

# **New Trend on Real Estate Finance**

## **—Analysis on Real Estate Trusts and Private Equity Investment**

Generally speaking, there are four types of resource of real estate finance, which are from banks, security market, trusts and funds. With the tightening controls the central government is taking toward developers on real estate finance, an emerging finance practice of trusts and funds is forging a new trend of indirect finance for real estate developers, who are usually counting on lending from banks. In this article, we will discuss two channels for real estate finance—real estate trusts and private equity investment.

### **Real Estate Trusts, from Prevalence to Surveillance**

A real estate trust (RE Trust), also referred as “real estate pooled investment fund”, is where trust companies raise funds from investors by ways of issuing trust plans, and work with real estate developers on real estate projects, in order to provide beneficiaries with profits in return.

#### **Legal Structure and Risks**

Compared with strict requirement of lending for real estate development, where four certificates of land title, zoning, planning and construction shall be sufficient and self-investment for the developer shall exceed 30% of total volume, trust companies can design flexible fund structure catering to different types of real estate projects. In practice, RE Trusts generate returns through specific assets, equity investments, loans, or a hybrid thereof.

Unlike other finance model, RE trusts can be less risky, given the severe supervision on compliance from the China Banking and Regulatory Commission ("CBRC") (e.g. according to circular 54 on strengthening supervision on RE Trusts, ratio of beneficiary interests between priority and secondary cannot exceed 3:1 in one trust product). However, legal structure of RE Trusts is more complex that make it difficult to surveillance, and therefore as a result, a lot of non-compliance exists, essentially illegal lending in name of equity investment, interest investment or assets trust. As of December of 2010, the CBRC issued a warning circular to control risk, more surveillance are taken until recently Shanghai Bureau of CBRC has suspended seven trust companies from RE Trusts business for non-compliance reasons.

Risks of RE Trust may arise from breaching of developers, which on the other hand is tied up with China's real estate market. Statistic from a trust company shows there are around one third of projects in the trust plans they issued since 2009 are unable to commence or complete construction on time, and hence may lead to breaching of trust deeds. Usually, the reason of delay is varied from different projects, and trust companies will come up with some solutions, for example, prolong payment terms upon consent of beneficiaries, refunding from issuing a new trust plan, dispose assets by selling project interests to purchaser, etc. However, if none of the above works, investors may suffer massive losses if the developer unable or unwilling to pay back their investment. In that case, investors can only resort to assets liquidation and lawsuit procedure that may extend for a long period.

Notwithstanding the above risks, RE Trusts is still promising. Now the business is moving from residential projects to commercial buildings and subsidiary houses, while more are targeting listed companies, large-scale groups or regional leading developers, and in the end may bring out REITs product.

### *Waiting for REITs*

REITs, even with a legal structure similar to RE Trust, are in essence a typical investment tool of assets securitization that issued and available to individual investors. A REIT is defined as an entity that invests primarily in real estate properties that can generate rentals continuously and qualifies for special tax status, so there is single taxation at the investor level.

There are still no Chinese REITs (C-REITs) products to be offered to the market. Chinese authorities are now studying two types of pilot schemes of C-REIT products—one is regulated by CBRC, the other by the China Securities Regulatory Commission (CSRC). The CBRC REITs will not affect the ownership of real property that the property owner finances from the trust by using rental as collaterals. It is essentially a scheme of securitization of revenue streams from a pool of real estate assets that will be offered to institutional investors and traded on the inter-bank market. The CSRC REITs, on the other hand, are traded in an open market by packaging a portfolio of real estate with sustainable rental income. It will be offered to retail investors and will resemble the REIT products offered in Hong Kong and Singapore. With reference to Hong Kong's experience of introduce its first REITs product on a subsidiaries houses project and its affiliated commercial and parking space, by far cities of Tianjin, Beijing, Shanghai and Haihan have already submitted their pilot scheme with regard to subsidiaries houses projects.

However, compare with international mature market, C-REITs legislation need to be enacted premised on the existing national legislation governing trust products, securities offerings, investment fund management and securitization. At this moment, lack of tax exemption, incentives or tax pass-through to the investors, unclear policies on property title transfer to REITs SPV and short of expertise on assets management and financial analysis make C-REITs even more difficult. As a result, some developers resort to offshore REITs, such as YueXiu REIT (00405) and recently Hui Xian REIT (87001) in Hong Kong. Capital Land also announced recently planning to issue offshore REITs with a portfolio of real property in mainland that values 5.3 billion USD. Apart from the market factors that foreign countries are different from China, such as evaluation method and profit expectation of returns, China's restriction on foreign investment in real estate and foreign exchange control makes offshore practice challenging. It is expected when C-REITs are finally introduced, those offshore REITs will definitely return to the Chinese Market.

### **Real Estate Private Equity Funds, in a Wild West Route**

Real Estate Private Equity Funds (REPE Funds) refers to PE funds that focus on real estate investment through ways of M&A or project development. The year of 2011 is a milestone for REPE in its robust, where PE contributes to a large part of fundraising for real estate developers while on the other hand provides wealthy group with another channel of investment.

Compare with ordinary PE funds that prefer IPO exit, REPE Funds, usually in great scale, is aiming at shorter payback term and higher profit. Nowadays, REPE Funds formed by real estate companies are dominant in the market, in which real estate companies such as Gemdale, Vanke and Soho China are PE sponsors. Apart from that, the others are independent REPE Funds, e.g. real estate investment by CDH.

