Chinese Institutional Investment in U.S. Real Estate Market

by

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Submitted to the Program in Real Estate Development in Conjunction with the Center for Real Estate in Partial Fulfillment of the Requirements for the Degree of Master of Science in Real Estate Development

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Abstract:

Followed by huge amounts of small real estate investments from wealthy Chinese individuals, large institutional investors, like well-known insurance companies and developers, also started to step into the U.S. real estate market to make large profit since 2013. Apparently, the strong economy and relatively steady real estate market are the major attractions for both individual and institutional investors all around the world; however, compared with individual investors who care more about return and immigration, Chinese institutional investors focus more from the strategic standpoint especially when the current U.S. real estate market has such relatively high price and possibly would face another round of depression within a few years.

This thesis will first look at all transaction details of large-scale real estate investments in major American cities to uncover the similarities and differences in terms of product types and geographic areas. And then, many reasons for the strong investment trend will be discussed on both macro- and micro-level. In addition, through interviews and literature reviews, specific real estate products, strategies, and investment methods will be discussed for each type of institutional investors. Finally, this thesis will compare Chinese institutional real estate investment nowadays with Japanese investors in the 1980s to find out the similarities and differences, and most importantly, what Chinese can learn from Japanese investors' failure and what is a good way to participate in the U.S. real estate market.

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Introduction:

As of March 2015, Chinese real estate buyers exceeded all other international buyers in terms of both dollar volume and units, and become the leading international buyer in U.S. real estate market. This is not surprising news, for decades, U.S. is always the top choice for wealthy individuals from China to invest, due to its stable economics and politics. Followed by these huge amounts of small real estate investment from wealthy individuals, large institutional investors, like well-known insurance companies and developers, also started to step into U.S. real estate market since 2013. Because of these investments from institutional investors, Chinese real estate investment in U.S. doubled in 2013. Apparently, strong economy and relatively steady real estate market are the major reasons to attract both individual and institutional investors around the world; however, compare with individual investors who cares more about return and immigration, Chinese institutional investors focus more from strategic standpoints especially when current U.S. real estate market is at such relatively high price and possibly would have to face another round of depression within a few years.

Purpose:

Because of the strong trend of Chinese institutional investment in U.S. real estate market, not only those who have already invested in U.S. market want to find out the best way to do deals, but also many others in China who have never invest in U.S. are interested in U.S. real estate market and want to get prepared for their first deal. In addition, many American real estate companies want to know more about Chinese investors, because of Chinese investors' strong financial background and the potential to attract more investors from China. So I think this topic will be a very interesting and helpful for both Chinese and American companies.

The major reasons this thesis is important are: first, after researching the existing way of large scale real estate investment, more and more institutional investors from China will gain confidence and experience to invest in the United States; second, by learning from Japanese, as we as other international institutional investors, the learning curve could be shorter and investors don't have to pay high "tuitions" when first entering U.S. market; third, this thesis could also help other international investors to expand to U.S. market, which can bring more liquidity and transparency to market and make it healthier.

This research has three components: First part will focus on current investment history, especially from 2013 to 2015, and try to find some investment preference in terms of property types and geographic areas; also I want to see the reasons why all investors start investing since beginning of 2013. Second part will

focus on current strategies that different investors used, as well as legal and tax regulations that investors should be noticed for investing in the U.S. market. Third part will focus on literature review about Japanese institutional investors' experience to find out why they failed, and similarities and differences between Japanese investors and Chinese investors in the U.S. real estate market.

Chapter 1: Current Investment Condition

Based on the real estate transaction data we received from Real Capital Analytics, there were 126 transactions, including residential, office, mixed-use, industrial, hotel, senior housing and retail properties, from May 2013 to May 2015. With accurate amount for 111 transactions, the total amount was $12,751,442,744. All these transactions were more than $1 million, which is considered as institutional investment level.

A. Investment by Investor Type

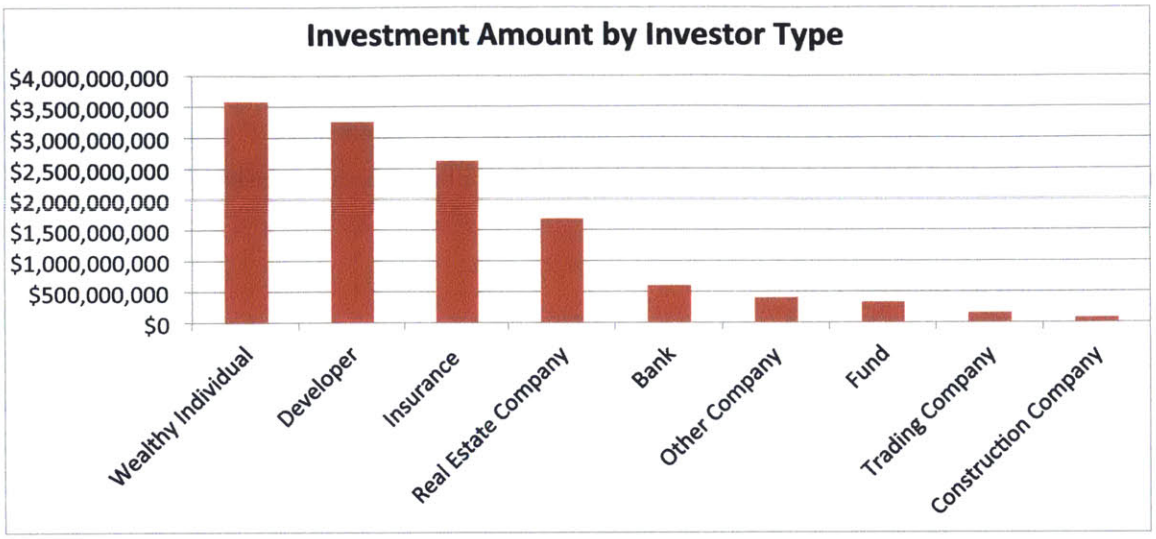
For all the Chinese institutional investors, they can broadly be classified into nine types: (1) real estate developers, (2) investment companies, (3) insurance companies, (4) real estate funds, (5) construction companies, (6) banks, (7) trading companies, (8) wealthy individuals, (9) and other companies.

A total of 75 companies are invested in these 126 transactions. Among these companies, there are 4 insurance companies, 25 real estate developers, 2 real estate funds, 9 wealthy individuals, 17 investment companies, 15 other companies, 1 construction company, 1 bank, and 1 trading company. As we can see, in terms of company numbers, real estate developers, investment companies, and other companies are the top three major institutional buyers from China.

In terms of deals, 10 transactions were closed by insurance companies, 35 by real estate developers, 12 by real estate funds, 9 by wealthy individuals, 25 by real estate companies, 25 by other companies, 1 by a construction company, 1 by a bank, and 7 by trading companies. So the top three investors are still real estate developers, investment companies, and other companies.

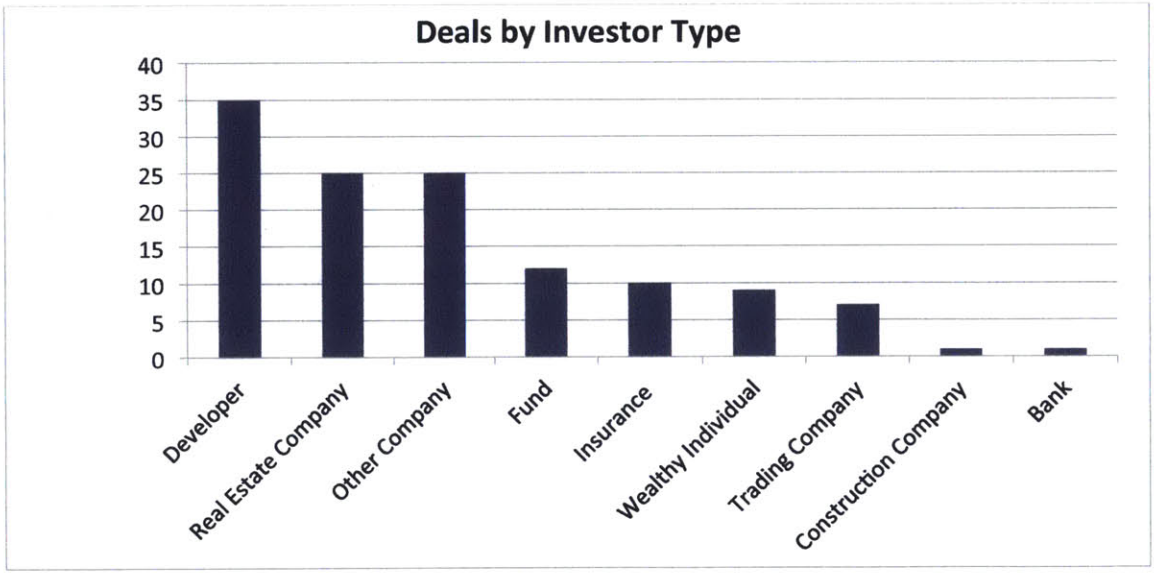
In terms of total price amount, the top four investors were real estate developers ($3.3 billion), wealthy individual ($3.6 billion), insurance companies ($2.6 billion), and investment companies ($1.7 billion). The total amount for other institutional investors were all less than $1 billion: $600 million from a bank, $402 million from other companies, $318 million from real estate funds, $155 million from trading companies, and $74 million from construction companies.

