SEMINAR ON VALUE ADDITION THROUGH MANAGEMENT ACCOUNTING, 2013

Funding Real Estate and Infra in India

Structuring and regulatory aspects

November 16, 2013

Mumbai

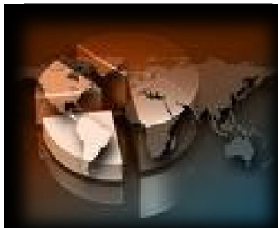
Synopsis

- Regulatory Framework
- Investment regimes
- ECB
- Structuring of FDI investments
- Structuring of FII / QFI investments – NCD
- Structuring for Singapore listing
- Structuring - Key issues

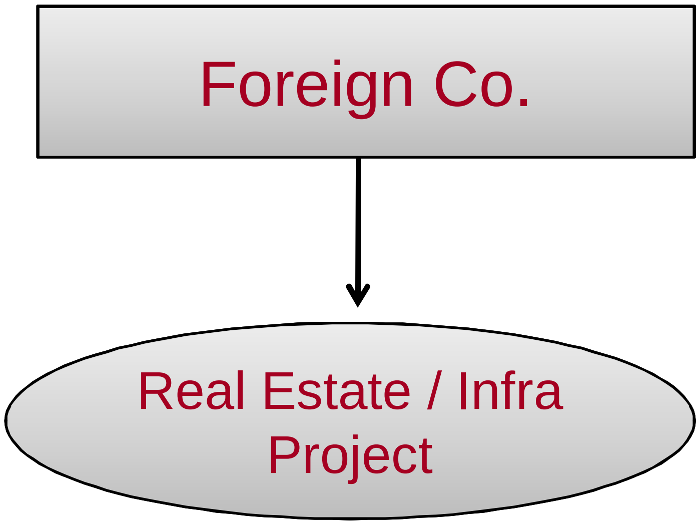
Regulatory Framework

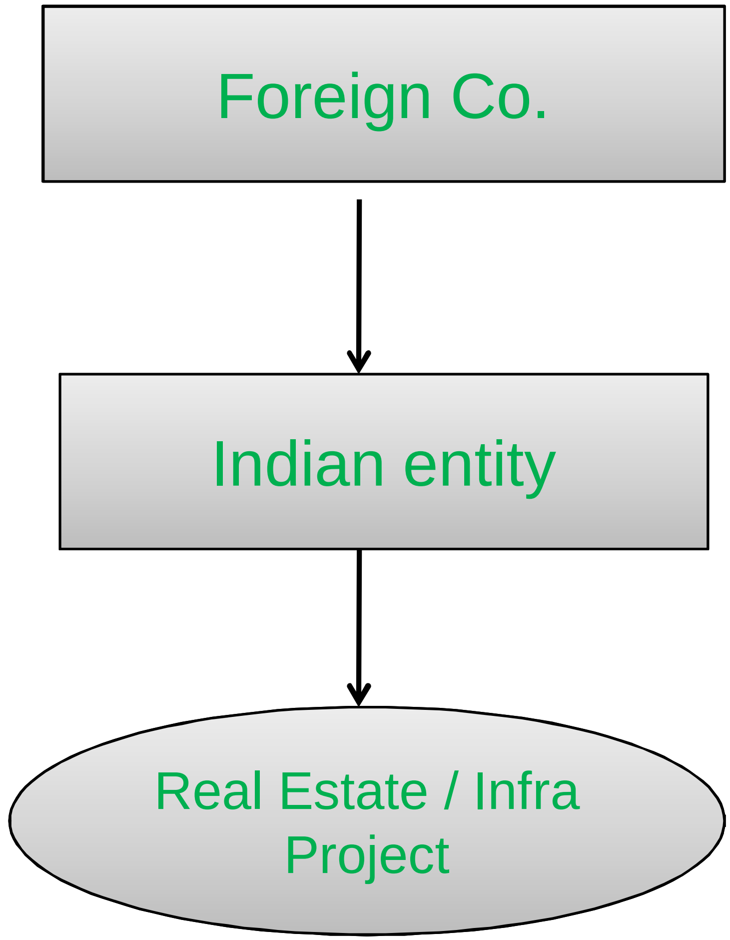
- The Regulators
  - Reserve Bank of India (RBI)
  - Department of Industrial Policy and Promotion (DIPP)
  - Foreign Investment Promotion Board (FIPB)
  - Cabinet Committee on Economic Affairs (CCEA)

