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Real estate sector reforms in India: A study

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Abstract

Real estate sector has been one of the major sectors in the Indian economy. The pre-recession experienced in 2008 had far reaching impact globally. India was substantially able to withstand even during the sub-prime crisis. The recovery post-recession is very encouraging for the growth in the economy. The Government of India reforms through the demonetization, GST, RERA and the like have brought about reforms in the sector to lure the investors across various income categories. The present study is a conceptual study in bringing about theoretical framework and the reforms introduced in the real estate sector.

Keywords: real estate, statute, tax reforms

Introduction

Indian real estate is going through a major transformation in the recent years. Some of the big decisions and new policies of the Indian Government have affected the real estate sector in big way, albeit in positive or negative manner. Few of the policy changes introduced by the government, such as demonetization, RERA, and REITs in 2016, followed by GST and FDI in 2017, have made huge impacts on Indian real estate sector. Apart from this, there are various other reforms anticipated by the experts in Indian economy, which may come into force in the coming time. However, the new legislation and trends that have come up in the real estate market have the power to reshape the Indian real estate sector for a long term and year 2018 can be a starting point towards the Indian real estate growth story.

Exploring real estate investments: Characteristics of real estate investments

One of the beneficial features of real estate is that it produces relatively consistent total returns that are a hybrid of income and capital growth. In that sense, real estate has a coupon-paying bond-like component in that it pays a regular, steady income stream, and it has a stock-like component in that its value has a propensity to fluctuate. And, like all securities that you have a long position in, you would prefer the value to go up more often than it goes down!

The income return from real estate is directly linked to the rent payments received from tenants, minus the costs of operating the property and outgoing mortgage/financing payments. So, you can understand how important it is to keep your property as full as possible. If you lose too many tenants, you won't have sufficient rents being paid by the other tenants to cover the building operating costs. Your ability to keep the building full depends on the strength of the leasing market - that is, the supply and demand for space similar to the space you are trying to lease. In weaker markets with oversupply of vacancies or poor demand, you would have to charge less rent to keep your building full than in a strong leasing market. And unfortunately, if your rents are lower, your income returns are lower.

Capital appreciation of a property is determined by having the property appraised. (We discuss the appraisal process further in chapter 7, but for now you should just know that an appraiser uses actual sale transactions that have occurred and other pieces of market data to estimate what your property would be worth if it were to be sold.) If the appraiser thinks your property would sell for more than you bought it for, then you've achieved a positive capital return. Because the appraiser uses past transactions in judging values, capital returns are directly linked to the performance of the investment sales market. The investment sales market is affected largely by the supply and demand of investment product.

The majority of the volatility in real estate returns comes from the capital appreciation component of returns. Income returns tend to be fairly stable, and capital returns fluctuate more. The volatility of total returns falls somewhere in between.

Other characteristics

Some of the other characteristics that make real estate unique as compared to other investment alternatives are as follows:

1. **No fixed maturity:** Unlike a bond which has a fixed maturity date, an equity real estate investment does not normally mature. In Europe, it is not uncommon for investors to hold property for over 100 years. This attribute of real estate allows an owner to buy a property, execute a business plan, then dispose of the property whenever appropriate. An exception to this characteristic is an investment in fixed-term debt; by definition a mortgage would have a fixed maturity.
2. **Tangible:** Real estate is, well, real! You can visit your investment, speak with your tenants, and show it off to your family and friends. You can see it and touch it. A

result of this attribute is that you have a certain degree of physical control over the investment - if something is wrong with it, you can try fixing it. You can't do that with a stock or bond.

