Funding Real Estate Projects – Exit Challenges

A. *Background*

Even as the approach to foreign investments changed from 'red tape' to 'red carpet' with the introduction of the New Economic Order in 1991 ushering in an era of deregulation, the real estate sector continues to exhibit traces of *red tapism* inasmuch as the degree of regulation exercised over foreign investments in the sector. Even though the recent moves towards globalizing India's economy have resulted in the attraction of approximately US $8.7 billion of FDI in the real estate sector since April 2000, the exit restrictions on FDI are in need of consideration, clarification and, at the very least, discussion.

Foreign investments in the real estate sector were fairly restricted until 2005, and 'real estate business', that is, investment in real estate not intended for the purpose of construction development is still prohibited. In 2005, Press Note 2 of 2005 ("**PN2**") issued by the Department of Industrial Policy & Promotion ("**DIPP**") permitted foreign direct investment ("**FDI**") into the real estate sector under the hundred percent automatic route, subject to certain entity level as well as project level restrictions intended to curb speculative trading in real estate. The Indian regulatory policy pertaining to foreign investments was consolidated in the new Consolidated FDI Policy ("**FDI Policy**") issued by the DIPP, and accordingly, PN2 stands repealed by the FDI Policy.

The FDI Policy reiterated most of the provisions of PN2, but digressed on one of the most important provisions – the lock-in restriction.

PN2 provided as follows.

> "Original investment cannot be repatriated before a period of three years from date of completion of minimum capitalization. However, the investor may be permitted to exit earlier with prior approval of the Government through the FIPB."

The FDI Policy enhanced the exit restriction as follows.

> *"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 3 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 Foreign Investment Promotion Board ("**FIPB**")."* [Emphasis added]

B. *Industry Recommendations*

The tranche by tranche lock-in restriction introduced by the FDI Policy does not really come as a surprise. In a white paper co-authored by us with the United States India Business Council's (USIBC) Real Estate Committee[1] last year and presented to Union Commerce Minister Mr. Anand Sharma USIBC, Washington DC, the following recommendation (*reproduced verbatim*) was made:

[1] Copy of the white paper is attached hereto as **Annexure I**

Lock-in Provision: *"…PN2 sets a lock-in period of three years on the original investment in an FDI venture. However, there is a lack of clarity within the industry about the precise applicability of the three year period. While the intent of PN2 seems to apply only to minimum capitalization, there is ambiguity as to whether the term 'original investment' refers to the first tranche of foreign investment, the entire foreign investment or just the minimum capitalization. <u>There are also questions on whether the lock-in period would only be three years from the original investment or would it be reckoned three years from the date of the subsequent investment</u>. Moreover, PN2 does not provide for an automatic route to repatriate an investment i) if applicable building or other permits cannot be obtained, ii) if a joint venture with a local party is dissolved, iii) if market forces require the shelving of a project, or other similar provisions outside the control of an investor, whether domestic or foreign. Accordingly, if the investor intends to exit before the completion of the three year lock-in period, prior approval of the FIPB is required. USIBC apprehends that such requirement of approval would be required even if the foreign investor were to transfer its stake to another foreign investor. Such an approach evinces lack of harmony and coherence and puts unnecessary burden on the foreign investor by trapping large amounts of investments. Additionally, the lock-in period can significantly complicate dissolving an unsuccessful venture. Since the key concern for potential investors is the ability to exit, flexibility in repatriation restrictions would stimulate foreign investments required to keep the growth momentum ticking.*

*<u>Proposal</u>**:** The term 'original investment' should be clearly defined and the lock-in for 'original investment' should not be* applicable *to share transfers between two non-residents.*

C. <u>Extant Policy</u>

As is evident, both the recommendations were not accepted. This research paper seeks to analyze the restrictions on the ability of foreign investors and more particularly private equity funds ("**PE Funds**") from real estate projects.

1. <u>Repatriation of Original Investment</u>

PN2 prohibited the repatriation of "*original investment*" until 3 years from the date of completion of the minimum capitalization ("**Lock In**"). Until the issuance of FDI Policy, 'o*riginal investment'* was commonly understood to mean the minimum capitalization amount (i.e., USD 5 million for joint ventures with Indian partners and USD 10 million for wholly owned subsidiaries), and any FDI beyond the minimum capitalization was not subject to any Lock-In restrictions.

However, the FDI Policy changed that perception. The expansion of the Lock In beyond the minimum capitalization to include the entire investment (reckoned from the date of each installment) ("**Staggered Lock In**") came in as a surprise to most foreign investors.

