



# **Module-D Unit- 17**

## **JAIIB PAPER-1**

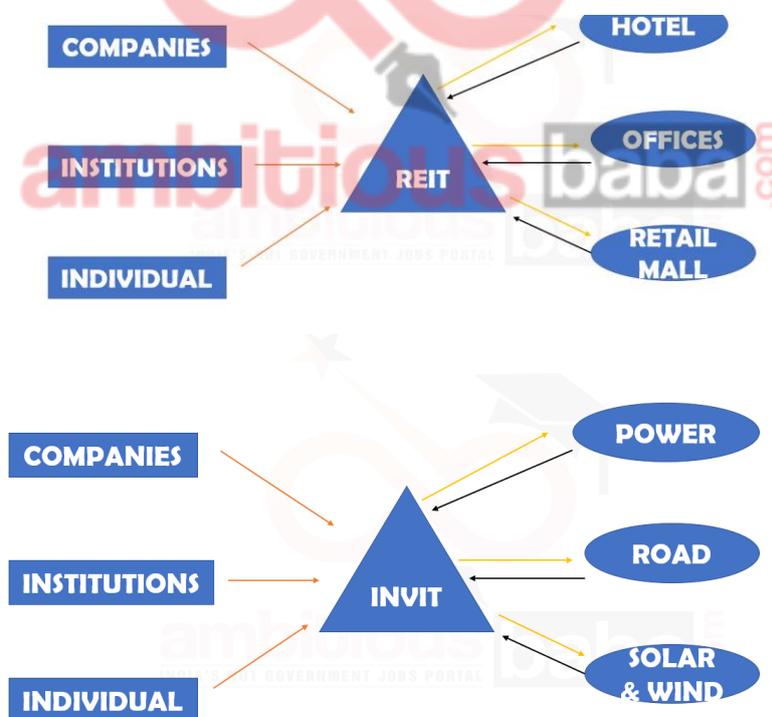
**Indian Economy and Indian  
Financial System (IE & IFS)**



## JAIIB Paper 1 IE & IFS Module D Unit 17: Real Estate Investment Trusts (REITs) and Infrastructure Investment Trusts (INVITs)

### Introduction

- REITs are stock market listed investments that allow investors exposure to real estate, without having to purchase or manage properties by themselves.
- REITs are like Mutual Funds, as they permit the investors to pool in their resources and the assets are managed by a designated person in charge.
- But, while the underlying asset of Mutual Funds is usually equity, debt, gold or a combination of these, the underlying assets in the case of REITs is primarily real estate holdings or loans secured by real estate.
- Similarly, InvITs are listed investments that allow investors to become stake holders in the infrastructure development activities of the nation.
- When a company agrees to formulate the Trust, it become sponsor for the Trust and appoints a Trustee.
- The Trustees hold the underlying assets of such established trust in trusteeship and such assets are no longer controlled by the Sponsor. Companies owning or financing such assets must meet a number of organisational, operational, distribution and compliance requirement to qualify as a REIT/InvITs

