Real Estate Mutual Funds are Arriving…..

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Real Estate Mutual Funds have been talked about for quite some time in India in view of a booming real estate market. Mutual fund industry has been demanding the SEBI permission to float Real Estate Mutual Funds as they have become preferred public property investment vehicles around the world. Finally SEBI announced on 16th April 2008 its permission to mutual funds to launch Real Estate Mutual Fund Schemes (REMFS) enabling them to invest directly or indirectly in real estate assets and other permissible assets. With this a new chapter has been added in the Indian mutual fund industry in particular and the capital market in general.

KEY FEATURES OF REMFS

The following key features of REMFS emerge from a study of SEBI (Mutual Funds) (Amendment) (Regulations), 2008, dated 16th April 2008 vide which the mutual fund industry has been allowed to float real estate mutual funds:

Real Estate Asset

Real Estate Asset means an identifiable immovable property which is located within India in the cities mentioned in:

1. List of million plus urban agglomerations/cities, or
2. List of million plus cities

Which appear in the census statistics of India (2001). The first list includes 35 urban agglomerations/cities and the second 27 cities. The lists are available on www.sebi.gov.in under 'circulars' in 'legal framework'.

3. Or, in a special economic zone.

Vacant land has been excluded from real estate assets. Hence REMFS can not invest therein.

Eligibility

1. An existing mutual fund may launch a REMFS if it has an adequate number of key personnel and directors having adequate experience in real estate.
2. In case of new entrants in the mutual fund business registration may be granted to an applicant proposing to launch **only real estate mutual fund scheme** if he has been carrying on business in real estate for a period of not less than five years.

Operational Details

1. Every REMFS has to be **closed-ended** and its units have to be **listed** on a recognized stock exchange.
2. The redemption of a REMFS may be done in a staggered manner.
3. The units issued by a REMFS shall not confer any right on the unit holders to use the real estate assets held by the scheme and any provision to the contrary in the trust deed or in the terms of issue shall be void.
4. The title deeds pertaining to real estate assets held by a REMFS have to be kept in safe custody with the custodian of the mutual fund.
5. A real estate mutual fund shall **not undertake lending or housing finance activities**.
6. All financial transactions of a REMFS have to be routed through **banking channels and there should not be cash or unaccounted transactions.**

Permissible Investments and Restrictions

1. Every REMFS has to invest at least **thirty five percent** of the net assets of the scheme **directly in real estate assets**.
2. Further every REMFS should invest:
   - At least seventy five percent of the net assets of the scheme in:
     (i) Real estate assets (35%).
     (ii) Mortgage backed securities (but not directly in mortgages).
     (iii) Equity shares or debentures of companies engaged in dealing in real estate assets or in undertaking real estate development projects, **whether listed** on a recognized stock exchange in India **or not**;
   - The balance twenty five percent in other securities which any other mutual fund is entitled to, such as, shares and debentures of non-real estate companies. ;
3. Unless otherwise disclosed in the offer document, no mutual fund can, under all its real estate mutual fund schemes, invest more than thirty percent of its net assets in a **single city**.
4. No mutual fund can:
   - Under all its real estate mutual fund schemes, invest more than fifteen percent, of its net assets in the real estate assets of any **single real estate project.**
   - Under all its real estate mutual fund schemes, invest more than twenty five percent, of the total issued capital of **any unlisted company.**
   - Invest more than fifteen percent of the net assets of any of its real estate mutual fund schemes in the equity shares or debentures of any unlisted company.
   - Transfer real estate assets amongst its schemes.

- Invest in any real estate asset which was owned by the sponsor or the asset management company or any of its associates during the period of last five years or in which the sponsor or the asset management company or any of its associates hold tenancy or lease rights.

5. No REMFS can invest in:
   - Any unlisted security of the **sponsor** or its associate or group company.
   - Any listed security issued by way of preferential allotment by the sponsor or its associate or group company;
   - Any listed security of the sponsor or its associate or group company, in excess of **twenty five percent** of the net assets of the scheme.

Direct Investment in Real Estate Assets

Initial Recognition

1. A real estate mutual fund scheme **can recognize** a real estate asset if:
   - It is probable that the future economic benefits that are associated with the real estate asset will flow to the real estate mutual fund scheme; and
   - The cost of the asset can be measured reliably.
2. The real estate asset shall be recognized **on the date of completion of the process of transfer** of ownership i.e. the date on which the REMFS obtains an enforceable right including all significant risks and rewards of ownership.

Measurement at Initial Recognition

1. A real estate asset should be measured initially **at cost**. Such cost shall comprise purchase price and any other directly attributable expenditure such as professional fees for legal services, registration expenses and asset transfer taxes.
2. If the payment for a real estate asset is deferred, its cost is the cash price equivalent. A REMFS shall recognize the difference between this amount and the total payments as interest expense over the period of credit.
3. A REMFS may acquire one or more **real estate assets in exchange** for a non-monetary asset or assets, or a combination of monetary and non-monetary assets. The cost of such a real estate asset should be measured at **fair value** unless:
   - The exchange transaction lacks commercial substance, or
   - The fair value of neither the asset received nor the asset given up is reliably measurable.

The acquired real estate asset needs to be measured in this manner even if a REMFS cannot immediately derecognize the asset given up. If the acquired real estate asset cannot be measured at fair value, its cost shall be measured at the carrying amount of the asset given up.

'Fair Value' means the amount for which an asset could be exchanged between knowledgeable parties in an arm's length transaction and certified by the real estate valuer. **'Knowledgeable'** means that both the buyer and the seller are reasonably informed about the nature and characteristics of the real estate asset, its actual and potential uses, and market conditions at the balance sheet date.

