Ratings

CRISIL
An S&P Global Company

India's REIT Opportunity

Rs 1.5 lakh crore proposition for global private equities as investment horizon and rules align

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Executive summary

India's commercial realty market has been on an upswing over the past few years. Well-managed, high-quality properties with an average tenancy of three years and nearly 90% stable occupancy have good cash flow visibility. They have, therefore, seen more investments by global private equity (PE) funds. Commercial real estate continues to see positive trajectory with improved profitability and comfortable leverage. Over the next 2-3 years, too, well-managed Grade A properties are likely to see 5-10% escalations per annum.

India's top 10 commercial real estate owners alone, which include both developers and funds, have a portfolio of around 184 million square feet (msf) translating into an annual lease rental income of over Rs 17,000 crore. The portfolio of steady cash flows has the potential to raise as much as Rs 1.5 lakh crore through the real estate investment trust (REIT) route.

While investor interest in the residential segment is declining fast because of limited property price appreciation and inability to monetise assets, REITs can be a potential investment option, providing assured and ongoing returns. REITs, which invest primarily in completed, income-yielding real estate assets, are similar to mutual funds, and can be listed and traded on stock exchanges. Through REITs, PEs can divest at the portfolio level instead of individual assets. This would sync better with their typical exit timelines of 7-10 years.

Developers stand to benefit as REITs provide higher upfront cash to asset holders, which will help partly ease the pressure on their balance sheets. They can use the divestment proceeds to reduce debt and sustain construction activity. This will also improve their credit profiles, as seen in India's first REIT, Embassy Office Park REIT – listed in April 2019.

While regulations allow REITs to have a minimum asset valuation of Rs 500 crore, not all commercial portfolio developers/ owners will take the route. Portfolios with minimum rentals of over Rs 1,000 crore, translating into asset valuation of Rs 10,000 crore, which can absorb higher transaction costs and comply with regulations, are more likely to use this option.

REITs account for nearly 50% of the capitalisation of the real estate industry in markets such as Singapore and Japan, where they were introduced nearly two decades ago, while they account for 96% of the market capitalisation in the US which pioneered REITs in 1960s. These trends also underpin the opportunity for India considering the real estate sector's market capitalisation (cap) of nearly Rs 1.5 lakh crore (ex-REITs). However, lack of incentives or regulatory support, like in Hong Kong, can restrict this growth. REITs were introduced in India in 2014, and over the five years a spate of regulatory changes have made it attractive to developers while also protecting the interests of investors.

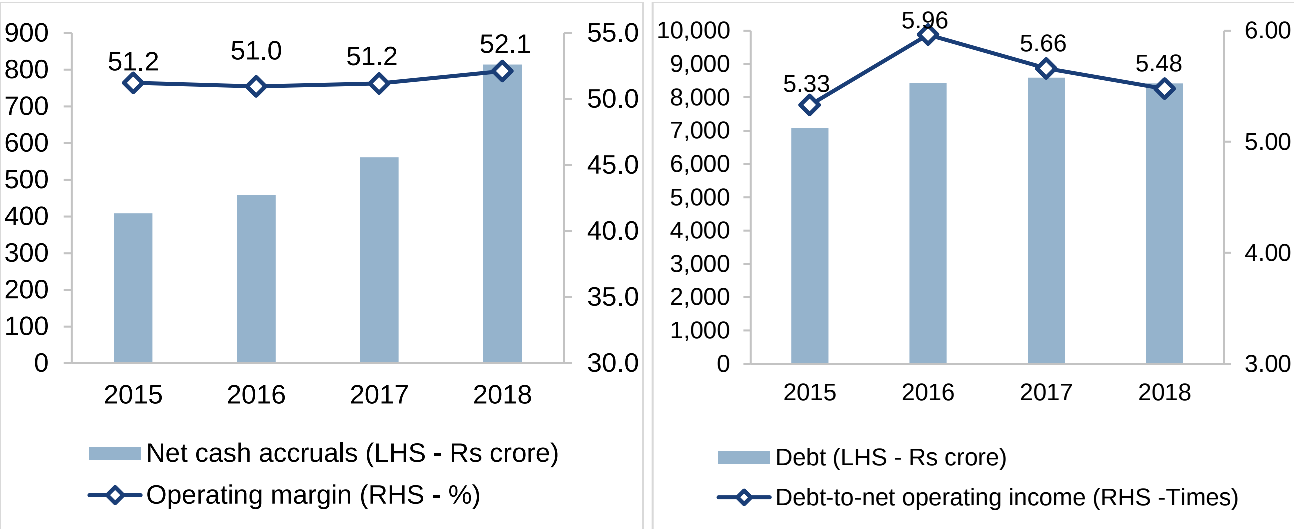
However, given the high level of compliance and stringent regulatory requirements for REITs, developers with smaller commercial portfolios would continue to use lease rental discounting loans, which are accessible at rates as low as 9%. Furthermore, developers who prefer to retain the capital appreciation opportunity and not dilute their stake, will not prefer the REIT route.

