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THE BRICK TO CLICK EVOLUTION IS HERE: SEBI NOTIFIES THE SMALL & MEDIUM REITS FRAMEWORK

29 March 2024 **Introduction**

The Securities & Exchange Board of India (SEBI) on 08 March 2024 notified the much anticipated Small & Medium Real Estate Investment Trusts (SM REITs) regime by way of an amendment (SM REITs Amendment) to the SEBI (Real Estate Investment Trusts) Regulations, 2014 (REITs Regulations). The SM REITs Amendment seeks to regulate, the hitherto unregulated fractional ownership platform (FOP) that offer fractional ownership to investors in underlying income generating real estate assets.

Background

In May 2023 SEBI issued a consultation paper on the “Regulatory Framework for Micro, Small & Medium REITs” (Consultation Paper). The Consultation Paper observed that in the past 2-3 years, there has been a proliferation of web-based platforms offering fractional ownership of real estate assets. These fractional ownership platforms (FOPs) provided investors with the option to invest in residential, commercial buildings and office spaces with a minimum investment ticket size ranging from INR 10,00,000 to INR 25,00,000. As per the Consultation Paper, such FOPs were often operated by real estate agents who after purchase of the property also acted as its manager. SEBI highlighted the risk of such structures violating the public offering norms and operating opaque business models without any clearly defined exit opportunity for investors.

Existing REITs Framework

Fractional ownership of rent yielding assets is currently governed by the REITs Regulations which is a listed investment product primarily targeting income generating real estate asset with a minimum value of INR 500 crores. REITs as an asset class was envisaged for retail investors, consequently, only large value assets were permitted to be acquired by the REIT and the minimum investment ticket size for an investor was kept at INR 10,000. The high asset size threshold kept a vast majority of rent yielding real estate asset from being available for monetisation amongst retail investor under extant REITs framework, leading to burgeoning of unregulated FOPs.

The SM REITs Amendment introduces a significantly reduced entry threshold of INR 50 crore for completed and income-generating assets, thereby, unlocking the monetisation potential of small and medium size income generating real estate asset.

Conditions for setting up SM REITs

The SM REITs Amendment provides for a similar legal structure for SM REITs as is provided for REITs, albeit with a fundamental difference viz., doing away with the requirement of having a separate sponsor entity. Some of the key conditions for setting up of a SM REITs are as under:

Legal Structure	<ul style="list-style-type: none"> • SM REIT must be set up as a trust. • The underlying assets will be held by the SM REIT through a special purpose vehicle (SPV). • The SPV will not have any other capital or ownership interest in it.
Investment Manager	<ul style="list-style-type: none"> • Investment Manager should have at least 2 (two) years' experience in the real estate industry or real estate fund management. • Alternatively, the Investment Manager can employ at least 2 (two) key managerial personnels each of whom must have at least 5 (five) years' experience in the real estate industry or real estate fund management. • Investment Manager should have a net worth of atleast INR 20 crore out of which INR 10 crore should be in the form of positive liquid net worth.
Investment conditions	<ul style="list-style-type: none"> • The size of the asset proposed to be acquired in a scheme of the SM REIT (Scheme) should be at least INR 50 crores and less than INR 500 crores. • The Scheme should invest (i) at least 95% of the value of the Schemes' assets in completed and revenue generating properties, as against the 80% requirement for REITs. • Investment in non-revenue generating real estate assets is prohibited; • Upto 5% of the value of the Schemes' assets may be invested in liquid assets, which are unencumbered.
Initial Offering	<ul style="list-style-type: none"> • The Scheme is required to raise contribution from investors by way of an initial offering. • The draft offer document is required to be filed with SEBI through a merchant banker. • The Scheme should have a minimum of 200 unitholders, excluding the investment manager, its related parties, and associates of the SM REIT. • Minimum subscription per investor has been kept at INR 10 lakhs.
Leverage	<ul style="list-style-type: none"> • Leverage may be undertaken both at Scheme level and at the level of the SPV. • The Scheme is permitted to undertake leverage through borrowing as well as issuance of listed non-convertible debentures (NCDs). • The SPV is permitted to undertake leverage through external commercial borrowing and through listed NCDs. Thus, domestic bilateral borrowing at the level of SPV is not permitted. • In case of Scheme level borrowing, the total borrowings and deferred payments net of cash and cash equivalents should not exceed 49% of the value of the Scheme assets. If such total borrowings and deferred payments net of cash and cash equivalents at the Scheme level exceed 25% of the value of the Scheme assets, a credit rating from a registered credit rating agency and approval by a simple majority of unit holders are required.
Launch window	SM REIT is required to make an initial offer of a scheme within 3 (three) years from the date of registration with SEBI.
Minimum public unitholding	The minimum offer and allotment to the public in each Scheme should be at least 25% of the total outstanding units of such Scheme.
Lock in requirements	The units held by the Investment Manager in each Scheme should be unencumbered and will be locked-in for the period set out below:

	Tenure (from the date of listing till the expiry of the below mentioned period)	Lock in period
	Initial three years	i. <i>Scheme which has opted not to undertake leverage:</i> at least 5% of the total outstanding units; ii. <i>Scheme which has opted to undertake leverage:</i> at least 15% of the total outstanding. Any excess holding over and above the above limits to be held by the Investment Manager for a period of at least one year.
	Fourth and fifth year	At least 5% of the total outstanding units
	Sixth to tenth year	At least 3% of the total outstanding units
	Eleventh year to twentieth year	At least 2% of the total outstanding units
	Post completion of twentieth year	At least 1% of the total outstanding units
Distributions	The Investment Manager is required to ensure that: <ol style="list-style-type: none"> i. not less than 95% of net distributable cash flows of the SPV are distributed to the Scheme; ii. 100% of the net distributable cash flows of the Scheme are to be distributed to the unit holders; iii. the distributions are required to be declared at least once in every quarter of the financial year and not later than 15 working days from the end of the quarter; and iv. the distributions should be paid to the unitholders within 7 working days of such declaration. 	

Migration of Existing FOPs

Existing FOPs have been provided a 6 (six) months window to move an application for registration as an SM REIT. FOPs will be required to complete the migration within 6 (six) months from the date of grant of registration or within such period as may be specified by SEBI.

Since the underlying purpose of the SM REITs Amendment is to bring all exiting FOPs under SEBI’s regulatory supervision, the asset size and minimum number of unitholder criteria applicable to new SM REITs have not been made applicable to FOPs migrating as SM REITs.

Analysis

Recognising the keen interest of Indian towards real estate as an asset class and the attendant systemic risk posed by FOPs, SM REITs Amendment address the twin challenge of bringing transparency in the manner in which the real estate asset is acquired and operated by FOPs and offering seamless exit opportunity to investors. The operational challenges relating to listing of Schemes, the cost of set up as well as the compliance cost are yet to be evaluated. While the requirements to onboard only completed assets may not bring cheer to stuck real estate projects or for those who look at this FOPs also as a growth investment but could certainly help the developers to monetise their completed inventory. Also, the requirement of doing away with the requirement of a sponsor and letting first time property managers engaged professionals to meet

the experience criteria is likely to encourage both traditional property managers as well as new age Prop-Tech entrepreneurs capitalise on the regulatory innovation offered by SEBI.

Conclusion

The proposed framework of SM REITs Amendment appears to address a regulatory vacuum that was felt to exist with the proliferation of FOP structures. The attempt to bring these under regulatory purview, recognizing the need for this asset class for investments by High Networth Individuals while retaining some flexibility, is surely a welcome move. We may need to wait and watch whether existing FOPs are willing to move to this structure or may consequently wind those down, which will indicate how appealing the framework is. Clearly, this has the potential to create a whole new investment asset class for investors interested in the real estate sector. The move to allow un-sponsored REITs through this form may also encourage professional fund managers to tap into this opportunity without necessarily having to bring an asset into the REIT as a sponsor under the larger REIT framework.

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