Are Managers Ready For REITs in India?

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How to break up the total return from investing in an asset into income versus appreciation is an investor's personal preference. Different investors select their investments accordingly. For example, real estate speculators and flippers strive to maximise the appreciation return component while pension funds prefer maximising the income return. What if an investment restricts the appreciation return? That is pretty much a story of REITs (Real Estate Investment Trust).

In most countries (except some, such as Pakistan), REITs are designed to generate income return while appreciation returns are discouraged. Differently put, the appreciation component of the total return is minimal for REITs. So is the proposed structure in India as well. A REIT will acquire properties, slice it into smaller pieces of equity shares, and operate the property to fulfill the equity holders' expectations. The focus of operations will be on maintaining healthy rent rolls rather than the gains from sale. After all, a REIT will not have much cash on its disposal to stay in a business of buying and subsequently selling real estate assets. By law, a REIT must distribute most of its income among shareholders as dividends. So much about the anatomy of REITs. Now, let us move on to their analysis.

Meeting Investor Expectations
Consider a REIT with several apartment units. Roughly speaking, an apartment unit worth Rs 1 crore owned by a REIT can generate nearly Rs. 25,000 per month in rent. The REIT would incur, let us say, Rs 5,000 in apartment-related expenses (maintenance, management fees, etc.). That leaves, Rs. 2,40,000 in annual income from the asset. This is 2.4 per cent return on the asset. From a portfolio perspective, the REIT will experience some vacancy loss as well, say 5 per cent. That reduces the income return to 2.3 per cent.

Optimistically, let us assume that Indian REITs are finally exempt from all income taxes and that net rental yield is 2.5 per cent. This does not seem sufficient. (It is worth mentioning that the rental yield will be scrutinised on the current value of the asset, not the historical value).

The proposed government draft mandates a REIT to be listed on a stock exchange. That means, REITs have to compete with other stocks. Let us say that the stock market yields an average total return of 15 per cent. To catch up with such a return, REITs must generate an additional 12.5 per cent. Other commercial properties in India, such as offices enjoy a relatively higher rental yield (6-10 per cent). Yet, a higher yield of, say 8 per cent, is unable to match the general stockmarket returns. If income returns are exhausted, the only respite is appreciation return. But, a REIT must focus on income returns because short term capital gains on a regular basis are discouraged.

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There is little doubt that the value of the properties held by REITs will keep up with the property market. May be, the value appreciation in more professionally managed REITs will surpass the market. But, unless the appreciation is realised through actual sales, how will the equity investors benefit from it? There are at least two possibilities. First, REITs must also focus on value appreciation; and maintain a pipeline of assets to be sold so that some appreciation gains could be realised continuously. This still leaves young REITs in a limbo given the restrictions on short-term capital gains.

(From left) Prashant Das and Divyanshu Sharma

Second, one could hope that the apartment price appreciation would reflect in net asset value (NAV) of the REIT and such implied gains may be priced into shares. The empirical evidence, however, has been against this. The disparity between property prices and corresponding REIT stock prices is well known. Real estate markets are illiquid in general and REITs face trading-constraints in particular. Tobias Mühlhofer (University of Texas at Austin) reports this finding in his recent (2013) research: "REIT returns consistently reflect property income returns, but not property appreciation returns".

There is a third possibility as well: riding on the human behaviour. A recent study found that Singapore REIT prices are driven up by noise traders' herding mentality. In particular, when the REIT stock price is higher than the NAV (per stock), investors widen the wedge between the two types of valuation. Perhaps, a self-fulfilling prophecy. Investor herding (read sentiments) or "Irrational Exuberance", as the Nobel laureate Robert Shiller would have put it, is known to drive markets bullish. However, let us not forget that sentiment is a double-edged sword which can move in either direction. Any conscious effort to shape the market sentiments without working on the fundamentals is irresponsible and risky, at best.

The Road Ahead
The success of REITs in India depends on a few critical factors: acceptance of REIT model by households and businesses and regulatory incentives for REITs. As SEBI is wisely lobbying for, REITs must enjoy special tax treatments, not only in regular income; but also on capital gains. Moreover, a case has to be made for strengthening the rental yield. Controlling the property prices (an evil that exists), increasing the appeal of rental assets are some obvious solutions. Rental occupancy is faced with socio-cultural challenges in the residential sector, but there is much to learn from continental Europe. Adding impetus to the current rental markets by, for example, longer term-leases will provide piece of mind to the tenants and financial stability to REITs. Moreover, tenants may be willing to pay premium rents. Rent premiums could be further strengthened by packaging the REIT properties favorably with useful amenities and features. The current demand for REITs for exemption from stamp-duty from acquisitions and capital gains from dispositions seems almost a must.

An understanding of the dynamics between space markets, asset markets, capital markets and development industry is a must for managing REITs. Finance researchers often exclude REITs from their sample since REITs are a "different animal". Clearly, the specialised knowledge of real estate which is often absent from the mainstream business education is a pre-requisite to REIT management. The good news is, India is moving in the right direction.

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