Commercial realty maintains positive trajectory

The real estate sector can be divided into two categories: residential and commercial real estate (CRE). The latter comprises properties that are used exclusively for business purposes with the intent to generate returns through rental revenue and capital appreciation. Based on functionality, CRE can be further divided into office, retail, industrial, and hotel.

Profitability has improved for operational commercial assets given low vacancy rates and consistent improvement in rentals, while debt has remained comfortable below 6 times the net operating income.

Operating and financial metrics of operational commercial assets

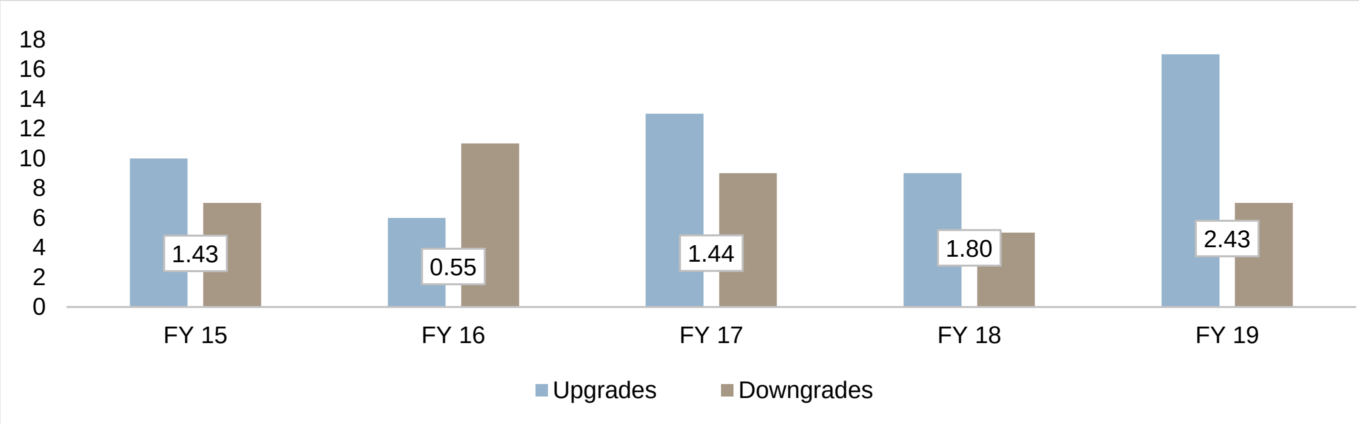


Source: CRISIL Ratings' analysis of 40 companies from its rated operational commercial real estate properties

Given the favourable commercial trend, developers with lease rental portfolio have embraced multiple alternative modes of funding, while deleveraging their balance sheets in recent times. This is evident from the fact that out of almost Rs 75,000 crore of PE investment in the sector in the past three years, as much as 70% has been parked in commercial and retail portfolios of developers.

This has had a positive bearing on the credit profile of such assets, with the credit ratio well above 1.0 time for the past three years.

Credit ratio – commercial real estate



Source: CRISIL Ratings

From the data set of over 700 CRISIL-rated companies in the real estate sector, of which around 10% are operating commercial entities

The trend is expected to hold across cities going forward as well. Vacancy levels for Grade A offices are in a low-to-moderate range across cities. This will work in favour of commercial lease rentals, which, we believe, are likely to escalate at 5-10% per annum over the next 2-3 years.

