India Viewpoint

SEZs IN THE SUNSET ERA: TO GO OR NOT TO GO?

The government of India introduced the Special Economic Zone (SEZ) policy in 2000 with the purpose of accentuating foreign investment and providing a competitive and conducive environment for business activities. However, in 2015, the government laid a road map to reduce corporate tax to 25% by 2019 and announced a sunset date for tax exemptions granted to developers and occupiers of SEZs. In this context, we review the present dynamics in the SEZ segment and highlight how occupiers and developers are reacting to the approaching sunset date.



Abhinav Joshi
Head, Research, India

Sachi Goel
General Manager, Research, India

Pradeep Nair
Assistant General Manager, Research, India

I. INTRODUCING THE 'EXPORT PROMOTION REGIME'

The government of India introduced the Special Economic Zone (SEZ) policy in 2000 with the purpose of accentuating foreign investment and providing a competitive and conducive environment for business activities. Its primary focus was on establishing India as a major global exporter. An SEZ can be defined as a geographic region under highly conducive tax regulations to attract foreign investments. In general, these areas are considered a part of a foreign territory for commerce purposes, with an underlying objective of boosting national exports.

Table 1: Key SEZ Requirements for Key Stakeholders – A Snapshot

Stakeholder	Key Requirements
Developers	• No minimum land area requirements, but the SEZ should conform to the minimum built-up area requirement of 100,000 sq. m. for category 'A' cities – Greater Mumbai, Delhi-NCR, Chennai, Hyderabad, Bangalore, Pune and Kolkata. For category 'B' and 'C' cities, the built-up area requirement is between 25,000 - 50,000 sq. m. • No ambiguity regarding land ownership – land title should clearly be with the developer
Unit Holders	• A unit holder's Net Foreign Exchange Earnings (NFE) should be positive cumulatively for 5 years from the commencement of operations • Has to be located only within a notified area • Operations need to commence within a period of one year or within an approved extended period only • Performance will be monitored based on the guidelines of the Unit Approval Committee

Source: SEZ India website, CBRE Research, Q2 2018

II. MARKET FACTORS THAT DRIVE SEZ OCCUPANCY

India's economic growth during the 2005–08 period resulted in tremendous real estate growth, particularly in the office space segment. However, the traditional office hubs of most leading cities were unable to cope with this spurt in demand for new space. The SEZ Act, passed in 2005, gave further impetus to the demand for large land parcels, which most central business districts (CBDs) were unable to fulfill. The CBDs of most cities were also unable to offer world-class, investment-grade facilities that most multi-nationals were accustomed to. This led to a spillover effect as most leading cities in India saw the growth of new commercial hubs to accommodate the burgeoning demand.

Across the country, SEZs came up in new commercial hubs such as Outer Ring Road, North Bangalore and Whitefield in Bangalore; Mount Poonamallee Road and Taramani in Chennai; Gurgaon and Noida in Delhi-NCR; IT Corridor (HITEC City and Madhapur) and Extended IT Corridor (Nanakramguda) in Hyderabad; and Hinjewadi and Kharadi in Pune; amongst others.

SEZs offer the 'best fit' real estate solution to corporate occupiers, effectively combining the attributes of size (scalability), quality, location, single ownership, cost and infrastructure. As SEZs in major cities fit the aforementioned criteria, pre-leasing of quality SEZ space across prime developments has emerged as a recurring trend over the past few years.

Table 2: Factors That Drive Corporates Towards an SEZ

Driving Factors	Inherent Advantages
Availability of single ownership large-sized spaces (scalability)	SEZs typically offer single ownership large-sized, contiguous space options for corporates, particularly those aiming at large scale consolidation/ expansion in a peripheral location. As vacancy levels continue to drop across most cities, SEZs have emerged as a viable option for occupiers.
Quality of space (services)	SEZs offer new, quality, investment-grade space to corporate occupiers.
Location attributes (cost-effective peripheral locations)	SEZ developments in India are mainly located in cost-effective peripheral/ sub-urban regions of leading cities, which have limited restrictions on availability of developable land. This bodes well for occupiers looking for large-sized developments offering space at a rental discount when compared with prime locations.

Source: CBRE Research, Q2 2018

Driving Factors	Inherent Advantages
Real estate cost (rental savings vis-à-vis core markets)	As SEZs are mostly located in peripheral or decentralized locations, rental values in most SEZ developments are usually lower than in core locations.
Overall Environment	SEZs offer quality space in a secure, close, well-integrated development which has support infrastructure and offers other services.

