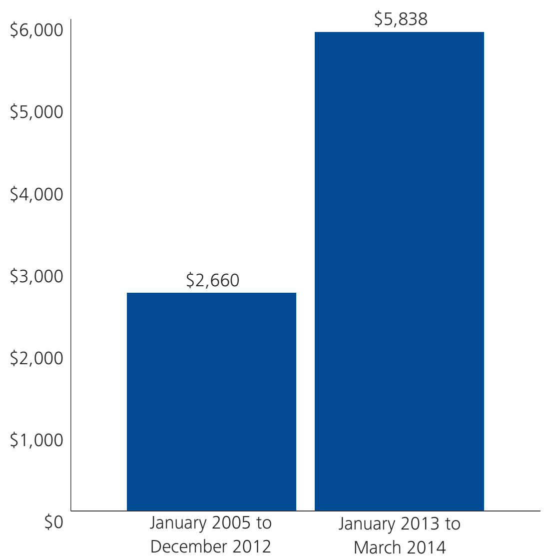
Chinese investment in U.S. real estate
Collaborate and benefit

According to the 2014 Association of Foreign Investors in Real Estate (AFIRE) survey, more than two-thirds of respondents consider the United States the most stable and secure real estate investment destination. Going forward, 68 percent of respondents plan to increase their portfolio size in the United States.[1] Chinese investors have been riding the U.S. commercial real estate (CRE) wave, perhaps motivated by the gradual shift in the Chinese government's policy to promote outbound investments and their preference for investing in real estate that provides comparatively modest and stable returns. From January 2005 to March 2014, Chinese investors made direct acquisitions of $8.5 billion in U.S. CRE. Of this, $5.8 billion has been invested in the 15-month period, January 2013 through March 2014. Consequently, China has emerged as the second-largest foreign investor, after Canada, with an eight percent share of the total cross-border investments in U.S. CRE.[2]

Figure 1: Chinese investment in U.S. CRE



Source: Real Capital Analytics (RCA)

What does this mean for the U.S. CRE sector? Traditionally, Canada and Australia have been the top international investors in U.S. CRE. However, with the recent inflow of Chinese capital, the U.S. property ownership profile is likely to change. According to Dan Cashdan, senior marketing director, HFF Securities, "there is an unusual flow of funds and this flood of capital can help reshape foreign ownership in the future. Such reshaping of flow of funds happens once in every 15 years."

In this Closer Look, we analyzed the Chinese investment strategy in U.S. CRE and highlighted ways in which U.S. real estate players can benefit from the trend.

Taste of the eighties?

Parallels are being drawn between the current wave of Chinese investment and that of the Japanese during the 1980s. While it is still early to consider the Chinese wave in terms of absolute investment volume, the differences in timing, market conditions, and investment objectives are substantial enough to dispel the fear of history repeating itself, allowing us to believe that the Chinese investors are in for the long haul.

To put things in perspective, the Japanese investments were made at a time when U.S. property prices were at a peak. Their investment strategy had two predominant aspects: a focus on trophy assets and an aggressive bidding process. This resulted in property prices moving further north from the existing peaks and eventually leading to a property bubble. In addition, Japanese investors overlooked logistically important practices of managing the purchased properties, such as building local relationships.

In contrast, Chinese investors increased their U.S. real estate investments at a time when property prices were recovering post-recession. Their investments appear to be focused on reasonably priced properties and/or those at below-market levels.[3] Secondly, barring a few high-profile deals, Chinese investors have been relatively conservative

