New Opportunities for Investing in PRC Real Estate Market

In July 2008, MOFCOM issued a circular granting provincial-level authorities more leeway in approving foreign investment real estate projects. Lawrence Guo, a partner at Broad & Bright, looks at how the delegation of power will change the playing field.

On July 1 2008, the Ministry of Commerce (MOFCOM) issued a circular in which it delegated its "powers of reviewing and verifying the recordal of foreign investment project proposals in the real estate sector" to provincial-level approval authorities. Did this mean that MOFCOM wants to permit provincial-level approval authorities more leeway in approving foreign investment projects in the real estate sector based on different local situations? The answer appears to be yes!

MOFCOM's power delegation coincides with a number of complicated, mostly adverse, market conditions in the Chinese real estate market. Real estate prices in most first-tier and second-tier cities rocketed in the latter half of 2007. As a result, fewer consumers can afford to buy properties and the property prices began to stagnate and then started to drop (sharply in a few cities) in the past few months. On the other hand, Chinese foreign currency reserves climbed from US$1.6 trillion to US$1.8 trillion in the first half of 2008. The domestic stock market plummeted by more than half as of July 2008 after reaching a record high in October 2007, giving real estate development companies limited channels for obtaining equity financing from stock markets. At the macroeconomic level, the central government tried to control liquidity by increasing benchmark interest rates[1] and central bank deposit reserve rates[2] to historically high levels, which made it much harder for property developers to get debt financings from banks. As a result, many property developers are extremely short of cash that is needed for keeping their normal businesses going on in the recent few months.

The adverse real estate market appears to be creating very good buying opportunities for investors. Real property prices have decreased in most first-tier cities. Property developers are more willing and eager to sell properties or shares in property development companies at lower or discounted prices in order to ease their cash flow pressure. At the policy level, local authorities are likely to be more willing to accommodate foreign investment in the real property sector in order to enhance the local real property market in which the local government has a significant stake (e.g. revenue generated from granting of land use rights).

As is widely known, some policy and legal restrictions were imposed by the Chinese government on foreign investment in the real estate sector in the past few years. However, foreign investors should be aware that these restrictions do not at all block serious foreign investors to complete real estate investment deals. To provide some strategic guidance for foreign investors, this article will outline the key legal restrictions in the real estate sector, review the regulatory framework and review some investment strategies and channels for foreign investors investing in the real estate market.

KEY POLICY AND LEGAL RESTRICTIONS IN THE PRC REAL ESTATE SECTOR SINCE 2006

The Chinese central government imposed a set of rules and measures that were intended to normalise and/or restrict foreign investment in the real estate sector starting from 2006. A recap of these measures is set out below.

On July 11 2006, MOFCOM, State Administration of Foreign Exchange (SAFE), the Ministry of Construction, and three other ministries set forth the following rules:

a) **Commercial presence requirement.** A foreign investor must establish an onshore company in China in order to make investment in the real estate sector. This was a significant change for foreign investors because many foreign entities had directly purchased properties in China without setting up onshore project companies.

b) **Increased capitalisation.** If the planned total investment of a foreign-invested real estate project is in excess of US$10 million, the registered capital of the project company should be no less than 50% of the total investment. Previously, this percentage was 40% in the event of a planned total investment between US$10 million and US$30 million, or 30% in the event of a planned total investment in excess of US$30 million.

c) **One year limit for payment of land price.** Where applicable, a foreign-invested real estate project is required to pay in full the land grant fees within one year after the establishment of the onshore project company.

d) **Special requirements in the case of a property acquisition.** Where a foreign investor acquires an existing real estate enterprise by a share acquisition or other means, the acquirer is required to (i) pay the acquisition price in a lump sum no later than three months after completion of the statutory registration of the acquisition transaction in China, (ii) warrant that it will duly perform the obligations of the target (or the seller) under related land grant contracts and land planning permits, and (iii) properly arrange employees in the target, and (iv) properly deal with the bank debts of the target.

e) **Limits on debt financing.** A foreign-invested real estate company may not take out domestic renminbi or foreign currency loans in the event of any of the following: its registered capital not yet fully contributed, the land use right certificate not yet obtained, or the funds available for a project not meeting 35% of the total fund requirement in the project.

f) **Limits on purchasing powers of branches and aliens in the PRC.** A branch office or a representative office on the mainland of a foreign company, or an alien that has worked or studied on the mainland for more than one year, may purchase real properties only for its own office or personal living use, and not for any other purposes.