As per the FDI policy, if 3 installments of FDI are made at different times (for example, installment A is made on January 1, 2011 and it satisfies the minimum capitalization requirement, installment B is made on January 1, 2012 and installment C is made on January 1, 2013), investment A could be repatriated after December 31, 2013, investment B could be repatriated after December 31, 2014 and investment C could be repatriated after December 31, 2015. Due to such restrictions, it may confine the ability of most of the PE Funds who are limited life funds of about 5 – 7 years, to make further contributions later in time. It may also result into the project being incomplete due to financial requirement in the real estate company as it is fairly common for the foreign investor to provide construction linked funding.

While some foreign investors view the Lock In as a hyper-restrictive provision and as a potential deterrent to the infusion of (initial and/or subsequent) capital into the real estate sector in India, the Commerce and Industry Minister, Anand Sharma believes that “investors must come with confidence that they are here to stay for more than that period.” Though there are emphatic demands from the industry to relax the Lock-In condition, relaxation of the Lock In condition seems unlikely in the near future.

2. *Non-Resident to Non-Resident Transactions*

What happens if a foreign investor offloads its stake to another foreign investor? Will such transfer also be subjected to the Lock-In condition as the actual investment in the project remains intact and only involves a change in the ownership of the investment? The 2i Capital case indicated that even offshore transfers are not free from the Lock-In condition.

In the 2i Capital case, 2i Capital (a private equity fund) requested FIPB approval for the sale of its investment (in the form of shares) in a New Delhi based real estate firm, Uppal Housing, to a Mauritius foreign fund, ICP Investments. Both the transferee and the transferor were foreign investors. Despite DIPP’s recommendation (as reported) to FIPB to approve the request, FIPB rejected the request and ruled that an investor is not permitted to sell its investment (even to a non-resident) before the end of Lock In period.

Prior to the 2i Capital case, the Lock In was understood to apply on an investment basis. In other words, the understanding was that the relevant factor was the movement of the investment funds outside of India as contemplated in the RBI stated policy of encouraging committed, long term foreign investment, as opposed to the transfer of shares from investor to investor.

One may argue that the approach of the FIPB is not convincing as the language in FDI Policy seems to restrict the repatriation of the “investment” outside India and doesn’t restrict the change of ownership of the investment. The 2i Capital case also raises more questions on the true meaning of “repatriation” in the context of Lock In. Is “repatriation” intended to include the transfer of ownership interests from one non-resident investor to another non-resident investor even though there is no return of the investment to the non-resident investor?

The FIPB seems to have a different perspective. It seems that the FIPB may not have intended to regard transfers between two non-residents as “repatriation” because, in one sentence, it restricts repatriation of the “investment,” but then in the subsequent sentence, it states that “… the *investor* may be permitted to exit earlier with prior approval of the Government through the Foreign Investment Promotion Board.”

The conflict lies in the construction of the paragraph which, in the first two sentences discusses restrictions on the repatriation of the original investment, as opposed to the last sentence, which discusses restrictions on exit of the investors prior to three years. Guidance is required from the DIPP/FIPB on the proper interpretation of these provisions.

That being the case, another question that needs to be answered is – to what extent does the Lock-In apply to a non-resident transferee? *If a non-resident transferor transfers the shares to another non-resident after 3 years, then will such non-resident transferee be free of the Lock-In condition as the lock-in of three years on the “original investment” has already been complied with?*

The regulatory approach seems that an acquisition of shares by the non-resident transferee would be considered a fresh “investment” and the Lock-In restriction would be reckoned from the date such shares are acquired by the transferee, irrespective of the length of time that the transferor held the shares.

For instance, if a foreign investor invests in a real estate project on January 1, 2010 and sells his shares in the company to another non-resident investor on January 1, 2013. The transferee shareholder will not be able to sell his shares in the real estate company even if the project is completed by December 2015 as he will be locked-in until January 1, 2016. These restrictions appear paradoxical to the other provisions of the FDI Policy which intend to restrict the actual 'investment', rather than the 'investor'.

3. *Effect of Lock In Condition on Private Investment Agreements (Put Options and Call Options)*

Call and put options are one of the most crucial forms of exit for any investor, whether domestic or foreign. Enforceability of the call / put option may be severely fettered by the provisions of the Securities Contracts Regulation Act (SCRA) and the regulatory approach to call / put options.

Challenges in enforcement of call / put option from a Securities Contracts Regulation Act (SCRA) perspective were discussed at length in an article written by Nishith Desai Associates ("*Options, puts and the law*", Mint, February 10,2009), which is reproduced herein below.

