Viable Ways for Foreign Investors to Acquire Premises for Senior Care Facilities

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Foreign investors are always inquiring on how to acquire land or property to open senior care facilities. In fact, the nature of property, acquiring approach and its property usage will all have big influence to the business of senior care, so investors will have to choose different ways of acquisition according to different status and condition of the property. Given that, we think it necessary to summarize the current viable ways on acquiring premises for senior care facilities under the Chinese legal framework.

- **To acquire state-owned land use right through public land bidding process**
- **Land use right invested as registered capital or cooperative condition by domestic partner into Sino-foreign joint venture**
- **To lease premises for senior care facility**
- **To purchase real estate property for senior care facility**
- **To operate senior care facility by entrustment**
- **A BOT model to invest in senior care facility**

To acquire state-owned land use right through public land bidding process

Pursuant to land administrative regulations, foreign enterprises are allowed to purchase state-owned land use right on government-run land market through public bidding procedure. According to Circular 171 issued by MOFCOM in 2006, there are two principles of business existence and project-based company for foreign investors to be able to acquire land use right. Although this is mostly applicable for foreign real estate investors, the same applies to foreign invested senior care investors who purchase land use right for their facilities in the public land market.

Normally prior contact or negotiation with local government is necessary while proceed with this way. For foreign investors, they intent to make an agreement under-table with local government to ensure a successful acquisition of the land through bidding, in a way for example setting up a “tailor-made” land use condition or bidder’s qualification; and also they are keen to enjoy all kinds of preferential policies by virtue of senior care project. On the other hand, for local government, it is attractive as well in that foreign investment on the senior care sector will contribute to the local economy and shoulder the burden for government on construction of fairly enough nursing beds for the elderly. So prior contact can produce a win-win situation for both and furthermore lead to a positive impact to the project.

However, we’ve found sometime foreign investors misunderstand the concept of “*guanxi*” and ignore the importance of legal boundaries, which would consequently bring about tremendous risks. Just to give an example on cautiously dealing with letter of intent with local government. Letter of intent (“LOI”) is always used between investors and government before land bidding information is released to public, and usually it is agreed in the LOI that investor will take part in the bidding with an minimum price commitment while the government shall ensure to grant land use right in the bidding process, and sometimes provide the investors with some preferential conditions as well. Sometimes the government will ask for a deposit in advance to mitigate the possibility on failure of the bidding. Given that such LOI of pre-deal collaboration with government violates the fair and transparency principle required by land bidding procedure, legally it is invalid for such an agreement, and may cause substantial negative consequence to the land grant outcome. Meanwhile whether the preferential condition committed by government can be eventually enjoyed and whether it is legally binding and enforceable remains as a question mark. It is worthy of further investigation and assessment if investors intent to sign this kind of LOI. We advise investors to be very careful on wording, trying not to affect the legitimacy of land grant consequence should they finally be the winner.

Land use right invested as registered capital or cooperative condition by domestic partner into Sino-foreign joint venture

Although under the current legal framework, barrier for foreign investment in the senior care facility has already been moved, foreign investors are still tend to cooperate with Chinese partners who possess land, by factor in different elements of regulatory, marketing, human resource, etc. While Chinese partners are also willing to invest their land use right into joint ventures, rather than selling it for one-off interest or renting for fixed payback. They want to enjoy long-term profitability from the senior care business.

Actually, Sino-foreign joint ventures in equity cooperative and contractual cooperative models have been practiced in China for more than two decades. From manufactory, trade enterprises to real estate and retail business, joint venture model has proven itself as viable ways for foreign investors to access the Chinese market. With the limitation of this article, we will not discuss the pros and cons for the models and related legal risks. To notice one thing, a joint venture that use the land use right or real property as part of registered capital is regarded as foreign investment in real estate and is subject to strict approval from bureau of MOFCOM.

To lease premises for senior care facility

Premises leasing is the most convenient and viable way for foreign investors to acquire a senior care facility, where investors can put the facility into use by just making some investment in renovation and decoration to the premises. In some cities, local authorities encourage private investors to open senior care facility by using warehouse, factory and school facility, among other existing land or real property. This can provide investors with more options in seeking for facility location.

A typical lease agreement will cover:

Premises Usage—there is no category as senior care purpose in land usage. Normally usage of leased premises is commercial, or sometimes residential or hotel purpose but tenant shall consider whether construction parameters are in line with compulsory standards for senior care facility. An additional approval from Planning Bureau will be required if the facility is remodeled from existing factory or warehouse.

