8 REAL ESTATE INVESTMENT TRUST (REIT) AND REMS

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LEARNING OBJECTIVE

After studying this chapter, you should be able to:

- Describe the concept and structure of REITs
- Define the different types of REITs
- Understand the guidelines of REITs in India
- Elaborate the concept of Real Estate Mutual Funds and how they are different from REITs

KEY TERMS

This chapter features these terms which you should strive to do more research about:

Equity REITs	REMFs	Mortgage REITs
Retail REITs	Hybrid REITs	REIT Risk

INTRODUCTION TO REAL ESTATE INVESTMENT TRUST

A Real Estate Investment Trust (REIT) is a corporation or trust that pools the capital of many investors to purchase income property (Equity REIT) and/or mortgage loans (Mortgage REIT). An equity REIT owns and manages property, as opposed to a Mortgage REIT which purchases mortgages and may also borrow money from banks to lend again at higher interest rates.

REITs are eligible for corporate income tax exemptions, and in return, REITs are required to distribute 90% of their income. This may be taxable in the hands of the investors. The REIT structure was designed to provide a similar structure for investment in real estate as mutual funds provide for investment in stocks.

History: Prior to 1960, only wealthy individuals and corporations had the financial resources necessary to invest in significant real estate projects such as shopping malls, corporate parks and health care facilities.

In response, US Congress passed the Real Estate Investment Trust Act of 1960. The legislation exempted these special-purpose companies from corporate income tax if certain criterion were met. It was hoped that the financial incentive would cause investors to pool their resources together to form companies with significant real estate assets, providing the same opportunities to the average American as were available to the elite. Three years later, the first REIT. These restrictions were lifted in the Tax Reform Act of 1986. Thirteen years later, in 1999, the REIT Modernization Act was passed.

Types of REITS

Equity REITs: The term Equity REIT refers to a corporate entity that is engaged in the acquisition, management, building, renovation, and sale of real estate. This type of real estate investment trust offers the greatest potential of reward and as such tends to be favored by professional money managers. Equity REITs often operate in a specific area of expertise.

Some examples include:

Residential REITs: This type of REIT specializes in apartment buildings and/or other residential properties leased to individuals. The biggest danger for residential REITs is over construction within a particular geographic area during a declining economic environment.

Retail REITs: There are a number of specialties in the field of retail REITs, including malls and shopping centers. The particular benefit for the former is that construction costs are significant; measured in the tens or hundreds of millions of dollars. This high barrier-of-entry cost helps keep control expansion, making excess supply a lesser concern.

Office and Industrial REITs: The office sector of the real estate investment trust market has historically been the largest. The primary drawback is the fact that office rents normally have much longer lease terms meaning that in times of declining rent and lower occupancy, those tenants that do sign leases will have lower, less-profitable rates locked in for many years. This can also be a blessing, however, if a property is filled during a time of short supply and high demand. Office REITs are, as can be imagined, highly cyclical. Industrial REITs, on the other hand, tend to generate steady, predictable cash flow thanks to high lease renewal rates and low capital expenditure and maintenance requirements.

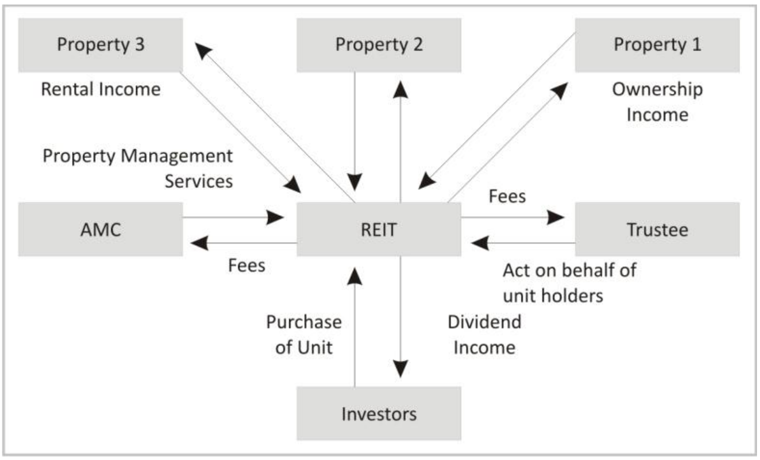
Health Care REITs: Health care REITs build, acquire and lease specialty buildings such a hospitals, nursing homes, medical buildings and assisted-living facilities. This REIT sector is fairly immune to recession, although they are largely dependent upon the financial health of the lessee which, in turn, relies on the medical reimbursements provided by the U.S. Government. Federal changing in health policy would obviously have a significant effect on health care REITs.