3. **Requires Management:** Because real estate is tangible, it needs to be managed in a hands-on manner. Tenant complaints must be addressed. Landscaping must be handled. And, when the building starts to age, it needs to be renovated.
4. **Inefficient Markets:** An inefficient market is not necessarily a bad thing. It just means that information asymmetry exists among participants in the market, allowing greater profits to be made by those with special information, expertise or resources. In contrast, public stock markets are much more efficient - information is efficiently disseminated among market participants, and those with material non-public information are not permitted to trade upon the information. In the real estate markets, information is king, and can allow an investor to see profit opportunities that might otherwise not have presented themselves.
5. **High Transaction Costs:** Private market real estate has high purchase costs and sale costs. On purchases, there are real-estate-agent-related commissions, lawyers' fees, engineers' fees and many other costs that can raise the effective purchase price well beyond the price the seller will actually receive. On sales, a substantial brokerage fee is usually required for the property to be properly exposed to the market. Because of the high costs of "trading" real estate, longer holding periods are common and speculative trading is rarer than for stocks.
6. **Lower Liquidity:** With the exception of real estate securities, no public exchange exists for the trading of real estate. This makes real estate more difficult to sell because deals must be privately brokered. There can be a substantial lag between the time you decide to sell a property and when it actually is sold - usually a couple months at least.
7. **Underlying tenant quality:** When assessing an income-producing property, an important consideration is the quality of the underlying tenancy. This is important because when you purchase the property, you're buying two things: the physical real estate, and the income stream from the tenants. If the tenants are likely to default on their monthly obligation, the risk of the investment is greater.
8. **Variability among regions:** While it sounds cliché, location is one of the important aspects of real estate investments; a piece of real estate can perform very differently among countries, regions, cities and even within the same city. These regional differences need to be considered when making an investment, because your selection of which market to invest in has as large an impact on your eventual returns as your choice of property within the market.

Investments/developments in the real estate sector

The Indian real estate sector has witnessed high growth in recent times with the rise in demand for office as well as residential spaces. Private Equity and Venture Capital investments in the sector have reached US$ 1.47 billion between Jan-Mar 2019. Institutional investments in India's real estate are expected to reach US$ 5.5 billion for 2018, the highest in a decade [1].

According to data released by Department of Industrial Policy and Promotion (DIPP), the construction development sector in India has received Foreign Direct Investment (FDI) equity inflows to the tune of US$ 25.04 billion in the period April 2000-March 2019.

Some of the major investments and developments in this sector are as follows

- New housing launches across top seven cities in India are expected to increase 32 per cent year-on-year by 2018 end to 193,600 units.
- In September 2018, Embassy Office Parks announced that it would raise around Rs 52 billion (US$ 775.66 million) through India's first Real Estate Investment Trust (REIT) listing.
- New housing launches across top seven cities in India increased 50 per cent quarter-on-quarter in April-June 2018.
- In May 2018, Blackstone Group acquired One Indiabulls in Chennai from Indiabulls Real Estate for around Rs 900 crore (US$ 136.9 million).
- In February 2018, DLF bought 11.76 acres of land for Rs 15 billion (US$ 231.7 million) for its expansion in Gurugram, Haryana.

Major positive trends in the Indian real estate market

Looking at the positive aspects of the reforms, there is a big possibility that years 2018-19 are going to be the bumper years for the Indian realty market. The transformation of market has attracted the eyes of domestic and foreign investors, and there are various positive trends observed by the experts, which point towards a more pro-active, positive and growing Indian Real Estate sector. Listed below are seven major positive trends in the Indian Real Estate market, which shows that there is great depth in the market and the so-called revival of real estate in India has already started.

1. **Global capital flow into Indian real estate:** One of the major signs of revival for Indian property market, investments by global investors has increased recently, with various international property funds and investors acquiring strong positions in Indian realty space. As per World Investment Report 2016-17 by the United Nations Conference for trade and development, India has been ranked fourth in terms of FDI inflows, which shows strong interest by the foreign buyers and investors in the Indian markets.

   Improvements in India's overall credibility with transformation of regulatory framework has built up an attractive destination for both global and Indian investors. Thanks to improvement in transparency, NRIs and foreign investors find country's real estate market more reliable than ever before. Thus far, Indian real estate has attracted USD 32 billion in private equity and various other foreign investors are willing to invest in various sectors in India. As per Economic Survey of India, Indian Real Estate sector witnessed significant improvement attracting a total Foreign Direct Investment of USD 257 million in the second half of 2017 only. Looking at this trend, the expectations from

[1] www.ibef.org

private equity is high in the coming years and it is projected that 2018 and 2019 will be even bigger years for FDI investments in India.