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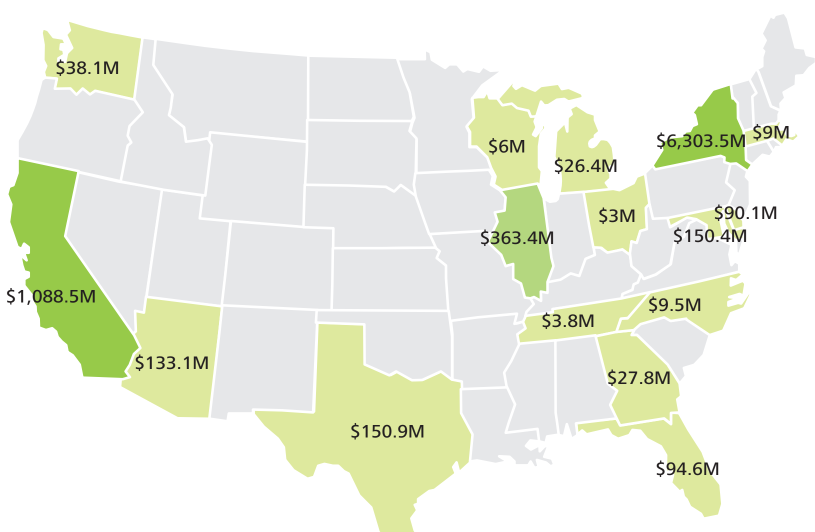
and appear aimed to diversify their risk by investing across property types. Lastly, Chinese investors, especially developers, are looking for non-financial benefits such as learning leading practices of developing and maintaining real estate in the United States.

Chinese investments in the U.S. CRE markets

Chinese investors are acquiring both commercial and residential real estate. The majority of the investments are either in markets such as California and New York (see Figure 2), or in regions with a significant Chinese presence pertaining to business and/or education. Consequently, office-property acquisitions have been predominant in prime markets such as New York,[4] just as hotel deals have been concentrated in Los Angeles and New York. The increase in Chinese immigration for the purpose of education has driven multifamily investments. Interestingly, the Chinese have also invested significantly in the U.S. housing market, accounting for nearly one-fifth of the U.S. home purchases by foreigners in the 12 months prior to March 2013.[5] Apart from these, the Chinese have shown keen interest in mixed-use development projects in markets such as the boroughs surrounding New York City.

Moving on to the Chinese investor profile, state-owned enterprises (SOEs) and high net worth investors are the dominant players.

Figure 2: Chinese investment in U.S. CRE by state (January 2005 – March 2014)



Source: Real Capital Analytics (RCA)

The SOEs include developers, such as Greenland Group and China Vanke Co., which have focused on multifamily and mixed-use development projects. Vanke has set a goal to increase its overseas spending from its current five percent to 20 percent over the next few years. According to Vanke's Chairman, Wang Shi, the developer will capitalize on the earlier successes of other Chinese investors and focus on cities such as San Francisco, New York, and Boston.[6]

> "We are entering the U.S. market to continue this learning process, to understand business models in a mature market and accumulate management experience through project cooperation."
>
> *- Wang Shi, chairman, China Vanke Co. (Chinese developer)*[7]

Chinese banks and sovereign wealth funds (SWFs) have also shown interest in U.S. CRE. For instance, since 2005, Bank of China has provided $8.4 billion for nearly 35 transactions involving U.S. CRE sales, refinances, and commercial mortgage-backed securities issuances.[8] Also, China Investment Corporation, one of the largest SWFs in the world, is an active investor in U.S. CRE, primarily through fund vehicles or lending affiliates.[9]

Going forward, the investor composition will likely diversify as the Chinese regulators open up international investments by other financial institutions such as insurance companies. For instance, in late 2012, Chinese insurance firms received a local regulatory nod to invest in overseas real estate. According to HFF Research, Chinese insurers can invest $14.4 billion in overseas real estate in the future, with the United States likely to secure a large share.[10] Eventually, as Chinese investments increase and investors mature, we may see a broader spread across U.S. regions and property types.