Hotel and Resort REITs: In the world of real estate investing, the hotel and resort sector is the one most closely tied to the overall economy. When times are bad, people travel less for business and pleasure, cutting right to the heart of these company's bottom-lines. As a result, investors in hotel

REITs have to concern themselves not only with overbuilding, but the economic outlook of both the geographic area in which the hotel or resort is located, as well as that of the entire country as well.

Mortgage REITs: A Mortgage REIT is a company that specializes in underwriting, acquiring and holding debt obligations guaranteed by real estate properties. Mortgage REITs are essentially loan portfolios as opposed to ownership of the asset, as is the case with their equity counterparts.

Hybrid REITs: A REIT is referred to as a hybrid when it has both equity and mortgage components. Although not as heavily favored by investment advisors as pure equity REITs, they are still attractive investment alternatives.



REIT Structure

A REIT will be structured in a way similar to a mutual fund. The sponsor company (trustee) will need to set up a Real Estate Investment Management Company (AMC) that will manage the funds on a day-to-day basis and will report to a REIT; in whose hands your money will be entrusted. The AMC and the trust will then launch real estate schemes that will solicit monies to be invested in real estate projects. The schemes will only be closed-end and will be listed on the stock exchanges within six months of their launch.

A REIT will then invest the money it collects in various real estate projects. It will not be allowed to invest in equity and debt securities of real-estate companies; it must invest only in real estate directly. REITs will not be allowed to invest in vacant plots either. They would need to invest in developed properties that they can then rent out. The rental income from these will be-the unit holder's-returns. So, these are essentially income-earning rather than capital-growing instruments.

Advantages: To Investors and Developers

To Investors

Liquidity: REITs offer the most liquid way to invest in real estate. REIT shares are traded daily on a national exchange, so, unlike actual real estate, they can be bought and sold at any time

Portfolio Diversification: REITs have been shown to add diversification benefits to portfolios with stock and bond exposure. REIT returns historically have a low correlation to the returns of large stocks, small stocks and bonds. Adding REITs to a portfolio with exposure to stocks and bonds has improved returns and decreased risk. Diversification to manage risk is achieved by investing in different types of REITs, as well as selecting REITs that invest in different geographical areas.

Dividends: REITs are normally exempt from corporate income taxes, as long as they distribute at least 90% of their net taxable income as dividends to shareholders. Average yields typically range from 5% for shopping center REITs to 6.6% for office REITs.

To Developers

Exit Option: REITs opens up another avenue for developers to unlock value from their income generating properties by transferring their properties to REITs. They are especially beneficial to small developers who are hit by the credit squeeze and restriction on foreign capital infusion.

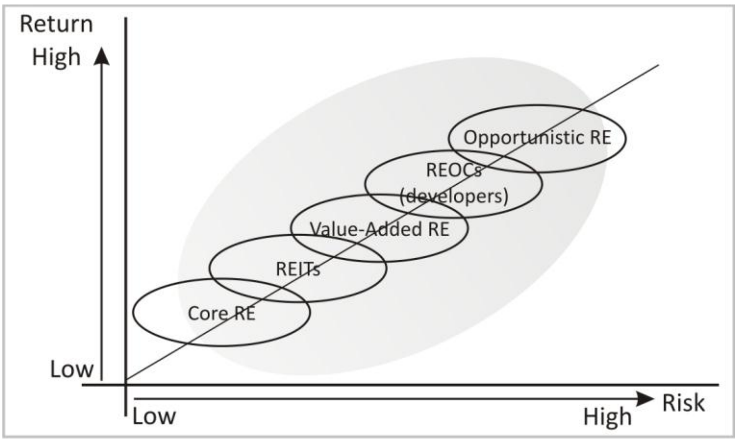
REIT Risk

- In a fast rising market, many REITs overpay and rely too much on future rent increases to make purchases pay off. The buildings owned by the trust may not generate enough cash flow to carry them. Resulting in a drop in income and fall in share value.
- If the stock market slips, in general, REITs slide down in tandem even if they have great assets.
- In order to control the maximum assets, REITs usually invest in highly leveraged properties resulting in high risk.

Relative Risk and Return

Real estate investment spans much of the risk-return spectrum. As depicted in Exhibit below there is a wide spectrum of real estate investment strategies that range from core investing at the low-risk-low-return end to opportunistic strategies at the high-risk-high-return end. Public real estate investment, either REITs or other listed Real Estate Operating Companies (REOCs) are positioned between the two ends, given their generally perceived risk-and-return characteristics. Our placement of REITs is in the middle of the spectrum, yet above core real estate. REITs normally employ more leverage than core private funds, tend to be riskier and are expected to generate higher returns.

