Indian real estate boom: facts and legislative background

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ALTHOUGH EXPERTS ARE WARNING that the real estate sector in Europe has peaked, and that there may now be deflation or collapse, as in the US, the Indian real estate sector is much healthier. Thanks to strong fundamental economic growth, it is expanding, both in terms of volume and return on investment. An analysis of the figures shows that the Indian real estate sector will outpace those in other countries.

According to industry estimates, infrastructure projects have margins between 4% and 5%, while realty projects provide returns in the range of 20% to 25% and, in certain cases, above 40%. However, the Indian realty sector is subject to complex legislation. Although the government continues to try to simplify it, foreign investors should know that profits lie beyond a maze of rules.

INDIAN REAL ESTATE: A DEFINITION

The term 'real estate' covers the sale, purchase and development of land and residential and commercial buildings, including offices, trading spaces such as theatres, hotels, restaurants and retail outlets, hospitals and care homes, infrastructure projects such as bridges, ports and highways, industrial buildings such as factories, and government buildings. Traditionally, agricultural and forest land is not a part of real estate. The law prohibits foreign investment in such land except for seed programs and horticulture in controlled conditions.

The Federation of Indian Chambers of Commerce and Industry estimates the value of the Indian real estate industry at $12bn. This figure has been growing at a pace of 30% a year for the past few years. Initially, almost 80% of real estate developed in India was residential space. However, the development of offices, shopping malls, hotels and hospitals is now growing. Development opportunities are now available in software technology parks, special economic zones (see below), export processing zones and other infrastructure projects, such as highways and ports.

DRIVING FORCE

Sustained economic development is the primary driving force behind the rapid growth of the real estate sector. World economists predict that emerging economies, including India, will overtake developed countries in terms of economic growth by 2050. The popularity of India and China as investment destinations is rising, while the appeal of Europe and North America is diminishing.

The Confederation of Indian Industry reports that industry will grow at a rate of 11% each year. With this growth comes rapid demand for commercial space, residential accommodation, entertainment, hospitality and healthcare services.

The government is providing legislative support to sustain this growth by promoting special economic zones, export processing zones, software technology parks and industrial parks. The government has approved 366 special economic zone projects since 2005. More than 30 software technology parks have been approved in Hyderabad alone, and over 38 industrial parks have been approved nationwide. This will create millions of square feet of commercial space.

RESIDENTIAL DEVELOPMENT

Commercial development fuels the growth of residential property. In the past decade, sleepy towns like Gurgaon, Noida and Faridabad have been transformed into enviable addresses. Today these 'tier one' cities are saturated and far beyond the means of the middle class. Attention has turned to opportunities for residential development in tier two and tier three cities. Over the coming years, Hyderabad, Cochin, Chennai, Coimbatore and Pune will see enormous growth.

More particularly, housing demand is rising on account of:

- the structural changes in the economy characterised by rapid urbanisation and a burgeoning middle class with greater purchasing power;
- the demographic transition, with a rising proportion of young Indians and an increasing number of nuclear families;
- the fact that financial sector reforms and a rising gross domestic savings rate (24.9% in 1999/2000 to 29.1% in 2004/05) coupled with softening interest rates has brought about a surge in demand for consumer and retail credit;
- the availability of fiscal and tax concessions; and
- non-resident Indians' (NRIs) renewed interest in Indian real estate.

RETAIL TRADE

According to the India Retail Report 2007, organised retail, which currently accounts for only 4.6% of the $270bn Indian retail sector, is expected to grow by as much as 37% in 2007 and 42% in 2008. Organised retail in India has the potential to create over $45bn worth of business by 2010.

This is expected to create a demand for around 220 million sq ft of retail space by 2010. According to industry estimates, 27 million sq ft of organised retail space is currently available. By 2008, 263 mall projects are expected to create another 90 million sq ft.

Shopping malls with over one million sq ft of space have become the order of the › day. In the National Capital Region, Unitech's Great India Place has one million sq ft of retail space. In Mumbai, there are at least eight malls covering over one million sq ft each, while two malls of over one million sq ft have been proposed for Thane. In Bangalore, at least three malls with similar dimensions are under development. Ludhiana will soon have a 1.6 million sq ft mall, built by Today Homes. The biggest mall in the world, the 'Mall of India' planned by DLF Universal along National Highway 8, will cover 32 acres, and will include a huge entertainment area and large 'town squares'. Meanwhile, India's largest amusement park, Noida Entertainment City (E-City), will stand upon approximately 150 acres.