Exhibit 1. U.S. Real Estate Investment Amount from Different Chinese Investors 05/13-05/15



Data Source: RCA

Exhibit 2. U.S. Real Estate Investment Transactions by Different Chinese Investors 05/13-05/15



Data Source: RCA

a. Insurance Companies

Among the top institutional investors from China, insurance companies are the most famous ones in the U.S. real estate market. Because of their unique investment character, which focuses on stable cash flow

with the intention to hold the property for the long term, insurance companies prefer to acquire trophy assets.

Anbang Deal:

On October 6, 2014, Anbang Insurance Group, a comprehensive group of companies in the insurance business in China, announced a deal with Hilton Worldwide to purchase the Waldorf Astoria Hotel, a famous historic landmark building in Manhattan, New York. By February 15, 2015, the Waldorf Astoria Hotel deal was closed with a purchase price of $1.9 billion. This historic hotel was built in 1931, and it is a full-service property with 47 floors, 1,425 rooms, and 6,000 square meters of meeting space. The Anbang Insurance Group was surprised by all the media exposure that made its name famous all over the real estate world. Because this deal was the largest hotel deals ever in the United States. Beside a brand name, Anbang thought the Waldorf Hotel was perfect to satisfy its need to acquire good assets for a long-term and stable return. Also, Anbang thought great properties like the Waldorf Hotel would have good potential for price appreciation, especially after the U.S. real market recovered. For the Hilton Group, this deal helped it change from asset holding to asset management, because the Hilton Group will keep managing this hotel for at least 100 years based on agreement, which makes the group able to reinvest the sales revenue in other new properties and still have a stable cash flow through management fees.

b. Real Estate Developers

Even though Chinese real estate developers are not on the cover pages of newspapers, they play a significant role in U.S. real estate investment, especially in new real estate developments. Because the real estate market is shrinking in China, many developers are trying to survive through different strategies, such as expanding overseas. Given that local developers play differently in the United States, Chinese real estate developers have to learn how this market works for developers, so most of them come to the United States, not only for expanding their business but also for learning the market and more advanced management strategies.

Vanke deals:

As one of the largest residential developers in China, Vanke started its ventures in the United States by announcing a Joint Venture (JV) with Tishman Speyer, a leading U.S. developer, on February 18, 2013, to develop a luxury, mixed-use residential property located at Main and Folsom Street, San Francisco. Even without an accurate number, someone who knew the inside information mentioned that the total cost of the deal was $620 million, within which Vanke will invest $175 million, Tishman will bring in $75 million, and the rest will be debt financing. The previous president and CEO, Shi Wang, mentioned that

the JV with Tishman indicates the overseas expansion of Vanke and that Vanke will treat this first deal with Tishman for learning purposes. Vanke not only wants to learn about the U.S. real estate market but also the business models and advanced management experience. For Tishman Speyer, bringing in Vanke will help it raise enough capital as a money partner, and most importantly, by building a relationship with Vanke, Tishman can get help from Vanke for developments in China.

c. Investment Company

Not like insurance companies and developers, most investment companies come to the United States for the purpose of diversify their investment portfolio, due to the stable character of the U.S. real estate market and relatively less strict foreign investment regulations.

Fosun International Ltd Deal:

On October 18, 2013, Fosun International Ltd. announced the news that would purchase one of the landmark buildings in downtown Manhattan, One Chase Manhattan Plaza, the current JP Morgan headquarter at the purchase price of $725 million. Seems like this is a big investment even for company like Fosun International, however, the total area is about 220,000 square meters, so the average price is only about $3,500 per square meter, which is roughly about one-third of rent compared with other new-build class A office building in midtown Manhattan. The reason behind this is that one of the major tenants, the previous owner JP Morgan, will move to another new building in midtown, which will leave Fosun with 50%-60% vacant space, and this dropped the price tremendously. As part of the negotiations, JP Morgan agreed to stay in the building for two more years. The CEO of Fosun, Mr. Xinjun Liang, believes this deal is an opportunity more than a risk. He thinks because of this big tenant turnover, Fosun will get the chance to renovate the whole building, so it can catch up the rent level and make a profit, and the new World Trade Center buildings will bring up the rent of the surrounding areas.

B. Investment by Product Type

The major institutional investment property types include: Residential/Apartment buildings, hotels, offices, industrial buildings, and retail, and mixed-use properties. Different investors prefer different types of properties, and each property type has its own major market, which the following text will discuss in detail.

Residential/Apartment buildings:

For stabilized property, the total residential/apartment properties into which Chinese institutional investors invested cost $440 million or 3,412 units across the United States. In terms of units, Houston, Texas, with 2,880 units is definitely the hottest market, as its average occupancy rate is 95%. Second is Jacksonville, Florida, with 260 units and a 93% occupancy rate. Third is Manhattan, New York City, with 150 units and a 99% occupancy rate. In terms of gross investment amount, the rankings will change to Houston, Manhattan, and San Jose, due to the housing price differences. The housing price is highest in Manhattan at $633,967/unit on average, compared with the lowest, which is Houston at an average housing price of $97,904/unit.

For new residential property under development, the northwest area, which includes Washington and Oregon, has the highest development square footage (653,400). Orlando, Florida, and Phoenix, Arizona, has relatively large amount of residential property developments funded by Chinese institutional investors.

Exhibit 3. Data Summary for Chinese Investments in U.S. Apartments

	Market	Number of Units	Price/Unit	Occupancy	Cap Rate	Price
Apartment	Houston	2880	97,904	95%	6.2%	$255,400,000
	Manhattan	150	633,967	99%	4.6%	$110,500,000
	San Jose	90	405,556	N/A	4.8%	$36,500,000
	Jacksonville	260	128,000	93%	N/A	$33,280,000
	Detroit	15	176,333	100%	N/A	$2,645,000
	Westchester	17	115,453	N/A	N/A	$1,962,695
	Total	3412				$440,287,695

Data Source: RCA

Hotels:

In terms of the number of hotel rooms invested, Los Angeles, California, with 2,705 units is at the top of the list, followed by Manhattan with 1,608 units. The total hotel investment amount is $2,217 million in Manhattan and $447 million in Los Angeles, due to the Waldorf Astoria Hotel deal. Also, because of this deal, the average hotel room price in Manhattan is also the highest, at about $1.3 million/room. Beside these two cities, hotel investments are basically spread into secondary segment market like Atlanta, East Bay, and Denver.

Exhibit 4. Data Summary for Chinese Investments in U.S. Hotels

	Market	Number of Units	Price/Unit	Occupancy	Cap Rate	Price
Hotel	Manhattan	1608	1,312,272	N/A	4.1%	2,217,500,000
	Los Angeles	2705	216,907	79%	5.2%	447,193,333
	Houston	297	219,192	N/A	N/A	65,100,000
	East Bay	387	115,762	N/A	9.0%	44,800,000
	Atlanta	494	55,916	79%	6.3%	27,823,000
	Denver	263	99,335	N/A	N/A	26,125,000
	Wilmington	217	108,410	N/A	N/A	23,525,000
	Orange Co	224	102,679	83%	7.6%	23,000,000
	Long Island	209	101,675	N/A	N/A	21,250,000
	Philadelphia	183	76,609	N/A	N/A	14,019,461
	Detroit	226	45,133	68%	7.2%	10,200,000
		6813				2,920,535,794

Data Source: RCA

Offices:

The total Chinese intuitional investment is $6.4 billion, and this accounts for more than 8.9 million square feet. For stabilized office buildings, Manhattan, Chicago, and San Francisco are the top three cities in total square footage, at 5,295 million, 1,501 million, and 593 million, respectively. In addition, investors also chose Los Angeles, Houston, Detroit, and San Jose as the target office markets. In terms of investment amount, Manhattan's $5.4 billion total investment is about 14 times higher than Chicago's $336million investment. For occupancy rate, the highest is in San Francisco (95%), and the lowest is in Detroit. For new development, San Francisco is the only city investors are interested in, and the total is 706,543 square feet.

