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Study of Current Trends in Real Estate Financing: A REITs Approach

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Abstract—*The Indian economy has gone through a dynamic change over the past 15 years with healthy growth, rising per capita income, increased consumer demand and changing consumer preferences with changing life style. The real estate sector has also assumed growing importance with the liberalization of Indian economy. India's real estate investment market is rapidly growing and following the relaxation of FDI Regulations the country is attracting substantial interest from cross-border real estate investors. As the result of this, various new financial instruments for real estate have come up in the Indian market. In this study we are going to study on these instruments and compare the risks involved in it. The aim of the study is to predict the real estate financing trend for the future years for India and suggest the most favorable way of raising finance for developers and individual investors.*

The traditional instruments of funding projects and land acquisition are through banks and financial institutions. In this study the methodology adopted is to undertake a comparative study on traditional finance instruments such as equity capital, debenture capital, preferential capital, term loan, venture capital with respect to unique financing instruments such as real estate investment trust(REIT) and real estate mortgage investment conduits (REMIC). The author has examined the Indian real estate financing scenario with that of other countries. The author has suggested the most favorable methods for raising finances based on the analyses. The conclusion of the paper is that in the present real estate conditions REITs will perform well and are more beneficial and less volatile financing option for the real estate developers as well as investors. The findings may be useful for the real estate developers as well as individual investors.

1. INTRODUCTION

The Indian real estate market is largely unorganized and dominated by large number of small players, with very few corporate or large players having national presence. The Indian real estate market, as compared to the other more developed Asian and western market is characterized by smaller size, lower availability of good quality space and higher price. Supply of urban land is largely controlled by state owned development bodies like Delhi Development Authority (DDA) and Housing Boards leaving very limited developed space free, which is controlled by a few major players in each city.

Restrictive legislations and lack of transparency in transactions are other main impediments to the growth of this sector. Limited investment from organized sector has also hindered the growth of this sector. There is a driving parallel economy in real estate, involving large amount of undeclared transactions, mainly due to high stamp duty rates. The current legislative framework also leads to substantial losses to the Government.

The various sources of funds can be; the real estate mutual funds, pension funds and insurance companies are the major investors in the housing sector in the developed countries. In United States, pension funds invest1 5% of their reserve in real estate equity and mortgages; whereas Indian developers have ability to get financial help from these sources is limited. Housing finance companies in India also need to be given access to pension, provident and insurance funds. As a generation period of real estate projects is more than 5 years, on an average, it is necessary that developers have access to such long term funding sources.

Answer to the problem is Real Estate Investment Trust/Real Estate Mutual Fund which is a success story in US and UK. The volume of REIT/REMFs in US is of (approx.) $984 billion2 which is most trusted investment for small investors having high returns.

The real estate sector in India has assumed growing importance with the liberalization of the economy also consequent increase in business opportunities as well as migration of the labour force even the demand for commercial and housing space, especially rental Housing. Developments in the real estate sector are being influenced by the developments major in the Retail, hospitality and entertainment (e.g., hotels, resorts, cinema theatres) industries, economic services (e.g., hospitals, schools) and information

[1] Steve Bergsman, .2003. Can REITs build their shareholder base by attracting foreign investors? [20-11-2007]. Available from World Wide Web : <http://www.nareit.com/portfoliomag/03sepoct/feat1.shtml>

[2] Available from World wide web: <https://www.reit.com/data-research/data/industry-snapshot>

technology (IT)-enabled services (like call centers) etc. So as the result of real estate boom various new financial instruments for real estate has come up in the Indian market.

In case of real estate business the factors which drive returns on REITs are like unexpected inflation, changes in the risk, term structure of interest rates and percentage change on the discount of close ended stocks. The impact of these variables is approximately 60 percentages of that for normal stocks. Equity REITs offered neither a superior return nor a hedge against unexpected inflation. Earlier Titman and Warga (1986) also have applied CAPM and APT models for equity and mortgage REITs Over 1973-1987 time periods. They found REITs are more volatile in nature. On an international basis, this result is confirmed by Ling and Naranjo (2002). Contrasting evidence for the U.S. is provided by Liu and Mei (1992) who shows that EREITs outperform large caps and small caps on a risk-adjusted basis but not bonds. Lying in between and probably settling the differences, Chen, Hsieh, and Jordan (1997) derive a Jensen measure for each EREIT using excess returns and conclude that EREITs outperform other investments during some periods but not always.