- The Regulations
  - Foreign Exchange Management Act, 1999
    - Foreign Exchange Management (Transfer and Issue of Securities to persons Resident Outside India) Regulations, 2000
    - Foreign Exchange Management (Acquisition and transfer of immovable property in India) Regulations, 2000
  - Press Notes issued by DIPP
  - Now, the Consolidated FDI Policy, 2013
  - Master Circular on External Commercial Borrowing



Foreign Investment in India





Indian Entity

Company

Sole Proprietorship

Partnership

Trust

LLP

Investment Regimes

- ECB
  - Governed by RBI ECB circular
  - Permitted in affordable housing / infrastructure
  - Many restrictions
- FDI
  - Governed by TISPRO Regulations and Consolidated FDI Policy (April 5, 2013)
  - Pricing Restrictions - Minimum floor price and maximum ceiling
  - Ex – CCI (average of PECV and NAV) to DCF method
- FVCI
  - Governed by SEBI (FVCI) Regulations, 2000.
  - Regime not available for real estate.
  - Permitted for infrastructure sector as defined in ECB policy
- FII
  - Governed by the SEBI (FII) Regulations, 1995
  - Investment in listed securities on the floor of stock exchange
  - Press Note 2 of 2005 not applicable
  - Applicability of RBI circular dated October 19, 2012
- QFIs
  - QFI route recently introduced; FATF and IOSCO compliant
  - No registration required
- NRIs
  - PN 2 of 2005 conditions not applicable
  - Direct acquisition of real estate permissible

External Commercial Borrowing

- Infrastructure sector under Automatic route;
  Infrastructure is defined as (i) power, (ii) telecommunication, (iii) railways, (iv) roads including bridges, (v) sea port and airport, (vi) industrial parks, (vii) urban infrastructure (water supply, sanitation and sewage projects), (viii) mining, exploration and refining and (ix) cold storage or cold room facility, including for farm level pre-cooling, for preservation or storage of agricultural and allied produce, marine products and meat.

- Real estate – not permitted, except low cost affordable housing under approval Route

- Restrictions:
  - Eligible Lenders – International banks, multilateral finance institutions (IFC, ADB), regional financial institutions, foreign equity holders
  - Maximum amount
    - In one financial year – USD 750 million
    - NBFC-IFCs can avail ECB upto 75% of their owned funds and must hedge 75 per cent of their currency risk exposure under automatic route; beyond 75% under approval route.

External Commercial Borrowing

- Restrictions:
  - Maturity – minimum average maturity
    - ECB upto USD 20 million – 3 years
    - ECB more than USD 20 million and upto USD 750 million – 5 years
  - All-in-cost ceiling
    - All-in-cost includes rate of interest, other fees and expenses in foreign currency except commitment fee, pre-payment fee, and fees payable in Indian Rupees.
    - Withholding tax in Indian Rupees is excluded for calculating the all-in-cost.
    - For loans between 3 to 5 years – 350 basis points over 6 month LIBOR
    - For loans more than 5 years – 500 basis points over 6 month LIBOR
  - End-use - permitted
    - Import of capital goods; new projects, modernization / expansion of existing production units in infrastructure sector
    - Interest During Construction (IDC) for Indian companies which are in the infrastructure sector, subject to IDC being capitalized and forming part of the project cost
    - In case of infra companies with project size of more than INR 250 crores, for repayment of rupee loans from banks or for fresh rupee capex; provided they are forex earners during past 3 financial years