But they are generally considered to be less risky than value-added real estate. One value-added strategy worth noting is to invest in properties that are not considered core at the time of acquisition for various reasons, such as having significantly below-market occupancy, requiring substantial capital improvements, or being located in distressed markets but with promising recovery potential. Through successful execution of upgrading and repositioning strategies, the value added properties can potentially be improved to achieve core status and be sold to investors in core real estate. Similarly, undesirable market dynamics such as a prolonged economic downturn and the deterioration of environmental quality, for example, could transform a core asset into a non-core one.



The above framework serves only as a general guideline and is certainly subject to debate. One could argue that positions for different strategies could vary from country to country. For example, REITs in some countries tend to have far less debt than others, sometimes due to regulatory limits, and are thus less risky than more highly levered REITs. In addition, certain REITs with high leverage, with unproven, risky strategies, specializing in less conventional property types, or any combination of these factors, might well be considered much riskier than an open-end fund focused on a value added strategy.

Moreover, not all REOCs are riskier than REITs, although it is generally true that they tend to have more volatile earnings and lower dividend payouts. In contrast, opportunity funds, free to use high debt levels, deploy creative strategies that might include acquiring non-performing loans backed by real estate, or investment in high-tech real-estate-related startups, and, usually having little liquidity for their closed-end units, are clearly at the high end of the spectrum.

These funds can be attractive to those investors with greater tolerance for risk and who are attracted by a strategy often to target returns in excess of 20% per annum.

REITs IN INDIA

REITs is an investment vehicle, similar to a Mutual fund, which is formed by way of a Trust structure registered under the Indian Trusts Act, 1882 and approved by the SEBI. It is a unique instrument by way of which retail investor can be part of the real estate boom in India today by investing in units of REIT's. REIT's shall be managed by a professional real estate investment management company and shall be appointed by the Trustee's.

The Securities and Exchange Board of India (SEBI) has recently issued draft guidelines on Real Estate Investment Trust (REIT) for public comment.

The salient features of REIT draft guidelines are:

- The REIT scheme will be managed by a Real Estate Investment Management Company (REIMC) incorporated in India with the objective of organizing, operating and managing real estate investment schemes.
- REIMC will be managed by its trustee, which can be a scheduled bank, trust company, financial institutions, insurance company or a body corporate. However, individuals cannot act as trustee.
- The minimum net worth of REIT and REIMC will be Rs30 million which will be increased to Rs50 million over a period of 3 years.
- Only close ended schemes with a purpose of investing in income generating real estate properties is permissible. However the units of these trusts will be traded on stock exchange and NAV would be disclosed annually based on property valuer's report.
- Investment in partly developed properties is to be allowed only up to 20 percent of its total assets.
- It cannot invest more than 15 percent in any single real estate project and not more than 25 percent in real estate projects developed, marketed, owned or financed by a group of companies
- Investment in vacant land and engaging in property development activity is prohibited.
- Restrictions have been imposed on the borrowings to be made by the fund which has been restricted to 20 percent of the total value of the asset.
- At least 90 percent of the annual net income after tax is to be distributed as dividends each year to unit holders

REITs and Mutual Funds/ Collective Investment Schemes

While mutual funds may be open-ended, REITs are closed-end funds. As such, REITs are typically listed and their market values may or may not be their NAVs.

Owing to nature of their assets, computation of NAVs by REITs is different from that by securities mutual funds

REITs are income-oriented .Investors relying on regular income have incentive to invest in REITs.

- Statutorily, REITs distribute substantial part of their taxable profits.
- REITs and Taxes: REITs do not have to pay federal taxes at the corporate level
- More specifically, REITs are allowed to deduct dividends paid to shareholders from taxable income, and thus have the ability to shield 100% of taxable income through distributions to shareholders
- No other firm in the economy can deduct dividends
- REIT shareholders still have to pay taxes on dividends and capital gains.
- Most states honor the REIT status and don't require REITs to pay state taxes

SEBI draft is mum on tax aspects for both REITs as well as unit holders. Normally REITs are tax exempted instrument world over and so tax benefits would be crucial for success of REITs in India. Moreover clarity on property taxes on property held in trust would be required.

Though REITs in India still have a long way to go, if successful it will expedite the development of the real estate industry by providing small scale investor's access to commercial property returns without substantial capital outlays. The infusion of capital will enable relatively smaller property developer's greater access to capital and will bring in much needed transparency in the sector

The primary difference between Real Estate Investment Trusts and a mutual fund is that investments made in the former are traded in real estate stocks and not invested in company stocks moreover they provides a heavier liquidity than the mutual funds.