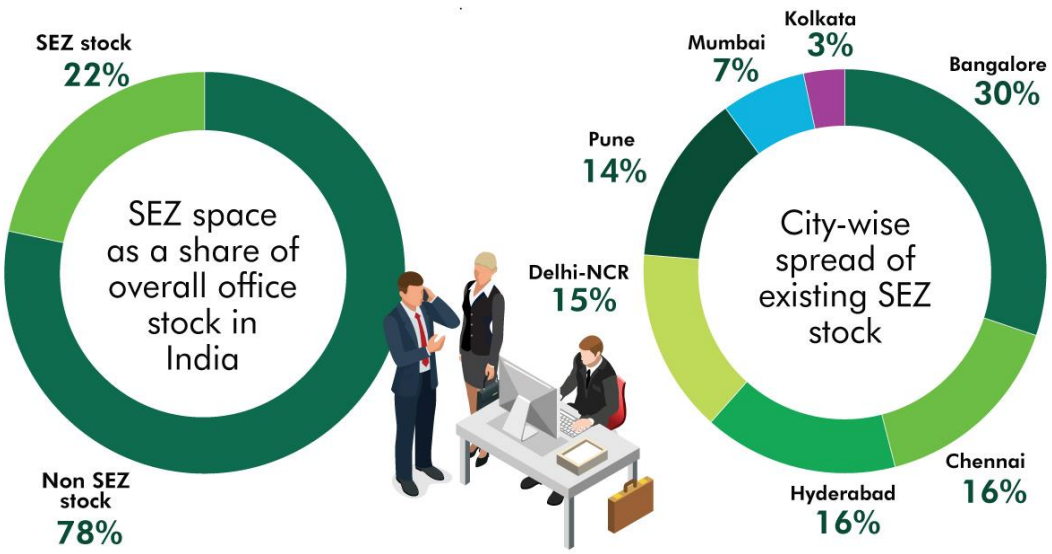
Source: CBRE Research, Q2 2018

Initially encouraged by tax incentives offered by the government, occupier preference was gradually driven by SEZs evolving as an excellent alternative to developments in core locations or those offering fragmented space in peripheral locations. Therefore, "availability" of large-scale quality space was a major demand driver for the success of SEZs in India. Initially, this demand was driven by firms belonging to the tech sector, however in the recent past we've seen increased traction from firms belonging to varied sectors such as banking, financial services, engineering, e-commerce and consulting, amongst others.

III. CURRENT SEZ DYNAMICS IN INDIA

SEZ space accounts for about 22% of the total office stock in India across the seven leading cities. Bangalore, Chennai, Delhi-NCR and Hyderabad house almost 80% of this SEZ stock. Almost 35 million sq. ft. of SEZ space (almost 30% of the overall SEZ stock) was added during 2015 - H1 2018.

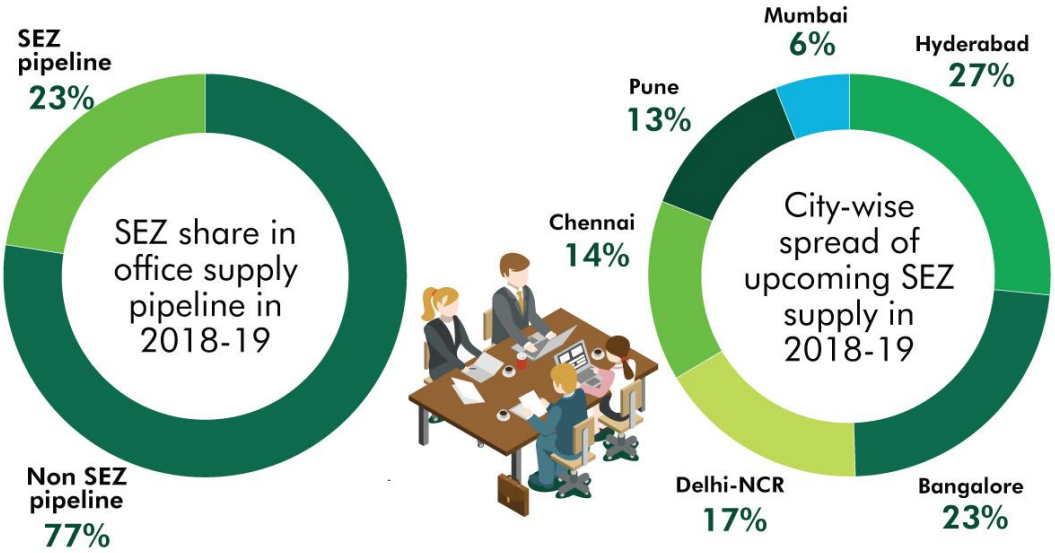
Figure 1: Current SEZ dynamics in India



Source: CBRE Research, Q2 2018

More than 20% of the upcoming office supply lined up for completion over the next two years in India is expected to consist of SEZ developments. More than 80% of this supply pipeline is expected to come up in Hyderabad, Bangalore, Delhi-NCR and Chennai.