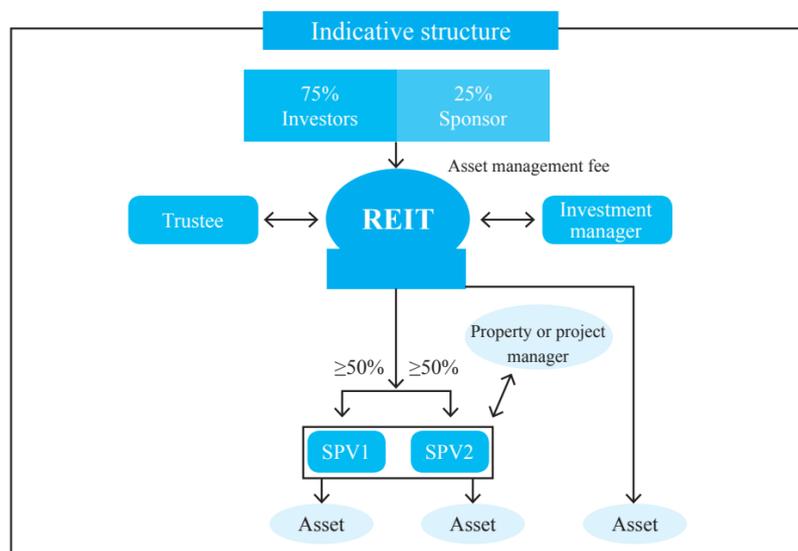


## What are REITs?

- Real Estate investment often features large ticket sizes of **Rs 1 crore or more, especially in Metro and Tier-1 cities.**
- There is another way to get exposure to real estate, i.e., investment in equity stock of listed Real Estate companies.**
- However, these investments are prone to market risk and though real estate is the underlying asset, these investments can be more appropriately termed as mid or small-cap equity investments, with a high degree of volatility.
- A viable solution to this situation is the Real Estate Investment Trusts, or REITs.
- REITs are investment vehicles that pool investor money like mutual funds and use them to buy a portfolio of real estate assets. They manage these assets to generate a regular income and capital appreciation.
- In order to ensure that the REIT is able to **generate income, 80%** of the portfolio of a REIT should be invested in completed and rent-generating properties.
- While REITs can invest in all kinds of income generating properties, such as residences, offices, hotels, malls, warehouses, etc., in India, the listed REITs are focused mainly on office space.

## Organisation Of REITs

- REITs are similar to Mutual Funds, as they allow multiple investors to pool their investments.**
- Fund Manager:** Assets are professionally managed by a designated Fund Manager.
- Underlying asset in the case of REITs, is primarily Real Estate Holdings or loans secured by Real Estate



- **SPONSOR:** When a Real Estate Company decides to form a Real Estate Investment Trust, it becomes the Sponsor for the REIT and appoints a Trustee.
- The Trustee holds the Real Estate Assets of the Trust in its Trusteeship and these assets are no longer directly controlled by the Sponsor.
- **SPVs:** A REIT may control its Real Estate Holdings either directly or through the formation of one or more Special Purpose Vehicles (SPVs).
- **In the case of REITs, the SPV is a domestic company that holds the Real Estate Assets on behalf of the REIT, and as per regulations, the Trust must hold at least 50% of the equity in the SPV.**
- **Manager:** The Trustee appoints a Manager, to manage the Real Estate Assets on behalf of the Trust and also make investment decisions.
- After the Manager is appointed, the REIT can be registered.
- Once registered, a REIT can raise money through the sale of units either publicly on stock markets or through private investors.

### Benefits to the Sponsor

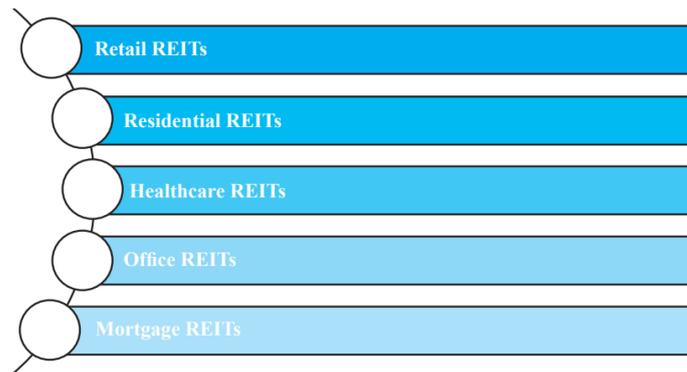
- Monetise revenue-generating real estate and infrastructure assets
- Lower the cost of capital, by tapping the right set of long-term investors (pension funds)
- Enjoy favourable tax treatment, including exemption from dividend distribution tax and relaxation of capital gains tax
- Have diverse sources of funding
- Once listed, provide regular source of capital to the sector.