Exhibit 5. Data Summary for Chinese Investments in U.S. Offices

	Market	Number of Units	Price/Unit	Occupancy	Cap Rate	Price
Office	Manhattan	5,295,995	1,055	80%	4.9%	5,415,500,000
	San Francisco	593,664	567	95%	4.3%	369,000,000
	Chicago	1,501,415	194	90%	6.5%	336,550,000

	Houston	336,561	297	N/A	N/A	100,000,000
	Los Angeles	202,873	286	94%	5.0%	58,400,000
	Orange Co	173,624	202	43%	N/A	31,868,000
	San Jose	206,367	143	92%	6.5%	29,022,500
	Seattle	58,738	341	94%	5.9%	17,900,000
	Detroit	511,808	29	15%	N/A	13,600,000
	Charlotte	57,416	166	N/A	N/A	9,518,333
	Total	8,938,461				6,381,358,833

Data Source: RCA

Retail:

Compared with offices and hotels, Chinese investors are not really focused on the U.S. retail market, as the total investment is only $683 million, and the total area is about 949,173 in square feet. Los Angeles is highest in terms of both total investment and square footage. Beside LA, Manhattan has substantial amount of investment from Chinese institutional investors.

Exhibit 6. Data Summary for Chinese Investments in U.S. Retail

	Market	Number of Units	Price/Unit	Occupancy	Cap Rate	Price
Retail	Los Angeles	450,272	723	83%	6.8%	440,695,000
	Manhattan	95,402	1,455	100%	N/A	118,632,000
	Seattle	44,346	1,038	N/A	N/A	49,800,000
	All Others - GA, NC, SC, TN, KY	111,237	192	N/A	N/A	21,400,000
	Kansas City	130,000	135	97%	N/A	17,600,000
	San Francisco	40,243	263	N/A	N/A	10,600,000
	San Diego	11,900	678	100%	N/A	8,072,500
	East Bay	43,680	179	N/A	N/A	7,800,000
	Orange Co	19,402	394	95%	4.8%	7,640,000
	Westchester	2,691	348	N/A	N/A	937,302
	Total	949,173				683,176,802

Data Source: RCA

Industrial:

Unlike other types of property, industrial real estate is usually located in smaller cities due to the cheaper land prices and supply chain purposes. For a mature property, the total investment is $164 million, or 6,701,793 square feet. So the city with highest industrial property square footage is Wilmington, Delaware, and the price is only $6/sq. ft. In terms of investment amount, Inland Empire, California, with $43.5 million is at the top of the list. Of course, not every industrial property is as cheap as $6/sq. ft., as the average price of property at Los Angeles is $581/sq. ft.

In addition to stabilized property, some new developers in Charlotte, North Carolina, will add a tremendous amount of square footages. The property developed by Keer Group will add up more than 18 million square feet once it's finished, and this will triple the total area for industrial property.

Exhibit 7. Data Summary for Chinese Investments in U.S. Industrial Properties

	Market	Number of Units (sq. ft.)	Price/Unit	Occupancy	Cap Rate	Price
Industrial	Inland Empire	605,000	72	N/A	N/A	43,500,000
	Orange Co	106,000	268	N/A	N/A	28,400,000
	Los Angeles	44,769	581	N/A	N/A	26,000,000
	Wilmington	3,200,000	6	N/A	N/A	18,000,000
	Dayton	1,400,000	11	N/A	N/A	15,000,000
	Chicago	230,104	66	100%	N/A	13,497,500
	Nashville	281,220	35	100%	N/A	9,900,000
	All Others - MI, WI	562,530	14	N/A	N/A	8,000,000
	All Others - DE, MD, VA, WV	272,170	9	N/A	N/A	2,550,000
	Total	6,701,793				164,847,500

Data Source: RCA

C. Investment by Geographic Area

a. NYC Manhattan Area

There is no doubt that Manhattan is the top choice for Chinese institutional investors. In terms of transaction amount, all top five deals are in Manhattan and seven of the top 10 deals there as well.

In summary, the total investment is around $8.6 billon, which includes $743 million in apartments/condominiums, $2.2 billion in hotels, $5.4 billion in offices, and $198 million of retail spaces. These investments total of 74,454 units of apartments, 1608 units of hotel rooms, 5.3 million square feet of offices, and 105,946 square feet of retail space. Given these numbers, investors prefer hotels and offices in Manhattan.

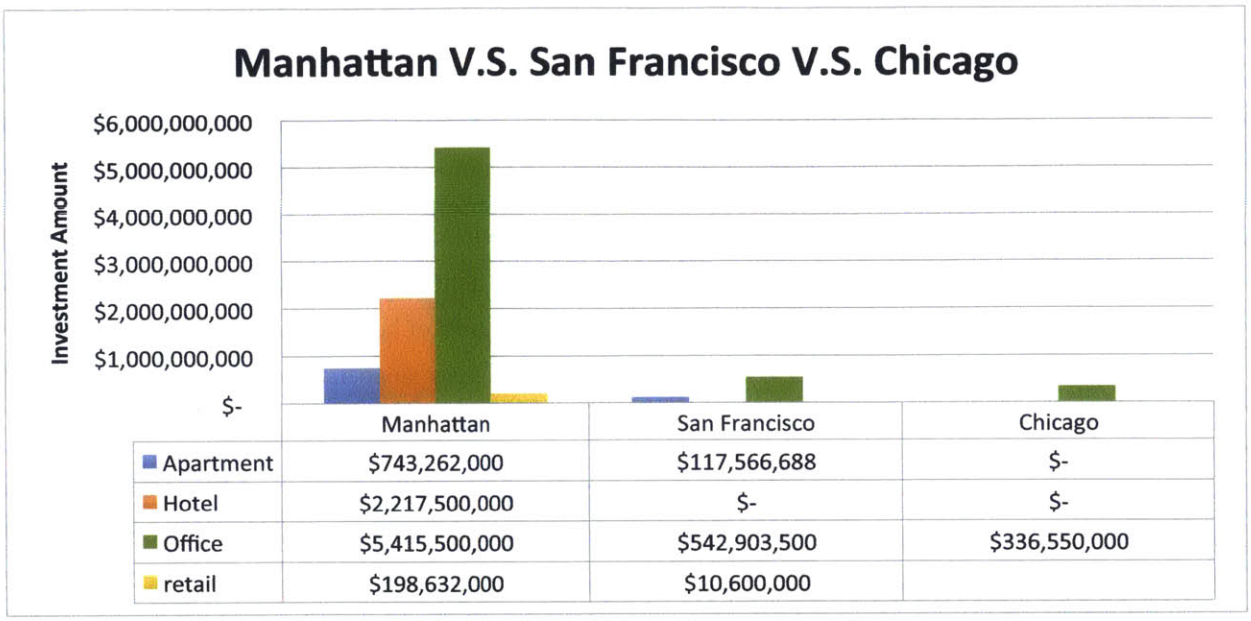
Under current market conditions: for apartments/condos, the average cap rate is 5.0% and the average occupancy rate is 97.2%. Other comparable numbers are class A offices (4.6% and 91.3%), hotels (7.4% and N/A), and retail (5.09% and 97.5%). Compared with the average for Chinese investors, residential prices are very close to market; however, neither offices nor hotels reached average market price level probably because they are less liquid markets and need more insider information to find a good deal.

b. San Francisco/San Jose Area

The second most popular area is the San Francisco/San Jose area. The total investment is $569 million, including $36.5 million for apartments, $522 million for offices, and $10.6 million for retail spaces. Compare with Manhattan, Chinese institutional investors only invested in 90 units of apartments, 1.6 million square feet of offices, and 40,243 square feet of retail spaces. So investors prefer offices and apartment buildings in San Francisco.

Based on market research data from the CoStar report in 2014, the San Francisco market has the following average cap rate and occupancy rates: apartments (5.3% and 96.9%); Class A offices (5.07% and 91.8%); and retail (4.67% and 97.7%). Compared with these Chinese deals, on average, apartment transactions are better than market average, and office prices are higher due to higher occupancy rates at purchasing. Due to a lack of data, this thesis cannot compare hotel and retail deals.