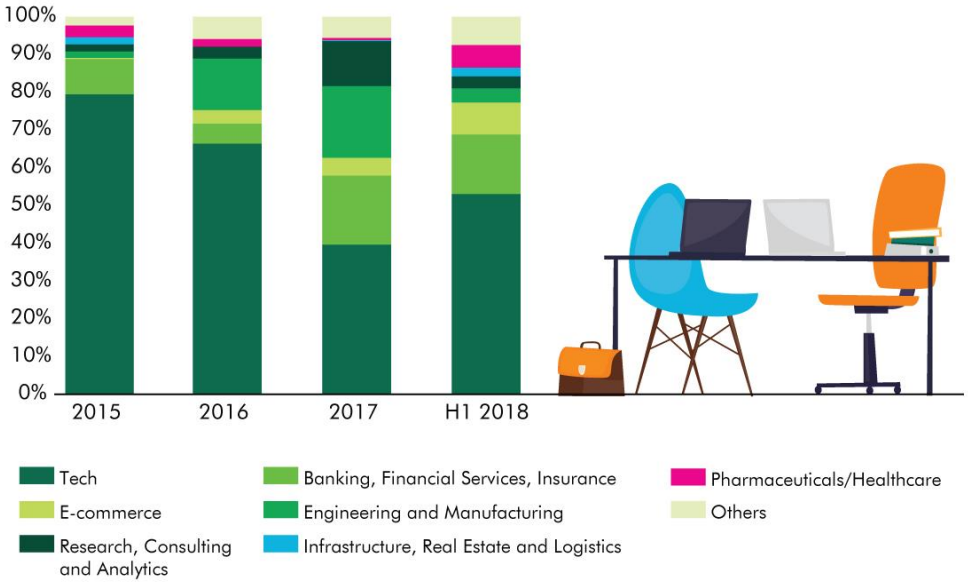
Figure 2: SEZ pipeline across India in 2018-19



Source: CBRE Research, Q2 2018

Almost 34 million sq. ft. of SEZ space was absorbed across the seven cities during 2015 to H1 2018, led by Bangalore, Hyderabad, Delhi-NCR and Chennai. It amounted to about 23% of the overall office absorption in the country during the period. Overall, the tech sector dominated SEZ space take-up with over 60% space absorption during 2015 to H1 2018.

Figure 3: Sector-wise segmentation of SEZ space take-up in India between 2015-H1 2018



Source: CBRE Research, Q2 2018

IV. WILL GOVERNMENT SUPPORT DWINDLE IN THE FUTURE?

SEZs in India have been granted both direct and indirect tax exemptions, which have attracted both developers and occupiers:

Table 3: Direct and Indirect Tax Exemptions for SEZs : A Snapshot

Stake Holder	Direct Tax Exemptions	Indirect Tax Exemptions
Developers	• An income tax holiday on income from the development of the SEZ; 100% income tax exemption for 10 years out of the first 15 years, starting from the notification of the SEZ[1]	• Exemption from central sales tax, service tax and state sales tax (now subsumed under GST) • Exemption from customs/ excise duties for development of SEZs • Single-window clearance for central and state-level approvals
Unit Holders	• 100% income tax exemption for SEZ units for the first five years, 50% for the next five years and 50% of the ploughed back export profit for the last five years within three years[2]	• Exemption from central sales tax, service tax and state sales tax (now subsumed under GST); supplies to SEZs are zero rated under Integrated Goods and Services Tax Act, 2017 • Exemption from other levies imposed by respective state governments • Duty-free import/ domestic procurement of goods for development, operation and maintenance of the units • Single-window clearance for central and state level approvals

Source: SEZ India website, RBI website, CBRE Research, Q2 2018

[1]To be effective from the commencement of commercial operations of the development. Benefits applicable only for zones notified before 1st April 2017, where development of at least one block has begun.
[2]To avail this benefit, unit holders need to commence operations before 31st March 2020

The government in 2015 laid a roadmap to successfully reduce corporate tax from 30% to 25% by 2019. For this, it was announced that to simplify the tax structure, profit/investment-linked incentives and area-based deductions would be phased out. This included announcing a sunset date on tax exemptions granted to SEZ developers and unit holders.

