

# Realty Bytes

Fractional ownership of real estate assets through SM REITs

September 2024



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# 01

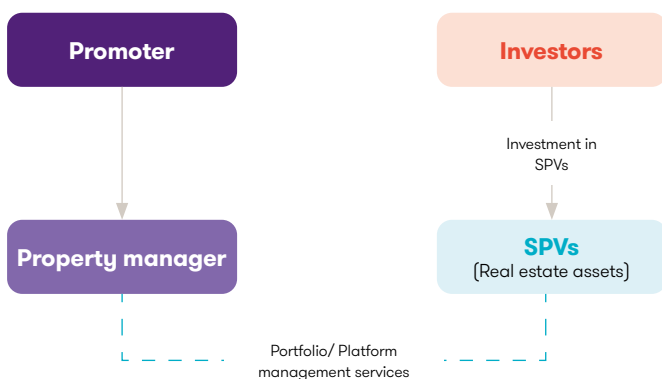
# Concept of fractional ownership platforms

## Fractional ownership platforms (FOPs)

Fractional ownership enables multiple investors to jointly own real estate, either directly or indirectly. Traditionally, this joint ownership meant that investors directly held a share of the property as co-owners, typically in completed projects. This method limited the number of investors who could participate in owning such assets. Now, with fractional ownership, investors can own a share in a Special Purpose Vehicle (SPV) that holds the property, which could be under construction or leased out. Instead of direct ownership, investors hold securities of the SPV or an investment vehicle, which owns the SPV, allowing for broader participation. The returns and capital appreciation of these units or securities are linked to the returns generated by underlying real estate (net of expenses).

### Typical FOP structure

In a typical FOP structure, a platform manager establishes a SPV to hold and manage a real estate asset. Investors purchase securities in the SPV, giving them a proportional ownership stake in the property. The SPV uses these pooled funds to acquire the property, whether it's under construction, developed, or leased. Rental income generated by the property is distributed to investors as interest or dividends, while any capital appreciation is realized through the sale of SPV securities. The platform manager earns fees for managing the investment, and investors typically enjoy a return of 10-15% through a combination of income and capital gains.



## Role of FOPs in real estate market

FOPs make real estate investment accessible with smaller capital, offering diversification and improved liquidity through secondary markets. They provide professional management and streamlined processes via tech platforms, ensuring a hands-off experience for investors. FOPs also benefit developers by expanding their access to funding through a broader investor base. Thus, creating a more inclusive, flexible, and user-friendly real estate investment opportunity for a wider range of participants.

## Evolution of Fractional Ownership Platforms (FOPs)

**2014**

Introduction of REIT regulations. This was restricted to an asset size of INR 500 crore or more.

**2023**

Consultation paper for introducing micro small, and medium REITs with INR 25 – INR 499 crore asset sizes.

**March 2024**

SEBI-approved regulation of medium and small REITs with asset size of INR 50 crore - INR 499 crore.

**June 2024**

SEBI's FAQ release clarifies some of the issues.

