INDIAN REAL ESTATE SECTOR: EMERGING ISSUES

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ABSTRACT

The real estate sector in India assumed greater prominence with the liberalisation of the economy, as the consequent increase in business opportunities and labour migration led to rising demand for commercial and housing space. At present, the real estate and construction sectors are playing a crucial role in the overall development of India's core infrastructure. The introduction of the regulations to permit foreign investment in IN-REITs by the RBI was part of larger move by the Government to allow foreign investment in alternative Investment Vehicles and was widely awaited. While it results in opening up a variety of investment opportunities to Foreign Investors, at the same time it provides domestic fund managers with an opportunity to manage these investments. This paper is descriptive one which highlights the real estate sector in India, real estate and infrastructure investment trusts regulations and land governance. This paper presented based on various issues discussed in news letters, crisil report and pwc report.

Key words: Indian real estate, IITs, land governance and RBI

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I INTRODUCTION

The real estate sector in India assumed greater prominence with the liberalisation of the economy, as the consequent increase in business opportunities and labour migration led to rising demand for commercial and housing space. At present, the real estate and construction sectors are playing a crucial role in the overall development of India's core infrastructure. The real estate industry's growth is linked to developments in the retail, hospitality and entertainment (hotels, resorts, cinema theatres) industries, economic services (hospitals, schools) and information technology (IT) - enabled services (like call centres) etc and vice versa. The Indian real estate sector has traditionally been dominated by a number of small regional players with relatively low levels of expertise and/or financial resources. Historically, the sector has not benefited from institutional capital; instead, it has traditionally tapped high net-worth individuals and other informal sources of financing, which has led to low levels of transparency. This scenario underwent a change with in line with the sector's growth, and as of today, the real estate industry's dynamics reflect consumers' expectations of higher quality with India's increasing integration with the global economy.

Residential real estate industry has witnessed stupendous growth in the past few years owing to the following reasons: • Continuous growth in population • Migration towards urban areas • Ample job opportunities in service sectors • Growing income levels • Rise in nuclear families • Easy availability of finance Demand for houses increased considerably whilst supply of houses could not keep pace with demand thereby leading to a steep rise in residential capital values especially in urban areas.

CRISIL Research expects housing shortage to decrease due to the government's thrust on improving rural housing by providing houses to the homeless under various development schemes and by enabling slum redevelopment programmes in urban areas under Jawaharlal Nehru National Urban Renewal Mission (JNNURM). However, housing shortage in urban areas will continue to rise owing to migration towards urban areas and increasing trend of nuclear families. Housing shortage in urban areas is estimated at 19.3 million units at the end of 2008, up from 15.1 million units at the start of 2005. Housing shortage in urban areas is likely to touch a walloping 21.7 million units by the end of 2014. Rural areas, on the other hand, will witness a reduction in housing shortage due to migration and conversion of kutcha houses into pucca houses. The government's continuous focus on improving the housing situation, especially for population below poverty line, under schemes like Indira Awaas Yojna, Rajeev Gandhi Aawaas Yojna, Two Million Housing Programme, is expected to reduce housing shortage in rural areas. Rural housing shortage is expected to decline to 53.8 million units by 2013-14 from 59.4 million units at the end of 2008.

Despite strong fundamentals backing the residential real estate, the segment is highly influenced by economic cycles. Owing to global meltdown, the residential real estate market in India too witnessed an astounding fall in demand and capital values, between first half of 2008 and first half of 2009. However, the sector experienced a pickup in demand during the second half of 2009 across major cities mainly attributed to improvement in economy. Residential projects across cities saw several new mid-income housing projects being launched by developers to attract potential buyers. Demand for houses mounted as the global economy improved bringing back financial confidence to the home buyers along with low interest rates. End-users, who had put their purchasing plans on hold due to the fall in affordability levels and job-related uncertainties, started booking houses. Improvement in demand also brought back the construction activity to back on track.

