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CHINA REITS - WHAT'S THE LATEST?

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After several years of speculation, it looks like China is at last in the process of implementing a real estate investment trust (REIT) regime. In doing so China would join a growing list of countries that have turned to the model as a means of encouraging investment in real estate and providing property developers greater access to capital. REIT or REIT-like structures currently exist in 28 countries worldwide and are being considered for adoption by several others as well, including India and Pakistan.

ADOPTION OF REIT FRAMEWORK MANDATED BY STATE COUNCIL

In a series of announcements beginning with the State Council in November 2008, the Chinese Government has stated that a legislative framework for Real Estate Investment Trusts will be introduced in the People's Republic of China (the "PRC") in the near future. The China Securities Regulatory Commission (CSRC) and the China Banking Regulatory Commission (CBRC) are currently in the process of formulating appropriate rules and structures, but no deadline for the adoption of REIT guidelines has been announced. Earlier this month the Peoples Bank of China (PBOC) announced that it is close to finalizing a draft proposal to set up real estate investment trusts as part of the government's efforts to ease the cash constraints of property developers and plans to seek approval of the State Council to launch a series of pilot REITs to test the efficacy of the proposed structure in China and to fine tune the model.

THE REGULATORY FRAMEWORK FOR DOMESTIC CHINESE REITS REMAINS UNCERTAIN

While property developers and investors, who have eagerly been awaiting the introduction of domestic REITs in the PRC, are hailing these recent pronouncements, many questions remain, including the timeframe for introduction and, more important, what the regulatory framework will look like. REIT regimes vary significantly among jurisdictions around the world.

A QUICK COMPARISON OF DIFFERENT REIT FRAMEWORKS - FIRST THE US MODEL

The US REIT model, which is the oldest, is also the most flexible in terms of the structure in providing for both public and private REITs that can be exchange listed or not, and allowing for both internally and externally managed REITs. In the internal model, the REIT Sponsor, generally a real estate developer and/or operator, merges its business into the REIT, which is then managed by its own employees. In contrast to the external model, where the interests of the manager and the unit holders are not always aligned and subject to conflicts of interest, the internal model better aligns the interests of management and the unit holders and enables the REIT to function as a fully integrated real estate operating company. The US model is also the most expansive in terms of the types of properties it can own and the activities it can undertake, including the unlimited ownership and development of raw land. Furthermore, US REITs have few restrictions on the means by which they can capitalize their business, including no limitations on the amount of gearing.

A LOOK AT THE EVOLUTION OF REITS IN ASIA

This stands in marked contrast to the typical REIT model being adopted throughout Asia, including Hong Kong and Singapore, which in an effort to provide heightened investor protection, places far greater restrictions on the structure and operation of REITs. Under these models, REITs are more like an investment product than a fully integrated operating company as they must be listed on a public exchange, are prohibited from being internally managed and require the oversight of an independent trustee. Furthermore, they are under strict limitations as to the amount of gearing (generally less than 45%); the amount of development activity (generally less than 10% of total assets); the inability to invest overseas (except for Hong Kong, Singapore and Japan); the requirement of annual property appraisals; and the limitation on affiliated party transactions.

By way of example, under the Hong Kong model a REIT must:

(i) be listed on the stock exchange;
(ii) be in the form of a trust with an independent trustee;
(iii) be externally managed by an approved management company;
(iv) employ an independent property appraiser to value the properties on an annual basis;
(v) invest primarily in real estate that generates recurring rental income;
(vi) limit its non-income generating real estate assets to not more than 10% of its total assets;
(vii) not sell any asset held for less than 2 years without the approval of its unit holders;
(viii) not invest in vacant land or engage in property development activities, except renovations;
(ix) not exceed a gearing ratio of 45%;
(x) obtain unit holder approval for all related property transactions; and
(xi) pay a dividend of at least 90% of its net income after tax.

The Singapore REIT regime is substantively similar to that of Hong Kong.

SUB-PRIME CRISIS WILL INFLUENCE DIRECTION OF CHINESE REITS

While there has been some speculation that China would lean toward the US model, a spokesman for the PBOC recently stated that in light of the lessons of the US sub-prime crisis, China would devise a REIT framework that placed an emphasis on risk control and was as simple and transparent as possible. Based upon such statements, it was anticipated that the REIT framework currently being considered would be closer in form to the Hong Kong and Singapore models than the US model.

A FORK IN THE ROAD: Two Regulatory Bodies – Two Different Regulatory Schemes.