**August 2024**

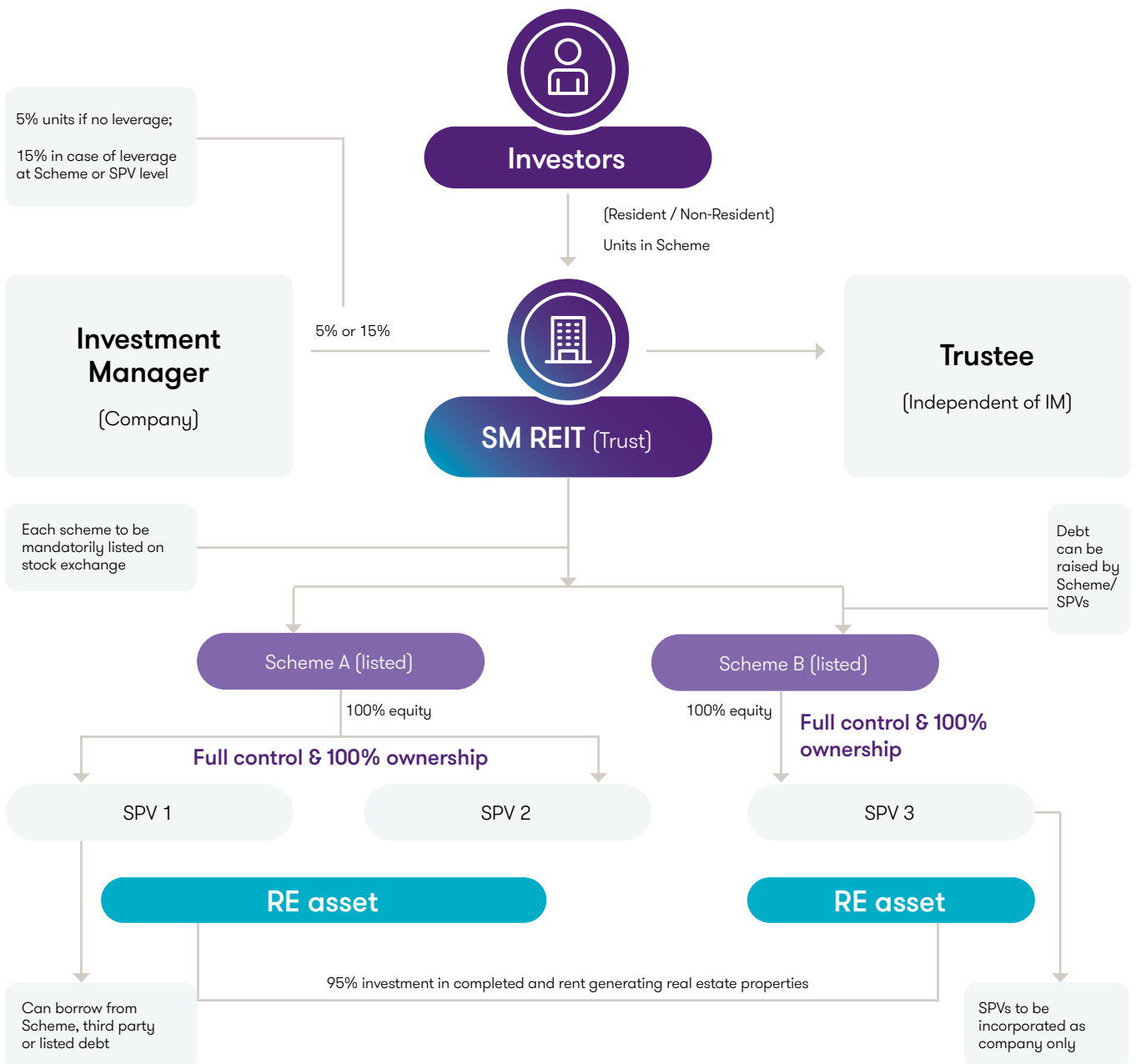
First SM REIT registered. Five applications under process.

# 02

# About SM REIT

In March 2024, SEBI introduced regulations for small and medium REIT (SM REIT) to govern FOPs owning assets worth INR 50 crore or more and having more than 200 investors. Under the SM REIT, a trust registered as SM REIT, (through multiple schemes) raises funds from investors by issuing units and invests in shares/securities of a company which owns rent-yielding real estate properties. An independent investment manager manages the property for the SM REIT. A trustee is appointed to oversee the management of the SM REIT.

## Typical SM REIT structure



## Benefits

Scale up the fractional ownership market size and its participation in rent-yielding projects.

No limits on the number of investors in a scheme compared to the existing limitation of 200 investors.

Non-resident investors can invest in such properties through SM REIT, which were not permitted earlier.

No lock-in for real estate held by the SM REIT compared to a 3-year lock-in for REIT assets.

Rent generating properties below INR 500 crore covered.

Can raise debt at beneficial terms from lenders.

No lock-in for investors compared to the lock-in required under existing unregulated platforms.

Investment ticket size of INR 10 lakhs

Disclosures and standardised processes.

Protection for investors.

Listing of units enables higher liquidity.

Takeover restrictions.

Mandatory distributions.

Reduced tax rate on capital gains.

## Challenges

Due to restrictions on related party transactions, developers are allowed to act as investment manager. However, they cannot transfer their assets under the SM REIT as an investment manager. Many developers intending to monetise assets must appoint an independent investment manager.

# 03

# Asset classes under SM REIT/FOP

## Office spaces

The offices space are not limited to Grade A office unlike REITs and Grade B offices are likely to be more suitable for SM REITs due to lower value of the office spaces compared to Grade A offices.

## Warehouses

Third-party logistics providers meet major warehousing requirements and have a huge potential, given the rise in the manufacturing sector and e-commerce.

## Retail assets

Grade A retail spaces, such as malls in metro cities, require bigger capital for individual investors.

## Holiday homes

An increase in tourism and flexibility to work remotely, as well as the demand for holiday homes, has been rising. The asset can be used and let out.

## Co-working spaces

Co-working space providers either own and lease the designated spaces to the tenants or take in on lease and further sub-lease to tenants. Players may consider operating the asset-light model to expand their operations and reduce dependencies on limited properties. The existing properties can be considered transferred to a REIT for a cash consideration and lease back the same properties. The surplus cash can be used to lease out more properties, thus expanding the operations.

## Other potential asset classes

Some of the key potential asset classes are co-living spaces, student housing, senior assisted living, data centers, and hospitality.



