Indian Real Estate and the prospects for REITs

Summary Opinion

Real Estate Investment Trusts, or REITs, have established themselves as the "Brand Name" investment vehicle of choice for institutional and retail investors looking to participate in real estate ownership, management and development. And while REITs are already common players in developed markets, they are now also making their presence felt in emerging markets.

The attractions of REITs for investors are clear: they provide a similar structure for investors buying into real estate as mutual funds provide for investment in stocks. Another key design feature is the elimination or reduction of the taxation differential between directly-owned property and property owned through a corporation – though whether this will be the case for Indian REITs remains to be seen. Nevertheless, as India’s real estate market grows and opens up, REITs could play a major part in its development.

Although there are no REITs in India now — some India-referencing REITs are reportedly considering listing offshore in established REIT jurisdictions — the Securities Exchange Board of India (SEBI) is currently finalizing guidelines for the introduction of Real Estate Mutual Funds (REMFs), and it will consider framing guidelines for REITs going forward. SEBI’s guidelines should also make it easier to invest in the sector through listed real estate operating companies (REOCs) and increasingly through foreign direct investment (FDI).

More broadly, the introduction of REITs could also provide many benefits to India’s economic development, just as they have to other countries such as Australia, Singapore, Japan, the UK and France. For instance, REITs can boost capital access and reduce capital costs for property owners, managers and developers.

Moreover, in many markets REITs have successfully helped the commercial property business better access the four quadrants of capital: debt and equity, public and private. REITs also help create conditions for building integrated property businesses, and are well positioned to appeal to foreign capital, thereby helping develop the Indian economy.

However, the road to establishing an Indian REIT sector could be challenging. Not least, the authorities will need to change parts of India’s legal and tax frameworks. Furthermore, the real estate transaction process is cumbersome, and the property industry’s transparency and disclosure levels could be improved.

<table>
<thead>
<tr>
<th>Contact</th>
<th>Phone</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>MOODY’S CONTACTS:</strong></td>
<td></td>
</tr>
<tr>
<td>New York</td>
<td>1.212.553.1653</td>
</tr>
<tr>
<td>John Kriz</td>
<td></td>
</tr>
<tr>
<td>Mumbai</td>
<td>91.22.2422.3152</td>
</tr>
<tr>
<td>Chetan Modi</td>
<td></td>
</tr>
<tr>
<td><strong>ICRA CONTACTS:</strong></td>
<td></td>
</tr>
<tr>
<td>Gurgaon</td>
<td>91.124.454.5300</td>
</tr>
<tr>
<td>Vikas Aggarwal</td>
<td></td>
</tr>
<tr>
<td>Naresh Takkar</td>
<td>91.124.454.5300</td>
</tr>
</tbody>
</table>

June 2007
Overview of India's Real Estate Sector

As real estate construction and values have expanded in India — underpinned by healthy economic growth, and coupled with a series of IPOs by property firms — so in recent years has India's property sector changed substantially. These trends of growth and modernisation are set to continue, with some market participants forecasting that real estate development in India will grow from US$12 billion in 2005 to US$90 billion by 2015.

In addition, global capital has become more interested in Indian property and is seeking transparent and liquid ways to invest. Furthermore, with a more global property market, the level of competition in the Indian property business is rising, while the need for property firms to strengthen their operational infrastructures, personnel and finances to better compete is also becoming more acute.

India’s GDP growth rate has averaged 8% over the last three years, up from an average of around 6% during the 1990s, and highlights India's emergence as a land of opportunities. The principle drivers of India's GDP are changing demographics, rising levels of foreign investment, a vibrant services sector powered by the IT and ITES sectors and buoyant exports. Notwithstanding concerns over lack of structural reform, these factors are likely to be sustained in the foreseeable future, resulting in continued strong GDP growth.

This economic growth has, in turn, stimulated demand for property to help meet the needs of business, such as modern offices, warehouses, hotels and retail shopping centres. It has also boosted housing demand as a wealthier populace seeks upgraded accommodation. Moreover, shrinking household size and improved access to housing finance have boosted the demand for residential property. Tax incentives have also been granted to interest and principal paid on home loans, which has made owner-occupied property more attractive.

Indian cities are customarily divided into three groups: Tier I, comprising of major urban centres like Delhi, Mumbai and Bangalore; Tier II, including such cities as Hyderabad, Kolkata and Pune; and Tier III, consisting of cities such as Ahmedabad, Gaziabad, Indore, Jaipur, Lucknow and Nagpur.