> *With the resounding "pop" of the global credit bubble, the IPO bandwagon that Indian companies were once rushing to jump onto appears to have driven out of sight. The all too obvious brunt of the financial crisis aside, a consequential emerging issue is, what of the millions of dollars that were invested by private equity funds in these companies in the hope of exiting through IPOs at favourable valuations?*
>
> *Typically as a fallback, the investor would have a "buy-back right" to cause the company to "buy back" its shares and/or a "put option right" to cause the management/promoters of the company to purchase its stake at an agreed return. But such seemingly standard exit rights may not always be enforceable under Indian law.*
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> *After a notification issued in 1969 under the Securities Contracts Regulation Act (SCRA), 1956, all transactions in securities other than on a "spot delivery" basis or unless settled through the stock exchange are illegal. Though this notification was repealed in 2000, another notification was issued on the same day, which, oddly, was for the most part similar to the 1969 notification. "Spot delivery" basis, as the name suggests, are transactions where the transfer of securities and payment of consideration for such securities take place on the same or the next day. This brings us to the focal point of our discussion: Is a put option a spot delivery contract as is permissible under SCRA, or is it a forward contract and thus illegal?*
>
> *To begin with, a put option may not even be treated as a completed contract as it is more in the nature of a contingent contract. It would result in a contract for sale or purchase of securities only upon the exercise of the option and not merely upon the grant of such option. Further, once the option is exercised, the contract is typically performed immediately, that is, on a spot delivery basis and should thus be enforceable. This line of reasoning was accepted by the Bombay high court in a case decided under the erstwhile Bombay Securities Contracts Control Act (BSCCA), 1925, an enactment that is broadly similar to SCRA.*

However, a recent decision of the Bombay high court in the Niskalp Investments and Trading Co. Ltd v. Hinduja TMT Ltd case in 2008 (Hinduja case) counters the above principle. In the Hinduja case, in accordance with the agreement executed between the parties for the purchase of securities, the purchaser was to be provided an exit by way of an IPO of the company, failing which the seller was to buy back the purchaser's stake at a 20% internal rate of return. The seller did not honour its obligations under the agreement and consequently, the purchaser approached the courts. However, the court held in favour of the seller, stating that the arrangement to buy back shares is hit by SCRA and is thus void.

The court appears to have reached such a conclusion solely by relying on a summons for judgement passed in 1997, which, in turn, had relied on a ruling passed by the Supreme Court. However, the suit filed in connection with the summons for judgement was dismissed in 2005 and consequently, had no bearing.

In its ruling, the Supreme Court had dealt with the illegality of ready-forward transactions (which are sometimes described as buy-back transactions) in the context of repo transactions and buy/sell transactions entered into by banks and financial institutions. Thus, in reaching its decision in the Hinduja case, the court primarily relied on one case that had been dismissed and another that deals with fixed buy-sell arrangements by banks, which are altogether different from the arrangement under the Hinduja case.

On the applicability of SCRA, given its objective (i.e., recognition of stock exchanges, conditions for listing and delisting of securities and so on), it should only apply to listed companies or companies that are about to list. However, the view of the courts under certain cases is that SCRA also applies to unlisted public companies (without any consideration of their intention to list).

The rationale for such a view rests on the basis of the definition of "securities" under SCRA, where the key criterion is that securities are required to be "marketable", a term that the courts have interpreted to be synonymous with "freely transferable". Unlike public companies, as private companies have the right to restrict the transfer of shares, such shares are not "freely transferable"/"marketable" and thus, private companies are fortunately outside the purview of SCRA.

Regardless of the applicability of SCRA, as long as put options are settled on a spot delivery basis, they should be enforceable. Necessary amendments to SCRA or a clarificatory circular by the Securities and Exchange Board of India to this effect would be useful, especially in the prevailing market conditions. Until such time, fairly customary, albeit vital, rights such as put option rights and rights to cause the company to buy back shares, even if settled on a spot delivery basis, may be regarded as being unenforceable, more so in light of the ruling in the Hinduja case.

From an exchange control perspective, though there is nothing written in black and white that prohibits the enforceability of the call / put options, there have been precedents where call / put options of convertibles exercisable at a pre-determined price have not been seen favorably by the RBI. The DLF case, discussed later in this paper, is one such example where the regulatory approach on fixed IRR options became manifest.

Further, even if a PE Fund chooses to bear the risk on the enforceability, it is the Lock – In condition that poses another a concern on the regulatory compliance of the exercise of a put/call option. For instance, there may be situations where a PE Fund may choose to salvage a sinking real estate project by purchasing the shares from the Indian promoter. In doing so, the PE Fund may be seen as making FDI into the project, thereby triggering the commencement of a fresh 3 year lock in period. In this case, the Staggered Lock In restriction is likely to discourage the purchase of such shares as the stacked Lock In periods may effectively exceed the life of the PE Fund itself.

4. *What if the exit is after the Lock-In Condition but before completion of 50% of the project*

Another condition that potentially restricts the ability of the foreign investor to exit from a real estate project is the stipulation to complete at least 50% of the project within 5 years from the date of obtaining all statutory approvals ("**50% Condition**"). A question that often comes is whether the foreign investor will be able to exit the real estate project after the expiry of the Lock-In Condition but prior to satisfaction of the 50% Condition? There are several ambiguities in the 50% condition. For instance, when can it be said that all statutory approvals have been taken and who procures such approvals. There are views that an 'intimation of disapproval' or a completion certificate could be regarded as the benchmark, but there is no formal clarity from the regulators on the same.

