Despite falling distribution yields, should you look at Embassy REIT?

The distribution yield is similar to a dividend yield calculation: dividend received/market price of the unit. As in the case of REIT, the distribution happens at least twice a year. Investors can also look at the holding period yield return to determine the investment returns.

Synopsis

REIT is a vehicle through which an individual can engage in income-producing commercial real estate holdings that are also professionally managed. REITs raise funds through IPO by offering their units, with the underlying assets being the real estate portfolio they manage.

Distribution is the primary attraction for investors while investing in real estate investment trusts (REITs). In that respect, it is worth examining if investing in this instrument is lucrative.

Embassy Office Parks REIT is the largest listed player with a portfolio of 42.8 million sqft (msf). This REIT is known for its vast portfolio and renowned sponsors, viz. Embassy Group and Blackstone. Though it is the largest REIT, distribution yields are not the highest among its peers. A distribution yield is a distribution received with respect to the market price of the unit.

REIT is a vehicle through which an individual can engage in income-producing commercial real estate holdings that are also professionally managed. REITs raise funds through IPO by offering their units, with the underlying assets being the real estate portfolio they manage. Indian REITs have recently gained popularity as 3 of the major players have listed their REITs in the past few years — Mindspace REIT, Brookfield REIT and Embassy REIT.

Liquidity in these securities is yet to reach a peak as REITs are relatively new to the masses. Hence, the market price of these units might trade at a discount to its net asset value (NAV) due to illiquidity. The NAV is the portfolio's total value divided by the number of units; this primarily indicates the value each unit will realise if the assets are liquidated as of date.

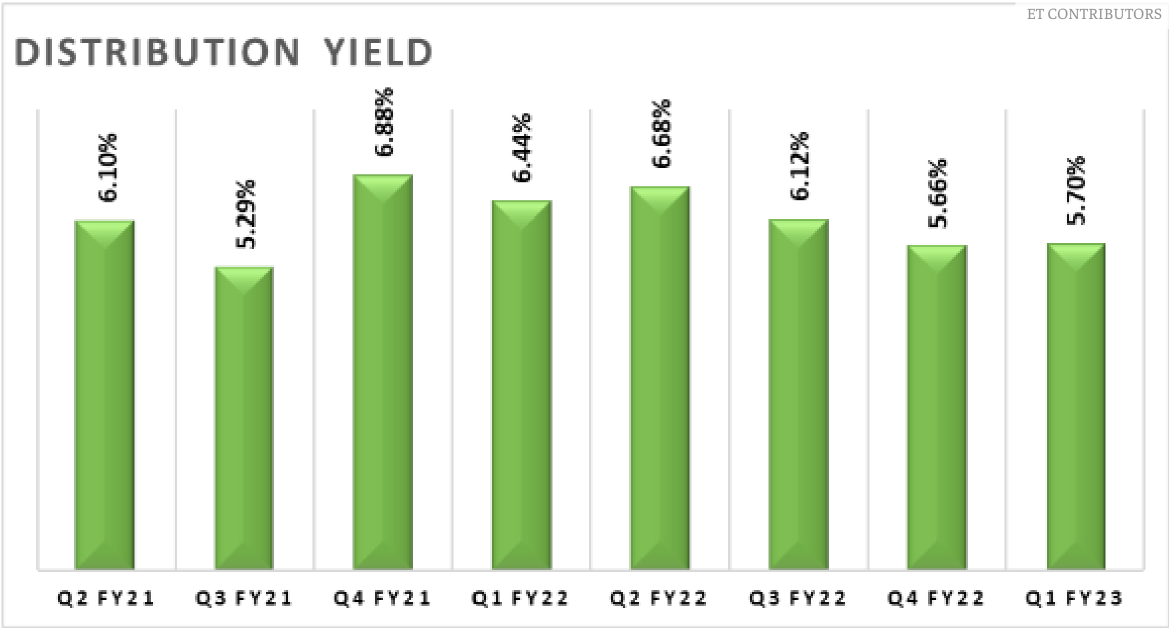
Being Indians, real estate as an asset class has been a significant part of our portfolios. A Reserve Bank of India (RBI) report from 2017 states that approximately 84% of a household's wealth in India is in real estate. Commercial real estate is more attractive than residential as rental yields are higher and capital appreciation is faster. But owning and managing commercial real estate in a major city is very difficult for a retail investor as these assets are expensive and tedious to manage. In such cases, REIT investments are deemed better as it is easier to own them, and this format ensures these assets can be managed by professionals.