### Benefits to the Investor

- Invest in real estate or infrastructure, without actually owning the asset
- Benefit from favourable tax norms (tax-exempt dividend income; no capital gains tax, if units are held for more than three years and sold through stock exchange; and withholding tax at 5 per cent for interest income to non-residential unit holders).

## Types of REITs

### Five Different types of REITs.



### Retail REITs

- These REITs are required to invest at least 24% of their assets into commercial retail such as shopping malls and freestanding retail stores.

### Residential REITs:

- Own and operate manufactured housing as well as rental apartment buildings and gated communities.
- Considering the never-ending demand for residential property in India, this is one of the most promising areas of growth.

### Healthcare REITs:

- These trusts primarily invest in and operate healthcare-focused Real Estates such as hospitals, nursing facilities, retirement homes, and medical centres.

### Office REITs:

- These primarily invest in and operate office space.
- Their main source of income for this type of REIT is thus, rental received from tenants under long-term lease arrangements.

### Mortgage REITs:

- **In the case of these REITs, an estimated 10% of investments are made into mortgages instead of physical real estate.**
- Based on the types of funding that they provide, REITs can be of three different types, viz.,
  - ❑ **Equity REITs:** They are owners of real estate properties and lease them to companies or individuals to make money. The income is then distributed among the REIT investors as dividends.
  - ❑ **Mortgage REITs:** They are not the owners, but earn through EMIs against the property from the owners and builders. The earnings are via Net Interest Margin (difference of interest earned on mortgage and cost of funding the loan), which they distribute among the REIT investors, as a dividend.

- ❑ **Hybrid REITs:** These REITs invest in both Equity and Mortgage REITs.

### Difference Between REITs And Real Estate Mutual Funds

- REITs and real estate mutual funds are similar, as they both offer liquidity and a cheap way to get exposure to diversified and substantial capital real estate assets.
- Long-term investors have the potential to reap the rewards of dividend income and capital appreciation over a long period.
- For retail or short term investors with a low investible surplus, these real estate funds present an opportunity to invest in properties that otherwise may not be feasible to invest in the sector.
- A real estate fund can invest in a real estate investment trust to offer benefits to investors, making REIT, a part of their investment portfolio. However, there are some differences, as well. Real Estate mutual funds offer wider diversification than the REITs, based on the investment strategy and have the benefit of experts and professionals managing their portfolio, unlike the REITs.
- The value of the real estate tends to increase during times of inflation as property prices and rent goes up, thus giving a better return to the REIT investors.
- As such, REITs distribute a higher amount of dividend every year to shareholders or investors than the real estate mutual funds.

### Advantages And Disadvantages Of Investing In REITs

*The following are the advantages of investing in REITs:*

- **Diversification:** REITs allow an investor to diversify the investment portfolio through exposure to real estate, without the hassles related to owning and managing commercial properties. This diversification allows an investor to go beyond the usual asset classes of Equity, Debt, and Gold, as part of the overall Asset Allocation Strategy.
- **Small Initial Investment:** One of the key problems associated with making Real Estate investments is the large ticket size especially in the case of commercial properties. REITs require a much smaller initial investment of around Rs. 15,000 to provide similar portfolio diversification benefits.
- **Professional Management:** Properties owned by a REIT are managed professionally. This ensures smooth operations and with no effort on the part of the investor towards managing Commercial Real Estate.
- **Regular Income Generation:** REITs generate income from rental collections and are required to mandatorily distribute 90 per cent of this income to investors, as dividends and interest payments. In this way, REITs provide regular income to investors.
- **Capital Gains:** REITs are listed and traded on Stock Markets and their prices depend on their performance. An REIT that performs well can thus potentially increase in value over time and be sold at a profit. This provides capital gains to the investors.

### ***There are also some disadvantages in investing in REITs:***

- **Limited Options:** Currently, there are only few REITs in India. This significantly limits the choices for investors.
- **Low Liquidity:** While REITs are listed and traded on stock markets, the number of market participants is currently low, especially, with respect to retail investors. As a result, selling REIT investments profitably might be a challenge, especially in an emergency. This results in lower liquidity of the investment.