The requirement to procure the approvals was cast solely on the investor in PN2. FDI Policy casts this responsibility on the investor / investee company. Even though the obligation to procure approvals has been cast on the investor / investee company under the extant FDI Policy, it appears that this restriction was intended to be cast largely on the Indian partner / investee company than the foreign investor who may not have on the ground presence to ensure timely development of the project.

5. *Pricing Restrictions*

Effective July 1, 2007, the Reserve Bank of India mandated that instruments not fully and mandatorily convertible into equity shares of the investee company were to be regarded as an external commercial borrowing ("**ECB**"), which were and continue to remain prohibited for the real estate sector.

To that extent, the only instruments that could be subscribed by a non-resident were fully and compulsorily convertible debentures, fully and compulsorily convertible preference shares and equity shares (together, "**FDI Instruments**"). The idea of the regulator was to ensure commitment to the risk capital of the company, and any funding that was not intended to form a part of the risk capital of the company was discouraged. The differentiation between an FDI Instrument and an ECB was essentially on the ability of a non-resident to draw out fixed returns from the investee company without committing to the risk capital of the company.

This differentiation became manifest in the DLF Case. In that case, US-based private equity investor DE Shaw had invested $400 million as convertible preference shares into DLF Assets (DAL), the company floated by the promoters of DLF Ltd, in 2007 with assurances from the developer of a public listing in 2008. However, with the worldwide real estate market collapsing in 2008, the investor negotiated with the cash-strapped DLF promoters to provide them an exit at fixed return of at least 27% IRR. RBI, reports suggest, issued a show cause notice on why the investment (even though through FDI Instruments) be classified as an ECB on the ground that it carried a fixed rate of return.

Whilst the DLF Case did indicate the regulatory perspective to fixed price exits for non residents, there is no update on what ultimately transpired. However, as it happens, FDI Instruments continue to be issued with a fixed rate of return and regulatory intervention seems to be on a case to case basis.

Enforcing a call/put option also becomes difficult sometimes as the FDI Policy requires that any issue or transfer of security to a non-resident should be effected at a price not less than the discounted cash flows valuation of the investee company, and any issue or transfer of security to a non-resident should be effected at a price not less than the discounted cash flows valuation of the investee company. To that extent, a non-resident can only 'put' its shares to a resident at no more than the DCF valuation, and cannot 'call' for the shares of a resident at a price no less than the DCF valuation. Since the FDI Policy requires that the pricing of convertibles on an as-if-converted basis should not be below the DCF as on the date of issuance, structuring anti-dilution and similar structures becomes challenging for non-residents.

D. <u>**Conclusion*: From Globalization to Protectionism?***</u>

In light of the increased restriction on FDI in the real estate sector, the RBI, following the release of the FDI Policy, advised the Government to impose stricter provisions under the FDI Policy in other sectors and mechanisms for monitoring the end use of inflows of foreign capital to prevent diversion of funds into speculative real estate transactions which have the potential of causing a real estate bubble.

Currently, 100% FDI is permitted in the hotel and tourism industries, but the RBI has proposed a quarterly or annual reporting requirement on "receipt and usage of foreign inward remittance, granting permission or license for running a hotel under which construction of the hotel should be completed within a stimulated period, and clauses under which the investor or investee company would not be allowed to sell undeveloped plots."

If the intent is only to curb speculative trading in real estate, then the original Lock In restriction (which just locked in the minimum capitalization as against each tranche of foreign investment) should have been sufficient as it evidenced commitment of the non-resident to the real estate project. Restricting the repatriation of investments to beyond the three year period or beyond the minimum capitalization appears overstretched and may militate against the interest of the sector as a whole, which is still trying to cope up from the recent downturn. With overseas markets becoming increasingly lucrative, restrictions on the ability of foreign investor to exit its investments may not be received favorably and may galvanize investments in other competing jurisdictions. Absence of a domestic REIT regime only adds to the vulnerability that the real estate sector is susceptible to.

Recommendation: In conclusion, the Lock In provision of the FDI Policy requires close examination and explanation by the DIPP. As discussed above, there are significant conflicts and ambiguities in the language of the policy. Accordingly, we believe that for a sustainable and harmonious growth of the real estate sector keeping in mind the need to curb speculative trading, at least the following recommendations may be considered:

(i) restrict the Lock-In restriction to the minimum capitalization;
(ii) define "repatriation" so more clarity can be provided as to what types of transfers are considered to be subject to the Lock In Condition;
(iii) enable non-residents to exit the real estate projects and park their proceeds in India for further investments in FDI compliant projects in India;
(iv) provide specific carve outs for which early exit would be permitted without obtaining formal FIPB approval (i.e., in the event of idle projects, litigation among joint venture/fund partners,

mutual decision to end development of a project or completion of certain percentage of the project).

