KPMG

cutting through complexity

NAREDCO

Real Estate & Infrastructure Investors' Summit - 2015

Challenges and industry recommendations

Key recommendations
A) Promotion of affordable housing and investments into the segment:

There is a latent domestic demand for housing in the country. Of the total housing shortage of ~ 11 crore units[1] in the country, around 96 percent shortage is in the economically weaker sections (EWS) and lower income group (LIG). With growing gap between demand and supply for housing, affordable housing segment poses a business opportunity worth USD 11.8 billion for developers[2] across seven cities (Delhi-NCR, Mumbai (MMR), Bengaluru, Chennai, Hyderabad, Kolkata and Pune) of India. There lies a huge opportunity for the development industry. While there is a need to increase the supply of units in the affordable housing segment, there is also a need to increase the investments into the segment. But there are challenges such as slow project approvals, land acquisition and inadequate funding. To bolster the investment climate primarily for affordable housing and mitigate the challenges, there is a need to adopt a renewed approach towards policy measures.

Here are some of the recommendations that emerged from the Summit that can help improve the supply of affordable housing. These measures if implemented are likely to attract foreign investors into the segment, increase housing stock and will provide an impetus to the sector:

- Streamlining of construction approvals required for projects and creation a single window clearance for real estate projects.

- Procedure for approving the development and commencement of affordable housing projects can be standardized across states. Some of the best practices adopted by a few states such as Maharashtra, Gujarat, Rajasthan and Madhya Pradesh can be adopted for such standardisation. For example, Maharashtra has already got a single window clearance mechanism for slum rehabilitation projects and industrial development projects.

- Ease land acquisition process for affordable housing projects- There is a need to ease the process of land acquisition for such projects. Some of the measures that can be applied are:
    - ✓ Provision of awarding the government owned land at subsidized rate to developers can be one such solution.
    - ✓ Majority of the land banks are available with the government institutions such as railways, military etc. These land parcels need to be freed.
    - ✓ Assistance can be provided by the government by provided pre-approved zoned land for such projects which can help negate the approval costs and help save a lot of time which otherwise would be utilized for approvals.

- Increment of FSI and mandated zones for low-income housing will add to the necessary supply of units.

- There can be provision for tax deductions or viability gap funding for affordable housing projects

Source: *1) Decoding Housing for all report, KPMG in India, 2014; 2) KPMG Report (Affordable homes offer USD 11.8 billion opportunity for builders, Business Standards website, 24 August 2015*

- Interest rate subsidies to low-income customers can be brought in place. Direct tax incentives to customers (e.g. waiver/ lowering of stamp duties, service tax) can be considered for evaluation.

- New avenues for project financing for affordable housing including that from insurance and pension funds can be taken up.

- There is a need to think upon innovative funding mechanism for these projects, as margins for these projects are low:

    - ✓ Increase bank lending towards affordable housing at lower rates

    - ✓ In this regard, a number of international models can be referred to. For example, Brazil Government has agreed on a pre-determined sale price for such units, providing tax incentives to developers. The government has also reduced notary registration fees and provisioned 100 per cent financing for such projects to enable low-income groups to avail mortgage.

B) Promote investments across smart cities/ non-metros/ township projects:

Government has initiated a massive plan to redevelop and develop the existing cities and create 100 new smart cities. While the government has already allocated over USD 7,500 million for smart cities project, the fund is not sufficient enough to achieve the target for each city. So is the case of 500 cities to be redeveloped under the AMRUT (Atal Mission for Rejuvenation and Urban Transformation) Scheme.

During the summit, a number of investors and fund managers were of the view that first rounds of investments into the space will be made from government, large banking and developmental institutions. They added that there is very little for foreign investors to contribute to at this stage, as projects envisaged have long term gestation. Thus, there is a need to make these developments attractive for investors too.

Here are our recommendations that emerged from the Summit and can help increase the participation of foreign investors:

- There is a need to improve upon the urban productivity of our existing infrastructure including that of our cities. Targeting long term sustainability is critical for this. For this purpose, it is important to bring economic, social and government capital together for a sustainable growth.

- Foreign investors would primarily want to harness the returns in a short span of time (3-5 years). As these projects are of massive scale, we need to find smaller and smarter asset based projects within the city development for foreign investors. Such projects will have the potential to give faster returns to investors.

- Before we take up big mega projects, it is imperative to take up pilot projects, which are smaller in size. The success of these projects will form the blueprint for bigger cities.

- There is also a need to prioritise the work for the urban local bodies (ULBs) for the development and rejuvenation of cities. For instance, ULBs need to galvanise their planning and designing work at priority with the current and expected development needs.

- ULBs currently face huge shortage of skilled professionals and funds across levels. There is a need to work towards reducing the skills shortage at the level of urban local bodies.

- While the industry and the government work towards the development of new cities and redevelopment, there is a need to ideate for increasing the housing supply and creation of jobs for the migrating population that is expected to shift to these cities. Therefore, while creating smart cities, housing and employment generation can be focused upon.