The commercial office space in India has evolved significantly in the past 10 years due to change in business environment. The growth of commercial real estate has been driven largely by service sectors, especially IT-ITeS. Previously commercial properties were concentrated towards CBD (Central Business District) areas in large cities. However, with the emergence of IT-ITeS, which had huge office space requirement, commercial development started moving towards city suburbs. It resulted in multifold development of city outskirts and suburbs like Gurgaon near New Delhi, Bandra and Malad in Mumbai, and the Electronic city in Bangaluru. In addition, over the last 10 years, locations such as Bengaluru, Gurgaon, Hyderabad, Chennai, Kolkata and Pune have established themselves as emerging destinations for commercial development, which are competing with traditional business destinations such as Mumbai and Delhi. Tax sops on the profits of IT-ITeS companies also led to stupendous development of IT Parks and SEZs. Demand for office space is directly linked to addition in number of employees, which in turn is dependent on economic growth. When economy slows down, companies hold their expansion plans leading to lower demand for office space. The demand for commercial real estate was on an upswing between 2005 and early 2008, driven by exceptionally high employee additions in the IT/ITeS sector. The strong demand from domestic IT/ITeS companies and captives of large global players was a result of increased business, primarily from the US and European markets. A healthy domestic economy coupled with aggressive corporate expansion plans led to strong demand from sectors such as Banking, Financial Services and Insurance (BFSI) and media and entertainment. Furthermore, limited supply of quality office space led to a sharp increase in lease rentals for commercial office space in most micro-markets, with an average increase of 108 per cent between 2005 and early 2008, according to CRISIL Research. CRISIL Research has estimated supply of office space at around 172 million square feet in 10 major cities (Mumbai, NCR, Bangaluru, Kolkata, Chennai, Hyderabad, Pune, Ahmedabad, Chandigarh and Kochi) during 2009-11. Expected demand during the same period is 70 million square feet Supply in the top 10 cities account for approximately 70-75 per cent of total office space supply in the country.

II REGULATIONS

The Reserve Bank of India (RBI) has notified the much-awaited regulations enabling foreign investments under the automatic route in IN-REITs regulated by the Securities and Exchange Board of India (SEBI). Further, the 2016 Budget proposes to rationalise the taxation regime for IN-REITs. Backdrop Real Estate Investment Trusts in India (INREITs) are regulated by the Securities and Exchange Board of India (Real Estate Investment Trusts) Regulations 2014. IN-REITs are required to list and hold rent generating properties in India or invest in Special Purpose Vehicles (SPVs) that hold rent generating properties in India. IN-REITs have been accorded effective tax pass through status, whereby certain specified income of the IN-REITs are taxable in the hands of the unit holders of the IN-REITs – for non-residents relief under the applicable Tax Treaty, if available. There is however, no specific tax exemption on gains from disposal of property. A concessional tax rate of 5% (plus applicable surcharge and education cess) is provided for interest income earned and distributed by the IN-REITs to non-residents. Sale of units of the IN-REITs are subject to a preferential tax regime i.e. long-term capital gains are exempt and short-term capital gains are taxable at 15% (plus applicable surcharge and education cess), subject to conditions. These provisions apply to both residents and non-residents. Recent developments creating a vibrant REIT market has been on the agenda of the Indian Government in recent times. On 6 May 2015, the Union Cabinet approved inclusion of IN-REITs as an eligible financial instrument under the exchange control regulations. The RBI wide notifications dated 16 November 2015 and 15 February 2016 notified the much awaited regulatory policy in this regard. The taxation regime for IN-REITs has further been rationalized by proposals set forth in the Union Budget for Financial Year 2016-17 announced by the Finance Minister on 29 February 2016. The budget proposals are expected to be passed into law in May/ June 2016. The regulatory policy notified by the RBI and the proposed amendment to the taxation regime for IN-REITs is discussed in detail in the following paragraphs. Regulatory framework foreign investment permitted in IN-REITs Persons

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resident outside India, including Registered Foreign Portfolio Investors (RFPI) and Non-resident Indians (NRI), are now permitted to invest in units of IN-REITs.

For this purpose, IN-REITs means an entity registered and regulated by SEBI. It should be noted that no specific regulatory approval would need to be required for the purpose of such investments, subject to satisfaction of the other prescribed conditions. Sale/ transfer/ pledge of units in IN-REITs Such investments can be transferred or sold in any manner or redeemed as per SEBI regulations/ RBI directions. However, the non-resident unit holder may not be able to exit investments in units of IN-REITs by exercising an option/ right to exit. Further, these units could be pledged by the non-resident unit holder to secure credit facilities.