### ***Advantages of Investing in REITs compared to Directly Investing in Real Estate***

- Investing in REITs is not as capital intensive as a direct investment in properties.
- It is easier to invest in REITs, than in real estate.
- Compared to direct investment in real estate, REITs have lower liquidity risk.
- REITs are regulated by SEBI and, hence, the chances of fraud are low.
- REITs are transparent as they disclose their capital portfolio semi-annually.

### **Comparison Of Various Modes Of Investment In Real Estate**

	<b>REITs</b>	<b>Direct Property Ownership</b>	<b>Real Estate Company Equity</b>	<b>Corporate Property Bonds</b>
<b>Type of Investment</b>	Units in a listed trust/ share of corporation owning real Estate	Investment in physical real estate	Shares of a listed company owning real estate and other business	Debt issued by the underlying real estate company
<b>Payout</b>	Majority of taxable income paid to unit holders	Majority of income paid to owner	Discretionary dividends to shareholders	Fixed Payout
<b>Investment Strategy</b>	Focused Activity	Focused Activity	Investment Choices Determined by the Company Board	Investment Choices Determined by the Company Board
<b>Liquidity</b>	Liquid investment	Illiquid investment	Liquid investment	Low Liquid investment
<b>Diversity</b>	Diversified portfolio	Concentration risk	Diversified portfolio	Concentration risk
<b>Risk</b>	Perceived low risk	Perceived high risk	Perceived high risk	Perceived low risk
<b>Gearing</b>	Gearing is limited by regulations	High gearing between 70% to 80%	Moderate gearing level between 60% to 70%	Moderate gearing level

### **Taxation Guidelines For Investors Of REITs**

#### **Taxation of Dividends:**

- Taxable in the hands of investors
- Included in the annual income of the investors and taxed according to investor's tax slab.

#### **Taxation & Capital Gains:**

- **Capital Gains from sale of REITs units are covered by Short term capital gains or long term capital gains**
- **STCG:** If holding period is 1 year or less from the date of date of allocation [15% of capital gains]
- **LTCG:** If holding period is more than 1 year from the date of date of allocation [10% of capital gains in excess of Rs.1 lakh]

### Regulatory Guidelines For REITs

- Governed by SEBI (Real Estate Investment Trusts) Regulations, 2014, and amendments to the same, issued thereafter.

*Some of the important regulations governing functioning of REITs are as follows:*

#### Structure of investment trust

- Sponsor to hold atleast 25% of the total units of the investment trust after initial offer, on a post-issue basis, for at least 3 years, from the date of listing of such units (unless such holding is disallowed by government or regulatory provisions)
- Invest atleast 80% of the value in completed and revenue-generating projects,
- Maximum 10% in 'under-construction' projects.
- Investment trusts to hold assets either directly or through special purpose vehicles (SPV)
- Investment trusts to hold controlling interest and min 50% equity share capital or interest in the SPVs (except in the case of public-private partnership projects, where such holding is disallowed, by the government or regulatory provisions)
- SPVs to hold not less than 80% of assets directly in properties and not invest in other SPVs
- SPVs not to engage in any activity other than those pertaining and incidental to the underlying projects.

#### Stipulations to ensure transparency

- Trustee to hold assets for the benefit of unit holders, oversee activities, and ensure compliance with respect to reporting and disclosure requirements
- A full valuation to be conducted by an independent valuer, at least once in a year  
All related-party transactions to be on an arm's length basis.

#### Distribution requirements

- Not less than 90% of net distributable cash flow of the SPV to be disbursed to the investment trust, in proportion to its holding in the SPV, subject to applicable provisions in the **Companies Act, 2013, or the Limited Liability Partnership Act, 2008**
- Not less than 90% of net distributable cash flow of the investment trust to be distributed to unit holders. Such distributions to be declared and made at least once, every six months.
- If any asset is sold by the investment trust or SPV, it can reinvest the proceeds into another property or infrastructure asset and will not be required to

distribute the sale proceeds. However, if no such reinvestment is made, it will be required to distribute not less than 90% of the sales proceeds.