External Commercial Borrowing

- Restrictions
  - End-use – not permitted
    - Real estate; general corporate purposes; on-lending or investment in capital market
- Security:
  - Guarantees by banks etc.
    - Issuance of guarantee, standby letter of credit, letter of undertaking or letter of comfort by banks, Financial Institutions and Non-Banking Financial Companies (NBFCs) from India relating to ECB is not permitted.
  - Other security
    - As agreed between the borrower and lender
    - Mortgage / pledge / personal or corporate guarantee, subject to NOC from AD
    - Conditions before AD can grant NOC
    - Enforcement subject to certain conditions

- Refinancing of an existing ECB:
    - Under automatic route if at lower all-in-cost ceiling and the outstanding maturity of the original ECB is maintained
    - Under approval route if higher all-in-cost ceiling

FVCI

- Registration with SEBI under the SEBI (Foreign Venture Capital Investors) Regulations, 2000

- No DCF valuation requirements

- Investment restrictions:
  - At least 66.67% of the investible funds in unlisted equity shares or equity linked instruments of Venture Capital Undertaking (VCU)
  - Not more than 33.33% of the investible funds may be invested by way of:
    - Subscription to IPO of VCUs;
    - Debt of debt instruments of VCU in which the FVCI has invested by way of equity;
    - Preferential allotment of listed company, subject to lock-in of one year;
    - Equity shares or equity linked instruments of financially weak companies or a sick industrial company which are listed;
    - SPV created for investment as per the FVCI Regulations.

FDI: Types of Instruments

- **Equity**
  - Equity Shares with equal rights
  - Equity Shares with differential rights
- **Preference Shares**
  - Fully / Compulsorily Convertible
  - Partly / Optionally Convertible
  - Non – Convertible
- **Debt**
  - Debentures
    - Fully / Compulsorily convertible
    - Partly / Optionally convertible
    - Non – convertible
  - Other External Commercial Borrowings
- **Warrants**

What is Real Estate?

- 100% Automatic Sector – Construction development (PN 2 of 2005)
  - FDI must be utilized for 'development capital'

- Prohibited Sector - FDI in 'real estate business'
  - TISPRO Regulations (Schedule 1) / FDI Policy – Not defined
  - Erstwhile FDI Policy (April, 2011) – *Dealing in land and immovable property with a view to earning profit or earning income there from*
  - Capital Account Transaction Regulations – *'Real estate business' shall not include development of townships, construction of residential / commercial premises, roads and bridges'*
  - Master Circular on Foreign Investment in India - *Dealing in land and immovable property with a view to earning profit or earning income therefrom and does not include development of townships, construction of residential / commercial premises, roads or bridges, educational institutions, recreational facilities, city and regional level infrastructure, townships*

FDI Policy on Real Estate

- Minimum area to be developed under each project would be as under:
  - In case of development of serviced housing plots, a minimum land area of 10 hectares (approx. 25 acres)
  - In case of construction-development projects, a minimum built-up area of 50,000 sq.mts
  - In case of a combination project, any one of the above two conditions would suffice

- Issues
  - What comprises built-up area? - FSI or below grade FSI
  - Does the minimum area need to be contiguous?

FDI Policy on Real Estate

- Investment conditions
  - Minimum capitalization of US$10 million for wholly owned subsidiaries and US$ 5 million for joint ventures with Indian partners.
  - The funds would have to be brought in within six months of commencement of business of the Company.

- Issues
  - What are the instruments for capitalization?
  - Is premium on shares counted towards minimum capitalization?

    Minimum capitalization includes share premium received alongwith the face value of the share, only when it is received by the company upon issue of the shares to the non-resident investor. Amount paid by the transferee during post-issue transfer of shares beyond the issue price of the share, cannot be taken into account while calculating minimum capitalization requirement.
  - What is meant by ‘commencement of business’?