Investments by an IN-REIT shall be regarded as foreign investment only if either the Sponsor, or the Manager, or the Investment Manager, is not Indian-'owned and controlled'. If such investments are treated as foreign owned, they would need to comply with the applicable sectoral caps and other restrictions. For this purpose, ownership and control of companies and Limited Liability Partnership (LLP) are to be determined in accordance with the regulations prescribed. For entities other than companies or LLPs, SEBI shall determine whether or not the entity is foreign owned and controlled.

The payments for the units of an IN-REIT are to be made by an inward remittance through normal banking channels, including by debit to an NRE or an FCNR account. IN-REITs will have to report to RBI or SEBI in the prescribed format. In the Foreign Exchange Management (Permissible Capital Account Transactions) Sponsor, Manager, Investment Manager can be organized in the form of a LLP. Regulations, 2000, 'real estate business' has been regarded as a prohibited sector for foreign investment. These regulations have now been amended to exclude IN-REITs registered and regulated under the existing SEBI regulations, from the ambit of 'real estate business'. This potentially enables the IN-REITs to buy (and sell) real estate directly.

Taxation regime Per SEBI regulations, business trusts can hold the income generating assets either directly or through a SPV. Where the SPV is a company, the SPV is required to withhold Dividend Distribution Tax (DDT) on income distributed to the business trust. There was a representation by the stakeholders that a levy of DDT by the SPV when it distributes its current income to the business trust makes the IN-REIT structure tax inefficient and adversely impacts the rate of return for the investor.

Proposed amendment by the Finance Bill 2016- In order to further rationalize the taxation regime for IN-REITs, the 2016 Finance Bill proposes to provide an exemption from the levy of DDT in respect of dividend declared, distributed or paid by the SPV to the business trust, subject to the following conditions: i. The exemption from a levy of DDT would only be in the cases where the business trust either holds 100% share capital of the SPV or holds all the share capital of the SPV (except which is required to be held by the other entity as part of any direction of any government or specific requirement of any law to this effect). ii. The exemption of DDT shall only be in respect of dividends paid out of current income after the date when the business trust acquires such shareholding in the SPV as referred to in (i) above. The dividends paid out of the accumulated or current profits up to this date as mentioned above shall be liable for DDT.

The amendment will be effective from 1 June 2016. Such dividend received by the business trust and investors shall not be taxable in their hands. Other tax amendments enabling sponsors to transfer shares in SPVs to the IN-REITs tax free were already in place.

III REAL ESTATE AND INFRASTRUCTURE INVESTMENT TRUSTS

The establishment of Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (InvITs) was first proposed by the United Progressive Alliance (UPA) government in 2008, but it wasn't until the BJP government's first Budget (interim Budget) in July 2014 that investment trusts were officially permitted. Aside from assisting the government to move forward key policies such as developing modern infrastructure, trusts are also intended to provide major benefits to investors. The trust structure has numerous advantages and key amongst them are increased transparency, professional management, a steady stream of dividends and access to an alternative source of capital. Increased requirements for public disclosures and a likely rise in institutional investors should see transparency and governance improve, and also necessitate the need for professional management. Countries with mature REIT markets have witnessed advancements in both of these areas following the launch of REITs. From the perspective of developers, including those struggling with debt, REITs can provide another avenue for raising capital and also the opportunity to exit investments. Although investment trusts are now permitted, there are two notable challenges to REIT formations. Firstly, a Dividend Distribution Tax (DDT) of 15% continues to be imposed on the distribution of profits from Special Purpose Vehicles to REITs which drags down overall returns. Secondly, rental yields for many sectors are not attractive relative to risk-free investment options such as government 10-year bonds (yields around 8%). However, with rents in some sectors below previous peak levels, there is significant room for rental appreciation. If we look at the Grade A office sector, rents are currently 15-40% below 2008 peak levels and with an improving economy and corporate sentiment, rents are expected to rise. This coupled with strengthening investor sentiment is also likely to see capital values move higher. Having cleared many major hurdles such as the relaxation of a Minimum Alternative Tax on the transfer of units and approved eligibility as a financial instrument under the Foreign Exchange Management Act (FEMA), we expect the first REIT in India to be launched in the first half of 2016. Developers and other real estate participants are currently lobbying the government on the DDT issue but no change is likely to be made until the next Budget is tabled in early 2016. Some large organisations such as DLF, Blackstone and Brookfield have expressed interest in REIT listings. Based on JLL estimates, we believe the REIT industry has the potential to reach a market capitalisation of USD 15 billion in three years. Firms which operate in the office sector are likely to be the first to seek a REIT listing.