### **Leverage restrictions**

- The aggregate consolidated borrowing and deferred payment of the investment trust net of cash and cash equivalents should never exceed 49% of the value of the investment trust assets
- If the aggregate consolidated borrowing and deferred payment of the investment trust, net of cash and cash equivalents, exceeds 25% of the value of the assets, for any further borrowing, credit rating to be obtained, from a registered credit rating agency.

### **Investment regulations**

- To improve liquidity in REITs and bring in more listings, SEBI recently announced that the minimum investment amount in a REIT be brought down to Rs 15,000, with the revised trading lot at one unit; the earlier investment amount was Rs 50,000, and the trading lot 200 units in the secondary market.

## **Infrastructure Investment Trusts (InvITs)**

### **What are InvITs**

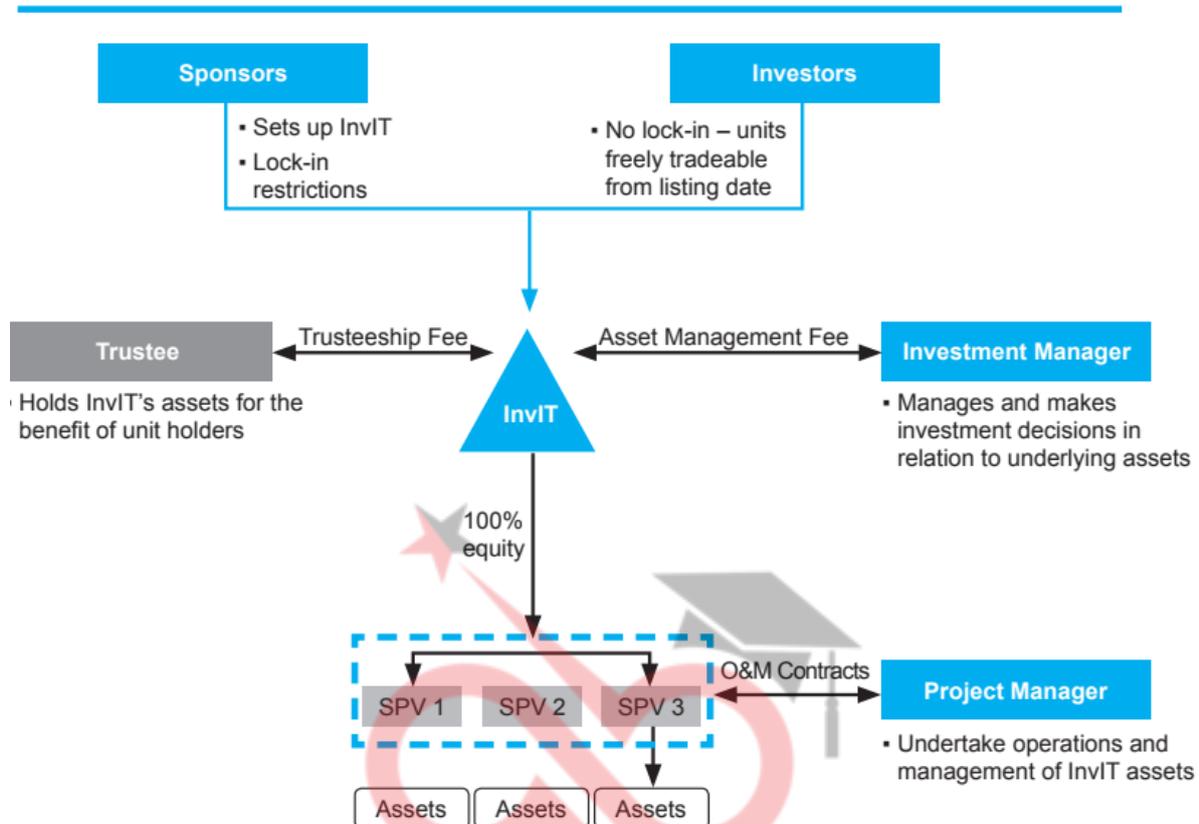
- According to recent reports of the Finance Ministry, India needs to spend USD 4.5 trillion on infrastructure till the year 2040, to improve the economic growth and community well-being.
- Every country needs a defined infrastructure that can provide adequate facilities for each individual and which paves the way for capital mobilisation.
- While addressing the public on the occasion of the Independence Day of 2019, the Hon'ble Prime Minister announced that Rs 100 lakh crores would be invested in infrastructure over the next 5 years.
- An initiative called the National Infrastructure Pipeline was launched to enable this investment.