Supply and demand sync, occupancy and rentals to remain strong

For Grade A offices	Unit	Bengaluru	NCR*	MMR	Pune
Estimated supply addition in 2019-2021	msf	15-17	15-17	8-10	7-9
Estimated demand in 2019-2021	msf	16-18	12-14	10-12	7-9
Existing office stock	msf	130-135	100-105	85-87	47-49
Prevailing vacancy	%	5-10%	25-30%	15-20%	5-10%
Estimated lease escalation per year (for next three years)	%	7-10%	3-5%	3-5%	3-7%

Source: CRISIL Research

**Excluding Noida, Greater Noida micro market has a high inventory, the rest of the locations have moderate inventory and supply-demand is in balance*

What is a REIT?

A REIT is an investment trust that owns real estate assets. It is created by a sponsor, who transfers the ownership of the assets from a special purpose vehicle (SPV) to a REIT in exchange of its units. The sponsor is obligated to hold certain units of the REIT. The remaining units are issued to investors through a public issue of the REIT. The initial public offering (IPO) proceeds accrue to the sponsor who sells units of the REIT. Subsequently, tenants of the assets owned by the REIT will pay lease rentals to the SPV that manages the asset. After statutory dues and tax deductions, lease rentals flow to the REIT and it distributes at least 90% of net distributable cash flows as dividend to the unit holders. In this way, REITs provide retail investors with an opportunity to invest in commercial real estate and generate a stable rental income.

Advantages of REIT

Demand side – Investors	Supply side – Developers / PEs
• Steady returns • Good capital appreciation opportunity • Low risk • Low ticket size of investment	• Monetises the portfolio of operational assets • Unlocks capital and deleverages balance sheets • Improved regulations • High credit quality and low cost of capital

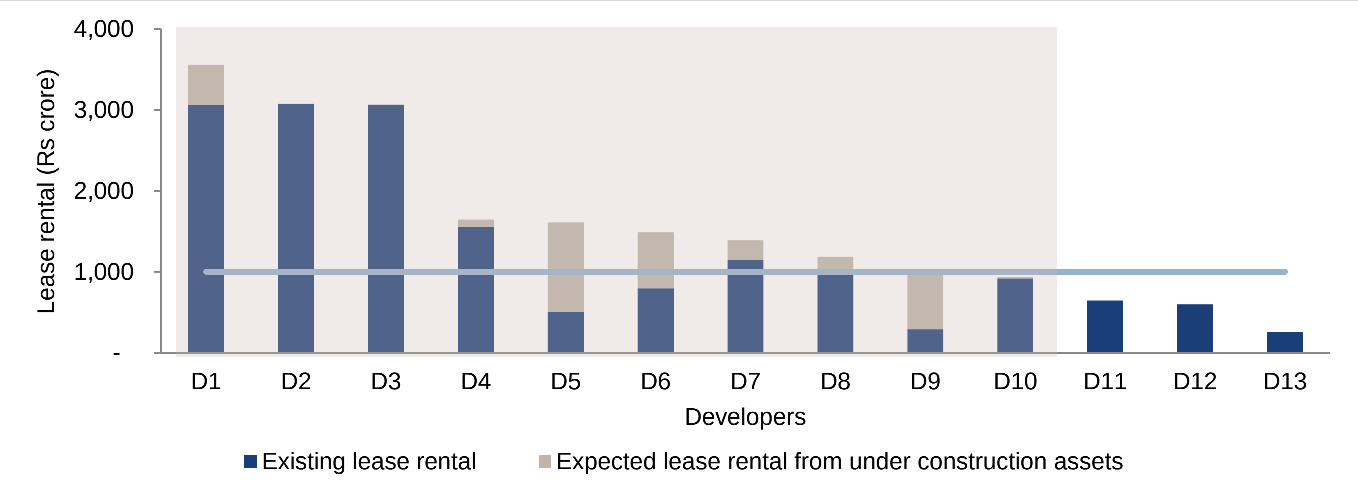
Top 10 developers can monetise 184 msf via REITs

Our analysis shows that the top 10 commercial real estate developers and operators in the country can raise as much as Rs 1.5 lakh crore through the REIT route by monetising 184 msf space assuming a capitalisation rate of 8.5% and stake dilution of 75%[1].

These assets, with annual lease rentals of around Rs 17,000 crore, represent around 30% of Grade A properties across major micro markets in the country.