ANNEXURE I

USINDIA BusinessCouncil

USIBC's Real Estate Executive Committee

Presents to Minister Anand Sharma, Union Minister of Commerce and Industry

Foreign Direct Investment Policy: Strengthening India's Real Estate Sector

March 18, 2010

Knowledge Partner:

Nishith Desai Associates
Legal & Tax Counseling Worldwide
Mumbai • Silicon Valley • Bangalore • Singapore • Basel

Executive Summary

The real estate industry is the second largest employer in India and contributes substantially to its Gross Domestic Product (GDP). Since India's real estate sector was opened to foreign direct investment (FDI) in 2002, the industry has witnessed periods of unprecedented growth. Then, the global financial crisis hit and badly affected real estate markets across the world. But after a year of consolidation, India's real estate sector is already seeing positive market trends. In order to fuel this sentiment and take advantage of the limited funds available in the new global environment, it is imperative that the policies surrounding investment in this sector are enacted in such a way that its growth potential can be realized. U.S.-India Business Council (USIBC) understands that the Ministry of Commerce & Industry is exploring proposals to relax minimum capitalization and minimum area development norms for mixed development projects. To facilitate the decision-making process, USIBC's Real Estate Executive Committee has proposed herein recommendations on relaxing the rules surrounding foreign investment in real estate as they pertain to minimum capitalization requirements; minimum area development norms; lock-in provisions; existing real estate assets; and agricultural land. Facilitating foreign investment for the participation of foreign investors and specialized players will not only introduce transparency, accountability and an emphasis on quality, but it will bolster urban planning and infrastructure development as India seeks to achieve the goals laid out in its eleventh Five Year Plan.

Foreign Direct Investment Policy:

Strengthening India's Real Estate Sector

Since India's real estate sector was opened to foreign direct investment (FDI) in 2002, the industry has witnessed periods of unprecedented growth. This has been fueled by the Indian government's successive liberalization of the sector along with heightened demand for commercial and residential space as the economy has continued to expand. However, the real estate industry was badly affected by the financial turmoil in 2008, which resulted in high amounts of debt as money dried up and demand dissipated. But after a year of consolidation and saving, the property markets of the emerging economies are already on a path of recovery. According to Jones Lang LaSalle Meghraj (JLLM), India's property sector has potential to attract up to US $12.11 billion worth of investment over the next five years. As positive market sentiments and demand in real estate resumes, it is imperative that policies surrounding investment in this sector are enacted in such a way that this growth potential can be realized.

Importance of India's Real Estate Sector

The importance of the real estate sector and of creating an investor friendly environment cannot be underscored. This industry is the second largest employer in India and contributes substantially to its Gross Domestic Product (GDP). Moreover, it is remarkably diversified, containing verticals such as investment, development, architectural design, construction, brokerage, lending, and is associated with 250 other industries. A recent JLLM study on emerging trends in real estate finance illustrates that this sector contributed US $36.56 billion to India's GDP during 2006-2007 and employed 7% of the total urban work force.[2] While developed countries are seeing less than modest levels of growth, India was able to achieve a near 8 percent growth rate last quarter, fostering further demand in the commercial and residential space. Real estate is clearly an industry that has potential to contribute substantially to India's overall development and economic growth. PricewaterhouseCoopers ranked India as the leading real estate investment destination in Asia.[3] India's residential real estate market is likely to see significant growth in the near to medium term. JLLM estimates India's housing shortfall to be on the order of 24.7 million units. They also expect to see a doubling of commercial real estate during the 2010-12 period. On the whole, their study shows that the Indian real estate market will require approximately US $23.66 billion incremental investments during 2010-2012 for the construction of commercial and residential projects. In India's current five-year plan, it is estimated that in urban housing alone, US $25 billion worth of investment is needed. But in order to attract this level of investment, certain restrictions on FDI in the real estate sector must be addressed.

Current FDI Policy in Real Estate [4]

In 2005, the Department of Industrial Policy and Promotion (DIPP) adopted Press Note 2 (2005) (PN2), which grants automatic approval for FDI up to 100 percent in qualifying infrastructure and construction development projects. This policy change was welcomed by industry and

[2] Jones Lang Lasalle Meghraj. Emerging Trends in Real Estate Finance. December 2009.
[3] PriceWaterHouse Coopers and Urban Land Institute. Emerging Trends in Real Estate Asia Pacific. 2010.
[4] Nishith Desai Associates. *Real Estate Fund Investments*. January 2010.

subsequently saw significant growth of the real estate market. Between 2005 and March 2009, Indian real estate attracted approximately US $5.5 billion of FDI. Despite the global recession, US $1.2 billion of FDI came into India in the first quarter of 2009-10 as private equity players helped stabilize various property companies through qualified institutional placements (QIPs)[5]. However, at the same time, certain restrictions still exist that limit the potential of growth in this sector. U.S.-India Business Council (USIBC) understands that the Ministry of Commerce & Industry is exploring proposals to relax minimum capitalization and minimum area development norms for mixed development projects. To facilitate the decision-making process, USIBC's Real Estate Executive Committee would like to highlight our members' concerns as it relates to liberalization of FDI in this sector.