Table 4: Timeline of SEZ Policy Changes

Date	Particulars
June 2011	Dividend Distribution Tax (DDT) of 15% (excluding 5% surcharge and 3% education cess) imposed on SEZ developers and unit holders.
December 2011	Approval for setting up of India's first International Financial Service Centre (IFSC)[3] unit (Section 18, SEZ Act) in Gujarat International Finance Tec-City (GIFT City) was given.
April 2012	Minimum Alternate Tax (MAT) of 18.5% imposed on developers and unit holders in SEZs.
February 2015	The 2015-16 budget proposed a sunset date of 31st March 2017 on tax exemptions granted to developers and unit holders under Sections 80-IAB and 10AA, respectively, of the Income Tax Act.
February 2016	The 2016-17 budget announced a sunset date of 31st March 2017 on tax exemptions for developers. After appeals from various stakeholders including EPCES[4] and NASSCOM[5], the sunset date for unit holders was extended to 31st March 2020. However, tax exemptions were granted to the IFSC in GIFT City. It has been exempted from DDT, capital gains tax and commodity/ securities transaction tax, while MAT has been lowered to 9%. The IFSC has also been exempted from the sunset clause.
February 2018	The 2018-19 budget did not act on EPCES's appeal to extend the sunset date to 31st March 2023 for unit holders and 31st March 2020 for developers.
March 2018	The US Trade Representative (USTR) raised concerns about Indian export incentives/ subsidies, including SEZs, at the Word Trade Organization.
7 June 2018	The commerce ministry set up a committee to examine the USTR's concerns. The committee is required to submit its recommendations within the next three months.

Source: Income tax website, USTR website, PIB, CBRE Research, Q2 2018

[3]An IFSC, which comes under the purview of the SEZ Act, is a financial hub and a part of an SEZ; it houses foreign and Indian banks, non-banking financial institutions, stock exchanges and commodity exchanges, etc.
[4]Export Promotion Council for EOUs and SEZs
[5]National Association of Software and Services Companies

Following the imposition of sunset dates for both developers and unit holders in SEZs, the current status of tax exemptions is as follows:

Table 5: Tax Exemptions for Developers and Unit Holders in SEZs: Current Status

Stakeholder	Time Period	Direct Tax Exemptions	Indirect Tax Exemptions
Developers	SEZs notified before 31st March 2017	Exemptions available for all SEZs in which development has commenced before 31st March 2017, including future blocks.	Exemptions would continue post the sunset clause.
	SEZs notified after 31st March 2017	No exemptions available.	
Unit Holders	Unit holders commencing operations before 31st March 2020	Exemptions available to unit holders commencing operations before 31st March 2020. These include those operating from fresh blocks of existing SEZs which obtain an OC before 31st March 2020.	
	Unit holders commencing operations after 31st March 2020	No exemptions available.	

Source: Income tax website, CBRE assessment post interactions with key stakeholders, CBRE Research, Q2 2018

V. CBRE INSIGHTS: WHAT'S NEXT FOR DEVELOPERS AND OCCUPIERS IN SEZs?

The overall impact of the introduction of the sunset clause on both occupiers and developers is yet to be fully gauged. Despite this development, we expect a continuity in several trends in the SEZ segment of the commercial real estate market.

How are occupiers reacting to the situation?

Despite the looming sunset clause, corporates are likely to continue leasing office space in prominent SEZs across leading cities. **Large-sized pre-commitments** (above 100,000 sq. ft.) have already been reported in upcoming SEZs (most are expected to become operational before 2020). This is an indication that corporates have continued to view SEZs favorably, not only due to their tax benefits, but also due to the availability of high-quality, large-sized floor plates that are ideal for their consolidation/ expansion needs.

CBRE's assessment indicates a continued preference for SEZ spaces by corporates, particularly those belonging to sectors such as technology, research and consulting, engineering and manufacturing, banking and financial services. However, at the same time, CRE teams of various corporates are closely evaluating **existing / planned non-SEZ supply dynamics** (primarily large tech parks or corporate office spaces) in order to make informed decisions about the options available after 2020 so as to ensure business continuity.