HEALTHCARE SECTOR

The healthcare industry is estimated to be worth $20bn, and this may increase to $60bn by 2010. The industry is predicted to grow at a rate of 13% annually, which will enable healthcare providers to secure a return of 15% to 20% on their capital. This demand-supply interaction has created conditions for increasing private/voluntary sector participation in healthcare delivery.

India offers world-class healthcare that costs substantially less than that of developed countries. For instance, heart surgery costs $30,000 in the US and just $8,000 in India, using the same technology delivered by competent specialists attaining similar success rates. Medical tourism in India has evolved at a great pace and the Indian sub-continent attracts patients from South East Asia, Africa, the Middle East, the UK and the US.

As per the CII-Mckinsey Industry Analysis Report, demand is expected to outstrip supply over the next decade. Almost 80,000 additional hospital beds will be required every year for the next three to four years to adequately meet growing healthcare demands.

HOSPITALITY INDUSTRY

2006 saw foreign tourist arrivals reaching a record 4.4 million, resulting in international tourism receipts of nearly $6.7bn. The Readers Travel Awards 2006, conducted by Condé Nast Traveller, placed India at number four among the world's must-see countries, up from number nine in 2003. The World Travel & Tourism Council estimates that the Indian tourism industry will grow at 10% each year over the next decade – the highest growth rate in the world. With an immediate demand for nearly 30,000 rooms in all categories, and a shortage of nearly 50,000 rooms in the budget hotel sector, hospitality is the fastest-growing sector in India.

MORE INTERNATIONAL MONEY IS COMING TO INDIA.

All these developments have attracted a great deal of international money into India. A report by property consultants Jones Lang LaSalle estimates that $10bn of foreign investment will be injected into the Indian real estate sector in the next 12 to 18 months. International companies such Ayala, Signature, Och-Ziff Capital, EurIndia and Old Lane have indicated their interest in entering the Indian real estate market.

Nearly two dozen US funds are raising $3.5bn for investments in Indian realty, including The Blackstone Group, Goldman Sachs, Citigroup Property Investors, Morgan Stanley and GE Commercial Finance Real Estate.

GOVERNMENT SUPPORT THROUGH LIBERALISED LEGISLATION

Real estate development is subject to a raft of complex legislation. The Indian rupee is not yet fully convertible. The Foreign Exchange Management Act 1999 (FEMA) controls Foreign Direct Investment (FDI) in real estate (ss3, 5 and 6). Under the Foreign Exchange Management (Acquisition and Transfer of Immovable Property in India) Regulations 2000, foreign nationals and companies can only acquire immovable properties for the purpose of carrying out permissible business activities. Only NRIs and Persons of Indian Origin (PIOs) can acquire immovable property freely. NRIs, PIOs and foreigners cannot acquire agricultural and plantation properties.

Under the Integrated Township Policy 100% FDI is automatically permitted in:

- townships and housing;
- commercial premises;
- hotels, resorts and recreational facilities;
- hospitals;
- software technology parks, special economic zones, export processing zones and industrial parks; and
- educational institutions.

The automatic route is subject to a few basic conditions, as follows.

CONDITIONS FOR INTEGRATED TOWNSHIP PROJECTS

Development criteria

- A minimum of 10 ha/25 acres is to be developed for serviced housing plots.
- For construction-development projects, a minimum built-up area of 50,000 sq m is prescribed.

In the case of a combination project, which includes serviced housing plots and construction, meeting any one of the above two conditions would suffice.

Investment conditions

- There is a minimum capitalisation of $10m for wholly owned subsidiaries and $5m for joint ventures with Indian partners.
- Funds are to be brought in within six months of the commencement of business.
- The original investment cannot be repatriated before a period of three years from completion of the minimum capitalisation. The investor may be permitted to exit earlier with prior government permission.

Other conditions

- At least 50% of the project must be developed within five years from the date of obtaining all statutory clearances.
- The investor is not permitted to sell undeveloped plots, ie a plot where roads, water supply, street lighting, drainage, sewerage and other services have not been made available. The investor must provide this infrastructure and obtain a completion certificate prior to the sale of the serviced housing plot.
- The project must conform to the norms and standards prescribed by the relevant state authorities.