FDI Policy on Real Estate

- Investment conditions
  - Original investment cannot be repatriated before a period of three years from completion of minimum capitalization.
  - Original investment means the entire amount brought in as FDI.
  - The lock-in period of three years will be applied from the date of receipt of each installment / tranche of FDI or from the date of completion of minimum capitalization, whichever is later.
  - However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB.

- Issues
  - Lock-in tenure
  - Up to what stage in a project can an FDI investor participate?
  - What does repatriation mean?

FDI Policy on Real Estate

- Other conditions
  - At least 50% of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor/investee company would not be permitted to sell undeveloped plots. For the purpose of these guidelines, “undeveloped plots” will mean where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available.
  - It will be necessary that the investor provides this infrastructure and obtains the completion certificate from the concerned local body/service agency before he would be allowed to dispose of serviced housing plots.

- Issues
  - Can no part of the project be sold prior to completion certificate?
  - Is it necessary to obtain ‘completion certificate’ before a serviced housing plot can be sold?
  - Is it necessary that one needs to complete the entire project before he can sell / lease a part of the project?

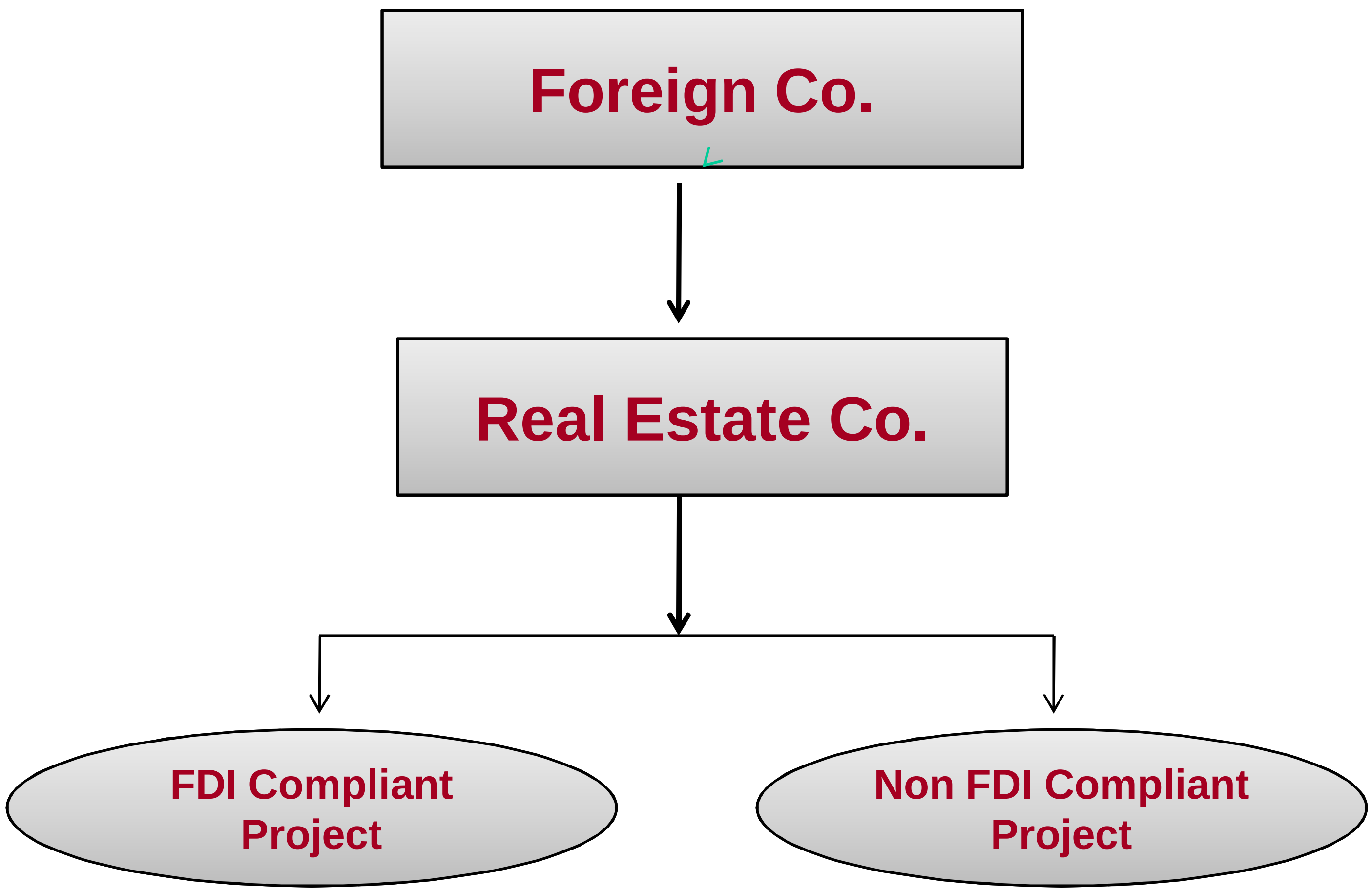
FDI Policy on Real Estate

- Other conditions
  - The investor/investee company shall be responsible for obtaining all necessary approvals, including those of the building/layout plans, developing internal and peripheral areas and other infrastructure facilities, payment of development, external development and other charges and complying with all other requirements as prescribed under applicable rules/bye-laws/regulations of the State Government/ Municipal/Local Body concerned.
  - The State Government/ Municipal/ Local Body concerned, which approves the building / development plans, would monitor compliance of the above conditions by the developer.

Permitted Investments

- Hotel
  - (PN 4 of 2001 and PN 2 of 2006)
  - Hotels include restaurants, beach resorts and other tourism complexes providing accommodation and / or catering and food facilities to tourists
- Hospitals
- Tourism
- Industrial Park
- Old-age homes
- Education sector

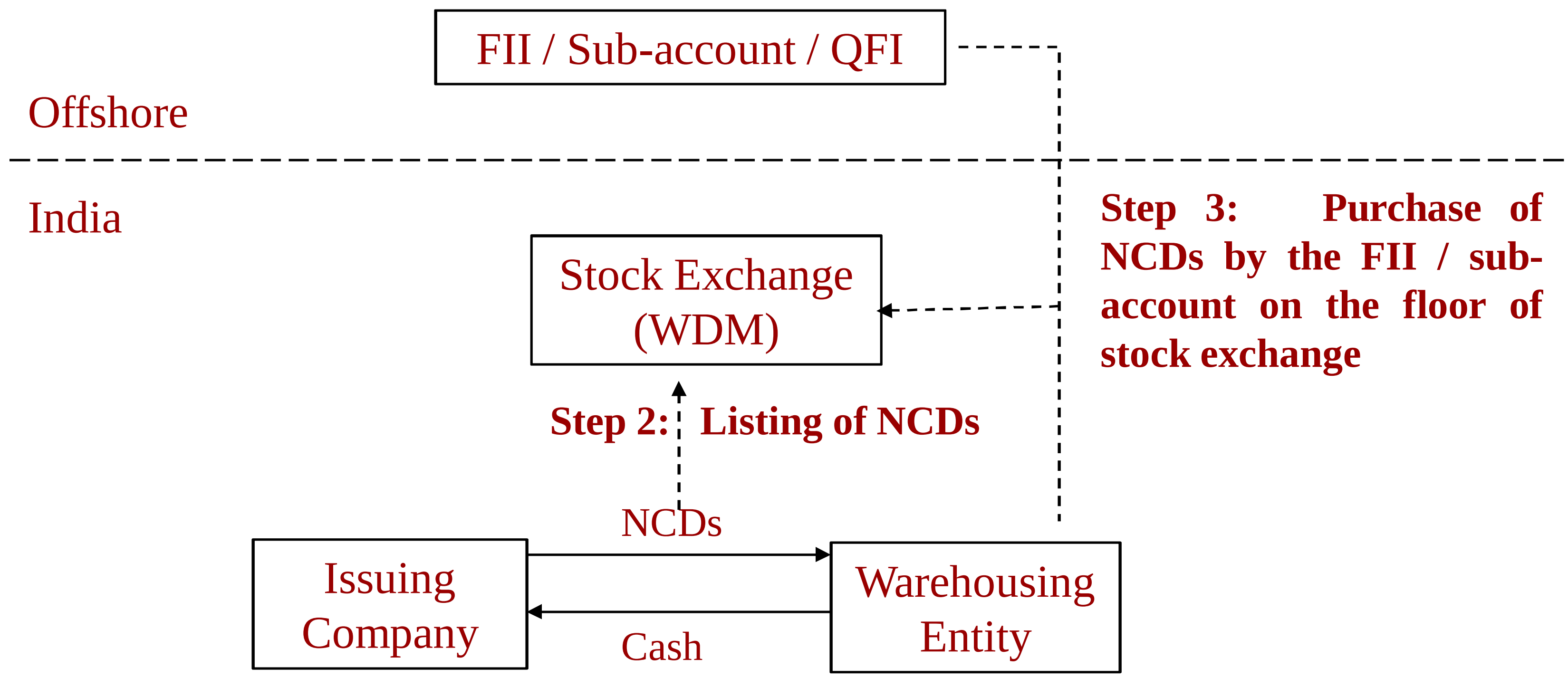
Is this possible?