According to the rules laid down for REITs, 90% of the rental yields from the assets are to be distributed to the unit-holders. The structure of this trust is such that a certain percent of the distributed value is tax free at the hands of the unit-holders. This percent is declared by the respective REIT every time it declares the distribution amount.

Distribution is important as investors need to consider this as the rental yield they receive from the underlying real estate. Professionals who manage the portfolio charge a management fee and any operating expenses incurred by the trust in the period. Hence, 90% of such rentals net of expenses is mandatorily distributed to unit-holders. To adjudge the performance of any trust, investors need to look at the distribution yield and compare it with that of the peers, while also considering the tax-free part of the distribution.

The distribution yield is similar to a dividend yield calculation: dividend received/market price of the unit. As in the case of REIT, the distribution happens at least twice a year. Investors can also look at the holding period yield return to determine the investment returns. Holding period yield is nothing but the total distribution received when the security was being held with respect to the purchase price. To get an annualised view, we could consider the distribution for the past 12 months with respect to the price at the beginning of the period.

Following the above approach, we arrive at the following yield trend. Below is the chart showing the distribution yields of Embassy REIT for the past 8 quarters.



Source: Quarterly Results & investyadnya.in Research.

As we can see, the yields are falling, making the investment less attractive. A comparative analysis shows that Q1FY23 was one of the lowest yielding quarters of Embassy REIT. On the other hand, Brookfield India REIT has been consistently distributing above 6.5% yield since listing in FY21 [Source: Quarterly Results & investyadnya.in Research]; it has also distributed at a yield of 9% in the initial quarters, after which the market price per unit has jumped by 47% to 329 as of June 2022.

The distribution will increase only when the rental income rises. A strong portfolio of assets with strategic locations is needed for rentals to increase.

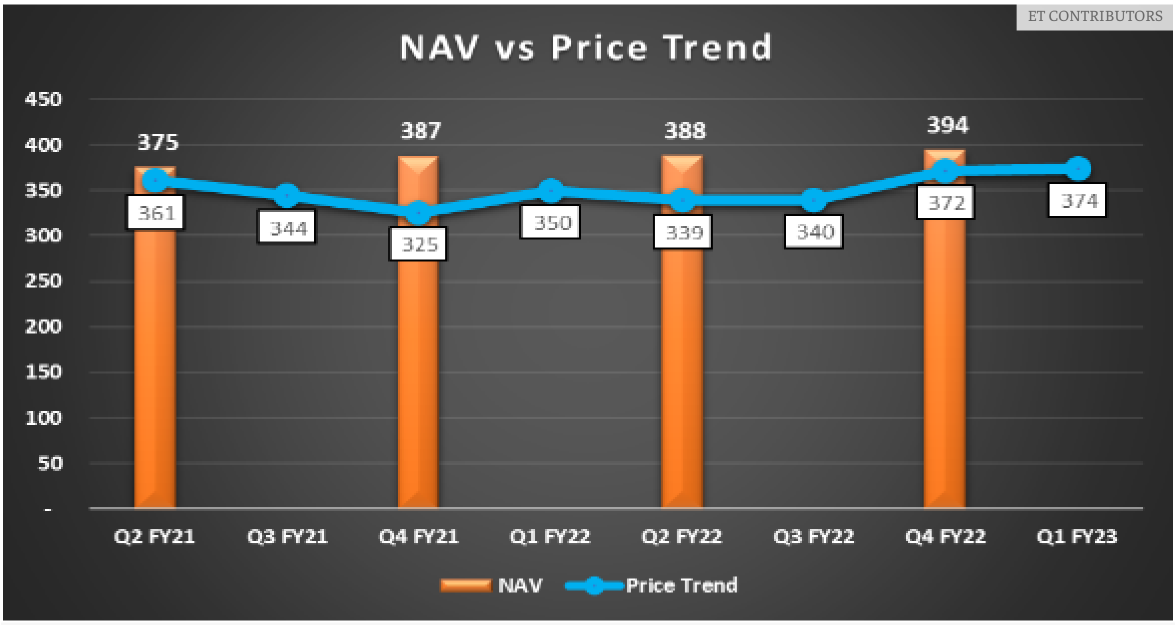
The quarterly filings show that Embassy operates a portfolio of 42.8 msf spread across 4 cities: Bengaluru, Pune, Mumbai and Delhi-NCR. Most of the portfolio is in Bengaluru or the Silicon Valley of India — around 70% of the assets are in the tech city — resulting in the acquisition of about 40% of clients from the technology sector. To increase the rentals from here, the trust needs to increase the occupancy rate at properties and add more assets to its portfolio through the deals available via (right of the first offer (ROFO) from Embassy Group.