Space Calculation—net area is the operation area under the exclusive use of the operation of tenant. Usually net area constitutes 50%-70% of gross area in commercial property.

Typical Lease Term—the usual lease term is 15-20 (20 at top) years for senior care operator and sometime right of renewal is negotiable, but rental will adjust based on the then applied market level.

Rents and Deposit—rents are quoted in RMB per square meter per day. Building area may be quoted on gross or net basis. Combination of turnover rent and fixed rent is applied sometimes. Usually a security deposit of 3 months' gross rent & management fee is required. The deposit will be refunded until termination of lease.

Rent Indexation—usually rent indexation is agreed depends on inflation, while sometime it is hard for the landlord to predict inflation, rent can be adjusted several years later by comparison with the market level.

Handover Condition—it depends on the lease premises. Typically senior care facility will require a comprehensive remodel to meet the needs of different compulsory standards. Tenant can negotiate requirement for remodel and decoration with landlord and the cost burden between the two. 3 months fit-out period is usually provided, and can be longer in some cases. Sometimes tenants are more willing to reach pre-lease agreement at a stage the premises are still under construction design in that the landlord can build "tailor-made" premises for the senior care facility.

Filing of the Lease Agreement—not a compulsory procedure for lease agreement to be legally binding, while it is still recommended filing the lease agreement with local housing bureau to defend the tenant's right against any other third parties. Usually the stamp duty (1‰ of the rent for each party) arising from such filing is borne by both parties.

Right of Sublease—usually landlord won't allow tenant to sublease premises at will, so some restrictions will be put into the lease agreement, such as a prior consent from landlord is required, otherwise the landlord is entitled to terminate the lease agreement. Given the practice that senior care operators may sublease portion of the premises in the event they outsource some of the business, such as catering, to third parties, it's better to agree the condition that allowing sublease certain part of the premises.

Lease Termination—upon expiration, by contract or from force majeure lease agreement terminates. Both parties should be very careful on setting termination right in the agreement. For the tenant, penalties for early termination may include deposit or sometimes decoration compensation and future income compensation; while for the landlord, being entitled of a right of early termination means uncertainty to the tenant of its business plan, which is therefore not recommended for the tenant's sake.

To purchase real estate property for senior care facility

Foreign investors or foreign-invested enterprises can acquire land use right or ownership of real property by means of purchasing. With the rising price of real estate in China, normally investor will choose leasing as first option to acquire facility usage. However, for those who are optimistic on the real estate market in China, real estate purchasing is more preferred. One of the reasons is to ensure the investor's long-term business in senior care facilities. According to the global practice, average payback period for senior care business is above 10 years, compare to the longest lease term of 20 years as is permitted in lease agreement, investors will of cause hope to secure more years in operating to profit from their investment. Real estate Purchasing suits exactly to this request. In addition, investors don't need to worry the increasing rental cost will eat up its business profit when they own the premises by themselves.

Risks for buyer are more controllable if the premises have completed construction or have been granted pre-sale permits; while risks will be bigger in the event premises are still under design or have just started construction. In the latter case, buyers will sign a pre-contract with seller and pay certain percentage of purchase price or a deposit in order to secure the deal, but on the other hand will expose themselves with more risks as they are actually unable to monitor the financial capability of the developer (seller). Keeping control of the legal risks depends on the circumstance in different cases.

If premises are acquired in a second-hand property transaction, buyer should also calculate the tax burden such as business tax, deed tax and land value added tax. Although sellers are obligated to pay more taxation than buyers, in practice, however, sellers will intent to indirectly transfer the tax burden to buyer by offering increased price of the real property. So it is helpful for buyers in negotiating with seller shall they be aware of the taxation of the deal. To be noted, *i*n some cases, to avoid heavy tax burden herein, both buyer and seller will wish to proceed with the deal by transferring equity of project company that hold possession of the premises, especially in big deals. Sometimes the equity transfer is conducted between offshore holding companies, thus makes legal due diligence more necessary and important. Whether the method of tax avoidance is legitimate and whether risks are magnified for buyers shall be firstly analyzed. Purchasing of real estate by foreign investors can be deemed as the self-use purpose, and investors can theoretically proceed with foreign exchange settlement according to relevant regulation. However, in practice it is more likely to be deemed as investment in real estate by foreign investors and subject to the principle of project-based company and business existence.

To operate senior care facility by entrustment

Sometimes foreign operator may find an under-operating senior care facility, or, may face legal obstacle or risk shall they choose the abovementioned second, third or forth ways of acquisition. In these cases, operating by entrustment from the owners of senior care facility will be a notable option.