To better understand the asset class, the analysis of the time-varying nature of real estate betas constitutes another stream of research. Eichholtz (1997) shows a high correlation between securitized real estate and stocks on an international basis, but there is evidence from several countries that this correlation has been declining (Ghosh, Miles, and Sirmans, 1996; Brounen and Eichholtz, 2003). Khoo, Hartzell, and Hoesli (1993) identify a clear declining tendency in EREIT betas and attribute it to the increasing information about securitized real estate as an asset class. More recently, Chiang, Lee, and Wisen (2005) find weak evidence for a decline in EREIT betas with a single-factor model; however, the declining trend in EREIT betas disappears when they use a three-factor model. They observe, however, a sharp decline in market beta in 2002 but cannot identify whether it is random or significant. During bull and bear markets, the variation in betas is examined by Glascock (1991) and Conover, Friday, and Howton (2000) who find that when betas are allowed to change across bull markets, they behave procyclically and explain cross-sectional returns.

In search of a more accurate determination of the hybrid nature of real estate, many authors have depicted its relationship with stocks, bonds and direct real estate. Liu and Mei (1992) report that the risk premiums of EREITs are similar in nature to those of small caps and to a lesser extent to those of large caps and bonds. Glascock, Lu, and So (2000) find that before 1992 REITs were co integrated with bonds and inflation, while after 1992 they were co integrated with stocks and more so with small caps. For the Swiss market, Cauchie and Hoesli (2006) find that real estate funds are integrated with both stocks and bonds.

The relationship between securitized and direct real estate is analyzed by Giliberto (1990), Gyourko and Keim (1992) and Mei and Lee (1994) who find that both sets of returns are determined by a common real estate factor that links their performances. Karolyi and Sanders (1998) acknowledge that other than the stock and bond market risk premiums, a significant risk premium for REIT returns was not being captured by traditional multiple beta asset pricing models. This is also ascertained by Clayton and MacKinnon (2001 and 2003) and Newell (2005) who report a steady increase over time in the proportion of volatility not accounted for by stock, bond and real estate factors. Nonetheless, Clayton and MacKinnon observe that REITs went from being driven by the same economic factors as large caps in the 1970s and 1980s, to being more strongly related to both small caps and real estate related factors in the 1990s. However, Newell finds that the contribution of property only marginally increased in recent years, while the importance of stocks decreased significantly, and bond-like features gained more importance. Anderson, Clayton, and Sharma (2004) distinguish between value and growth small cap stocks and find that REITs behave more like small cap value stocks than like small cap growth stocks or large cap stocks.

In 2006 Martin Hoesli* and Camilo Serrano M have analyzed globally and found that there is a link between securitized real estate and stocks, bonds, and direct real estate. First, they investigated the behavior of betas in 16 countries and they have identified the causes of their variation. Second, securitized real estate returns are regressed on "pure" stock, bond and real estate factors. The betas are generally found to decrease over the 1990-2004 period, but the causes for such decline differ across countries. Furthermore, securitized real estate returns are found to be positively associated with stock and direct real estate returns, but negatively related with bond returns. Ultimately, financial assets contribute greatly to the variance of securitized real estate, while the impact of direct real estate is limited. However, a large fraction of the variance is not accounted for by these factors, especially in the U.S., suggesting that other factors are at play.

2. INDIA: A REAL ESTATE INVESTMENT FUTURE

India has vast potential in all its property investment categories. Strong population growth, a large pool of qualified workers, greater integration with the world economy and increasing domestic and foreign investment are fuelling demand for office, retail and residential property. This demand growth can also be applied to many special property classes such as hotels and second homes.

Growing forward, it will be matter of exploiting this potential. For the real estate industry, three aspects are most particularly important. First, further opening to foreign investment is desirable. Second, India needs a stronger capital market base for property financing. The debate on potential introduction of REITs and real estate funds points in the right direction. The introduction of REITs will give international investors in particular a familiar investing vehicle. Private investors could also enter into indirect investment in real estate. Third, the government needs to step up developing the urban infrastructure. Channeling the process of urbanization into new agglomerations is a plausible step, given the growth scenarios for the metro cities. But it requires additional funding and is likely, at best, to make an impact on real estate markets in the medium term.

In order to evaluate and compare the opportunities and risk of India's various real estate markets it is necessary to have a broad picture of their investment potential i.e. the size of the respective markets. This is not an easy task, however, given the difficulty in obtaining reliable data on global real estate markets and, in particular, real estate in emerging markets.