On May 23 2007, MOFCOM and SAFE further set forth the following rules:

g) **One company for one project.** A foreign investor needs to first obtain land use rights or building ownership or at least a related intention agreement before it can apply for an approval for the establishment of a project company.

h) **Enhanced review by approval authority.** All foreign investment projects approved by local authorities must be submitted to MOFCOM for "recordal" ("bei-an" in Chinese pinyin; essentially a discretionary verification by MOFCOM); otherwise the foreign currency capital contribution may not be converted into renminbi. Because MOFCOM often needs an extended time period to grant its consent for the recordal, this recordal process essentially made foreign investment in the property sector significantly more difficult. However, as mentioned at the beginning of this passage, this recordal requirement was delegated by MOFCOM starting from July 1 2008.

Shortly thereafter, SAFE further set forth the following policy which took effect from June 1 2007:

i) **No offshore loans permitted.** Any new foreign investment projects approved after this date may not take out any foreign currency debt. As a result of this, a new foreign investment project company needs to count on its own registered capital or domestic renminbi loans for financing.

REGULATORY FRAMEWORK IN THE REAL ESTATE SECTOR

The real estate sector covers a broad range of businesses, which are outlined below.

Land tract development

The land tract development business is usually conducted by a company owned or controlled by the local government (e.g., the municipality or township). The developer usually acquires the granted land use rights by going through the land requisition and granting process, in which proper compensation should be provided to the farmers that occupied the land previously for their loss of crops, trees and future cultivation rights, etc. The tract developer usually needs to level the land and connect necessary public utilities to the land so that the land becomes ready for construction by downstream development companies. Regulations require that a foreign investor must form a joint venture with a PRC company in carrying out such tract development business. Because of complicated and sensitive local practices and policy considerations, foreign investors are rarely involved in the tract development business.

In addition, foreign investors are prohibited from constructing and/or operating a golf course starting from December 1 2007, according to the *Foreign Investment Industrial Guiding Catalogue* (last amended on October 31 2007).

Development and/or operation of various types of real estate properties (for use of residential, office, high-grade hotels, conference and exhibition centres)

The development of real properties includes a series of activities – acquiring land use rights from the local government or from a tract developer, obtaining all requisite land approvals, construction-related and project-specific approvals and permits, engaging a construction company to carry out the construction work, and finally completing the construction acceptance procedure and obtaining building ownership certificate.

Instead of developing and constructing a building, a foreign investor may quickly enter the real estate business by purchasing existing properties. An investor can operate and lease the property for rental income, or renovate the properties for new and enhanced functions (e.g. hotels, shopping malls, office buildings). Certainly, a future resale of the property is also an option.

Foreign investors are "restricted" (but not prohibited) from carrying out the development and/or operation of *high-grade* hotels, villas, *high-grade* office buildings, or international conference or exhibition centres. Such restriction means than where the total investment of an investment project is in excess of US$50 million, such a project should be approved by the central ministries (primarily PRC National Development and Reform Commission or NDRC, and MOFCOM), rather that at the provincial level. It is usually perceived that the approvals by the central ministries are much more difficult to obtain.

However, there are no exact definitions of the word "high-grade". This leaves much room for the local approval authorities to determine whether a development project is "high-grade" or not.

The development and/or operation of other types of buildings (e.g. ordinary office or residential buildings) other than those mentioned in the above would fall under the "permitted" category, which would mean that the provincial-level authorities have the power to approve a foreign investment project with a total investment below US$100 million (rather than US$50 million).

Real property management

Foreign investors may set up management companies to manage various types of real properties, such as hotels, office buildings, commercial facilities and parking lots. Property management normally falls under the "permitted" category, for which the approval threshold for provincial-level authorities is US$100 million.

Real property brokerage or agency business

Real property brokerage or agency business is newly added into the "restricted" category in the latest *Foreign Investment Catalogue*. As such, where the proposed total investment of a foreign investment brokerage or agency project is in excess of US$50 million, the project shall require the approval of NDRC and MOFCOM.

INVESTMENT STRATEGIES AND CHANNELS FOR INVESTING IN THE REAL ESTATE MARKET

An investor is likely to face various investment opportunities for different types of properties in different tiers of cities. Set out below are some fundamental investment strategies and channels that a foreign investor may consider when investing in the real estate market.

Acquiring newly-completed or second-hand real properties

This appears to be the quickest approach to invest a huge sum of capital within a short timeframe. If the target property is already owned by an independent PRC company, the new investor may just buy out the equity interest of the target company. If the target property is indirectly owned by an offshore company, the foreign investor may acquire the shares of the offshore company without triggering onshore governmental approvals. An offshore structure usually permits a transaction to be closed much more quickly and with more certainty. Otherwise, if a share deal is not feasible, the new investor may form a new subsidiary in China, and use this subsidiary to acquire the target property.