Over the last few years, modern real estate development — and some investor interest — has spread beyond Tier 1 cities to Tier II and Tier III cities. However, although the longevity of this development is not certain, it does indicate that the Indian property business is more competitive and thinking more broadly.
In addition, reform to the Indian regulatory environment is underway. Perhaps the clearest example of this is the 1976 ‘Urban Land Ceiling Regulation Act’. Although this Act has already been repealed in a number of states, it still remains in force in some states including Andhra Pradesh, West Bengal and Assam. The Act, originally designed to ensure a more equitable distribution of land, stands accused of impeding the assemblage, sale and reuse of urban land, thereby helping to raise land prices.

One of the Act’s main provisions includes setting a limit on the ownership of vacant land (graded according to the classification of the urban conurbation) so to provide cheaper land to poor communities. As such, the Act gives power to state governments to acquire any excess vacant land above the limits set by the Act, to regulate the transfer of ownership of the vacant land, and distribute it according to the common good. Under the Act, individual states are authorised to grant exemptions depending on the category of land.

However, the Act has been criticized on a number of issues: that it has vested too much discretionary power in the state governments to grant exemptions which has led to corruption; that it is highly expropriatory, resulting in lengthy court cases; and that it does not provide for a mechanism to force the entry of vacant urban land onto the market, thereby resulting in an unduly low supply of land for housing and development, and boosting land prices, particularly in the larger cities. As such, its repeal is likely to add further momentum to growth of the real estate sector in India.

Why REITs?

REITs have become the preferred “Brand Name” public property investment vehicle around the world. Some of the more salient reasons why nations have reformed their tax and other laws to create REITs are listed below. These are also important credit factors Moody’s and ICRA review in rating analysis.

- REITs boost and help to stabilize capital access, and reduce capital costs. REITs have proved successful in helping the commercial property business efficiently access the four quadrants of capital: debt and equity, public and private. Capital, especially long-term capital, is a vital resource for the property business, and REITs have proved effective in attracting it. This is in part a reflection of their public status and partly of their tax efficiency. Unsecured debt — the most flexible debt type — has been a hallmark of REITs, and has aided them in boosting both their strategic and financial flexibility.

- REITs create conditions for building integrated property businesses. Most REITs in the leading national markets are internally managed, and have diverse skill bases in property development, redevelopment, acquisitions, divestitures, leasing and management. As such, they can create long-term, value-added ongoing enterprises, and not just assemblages of assets or “deals”.

- REITs can help attract foreign capital. There is a substantial amount of global capital seeking commercial property opportunities in India and elsewhere. Transparent, liquid entities such as REITs can help tap into this pool. This can also add to a REIT’s financial flexibility.

- REITs can help develop the broader economy. With the introduction of REITs usually comes better transparency and efficiency, and access to stable, global and more competitively priced capital, as well as stronger and more professional property businesses. As such, the commercial property sector can become better positioned to help develop the Indian economy.

But Legal and Governance Issues Remain To Be Resolved...

However, several issues would likely need to be addressed for REITs to find a footing in India.

For instance, India has one of the highest levels of Property Taxes and Stamp Duty among the major countries in Asia – stamp duty is running at 5-7% for example. This has lead to high levels of non-registration of property transactions as well as transfers through the ‘Power of Attorney’ route.

Moreover, high stamp duties, registration charges and capital gains tax leads to high incidence of cash transactions. These cash-based transactions are typically routed through various shell companies. A multitude of Approving Agencies for planning permission also boosts costs, and adds time to development. A creaky Land Title monitoring system also means that ownership problems are all too common.

These factors have led to corporate governance issues within real estate companies regarding transparency and disclosure. Common areas where there is a lack of clarity include the number and size of projects being executed by any given property group, the end use of customer advances, and the nature of consolidated indebtedness and fund flows within the group.

The mushrooming of property players without a track record in the real estate sector has exacerbated these issues.
...Though Improvements Are Expected Going Forward

Given that urban areas account for over 60% of India’s GDP — and are expected to continue to account for the significant share of future economic growth — it is imperative that significant investment be made in urban India’s deficient infrastructure to improve its productivity.

The Indian government is aware of this, and towards this end has constituted the Jawaharlal Nehru National Urban Renewal Mission (JNNURM) – a national level framework program covering 63 cities. The objectives of this mission are: i) improvement of India’s urban infrastructure; ii) planned development of all urban regions — especially suburban ones — thus relieving pressure on better-developed areas; and iii) increased accountability of urban local bodies.