Table 6: After the Announcement of the Sunset Clause, Would Occupiers Remain Active in the SEZ Segment?[6]

Why would occupiers stay?
1. Those already operating in SEZs – 'comfort' factor **Occupiers already operating from an SEZ** are aware of its benefits and operational issues. Their decision to expand further will depend on the assessment of the rental arbitrage and tax benefits against compliance and other costs associated with an SEZ. Therefore, long-term **financial viability** will be a key deciding factor. A majority of the tech firms operating from SEZ spaces in cities such as Bangalore, Hyderabad and Gurgaon would fall under this category.
2. Those still wishing to avail 'benefits despite the expiry date' There have been instances of occupiers, who were already **operating from non-SEZs, considering a move to SEZs** to meet their consolidation/ expansion needs due to tax advantages. However, such occupiers must move into an SEZ at least by December 2019 to be able to show some billing by 31st March 2020 and continue to avail tax benefits beyond the sunset date.
3. Those seeking at least some benefits There are instances of occupiers striving to commence operations on a small scale (for either incubation or traditional operations) before the sunset date to **marginally avail at least some tax benefits**[7]. After the sunset date, these unit holders might decide to expand operations in the same SEZ, but the benefits of the space taken up before the sunset date would continue for the next 15 years as per the policy.
4. Those looking to 'consolidate' operations regardless of the tax benefits The availability of quality office spaces offering large floor plates and options for further scalability is extremely low in most of the prime/ centralized locations in our cities. Corporates considering **large-scale consolidation might be inclined towards SEZs, regardless of the tax benefits**. Such occupiers will continue to drive demand for SEZs even after 31st March 2020.

Source: CBRE Research, CBRE interactions with occupiers, Q2 2018

[6]Basis CBRE's interactions with various occupiers; however, feedback varied across cities.
[7]After the sunset date, even if the unit holders choose to expand, they are likely to get tax benefits for the space taken up before the sunset date as per the current policy.

Why would occupiers leave?

1. **Scales tipped heavily against 'compliance costs' and stringent requirements**

Select occupiers have expressed concerns over SEZs' **cumbersome documentation and compliance requirements.** These include separating domestic and NFE operations, along with the process to be adhered while migrating employees from existing non-SEZ operations to new SEZ units. This has resulted in few long-term occupiers **moving out of existing SEZ spaces** to non-SEZ developments post availing benefits in certain cases. Along with **the stringent requirements, high compliance costs for either outsourcing compliance services or hiring additional in-house teams to track people / capital / goods movement was also listed as a deterrent.**

2. **Confidentiality concerns**

Certain occupiers have raised doubts over the **confidentiality of information being shared with authorities regarding their operations, vendors, sources of raw materials, human resource details, etc.**

3. **SEZs were never really a part of their CRE strategies**

There have been instances of occupiers, who were operating from non-SEZ spaces, deciding against taking up space in an SEZ due to an **internal opex/ taxation strategy.** However, such decisions are usually not a result of the sunset clause. Hence, corporates that can operate from a non-SEZ space will continue to prefer operating from such spaces if they feel that the trade-off between taxation incentives and cumbersome documentation for compliance and confidentiality (points 1 and 2) is skewed against the latter.

Source: CBRE Research, CBRE interactions with occupiers, Q2 2018

CBRE's interactions with select occupiers in Bangalore revealed that those with a large presence in non-SEZs are not very keen on consolidation or taking up new space in an SEZ either due to operating concerns or an internal opex/ taxation strategy (as mentioned above) and the decisions are not primarily influenced by the sunset clause. The sunset clause has influenced decision making of occupiers considering large consolidations who wish to evaluate all possible parameters to identify the best strategy.

There are instances of occupiers committing to making consolidations only in an SEZ. In Chennai, for example, many occupiers operating from non-SEZs are looking to consolidate in large spaces in SEZs due to the availability of high-quality, large-sized floor plates. In Bangalore, most occupiers prefer non-SEZs for large consolidations. However, SEZs have now become a mature market, with few new occupiers entering the market and evaluating fresh options. Such new occupiers typically evaluate **both SEZs and non-SEZs** during their decision-making process.

Even though corporates are likely to continue to avail **indirect tax benefits after the sunset date**, stakeholder discussions reveal that some **direct tax exemptions could be allowed for select corporates after that date.** This will obviously be subject to approval from the SEZ India Authority. Additionally, after receiving the requisite approvals, India's second IFSC, proposed to be set up in Mumbai, will remain exempt from the sunset clause, thereby strengthening the demand for SEZ space. The overall scenario is bound to become clearer as we approach the sunset date.

What about the Developers?