IV AMENDMENTS

Land Acquisition, Rehabilitation and Resettlement (LARR) Bill Land acquisition has often been a major challenge for businesses and governments in India. Difficulty in purchasing land has stalled projects and in some cases resulted in project cancellations. The LARR Act which was introduced and enacted by the previous government put rules and procedures in place for acquiring land and determining fair compensation to sellers. However, the Act had some provisions which discouraged private investors and businesses from buying land. For this reason, the Modi government proposed amendments to the Act in order to make it more business-friendly. The changes put forth by the Modi government aimed to narrow the scope of approval for purchasing land and also to establish special categories of projects to enable faster acquisition of land for projects of a strategic nature. However, the recently concluded session of parliament (August 2015) saw limited progress on Bills central to the BJP platform, including LARR. As a result, it now seems unlikely that the amendments put forth by the government will move ahead as opposition parties strongly oppose the changes. Prime Minister Modi stated at the end of August that his government will let the Land Ordinance lapse. Some political analysts have suggested that the government may agree to leave the Act in its existing form in return for supporting the passage of the GST Bill. Real Estate (Regulation and Development) Bill A lack of adequate transparency and corporate governance has always been a stigma associated with the Indian real estate industry and this has affected market sentiment. The Real Estate (Regulation and Development) Bill, tabled by the previous government in June 2013, aimed to protect property buyers and provide a platform to resolve disputes. However, the initial version had stringent clauses - e.g. restrictions on pre-sales - which were strongly opposed by developers. In a bid to appease both developers and consumers, Modi's government proposed amendments to the Bill. From the consumer standpoint, notable changes include establishing state regulators to resolve disputes; creating a Central Advisory Council to protect consumers, foster growth and development of the real estate industry; and imposing strict penalties on developers for non-compliance with project registration and disclosure of wrong or misleading information. From a developer's viewpoint, the most significant change was the lowering of the minimum requirement of funds held in escrow for pre-sales from 70% to 50%. The Bill was referred to a special parliamentary committee, which accepted relaxing some clauses in order to alleviate developers' concerns while still maintaining its firm position on consumer protection. However, political manoeuvrings did not allow the government to table the Bill in the August session. The recent amendments by the Modi government have brought commercial real estate into the purview of this Bill and should help enhance transparency in the industry and in turn attract more investors. However, one major area not addressed is the slow approvals process of government agencies which often cause delays. Such delays not only postpone construction timetables but can also push up costs

Build Housing for All -The Modi government campaigned on a promise to roll out a low cost housing program that would help alleviate a severe housing shortage. Initiatives announced since taking office include granting infrastructure status to the affordable housing segment in the 2014-15 Budget which will enable lower borrowing costs for developers, and increasing homebuyer loan limits for affordable housing from INR 2.5 million (USD 39,000) to INR 6.5 million (USD 100,000) in metropolitan cities and to INR 5 million (USD 78,000) in other cities. Although progress has been made, detailed information on exactly how this mammoth task will move forward has been limited. The Technical Group on Urban Housing Shortage (a government organisation) estimated in 2012 that there was a deficiency of 18.8 million urban homes in India. Based on this estimate, roughly 2.34 million homes or 750 million sq ft of residential space is needed annually to meet the 2022 goal. During the most recent peak of the real estate cycle in 2008, all leading private developers combined supplied roughly 250 million sq ft of residential space while the previous UPA government only managed to build 1.2 million homes per annum (5.92 million in total) during its last term. While we believe this objective is not insurmountable, it is unlikely to be reached without a clear roadmap and appropriate incentives to encourage private sector participation. In addition, the government needs to streamline its internal approval processes to enhance the viability of such projects and ensure a timely start.

