REIT Basics

What is a REIT?

- REIT stands for Real Estate Investment Trust
- REITs originated in the US in the 1960s as a way to allow retail investors to efficiently invest in commercial real estate that is listed on the stock exchanges
- In India, REITs allow investors to access the benefits of investing in real estate through a publicly traded unit
- REITs own, operate and/or manage income or rent generating real estate assets
- REITs are tax efficient vehicles that are required to distribute at least 90% of their cash flows to the unitholders, atleast semi-annually
- REITs provide distribution yields with in-built capital appreciation potential
- REITs are heavily regulated by SEBI and exhibit high levels of disclosure, transparency, and corporate governance

What assets can an Indian REIT own?

- Indian REITs are permitted to own real estate, such as offices, retail, among others. They are not permitted to own speculative landbanks
- Indian REITs can only own assets situated in India
- Indian REITs must have at least 80% (by value) of their assets completed and income or rent generating; the remaining 20% can be invested in under-construction assets and certain other investment instruments

Why were Indian REITs created?

- Globally, REITs have been in existence for over 60 years, with the first-ever REIT listed in USA in the 1960s
- Currently, there are over 1,000 listed REITs globally valued at over $2 trillion, which contribute to over 60% of the global real estate market
- Historically, Indian real estate has been illiquid and primarily residential-focused. REITs were launched in India to enable investors to invest in commercial or other real estate without actually having to buy, own and manage a physical real estate asset
- The first REIT was listed in India in April 2019, and since then 3 other REITs have been listed on the Indian bourses

How can one buy or sell Indian REIT units?

- REIT units are listed on the Indian stock exchanges NSE and BSE through an Initial Public Offering (IPO)
- Any eligible investor (domestic / foreign / retail / institutional) can buy REIT units in India
- The REIT units can be bought or sold through a demat account, and the process is similar to the buying or selling of an equity share of a listed company
- An investor can buy or sell a single unit at a time

What are the advantages of investing in Indian REITs?

- REITs are universally considered to be a safe and transparent way to invest in income producing real estate
- Real estate has always played an important role in a global asset allocation strategy. REITs are a 'total return' product that typically offer stable distributions along with long-term capital appreciation
- REITs are liquid, allow investors to invest and trade in small amounts, and represent ownership in a real estate vehicle while leaving the management to professionals

- In summary, there are 6 key advantages of investing in Indian REITs:
  - Accessibility – REITs allow ownership in professionally-managed real estate assets, even with a small capital outlay
  - Liquidity – REIT units are freely traded in the stock markets like equity shares
  - Transparency – REITs are highly regulated with a strong governance framework and disclosure requirements prescribed by SEBI
  - Tax-efficient Yields – REITs typically provide consistent tax-efficient income, due to the regulatory requirement to distribute at least 90% of REIT cash flows at least semi-annually
  - Growth Upside – REITs allow investors to participate in the potential capital appreciation of REIT units from organic or inorganic growth
  - Diversification – REITs offer access to the real estate market which typically has low correlation with other asset classes and can also help in diversification of portfolio across sectors and cities

What are the risks associated with investing in Indian REITs?

- Investment in REIT units are subject to risks which are similar to those related to investments in equity markets and real estate. Some of the key risk factors which may affect the financial condition, results of operations, distributions or returns of the REITs are listed below. Please note that this is not meant to be an exhaustive list and the investors should refer to the prospectus or offering documents issued by the relevant REIT for further details.
  - Market risk – Just like any other publicly-traded product, any REIT's unit price is also subject to global economic and market conditions. There is a risk that investors will receive less than the original amount invested when they sell their units. Such prices generally reflect investor confidence and sentiment about the property market and its returns, the REIT's management, interest rates, and other related factors.
  - Income risk – REIT's income is dependent on the performance of the Indian commercial real estate market, which may be dependent upon global economic and other market conditions, demographic trends, employment levels, availability of financing, prevailing interest rates, competition, performance of the industry sectors of tenants, bargaining power of tenants, operating costs, government regulations and policies, market sentiment etc. Events such as a fall in occupancy rates, reduction in market or portfolio rent levels or a higher cost of debt etc. may negatively impact the REIT's income and cash flows and in turn the distributions made by the REIT to its unitholders.
  - Leverage and refinancing risk – Investors should consider the capital structure of the REIT as a higher leverage which may have an impact on the REIT's distributions. Under the SEBI REIT regulations, the leverage levels are capped at 49%. REITs may enter into new borrowing agreements or issue new debt to repay existing loans. This gives rise to the risk that the terms of such refinancing undertaken may be less favorable than the terms of the original borrowings. If the REIT is unable to secure refinancing, it may be required to sell off some properties if they are mortgaged under the loan. These risks could affect the unit price and income distribution of the REIT.
  - Other risks – REIT's operational performance and returns may also be impacted by other factors such as government regulations and policies, including taxes and duties, development timelines and costs, operating and maintenance expenses, future acquisitions and financing structure etc.

How does a REIT fund its operations and growth?

