

Real Estate Update

November 07, 2014

FOREIGN INVESTMENT NORMS FOR REAL ESTATE LIBERALIZED

- Minimum area threshold reduced from 50,000 sq ft. to 20,000 sq ft.
- No minimum area threshold, if 30% project cost is contributed towards development of affordable housing.
- Are investments in completed yield generating real estate assets allowed?

In a recent press release issued in relation to its meeting dated October 29, 2014 ("**Press Release**"), the Union Cabinet has cleared the further liberalization of Foreign Direct Investment ("**FDI**") in 'construction-development sector', in line with the announcements in the Finance Minister's budget speech for 2014.

CHANGES

The changes sought to be made by the Press Release are set out below.¹

Provisions	Revised policy pursuant to Press Release	Existing Policy
Minimum Land Requirements	Minimum area to be developed under each project would be: (i) Development of serviced plots: No minimum land requirement; (ii) Construction-development projects: Minimum floor area of 20,000 sq. meters; (iii) Combination project: Any of the above two conditions need to be complied with.	Minimum area to be developed under each project would be as under: (i) Development of serviced housing plots: Minimum land area of 10 hectares; (ii) Construction-development projects: Minimum built-up area of 50,000 sq. meters; (iii) Combination project: Any of the above two conditions need to be complied with.
Minimum Capitalization Requirements	Minimum capitalization of USD 5 million.	For wholly owned subsidiary: minimum capitalization of USD 10 million; For joint ventures with Indian partners: minimum capitalization of USD 5 million.
Timing of investment	The funds would have to be brought in within 6 months of commencement of the project. 'Commencement of the project' has been explained to mean ' <i>date of approval of the building plan/lay out plan by the relevant statutory authority</i> '. Subsequent tranches can be brought in till the earlier of: (i) Period of 10 years from the commencement of the project; or (ii) The completion of the project.	The funds would have to be brought in within 6 months of 'commencement of business of the Company'. No such concept of 10 years from commencement of business earlier.
Lock-in	The investor is permitted to exit from the investment at (i) 3 years from the date of final installment, subject to development of trunk infrastructure, or (ii) on the completion of the project. 'Trunk infrastructure' has not been defined, but is explained to include roads, water supply, street lighting, drainage and sewerage.	The investor is permitted to exit from the investment at expiry of 3 years from the date of completion of minimum capitalization. For investment in tranches: The investor is permitted to exit from the investment at the later of (a) 3 years from the date of receipt of each tranche/ installment of FDI, or (b) at expiry of 3 years from the

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	Repatriation of FDI or transfer of stake by a non-resident investor to another non-resident investor would require prior FIPB approval.	date of completion of minimum capitalization. Prior exit of the investor only with the prior approval of FIPB.
Sale of developed plots only	Only developed plots are permitted to be sold. Developed plots would mean plots where trunk infrastructure is developed, including roads, water supply, street lighting, drainage and sewerage. The requirement of completion certificate has been done away with.	Sale of undeveloped plots prohibited. Undeveloped plots would mean plots where roads, water supply, street lighting, drainage and sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. The investor was required to provide the completion certificate from the concerned regulatory authority before disposal of serviced housing plots.
Minimum development	No requirement of any such minimum development.	At least 50% of the project must be developed within a period of 5 years from date of obtaining all statutory clearances.
Exemption	They are no longer exempt from the sale of undeveloped plots.	Certain investments were exempt from complying with the following requirements: (i) minimum land area; (ii) minimum capitalization, (iii) lock-in, (iv) 50% development within 5 year requirements and (v) sale of undeveloped plots.
Affordable Housing	Projects which allocate 30% of the project cost for low cost affordable housing are exempt from the minimum land area, and minimum capitalization requirements.	No such exemption.
Certificate from architect	The investee company required to procure an architect empanelled by any authority authorized to sanction building plan to certify that the minimum floor area has been complied.	No such requirement.
Completed projects	It has been clarified that 100% FDI permitted in completed projects for operation and management of townships, malls/ shopping complexes and business centers.	No such provision/ clarification
Responsibility for obtaining all necessary approvals	Investee Company.	Investor/ Investee company.

ANALYSIS

Particulars	Revised policy pursuant to Press Release	Existing Policy
Minimum Land Requirements	<p>Minimum area to be developed under each project would be:</p> <p>(i) Development of serviced plots: No minimum land requirement;</p> <p>(ii) Construction-development projects: Minimum floor area of 20,000 sq. meters;</p> <p>(iii) Combination project: Any of the above two conditions need to be complied with.</p>	<p>Minimum area to be developed under each project would be as under:</p> <p>(i) Development of serviced housing plots: Minimum land area of 10 hectares;</p> <p>(ii) Construction-development projects: Minimum built-up area of 50,000 sq. meters;</p> <p>(iii) Combination project: Any of the above two conditions need to be complied with.</p>

Serviced plots and combination projects

Removal of minimum land requirements for serviced plots is a substantial relaxation. It appears that in case of combination projects as well, there shall be no minimum land requirement. Such relaxation could attract creative structuring for foreign investments in smaller areas.