RREEF/DB real estate research has estimated India's total commercial stock to USD 300 bn, make it the fourth largest commercial stock in Asia, just behind Japan, China and South Korea. However, this still represents a small fraction of global real estate stock, which totals roughly USD 1900 bn.

In addition, India's institutional real estate market is still underdeveloped. The investible stock amounts to no more than USD 83 bn i.e. only 27% of the total stock can be classified as investment grade. This somewhat pales in contrast against China with 35% and starkly against Japan's 65%. With the Indian economy growing strongly the demand for office, retail and logistics space is set to expand significantly in next few years.

Even this is still a conservative estimate as it can be expected that, with the maturing real estate market, even greater institutional activities will result. The Indian real estate market still lacks transparency and liquidity compared to more mature real estate markets but at the same time its market structure is changing fast.

At present Real estate investment trust does not exist in India, implying that the real estate market is still limited. The only way to invest in real estate in the public market is through listed property companies but currently there are very limited companies. Generally speaking, the creation of REITs will improve transparency and liquidity on the real estate capital market. In India, current trend in real estate suggests that the potential introduction of Indian REITs in 2016-17 might provide investors with a comfort zone to reduce the transparency and liquidity risks. This will also provide a wider range of choices for investors to engage in real estate investment, considering the current limitation of the public property.

2.1 Challenges

Capital Market Constraints: Market liquidity is gradually improving but real estate capital participation through capital markets is still constrained. The primary market in direct equity or debt participation is active, but the absence of REITS, Commercial Mortgage Backed Securities (CMBS) and property derivatives are hindering capital flows. Domestic institutional investment is still relatively low, and pension and insurance funds are restricted from investing directly in real estate.

Ownership and Land Title Issues: There are many issues relating to ownership and land title, which reduce the number of investment opportunities. Mainly the issues include:

- A large proportion of land holdings do not have clear title deeds. Private land with clear title is limited.
- Families and individuals typically hold most private land. As a result organized dealings are restricted and title transfer is often hindered.
- The disposal of surplus corporate real estate often involves lengthy processes. There is an increasing propensity, however, for investors to reduce title risk by securing title insurance, which is being structured by insurance companies.

High Transaction Costs: Transaction related duties increase transaction costs significantly, for example the stamp duty paid by the purchaser on direct acquisitions of real estate assets can be as high as 10-12% in some states, encouraging investors to take the SPV (Special Purpose Vehicle) or company equity routes, thus reducing purchase costs to as low as 0.5% of the asset value. Stamp duty is set at state level; it currently ranges from 5% in Maharashtra (i.e. Mumbai) to nearly 10% in Karnataka (i.e. Bangalore).

Slow Development Processes: Development approval processes are slow, lack transparency and can vary significantly between sectors and states. In particular, conversion of agricultural and industrial land into commercial or residential uses is time consuming and costly. For developers, this increases the attraction of Special Economic Zones, which offer single window approval mechanisms.

Short Tenancies: Tenancy laws have not traditionally been in favors of the owners in India due to historic rental controls, although this is undergoing gradual change. Leases in the main cities are typically for a period of nine years, with tenants locked-in for only three years, thus increasing vacancy risk. However, tenant improvements are funded by the tenants, and bank loans against rent receivables are easily available.

3. REAL ESTATE FINANCING OPTIONS

Capital is the prerequisite of any business. Real estate firms invest in long term assets so they necessitate means of financing them. The firm can rely to some extent on funds generated internally. However in most cases internal sources are not enough to meet investment plans. In this case firms seek external funding. The external funding can be raised from a variety of resources. This chapter looks at the various sources of long term finance employed by real estate business firms.

3.1 Retained earnings

Depreciation charges and retained earnings represent the internal sources of finance available to a company. If depreciation charges are used for replacing worn-out equipment, retained earnings represent the only internal source of financing expansion and growth. Companies normally retain 30 percent to 80 percent of profit after tax for financing growth. Hence retained earnings can be an important source of long term financing.

3.2 Equity capital

Equity capital represents ownership capital as equity shareholders collectively own the company. They enjoy the rewards and bear the risks of ownership. However, the liability, unlike the liability of the owner in a proprietary firm and the partners in a partnership concern, is limited to their capital contributions.

3.3 Preference capital

Preference capital represents a hybrid form of financing- it partakes some characteristics of equity and some of debentures.

3.4 Debenture capital

Akin to promissory notes debentures are instruments for raising long term debt capital. Debentures holders are the creditors of the company. The obligation of the company towards its debenture holders is similar to that of a borrower who promises to pay interest and capital at specified times.

