India, REITs Hurricane

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REITs are a highly efficient way by which capital can flow into the property market. It will definitely enter into China as it can enhance the capital market and lower the cost of capital. 10th August 2014, the Indian government approved the establishment of the Indian domestic REITs (Real Estate Investment Trusts) system. So far, all the major Asian economies have established REITs regimes, leaving behind China alone.

The plan of introducing REITs to India originated in August last year. However its launch encountered a bottleneck as it was difficult to determine its tax structure. In the state budget in July 2014, Finance Minister Arun Jaitley announced the tax benefits for this investment vehicle, which clears the way for launching the REITs regime. According to the Asia Pacific Real Estate Association, these tax benefits have no clear expiration date.

What is the Indian REITs?

The establishment of REITs regime in the Indian market is a significant break-through, although specific legislation still needs to be introduced. Regulations are still at the discussion stage and the REITs product has not yet been launched. The market's reaction has been very positive. What are the details of current tax benefits for REITs?

First, REITs will be given tax pass-through status, which means that if REITs distribute more than 90% of net income to investors through dividends, they will be exempted from any federal taxes.

Secondly, all REIT must be listed and traded on the stock exchange. To meet the listing requirement, the trusts, or REITs, will have to own assets worth at least 5 billion rupees.

Thirdly, at least 80% of assets must be fully constructed and be income generating, 10% of the income can be invested in the construction of other properties. SEBI noted that REITs can also invest a small portion in other securities, such as mortgage-backed securities and money market funds.

In addition to the clarification of key tax benefits, the requirement on the asset size of listed REITs has been reduced, from 10 billion rupees before to five billion rupees, which is a significant reduction for small and medium property companies. Meanwhile, the policy allows REITs to be initiated by "co-sponsor" and withdraws the restrictions on "single property".

Restrictions on the investment assets have been relaxed. The ratio of development properties and other investment has increased to 20%, the ratio of existing income producing assets has decreased to 80%, and 10% for other investments is allowed.

"Inherent Problem"

It cannot be ignored that although Jaitley is "breaking the ice" for Indian REITs, there is still some "ice". Capital gains will be levied as a minimum alternate tax, the details of which need to be further clarified. The minimum alternate tax is only for the companies at set-up phase, rather than the operational phase. In addition, overseas investors will pay withholding tax, but the tax rate is only 5%, which is quite low compared with other countries 15% withholding tax rate.

For business owners, when they transfer assets on current balance sheets into REITs products, minimum corporate tax will be triggered. Ken Atchison, managing director of Atchison Consultants believes that this will be the major barrier for India REITs to build momentum as the tax is not common in other Asian markets.

"If the Indian property firms step out of the country and list in Singapore, they will not incur the lowest corporate tax. This will make the Indian property firms prefer to be listed in Singapore, rather than in the domestic market," Atchison says.

Reportedly, the lowest corporate tax in fact is a tax-channel. However the Indian REITs market, which is considered very similar to Singapore REITs market, has the largest difference on this point.

It seems that the lowest corporate tax will become a major impediment for Indian real estate to be listed in the domestic market. It seems that it encourages more investment listings to go overseas. However, as noted by Atchison, on the specific operational level, this "encouraging" or "favourable factors" will not exist for overseas listing.

"From the point of view of Indian REITs, the biggest attraction is that it provides a channel for local assets, allowing individuals and institutions having opportunity to invest in such a portfolio, and this portfolio is more liquid. In most markets, the largest proportion of investors is from the local participants, so overseas investors, although attracted, will certainly not dominate ", Atchison said.

Of course, the Indian REITs are designed to attract local investors, but also to provide an ideal environment for foreign investors. The issues that India REITs face at the establishment phase are still in intense discussion.

As the policy is still at the negotiating stage, it is hard to predict what standard the final tax will be positioned. However, this issue is also under discussion in other countries, particularly countries in Europe. Most international experience has concluded that such a tax should be exempted. Whether Indian authorities will adopt international experience in the final decision-making stage, it is unknown.

Asian Domino

The Indian market is already anticipating REITs which are not yet issued with only policies introduced. Although the Indian market has not received capital inflows, different parties have responded positively. It is expected that there will be a strong capital inflows after REITs are issued.

It is predicted that, once formally launched, REITs will cover 50% of commercial real estate in India, then how will REITs affect the Indian territory of commercial real estate? Atchison believes that a portion of the money will come from private investors, and produce "democratisation of real estate" being ownership by individuals

"At the moment, only the very rich class, wealthy families or institutional investors have the financial ability to invest in real estate assets, while in future, individuals can have the property exposure, which will inject massive funds into property market."

Mr Atchison further pointed out that at the same time, local property developers also will have a broader financing channel, which will change the financing structure. Through this financing mechanism, the cost of capital will be reduced. Banks will also hold more open attitude to loans for new development projects.

The introduction of REITs to India capital markets broadens the range of capital flow. In the Indian market, infrastructure is also experiencing financing attempt, which also occurred in the "shadow banking" system. "So we can see that the securitisation of these areas is building a momentum, although it is outside the banking system, but it will be regulated in other ways. So large institutional investors can bypass the banking system, directly provide financing to companies", Atchison explained.

Not difficult to see, this move of India is a way of competing with the Singapore market. After India, other countries soon will keep up the pace; otherwise Singapore will attract a large number of high-quality assets to Singapore listings. Therefore, this is a move that will accelerate the Asian countries' REITs tide.

As one of the few countries without REITs, the problem that concerns Chinese market concerns the most is when the Chinese version of the REITs will come into place. About this, Atchison holds a very optimistic view. REITs are very efficient forms in which capital can enter into the real estate market. Due to the role of REITs in helping expand the capital market as well as reducing the cost of capital, it will definitely enter China.

Expansion of the Chinese capital markets, which is concentrated in bank deposits is underdeveloped, the current priority is to improve market efficiency through new instruments such as REITs. But he also pointed out that with the improvement of market efficiency, volatility will follow. "But the capital volatility will impact more on the short-term investments; the impact will be minimal if investments are held long-term." Atchison says.

Translated by Ming Niu