C) Fast track establishment and promotion of Real Estate Investment Trusts (REITs)

Like most mature markets around the world, Real Estate Investment Trusts (REITs) is among the important reforms introduced by the Securities and Exchange Board of India (SEBI) in 2014.
While we await a comprehensive and clear regulatory framework permitting the establishment of REITs, there is no doubt that the imminent realisation of the long-awaited investment instrument could provide a long-term liquidity channel to the commercial real estate sector. REITs pose a large opportunity in the market. India potentially has about 375 million sq. ft. Grade A office space which is valued at USD 65-70 billion. Of this, 80-100 million sq. ft. is estimated to be eligible for REITs in the coming two to three years and would be valued at USD 15-20 billion.[3] Apart from Grade-A office spaces, there are other commercial assets such as shopping centres, hospitality and industrial warehouses which might come under the purview of REITable space, thereby presenting a potential for increasing the overall stock.

It is thus imperative to notify the proposed Bill and establish REITs in the country soon. Here are our recommendations for REITs in the country:

- There is need to evaluate the exchange controls regulations in this respect. Under this, foreign portfolio investors and non-resident Indians could be permitted to invest in units of REITs without any cap or restriction on the units that can be acquired. Entry of large international pension funds operating globally can also be facilitated.

- Provisions can be introduced to tax the transfer of REITs units received in exchange of shares of the SPV only to the extent of the value of the property at the time of exchange and not in respect of the appreciation in the value thereof. For instance, if the cost of shares of SPV is INR 10 and the fair value thereof on date of transfer to REIT is INR 50 (gain of INR 40), and the REIT units are ultimately sold for 80 (gain of INR 70), then only INR 40 should be taxed and the balance gain of INR 30 (accrued post transfer to REIT and listing of units) should not be taxed. The provisions as they currently stand would go to tax the entire gain of INR 70 in the hands of the sponsor.

- There is a need to provide more clarity over taxation of the proposed REITs in the hands of the investors and unit holders. There is also a need to re-evaluate the dividend distribution tax for REITs in India. Clear guidelines in this regard would pave the way for foreign investors and would help them understand the market well from REITs perspective.

- Capital structure of SPVs which are primarily funded by share capital may need to be re-structured to a reasonable mix of debt and equity for the REIT to be able to extract cash from the SPV in a tax and regulatory efficient manner. It can be specifically clarified that any interest paid by SPV to the REIT is a deductible expenditure from a tax perspective.

- To open and gradually increase the market for more funding, it is vital that a variety of investments are made from other sector into the REITs market. Apart from the sizable pool of REITable commercial space in the hands of the private sector, government organizations such as banks, pension funds and insurance companies own sizable quantities of real estate assets as well. Introduction of REITs would help these government institutions in unlocking capital as well.

- Apart from the perceived sectors and real estate segments, other key sectors such as the insurance sector is considered to be a strong source of investment into the sector. However, current regulations in the country prohibits insurance companies to hold investments directly in the real estate sector. Contrary to this, global insurance companies have a sizeable portion of their investments in to the real estate sector. Thus there is a need to evaluate the participation of insurance companies within the real estate market through REITs.

D) Evaluate the provisions of the proposed Real Estate Regulation

The fragmented and unorganized real estate market needs a regulation like other sectors. The long awaited Real Estate Regulation and Development Bill was reviewed by a Parliamentary Standing Committee in 2014. The Committee submitted it report on 17th February 2014.

The Union Cabinet approved the Real Estate (Regulation and Development Bill in April. The Bill has not been approved by the Parliament, and is likely to be taken up in the winter session. The Regulation aims to protect the interest of consumers, bring transparency in the real estate transactions and provisions timely completion of projects. The Bill is a revolutionary initiative, aiming to ensure systematic growth of the real estate sector.

Disclosures by way of certain provisions of the enacted Regulation can help generate more credibility among foreign investors. It would also help them to select the right partner for investments and development of projects. However, we believe that there is a need to evaluate some of the provisions of the proposed Regulation.

Here are our recommendations:

- Regarding the creation of an escrow account, the current holding of 50 per cent of sales proceed needs to be evaluated. This is because a number of projects are still under-construction and firms have already charged 80-90 per cent of the sales proceed. Parking the money in escrow would not only affect the developer but other stakeholders as well such as the investors and lending institutions investing in the project. Better innovative ways such as the escrow account money being determined on per sq. ft. basis can be looked at.

- Moreover, industry is of view that the escrow provision in the bill would result to an increase of the use of black money funding in the project.

Source: 3) Destination India – Are we ready for REITs? KPMG in India, 2014

- The provision of creating an escrow mechanism can differ as per the requirement of states. For example, in the case of Mumbai, where the land cost is very high, it does not make sense for the developer to hold 50 percent of the money from the sales proceeds since the money would just lie in the escrow and would not be able to be utilized for loan repayments. The other way is to hold a certain amount of housing stock as security and sell that once all approvals have been received.

- The bill does not address the need for a single window for approvals which would enable getting permissions and approvals expeditiously. There is a need to remove bottlenecks within the approvals process for projects. The responsibility of easing project approvals' process lies with the government agencies involved. Under the provisions of the proposed Regulation, the government agencies can be held equally responsible for approvals required for the project commencement.

- Moreover, the developers believe that the provision of imprisonment of developers failing to register their projects is very negative and wrong for the sector, which can be grossly misused as well as it could refrain large business groups from entering into the sector.

- The proposed Bill also needs to lay down a structure for the creation of the regulatory framework at the centre and states for effective implementation of the grievance redressal mechanism.

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