- The investor is responsible for obtaining the necessary approvals prescribed under the applicable rules/ bye-laws/regulations of the state.
- The relevant authority is to monitor the developer's compliance with the prescribed conditions.

SPECIAL ECONOMIC ZONES

Special economic zones are specifically delineated duty-free enclaves within India and are deemed to be foreign territory for the purposes of trade operations, duties and tariffs. The initiative was launched with a view to providing an internationally competitive and hassle-free environment for exports.

Each state has its own special economic zone regulations. The policy provides for the setting up of such zones by businesses in the public and private sectors or by state governments. It was also envisaged that some of the existing export processing zones would be converted into special economic zones.

Approval criteria

- The minimum size of the special economic zone shall be 1,000 ha.
- The special economic zone, and the units within it, will abide by local laws, rules, regulations or bye-laws in regard to area planning, sewerage disposal, pollution control and the like. They will also comply with industrial and labour laws and such other laws/rules and regulations as may be locally applicable.
- The special economic zone must make adequate arrangements to fulfil all the requirements of the laws, rules and procedures applicable to it.
- Only units approved under the special economic zone scheme would be permitted to be located in the zone.
- At least 25% of the area must be developed as an industrial area to set up permissible units, and the rest can accommodate infrastructure and housing plots.

Facilities for special economic zone developers

- The developer may import/procure goods without payment of duty for the development, operation and maintenance of the zone.
- There is an income tax exemption for a block of ten years in the first 15 years.
- The developer has full freedom to allocate developed plots to approved special economic zone units on a purely commercial basis.
- The developer has authority to provide services, such as water, electricity, security, restaurants or recreation centres, on commercial lines.
- Foreign investors are permitted to develop a township within the zone, with residential areas, markets, playgrounds, clubs and recreation centres.
- The developer may build a Standard Design Factory (SDF), which houses manufacturing units, in existing special economic zones.
- The developer is exempt from Service Tax.
- Investment made by individuals in a special economic zone company is also eligible for exemption from Personal Tax.
- The generation, transmission and distribution of power in special economic zones is allowed.

REAL ESTATE INVESTMENT TRUSTS

Real Estate Investment Trusts (REITs) are founded by groups of real estate professionals in order to 'manage' property for investors. In the US a REIT is a publicly listed entity, which passes on at least 90% of its profits to investors. REITs typically own large commercial office spaces and hotels, and rely mainly on rental incomes. REITs also buy, develop and sell property, and share profits with investors/unit holders from any capital appreciation on the sales.

REITS will be registered in India as collective investment schemes under the Collective Investment Scheme Regulations 1999. The rules for a typical interval fund for REITs are as follows:

- The scheme will be close-ended for a minimum of three years.
- The scheme would open at the end of every quarter for sale of fresh units based on the quarterly net asset value (NAV) calculation and remain open for a minimum period of 15 days.
- The scheme should offer redemption/ repurchase to the investors at the end of three years in a staggered manner.
- As the scheme would be an interval fund, and offers redemption at the end of three years, the scheme may be listed on any stock exchange to provide liquidity to the investors.
- The scheme will calculate the NAV on quarterly basis as per the valuation of the underlying investments.
- The scheme shall operate within the regulations of mutual funds as amended from time to time, and comply with all the requirements of the Securities Exchange Board of India (Mutual Fund) Regulations.
- Being part of a mutual fund, REITs would be eligible for all tax benefits applicable to mutual funds in general. This would enhance the attractiveness of these schemes to investors.

Different sets of criteria apply to hotels, resorts and recreational facilities, hospitals and educational institutions.

FOREIGN COLLABORATION

Foreign investors can bring in money and technology in three ways:

- **Private equity capital:** Pure financial investment in existing construction and development companies or new companies to provide the base capital required to undertake larger projects and reduce exposure to debt financing.

- **Joint Venture Company:** The foreign investor contributes capital and engineering capabilities and the Indian developer contributes land and local resources. Both partners have joint ownership of a project-specific Special Purpose Vehicle.

- **Joint Development Agreement:** The foreign investor sets up an Indian presence and undertakes development activity. The Indian partner contributes land and receives deferred consideration in terms of share of development or share of revenues.