Even after the announcement of the sunset clause in 2015, significant SEZ supply is lined up for completion until 2020, narrowing the demand-supply gap in both completed and upcoming SEZ projects.

Table 7: After the Announcement of the Sunset Clause, Would Developers Remain Active in the SEZ Segment?[8]

What are developers focusing on?
1. Pre-commitments, limited speculative development Developers are now focusing largely on delivering pre-committed or built-to suit (BTS) supply and not aiming at speculative developments in this segment. Corporates who have traditionally favored SEZs or those looking for large-scale consolidation spaces (in cities such as Gurgaon, Chennai and Hyderabad) **are the primary clientele.**
2. Complete pending projects by Q3-Q4 2019 Developers are working closely with occupiers to deliver their upcoming projects within the stipulated timeframe, so that **at least occupiers can avail tax benefits**. Developers keen on availing indirect tax benefits of space development in SEZ are also using **fast-track construction technologies** to meet the sunset date[9]. Of the entire supply lined up for completion till 2020, almost 70% will be completed by 2019. In fact, about half of the pipeline for the next three years will be completed by 2018.
3. De-notification (only in special instances) There have been a few instances of developers shying away from the SEZ segment, either due to their **inability to develop a minimum 1 million sq. ft.** built-up area before the sunset date, **genuine reduction** in demand for SEZ space or large-sized pre-commitments from occupiers looking for **non-SEZ space**.

Source: CBRE Research, CBRE interactions with developers, Q2 2018

[8]Basis CBRE's interactions with various occupiers; however, feedback varied across cities.
[9]After factoring in the need for occupiers to commence billing before 31st March 2020 and time taken for physical occupation post fit-outs, developers should ideally complete construction by Q3 2019

Meanwhile, several developers have requested the government to extend indirect tax exemptions for them beyond 31st March 2020 – highlighting their continued interest in remaining active in the SEZ segment. However, at the same time, developers are following the occupiers' strategy of hedging their risks in the long run and are reviewing their plans for the non-SEZ segment.

In the long run, if the sunset date is not extended, developers might be inclined towards developing tech parks or corporate office spaces, rather than SEZs; subject to land availability, development costs and occupier preferences.

VI. CONCLUSION

Overall, most occupiers would be keen to start operations in an SEZ by Q3-Q4 2019 in order to avail benefits before the sunset date. This will ensure that space take-up in this segment remains high and vacancy levels remain in single digits (at least till the end of 2019). However, in case the government decides against modification of the sunset clause or extension of the sunset date, we can expect a rationalization in the overall leasing activity in SEZs with occupier decisions based upon well-thought out CRE strategies rather than the tax benefits only. Corporates looking for large contiguous spaces for consolidation might still continue to evaluate SEZs, irrespective of the sunset clause.

The developer community will remain cautious about launching any large-scale, speculative development in the SEZ segment. Their focus will be more towards leasing space in their operational SEZs, while developing a more equilateral portfolio focusing on segments such as tech parks and corporate office spaces as well.

CBRE Global Research

This report was prepared by CBRE India Research Team, which forms part of CBRE Global Research – a network of preeminent researchers who collaborate to provide real estate market research and econometric forecasting to real estate investors and occupiers around the globe.

For more information regarding this *ViewPoint,* please contact:

RESEARCH

Abhinav Joshi
Head of Research, India
19th Floor, DLF Square, M Block, Jacaranda Marg, DLF City Phase II, Gurgaon 122 022
+91 124 465 9700
abhinav.joshi@cbre.co.in

Sachi Goel
General Manager, India Research
Ground Floor, Hulkul Brigade Centre, No. 82
Lavelle Road, Bangalore 560 001
+91 80 407 40000
sachi.goel@cbre.co.in

Pradeep Nair
Assistant General Manager, India Research
Ground Floor, Hulkul Brigade Centre, No. 82
Lavelle Road, Bangalore 560 001
+91 80 407 40000
pradeep.nair@cbre.com

Mohamed Atif Khan
Analyst, India Research
11th & 12th Floor, Raheja Tower
Plot No: C-30, Block G, Next to Bank of Baroda
Bandra Kurla Complex, Bandra (E)
Mumbai 400051
+91 22 406 90100
mohamedatif.khan@cbre.com

Ram Chandnani
Managing Director –Advisory and Transaction Services, India
Ground Floor, Hulkul Brigade Centre, No. 82
Lavelle Road, Bangalore 560 001
+91 80 407 40000
ram.chandnani@cbre.co.in