2. **Developers will revamp their business models:** From year 2000 to 2016, because of lack of strong regulations of Indian property sector, developers used to launch many projects at the same time and there was no guarantee of completion of projects on time. There are numerous instances where investor’s hard earned money went down the drain, simply because the developer is highly over-leveraged and could not complete the project. Now, with the enactment of RERA Act (Real Estate Regulation and Development Act, 2016), a deadline has been fixed for the projects to be completed, which will force developers to re-zig their business models.
   The developers will require bringing more transparency as well as accountability in their processes, and do a lot more to increase consumer confidence in the project. Also, other legislative reforms such as The Goods and Service Tax (GST) Act 2017 as well as The Benami Transactions (Prohibition) Amendment Act 2016, will have a major impact on the business models and work ethics of developers. This also means that most of fly-by-night developers will be out of market and Indian real estate will have more reputed and serious property developers. This will bring in more confidence of domestic and foreign investors into the market, which may result in higher and sustainable demand in the long run.
3. **Ever increasing housing demand:** Although past few years have observed comparatively lower transactions in the residential sector, housing demand in the country is quite high, thanks to its ever-growing population size. In India, there is an estimated shortage of around 40 million houses (urban and rural). In addition, population growth of 1.3 per cent per annum, favorable demographics, rise of concept of ‘nuclear families’, increased migration to urban areas, fiscal benefits, rising income/aspirations, etc. could lead to another 10 million demand for houses per annum.
   However, in the recent times, most of the property developers focused on luxury to mid end housing only, whereas much of this demand is in the affordable housing segment. Moreover, with time, the definition of affordability also has changed and with ever increasing land prices, high finance rates, construction cost and stringent development regulations, affordable housing was not at all profitable option for real estate developers. This required some impetus from the government for developers to focus on affordable housing segment.
   With the government nod of infrastructure status to affordable housing in Union Budget 2017-18, this sector is expected to grow at a high pace. The affordable housing segment is expected to be the next big growth driver of the Indian economy with property experts predicting a phenomenal growth rate of over 30% in the medium term. Developers may now have options for diverse and cheaper sources of funding, including external commercial borrowings (ECBs), which eventually can lower the borrowing costs of developers, who should pass on the savings to the buyers and investors.
   New reforms also amended the size of affordable housing units in big cities, which is more in line with the markets. Moreover, banks may also be willing to lend these projects at attractive interest rates, which will result in easy and cheaper financing options to end users as well. With this in mind, various property developers and builders in India are gearing up to develop affordable housing projects, which are expected to improve the market sentiments in the time to come.
4. **Commercial market shots:** One of the major leader of property sector, commercial office market, is turning out to be the front-runner in witnessing positive changes in the market owing to various legislative revolutions. RERA, REIT, demonetization, GST, make in India and various other reforms have given numerous positive shots to commercial real estate market, which has started springing back towards high growth curve.

A. REITs: With the government making way for REITs (Real Estate Investment Trusts) in Indian realty market, the commercial office market has already started bouncing back in Mumbai, Bangalore, Delhi and Pune. With major market players such as Blackstone, Embassy and DLF making fast in-roads for REIT model in India, the trickle down impact on other realty players in anticipated in 2018-2019, which may result in improvement in other commercial office markets of the country with higher investment returns to its investors. The REIT potential in India is huge, with around 229 million sq. ft. of office space currently being REIT compliant. As per industry experts, even if 50% of this space is listed in the next few years, it will be mammoth $18.5 billion worth of REIT listing. Moreover, India's stock of Grade A commercial assets is also increasing with more and more developers are looking to contribute to this sector and REITs acting as a sure-fire growth catalyst. The long term results should show investments in other markets such as retail, industrial and hospitality, which is expected to improve the overall market sentiments.