Exhibit 8. Chinese Investment Comparison among Manhattan, San Francisco, and Chicago



	Manhattan	San Francisco	Chicago
Apartment	$743,262,000	$117,566,688	$-
Hotel	$2,217,500,000	$-	$-
Office	$5,415,500,000	$542,903,500	$336,550,000
retail	$198,632,000	$10,600,000	

Data Source: RCA

Chapter 2: Reasons behind the Force

Although recent years are not the first time Chinese institutional investors invested in overseas real estate markets, 2013 was the first year that major institutional real estate investors chose to invest on such a large scale. Based on data from Colliers International, Chinese overseas real estate investment kept climbing, from $69 million in 2008 to $16 billion in 2013. Apparently, many reasons caused such huge jump, and it is crucial to find out these reasons to help both Chinese and U.S. real estate market players understand the trends and predict the future. In general, this thesis will focus both macro- and micro-level reasons that drove this huge investment trend.

1. Macro-Level Forces

From macro-level standpoint, current macroeconomic conditions in China, Chinese government regulation stimulation, and U.S. real estate market condition are the major forces.

a. Macroeconomic conditions in China

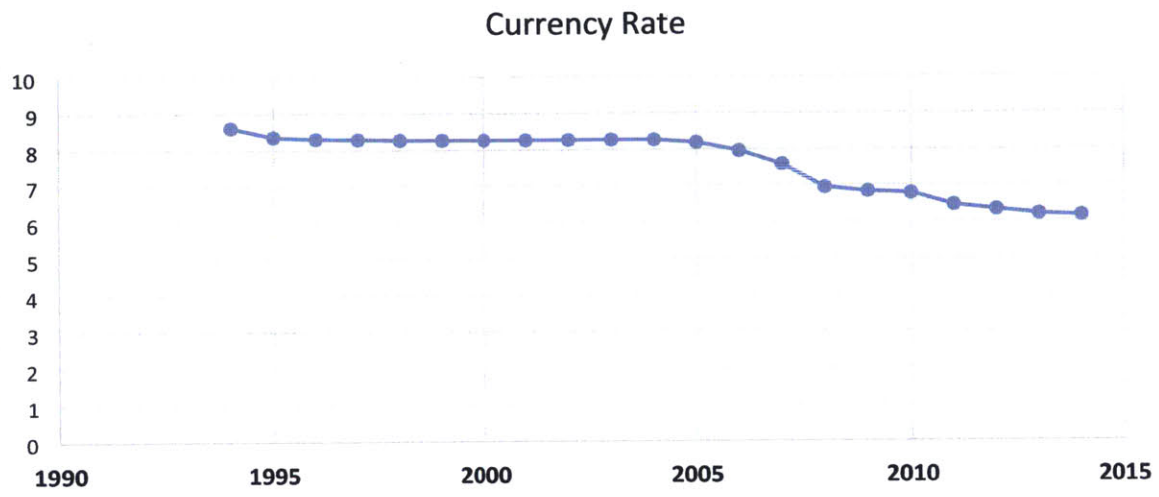
As Chinese GDP growth rate slowed down in the past few years, from 12.1% year on year in 2010 to just 7.3% in 2014, more and more Chinese companies stared to worry about domestic economic conditions. For the sector, which contributed about 16% of GDP, real estate became more vulnerable due to the economic slow down.

First, due to the nature of Chinese real estate market, which is a policy-driven instead of market-driven factor, real estate investors have strong feelings about risk and uncertainty, especially in the market downturn in China. After the housing purchase restrictions and financial contraction issued in 2010, the Chinese real estate market was strongly affected, and domestic housing demand dropped tremendously. Based on a research report from Knight Frank about Chinese housing prices, as of September 2014, total residential sales by value dropped 10.8% year on year. On one side, government control limited the demand for top-tier cities like Beijing, Shanghai, and Shenzhen, and, on the other side, market was oversupplied in second- and third-tier cities due to over-development. The vacant residential floor space has increased by more than 80% since 2010, which caused real estate price drop. Under current market conditions, both real estate developers and real estate investors had a hard time using their old strategies to play in the new Chinese market, which pushed them to try new ways to survive, and oversea real estate investment became one of their viable options.

Second, financial cost and return became off-balanced in the Chinese real estate market. Even though it was not a problem to get loan with a low interest rate for most government-owned real estate developers, it was one of the major issues for privately owned developers. As the major source of financing, construction loans became harder to get due to contraction policy influence, even developers that got loans, saw high interest rates eat up their returns. In addition, the other source of financing, the bond market, wasn't good either. Based on Goldman Sachs, even though the bond prices of Chinese developers bounced back a little from severe market dumping, the bonds still had the highest risk and were not recommended to buyers. So in both the bank loan and public debt markets, real estate developers had to pay high financing costs. For real estate investors, like insurance companies, it became harder and harder to find good long-term real estate asset with secured and stabilized cash flow return. From research reports on commercial real estate, the average annual return was between 3% and 6%, and these numbers were even lower for major commercial properties within downtown areas in top-tier cities.

Third, the currency rate benefit encouraged overseas investment. For the past 20 years, the U.S. dollar to Chinese Yuan rate kept decreasing. Based on data from People's Bank of China, the central bank of China, the currency rate could roughly be split into three phases. The first phase was from 1994 to 2005, when the currency rate stayed above 8.0, and Chinese economy was dominated by exporting. The second phase was from 2006 to 2010, when the currency rate dropped from above 8.0 to lower than 6.8, around a 17.36% drop, and Chinese economy grew tremendously during this period. The third phase was from 2011 to the present, as the currency rate dropped below 6.5 and stayed around 6.2. Since "Made in China" became more and more expensive, the Chinese economy was facing strong pressure from product exporting, but this was the perfect time for capital exporting. Due to the low currency rate, not only the U.S. products became cheaper but U.S. assets also became cheaper for Chinese investors. In 2013 and 2014, with the lowest currency rate level in the past 20 years, this turned out to be the perfect time to invest overseas real estate market.

Exhibit 9. Chinese V.S. U.S. Currency Rates 1994-2014



Data Source: Board of Governors of the Federal Reserve System

b. Chinese Government Regulation

For most of these times, Chinese institutional overseas investment was directly affected by Chinese government regulations. For the past 20 years, government regulations became looser and looser, especially from 2009. For the first time, Chinese government mentioned a "Going Out" strategy in the proposal of the 10th Five-Year Plan of China on October 2000, and many new regulations were issued to encourage Chinese businesses to invest abroad.

1. National Development and Reform Commission:

The National Development and Reform Commission issued the Temporary Administrative Measures for Authorization of Outbound Investment Project in 2004, which canceled the requirement for approval and replaced it by verification. This regulatory change helped to set up the basic format for operating the government's strategy.

However, the real effect of this "Going Out" strategy came after a new regulation were issued by the Ministry of Commerce in 2009. This regulation not only simplified the verification process but also passed the verification right to local government. So province level commerce department can decide most of the outbound direct investments. Since then, most companies started to think seriously about overseas investment.

As of September 6, 2014, the Ministry of Commerce issued another new regulation, the Administrative Measures for Verification and Filing of Outbound Investment Projects, and this regulation replaced the old 2009 regulation. The new regulation no longer required National Development and Reform Commission (NDRC) approval for overseas investment projects below $1 billion, and only needed to register with them or local government agencies. For central government-owned or local government-owned enterprises, if the investment amount exceeded $300 million, they needed to register with NDRC; if the amount was below $300 million, they only needed to register with local governments.

2. State Administration of Foreign Exchange:

On May 12, 2014, State Administration of Foreign Exchange (SAFE) released the SAFE Circular Concerning the Issuance of Provisions on Foreign Exchange Management of Cross-border Guarantees for the purpose of "deepening the reform of the foreign exchange management system, advancing convertibility under the capital account in an orderly manner, and regulating receipt and payment activities under cross-border guarantees."

Based on SAFE news, the new regulation mainly focuses on five areas. First, SAFE reformed the foreign exchange management modes to streamline administration and delegate power to lower levels. The approval process had been cancelled or simplified. Second, they standardized the process of foreign exchange management of cross-border guarantees, so the scope of management was rationally defined matched with objectives and responsibility. Third, SAFE would start to treat Chinese- and foreign-invested enterprises equally. Forth, the management concept for risk prevention was strengthened through off-site verification and foreign exchange inspection. Fifth, laws and regulations was cleared up and consolidated to enhance transparency. This new SAFE provision was implemented as of June 1, 2014.

However, the new provision kept the old rules that debtors could not transfer the money back from overseas through inbound lending, equity investment, or bond investment, unless this had been approved by SAFE. Otherwise, the penalty charge would be up to 100% of funds transferred.

This provision unquestionably opened another door for financing large-scale real estate deals in the United States, as the cross-border guarantees neither need SAFE approval nor have certain restriction requirements. So all of these new rules made overseas investment easier and more flexible.