FII / QFI route - NCDs

- Equity investments in real estate under FII / QFI route not popular
- NCDs route – very common
- Aggregate debt investment limit for all FIIs / QFIs: USD 51 billion (no individual limit)
- No lock in or residual period – No approval till aggregate debt limit reaches 90% of the total limit
- For an exit, NCDs may be sold on the floor of the stock exchange, but most commonly are redeemed
- Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee

NCD Structure



Step 1: Issuance of NCDs

NCDs can now be issued directly to QFIs / FII / sub-account, provided they are listed within 15 days of issuance; to that extent, warehousing entity may not be required

CCD vs. NCD – Comparative Analysis

Particulars	CCD – FDI	NCD - FII / QFI
Equity Ownership	Initially debt, but equity on conversion	Mere lending rights; however, veto rights can ensure certain degree of control.
ECB Qualification	Assured returns on FDI compliant instruments, or put option granted to an investor, may be construed as ECB.	Shall not qualify as ECB.
Coupon Payment	Interest pay out may be limited to SBI PLR + 300 basis points. Interest can be required to accrue and paid only out of free cash flows.	Arm's length interest pay out should be permissible resulting in better tax efficiency. Higher interest may be disallowed. Interest can be required to accrue only out of free cash flows. Redemption premium may also be treated as business expense.
Pricing	DCF Valuation applicable	DCF Valuation not applicable
Security Interest	Creation of security interest is not permissible either on immoveable or movable property	Listed NCDs can be secured (by way of pledge, mortgage of property, hypothecation of receivables etc.) in favor of the debenture trustee who acts for and in the interest of the NCD holders

CCD vs. NCD – Comparative Analysis

Particulars	CCD – FDI	NCD - FII / QFI
Sectoral conditionalities	Only permissible for FDI compliant activities	Sectoral restrictions not applicable.
Equity Upside	Investor entitled to equity upside upon conversion.	NCDs are favorable for the borrower to reduce book profits or tax burden. Additionally, redemption premium can be structured to provide equity upside which can be favourable for lender since such premium may be regarded as capital gains which may not be taxed if the investment comes from Singapore or Mauritius.
Administrative expenses	No intermediaries required	For a INR 100 crore NCD, listing may cost around INR 10-15 lakh including intermediaries cost. In case of FII / sub-account, additional cost will be incurred for SEBI registration. In case of QFI, there may be additional cost as fees charged by the QDP.