3.5 Term loan

Term loans, also referred to as term finance; represent a source of debt finance which is generally repayable in more than one year but less than 10 years. They are employed to finance acquisition of fixed assets and working capital margin. Term loans differ from short term bank loans which are employed to finance short term working capital need and tend to be self-liquidating over a period of time, usually less than one year.

3.6 Venture capital

Venture Capital is "An Investment in a Start-up business that is perceived to have excellent growth prospects but does not have access to Capital markets. It is a type of financing sought by early-stage companies seeking to grow rapidly."

3.7 Comparison

Table 1: Comparison between Various Financing Instruments.

	Cost	Dilution of control	Risk	Restraint on managerial freedom
Retained earnings	High	No	Nil	No
Equity capital	High	Yes	Nil	No
Preference capital	High	No	Negligible	No
Debenture capital	Low	No	High	Some
Term loans	Low	No	High	Moderate

4. REAL ESTATE INVESTMENT TRUSTS

A Real Estate Investment Trust, or REIT, is a company that owns, and in most cases, operates income producing real estate. Some REITs finance real estate. To be a REIT, a company must distribute at least 90% of its taxable income to shareholders annually in the form of dividends. In other words REITs are securities that sell like a stock on the major exchanges and invest in real estate directly, either through properties or mortgages.

REITs receive special tax considerations and typically offer investors high yields, as well as a highly liquid method of investing in real estate.

4.1 Benefits of investment in REITs

Improved Liquidity and Transparency: With the advent of favorable REIT legislation in a growing number of countries, there has been a considerable amount of initial public offerings by private property owners seeking tax-efficient liquidity, as well as conversions by existing listed property companies seeking both improved access to a lower cost of capital from yield-driven investors and the “mark-up” to NAV resulting from tax transparency. This, combined with increased investor demand, has spurred substantial growth in the sector’s overall market capitalization and trading volume, which has, in turn, significantly enhanced the liquidity and transparency of the global real estate securities market.

Enhancement of Diversification Benefits: The diversification benefits of a multi-asset portfolio are improved with the addition of real estate securities. Especially those with REIT-type structures, trade as a separate asset class with low and decreasing correlation to broader equities and bonds. Global real estate investing enhances these basic diversification benefits because the investment scope expands from purely domestic to include international markets, which in turn provide exposure to real estate markets that are positioned in different phases of the real estate cycle.

Efficiency: Investing in global real estate securities is the most efficient means of achieving diversified, core real estate exposure to various markets and sectors abroad because it requires a minimal nominal investment and provides superior liquidity, as compared with direct real estate investments, which are generally capital-intensive and illiquid. Furthermore, shares of REIT securities, in particular, should serve as an even better proxy for direct real estate investment and tend to trade closer to NAV. Additional efficiencies provided by real estate securities include access to diversified, professionally managed, large capital value real estate portfolios and the potential to benefit from economies of scale and local market knowledge, which may be invaluable in certain sectors.

5. INFERENCE

Indian real estate is in booming stage, so India is ready for Global financial instruments to fulfill the need of huge investments in the sector. Since, the regulations and processes of getting finance through traditional finance options is not very easy so Indian companies are raising funds from other countries. The REITs in other countries are performing well and amongst Global REITs Singapore REIT is giving highest return and performance. Pakistan, our neighboring country which has similar conditions like India, has launched REIT in June 2007.

NAREIT report proves that diversifying investment portfolio with REIT increases the yield and reduces the market risks involved. Through Monte Carlo Simulation it has been proved that REITs are less volatile than stocks and bonds. The deviation in rate of return is also less relatively. The risks involved with REITs are less in comparison with other assets.

The financial model proves that project financing through REITs gives better returns and less payback period when compared with financing through traditional options.

Through the above case and simulation we infer that investors will get higher return, so they will invest more in REITs and this will help the developers to raise fund easily and with tax benefits.

So, we conclude that in present real estate conditions REITs will perform well and will be the most beneficial financial option for the real estate developers as well as investors.

6. RECOMMENDATIONS

Table 2: Recommendations for Indian REIT

Country	**India (REIT)**
REIT type	Trust type
List	Yes
Key requirements	It should be regulated by SEBI. Managed by a management company
Legal form	Unit Trust
Minimum Share / Initial capital	No
Shareholder requirements	At least 100 shareholders 5 or fewer individuals or foundations may not hold more than 50% of the shares
Operating Income	90% of annual net income

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