3. Shanghai Pilot Free Trade Zone:

On May 22, 2014, People's Bank of China announced the provision of a Free Trade Account for companies within the Shanghai Pilot Free Trade Zone. This account was established to make the process of cross-border money transfers easier for both domestic and foreign firms. Currently, there are five banks

offering free trade accounts for companies in the Free Trade Zone: Bank of China, Industrial and Commercial Bank of China, China Construction Bank, Shanghai Pudong Development Bank, and Bank of Shanghai. By setting up this Free Trade Account, companies can not only benefit from lower offshore exchange rates when investing in an overseas project but also make the investment process smoother.

4. Qianhai Pilot Free Trade Zone:

As two of the most famous overseas investment programs, Qualified Domestic Individual Investor (QDII) and Qualified Domestic Investment Enterprise (QDIE) registered within the Qianhai Free Trade Zone recently encouraged both individuals and companies to make overseas investments. For QDII, it would invalidate the $50,000 foreign exchange cap for Chinese individuals to invest in foreign stocks, bonds, and other public investment vehicles. For QDIE, it extended the allowance to include hedge funds, some non-public companies' stock, and real estate, and allowed financial institutions, like real estate funds, to invest directly in overseas markets.

c. U.S. real estate market conditions

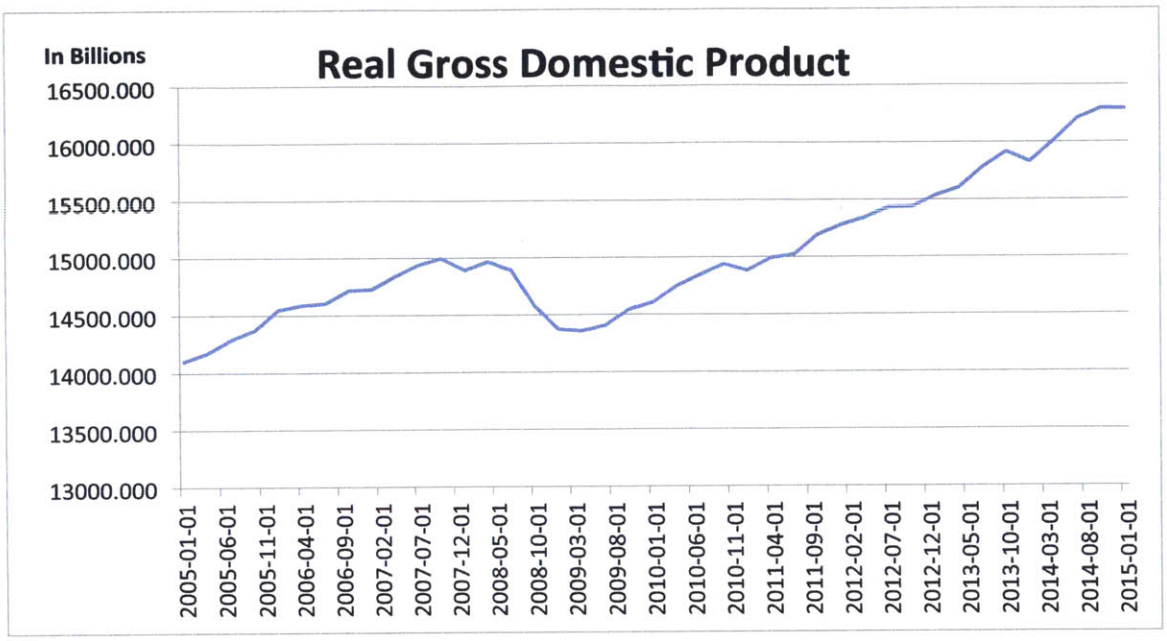
After 2008, U.S. economy started to recover, and most investors started to get their confidence back from the depression. Due to the lagging character of real estate compared with the stock market, the year that real estate really started to pick up was 2012. In this section, the thesis will focus on U.S. real GDP levels, the housing prices, mortgage rates, and unemployment rates to explore the economic reasons why it is a perfect time to invest in U.S. real estate market.

A real GDP level relates to all real estate product types, and if the overall U.S. GDP grows, the real estate market will also grows, in general. For housing prices and mortgage rates, they all directly affect residential markets. If housing prices or mortgage interest rates increase, demand for residential property drops. Unemployment rates will directly affect office and retail markets. When unemployment rates rise, companies will no longer need that much office space; in addition, consumers will spend less on purchasing merchants products, which will indirectly affect retail investment returns because part of rents is calculated as a certain percentage of store sales.

The U.S. Real GDP:

The basic index to reflect the U.S. economy is GDP level, and after subtracting inflation, the real GDP level will be a more accurate reflection of the U.S. economy. As we can see from Exhibit10, for the past 10 years, the overall trend was growth and the economy recovering to the same level in 2011 as before the 2008 depression, and it didn't stop rising after that. Even the average real GDP grow rate was lower than 1% after 2008, yet people still had confidence in the U.S. economy.

Exhibit 10. U.S. Real GDP 01/01/2015 - 01/01/2015



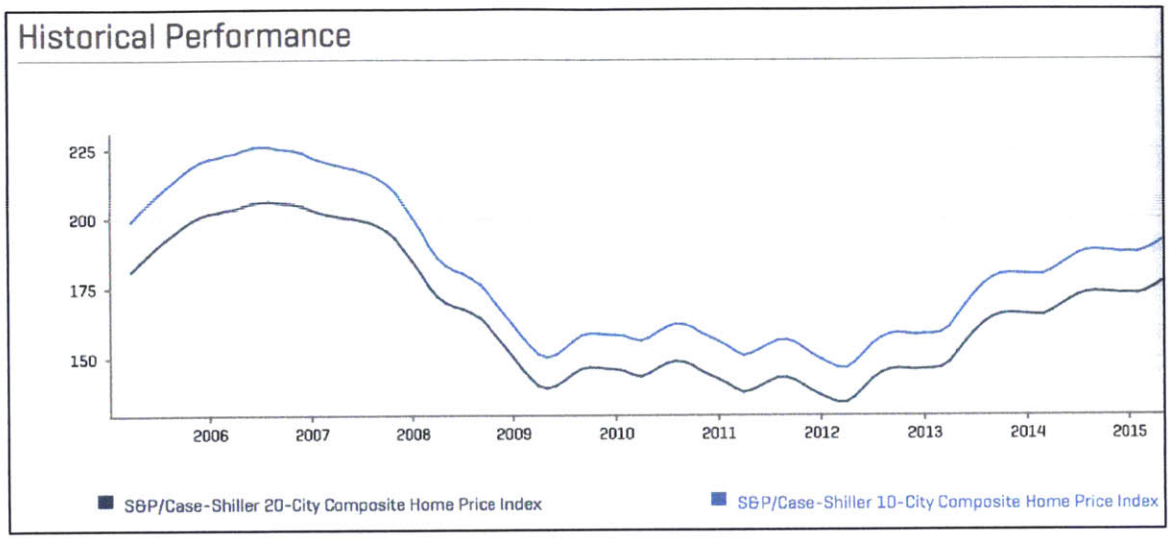
Data Source: Federal Reserve Economic Data

Housing Prices:

Based on Nobel Prize winner Robert J Shiller's housing price index, from 2005 to 2015, the U.S. national home prices reached their highest level in 2007, and then started to drop to the bottom in 2012. From there, U.S. housing price started to climb very quickly, especially in 2012 (6.48%) and 2013 (10.75%). So from both investor and homebuyer standpoints, 2012 and 2013 were the best time to enter the market.

The S&P/Case-Shiller U.S. National Home Price Index is a composite of single-family home price index covering nine U.S. census divisions, and economists Karl Case, Robert Shiller, and Allan Weiss created it.