Subsequent Measurement

1. After initial recognition, a real estate asset held by a REMFS has to be measured at its fair value.
2. A gain or loss arising from a change in the fair value of the real estate asset shall be recognized in the Revenue Account for the period in which it arises. **The gain that arises from the appreciation in the value of real estate asset is an unrealized gain and thus the same cannot be distributed.**
3. To determine the fair value of a real estate asset a REMFS is required to use the services of **two independent and approved real estate valuers** having recent experience in category of the real estate asset being valued and use the **lower of the two valuations.** "Real Estate Valuer" means a qualified valuer of real estate assets who has been accredited by a credit rating agency registered with SEBI.
4. For accounting for rental income on real estate asset, Accounting Standard (AS) 19, ***Leases,*** shall be followed. Such income shall be accrued on a daily basis, till the currency of the lease agreements.

Derecognition of Real Estate Asset

1. A REMFS has to **derecognize a real estate asset on disposal** or when the asset is permanently withdrawn from use and no future economic benefits are expected from its disposal.
2. **Gains or losses** arising from the disposal or retirement of real estate asset should be determined as the difference between the net disposal proceeds and the carrying amount of the real estate asset and should be **recognized in the Revenue Account** in the period of the disposal or retirement.
3. The consideration receivable on disposal of a real estate asset is to be recognized initially at fair value. In particular, if payment for a real estate asset is deferred, the consideration received is recognized initially at the cash price equivalent. The difference between the nominal amount of the consideration and the cash price equivalent has to be recognized as interest revenue over the period of credit.

Net Asset Value

1. The asset management company, its directors, the trustees and the real estate valuer have to ensure that the **valuation of assets held by a REMFS are done in good faith**, and that the accounts of the scheme are prepared in accordance with accounting principles specified for mutual funds.
2. The net asset value of REMFS has to be calculated and declared at the close of **each business day** on the basis of the most current valuation of the real estate assets held by the scheme and accrued income thereon, if any.

Obligations of asset Management Company

1. The asset management company has to exercise due **care while appointing real estate valuers** for valuing the real estate assets held by the REMFS and shall ensure that there is no conflict of interest. The asset management company has to put in place systems to ensure that all financial transactions are done **through banking channels and exclude transactions in cash or unaccounted transactions.**
2. The asset management company has to ensure that **no real estate valuer continues with valuation of particular real estate asset for more than two years** and that no such valuer values the same asset for a period of at least three years thereafter.

Usage of Real Estate Assets

1. The asset management company may **let out or lease out** the real estate assets held by the REMFS if the term of such lease or letting does not extend beyond the period of maturity of the scheme.
2. Real estate assets held by a REMFS may be let out to the sponsor, asset Management Company or any of their associates, at market price or otherwise on commercial terms such that **not more than 25% of the total rental income of the scheme shall be derived from assets so let out.**

Obligations of Trustees

1. The trustees shall review the market price of the units during the year and shall recommend **proportionate buy back** of units from unit holders, if the units are traded at steep discount to the net asset value.
2. The trustees shall ensure that all financial transactions of the REMFS are made only through **banking channels and that systems exist to exclude transactions in cash and unaccounted transactions.**

Transactions by Directors and Employees etc.

1. All transactions done by the employees or directors of the asset management company or the trustee company in real estate assets shall be disclosed by them to the compliance officer within one month of the transaction.
2. The compliance officer shall make a report thereon from the view point of possible conflict of interest and shall submit it to the trustees with his recommendations, if any.

The Offer Document

The offer documents of REMFSs need to contain disclosures which are adequate for investors to make informed investment decisions and such further disclosures as may be specified by SEBI.

CRITICAL ANALYSIS

Let us now carry out a critical analysis of real estate mutual funds. First, the strengths and then the concerns.

Strengths

SEBI has addressed the risks related to:

- One scheme and its subscribers gaining at the cost of the other by putting a ban on inter-scheme transfer.
- Distribution of unrealized appreciation by putting a ban thereon.
- Single valuer and his continuity.
- Investments in a single city, single project, single company, and securities issued by sponsors/associate companies by imposing caps thereon.
- Units being traded at steep discount to their NAV through proportionate buy back.
- Lending and housing finance activities by banning them.
- Liquidity by allowing up to 25% investment in common stocks.

These apart I see the following benefits of real estate mutual funds:

1. They have opened the doors of investment in real estate by a commoner. One can just buy units of Rs. 1,000=00 and reap the benefits of capital appreciation in the booming real estate industry. Now there is no need to have millions of Rupees to be able to invest in property. Otherwise for bulk investment also these mutual funds can become vehicles of choice.
2. The already booming real estate industry is expected to boost further in view of flow of funds from real estate mutual funds.
3. Real estate companies coming out with IPOs can expect a better subscription due to these dedicated mutual funds. Hence, corporate governance of these companies is expected to improve. They are expected to become more professional and transparent.

Concerns

It is not clear why investment in vacant land has not been allowed. It is common knowledge that biggest gains in property come from land. It is also not clear why investment has been denied in the listed securities issued by way of preferential allotment by the sponsor or its associate or group company. I hope these issues will be addressed in due course.

The biggest concern however is related to overvaluation of real estate while buying and undervaluation at the time of selling. In such situations there will be cash kick backs at the cost of the unit holders. SEBI has itself warned at number of places in the regulations to ensure that all financial transactions are done **through banking channels and exclude transactions in cash or unaccounted transactions.**

As long as transactions are done with honesty and cash kick backs are firmly resisted, real estate mutual funds will survive. Otherwise they will vanish.