We believe portfolios with annual rentals of over Rs 1,000 crore, translating into a minimum asset valuation of Rs 10,000 crore, can absorb higher transaction costs and comply with regulations, and are more likely to use this option.

Players with high likelihood of raising funds through REIT



Source: CRISIL Ratings

[1] As per regulations, sponsors are required to hold at least 25% of total units post issue for minimum three years.

A snapshot of the first Indian REIT

The first REIT was issued by BRE Mauritius Investments (part of the Blackstone group) and Embassy Property Development Pvt. Ltd (part of the Embassy group) in late March 2019. The issue was oversubscribed and logged returns of nearly 21% in the past six months. Compare that with the S&P BSE Realty Index, which is down 2%. After the success of the first India REIT (In-REIT), few players are in talks to launch the next REITs.

Snapshot of Embassy Office Parks REIT (rated CRISIL AAA/Stable)

11 commercial properties + **4 hotels + solar park** ➡ **23 msf operational leasable area** ➡ **4 major micro markets** ➡ **>Rs 30,000 crore (market value as of August 2019)**

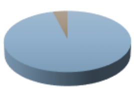
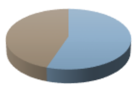
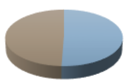
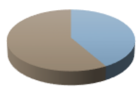
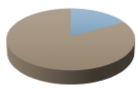
In May 2019, CRISIL assigned a rating of 'CRISIL AAA/Stable' to the non-convertible debentures (NCDs) of Embassy Office Parks Reit (Embassy REIT). It has 11 commercial assets (office parks and city-centric offices), four hotels, and a solar plant. The rating reflects Embassy REIT's comfortable loan-to-value ratio, driven by low debt and significant deleveraging of the underlying SPV; strong debt protection metrics, supported by a cap on incremental borrowing; and stable revenue from the underlying assets, given high occupancy and geographical diversification. These strengths are partially offset by susceptibility to volatility in the real estate sector, resulting in fluctuations in rental rates and occupancy.

A comparison with REITs globally shows India's potential

In-REIT is a recent phenomenon. Therefore, in order to gauge its potential and understand the challenges and opportunities, a comparative study with other established REIT markets in Asia provides some perspective. The study also considers the US-REIT market, which is more mature and could act as a benchmark for In-REIT.

REITs have come a long way since these were introduced in the US in 1960 to provide retail investors access to income-producing real estate and enhance liquidity in this space. Today, REITs are an investment vehicle in over 37 countries.

Global REIT market at a glance

	USA	Singapore	Japan	Hong Kong	Malaysia	India
Year of introduction	1960	2001	2001	2003	2007	2014
No. of publicly-traded REITs	194	44	62	11	18	1
Market capitalisation of REITs (US$ bn)	1232	76	148	35	9	4
Market capitalisation of real estate sector (US$ bn)	1284	137	292	585	22	24
REIT as a % of real estate	 REIT Mcap 96% Other Real Estate 4%	 REIT Mcap 55 % Other Real Estate 45%	 REIT Mcap 51% Other Real Estate 49%	 REIT Mcap 6% Other Real Estate 94%	 REIT Mcap 42% Other Real Estate 58%	 REIT Mcap 17% Other Real Estate 83%

Source: S&P CapIQ as of August 2019

The REIT structure differs across countries owing to differences in governance, legislation and demographics. The implemented structure has played a key role in the development of REITs in these countries.

In the US, REIT has a market cap of over $1.2 trillion, accounting for 96% of the entire real estate industry.