Construction- development projects

In case of construction-development projects, the minimum land requirement has been reduced from 50,000 sq. meters of built-up area to 20,000 sq. meters of floor area. The introduction of floor area concept, as against the earlier benchmark of built-up area may need to be examined. 'Floor area' has been stated to be defined '*as per the local laws/ regulations of the respective state governments / union territories*'. Definitions of 'floor area' vary from state to state. While floor area is defined for some areas, other areas do not have any definition of the term, such as the

regulations for Greater Mumbai. It is to be seen whether floor area in these regions would be equivalent to built-up area or floor space index (FSI), though in some cases, floor area is close to built-up area.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Minimum Capitalization Requirements	Minimum capitalization of USD 5 million.	For wholly owned subsidiary: minimum capitalization of USD 10 million; For joint ventures with Indian partners: minimum capitalization of USD 5 million.

In a market largely driven by debt such as listed non-convertible debentures, a lower minimum capitalization would be helpful considering minimum capitalization can only consist of equity and compulsorily convertible instruments. This will also be helpful in tax structuring and optimization of returns for investors.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Timing of investment	The funds would have to be brought in within 6 months of commencement of the project. 'Commencement of the project' has been explained to mean ' <i>date of approval of the building plan/lay out plan by the relevant statutory authority</i> '. Subsequent tranches can be brought in till the earlier of: (iii) Period of 10 years from the commencement of the project; or (iv) The completion of the project.	The funds would have to be brought in within 6 months of 'commencement of business of the company'. No such concept of 10 years from commencement of business earlier.

Commencement of business of company to commencement of project

'*Commencement of business of the company*' had not been defined in the FDI Policy. It was seen practically that the regulator's view was that the period of 6 months was to be calculated from the earlier of the date on which the investment agreement was signed by the investor, or the date the funds for the first tranche are credited into the account of the company. However, the criterion has now been changed to 6 months from the commencement of the project of the company, which has been explained to mean the date of the approval of the building plan/ lay out plan by the relevant authority. This is a welcome move since this brings clarity as against dependence on interpretation of 'commencement of business'.

Period for subsequent tranches

The FDI Policy did not have any restriction on the maximum period till which the investor could infuse funds. However, the Amendment states that subsequent tranches of investment can only be brought in till a period of 10 years from the commencement of the project, which seems to imply that the regulator is reluctant towards real estate projects which have extremely long gestation periods.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Lock-in	The investor is permitted to exit from the investment at (i) 3 years from the date of final installment, subject to development of trunk infrastructure, or (ii) on the completion of the project. 'Trunk infrastructure' has not been defined, but is explained to include roads, water supply, street lighting, drainage and sewerage. Repatriation of FDI or transfer of stake by a non-resident investor to another non-resident investor would require prior FIPB approval.	The investor is permitted to exit from the investment at expiry of 3 years from the date of completion of minimum capitalization. For investment in tranches: The investor is permitted to exit from the investment at the later of (a) 3 years from the date of receipt of each tranche/ installment of FDI, or (b) at expiry of 3 years from the date of completion of minimum capitalization. Prior exit of the investor only with the prior approval of FIPB.

Exit on completion

A welcome change is permitting investors to exit on the completion of the project. Hitherto, each tranche of investments were locked-in for a period of 3 years, even if the project was completed. This posed a major challenge for last-mile funding for projects, since the investment was stuck even on the completion of the project.

Lock-in of 3 years from final instalment

The lock-in for ongoing or non-completed projects for 3 years from the final tranche may need to be examined. The earlier regulations required any tranche to be locked in for a period of 3 years from the date of receipt of such tranche only.

50% in 5 years

Another positive move is the removal of the minimum development of 50% in 5 years from the date of obtaining all

statutory clearances. Earlier, there some ambiguity in relation to when the 50% development requirement would trigger, since it was unclear what all statutory approvals meant. To remove this ambiguity, the requirement for the minimum development of 50% in 5 years has been removed. However, in spirit, the same has been introduced by requiring 'trunk infrastructure' to be developed before any exit.

Trunk infrastructure

To be eligible to exit at the end of 3 years from the last tranche, trunk infrastructure (explained to include roads, water supply, street lighting and drainage and sewerage) must be developed. This requirement did not exist previously, and has been a recent introduction. This has also removed all ambiguities in relation to the 50% development requirement, since this is no longer linked to the obtaining of statutory clearances.