Two separate governmental bodies oversee the Chinese securities regulatory system, each with a disparate clientele and focus. The PBOC, which along with the CBRC, has regulatory authority over the PRC's Banking System and debt instruments issued by financial institutions in the Intra-Bank Trading Market. On the other hand, the CSRC generally has regulatory authority over PRC public entities and securities listed for trading on the Shanghai and Shenzhen Exchanges. Because of the differing interests of the constituents' of the two regulatory bodies, the PBOC and the CSRC have not been able to agree on a unified regulatory approach for REITs. As a result, it is expected that the PBOC will adopt a framework for the issuance of debt securities collateralized by real property. These collateralized debt instruments would be listed for sale in the Intra-Bank Trading Market. In fact the PRC's recently adopted framework for the issuance of Asset Backed Securities could generally provide the framework for these REIT-financial instruments. In contrast, the CSRC is moving more cautiously and is believed to be working towards the adoption of a REIT framework based on the Hong Kong and Singapore models.

SEVERAL STRUCTURAL IMPEDIMENTS MUST BE ADDRESSED

In order for China to successfully implement a REIT regime it must address several structural impediments. First there is a lack of existing legal structure for REITs, as the legislation will have to make refinements to China's existing trust, partnership and corporate codes to enable common REIT structures to be utilized. Uncertainties associated with land ownership and land use rights may need to be clarified to promote investor confidence, including title concerns and the procedures for renewing land use rights.

THE NEED FOR TAX TRANSPARENCY

In addition, significant amendments to China's tax system will be needed in order to make the creation and operation of REITs cost effective. Under the existing PRC tax regime, the operation and sale of real estate assets are subject to various taxes, including a 5% business tax, a 25% corporate tax, a 30% to 60% land value appreciation tax, a 3% to 5% deed tax, and a .05% stamp tax. The imposition of these taxes can make the contribution of real estate assets to the REIT and the operation of the REIT's business prohibitively expensive. Furthermore, the tax regime will need to be modified to ensure that the REIT functions as a pass through entity for tax purposes so it will not be subject to double taxation on its earnings. Tax transparency at both the formation and asset acquisition stage and upon dividend payments is critical to creating a viable REIT market.

ISSUES SURROUNDING FOREIGN OWNERSHIP

Significant issues surrounding foreign ownership of the REIT must also be addressed. First, it is expected that REITs will be required to list their shares on either the Shanghai or Shenzhen exchanges. Currently there are severe restrictions on the ability of foreign investors to own shares on either exchange. In addition, no foreign controlled entity has been allowed to list on either exchange since 1999. Unless the government modifies its position, foreign investment will consist of minority positions with non-controlling management rights. It also needs to be seen whether the government will permit dual listings of domestic REITs on foreign exchanges such as the Hong Kong exchange or in conjunction with US ADR's and London AIM listings.

Finally, issues regarding the redenomination and repatriation of RMB denominated dividend payments must be solved. Under existing policies of the State Administration of Foreign Exchange (SAFE), the payment of dividends to foreign investors (or more appropriately the receipt of such payments) will be problematic and subject to significant time delays. Generally SAFE does not allow dividend payments to be made until after the company's annual audit is complete, which can be up to 6 months after the close of the fiscal year and can be limited in amount. In order to make the REIT market viable to foreign investors, who are use to being paid REIT dividends on a monthly or quarterly basis, SAFE will have to address these issues.

SO WHEN WILL WE SEE DOMESTIC CHINESE REITS?

In conclusion, the recent pronouncements by the Chinese government that a framework for REITs is under development are a welcome sign to real estate developers operating in the mainland and investors. As discussed herein, the government must address a number of significant issues in order to create a viable framework for domestic REITs. As to timing, we are likely to see the first pilot REITs sometime this year, most likely under the PBOC sanctioned scheme. But as a representative of the PBOC recently acknowledged, the designing of a final REIT framework will require the review and input of a number of governmental departments and intermediaries; and as such it will take some time for a final proposal to be ready for submission to the State Council for approval.

LOCKE LORD AT THE FOREFRONT OF THE GLOBAL REIT MOVEMENT

Partners of our firm have been active in advising various study groups and other interested parties in the PRC focused on the adoption of a domestic REIT scheme as well as on their adoption of their ABS/Securitization law. Our partners have also been active in advising numerous governments around the world on the adoption of REIT legislation and on the implementation of industry best practices, including several other Asian governments, the United States, Europe, Australia and South Africa. We will provide further updates as the PRC's legislative and regulatory framework for REITs evolve.

FOR FURTHER INFORMATION

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