Exhibit 11. The S&P/Case-Shiller U.S. National Home Price Index 2005-2015



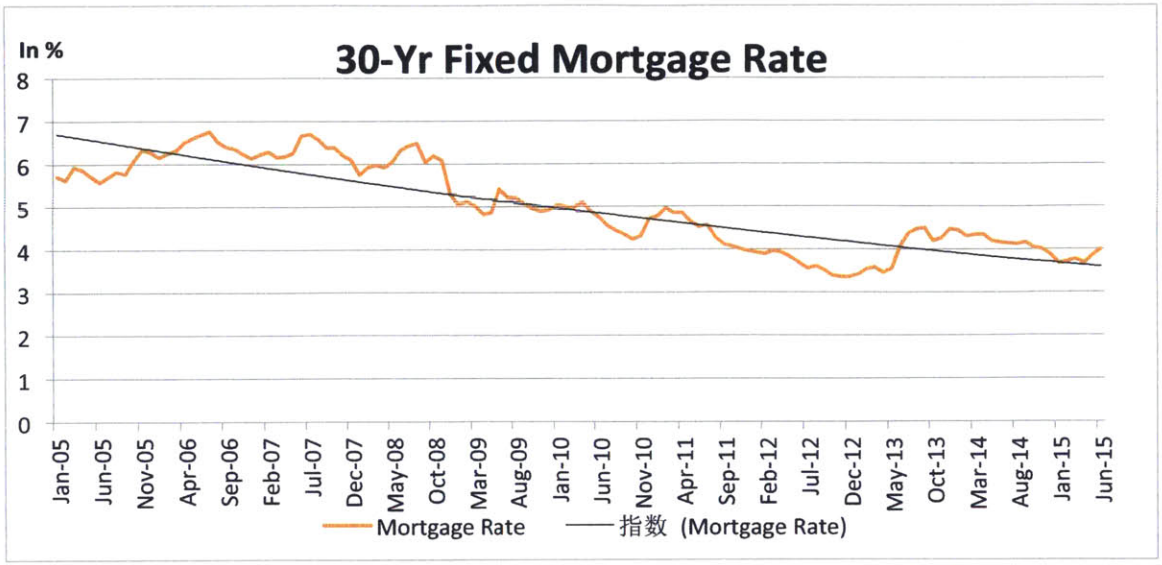
Data Source: S&P Dow Jones Indices

Mortgage Interest Rates:

For the past 10 years, the general trend for 30-year fixed mortgage interest rate was fell from a high of 6.76% on July 2006 to a low of 3.35% in November and December 2012. As most U.S. real estate investment deals like to use a mortgage to leverage their equity return, lower mortgage interest rates definitely decrease their overall cost of money so they can get a higher return.

Even though Chinese institutional investors may or may not use as much of debt as U.S. investors, low mortgage interest rates would definitely bring in extra consumer demand, as well as boost investor confidence. Also, if we look back since the 1970's, the interest in 2012 was the lowest in the history; so many investors want to take advantage of this just in case the mortgage rates climb again.

Exhibit 12. U.S. Mortgage Interest Rate 01/2005-06/2015

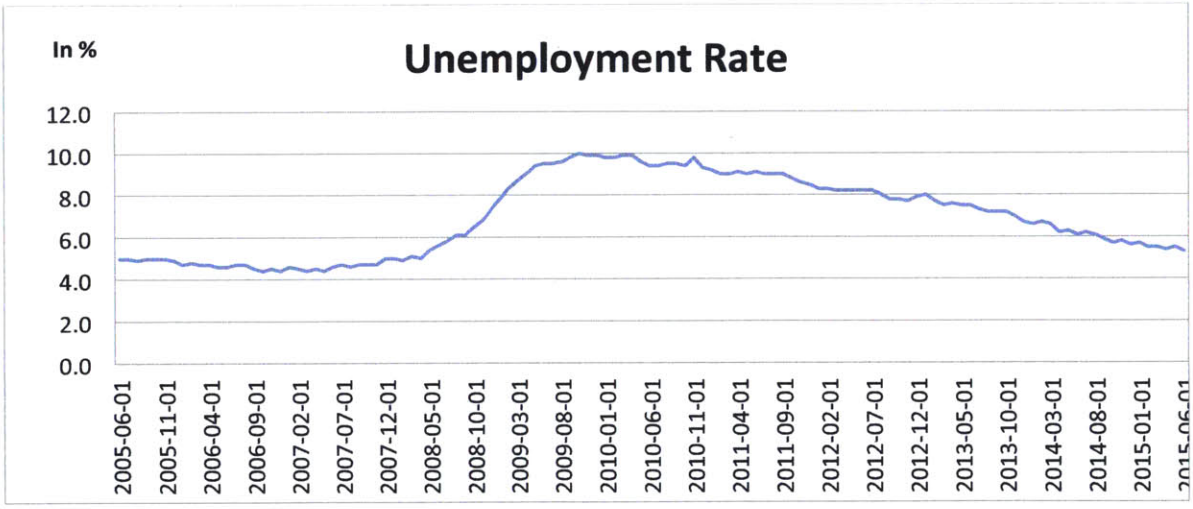


Data Source: Federal Reserve Economic Data

Unemployment Rate:

The unemployment rate kept decreasing after 2009 from around 9% to 5%, and then showed a good economic recovery for six years. As mentioned previously, as unemployment decreased, the demand for office space and retail space increased.

Exhibit 13. U.S. Unemployment Rate 06/01/2005-06/01/2015



Data Source: Federal Reserve Economic Data

2. Micro-Level Forces

In addition to economic conditions, most companies have more specific reasons to invest overseas. In general, Chinese institutional investors have four micro-level reasons: expansion of the market, investment diversification, learning from expertise, and looking for investment return.

a. Expansion of the Market

For many Chinese institutional investors, especially large real estate developers, the strategically expanding international market is one of the most important reasons they chose to invest in the U.S. real estate market. First, investing in the United States could satisfy the need of domestic customers. Second, by investing in landmarks in big cities, investors can build up their reputation. Third, after expanding into the U.S. real estate market, Chinese investors gained access to U.S. capital market in which investors can get lower financing cost.

Domestic Consumers' Needs:

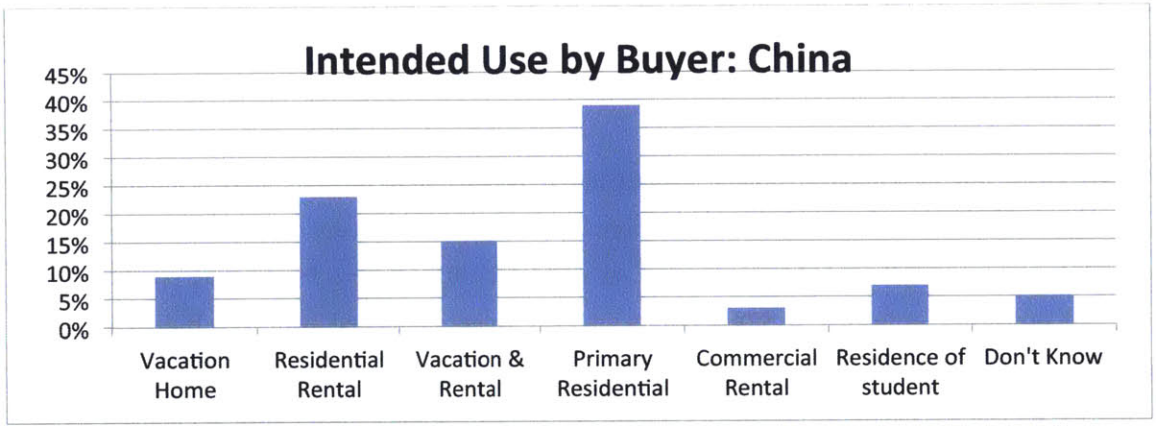
In recent years, due to economic growth, many Chinese people chose to study abroad, immigrate, and travel to the United States, and all of these promoted demand for residential houses. Based on the National Association of Realtors' annual report, as of March 2015, buyers from China purchased U.S. residential properties estimated at $28.6 billion in total value, compared with $22 billion last year. Chinese buyers accounted for about 28% of total international house transactions by dollar amount. From Exhibit 13, we can see that more and more Chinese people came to the United States to purchase houses, and starting from 2013, the annual volume of purchase numbers increased tremendously.

Exhibit 14. Volume of U.S. Housing Purchases by Chinese 2009-2015

Data Source: National Association of Realtors

For all houses purchased, a major part (39%) is for primary residence purpose, and the other intended uses include vacation home, residential rental, and vacation rental. Because of this huge demand for residential housing in the United State from Chinese buyers, many Chinese institutional investors also want to take this opportunity. Many of them would either develop new residential houses or purchase existing ones. In addition, a large percent of Chinese house buyers (69%) pay everything by cash and never use any loans. This also attracts investors due to a high investment turnover rate.

Exhibit 15. Intended Use of U.S. Housing Purchase by Chinese Buyer



Data Source: National Association of Realtors

Build Reputation:

For institutional investors who invested in United States, for the first time, many of them would consider the purpose as being their brand name as international company in China. For residential developers, since they understand Chinese buyers' preferences better than regular U.S. developers, many people would love to buy houses from Chinese developers. Mr. Shi Wang, the president of Vanke, the largest Chinese residential developer, mentioned that many his clients asked them when Vanke would expand to United States and those clients would love to buy from Vanke because they trust the brand and its quality. By building internationally, developers' reputation is strengthened in China, and let overseas customers learn about their brands. So in the future, they could do business internationally easier if their names are already known in United States.