If a new onshore company is established, the new project company would not be permitted to take out foreign currency loans, according to SAFE's restrictions outlined above. The investor may need to inject more registered capital if renminbi loans would not be available.

As a rule of thumb, where possible, a foreign investor should try to keep a new investment proposal within the regulatory total investment limit so that the project can be approved by provincial authorities, instead of the central ministries. One obvious tactic is to break one giant project into two or more smaller projects.

A resourceful investor ... should be aware that policy restrictions may present some difficulties but are not deal-killers at all.

To complete a successful acquisition, well-crafted, thorough due diligence on the target property should be conducted by the acquirer. In addition to finding an ideal investment structure and navigating the regulatory approval maze diligently, a prudent acquirer should also seek to resolve any significant project-specific issues before signing definitive agreements and to procure sufficient representations and warranties and other necessary contractual protections.

Constructing and developing real estate properties

A more complicated approach for a foreign investor is to acquire legitimate land use rights on the mainland and construct specific, real properties. The approach would require a foreign investor to be confident and experienced in the real estate development and construction process. An investor selecting this approach should be well aware that the PRC land use rights acquisition process and the government's licensing procedures are usually complicated and often lack transparency. This would likely mean more substantial risks of delay and inefficiency in terms of project implementation.

If the foreign investor wants to engage in direct development and construction, but lacks local experience, the foreign investor may consider forming a joint venture with a local real estate development company. A joint venture could create a win-win situation since the partner normally has local market and construction-related expertise and established governmental relationship while the foreign side will bring about capital and management and technical expertise. However, a foreign investor should be well aware of the increased transaction cost (e.g., negotiating, drafting and implementing the joint venture documents) and the agency cost arising out of a joint venture structure. The agency cost denotes the cost of controlling and/or supervising the Chinese partner since the Chinese partner usually runs the entire licensing and development process and manages the groundwork (unless the foreign investor takes a majority stake, which is not common).

Buying shares of real estate public companies

A foreign investor may purchase shares of real estate companies listed on offshore stock exchanges, primarily the Hong Kong Stock Exchange (HKSE). Shares of mainland companies that are directly listed on the HKSE are called H shares. In addition, there are also red chip shares listed (usually) on the HKSE, which are shares of holdings companies incorporated in offshore jurisdictions (e.g., Cayman Islands or Hong Kong) which in turn own or control the equity interests of onshore real estate companies as its substantive business. Since Hong Kong is legally treated as a foreign jurisdiction by China, a foreign investor may freely purchase such H or red chip shares on the HKSE, free from PRC regulatory approvals but of course subject to the listing rules of the HKSE. Examples of H-share companies include Capital Land (Beijing), North Star (Beijing), Forte Land (Shanghai) and R&F Properties (Guangzhou). Examples of red chip real estate companies include Country Garden Holdings, SOHO China, Hopson Development Holdings, China Resources Land and Sino-Ocean Land Holdings, and many more.

A foreign investor is prohibited from directly purchasing A shares in China, i.e., shares of PRC companies listed on PRC mainland stock exchanges. Central ministries issued measures several years ago that permit foreign investors to acquire PRC A shares by way of making a "strategic investment", but this approach is not easy because a foreign investor will need to deal with all relevant central ministries (e.g., MOFCOM, China Securities Regulatory Commission, National Development and Reform Commission in some instances, and State-owned Assets Supervision and Administration Commission where state-owned shares are involved) in order to complete an acquisition. However, as another narrow window, a foreign investor may indirectly purchase shares of real estate companies listed on the mainland stock exchanges by way of investing in or via QFIIs (qualified foreign institutional investors) that have been duly approved by Chinese central ministries to buy A shares within capital quotas and in accordance with special investment rules.

In summary, while foreign investors need to deal with some policy restrictions and obstacles in investing in the real estate market, a resourceful investor should spend some time understanding the relevant laws and policies, and should be aware that such policy restrictions may present some difficulties but are not deal-killers at all, and there are plenty of investment opportunities in the real estate market in the PRC.

Endnotes

1. Benchmark lending rate for a one-year loan was 7.47% starting from 21 December 2007 versus 6.39% prior to 18 March 2007.
2. Central bank deposit reserve rate was 17.5% starting from June 25 2008 versus 9% before January 15 2007).