***While there is no hard and fast rule to define infrastructure, the sectors that are included in infrastructure are:***

- Roads
- Ports
- Power
- Railways
- Airports
- Telecommunication
- Energy
- Coal, petroleum and cement production

## Organisation Of InvITs

*InvITs have a 3-tier management structure, consisting of Sponsor, Manager and Trustee.*



### Sponsor

- An InvIT can have a maximum of 3 sponsors.
- Usually, a sponsor is an infrastructure development company that originally built, owned, and/or operated the infrastructure assets of the trust.
- The primary responsibility of the sponsor is to set up the Infrastructure Investment Trust and appoint a SEBI-approved Trustee.
- As per current regulations, InvIT Sponsors are mandatorily required to hold a minimum 15% stake in the Trust for at least **3 years, after the formation of the trust.**

### Manager

Usually, an InvIT has two types of managers -

- An investment manager
- A project manager.
- The investment manager is responsible
  - ✓ For ensuring that existing investments of the InvIT are providing returns, as per expectations.
  - ✓ Responsible for making new investment decisions on behalf of the Trust to ensure further growth of InvIT assets.

- The project manager is usually a company that specialises in developing and operating infrastructure projects.
- ✓ **Responsibilities:** ensuring smooth operations in the case of completed projects of the Trust as well as timely delivery of under-construction projects.

### Trustee

***A SEBI-approved Trustee is a company that has a proven track record of providing Trusteeship services.***

- **Key responsibilities:** Holding the assets of an InvIT in trusteeship to safeguard the interests of the unitholders.
- Other responsibilities of an InvIT trustee include ensuring timely distribution of dividends to unit holders and overseeing the activity of the InvIT managers.

### **Types Of InvITs**

**InvITs can be divided into 5 types depending on the types of infrastructure they own or operate:**

- Energy such a power generation and distribution
- Transport & Logistics, such as roads and highways
- Communications, such as optical fibre networks and telecom towers
- Social and Commercial Infrastructure, such as parks
- Water and Sanitation such as irrigation networks

**From the viewpoint of source of funds, InvITs can be categorised into two types, viz.,**

- Public listed InvITs
- Privately held InvITs

#### **Public-Listed InvITs**

- After an Infrastructure Trust lists itself for trading on the stock exchange, it is known as a public-listed InvIT.
- Units of a public-listed InvIT can be bought and sold on stock exchanges by retail as well as institutional investors.

#### **Privately-Held InvITs**

- This type of InvIT is not listed on the stock exchange and units of this type of infrastructure trust cannot be bought or sold on a stock exchange.
- All units of this type of unit are held privately, by a very limited number of individuals or institutions.
- Under SEBI guidelines, at least 80% of an InvIT's assets should be generating operational income.
- Moreover, 90% of the net distributable cash flow is required to be distributed to the unit holders.

#### **Advantages And Disadvantages Of InvITs**

**Diversification:**

- Investors seeking to diversify their investments can choose to invest in listed InvITs.
- Through this route, InvITs allow investors to assume part ownership in infrastructure projects and this helps them to diversify their investments to a new asset class, viz., infrastructure projects.

**Regular Income**

- InvITs have to mandatorily distribute at least 90% of the income through dividends and interest pay-outs, on a bi-annual basis.
- Thus, the investments can provide investors, with regular income.