Potential considerations for Chinese investors

While U.S. real estate is an attractive investment choice for the Chinese, many investors lack knowledge of U.S. CRE markets, entitlement processes, and relevant regulations and tax laws. For example, investors need to assess the potential for a deal to be considered a covered transaction,[11] as that may entail a Committee on Foreign Investment in the United States (CFIUS)[12] review. CFIUS notices can potentially delay or impede transactions. In 2012, Chinese investors received the highest share (more than one-fifth) of notices for covered transactions.[13] Chinese investors should consider partnering with local U.S. real estate players to overcome these challenges. Some of the approaches to local partnership include:

- **Investment through a U.S. corporation:** Chinese investors can potentially infuse equity or debt capital in a U.S. company that invests in real estate. This structure will help them avoid a direct filing obligation of U.S. income tax returns. In such a partnership, profits are repatriated through payment of interest and dividends, which may be subject to reduced rates of U.S. taxation pursuant to a tax treaty, or by taking advantage of domestic law exemptions such as interest paid with respect to portfolio debt. Further, these investors may also avoid direct taxation under Foreign Investment in Real Property Tax Act (FIRPTA) norms upon exit, if the U.S. company sells all its real estate and distributes the profits in a liquidation transaction.
- **Investment through a real estate investment trust (REIT):** Alternately, Chinese investors can consider equity investments in a REIT and save on corporate taxes. In such a scenario, dividends paid from operations are subject to U.S. withholding taxes subject to treaty reduction. Investors can also claim special exemption from FIRPTA for sale of shares in a domestically controlled REIT[14] versus the sale of the underlying real estate.
- **Investment through a U.S. limited partnership using a "blocker" corporation:** Chinese investors can also consider investing in a U.S. company that eventually invests in a U.S. private equity real estate fund. The company in this case is called a "blocker corporation," and will not require Chinese investors to be directly involved in the U.S. business and subsequent payment of U.S. taxes. While the blocker corporation is subject to U.S. federal and state income tax, Chinese investors can reduce tax liability in the form of interest deduction by providing debt funding, rather than equity, to the blocker corporation.

According to Jeff Rubin, partner, Deloitte Tax LLP, "investments through intermediate vehicles and structures can reduce the overall tax burden and eliminate the requirement to directly file U.S. income tax returns."

Opportunities for U.S. real estate players

The rising Chinese investments should bode well for U.S. real estate players, especially as an additional funding source for both completed and under-construction properties. Development activity has been at record low levels since the financial crisis and funding through traditional sources such as banks continues to remain stringent.

As an example, in 2013, Greenland Group entered into a memorandum of understanding with Forest City Enterprises to acquire a 70-percent share of its $5 billion 22-acre Atlantic Yards project in Brooklyn. The property is currently under development and will include 14 apartment buildings, one office property, and retail space. Forest City acknowledged that the fresh inflow of capital from Greenland will likely speed up the development of the project.[16]

Chinese investors can also help resolve distressed U.S. CRE assets, which stood at $99.6 billion, or 27.1 percent of the total 2013 transaction volume.[17] According to RCA, four of the 15 largest Chinese property investments in the United States over the past two years have resolved distressed situations.

> "People from China look at the price in which you can buy these buildings and think that's the cost of one apartment in Shanghai."
>
> *- Goodwin Gaw, founder of Hong Kong-based Gaw Capital Partners*[15]

Conclusion

For U.S. real estate players, international interest is not a new trend. However, as Chinese interest increases, it is important for U.S. property owners to understand the former's investment pattern and objectives in order to build long-term and mutually beneficial partnerships. Both U.S. and Chinese investors will benefit from a thorough assessment of optimal and tax-efficient structures, as well as due diligence of target assets or entities with a trusted advisor in order to save any additional time and costs that may result from a potential deal fallout.

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Endnotes

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11 "Covered transaction" is any transaction involving a foreign person, which could result in control of a U.S. business by a foreign person and which can be considered for review by CFIUS under section 721 of the Defense Production Act of 1950, as amended by the Foreign Investment and National Security Act of 2007. Source: CFIUS Annual Report to Congress, December 2013 and SWF Institute.

12 "CFIUS is an interagency committee authorized to review transactions that could result in control of a U.S. business by a foreign person ("covered transactions"), in order to determine the effect of such transactions on the national security of the United States," U.S. Department of the Treasury.

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14 A domestically controlled REIT is one that is less than 50 percent owned by non-U.S. investors.

15 Matthew Dolan and Craig Karmin, "China Moves to U.S. Projects," *The Wall Street Journal*, October 28, 2013.

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