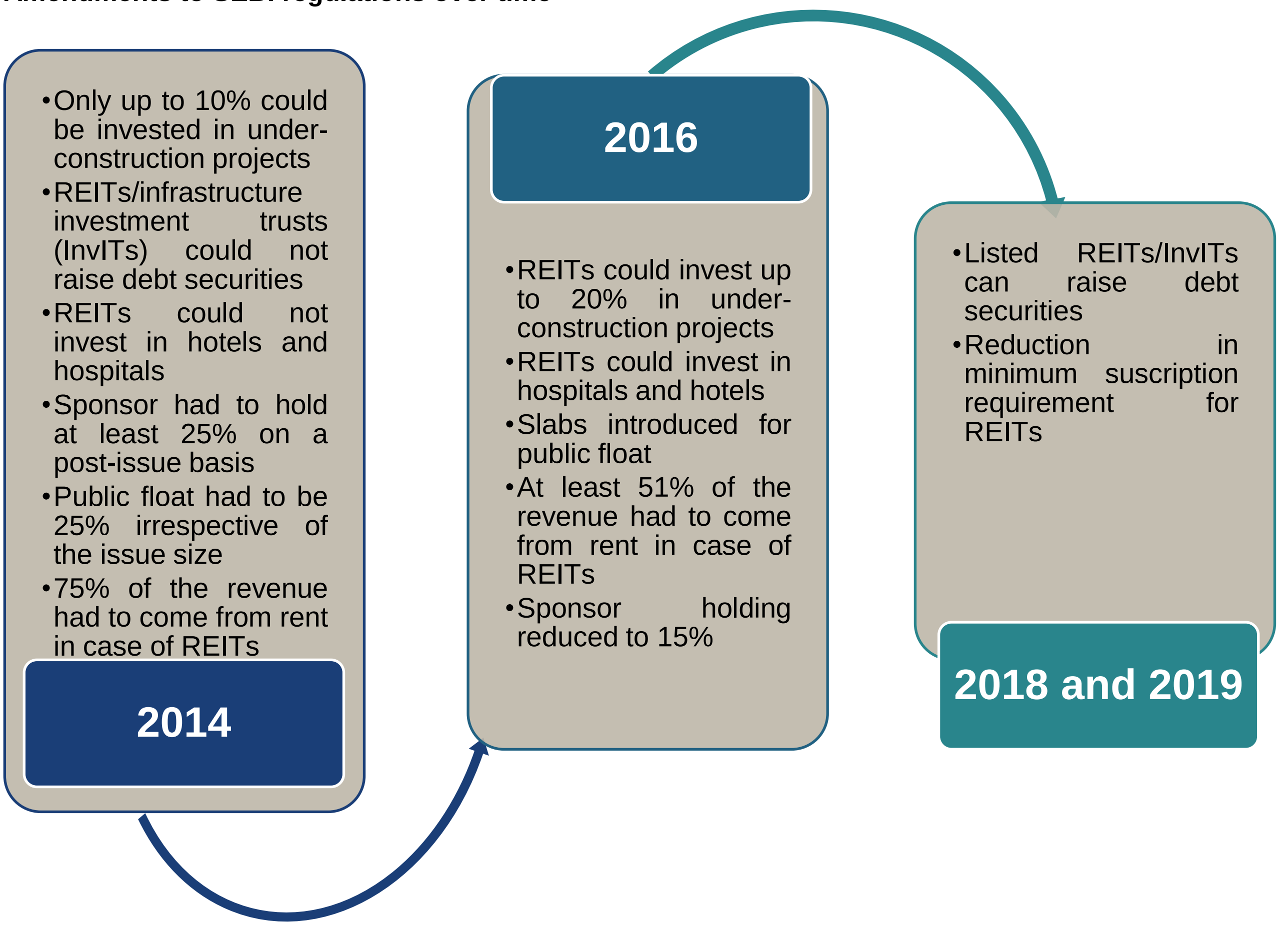
In Singapore and Japan, where it was introduced nearly two decades ago, REIT accounts for nearly 50% of the real estate industry's capitalisation.

However, Hong Kong – where it was introduced at the same time as in Singapore and Japan – has an underdeveloped market, with only 11 REIT issues since inception. This can be attributed to the lack of tax incentives for REITs and lack of regulatory support to sponsors, unlike in Singapore and Japan, which have introduced reforms continuously to promote the REIT market.

Slow and steady – REITs in India follow global trend

REITs, introduced in India by the Securities and Exchange Board of India (SEBI) in 2014, had trouble getting off the ground. India saw its first REIT – Embassy Office Parks – in March 2019, after nearly five years and five sets of amendments to SEBI's original REIT Regulations of 2014 and multiple tax tweaks.

Amendments to SEBI regulations over time



Source: SEBI

India is not alone in its experience of a sluggish start to the REIT regime. For instance, in the US, even though the first REIT was set up in 1961, it took several decades for REITs to be accepted as an investment vehicle.