REAL ESTATE MUTUAL FUND (REMF)

Real estate investment is one of the best avenues to create wealth. Property prices are always on the upward journey and from the long term perspective they always stay a few percentage points above the general inflation levels. As a smart investor you must ensure that your money outdoes inflation by choosing growth assets. Property is a growth asset yet only a few fortunate people are able to leverage it as an asset for wealth creation because of many practical limitations.

Property investment in India has yielded an average of 14% per annum in the last decade. Here we're talking about the average returns on real estate in different cities of India, as observed in the property index of India, Residex. Of course, you might have heard stories of how this person or that person got extraordinary returns from real estate investment, but we will hold on to the average value. So if real estate is such a rewarding investment option, what is hindering people from investing in it?

Darker Side: You will agree on the reasons that first of all property investment is a rich man's game. Big money, such as is beyond the dream of many an investor even today in 2012, is required to be in the game. Secondly many of those who can afford shun it because of cumbersome procedures of identifying suitable property, getting title deed, maintenance, etc. Thirdly liquidity might be an issue. Investors might not be successful in liquidating and exiting their investment at the exact moment of their need.

Many of these hurdles can be jumped over through real estate mutual funds. What is a real estate mutual fund (REMF)? It is a fund that works like the usual closed-end mutual fund scheme that manages money pooled from investors by investing in shares, bonds and money market instrument. The REMF would invest money solely in real estate and real estate related financial securities. Before we go on to details, keep in mind that presently there are no REMFs in India. What we do have is Real Estate Private Equity (PE) funds that are close-ended funds not listed on exchanges. Sadly retail investors cannot participate in these as the minimum investment is as high as 5 crores. You might actually be able to identify a decent property for one-tenth the amount!

How Real Estate Mutual Funds Work?

It seems India's financial market regulator is a visionary. SEBI issued guidelines for real estate mutual funds in 2008. Real estate mutual funds may pick up in India soon. Real estate in India is on a high growth trajectory. Property and stocks are two asset classes whose returns are highly correlated to economic and business growth.

Now let's look at how exactly real estate mutual funds (would) work. A real estate mutual fund scheme is a scheme of a trust fund set up to manage pooled money of unit holders (like a mutual fund does) by investing in real estate. Real estate mutual funds are close-ended and its units are listed on stock exchanges.

REMFs must mandatorily invest a minimum of 35% of their total assets in real estate assets. These real estate properties must be located in Indian cities specified by SEBI or in SEZs. The property must have completed construction. For this purpose they cannot invest in open plots of land or under-construction property. The mutual fund can give out the property on lease and rentals received will form part of investors' profits.

Including the 35% investment discussed above, REMFs are supposed to invest a minimum of 75% of total assets in real estate property and real estate related securities of companies dealing with real estate properties or their development. Typically these securities could be in the form of equity shares, bonds and debt papers of such companies and mortgage backed securities. The rest 25% is allocated to any other financial securities.

How REMFs could be your answer: The greatest problem of investment lot would be resolved as the minimum investment amount may be as low as Rs 5000-10,000 as in other mutual funds. So for as little as Rs 5000 you can participate in the game.

You can save yourself all paper work pertaining to property. The REMF's custodian is required to verify and keep safe custody of the title deed.

Like other mutual funds that diversify client's portfolio by investing in a number of stocks and other assets, real estate funds will actually diversify your real estate investments across different cities of the country. Nobody would want to enroll themselves for the cumbersome process of investing in numerous locations for the purpose of diversification. The fact is that REMFs are prohibited from investing more than 15% of total assets held as real estate property in a single project and unless explicitly specified in the offer document, not more than 30% of the total assets of all real estate schemes managed by a fund can be invested in a single city.

Arriving at the true value of property in a place is many times a challenge. REMFs will declare net asset value (NAV) of the real estate scheme every day.

Finally the economic and social demon black money that is so rampant in property transactions will be reduced since these funds are required to channelize all financial transactions through banks.

REMFs Launched in India

HDFC Property Fund which is a wing of HDFC and State Bank of India has jointly announced the launch of its first Real Estate Mutual Fund with a joint corpus of Rs.1000 crores.

Prudential ICICI AMC Ltd., Kotak Mahindra Mutual Fund, and some other domestic and foreign companies have already started Real Estate Mutual Funds worth about $1 billion.

More and more real estate mutual funds are expected to come up in the near future.

Property is an all-time favorite investment avenue for the long term. This is true in India and other economies as well. Real estate investment is truly rewarding in term of capital appreciation and income generation through rent.

However the process involved in acquisition, maintenance and selling for profit booking is a very tedious one and not every investor who has the money would choose to go in for it. Real estate mutual funds could turn out to be the answer for these and many other drawbacks in real estate investment.

POINTS TO REMEMBER

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