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Embassy Office Parks REIT IPO: What it means for your portfolio and taxes

If investing in real estate has been a hindrance because of a high ticket size for investment, then real-estate investment trusts (REIT) could be your entry pass into real estate. Just like when you do not have enough money to buy a basket of equity shares or government securities and so you buy an equity mutual fund or a government securities mutual fund scheme, respectively.

The initial public offering (IPO) of Embassy Office Park REIT opened on March 18. It will be India's first listed REIT. At the upper end of the price band of Rs 299-300, it will garner Rs 4,750 crore.

The minimum lot size while applying at the time of IPO is 800 units (close to Rs 2.40 lakh) and thereafter in multiples of 400 units (around Rs 1.20 lakh).

Also read: All you need to know about India's first Real Estate Investment Trust

A REIT is an investment vehicle that gives you a chance to invest in real estate. The sponsor company launches a REIT that holds the properties under it and then leases it out to earn rental income. Typically, a REIT can hold commercial and/or residential properties, but in India REITs are only allowed to hold commercial properties.

Of the rental income that the REIT receives, it is mandated to pass at least 90% of it to the unitholders. The remaining 10% of its rental income can be re-deployed into the main business activities. REITs can also earn income by way of capital appreciation if and when it sells any of its underlying properties.

Let's see if the new offering is worth having a look at.

What works for investors?

Almost 89% portfolio of Embassy REIT is operational where the income is already coming in. Further, its portfolio consists of commercial real estate spaces (that earn higher rents) and not residential. That's the biggest plus in this offering.

"A diversified portfolio of best in quality commercial space is beyond the reach of most high networth individuals. This space is occupied by institutional investors. REIT is the best way to invest in this attractive avenue," says Ashish Shanker, head investment advisory, Motilal Oswal Private Wealth Management.

As of December 31, 2018, approximately 81% of gross rentals are earned from more than 160 tenants which are multinational companies. 43% rentals are earned from tenants which are Fortune 500 companies. The commercial space has seen 95% committed occupancy and weighted average lease length is of seven years. Quality of tenants, high occupancy and long-term lease contracts offer earnings stability and minimal or nil chances of default.

A typical lease with a tenure of 9-15 years is embedded with rent escalations of every three to five years. When a lease expires, the rents can be negotiated to match the market rates. Existing vacancies can be leased out which add to future revenues. Ongoing construction of 2.4 MSF leasable area and proposal to develop additional 5.4 MSF leasable area may offer further upside. This should ensure that revenues keep on increasing steadily and in the worst of the cases, the investor sees returns above inflation in long term.

What does not work for investors?

Going a bit deeper into its assets, Bengaluru-based Embassy Manyata accounts for 14.2 MSF out of 32.7 MSF leasable land. It also accounts for 42.2% of the market value of Embassy REIT asset portfolio. It connotes concentration risk. Embassy REIT also sees high client concentration.

As on December 31, 2018, 49% of gross rentals came from tenants in technology sector and top 10 tenants accounted for 42.31% gross rentals.

A relatively high minimum investment (around Rs 2.4 lakh) could be a deterrent for most retail investors, though it's much cheaper owning real estate through REIT than trying to buy a piece of real estate, directly. The space of REIT will see more issuances in the near future and savvy investors will watch changes in the regulatory framework governing REITs before committing serious money.

How REITs are taxed

How the income gets taxed in your hands depends on whether your REIT is passing it off as a dividend income or rental income. If it's the rental income that it is passing on- which would mostly be the case since REITs are meant to pass on at least 90% of its rental income, then it will be added to your overall income and get taxed at your income-tax rates.

"But, your REIT will deduct a tax (tax deducted at source or TDS) at 10% for resident investors and at rates in force (40%, at present) for non-resident investors", says Gaurav Karnik, Tax Partner & National Leader, Real Estate practice, EY India.

But if the income distribution is in the nature of a dividend, then there won't be any dividend distribution tax or any tax in the hands of unitholders.

If you sell your REIT units on the stock exchange after three years, you will need to pay a capital gains tax at 10% (plus applicable surcharge and cess). If you sell your REIT units within three years, a short-term capital gains tax of 15% (plus applicable surcharge and cess) will be imposed.

What should investors do?

Embassy REIT offers an opportunity to own best in quality well-diversified commercial office space portfolio in India. Instead of the traditional means of owning physical real estate, units of REIT make it hassle-free. As REITs are regulated by Securities Exchange Board of India, it ensures a reasonable amount of transparency for investors. Since the units are listed on the stock exchanges, the investors may expect liquidity in an otherwise illiquid asset class – real estate.

However, investors should set their expectations right. Though the REIT structures talk about increasing rentals and possibility of capital appreciation (if and when the REIT sells its underlying properties) one should not treat it as a means to make some quick buck.

“Moderation in rental growth going ahead can’t be ruled out. Though the management has stated that in some cases the rental growth rate stood at higher than 10 percent, it is unlikely to stay higher consistently,” says Prasanna Bidkar, Mumbai based independent investment expert.

“Do not expect high returns from this issue as dividend yield might be between 6.5 and 8 percent. Even the capital appreciation can also be limited to single-digit.”

While the returns are expected to be low, there are concerns over the liquidity investors will get.

Feroze Azeez, deputy CEO of Anand Rathi Private Wealth Management says, “REIT is a new category of product for the Indian market and generally new product launches take time to catch up. This ensures that there will be low liquidity in the secondary markets. The units are expected to trade at a discount to the fair value.”

Some more REITs are expected to hit the market in the near future and investors will have multiple avenues to invest limiting liquidity in units of this REIT.

“Many Indian investors already have significant exposure to real estate. Do not go overboard if you already own a significant amount of real estate in your portfolio. We would like to see the listing of the units of Embassy REIT. Let it establish a track record and let there be more options before we start recommending it to our clients,” says Vishal Dhawan, founder and chief financial planner of Plan Ahead Wealth Advisors.

Even if you are keen to bite the bullet, it is better to go slow on investing in REIT.

“More REITs will come and offer investors opportunity to participate in growing commercial real estate sector. Since this is the first offering not much is known about the returns that investor will get. As the REIT will be listed and available for participation, one can add later also, once more information is available,” says Deepak Chhabria, CEO & Director, Axiom Financial Services.

REITs are best considered as a means to diversify your portfolio across asset classes than for earning higher returns.