Real Estate Investment Trusts (REIT) – The Road Less Taken

written by Sonali Sylvia | June 16, 2022

What Is A Real Estate Investment Trusts (REIT)

Real Estate Investment Trusts (REITs) are investment instruments provide developers with an avenue to accrue profits from revenue-generating real estate while simultaneously allowing investors (more specifically known as “unit holders”) to invest in these assets without the requirement to own them. In essence, a REIT is a pool of real estate assets that can create regular income and is structured like a mutual fund. Just as a mutual fund operates by collecting monies from investors and then investing the same in the stock market, a REIT will collect money from retail and institutional investors and deploy these funds towards revenue-generating real estate assets.

Typically, these investments would be made in commercial real estate assets such as offices, workspaces, retail buildings and shopping malls that can generate regular rental income. Another noteworthy similarity that REITs share with mutual funds is that they allow multiple investors to pool their money together, which is then managed by a designated manager. However, while the underlying asset of mutual funds is usually equity, debt, gold, or a combination of these, the asset in the case of REITs is primarily real estate holdings or loans secured by real estate.

Generally, a REIT leases out the properties that it owns and accumulates rent as the chief source of revenue. Some REITs don’t possess ownership over the property, choosing instead to finance real estate transactions and generate income from the interest accrued on the financing. While it is typical for REITs to specialize in a specific real estate sector, there have been diversified and specialty REITs on the rise which may hold different types of properties in their portfolios.

Types Of REIT

Equity REITs: A REIT where owners of real estate properties lease these properties out to companies or individuals to generate revenue. The revenue is then distributed among the REIT investors as a dividend.

Retail REITs: These are a type of REIT that invests in the retail sector like large scale shopping complexes, grocery store chains, supermarkets etc. However, such REITs are not directly involved in running these retail outlets and day-to-day operations are handled by designated managers. These REITs merely rent or lease these spaces to retail tenants.

Residential REITs: Residential REITs own and operate residential facilities like apartment buildings, community complexes and gated communities.

Healthcare REITs: These REITs primarily invest in and operate healthcare-focused real estate such as hospitals, nursing facilities, retirement homes, and other medical centres.

Mortgage REITs: These REITs do not own the real estate property, but collect and receive EMIs against the property from the owners and developers of the property. The earnings are by way of Net Interest Margin (i.e., the difference between interest earned on mortgage and cost of funding the loan) which they distribute among the REIT investors as a dividend.

Hybrid REITs – A combination of both equity and mortgage REITs are Hybrid REIT models.

How Do REITS Work?

- Commercial entities that finance, purchase or operate commercial real estate properties are permitted to launch REITs in India.
- A REIT is then set up in the form of a trust registered with the stock market regulator i.e., the Securities and Exchange Board of India (SEBI).
- This commercial entity must subsequently meet several requirements to qualify as a REIT and gain pass-through entity status.
- Once a REIT is open for public investments, each individual REIT “unit” can then be purchased at the prescribed price.
- REITs generate income primarily through rental yields and capital appreciation. As a REIT investor, dividends shall be distributed from the revenue generated from the REIT assets.

Components Of A REIT Structure

Sponsor: A sponsor is a person or entity which forms the REIT. They set up the REIT and transfer the property owned by them. A builder or developer desirous of raising funds through REIT generally plays the role of a sponsor.

Trustee: The trustee is a person appointed by the sponsor, who holds the assets on behalf of the unitholders.

Manager: The trustee appoints a manager who would manage the REIT assets and would be responsible for making investment decisions. The manager is typically a private company held by the sponsor.

Unitholders: They are the beneficiaries of the trust, who become indirect holders of REIT assets by subscribing to the units of the REIT. Unitholders can be Indian residents or foreign investors.

SPV: An SPV is a company in which either a REIT or Holdco holds or proposes to hold an equity stake or interest of at least 50%. The SPV holds at least 80% of its assets directly in properties and is not allowed to invest in any other SPVs nor engage in any activity, other than holding and developing a property and any incidental activity related to the same.

Holdco (Holding Companies): A Holdco is a company or a limited liability partnership in which the REIT holds or proposes to hold an equity stake or an interest of at least 50% and is a company which has made investments in other SPV(s), which ultimately hold the real estate property or properties.

Figure 1: Structure of a REIT

How Do They Generate Income?

Rental income, dividends and interest: Rental income is earned by a REIT from direct investments in properties whereas dividend income is earned if such investments are made through a SPV. By law, a REIT is required to distribute at least 90% of the net distributable cash flow (“NDCF”), i.e., the income generated after deducting expenses, to its unit holders at least twice a year.

Capital appreciation: Just like how the price of stocks rise or fall over time, the units of the REIT also appreciate or depreciate in value. Since unit holders indirectly own a portion of the property that REITs buy, the investments grow in tandem with the value of the properties that the REIT holds.

Advantages

- Opportunity: Offers an individual the chance to buy real estate as financial security.

- Operational Assets: Indian REITs, according to regulatory guidelines, must have 80% operational and income-generating assets.
- Stability Of Earnings: REITs are less volatile than other investment avenues.
- Mandatory Distribution: The retail investor is mandated to receive 90% of such distributable cash flows.
- Transparency: There are stringent regulations under SEBI, governing REITs, and the parties to REITs

Disadvantages

- Limited Options: Currently there are only three listed REITs in India. This limits the choice for investors.
- Property Vacancy: One of the biggest risks that REITs face is vacancy. This issue has been further aggravated by the pandemic and the wide-spread adoption of remote working.
- Low-growth Prospects: REITs are mandated to distribute 90% of their income to the unitholders. This stifles their ability to plough money black into the REIT business, which stifles growth.
- Low Liquidity: While REITs are listed and traded on stock markets, the number of market participants is currently low especially with respect to retail investors.

Recent Regulations to Bear in Mind

A REIT is a trust formed under the Indian Trust Act 1882 (the Trust Act) and registered under the Registration Act 1908 with the primary objective of undertaking the business of real estate investment in accordance with the REIT Regulations.

In 2014, SEBI notified the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations 2014 (the "REIT Regulations") which made it mandatory for a real estate investment trust (REIT) to register with SEBI to conduct their business.

Recent Developments

REITs are listed and traded on stock markets just like exchange traded funds. As such, purchasing units on the stock market is the best way to invest. A Demat account is mandatory for investing in REITs in India. Just like ETFs (Exchange-Traded Funds), the prices of REITs units on stock markets change depending on both the demand for units as well as the performance of the REIT. To encourage investors, SEBI has made two significant amendments to rules of investing in REITs in India:

1. Earlier, there was a minimum requirement of INR 50,000 for an investor to invest in units of REITS; however, recently, vide notification issued by SEBI on July 30th 2021, the same has been dispensed away with for investments directly via stock exchanges. The new minimum investment criteria of INR 10,000-15,000 is now applicable for investment through initial public offerings (IPOs) and follow-on offers (FPOs).
2. Another shift in policy is the lot size of REITs traded, which was a lot size of 100 units. By virtue of the same SEBI notification, the minimum lot size has been reduced from 100 units to 1 unit.

Conclusion

The real estate sector has played a crucial and pivotal role in the trajectory of the Indian economy. Recent successes by maiden REIT listings in India have provided impetus to an entire category of new investors. Current inflationary pressures present a suitable time for REITs to outperform bonds and stocks. Increased prices lead to an rise in real estate rents as leases are directly tied to inflation. This is advantageous for REITs as high inflation rates also reflect higher rental incomes. REITs have provided growth opportunities in this sector which has slowly, but surely, mobilised attention from institutional investors and the public alike.

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