Our understanding is that in the case of the development of serviced housing plots, a minimum land area of 10 hectares is currently required. In the case of construction-development projects, projects must have a minimum 'built-up area' of 50,000 square meters. And in the case of a combination project, satisfaction of any one of the two conditions would suffice. With regard to capitalization, minimum capitalization of US $10 million is required for wholly owned subsidiaries (WOS) and US $5 million for joint ventures (JV) with Indian partners. The funds must be invested within six months of commencement of business of the company, and the original investment cannot be repatriated before a period of three years from date of completion of minimum capitalization. If the investor seeks to make an early exit, he is required to get prior approval from the Foreign Investment Promotion Board (FIPB).

We also understand that at least 50 percent of the project must be developed within a period of five years from the date of obtaining all statutory clearances. The investor is not permitted to sell undeveloped plots, which are understood to mean plots where roads, water supply, street lighting, drainage, sewerage, and other conveniences, as applicable under prescribed regulations, have not been made available. The investor must provide this infrastructure and obtain a completion certificate from the concerned local body or service agency before he is allowed to dispose of serviced housing plots. All projects must conform to applicable norms and standards, including land use requirements and provisions of community amenities and common facilities, as laid down in the applicable building control regulation bye-laws, rules, and other regulations of the state government and municipal bodies concerned.

In addition, the investor is responsible for obtaining all necessary approvals, including those of the building and 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 and regulations of the state government or municipal bodies concerned. The corresponding local bodies that are in charge of approving building and development plans, would monitor compliance of the above conditions.

Recommendations

We can appreciate the sensitivity of the real estate sector and understand the rationale of the Indian government to impose restrictions to ensure that excess foreign investment in the sector does not lead to an uncontrolled increase of real estate prices. But in light of the reduced funds

[5] Ernst & Young and FICCI. *Staying Real in India: What makes Indian Real Estate resilient and an exploration of opportunities*. December 2009.

available in the new global environment, it is critical to address these regulatory hurdles in order to sustain the growth of the industry. Outlined below are aspects of India's existing FDI policy, which if addressed could foster significant opportunities for growth and investment in the real estate sector.

I. Minimum Area & 50% Completion: Under PN2 of 2005, an entity may receive FDI provided that the minimum area to be developed under each project is a minimum of 10 hectares of land area in the case of serviced housing plots, and a minimum of 50,000 square meters built-up area in the case of construction-development projects. But a majority of realty players have had difficulty finding land parcels that meet such requirements, especially in the Tier I metro cities. This stipulation thereby reduces the effectiveness of the FDI policy. Furthermore, since valuation of land in these cities is very high, acquiring such land parcels is critically dependent on the ability of the acquirer to raise money. Consequently, this requirement acts as a severe stumbling block in attracting FDI. Conversely, salability of a 50,000 square meter project in a Tier II or Tier III city may not be feasible, especially if the plot is for commercial use.

Additionally, as used in PN2 and subsequent policy documents, the concept of 'built-up area' is not clearly defined nor is the term standardized within the industry so as to allow for clear guidance. In particular, the ambiguity pertains to whether the area includes only floor-space index (FSI), as licensed by a relevant local authority, or whether it also includes garage and other below grade areas, which are not considered FSI. In either case, a clear system of measurement on how the minimum area should be calculated is important to refine the process of vetting potential projects for FDI compliance.

Similarly, there is some concern about how to define the 50% completion requirement of an FDI project within five years. If this policy requires full, substantial completion (with an occupation certificate, for example) of 50% of the project, then a project consisting of only one building would have to be entirely complete in order to comply with the standard. Compliance with this provision would be greatly eased by a clear system of defining 50% completion.

*<u>Proposal</u>**:** The minimum built-up area for construction development projects should be reduced from 50,000 square meters to at least 20,000 square meters for projects in Tier 1 cities.*

II. Commencement of Business & Timing of Investment: Under the conditions laid down in PN2, FDI in an entity proposing to develop real estate is subject to minimum capitalization norms (US $5 million for JVs with Indian partners and US $10 million for WOS) and the funds have to be brought in within six months of the commencement of business of the company. There have been certain concerns relating to this aspect. Firstly, it is not clear whether the term 'commencement of business' is to be reckoned from the date of incorporation of the company; the date of commencement of business of the Indian company; the date of the investment agreement signed by the investor; or from the date the funds are credited into the account of the company. Interestingly, for the purpose of service tax, the Union Budget 2010-11 defines an under construction project as one which has not received the 'occupation certificate.' A similar interpretation can also be drawn from an FDI perspective suggesting that FDI into real estate can be brought in until the "occupation certificate" has been received. Owing to the huge demand of foreign investments in this sector, clarity on these aspects is very much required.