Grandfathering

It is unclear whether existing investment, on the anvil of exit currently would be required to satisfy the trunk infrastructure requirements. This may be a major barrier for investors who have completed the 3 year period from their investment, and are seeking exit, although trunk infrastructure has not been developed. It is also unclear whether existing tranches of investment would be locked in till the end of 3 period from any future tranches, if any.

Grandfathering of the existing investments from the requirements to comply with trunk infrastructure and the lock-in period would be important for existing investments.

Sale of stake from non-resident to non-resident

While the exit of a foreign investor earlier required FIPB approval, transfer of a non-resident investor's stake to another non-resident investor was not expressly included. The Press Release now confirms this.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Requirement of commencement certificate for serviced plots	The requirement of commencement certificate has been done away with.	The investor was required to provide the completion certificate from the concerned regulatory authority before disposal of serviced housing plots.
A major relaxation which has now been introduced is the removal of the completion certificate requirement. Since these were service plots, a completion certificate was not forthcoming. Addressing this concern, this is no longer required as long as trunk infrastructure is developed.		

Particulars	Revised policy pursuant to Press Release	Existing Policy
Minimum development	No requirement of any minimum development.	At least 50% of the project must be developed within a period of 5 years from date of obtaining all statutory clearances.

Earlier, there some ambiguity in relation to when the 50% development requirement would trigger, since it was unclear what all statutory approvals meant. To remove this ambiguity, the requirement for the minimum development of 50% in 5 years has been removed. However, in spirit, the same has been introduced by requiring 'trunk infrastructure' to be developed before any exit.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Affordable Housing	Projects which allocate 30% of the project cost for low cost affordable housing are exempt from the minimum land area, and minimum capitalization requirements.	No such exemption.

Affordable housing projects have been defined to mean projects which allot at least 60% of the FAR/ FSI for dwelling units of carpet area not being more than 60 sq. meters. Out of the total dwelling units, at least 35% should be of carpet area 21-27 sq. meters for economically weaker section category.

This would encourage creative structuring of investments into affordable housing. While the intent clearly is to encourage investment into affordable housing and housing for the economically weaker section, the equilibrium between luxury housing and affordable housing remains to be seen.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Completed projects	It has been clarified that 100% FDI permitted in completed projects for operation and management of townships, malls/ shopping complexes and business centers.	No such provision/ clarification

It has been long debated whether FDI should be permitted in commercial completed real estate. By their very nature, commercial real estate assets are stable yield generating assets as against residential real estate assets, which are also seen as an investment product on the back of the robust capital appreciation that Indian real estate offers. To that extent, if a company engages in operating and managing completed real estate assets like a shopping mall, the intent of the investment should be seen to generate revenues from the successful operation and management of the asset (just like a hotel or a warehouse) as against holding it as a mere investment product (as is the case in residential real estate). The apprehension of creation of a real estate bubble on the back of speculative land trading is to that naturally accentuated in context of residential real estate. To that extent, operation and management of a completed yield generating asset is investing in the risk of the business and should be in the same light as investment in hotels, hospitals or any asset heavy asset class which is seen as investment in the business and not in the underlying real estate. Even for REITs, the government was favorable to carve out an exception for units of a REI from the definition of real estate business on the back of such understanding, since REITs would invest in completed

yield general real estate assets. The Press Release probably aims to follow the direction and open the door for foreign investment in completed real assets, however the language is not entirely the way it should have been and does seem to indicate that foreign investment is allowed only in entities that are operating an managing completed assets as mere service providers and not necessarily real estate. While it may seem that FDI has now been permitted into completed commercial real estate sector, the Press Release leaves the question unanswered whether these companies operating and managing the assets may own the assets as well.

Particulars	Revised policy pursuant to Press Release	Existing Policy
Responsibility for obtaining all necessary approvals	Investee Company.	Investor/ Investee company.

Analysis: The obligation to obtain all necessary approvals, including the business plans has now been clarified to be that of the investee company in India, doing away with the unnecessary hassles around this for investor.

CONCLUSION

The changes introduced by way of the Press Release are along expected lines after the Budget Speech earlier this year. The minimum land requirement was an impediment for foreign investment, since it was difficult to find large tracts of land for development to satisfy the minimum land requirements in Tier-I cities. Further, the demand was inadequate for such investment to be made in Tier-II cities, where minimum land requirements could be met. Reducing or removal of minimum land requirements, along with removal of the requirement to obtain a completion certificate for sale of such plots would encourage foreign investment into this space.

While the final press note is still awaited to clarify certain aspects, this seems to be a positive move by the government to attract further investment.

– Abhinav Harlalka & Ruchir Sinha
You can direct your queries or comments to the authors

¹ The changes brought in by the Amendment are expected to be formalized in the form of a Press Note or by way of inclusion in the FDI Policy, and till such time the changes do not have the binding force of law.

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