- Given that REITs are required to pay out at least 90% of their NDCFs to their unitholders at least semi-annually, they are reliant on the capital markets to fund their operations
- A REIT primarily funds its operations and organic or inorganic growth through several sources, such as:
  - Debt, which can be raised through listed non-convertible debentures, commercial papers, term loans, among others.
  - Equity, which can be raised through institutional placements, preferential allotments, or rights issues

REIT Structure

What are the key differences between a REIT and a regular listed company?

- REITs are structured and governed differently vis-à-vis a regular listed company. Some of the key differences are:
    - REITs are registered as business trusts and not as a limited company
    - REITs have restrictions regarding the assets that they can own, whereas no such restrictions exist for a listed company
        - Indian REITs are permitted to own income or rent generating real estate, such as offices, retail, etc. They are not permitted to own speculative landbanks
        - Indian REITs can only own assets situated in India
        - Indian REITs must have at least 80% (by value) of their assets completed and income or rent generating
    - REITs can raise debt upto a maximum of 49% (net debt / total enterprise value)
    - REITs are mandated to distribute at least 90% of their cash flows (called NDCF) to their unitholders at least semi-annually, whereas listed companies are not mandated to give out distributions
    - REIT distributions are comparatively more tax-friendly in the hands of the investors

What's the role of the REIT's manager?

- REIT's manager is responsible for all day-to-day functions and operations of the REIT, including lease management, asset maintenance, finance and treasury management, regular audits, etc.
- The manager takes all investment decisions with respect to the underlying assets of the REIT, including any further investment or divestment of the assets
- The manager is responsible to declare distributions to the unitholders, to ensure adequate and timely redressal of all investor grievances and to ensure adequate and timely disclosures to the unitholders, SEBI, trustees and designated stock exchanges
- In summary, the manager ensures that the REIT is run in accordance with all applicable regulations and in the interest of all relevant stakeholders. Also, the rights and responsibilities of a REIT manager are clearly outlined by SEBI under the SEBI REIT regulations

What's the role of the REIT's Sponsor(s)?

- REIT's sponsor is responsible to set up the REIT and appoint a trustee and a manager
- The rights and responsibilities of a REIT Sponsor and Sponsor group, along with their minimum unitholding requirement, are clearly outlined under the SEBI REIT regulations

What's the role of the REIT's trustee?

- REIT's trustee oversees the activities of the REIT manager in the interest of the unitholders, ensures that the manager complies with the relevant reporting and disclosures requirements
- The REIT's trustee is responsible for holding the REIT assets in trust for the benefit of the unitholders in accordance with the trust deed and the SEBI regulations. Also, the rights and responsibilities of a REIT trustee are clearly outlined by SEBI under the SEBI REIT regulations

REIT Distributions

How does a REIT generate cashflows and how is REIT NDCF calculated?

- A REIT generates rental income from its underlying properties by leasing space and collecting rent from its tenants
- Post deducting cash expenses (such as property tax, insurance, interest, income tax etc.) and other relevant adjustments, the remaining cash flows, referred to as 'Net Distributable Cash Flows' (NDCF), are available for distribution to the unitholders
- For Indian REITs, the NDCF is calculated as per the standardized NDCF framework defined under the SEBI REIT regulations
- Also, Indian REITs are mandated to pay out at least 90% of their NDCF to their unitholders at least semi-annually

How are Indian REIT distributions taxed in the hands of the unitholders?

- The taxability of REIT distributions differs across investor categories and hence we request all the investors to contact their respective financial / tax advisor(s) for the tax positions to be adopted by them with regard to the REIT distributions
- In general, Indian REIT distributions are classified as (i) dividend, or (ii) interest, or (iii) amortization of debt received from the Special Purpose Vehicles ('SPVs') or (iv) other income or (v) a combination of the above.
    - <u>Amount of income in the nature of dividend</u> – Dividend income is not taxable in the hands of the unitholders as per Section 10(23FD) read with Section 115UA of the Income-tax Act, 1961 if the SPVs of the REIT have not opted for the lower corporate tax regime under section 115BAA of the Act. No tax is deductible on this portion of distribution.
    - <u>Amount of income in the nature of interest</u> – Interest income is taxable in the hands of the unitholders. Please note that tax is deductible at applicable rates under Section 194LBA of the Income-tax Act, 1961.
    - <u>Proceeds from amortization of debt received from SPVs of the REIT</u> – SPV loan amortization refers to repayment of loans by SPVs to the REIT. Please note that this is a repayment of debt extended by REIT to the SPVs. In case where aggregate sum of such "amortisation of SPV debt" component exceeds issue price of the unit, the same is taxed in the hands of the unitholders as "specified sum" under the head income from other sources as per the provisions of Section 56(2)(xii) of the Income-tax Act, 1961. The tax withholding provisions are applicable only to non-residents under section 195 of the Income-tax Act, 1961 and get triggered only once the aggregate of the sum received as "amortisation of debt" exceeds the issue price.