**Professional Management**

- While the investors assume part ownership of an infrastructure asset by purchasing InvITs units, the project is professionally managed by designated managers.
- This ensures optimal performance of the infrastructure project, with minimal hassles to the investors.

**Capital Gains**

- Units of an InvIT can be traded on stock exchanges similar to shares.
- Therefore, if the InvIT performs well, the price of units will increase, leading to capital gains.

**Reduction in minimum subscription**

- In 2019, capital market regulator SEBI reduced the minimum investment limits on InvITs, thereby, making them more easily accessible.
- Reduced from Rs 10 lakhs to 1 lakh.

**Limitations:**

- Income generated by infrastructure projects such as roads/highways, electrical distribution networks, and even telecommunications networks are dependent on two key factors –
  - ✓ **Tariffs and**
  - ✓ **Usage.**
- A change in either of these two variables can lead to an increase or decrease in the income generated by the project.
- Tariffs can change, as a result of Government regulations or interventions.
- Infrastructure usage levels can also change in certain cases.
- For example, a significant decrease in usage of roads and highways occurred during the COVID-19 lockdown of 2020. This had contributed to reduction in toll

booth collections, i.e., income for highway projects, even though the tariffs had remained unchanged during that period.

### InvIT's Revenue Model

- Under an InvIT transaction, infrastructure asset owners, transfer multiple revenue generating assets' special purpose vehicles (SPVs), through holding company or otherwise to a trust, which then issues units to investors for raising money.
- The upfront money so raised is utilised by the developers, for creation of new greenfield assets as also for repayment of debt, which enables availability of capital with lenders for investment/lending to new projects.
- The investors, in lieu of invested money, receive a share of Net Distributable Cash Flows (NDCF – similar to the dividend pay-outs) on a periodic basis, commensurate with their unit holding in the Trust.
- 90% of the net distributable cash flow is required to be distributed to the unit holders.

**Improved yields for the unit holders can be insured, by adding revenue-generating projects and expanding its portfolio.**

#### NDCF for FY-18

Sr. No.	Particulars	Year ended March 31, 2018
1	Cash flows received from Project SPVs in the form of interest	51,122.81
2	Cash flows received from Project SPVs in the form of Dividend	-
3	Any other income accruing at the Trust level and not captured above, including but not limited to interest/return on surplus cash invested by the Trust	446.14
4	Cash flow received from the project SPVs towards the repayment (Net) of the debt issued to the Project SPVs by the Trust	21,911.71
5	<b>Total cash inflow at the Trust level (A)</b>	<b>73,480.66</b>
	Less:	
6	Any payment of fees, interest and expense incurred at the Trust level, including but not limited to the fees of the investment Manager	(7,546.97)
7	Income tax (if applicable) at the Standalone Trust Level	-
8	Repayment of external debt	(389.50)
9	<b>Total cash outflows/retention at the Trust level (B)</b>	<b>(7,936.47)</b>
10	<b>Net Distributable Cash Flows (C) = (A + B)</b>	<b>65,544.19</b>

### **Taxation On Investments In InvITs**

There are two aspects of taxation on income received from investment in InvITs. These are as follows:

#### **Tax on Dividend and Interest Income**

- ✓ Any dividend or interest income from an InvIT is taxable as per the investor's Income Tax Slab rate.
- ✓ Hence, if the investor is, otherwise in the 30% tax bracket, the dividend/interest income from the InvIT will also be taxed at 30 per cent.

### **Tax on Capital Gains**

- ✓ Capital Gains taxation rules are applicable only when the InvIT units are sold.
- ✓ If the investor has stayed invested in InvITs for a period up to 3 years - Short-Term Capital Gains (STCG) taxation rules are applicable. [15% on profits made by the sale of InvITs units]
- ✓ On the other hand, if the investor has held the InvITs units for over 3 years before selling them, Long-Term Capital Gains (LTCG) taxation rules are applicable [10% of long-term gains exceeding Rs. 1 lakh.]

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