Access international capital markets:

As mentioned previously, compared to China, the construction loan rate was much lower in the United States. Moreover, the required return on equity investment was also lower in the United Sates. By expanding into U.S. real estate market, developers and investors can build up financing channels through their U.S. subsidiary companies. This would help Chinese institutional investors lower their overall financing cost.

b. Investment diversification

As part of modern finance theory, investment risk is always the biggest concern for investment. "Don't' put all of your eggs in one basket," or investment diversification, is the best way to reduce risk. Using modern portfolio allocation methods, different investment vehicles have different risks and different correlation with other investments, so by putting different types of investments together with certain ratios, total investment risk could be reduced to systematic risk, because the systematic market risk cannot be avoided. By doing this, one investment's loss could be absorbed by another investment's gain.

Because real estate has the characteristics of both the economy and virtual economy, it has the ability to hedge against inflation, which becomes more important for portfolio allocation. Actually, many researchers sought to find out the benefit of real estate diversification, and they found that not only did different real estate product diversification reduce nonsystematic risk but also real estate diversification by geographic area reduced risk dramatically.

Based on Piet. M. A. Eichholtz's research in 1996, international diversification works better for property shares (REITs) than it does for stocks and for bonds because the correlations among property shares in different countries are lower than common stock or bond returns. Also, because property shares have the character of both stock and real estate markets, and because the correlation between common stocks is higher than for property stock, the correlation between international direct real estate investment returns should be even lower than for property shares. So Eichholts concluded that international diversification works better for real estate than it does for stocks.

c. Learning from Expertise

On February 18, 2013, Vanke signed an agreement with Tishman Speyers to develop the luxury mixed-use residential property located on Main and Folsom Street in San Francisco. At the announcement, Shi Wang, the president of Vanke, pointed out that Vanke is always trying to learn from industry leaders and this cooperation with Tishman Speyers was for the purpose of learning. He hoped that Vanke could learn

more about the U.S. real estate business model as well as advanced management experience through this partnership cooperation.

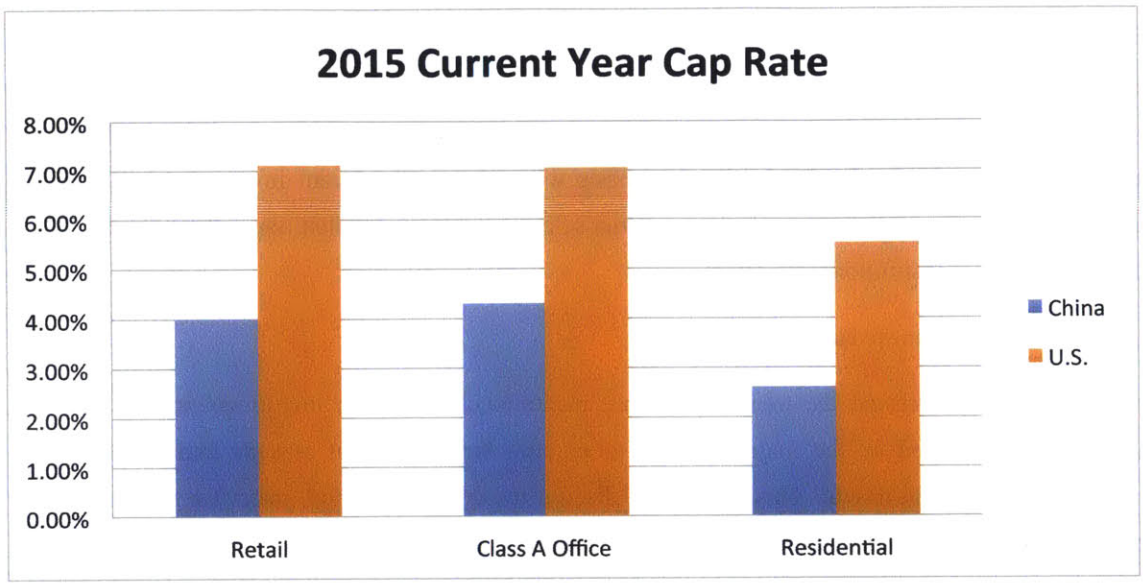
Actually, not just Vanke, but most Chinese real estate developers come to the United States with the purpose of learning from U.S. real estate developers about their business model. In 2002, Mr. Lun Feng, the president of Vantone Real Estate, had pointed out that Chinese real estate developers needed to transfer from the Hong Kong business model to the U.S. business model due to the excessive dependence of bank loans, as too much debt is too risky for developers, especially in an economic downturn. In the United States, much less financing is from Bank, and more financing is from the public, which includes pension funds, insurance companies, REITs, and other real estate funds. So in this way, real estate investment is actually a long-term investment in the United States. However, the one in China is currently short term because developers need to turn the property quickly to avoid risk.

One of the typical U.S. real estate models that Chinese developers wanted to learn is the Asset-Light model, in which real estate developers sold the ownership of the real estate to either a real estate fund or to a Real Estate Investment Trust (REITs), while the company maintained a certain degree of control on entering a long-term agreement to manage the property. In this way, a heavy real estate asset could be moved off the balance sheet, and developers could quickly cash out for next development project. For their part, developers can still control the quality of property through their management.

d. Looking for High Operating Return

Due to the emerging market characteristics, the overall IRR of real estate investment return was higher in China than in the United States because asset appreciation was much lower for a mature real estate market. However, other important components, such as operating return, or current year cap rate, was higher in the United States for all real estate product types (Exhibit 14). Because of this characteristic of U.S. real estate returns, Chinese institutional investors who are looking for stable high annual operating return, like an insurance company, will have a strong interest in the U.S. real estate market.

Exhibit 16. 2015 Cap Rate Comparison between China and United States



Data Sources: Yunfang Data and Integra Realty Resources

In addition to taking advantage of the U.S. economy recovery, many Chinese institutional investors came to United States to buy real estate at the bottom level. This investment strategy may work in 2012 and 2013, but as real estate price keep increasing, value appreciation may not work as good as before.

Chapter 3: Investment Pattern and Strategy

Because of the outbound direct investment trend and strong incentives, many Chinese institutional investors want to invest in U.S. real estate. However, due to a lack of knowledge and experience, only a few of them actually invest in the United States and the majority of investors are still watching and learning from first-movers. In Chapter 3, this thesis will discuss the current investment patterns and strategies related to finance, project selection, partner selection, and localization issues through interviews with leading Chinese institutional investors.

A. Interview with Chinese Investors

In order to better understand the trend of Chinese institutional real estate investment in U.S. market, interviews were selected as the major method to explore the investment reasons and strategies for outbound real estate investment. This thesis will discuss the detailed method, interview questions, and investors' answers to help us find out their investment patterns and strategies.

a. Interview Method

Because most Chinese institutional investors are still at early stage of real estate investment circle, it is still hard to judge whether their investment strategies are correct. Also, because these investors are still trying out different strategies based on their own knowledge and experience, most investors require confidentiality and all answers are for academic purpose only.

1. Interviewee Selection: Due to Chinese institutional investors belong to different investor types (real estate developers, investment companies, real estate funds, and insurance companies), only one or two company of each type was selected as representative to conduct interviews. This way, every category could be covered for this research. All the interviewees from each target company were at least director level to guarantee the quality of answers.
2. Interview Question: Open-ended interview questions were used rather than multiple choice questions because: (1) limited sample size of investors who want to share their information, (2) through open-ended questions, interviewees would like to talk more not only about their own firm but also similar firms, (3) interviewees can lead the interview discussion without been affected by multiple choice questions.
3. Interview process: Most interviews were done in person at United States, and a few of them were done through emails and phone interviews. Typical interviews took 20-30 minutes.

b. Interview Questions

The following interview questions were prepared, but not all of them were asked during interview process.

1. Why did your company want to invest in U.S. real estate market?
2. What real estate products do your company interested in?
3. How did your company finance the past deals?
4. How did your company get project information?
5. How did your company select joint venture partners?
6. What localization strategies did your company use?
7. What is your long-term investment goal in the United State?

B. Financing Strategy

One of the biggest concerns for overseas real estate investment is how to get faster and cheaper financing to support real estate projects. Investors not only need to face Chinese government regulations from domestic financing, but also have to face the high interest rate due to lack of credibility in U.S. capital market for oversea financing. This section will discuss different financing strategies including oversea bonds, bank loans, and cross-border guarantees, QDII (Qualified Domestic Institutional Investor) and QDIE (Qualified Domestic Institutional Enterprise), and EB-5. Exhibit 15 shows the interview results for their financing methods.

