structured and transparent framework has kept many funds and institutions away from this market. REITs are a natural choice for such investors and there will be an influx of foreign investment into REITs if the valuations and yields are attractive.

In addition, opportunities for high-net-worth individuals (HNI) and large retail investors in the organised commercial real estate space have been negligible. The REIT platform is apt for such investors and with increased demand from such investors and limited REIT offerings in the offing, demand for investment opportunities is set to increase disproportionately to the supply. This will also signal an eventual gradual shift from sporadic strata buying to a relatively more liquid and transparent investment in units of REITs.

3

Market to witness consolidation

The commercial real estate market is dominated with a few large players who have consistently demonstrated the ability to develop, deliver, and lease high-quality assets. This limited market has been the only source of REIT-worthy assets in India. With the demand for such assets set to increase disproportionately to the supply, consolidation of the smaller players is one of the possibilities. Smaller players could include real estate developers who desire to upgrade to the higher category. Consolidation can also happen by aggregating assets from smaller developers to create asset pools that will eventually be migrated to a REIT platform. In a sense, this could be a win-win proposition as owners of limited assets (say one or two commercial projects) can swap their assets for units in the REIT and, can thereby diversify their portfolio and somewhat hedge their risk besides providing avenues for liquidity.

4

Regulatory and tax framework to become more progressive

The regulatory and tax framework for REITs has been constantly evolving. Both the government and industry participants have been instrumental in this decade-long evolution process. However, this alternative investment industry is still in its infancy and needs periodical tax and regulatory policy interventions by the government to make it more progressive.

On the tax front, extending the capital gains tax exemption on the direct transfer of assets to REIT and further streamlining the dividend tax exemption across all special purpose vehicles (SPVs) owned by REITs will be welcome. On the regulatory side, further reduction of minimum investment size can attract more retail investment in REITs. The recent tax and regulatory reform announcements by the government can lead towards progressive changes and provide a vibrant and robust REIT market in India.

5

Macroeconomic outlook and its impact

Inevitably, prevailing macroeconomic conditions will have an influence on the success of any investment product. In particular, real estate investments could largely be affected since the performance of real estate assets is inherently linked to the level of economic activities. With the recent macro-economic statistics indicating a weak market outlook, it is possible that the growth of commercial activities may be impacted, and consequently dampening or slowing down transactions in the real estate sector. This may be the cause for some potential dark clouds in the horizon that could darken the outlook for REITs. Proactive steps for strong push on manufacturing and job growth, consumer spending, and increasing overall business activity may sustain the demand for commercial real estate and propel interest in REITs.

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