B. Co-working spaces: Indian office sector is moving into ‘hybrid’ spaces or co-working culture, looking at the strong demand for flexible working spaces in India. The rise of numerous start-ups in Indian markets has paved the way for this market, which is turning out to be a big boost for the commercial office sector. Co-working spaces are popping up across Indian metros as well as Tier-II cities, providing start-ups with flexible working options at affordable rents. Presently, there are more than 100 operators in this space across India, though there is still very limited supply of co-working spaces available. This sector is slowly moving to become a big success story, with various other countries also following the same model.

C. Industrialization and Trade: Apart from various other factors, improvement in industrialization and trade opportunities in the recent past are also fueling the demand for commercial office space in various cities in India. Moreover, with recent changes in FDI policy, demand for warehousing industry is expected to increase many-folds in 2018-2019, which will have a positive impact on other sectors including commercial office market.

1. **Tourism and hospitality industry:** Tourism in India was always a big revenue generator for the Indian economy and one of the key drivers for creation of jobs in various cities and region in India. It is a critical and economically important industry in India, which has started to show signs of revival in the recent years.
   As per World Travel & Tourism Council, tourism in India has generated USD 230 billion in year 2017, which is equivalent to 9.4% of the nation's GDP. Apart from being the main GDP contributor, India Tourism has supported 41.622 million jobs, almost 8% of its total employment. The sector is predicted to grow at an annual rate of 6.9% to USD 490 billion by 2028 (9.9% of GDP), which should result in good demand and high growth for the hospitality industry. Apart from leisure, religious and business tourism in India, medical tourism is also increasing at a high growth rate, thanks to economical and quality medical services available in the country. In October 2015, India's medical tourism sector was estimated to be worth USD 3 billion, which is projected to grow to USD 7-8 billion by 2020. All these changes are reflecting in the present trends in hospitality industry. It is observed that 2016-2017 was a great year for hospitality industry in India, with overall ARR clocking at approx. USD 90, with average hotel occupancy observed at 65.6%. Although these figures are much lower than the 2007-08 results, the steady improvement suggest a strong outlook for the hospitality sector, which is showing all signs of revival and expected to grow in mid to long run. Consequently, various international and domestic hotel and hospitality investors have started scouting for right investment opportunities in various cities in India.
2. **Alternative asset classes:** It is quite heartening to know that it is not only the residential, commercial and hospitality sector, which are showing revival of trends. Instead, various alternative and new asset classes have emerged in the Indian real estate sector such as short term stays, specialty hospitals and medical institutes, schools, student housing, aged care facilities, etc. These emerging sectors are showing great signs of high growth in the recent times and promises to push the sector further up with induced investments by various domestic and foreign investors.
3. **Market consolidation:** In the past few years, owing to slowdown of realty sector, comparatively few sales and lack of financing options in India has led to various developers over-leveraging themselves. This means that most of small time developers may either have to sell off their assets or enter into JV with big and more reputed developers to save them from this financial mess and deliver their projects. With this consolidation of property development market on the cards, the highly overcrowded real estate sector in India is expected to become a lot leaner and meaner. With consolidation happening by ways of joint developments and joint ventures between landowners and/or small developers with bigger, better-organised players, smaller developers being bought out by larger players, and struggling developers cashing in their land banks by selling them to players with stronger balance sheets and appetite for growth.

Impact of demonetization, RERA and GST on real estate

The real estate sector has faced several obstacles over the past few months in the light of the implementation of demonetization, RERA and GST. Each of these reforms brought about an added dimension of change to the sector, and with it a new set of challenges to take on.

Demonetization

The demonetization move was received with a lot of panic, causing people to be wary of spending, leading to a decline in demand for housing. Property registrations saw a decrease of up to 40%, giving rise to an air of fear among developers. This led to them putting many projects on hold to avert losses and risk. Regular sale of homes had taken a hit with several thousands of properties across the country having seen a sudden stoppage in sales. The effects of demonetization on the real estate sector have varied from place to place but with time, the demand for housing saw a gradual increase, especially in the affordable housing segment, a large chunk of which is comprised of small sized flats. Affordable housing is being given a healthy push by the government and there are also a few tax benefits that have been introduced.