Identify and Develop “Smart Cities” The “Smart Cities” initiative was launched within two months of Mr. Modi becoming Prime Minister, highlighting the importance that cities play in the social and economic development of the country. Nearly one-third of Indians currently live in cities and this number is expected to reach one-half by 2050. From an economic viewpoint, urban areas account for over 60% of national GDP (The Ministry of Urban Development, 2014) and this percentage is continuing to rise. The “Smart Cities” policy attempts to create on a large scale, urban areas that attract investment and provide sustainable, high quality living standards for their residents. The Modi government has targeted to identify 100 cities for potential development by the end of 2017 and has allocated INR 70 billion (USD 1.1 billion) in the recent Budget for this project. In collaboration with an international organisation – Bloomberg Philanthropies - the government is currently short listing cities and each selected city is to receive a INR 1 billion (USD 15.7 million) grant per year over a five-year period. Although success of this project can only be evaluated in the long term, the outcome will be heavily dependent on collaboration between governments and the private sector, and progress on real estate related policies.

V LAND, GOVERNANCE AND CORRUPTION: THE LINKAGES:

Land governance is fundamentally about understanding power and the political economy of land. It involves the ‘rules, processes and structures through which decisions are made about the use of and control over land, the manner in which the decisions are implemented and enforced, and the way that competing interests in land are managed’. Land governance encompasses different decision-makers, processes and structures, including statutory, customary and religious institutions. When taken together as a system, land governance is ultimately centred on how people use and interact with land. Effective and enforceable land governance provides a necessary framework for development and an important defence against many forms of corruption. It supports food security and ensures sustainable livelihoods that are essential for people and countries that rely on land as one of their main economic, social and cultural assets. For example, empirical findings from more than 63 countries show that where corruption in land is less prevalent, it correlates to better development indicators, higher levels of foreign direct investment and increased crop yields. Corruption in land is often the culprit or an offspring of the breakdown of a country's overall governance. Recent findings by TI show that there is a very strong correlation between levels of corruption in the land sector and overall public sector corruption in a country. This result suggests that countries confronting pervasive public sector corruption are also suffering from a corrupt land sector — a finding which has broad and important implications for ensuring the integrity and effectiveness of initiatives related to natural resource management, including climate mitigation projects and agricultural output initiatives. Evidence and consequences Corruption in the land sector can be generally characterised as pervasive and without effective means of control. It can be found in statutory as well as in customary systems. It can vary from small-scale bribes and fraud (e.g. administrative corruption), to high-level abuse of government power and political positions (e.g. political corruption). Corruption, whether administrative or political, does not favour the establishment of long-term national or local land strategies. When corruption is present in the land sector, related actions and decisions are driven by distorted interests and policies that favour the few. Examples of both administrative and political corruption are described in more detail below. Administrative corruption that occurs in public administration and government services is a common feature in the land sector. It can take the form of small bribes that need to be paid to register property, change or forge titles, acquire land information, process cadastral surveys, and generate favourable land use plans. Such bribery is facilitated by complicated processes

VI CONCLUSION

The real estate sector in India assumed greater prominence with the liberalisation of the economy, as the consequent increase in business opportunities and labour migration led to rising demand for commercial and housing space. At present, the real estate and construction sectors are playing a crucial role in the overall development of India's core infrastructure. The introduction of the regulations to permit foreign investment in IN-REITs by the RBI was part of larger move by the Government to allow foreign investment in alternative Investment Vehicles and was widely awaited. While it results in opening up a variety of investment opportunities to Foreign Investors, at the same time it provides domestic fund managers with an opportunity to manage these investments. More importantly, it could help in providing much needed liquidity by providing an alternative source of finance to the real estate sector. With respect to taxation, the levy of DDT on distributions by the SPV was seen by the industry as a final hurdle to the successful listing of REITs in India. Hence, rationalizing the taxation regime for IN-REITs by exempting DDT on income distributions by the SPV is a welcome move as it results in improved yields for the investor, and is expected to herald the successful launch of REITs in the not too distant future

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