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Outbound China real estate investment: "The next phase"

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News of upwardly mobile Chinese individuals scouring the markets around the globe and purchasing high end residences in places like London, New York, and Paris has made headlines. Outbound investment from China into real estate, however, is not a new phenomenon and it is by no means limited to individuals dabbling in residential real estate.

China's efforts to "go global" in the real estate arena commenced a number of years ago. In China's rapidly evolving economy, there are a number of key trends to watch in the next phase of China's outbound investment into real estate.

The Sovereign Wealth Funds

Sovereign wealth funds have become important forces around the world in cross-border real estate investment. To date, China Investment Corporation (CIC) has historically been China's most active fund investor in cross-border real estate investment. Examples of early high profile CIC deals included, among others, a strategic investment of US\$800 million in a Morgan Stanley real estate fund and a position in the company that is the majority owner of London's Canary Wharf.

In the next phase of China's outbound real estate investment push, it is expected that both China's State Administration of Foreign Exchange (SAFE) and the National Social Security Fund (NSSF) will join the CIC as active players and will likely bring to the table substantial capital to deploy into global real estate.

The Real Estate Developers

China's policy response to an overheated domestic real estate market has been a mix of restrictive measures designed to cool the market and to gently deflate speculative bubbles. Chinese developers, finding it difficult to source domestic deals and get approvals, have started to look abroad for opportunities.

Broadly speaking, Chinese real estate developer investors looking outbound fall into two categories. The first is the entrepreneurial developer focusing primarily on residential development projects that are often, but not always, relatively small in scale. These developers see themselves as creating a product for their existing Chinese customers



albeit located in a foreign country.

A second category is the large established Chinese real estate developer. These players will more likely team up with a local player and complete projects through a joint venture. They recognize that it is necessary to work with a local partner who can help navigate complex governmental approvals, environmental reviews and labor issues to complete a large-scale project in a foreign country.

China's commercial real estate market is still relatively new in comparison to developed markets in North America and Europe. Forward looking Chinese real estate developers are completing deals in developed markets now because they desire to learn how real estate projects are developed, operated and marketed in developed markets in preparation for the next phase of the real estate market's growth in China.

Contractors and Debt Providers

Major Chinese building contractors like China State Construction Engineering Corporation and China Railway Construction Corporation Limited have completed large scale infrastructure and development projects around the world, from South America, to Africa to Southeast Asia. In the next phase of China's outbound real estate investment, we will likely see these contractors increasingly bidding for and winning major projects in developed real estate markets.

A key strategy of the Chinese building contractors is and will be to team up with Chinese banks. Their construction bid may come wrapped with a proposal for financing from a Chinese policy bank like the China Development Bank or the China Export-Import Bank. Select the building contractor on the deal and the Chinese bank will provide construction financing on very attractive terms. These deals are a win-win for all parties involved. China has a surplus of foreign currency reserves, so channeling these reserves into foreign real estate loans will help China earn more attractive returns. At the same time, the arrangements will help support the Chinese economy by enabling contractors to win major deals. Finally, the real estate developer and investor will benefit by receiving construction financing on attractive terms.

The Insurance Companies

In the next phase of outbound real estate investment from China, the universe of outbound real estate investors from China is set to expand significantly. One key emerging institutional player is likely to be Chinese insurance companies. Reforms in the regulatory framework governing where and how China's insurance companies can invest have

opened the door to outbound investment into real estate assets and into real estate private equity funds. For example, China's Ping An Insurance Group purchased the Lloyd's building in London for approximately US\$388 million. This deal marked the first major high-profile foreign real estate acquisition by a Chinese insurance company, but it is unlikely to be the last. Amid domestic reforms, these companies are now actively searching for income-producing, stabilized real estate assets around the globe.

The Private Equity Industry

China's relatively young but rapidly maturing private equity industry is expected to emerge as a participant in the next phase of outbound investment from China into real estate. China-based fund sponsors and managers will devise innovative products to channel funds into real estate. Regulatory hurdles and restrictions currently remain which make it difficult to easily aggregate RMB funds onshore in China to invest on a cross border basis. Consequently, the first wave of outbound China private equity fund investment in real estate will be US Dollar-denominated funds formed outside of China but largely funded by Chinese individuals or companies who have US Dollar resources located offshore from China. There are a number of examples of these types of funds which have already

successfully raised funds and closed deals.

The Journey Has Only Begun - What is Next?

There is a Chinese proverb that "a journey of a thousand miles begins with a single step". When it comes to outbound real estate investment from China, the journey has already begun, and far more than a single step has already been taken. Chinese financial institutions, investors, contractors and developers have embarked on the long journey around the globe in search of opportunities in real estate. In the next phase of outbound investment from China, the pace of investment activity will only quicken and market participants in developed markets in North America, Europe and elsewhere will meet many new travelers from the Middle Kingdom.

(Note: This article was contributed by Joel Rothstein, who is a partner with law firm of Paul Hastings LLP. He is the firm's longest serving attorney in Asia where he has played an instrumental role in the development of the firm's market leading Asia real estate practice.)

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