*<u>Proposal</u>**:** The term 'commencement of business' should be clearly defined.*

III. Lock-in Provision: As stated above, PN2 sets a lock-in period of three years on the original investment in an FDI venture. However, there is a lack of clarity within the industry about the precise applicability of the three year period. While the intent of PN2 seems to apply only to minimum capitalization, there is ambiguity as to whether the term 'original investment' refers to the first tranche of foreign investment, the entire foreign investment or just the minimum capitalization. There are also questions on whether the lock-in period would only be three years from the original investment or would it be reckoned three years from the date of the subsequent investment. Moreover, PN2 does not provide for an automatic route to repatriate an investment i) if applicable building or other permits cannot be obtained, ii) if a joint venture with a local party is dissolved, iii) if market forces require the shelving of a project, or other similar provisions outside the control of an investor, whether domestic or foreign. Accordingly, if the investor intends to exit before the completion of the three year lock-in period, prior approval of the FIPB is required. USIBC apprehends that such requirement of approval would be required even if the foreign investor were to transfer its stake to another foreign investor. Such an approach evinces lack of harmony and coherence and puts unnecessary burden on the foreign investor by trapping large amounts of investments. Additionally, the lock-in period can significantly complicate dissolving an unsuccessful venture. Since the key concern for potential investors is the ability to exit, flexibility in repatriation restrictions would stimulate foreign investments required to keep the growth momentum ticking.

Proposal: The term 'original investment' should be clearly defined and the lock-in for 'original investment' should not be applicable to share transfers between two non-residents.

IV. Non FDI Compliant Projects: Implications of PN2 on entity level foreign investments becomes intriguing when the company into which the FDI is being infused either has i) certain projects that are not PN2 compliant, or ii) certain subsidiaries that have projects that are not PN2 compliant. As we understand, FIPB has rejected many proposals wherein a company was involved primarily in FDI compliant projects but simultaneously carried out a few non-FDI compliant projects in the same entity. Since it is difficult at times to hive off such non-FDI compliant projects to a separate company, such a stand becomes a major impediment to the realty sector in availing funds under the FDI route. Also, if the FDI compliant projects are hived off into a new company, the newly incorporated company may not be able to attract FDI at better or similar valuations as compared to that of the parent company. Therefore, a relaxation in such policy would be a major booster for foreign investment. The concerns regarding foreign money sneaking into non-FDI compliant projects can be addressed by setting up a separate account for the foreign investment from which money shall be utilized only for the FDI compliant projects. Such an account can be periodically monitored by the regulators.

Proposal: A provision for setting up a separate account for foreign investment should be created and monies from this account shall be utilized only for FDI compliant projects.

V. Affordable Housing: Significant emphasis has been given to the affordable housing sector in the Union Budget 2010-11. If affordable housing is to be promoted, lesser area and minimum capitalization requirements need to be provided for in the FDI policy. Moreover, there will also be a need to define the term affordable housing.

Proposal: For affordable housing projects, the minimum area and minimum capitalization requirements should be lowered.

VI. FDI in Built-Up and Completed Projects: Many foreign investors are keen to deliver a higher standard of construction quality, design specifications and energy efficiency than those that are readily available. However, the requirement that FDI be invested only in so-called 'greenfield' development schemes limits the potential for FDI to make investments in existing assets to improve the quality of the existing stock of wide variety of asset classes. Existing Indian assets are usually owned 'strata-title,' with single buildings owned by multiple owners. This ownership mechanism creates little incentive for owners to make capital improvements in their existing assets. Permitting access to existing assets will enable liquidity and exit options to existing developers and lower costs of development and occupancy through a well-developed resale market with international players.

Proposal: Permit foreign investment in existing real estate assets so long as the real estate asset will be redeveloped /refurbished per the provision of PN2.