### *Legal Structure*

REPE Funds are usually structured in forms of corporate, limited partnership or trust scheme. Partnership in practice is more common thanks to its flexibility on internal set up, tax treatment and

liability and profit allocation, and therefore adopted by most fund raisers. Pursuant to provisions on limited partnership in China Partnership Enterprise Law, there is no specific requirement on capital amount and its injection when incorporate a limited partnership. Investors can freely decide their investment amount depending on the essence of real estate projects. In addition, there will be local regulations on PE investment updated from time to time, we recommend investors to follow in fund incorporation.

However, the limitation of a topped 50 partners in a partnership enterprise brings quite a trouble for some REPE Funds where vast capital requirement is accompanied by exceed partner numbers. As a consequence, recent years we've seen a new model of "Trust + Limited Partnership". Under such, investment companies or fund management companies will first set up a partnership enterprise as general partners ("GP") before trust companies would issue trust schemes to raise trust funds. After the trust schemes are set up, the trust funds raised will be invested in the partnership enterprise, where the trust schemes are limited partners ("LP"). Combined with both trust scheme and partnership, this model also to a large extent solve the tax and exit issues, but in practice still facing with continuous doubting. Insiders alleged that in essence this is real estate trust finance—only by means of PE. Meanwhile, on Dec 23 National Development and Reform Commission ("NDRC") in its Notice on Promoting Regulatory Development for Equity Investment Enterprises (Notice 2864), for the first time challenges the legitimacy of such practice. The Notice requires that investors spring from trust or partnership that serves as LP in a fund shall be counted pass-through as qualified investors, except for those are funds of funds. It seems the door to circumvent the limitation of investor number has closed, but the attitude of Chinese authorities whether there will be a thorough enforcement is still unclear.

### **Overseas Power**

Speaking of PE, early entrants are really those overseas funds in the Chinese market. Under the regulatory circumstance, foreign invested PE funds are formed mainly in three structures: investment company pursuant to Circular (2004) No.22 promulgated by MOFCOM, foreign-funded venture investment enterprises pursuant to Circular (2003) No. 2 and foreign-funded partnership pursuant to Partnership Enterprise Law and Circular (2010) No. 47 of State AIC.

While from year 2006 the Chinese authority has strengthened to curb in foreign investment in real estate through a series of regulation, particular prohibited Foreign-funded PE from any direct or indirect foreign investment in non self-use real properties regardless investment is pursued through property purchase or equity investment in real estate companies.

As of early this year, cities like Shanghai, Beijing or Tianjin have started pilot schemes on Qualified Foreign Limited Partner ("QFLP"). A foreign-fund GP that has obtained the pilot qualification is permitted to convert its foreign currency into RMB for investment in an RMB Fund, provided that the amount so converted does not exceed 5% of the aggregate capital commitments of the RMB Fund. Such investment would not change the nature of the RMB Fund. This seems to imply that the RMB Fund formed by the structure may be treated as a domestic partnership as opposed to a foreign-invested partnership that have investment restrictions; provided there are no foreign LPs. However, due to the complexity and time-consuming procedure, only very few funds are trying this approach, while most foreign PE funds are invested through establish of WFOE or JV despite of the policy restriction. In practice, foreign-funded PE will establish a domestic management company as GP to sponsor and establish an RMB Fund, provide investment management and related services to

RMB Funds. The Fund will eventually invest in real estate projects after fundraising.

**Supervision and Risks**

With respect to supervision of PE Funds, in early 2011, NDRC in its Circular 253 has Regulated the Administration on mandatory filing of equity investment enterprises under certain circumstance in Pilot Areas of Beijing, Tianjin, Shanghai, among others, and furthermore in the abovementioned Notice No. 2864 expands such mandatory filing to all newly founded and existing equity investment enterprises all over the country and requires legal opinion from law firms being presented regarding the compliance of such business. However, due to the low hierarchy of NDRC’s legislation, only sanctions of “warning” and “notice of black-name on website” can be taken to supervise investors’ behavior, we believe the enforcement of such regulation may face challenges. Meanwhile in other local areas, the policies are continuously issued with an appropriate monitoring attitude in general. In a recent revise draft of Securities Investment Fund Law, we’ve found PE is included in the territory of fund to be regulated.

On the other hand, REPE Funds grow with a national policy on curbing the real estate market, no mature model and standard have yet been established, and many practice on investment orientation, tools, strategy or exit approaches are still in an experimental stage that no best solution can refer to. We’ve seen some are raising money in a name of PE investment, but in fact engaging real estate speculation activities, or in essence are pure lending disguised with equity investment—both will be risky to the investors being little regulatory protection out there.

Last but not the least problem to be solved is exit solution. Normally, foreign-funded PE will seek three capital exits by disposing their invested equity, which are (a) partially or wholly sell of equity share in the target enterprise; (b) purchase-back by target enterprise or its shareholders subject to specific conditions; or (c) IPO in security market home and abroad. These exit solutions sometimes will face different limitation or restriction in practice, and we believe by its nature of real estate investment, REPE is definitely suitable for an exit strategy of issuing REITs product in a capital market, as we discussed in first half of this article.

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