NCDs - FII vs. QFI

Issue	FII	QFI
Eligible Investors	Institutional Investors (AMCs, Pension Funds, Mutual Funds, Investment Trusts as Nominee Companies, Portfolio Managers etc.)	Persons resident in FATF member country or member of group which is FATF member, and signatory to IOSCO MMOU or SEBI bilateral MOU.
SEBI Registration	Required	Not Required
Aggregate Debt Limits	USD 51 billion. No separate sub-category.	USD 51 billion. No separate sub-category.
Listing	Mandatory (within 15 days)	Same as FII
Pricing	No guidelines	No guidelines

Singapore Listing

❑ The India Singapore Advantage

- Favourable tax treaty
- Exemption from proposed GAAR
- Market that understands real estate

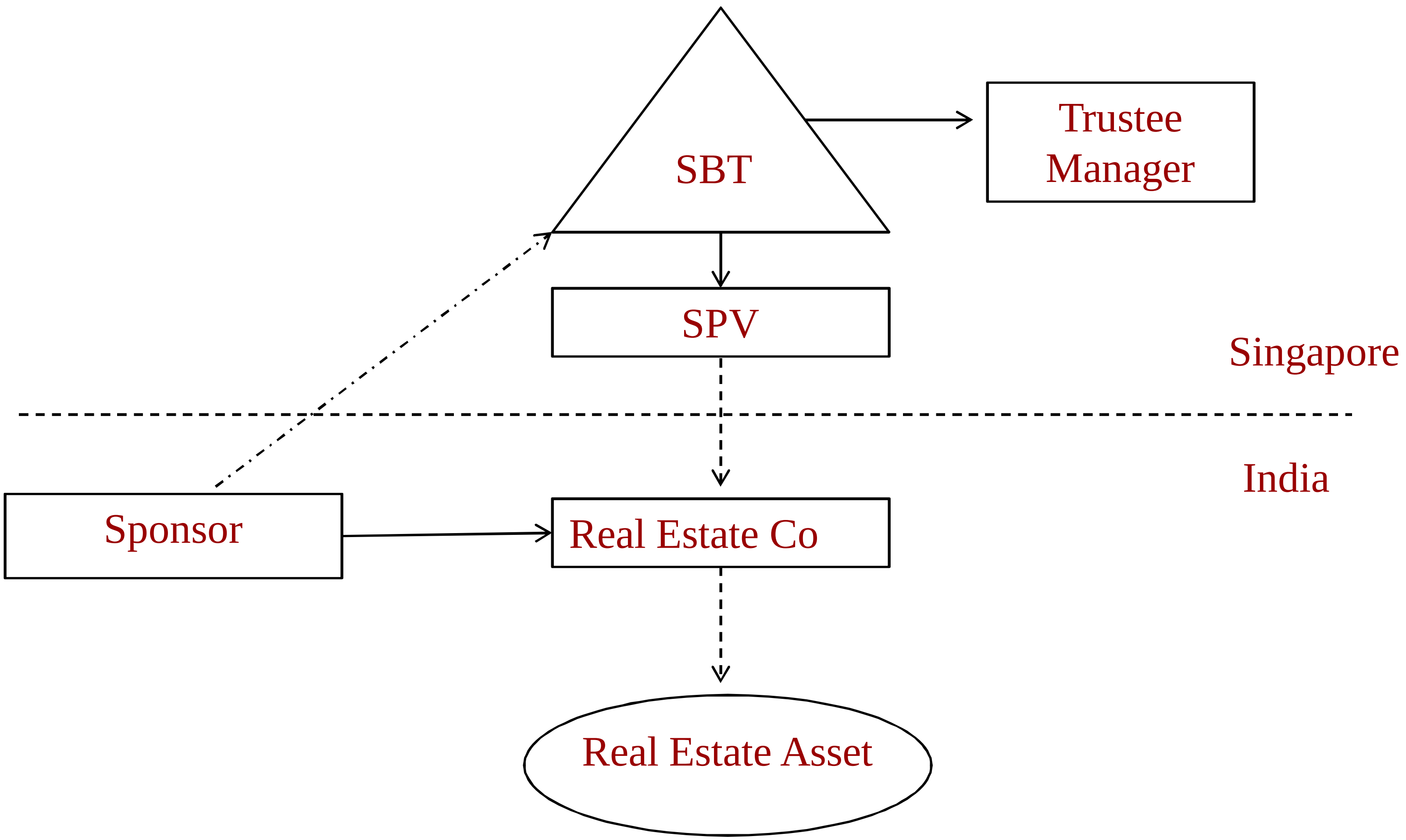
❑ Background on offshore listings

- Yield generating stabilized assets vs. developing assets
- Need for on the ground presence and domestic sponsor and track record
- Appetite for Indian assets
- Identified assets in fold versus pipeline

❑ Regulatory Challenges

❑ Overcoming regulatory challenges

Typical Structure



Regulatory Challenges

- **FDI Policy**
  - Real Estate Business – Prohibited; FDI permitted only in construction development projects;
  - Projects exempted from PN2 - SEZ, Industrial Parks, Hotels, Serviced Housing Apartments, Old age homes, Education Institutions.
  - FDI permitted in last mile projects which are still under construction development; Ambiguity on status of completed assets from an FDI perspective
  - Minimum area restrictions – 50,000 square meters
  - 3 year lock-in – down-sell inability
  - DCF valuation for entry and exit

Regulatory Challenges

- **Flips / transfer of assets to Singapore Business Trust**
  - Flipping the assets into the fold of SBT
    - India
    - Offshore
  - Promoter acquiring interest in SBT
  - Tax implications on transfer of assets