# 04

## How FOPs and SM REITs differ

Key characteristics and regulatory framework for FOPs in contrast with amended SM REIT regulations:

		FOPs	SM REITs
<b>Asset</b>	Minimum asset value	Less than INR 50 crores	INR 50 crores or more
	Asset class	Any assets generating rental income. Under-construction property can be held.	Only completed and rent-yielding assets are permitted
<b>Investor</b>	Investor holds	Shares, debt instruments, interest in SPV	Units in trust
	Maximum investors	200	More than 200
	FDI in FOPs	Only for NRIs/OCIs	Any non-resident eligible under FDI
	Ticket size	Ranges from 15 lakhs to 30 lakhs in general	INR 10 lakhs
	Liquidity	Comparatively less than SM REITs	Comparatively higher than FOPs
<b>Investor's tax</b>	Taxation rate <sup>1</sup>	<ul style="list-style-type: none"> <li>Long-term capital gains – 12.5%</li> <li>Short-term capital gains – At slab rates of investors</li> </ul>	<ul style="list-style-type: none"> <li>Long-term capital gains – 12.5%</li> <li>Short-term capital gains – 20%</li> </ul>
	<b>Tax</b>	Period of holding for shares vs units	<ul style="list-style-type: none"> <li>More than 24 months – long-term capital asset</li> <li>24 months or less – short-term capital asset</li> </ul>
<b>Property manager</b>	Carried interest ((performance based fees))	No restrictions	Not permitted
	Investment manager	No requirement for holding securities	Minimum holding of 5% for 3 years
<b>Regulatory</b>	Compliances	Less compliances	High compliances
	Transparency	Low	High
	Branding	No restrictions on branding	Exclusive branding for SM REIT required
<b>Structure</b>	Regulated structure	No	Yes
	Asset holding entity	Private company/LLP/direct ownership	Company
	Related party	No restrictions except an arm's length	Restrictions on related parties except management fee
	Joint ownership of property	No limitations	Restricted

1. Taxation rates will be subjected to applicable surcharge and cess rates

# 05

## Technological innovation enhancing FOPs

Technology plays a pivotal role in the operation and success of FOPs, transforming how real estate investments are accessed, managed, and optimised. FOP utilises technology as an enabler to streamline complex business processes. Key technological advancements driving FOPs include:



### Blockchain technology

Blockchain enables the tokenization of real estate assets into fractional shares represented by digital tokens. This ensures transparency, security, and ease of transfer, simplifying transactions and fostering trust among partners involved in FOPs.



### Smart contracts

These self-executing contracts automate the terms of fractional ownership agreements, reducing the need for intermediaries, minimizing the risk of disputes, and cutting down on time and costs associated with traditional contract management.