Entrust an operation right usually means by entrustment agreement, trustee can manage principal's business under the principal's name, and obtain remuneration in return. The model is widely practiced in the hotel management business, and has been developed and evolved into different practical mechanisms to enable both principal and trustee to allocate their risks and responsibilities as they wish. Commonly, trustee will reach a long-term management agreement with the principal, by using its experience and expertise in operation, human resource and branding in the senior care business. Upon handover of the facility, trustee will charge from the principal a fixed remuneration or some payback in alignment with operating income during the entrustment term.

It is notable the entrustment term can break the top the 20 years as is limited in a leasehold case. Moreover, with further alteration, this model is viable in some projects seemingly with legal flaws. For example, it can be used under the circumstance private investors cannot use the school or hospital facilities built on allocated land by ways of leasing or purchasing for the for-profit business of senior care. Or investors can, by using this model properly, mitigate risks to the largest extent in the projects with flaws in ownership or planning. It can make some dead projects alive.

Of course, the author does not intent to encourage investors to circumvent legal restrictions by using this model, given the fact the entrustment model is in practice facing quite a few challenges and problems. Cases happened in the hotel industry in recent years reflect a snapshot of that challenge. In 2011, we've seen from report international brands such as Intercontinental, Hilton, Sofitel have terminated some of their management contracts with their Chinese partners, in part due to cultural conflict, lack of restraint and incentive mechanism, non-transparency of financial status, or the development of the hotel business itself. However the biggest problem is the parties fail to find a balance to achieve win-win situation. As such, both parties should, in the first place, recognize and understand the characters of this entrustment model, find a cooperative basis and management measure tailored to tackling with the separation situation of ownership and management right within this model.

A BOT model to invest in senior care facility

BOT (Build, Operate and Transfer) is a special model of investment and finance, in which private capital participates in the construction of infrastructure facilities and public sector can find financing resource for the projects. In a BOT type of arrangement, the public sector grants to the concessionaire by contract special rights to build and operate the infrastructure facilities, and the concessionaire undertakes investments and operates the facility for a fixed period of time after which the ownership reverts back to the public sector. In this type of arrangement, operating profit is enjoyed by the concessionaire, while, on the other hand, investment risks are substantially transferred to the concessionaire as well. The most attractive thing for government is it can partially shoulder the financial burden on constructing these facilities. And by utilizing experienced and excellent investors in the marketplace, it can increase the management capability of such facilities.

BOT model is very catering to the investment in senior care facility, which requires huge investment but is expected for long payback period. By far, there has been some practice in the sector using this model. For example in Wuhan, the first implementation of BOT concession in nursing home has achieved by means of joint venture vehicle. In this project, social welfare institution provides the land use right, and real estate developer will construct, hold possession and operate the facility for a 20 years period. Usually in a BOT concession, the concessionaire may be required to establish a special purpose vehicle (SPV) for implementing and operating the project. The SPV may be formed as a joint venture company with equity participation from multiple private sector parties and the public sector. In this way, private investors can achieve a win-win situation with local government. In addition to equity participation, the government may also provide capital grants or other financial incentives to a BOT project. It is a predictable trend that more private funds will flow into the senior care industry through this model of BOT.

However, there is still no applicable laws or regulations in regard to BOT franchise practice, the only nation-wide applicable regulation is *Administrative measures on the franchise of municipal public utilities*, which is stipulated by former Ministry of Construction. The other policies or measures issued by some authorities, or some local regulations from Shanghai, Beijing or Shenzhen seems unsuitable in practice in many circumstance. Therefore, it is more important for BOT investors to mitigate risks in marketing, technical, finance, force majeure and policy alteration in implementing the BOT projects.

In addition, government plays an indispensable role in BOT projects. Firstly, all projects are subject to approval from governmental authorities and agreement with regard to rights and liabilities for project companies is to be reached between the government and private investor. Second, as senior care facilities are usually for public purpose, government will sometimes provide funds, credit or performance guarantee to these project, or own equity of the project companies. So to deal with the government relationship and strike for its most benefit is a skill and art for BOT investors. We recommend investors find professionals from both legal and financial to assist in the whole progress of BOT project. Especially, a prior analysis and evaluation on project profit, occupancy and rental forecast from financial advisor can provide more assurance to the success of the project and mitigate risks there from.

As a conclusion, China is on a dynamic route to regulate and develop the laws and regulations in the senior housing and care sector. Every model we introduce will have pros and cons for different business purpose. The best we can suggest is to find one suitable for your own particularity, be it your profit model or risk resistance capability.

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