

Real estate investment trusts: Recent amendments to the regulations puts the spotlight on exits and governance

Real estate investment trusts (“**REITs**”) are pooled investment vehicles that hold and make investments in real assets. Structurally, a REIT is no different from any other pooled investment vehicle where the sponsor sets up the fund, raises capital and appoints a trustee who manages the fund for the benefit of the beneficiaries (i.e., investors in the fund). A REIT is a professionally managed investment vehicle that allows unit holders to partake in the economic benefits of commercial real estate ownership. From the perspective of the unit holder, investment in REITs offer predictable cash flow, capital appreciation from passive ownership of real estate assets and liquidity of investment.

Ever since 2014, when the REIT framework was notified by the Securities and Exchange Board of India (“**SEBI**”)¹, it has emerged as a preferred vehicle for institutional investment in the real estate sector.

Despite the positive outlook, a recent report² puts the REIT penetration at 11%. It identifies commercial reasons for achieving a substantial upside³.

The REIT regime has evolved over the years, and SEBI has proactively engaged with relevant stakeholders from time to time. SEBI recently published consultation papers on February 23, 2023 (“**February 23 Consultation Paper**”) and May 16, 2023 (“**May 16 Consultation Paper**”) proposing certain changes to the REIT framework. On August 16, 2023, SEBI notified the Securities and Exchange Board of India (Real Estate Investment Trusts) (Second Amendment) Regulations, 2023 (the “**Amendment**”). The impact of the Amendment is discussed below.

Key Changes

1. Sponsor ‘lock-in’ during the lifetime of the REIT

A sponsor is a person who establishes the REIT i.e., the person who files the relevant application with SEBI and procures the necessary registration from SEBI. The sponsor is also responsible for transferring the assets from the

¹ SEBI notified the Securities and Exchange Board of India (Real Estate Investment Trust) Regulations, 2014 (“**REIT Regulations**”) in 2014.

² <https://www.colliers.com/en-in/research/reits-june-2023-report>

³ According to the report, listed REITs in India have provided an annualized distribution yield of 6-7%. The three listed office REITs cumulatively hold approximately 74.4 (seventy four point four) million square feet of office space, representing around 11% of the total existing Grade A office stock.

relevant special purpose vehicles (i.e., the owner of the relevant real estate asset) to the REIT, filing an application for registration of the REIT with SEBI and the appointment of trustees of the REIT.

Prior to the Amendment, the REIT Regulations mandated a minimum ownership percentage with respect to the sponsor. The minimum ownership percentage was 15% of the total number of units, and this ownership stake had to be maintained for 3 (three) years from the date of listing of the units. The Amendment has changed this position considerably. According to the newly inserted Regulation 11(3), the sponsor is required to maintain a minimum stake in the REIT throughout the term of the REIT. We explain with the help of the table below.

Time period (From the date of listing of the units)	Percentage or maximum value of units held by sponsor
First 3 (three) years	15%
From the beginning of 4th year till end of 5th year	5% or INR 500,00,00,000 (Indian Rupees five hundred crore) (whichever is lower)
From the beginning of 6th year till end of 10th year	3% or INR 500,00,00,000 (Indian Rupees five hundred crore) (whichever is lower)
From the beginning of 11th year till 20th year	2% or INR 500,00,00,000 (Indian Rupees five hundred crore) (whichever is lower)
After completion of 20 (twenty) years	1% or INR 500,00,00,000 (Indian Rupees five hundred crore) (whichever is lower)

The manner of arriving at the value of units has been prescribed by the Amendment. Accordingly, it provides that the value of units will be based on the net asset value of the REIT.

In relation to REITs that exist at the commencement of the Amendment, the lock in covenant will only apply in respect of fresh units issued by the REIT. The new Regulation 11(3A) of the REIT Regulations also provides that the locked-in units will remain un-encumbered. The sponsor is restricted from the creation of any security interest or rights over such units during the restricted period.

The Amendment also provides for a mechanism to evaluate compliance of the above requirements by the sponsor. It provides that an assessment of compliance will be done from the fourth year onwards: (a) at the time of each fresh issuance of units; and (b) at the beginning of change in threshold of the percentage for minimum unitholding requirement.

The rationale for the minimum lock-in stipulation is to ensure 'skin in the game' for the sponsor. SEBI wants the sponsor to remain invested in the REIT for as long as possible. They do not want the REIT platform to be used by unscrupulous sponsors who are looking to make a 'quick' buck from the REIT platform. SEBI had also raised concerns on the high levels of leverage held on the books of the REIT. In the February 23 Consultation Paper, SEBI pointed out that the sponsor contracts the debt even before the transfer of the assets to the REIT. This puts other institutional and retail investors at a disadvantage as the REIT would have to service the debt from its future cash-flow.