Furthermore, a significant part of the urban development activities currently underway is being undertaken by private sector real estate development companies. To raise resources from the capital markets and to achieve economies of scale, these private sector developers are adopting better corporate governance and financial transparency practices.

Therefore, going forward, Moody’s and ICRA do not expect that the existing, extremely fragmented structure of the Indian real estate market and its general lack of transparency can be sustained for very long. In fact, as regulatory reforms pave the way for a more organised approach to urban planning and development, large-scale projects are likely to become more common while governance standards improve.

India’s Property Sector: Credit Strengths

In the residential sector, a growing middle class is enjoying rising income levels. Combined with smaller household sizes, this demographic change has boosted demand for more modern housing and home loans. Meanwhile, increasing consumer spending power has encouraged growth in organized retailing — both feeding off and contributing to the spread of ‘mall culture’ and the popularity of other large-scale retail property developments.

In the commercial property segment, strong growth in the services sector — particularly in the IT and ITES sectors — and corporates’ growing scale of operations have led to greater demand for commercial space, including modern offices, warehouses and lodging space. Moody’s and ICRA see all these as long-term factors providing credit support for the Indian property business.

Many property developers have substantial plans to increase both their size and geographical spread. They are also expanding into different kinds of properties, which can boost the firms’ franchise values and reduce concentration risks. However, managing and financing such activities can be a challenge, and puts a premium on financial flexibility, capital access and operational infrastructure.
**India’s Property Sector: Credit Challenges**

The property industry is also wrestling with oversupply in certain areas, such as in India’s commercial property sector, which may lead to rent reductions and value drops. Meanwhile, property firms must also cope with a reduction in customer advances on new construction, increasing land values (making acquisition and development deals tougher), rising interest rates since 2005, and increased difficulty in arranging capital. The latter is exacerbated by rising interest rates and property prices, which have encouraged banks to become more selective in granting loans as they try to preserve asset quality.

Moreover, the Reserve Bank of India (RBI) has increased risk weighting for real estate exposure, which has served to curtail direct lending to this sector.

The property business in India also faces political risks. These risks may come in various forms, but include the stalling of decisions over acquisitions or planning permission during elections, while some approvals have even been rescinded following elections and changes to state governments.

Property financing remains largely conducted through conventional mortgages, with the volume of more modern, transparent and liquid products — such as shares in public property firms and CMBS — still negligible. This is partly due to high registration charges and transaction costs and structural impediments in the securitization legal framework. Industry databases on transaction volumes, structures and prices are also largely undeveloped.

Furthermore, mutual funds lack the appetite for long-tenure deals, and mostly invest in high quality debt, while pension funds and insurance companies have yet to invest in structured paper either.

**REITs in Australia and Singapore — Examples Of Different Stages Of Development**

REITs, or listed property trusts (LPT) as they are known locally, are the leading actors in the commercial property industry in Australia. The Australian commercial property market is mature in a global context, with well over half of the value of institutional quality commercial properties being held by LPTs, underpinned by an active unsecured debt and CMBS market.

These factors result in high transparency, liquidity, financial flexibility, and a well-run commercial property industry that provides strong support for the Australian economy. Given the maturity of the property business and penetration of LPTs, Australians have become more active in investing in property overseas.

In Singapore, though REITs are still in the early stages of development, that development has been rapid, with many IPOs and much internal growth. S-REITs have begun to position themselves as regional investors in property, helping to solidify Singapore’s role as a financial hub.
Related Research

Industry Outlook:
Australian LPT Industry Outlook 2006 (96708)

Special Comment:
Singapore REITs, May 2006 (97360)
South Africa: Joining the REIT Club? October 2006 (100104)

Rating Methodology:
Rating Methodology for REITs and Other Commercial Property Firms, January 2006 (96211)

To access any of these reports, click on the entry above. Note that these references are current as of the date of publication of this report and that more recent reports may be available. All research may not be available to all clients.

Related Websites

Moody's Investors Service
www.moodys.com

ICRA Limited
www.icraratings.com

MOODY’S has provided links or references to third party World Wide Websites or URLs (“Links or References”) solely for your convenience in locating related information and services. The websites reached through these Links or References have not necessarily been reviewed by MOODY’S, and are maintained by a third party over which MOODY’S exercises no control. Accordingly, MOODY’S expressly disclaims any responsibility or liability for the content, the accuracy of the information, and/or quality of products or services provided by or advertised on any third party website accessed via a Link or Reference. Moreover, a Link or Reference does not imply an endorsement of any third party, any website, or the products or services provided by any third party.