      Further, in computing capital gains on the sale of units of a REIT, the cost of acquisition of such units shall be reduced by distribution received by a unitholder in the form of amortization of debt, which is not subject to tax under section 56(2)(xii) of the Act, i.e., such portion which does not qualify as "specified sum" under the provisions of section 56(2)(xii) of the Act.
    - <u>Other income</u> - Other Income refers to the interest income earned by the REIT on fixed deposits, income earned on sale of mutual funds etc. The Indian REIT pays taxes on such income and this income is exempt in the hands of the unitholders under section 10(23FD) of the Income-tax Act, 1961 and consequently, no tax is deductible on such income.

Valuing REITs

How are REITs valued?

- Some of the commonly used approached for valuing a REIT are as follows:
    - Discounted Cash Flow (DCF) – This method calculates the value of a REIT by estimating future cash flows of the REIT and discounting them to a present value using the WACC ('Weighted Average Cost of Capital') rate relevant for the REIT

- Dividend Discount Model (DDM) – This method calculates the value of a REIT by discounting all future expected dividends of the REIT to a present value using the cost of equity rate relevant for the REIT
- Net Asset Value (NAV) – This method calculates the value of a REIT by assessing the fair market value of all assets owned by the REIT and deducting the value of all liabilities. When divided by the number of units outstanding for the REIT, the NAV per unit is viewed by investors as a useful guideline for determining whether the REIT is trading a premium or a discount with respect to its intrinsic value
- Cap Rates – A cap rate or 'capitalization rate' is calculated by dividing the Net Operating Income (NOI) of a property with its current total value. A higher cap rate implies a higher risk is attributable to the investment and vice versa. The cap rate method is used to determine the appropriate valuation of a REIT, wherein the minimum required rate of return is achieved. Using this method, the value of a REIT is calculated by dividing the REIT's NOI by the market cap rate.

- Indian REITs are required to obtain and publish a half yearly valuation report, based on a valuation exercise conducted by an independent external property valuer, appointed under Regulation 21 of the SEBI REIT regulations

What are the key metrics that an investor should consider while evaluating a REIT for investment?

- Price to Net Asset Value (NAV) – A REIT's NAV indicates an independent valuation of its underlying real estate assets. Price to NAV ratio gives an indication of whether the REIT is trading a premium or a discount with respect to its intrinsic value
- Quality and track record of management, portfolio and financials – A strong management team displays a good track record of creating value for the unitholders. This may be demonstrated by a growing DPU, a growing NAV or a combination of the two
- Occupancy rate – Higher occupancy rates in the portfolio indicate greater assurance of rental income flows from the portfolio assets
- Tenant mix – A good mix of tenants from a diverse range of industries and sectors, along with the creditworthiness of the tenants, reduces concentration risk
- Weighted Average Lease Expiry (WALE) – REITs with longer WALEs face a lower risk of vacancy. However, it is possible that such REITs may not be able to negotiate for higher rents when market rents increase
- Lease expiry profile – A well-staggered lease expiry profile will minimize the number of leases that are due to expire in any given year, thereby reducing vacancy risks
- Leverage (Gearing) ratio – This ratio indicates REIT's net debt to total enterprise value and is capped at 49% by SEBI regulations
- Debt expiry profile – A well-staggered debt expiry profile will reduce debt refinancing risks for the REIT which may otherwise impact the REIT's cash flows
- Interest cost – A lower weighted average interest cost will improve the flowthrough from revenue to distributions

Indian REIT Landscape

Which are the REITs listed in India currently?

- There are 4 REITs listed in India currently – Embassy REIT, Mindspace REIT, Brookfield India Trust and Nexus Select Trust (in the order of listing)
- The 4 REITs have a substantial ₹1.3 lakh crores in gross Assets Under Management (AUM), combined market cap of over ₹80,000 crores and a portfolio of over 112 million square feet of Grade A commercial and retail spaces nationwide (Data as of September 30, 2023)
- Cumulatively, the Indian REITs have distributed over ₹14,300 crores till date since 2019, surpassing the combined dividends distributed by real estate companies constituting the entire Nifty Realty Index (Data as of September 30, 2023)

Who owns Indian REITs?

- The 4 listed Indian REITs have a combined investor base of over 2 lakh unitholders (Data as of September 30, 2023)
- The register across the Indian REIT universe is a stable and growing mix of global and domestic institutional investors, along with an ever-growing base of retail investors

Useful Links

Link to Indian Regulators / Exchanges

- SEBI - Securities and Exchange Board of India
- RBI - Reserve Bank of India
- NSE - National Stock Exchange of India Ltd.
- BSE - Bombay Stock Exchange of India Ltd.

Link to Online Dispute Resolution Portals

- SMART ODR - Securities Market Approach for Resolution Through ODR Portal
- SCORES - SEBI Complaints Redress System

Link To International Real Estate / REIT Associations

- NAREIT
- EPRA
- REITAS
- APREA

Link To International Property Consultants

- Colliers
- CBRE
- Cushman and Wakefield
- JLL