- **Sponsor holding of the Trustee Manager**
  - Investment in Trustee Manager
  - Only an financial company can invest, approval not forthcoming
  - Sponsors may hold under LRS or through any other offshore group entity
  - Sponsor brand name typically necessary for marketing; JV models also successful

Tax challenges

- **Tax optimization**
  - Limit on interest deduction – due to cap on the maximum interest which can be paid by Indian company – SBI PLR + 3%
  - Any higher yield to be structured by way of dividends and buyback
  - Dividend and buy-back post corporate tax of 30%
  - Dividend distribution tax of approx. 16.2%

- **Hence NCD structure may be considered**

Structuring – Key Issues

- Security
  - Mortgage of property
  - Pledge of shares
  - Guarantee – Personal and Corporate
  - Hypothecation of receivables – Escrow Arrangement
  - Mortgage or Pledge - Security trustee; repatriation of proceeds only

- Structuring distribution waterfall
  - Investor returns higher than promoter returns until certain IRR, and vice versa thereafter
  - Different returns on same instrument not permissible
  - Different classes of shares - public companies (listed and unlisted)

- Tax
  - Buyback
  - Interest
  - Dividend

Structuring – Key Issues

- Exits - equity
  - IPOs and offer for sale
    - Not very common in real estate
  - Third Party Purchase
    - Merely an endeavor
  - Buy Back
    - Convertibles must be converted into equity
    - Only up to 25% of the total paid up capital and reserves each financial year
    - At least 2:1 debt-equity ratio post buy-back
  - Put on the Promoters
    - Pricing restriction
    - DLF case

- Exits – NCDs
  - Redemption of NCDs
  - Sale on the floor of the stock exchange

Way forward

- FPI?
- Proposed REIT Regulations

Questions?

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Deepak Jodhani