VII. External Commercial Borrowing (ECB) / Investment in Real Estate: Fundraising is steadily increasing as demand has begun to pick up. As a capital intensive sector, real estate always faces challenges raising liquidity. Currently, ECB is not permitted for real estate except for integrated townships (until December 31, 2010), and this is only with prior approval of the Reserve Bank of India and that too with several stringent conditions. Relaxation in the ECB norms for real estate has been a long standing demand and would provide a significant relief to developers since it would enable them to use this route for raising funds. Moreover, expanding the scope of ECB to allow it in built-up infrastructure and construction development projects, with restrictions, of course, would not only throw open another avenue for raising capital, but would also add to the existing housing stock and built-up infrastructure, expediting the slow recovery process. Similarly, at present there is a ban on proceeds from American Depository Receipts (ADR)/ Global Depository Receipts (GDR) from being invested in the real estate sector. This should also be relaxed as investors manage risk by a mix of debt and equity. A debt-equity ratio may be prescribed as an alternative. While fundraising regulations are out of the direct purview of the Ministry of Commerce, we suggest that this dialogue be initiated by the Ministry of Commerce in the interest of the growth of the industry. Permitting developers to raise foreign debt will go a long way in ensuring long-term funds are available to them at highly competitive rates, which will result in lower per unit costs, thereby fuelling higher demand.

<u>*Proposal*</u>*: A dialogue and collaboration with the Ministry of Finance and Reserve Bank of India should be initiated to advocate for the benefits of allowing developers to use ECBs and other fundraising tools to raise foreign debt.*

VIII.FDI in Agricultural Land: FDI is not permitted in agricultural or plantation activities. Therefore, FDI may not be used for acquiring agricultural land. This results in a situation where an Indian company first purchases the agricultural land and then obtains necessary approvals for converting it for non-agricultural use. Only thereafter is funding possible by foreign partners. Also, companies with FDI are prohibited from undertaking agricultural activities under the extant FDI policy, which is clearly not the intention. Taking into account the fact that there is a minimum area requirement norm and it is difficult to find non-agricultural land in urban areas, a more relaxed norm should be considered. An Indian company with FDI should therefore be allowed to acquire even agricultural land for the purpose of construction development, so long as the provisions of PN2 are complied with.

<u>*Proposal*</u>*: Allow Indian companies with FDI to acquire agricultural land so long as the land is being used for construction and development per the provisions of PN2*

<u>***Conclusion***</u>

USIBC appreciates the Commerce Ministry's proposals to address the stipulations surrounding FDI in real estate. Effective FDI policy plays a critical role in attracting investment into a sector and is essential for economic growth and development. The benefits of relaxing investment policy as it relates to India's real estate sector are manifold. Since the real estate industry is broad and diversified, it offers cross-sectoral opportunities for growth and development. Facilitating foreign investment for the participation of foreign investors and specialized players will not only introduce transparency, accountability and an emphasis on quality, but will enhance the sector by making it more structured and corporatized. Improved organization and growth of real estate will generate higher tax revenues for the Indian government while fostering job creation. Moreover, liberalizing the foreign investment regime will facilitate urban planning and infrastructure development. While India's growth levels are impressive, it is vital that India's urban infrastructure keeps pace with its economic growth so that it can continue on an effective trajectory. We recognize that many facets of real estate are regulated outside the domain of the Ministry of Commerce, but we have specifically addressed points herein which fall within your realm of foreign investment policy. USBIC's Real Estate Executive Committee is wholly committed to working with your Ministry as you reconsider revising the policy surrounding FDI in real estate. We anticipate favorable consideration of our recommendations and look forward to an open dialogue on these matters.

About U.S.-India Business Council

The USIBC, formed in 1975 at the request of the Government of India and the U.S. Government to deepen trade and strengthen commercial ties, is hosted under the aegis of the U.S. Chamber of Commerce. The U.S. Chamber of Commerce is the world's largest business federation representing more than 3 million businesses and organizations in every size, sector and region.

About Nishith Desai Associates

Nishith Desai Associates (NDA) is a research based international law firm with offices in Mumbai, Bangalore, Silicon Valley, Singapore and Basel. We specialize in strategic legal, regulatory and tax advice coupled with industry expertise in an integrated manner. We focus on niche areas in which we provide significant value and are invariably involved in select highly complex, innovative transactions. Our key clients include marquee repeat Fortune 500 clientele, of which over 60 per cent are US corporations.

Summary of Recommendations:

- ***The minimum built-up area for construction development projects should be reduced from 50,000 square meters to at most 20,000 square meters for projects in Tier 1 cities.***
- ***The term 'commencement of business' should be clearly defined.***
- ***The term 'original investment' should be clearly defined.***
- ***The lock-in for 'original investment' should not be applicable to share transfers between two non-residents.***
- ***A provision for setting up a separate account for the foreign investment should be created and monies from this account shall be utilized only for FDI compliant projects.***
- ***Permit foreign investment in existing real estate assets so long as the real estate asset will be redeveloped/refurbished per the provision of PN2.***
- ***For affordable housing projects, the minimum area and minimum capitalization requirements should be lowered.***
- ***A dialogue and collaboration with the Ministry of Finance and Reserve Bank of India should be initiated to advocate for the benefits of allowing developers to use ECBs and other fundraising tools to raise foreign debt.***
- ***Allow Indian companies with FDI to acquire agricultural land so long as the land is being used for construction and development per the provisions of PN2.***

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