Rera

The Real Estate Regulation (and Development) Act, 2016 (RERA) came into effect on May 1, 2017. It aims to boost investments in the real estate sector and create a more transparent environment for property buyers by increasing the accountability of builders. There are three groups of people who are the main stakeholders in the real estate sector - builders, brokers and buyers. The impact of the above on interested groups is as under:

Builders

Builders are required to register all properties above 500 square meters or those having eight units in order to facilitate regulation. RERA also requires builders to do away with terms like built up area. Property is now to be sold on the basis of carpet area, which has been clearly defined in the act. Builders are also liable for structural defects for up to 5 years from handing over possession to buyers. Any new projects will need to be licensed and approved by RERA before they can commence development, leading to a decrease in the approval of new projects.

Brokers

Real estate brokerage in India has been relatively unorganized. In accordance with RERA, real estate brokers will have to register themselves and acquire a license. They are also required to provide complete and correct information to buyers and perpetuation of any false information on their part can result in heavy penalties.

These regulations will serve to weed out brokers who engage in malpractices to win the confidence of buyers.

Buyers

Buyers now enjoy more power as the new regulations have laid down the foundation for a more transparent buying process. Developers are now going to be held accountable for their actions and can face severe penalties for deviating from RERA requirements. Each state is going to have regulatory bodies as well where disputes between buyers and builders are to be resolved within a period of 60 days.

In order to combat the issue of late delivery of property, RERA has also established regulations where the developer has to pay interest to buyers in the event of any delay in the transfer of possession.

The real estate sector is set to greatly benefit from RERA. It will go a long way in increasing buyers' trust in the sector and will serve to encourage foreign investment as well. RERA has brought forth a number of other changes which will transform the face of real estate in India. For more information on RERA, take a look at some of our other articles.

GST

Developers across the nation have been gearing up for the changes that GST would bring along. The GST is still in its initial stages and there are many processes that are yet to be streamlined. However, its effects are already being felt in a major way. People are mainly adapting the new tax structure. Under the previous tax regime, there were multiple taxes levied on various construction materials including paid customs duty, central sales tax, excise duty and many others. The GST subsumes many of these taxes which can improve the profit margins of developers.

There are a number of materials for construction which come under the 28% tax slab. This will lead to an increase in prices of materials like marble, granite, tiles and ceramics among others. This might in turn lead to increase in prices of construction projects. Furthermore, residential projects which are under construction will attract a tax of 12%. In scenarios where the majority of construction has been completed before the implementation of GST, there will be minimal credit input available to the developer. Stamp duty, however is still applicable irrespective of whether a project is in the construction or completion phase.

Ready-to-move-in properties might be seen in favorable light by buyers, as they are not affected by GST, although such properties will be priced at a slightly higher rate as they do not see the benefit of input tax credits. Go through some of our other articles for more information on the intricacies of GST. When it comes to resale, properties that have occupation certificates do not come under the ambit of GST. However, buyers of under construction resale property will incur GST rates. Stamp duty and registration charges also apply in these situations but they vary from state to state.

In spite of all the uncertainty around the GST, the reformation of the complex tax structure stands to bring increased transparency to the real estate sector and boost foreign investments. The economy is still in a transitory stage when it comes to RERA and GST and there are many developments that will happen over time as the new regulations get further streamlined. Industry veterans hold a positive stance towards these changes and expect to see tremendous long term benefits out of them.

Conclusion

The real estate sector has huge potential for growth in the forthcoming years. The contribution to the GDP of the country is commendable. The initiatives of the economic reforms have led to a lot of prominent changes in the sector. The rationalizing of the sector has shaped the mechanism of the real estate sector. The supply and demand gap in the real estate sector is to be filled in the years to come.

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