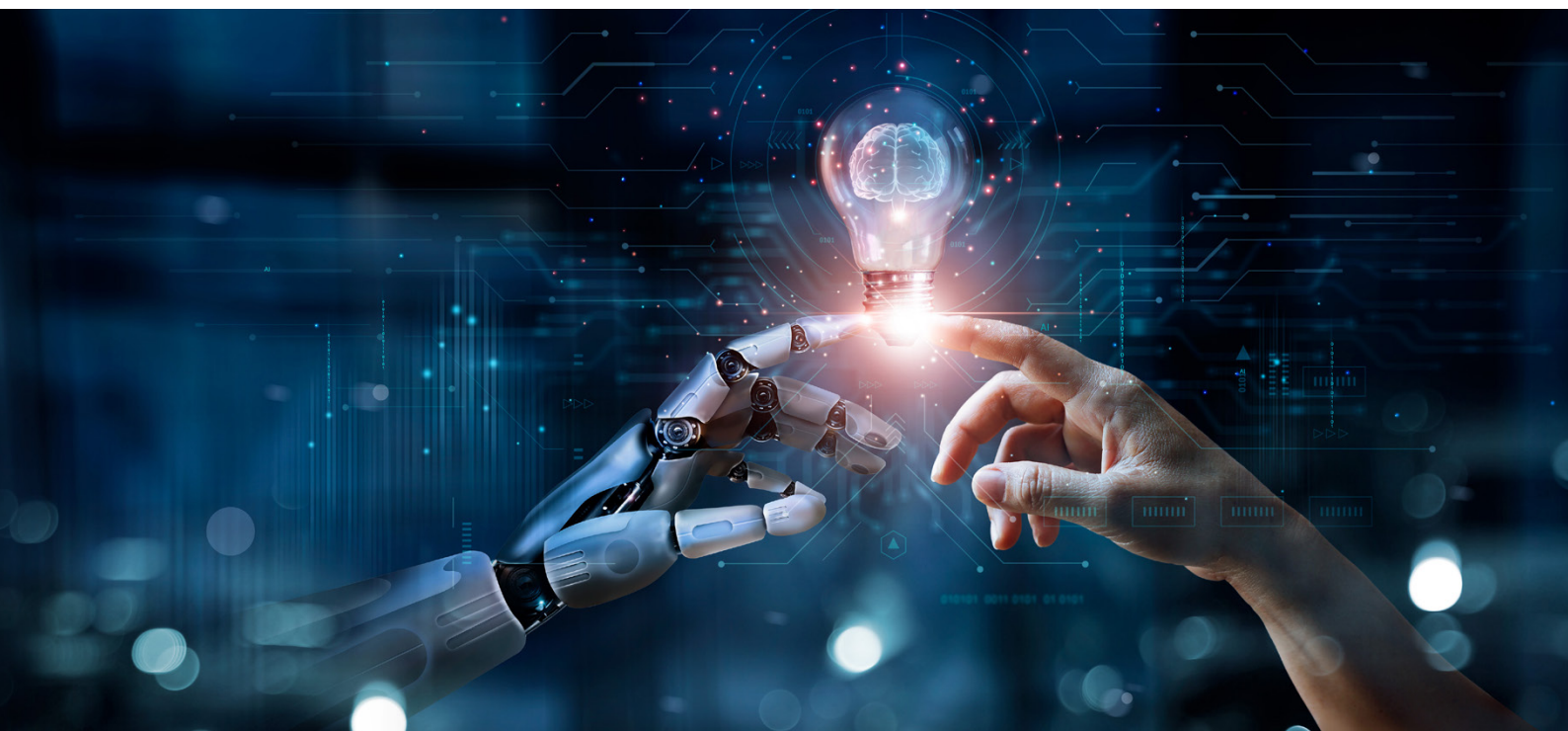
### Use of AI

The developers are engaged in utilising AI to analyse the market data, keep track record of all the potential investment properties, and predict trends of the future in terms of investment.



### Data analytics and data modelling

Advanced data analytics tools assess historical, current, and predictive trends to help investors understand market dynamics, optimize property valuations, and perform risk assessments. This streamlines investment strategies and reduces costs.







### Enhanced investor experience

Technology platforms offer user-friendly interfaces with real-time dashboards, automated reporting, and access to key investment metrics, providing a seamless and engaging experience for investors.



### Increased transparency

Distributed ledger systems and advanced data analytics provide detailed, transparent information about property performance and financials, boosting investor confidence and trust in the platform.



### Improved compliance and scalability

Tech solutions automate compliance checks, ensuring adherence to regulations and enabling FOPs to scale efficiently by automating operational processes, from investor onboarding to property management.



### Automated portfolio management

AI-driven automated portfolio management adjusts investments according to market conditions, investor goals, and risk tolerance, optimizing returns.



### Customisable investment options

Technology allows FOPs to offer tailored investment products that align with individual investor preferences, risk profiles, and return expectations.



### Global accessibility

Technology enables investors worldwide to participate in real estate investments, breaking down geographical barriers and expanding investment opportunities.



### Risk mitigation

Predictive analytics and advanced modeling help identify and mitigate potential risks, ensuring more secure investment opportunities.



# 06

## Market outlook and future trends

The Indian real estate market is witnessing an impressive growth in fractional ownership. According to various news reports, the fractional ownership market is likely to grow by more than 10% over the next four to five years. As we expect growth in investment, investors are also looking at alternative investment models that provide easy financing models with better returns on investments.

This is further supplemented by support from various government regulators, with SEBI being one of the most instrumental in this regard. SEBI has approved amendments in SEBI (Real Estate Investments Trust) regulations 2014, which provides the regulatory framework for small and medium real estate investment trusts (REITs). This is expected to prove to be a promising step to boost investor confidence.

Cities like Gurugram are emerging as prime properties with retail complexes and business hubs following the same model that offers steady growth in rental and capital growth.

A few key trends and drivers are:

### **Increased accessibility**

Fractional ownership has enhanced accessibility and lowered entry barriers to accommodate big and small size investments. Multiple investors can also invest together to enable this model to work in cohesion. This has motivated investors and increased the number of investments in the industry.

### **Technological advancements**

The rise in fractional ownership and interest of investors have pushed innovative ways of adopting technology in the industry. For example, asset tokenisation and digital platforms are on the rise, making the process transparent and easy for all parties to work together.

### **Diversification and risk mitigation**

Multi-investors and diversified investment value mitigate portfolio risks.

### **Increased focus on commercial real estate**

The Indian real estate market is rising, especially in the commercial sector. This creates further opportunities to replicate the same FOP model into commercial real estate, which can yield better returns and capital appreciation to the owners.

### **Emerging hubs in Tier 2 cities**

SM REITs regulations will further boost real estate monetisation in Tier 2 cities. The future of fractional ownership in Indian real estate looks promising, driven by regulatory support, technological advancements, and changing investor preferences. As the market continues to evolve, fractional ownership is set to become a mainstream investment model, offering a flexible and accessible way to invest in real estate.



# Acknowledgements

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