REAL ESTATE DEVELOPMENT: OTHER LEGISLATION

Apart from policy initiatives and sector-specific guidelines, there is plenty of legislation regulating the various aspects of real estate projects. These include:

- **Indian Contract Act, 1872:** This governs the provisions of agreements relating to foreign collaboration, development, funding, land acquisition, and the sale and lease of real estate. All the requirements of a valid contract, ie consideration, intention to contract and validity under the law of the land, must be satisfied.

- **Transfer of Property Act, 1882:** This lays down the general principles of realty, like part-performance, and has provisions for dealing with property through sale, exchange, mortgage, lease, lien and gift. A person acquiring immovable property or any share/interest in it is presumed to have notice of the title of any other person who was in actual possession of such property.

- **Registration Act, 1908:** The purpose of this Act is the conservation of evidence, assurances, title, and publication of documents and prevention of fraud. It details the formalities for registering an instrument. Sales, mortgages (other than by way of deposit of title deeds) and exchanges of immovable property are required to be registered by virtue of the Transfer of Property Act.

- **Special Relief Act, 1963:** This Act is only to enforce individual civil rights. A person dispossessed of immovable property without their consent (other than in due course of law) can recover possession by a suit filed within six months from the date of dispossession.

Unless the contrary is proved, in a suit for specific performance of a contract, the court shall presume that a contract to transfer immovable property is one in which monetary compensation for its non-performance would not afford adequate relief. The court could also grant a permanent/mandatory injunction preventing the breach of such contract and award damages.

- **Urban Land (Ceiling and Regulation) Act, 1976:** This legislation fixed a ceiling on the vacant urban land that a 'person' in urban agglomerations can acquire and hold. A person is defined to include an individual, a family, a firm, a company, or an association or body of individuals, whether incorporated or not. This ceiling limit ranges from 500 to 2,000 sq m. Excess vacant land is either to be surrendered to the competent authority appointed under the Act for a small compensation, or to be developed by its holder only for specified purposes.

  This Act has been repealed in many states, but Andhra Pradesh, Assam, Bihar, Maharashtra, Orissa and West Bengal have not adopted the repeal.

- **Land Acquisition Act, 1894:** This Act authorises governments to acquire land for public purposes, such as planned development, provisions for town or rural planning, provisions for residential purposes for the poor or landless, and for carrying out any government education, housing or health scheme. In its present form, the Act hinders speedy acquisition of land at reasonable prices, resulting in cost overruns.

- **The Indian Evidence Act, 1872:** Under the Act, whenever the status of any person as the owner of a piece of immovable property of which they are shown to be in possession is questioned, the burden of proving that they are not the owner lies on the person who is questioning the ownership. A person who is in possession, even if it is invalid, cannot be evicted immediately.

- **Rent Control Acts:** Rent control by the government initially came about as a temporary measure to prevent the exploitation of tenants by landlords after the Second World War, but it became a permanent feature. The legislation governs the payment of fair rent to landlords and protects tenants against eviction, which effectively allows tenants to hold on rented property. Tenants who have occupied the same properties since 1947 continue to pay rents fixed at that time, regardless of inflation and the realty boom.

- **State laws governing real estate:** Each state has its own set of laws governing planned developments, rules for construction and the Floor Area Ratio or Floor Space Index. State governments also prescribe laws regulating the formation of societies and condominiums.

- **Stamp duty:** There is a direct link between the Registration Act, 1908 and the Stamp Act, 1899. Stamp duty needs to be paid on all documents which are registered and the rate varies from 4% to 12% of the property value. India has perhaps one of the highest levels of stamp duty in the world. Some states even have double stamp incidence, first on land and then on its development. In contrast, the maximum rate levied in most developed markets, whether in Asia or Europe, is in the range of 1% to 2%.

- **Property Tax:** Property Tax is a levy charged by the municipal authorities for the upkeep of basic civic services in the city. In India owners of property are liable for the payment of municipal taxes, whereas in countries like the UK the occupier is liable. Generally, the property tax is levied on the basis of reasonable rent at which the property might be let from year to year.

- **Municipal laws and zoning rules:** Each municipal council has its own laws and rules regarding the development of specific areas in towns, cities and villages. The state government normally prescribes land zoning rules on land use.

CONCLUSION

It is very difficult for foreign investors to navigate through the maze of legislation to implement their real estate development projects. The Indian government is keen to simplify most of the legislation, for example none of the above laws can impose restrictive covenants on approved special economic zones. However, foreign investors have nothing to fear so long as their projects comply with the prescribed norms.