2. Appointment of a director on the board of the investment manager

Regulation 4(2)(g) of the REIT Regulations stipulates that no unitholder will enjoy superior voting rights or any other rights over other unitholders and there should not be multiple classes of units in a REIT. The Amendment has changed this position. Pursuant to the Amendment, a proviso to Regulation 4(2)(g) has been introduced. The proviso provides that unitholders who individually or collectively hold not less than 10 % of the units of the REIT are entitled to nominate a director on the board of the manager. One could argue that the proviso is a departure from the regulatory principle of treating all unitholders alike.

Since the expression “collectively” has been used, it means that one unitholder can get together with other unitholders and achieve the 10% threshold required to undertake such appointment. The May 16 Consultation Paper recognizes the disparity between the unitholders holding a majority and the rest. Essentially, the proviso is a minority-protection measure.

The REIT Regulations do not provide a framework for exercising such right. It is silent on whether such a right is to be exercised pursuant to a contract between like-minded unitholders, or an ad-hoc exercise of powers.

3. Framework for Self-Sponsored Managers

A new definition of ‘Self-Sponsored Manager’ by way of Regulation 2(1)(zra) has been introduced in the REIT Regulations. Accordingly, a ‘Self-Sponsored Manager’ is defined in Regulation 2(1)(zra) of the REIT Regulations to mean the manager of a REIT who has dual responsibilities of both the manager as well as the sponsor.

The REIT Regulations now include a framework that enables a sponsor to transition the REIT from a sponsor-controlled REIT to a professionally managed REIT. Accordingly, a sponsor of a REIT can disassociate itself as sponsor and convert the REIT to a self-sponsored REIT subject to the fulfilment of certain conditions. The key requirements are:

- a) The REIT has been listed for a period of at least 5 (five) years.
- b) The REIT has undertaken not less than a minimum of 12 (twelve) distributions on a continuous basis and complied with the distribution norms set out in the REIT Regulations in the preceding 5 (five) years.
- c) The REIT has been rated AAA by a registered credit rating agency for a continuous period of 5 (five) years immediately preceding exit of the sponsor.
- d) The sponsor has not transferred / sold assets to the REIT in the last 3 (three) years and no assets/ projects will be acquired by the REIT from the outgoing sponsor(s) for a period of 1 (one) year from the date of conversion to self-sponsored manager.
- e) The REIT does not have any under-construction properties acquired from the sponsor that have not commenced commercial operations.

The Amendment is currently silent on the mechanics for undertaking the above transition and one would have to wait for SEBI to provide the necessary guidance on the same.

4. Stewardship code for unitholders

A new ‘stewardship’ code for unitholders has been introduced. A new proviso to Regulation 4(2)(g) of the REIT Regulations provides that unitholders holding not less than 10% of the units of the REIT must comply with a ‘stewardship’ code’. The stewardship code has been specified in Schedule IX of the REIT Regulations. The stewardship code requires the unitholders to:

- a) act in the best interests of the REIT and its unitholders.
- b) formulate a comprehensive policy on the discharge of their stewardship responsibilities, review and update the same periodically.
- c) implement a policy to manage issues of conflict of interest while fulfilling their stewardship responsibilities.
- d) periodically monitor the REIT and its investee entities viz. the holding company and special purpose vehicle.
- e) implement a policy on voting.

The May 16 Consultation Paper states that the rationale behind a stewardship code is to ensure greater responsibility on the part of institutional investors.

JSA Analysis

The requirement to 'lock-in' the sponsors' holding till the lifetime of the REIT is likely to increase the investment horizon for institutional investors such as private equity funds and other strategic investment platforms. Accordingly, their exit timelines will have to be adjusted. Also, large unitholders and institutional investors will have to cede certain governance rights in favor of unitholders holding 10% or more of the units who decide to appoint a director.

The criteria to transition to a self-sponsored manager is stringent and one needs to see how many sponsors really exercise this option. There could be some practical difficulties in fulfilling all the requirements set out by SEBI. For example, the restriction on not including any under construction properties within the REIT is quite difficult to fulfil. The ground reality is that a significant portion of the assets held by a REIT are usually under construction projects acquired from the sponsor. The REITs that are currently listed are likely to find it difficult to transition the REIT to a self-sponsored manager.

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