Similarly, Singapore's first REIT listing was REIT Capital Land Mall Trust in 2002, following the introduction of a regulatory framework for S-REITs in 1999. Japan had two REITs within the first year of REIT regulation in 2000. Since then Singapore and Japan have given impetus to the REIT market by providing tax incentives and clear regulatory frameworks that support both sponsors and investors. Resultantly, the industry's market value increased at a compound annual growth rate (CAGR) of 22% in Singapore in the past 10 years.

Country	Timeline					
 USA	1960	1965	1969-74	1986	1989	1991
	The Congress introduced a legislation for REITs	First REIT listed on the NYSE	Mortgage REITs fuelled the first REIT expansion	Tax reforms and REIT simplification	Dramatic real estate downturn	Kimco's IPO launched the modern REIT era
 Singapore	1999	2002	2005	2009	2018	2019
	Regulatory regime for REIT established	CapitaMall Trust is the first listed S-REIT	Five REITs issued	Regulatory support to REITs during the financial crisis	Removal of withholding tax of 17% for S-REIT ETFs	S-REITs' market cap increased at 22% CAGR in the past 10 years
 Japan	2000	2001	2007	2012	2014	2019
	REITs framework introduced	Two REITs listed publicly on the Tokyo Stock Exchange	REITs issuance in Japan increased steadily to 42	Listed REITs dropped to 33 owing to consolidation following the financial crisis	Operational REITs increased to 46 in two years after no public REIT issue for five years	Japan has over $150 billion REIT market capwith 62 listed REITs

Sources: National Association of Real Estate Investment Trust (NAREIT), US, The REIT Association of Singapore (REITAS) and the Association of Real Estate Securitization (ARES), Japan

Thus, a slow and sluggish start for In-REITs is in line with developed market counterparts and may be attributed to lack of investor familiarity with the vehicle and setting up of a responsive regulatory framework. If India continues to evolve its REIT regulations in response to market requirements, as seen in the case of Japan and Singapore during the financial crisis and thereafter, we can expect more REITs in the coming years.

REITs have inbuilt provisions to safeguard investor interest and add to credit quality

REITs offer a new investment opportunity to retail investors who currently find it difficult to invest in commercial real estate assets on account of high capital costs and in the residential segment owing to low/negligible returns.

Unlike other equity investments, REITs provide assured returns to investors through compulsory dividend distribution. REITs have to mandatorily distribute 90% of the net distributable income as dividend. Further, there is a potential upside available to the investors based on periodic valuation of property.

REITs are expected to avail debt to stimulate growth and improve shareholder returns. However, in order to avoid financial stress, SEBI has imposed restrictions on leverage at 49% of the value of the REITs' assets. Also, if the leverage exceeds 25% of the asset value, credit rating and approval from majority of shareholders are mandatory.

Trustee and manager-monitored operations, rent-generating asset mix (only up to 20% of the total investment can be towards under-construction assets), listing requirements, mandatory disclosures, an escrow mechanism with at least 90% income distributed and minimum capital requirements are provisions embedded to protect the interests of investors, and are expected to create optimism about REITs as investments and add to their creditworthiness.

Some bottlenecks remain

In-REITs, however, do face some operational challenges. The fragmented and opaque real estate market could pose a hindrance to the expansion of the REIT market in India.

Given the high level of compliance and stringent regulatory requirements for REITs, developers with smaller commercial portfolios may continue to use lease rental discounting loans, which can provide funding of 5-6 times the net lease income and are accessible at rates as low as 9% currently.

REITs also currently limit the access of banks and insurance companies to the real estate sector.

Developers who prefer to retain the capital appreciation opportunity and not dilute their stake will not favour REITs.

However, given the success of the first REIT, there is confidence in the market and we believe a few more REITs will see the light of the day over the medium term.

About CRISIL Limited

CRISIL is a leading, agile and innovative global analytics company driven by its mission of making markets function better.

It is India's foremost provider of ratings, data, research, analytics and solutions, with a strong track record of growth, culture of innovation and global footprint.

It has delivered independent opinions, actionable insights, and efficient solutions to over 100,000 customers.

It is majority owned by S&P Global Inc, a leading provider of transparent and independent ratings, benchmarks, analytics and data to the capital and commodity markets worldwide.

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