FIRSTLEAD

Madhavan Jayashankar and **Prashant Chaubey** take a look at real estate mutual funds (REMFs) and their viability, as an alternative way to invest in real estate

INVESTING, THE REMF WAY

Over the past decade, the real estate sector in India has emerged as one of the fastest growing segments, driven by a growing and liberalised economy, improving urban infrastructure, favourable demographics, better employment opportunities, rising income and low mortgage-to-earnings ratios. These factors have led to an increasing demand for residential, commercial and retail spaces, hotels, educational institutions and hospitals, across the social strata of our country. Capital values of real estate across the country, have almost doubled in the last decade, suggesting that demand continues to exceed supply. However, from an investment perspective, whether small and retail investors have been able to take advantage of the positive circumstances, is not clearly evident.

One positive outcome for the sector, in the last five years, has been the institutionalisation of real estate business, which is evident from the growing number of real estate companies that are going public. This has led to increased transparency and accountability. Commenting on the same, NG Srinivasan (head – risk management and strategy) of Nitesh Estates, says that "Institutionalisation of the business is imperative, as the need for funds has increased among the real estate players, to meet the rising demand and construction commitments."

In April, 2008, a major thrust was bestowed upon the real estate sector, by SEBI, the apex regulatory body of the country for the securities market.

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They recognised it as an alternative investment asset class, by introducing the Real Estate Mutual Fund (REMF) guidelines. The objective of the guidelines was 'inclusive growth', as it allowed small and retail investors to participate in the asset class, which offers income at predictable intervals and capital growth (property price appreciation), along with low volatility and collateral. Until now, the only way to participate in the real estate sector, from an investment perspective, was either through direct ownership (which was plagued by rising prices, high transaction cost and diligence cost and illiquidity) or indirect ownership in the form of equity shareholding in listed real estate companies and unit holding in real estate venture capital funds (primarily meant for financial institutions and HNIs). However, due to the global recession and double-dip fears, activities under the REMF guidelines have remained muted. Nevertheless, the global recession proved that the Indian real estate industry is resilient and can withstand unusual circumstances.

The regulator seems to have outlined the guidelines, after researching similar real estate investment trusts in the US, UK, Singapore and other countries. According to Peter Mitchell, CEO of the Asia Pacific Real Estate Association (APREA), Singapore, "Listed real estate funds around the world have become very popular with investors for many reasons, including diversification and liquidity. Institutional investors, increasingly, have fixed allocations to listed real estate. For example, an additional USD 22 billion has flowed into Singapore's economy, because of the success of its REIT market."

According to the guidelines, real estate companies or mutual funds, with expertise in real estate, are eligible to venture into the REMF space. In case of the former, the company has to apply for a fresh REMF licence, while existing mutual funds are allowed to float a new scheme in real estate. REMF is similar to other closed-end mutual fund schemes (that invest in equity and fixed-income), except for the fact that the new entity will invest in real estate projects. The regulations define REMF as a scheme of a mutual fund, established in the form of a trust, which invests directly or indirectly in real estate assets or other permissible assets.

In order to keep the REMF scheme real estate-centric, the regulator has set out two conditions. Firstly, at least 75 per cent of the net assets of the scheme must be invested in completed real estate assets, mortgage-backed securities (but not directly in mortgages) and equity shares or debentures of companies engaged in dealing in real estate assets or in undertaking real estate development projects, whether listed on a

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recognised stock exchange in India or not. Secondly, of the total net assets of the scheme, at least 35 per cent is to be invested directly in completed real estate assets.

On the valuation of real estate assets, the regulator has prescribed detailed norms. The net asset value (NAV) of the REMF scheme has to be disclosed daily, akin to other existing mutual fund schemes. However, the fair valuation of the real estate assets (unlisted) has to be conducted every 90 days (quarterly valuation) by rated third-party property valuers. The listed security investments valuation shall carry the daily market closing valuation.

As per the regulatory guidelines, a REMF sponsor cannot invest in owned assets or assets belonging to its associates. The unlisted entities owned by the sponsor or group company or the associate companies, are also outside the purview of permissible investments. This shall ensure that REMF investments are carried out at arm's length and the opaqueness of the real estate investment is firmly addressed.

REMF, as an asset allocation strategy, offers significant diversification benefits (low correlation with other asset classes), to both retail and institutional investors, away from the currently prevailing three out of four primary asset classes namely equity, fixed income and cash. REMF can provide an opportunity to the ordinary investor, to re-balance his/her portfolio among equity, fixed income, real estate and gold. It will make it possible for retail investors to invest, according to their prevailing income and financial circumstances, in an asset class which traditionally required sizeable amount of financial capital. Moreover, a portfolio of real estate assets under REMF will offer a lot more breath and depth to a retail investor than owning a single home, with assets ranging from office space to residential properties all around the country. The legal and maintenance hassles of owning a property will also be negated, as it will be the responsibility of the asset management company of the REMF scheme.

Additionally, a real estate investment within the mutual fund ambit, will offer the advantages associated with mutual funds, to the retail investor. The REMF product would come with benefits such as regulations supported by convention, precedent and best practices, rigid and extensive oversight by the regulator and strong norms against self-investment.

REMF can also offer developers and property companies, with avenues to release property assets from corporate balance sheets, into professionally-managed firms. It will enable the realty sector, to access funds from new avenues and at an economical cost. However, a cohesive effort from all stakeholders is necessary, in order to make REMFs successful. Tax incentives by the government, can also be used, to make the product successful.