REITs – A U.S. and Indian Perspective

Chaitanya Ch
Associate Professor, M.B.A. Department, Vidya Dayini College Of It & Management Studies, Osmania University, Hyderabad, India

Real Estate Investment Trusts (REITs) are the most talked infrastructure investment vehicles nowadays in India. India’s economic growth is going great guns in the recent years. Witnessing rapid growth in the real estate sector, the scale of operations is growing day by day in turn increasing the demand for office space and commercial buildings.

With the backdrop of the above, the regulators in India felt it is crucial to have investment vehicles like Real Estate Investment Trusts (REITs) in the country. Securities Exchange Board of India (SEBI) has recently (Aug-Sep 2014) cleared a proposal allowing Indian firms to launch REITs. This move enables easier access to funds for developers who are in short of money. Specifically, the setting up of REITs creates new investment avenues for Institutions, High Net-Worth Individuals (HNIs), and in turn for common share holders.

REITs – U.S. Perspective
Real Estate Investment Trusts (REITs) are a way for investors to invest in commercial and residential real estate businesses. REITs usually own, and sometimes operate, income producing real estate, such as residential apartments, office buildings, hotels and healthcare facilities. As an investment, REITs combine the features of real estate and stocks. They give an investor a means to include professionally managed real estate in a diversified investment portfolio.

History of REITs
Dating back to year 1960 in the United States, the Congress created REITs to facilitate investments by smaller investors in commercial properties, including large scale, income producing real estate through the purchase of common shares. The REIT’s organizational structure i.e. the company elected as REIT enables shareholders to earn a pro-rata share of the economic benefits that are derived from the production of income through commercial real estate ownership. A company, to be elected or qualify as REIT in the United States, must distribute at least 90% its taxable income to shareholders on an annual basis. Apart from the United States, this framework for REIT exists in several countries, including Australia, Singapore, Japan, France, and the United Kingdom, etc.

Advantages of Investing in REITs
REITs offer distinct advantages for investors. Specifically they offer highly diversified investing in a portfolio of properties by experienced real estate professionals. Investors who are interested in reliable, income producing characteristics such as stable cashflows, current yield, and tangible assets favor REITs.

REITs are considered as total return investments and the returns from these usually somewhat more than the returns of bonds and less than the returns from high-growth stocks. The main characteristic of REITs is that they provide the potential for moderate, long term capital appreciation, along with high dividends. Several research studies in the United States found that there is a relatively low correlation between returns from REITs and publicly traded real estate stocks. This characteristic helps investors to build a diversified portfolio.

Types of REITs
REITs can be classified as Equity REITs, Mortgage REITs and Hybrid REITs. Equity REITs engage in a wide range of real estate activities primarily acquiring and developing their properties. They intend to operate them as part of their own portfolios rather than to resell them once they are
developed. Mortgage REITs lend money directly to real estate owners and operators or extend credit indirectly through the acquisition of loans or mortgage backed securities. Hybrid REITs both own properties and makes loans to real estate owners and operators.

Valuation of REIT Stocks/Units
In general to assess the investment value of REIT shares, the following criteria is considered: management quality and corporate structure; anticipated returns from the stock estimated from the expected price changes and the prevailing dividend yields; current dividend yields relative to other yield oriented investments; and underlying asset values of the real estate assets.
In addition, Funds From Operations (FFO) is also considered as way to measure the performance of an REIT. Securities analysts usually measure a REITs performance through FFO per share growth. As REITs do not require much cash flow to maintain and replace their physical assets, FFO recaptures that cashflow and presents it as part of a REIT's annual financial performance.

REITs - Indian Context
In the Budget for 2014-15, Honorable Finance Minister of India has made some key announcements on the establishment of REITs in India. Further, SEBI has come up with the necessary rules and regulations through its gazette.

Concerned Parties in REIT and their Roles
Sponsor: Its primary responsibilities include setting up of the REIT and appointment of the Trustee. Further, sponsor has to maintain a certain percentage holding in the REIT.
Trustee: Its role is primarily to supervise. The trustee has to ensure that the activity of the REIT is being operated in accordance with the proposed regulations.
Manager: The operational responsibilities of the REIT have been assigned to the Manager.

Market and Raising Funds
An REIT shall make an initial offer of its units by way of public issue only. The price of REIT units issued by way of public issue shall be determined through the book building process or any other process in accordance with the circulars or guidelines issued by SEBI. Since the Indian real estate market is in development stage, it is proposed that initially the units of the REITs may be offered only to Institutions/HNIs. Hence, it is proposed that the minimum investment amount to be maintained at Rs. 2 lakhs and trading lot at Rs. 1 lakh.
The REITs can raise funds either from native or foreign investors adhering to the above conditions. Further, the minimum size of the assets under the REIT has been specified at Rs. 1000 crore in order to ensure that initially only established players enter the market. In addition, to see that there exists sufficient liquidity, minimum initial offer size has been specified at Rs. 250 crore and a minimum public float of 25%.
Within a period of 12 working days from the date of closure of the initial offer, it is mandatory for all units of REITs to be listed on a recognized stock exchange having nationwide trading terminals. Further, it is specified that any subsequent issue of units by the REIT may be done through follow-on offer, preferential allotment, qualified institutional placement, rights issue, bonus issue, or offer for sale etc., as specified by SEBI.

REIT Investments
REITs are allowed to invest both directly and through and up to one level of Special Purpose Vehicles (SPVs). It is proposed keeping in view the nature of REITs that minimum 90% investment is to be made in completed revenue generating properties. The rest 10% may be invested in under construction properties, equity shares, debt securities, money market instruments etc. Like in the case of United States, it has been mandated to distribute at least 90% of the net distributable income after tax of the REIT to the investors in order to ensure regular income.
Mandatory Disclosures
It is proposed by SEBI that the manager of the REIT must submit an annual report to all unit holders of the REIT with respect to activities of the REIT, within 3 months from the end of the financial year. Also, it is proposed that within 45 days from the end of the half year ending on September 30th, the manager has to submit a half-yearly report to all unit holders of the REIT.

References
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