As Embassy and Blackstone Group have significant assets to provide for ROFO, the importance of a strong sponsor will be realised in the long run. Additionally, as only 80% of the total assets need to be completed and revenue generating, the trust has a strong operating cash flow, enabling it to have more valued projects under construction than its peers.

Capital appreciation in the underlying assets is another aspect investors look out for in REITs. NAV indicates this capital appreciation; any REIT must declare its NAV every 6 months, which is signed off by a designated valuer.

However, the market price of a unit traded on the exchange is not the same as NAV and depends on the demand-supply mechanism, like any other security. If everything else is kept constant, an increase in unit price will decrease yields. Similarly, the distribution goes up if yields increase and the unit price is constant. A favourable situation for an investor would be when both yields and market price of a unit go up, which will mean that the asset values are appreciating and, at the same time, rentals are going up.

In the case of Embassy REIT, the IPO took place at Rs 300, and the current price is at around Rs 375, which shows a capital appreciation of 25% in 3.5 years. Below is the NAV vs market price trend of the Embassy REIT:



Source: Quarterly Results & Ace Analyzer.

According to data available from the exchanges, Embassy REIT has the highest trading volume, which means that the probability of mispricing and arbitrage opportunities in this security will be lower. Investors need to consider the liquidity of these securities as the concept of REITs is relatively new for the masses.

Lastly, taxation from the distributed income is one of the most important parameters for investors. A tax-free component enables any investor to claim exemption from paying taxes on that distribution portion. Although Brookfield India REIT distributes yields at 6.5%+, the tax-free component has been as low as 25% in the initial quarter, which necessarily means that an investor falling in the highest tax bracket will pay tax as follows:

	Embassy REIT	**Brookfield REIT**
Single Unit Price	100	100

Yields as on Jun-22	5.7%	6.5%
Distribution [INR]	5.7	6.5
Tax-free component	88%	25%
Taxable income (INR)	0.68	4.88
Tax @30%	0.21	1.46
Net Earnings(INR)	5.49	5.04

Source: investyadnya.in Research

The above example is a representative of the total returns one might earn while investing in both REITs. Distribution yields have been calculated according to the latest quarterly filings available. The taxation part assumes that the individual falls in the highest tax bracket, and the impact has been calculated accordingly.

While considering an investment in any of these REITs, individuals should consider all of the above methods to arrive at a conclusion and align the result with their risk assessment. As the REIT markets develop in India, some major REITs will bring IPOs. Investors who want commercial real estate exposure in their portfolio can look to REITs as an investment avenue.

(The authors, Gaurav Jain & Parimal Ade are Founders, InvestYadnya.in. Views are their own)

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