Exhibit 17. Financing Sources for Different Investors

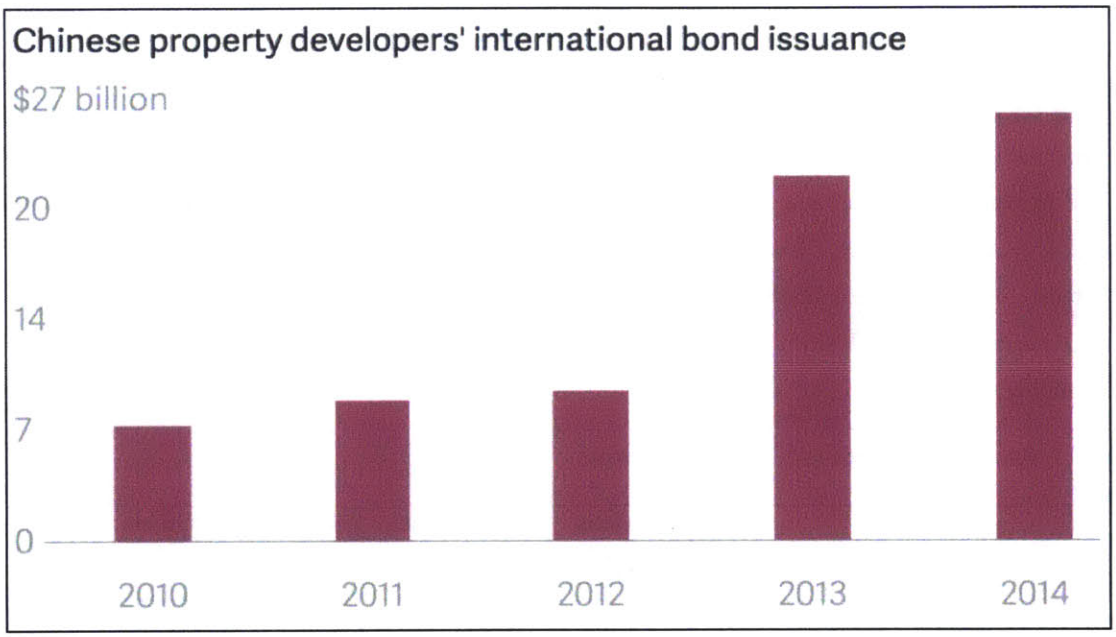
	Overseas Bonds	Bank Loan	Self-Finance	Others
Real Estate Developer (2)	2/2	2/2	2/2	EB-5 (1/2)
Investment Company (2)	0/2	2/2	2/2	N/A
Real Estate Fund (2)	0/2	2/2	2/2	N/A
Insurance Company (1)	0/1	0/1	1/1	N/A

a. Overseas Bonds

Due to the effect of U.S. QE3 policy (third round of quantitative easing policy), from which the U.S. government is trying to boost the economy through lower interest rates and purchasing bonds, the

overseas bond market became very popular, as companies can issue U.S. bonds at a very low interest rate outside China. At the same time, however, as the major source of financing for real estate developers, bank loans in China require a much higher interest rate because of government regulations for controlling the over-heated Chinese real estate market. In order to solve the high interest problem, many developers chose to issue bonds on overseas markets, and either use these funds for direct investment in the United States or bring them back to China to finance new projects. Exhibit 15 shows the annual amount of overseas bonds issued by Chinese real estate developers, and it also shows a strong increasing trend since 2012.

Exhibit 18. Overseas Bonds issuance by Chinese Real Estate Developers



Date Source: Dealogic

Compare with other financing methods, overseas bonds have the following advantages: first, they can drop the financing cost for real estate companies. This is because there's a big gap in interest rates between Chinese and U.S. markets, and exchange rate benefits. Since Chinese developers need to pay U.S. dollars at a bond's maturity date, when the exchange rate is rising in terms of Chinese Yuan, Chinese developers will convert fewer Chinese Yuan to dollars to pay off the loan.

Second, overseas bonds can satisfy the huge financing needs of developers. Because of the stable and low uncertainty characteristics of bonds, many investors feel more comfortable investing in bonds rather than

stocks, which made the scale of bond market larger. In 2013, a booming year of overseas bond issuing, the total amount exceeded $20 billion.

Third, bonds are more flexible in terms of maturity. In general, real estate developers can choose to issue 3-, 5-, 7-, or 10-year bonds to meet their financing target.

Fourth, by issuing corporate bond in the U.S. market, Chinese developers can better build their reputation and credit history. For most Chinese institutional investors, it is still hard to get the best deals in terms of financing and projects due to a lack of industry reputation and company credibility. So by starting to issue bonds in the United States, companies can open the door to get access to more opportunities.

Fifth, developers can use funds from bonds directly to invest in the U.S. real estate market. Because the currency of raised money is in U.S. dollars, companies don't have to convert any currency, which then avoids currency risk and the hassle of Chinese currency regulations.

A perfect example of an overseas bond is Vanke's issuance of an $800-million, five-year U.S.-dollar bond through its subsidiary in Hong Kong in 2013. The bond's annual interest rate was only about 2.7%, which is much lower than bank interest rates in China. This U.S.-dollar bond helped Vanke to raise enough money to invest in its projects in the United States.

b. Bank Loans

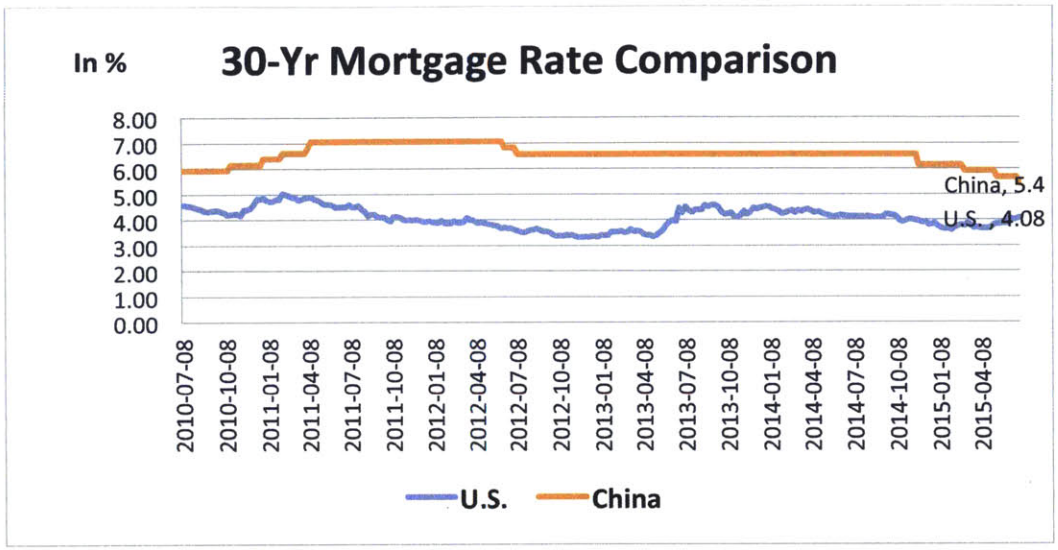
As the most familiar way of financing for Chinese real estate companies, bank loans are still play an important rule for direct overseas investment. In general, there are two types of bank loans: loans from domestic banks and loans from foreign banks.

According to the RCA data source, 10 U.S. real estate deals from 2013 to 2014 used $678 million in loans from Chinese domestic banks. All of these loans were from government-owned banks, including Industrial and Commercial Bank of China ($414 million), Bank of China ($80 million), and China Merchant Bank ($183.8 million).

For Chinese institutional investors who used bank loans to finance their projects, the majority (49 of 59 deals) used bank loans from foreign banks. The amount of foreign bank loans totaled $2,676 million, which is about four times in loans as from Chinese domestic banks. The foreign banks, included Goldman Sachs ($185 million), Deutsche Bank ($1,425 million), and CIBC ($222 million). Although the bank loan cost could be higher for Chinese investors due to a lack of credit history and sufficient financial records,

most of Chinese institutional investors used their Joint Venture Partner's credit and reputation to get relatively cheaper bank loans.

Exhibit 19. 30-Yr Fixed Mortgage Rate Comparison: China V.S. U.S.



Data Sources: Bank of China and Freddie Mac

The State Administration of Foreign Exchange (SAFE) released the SAFE Circular Concerning the Issuance of Provisions on Foreign Exchange Management of Cross-border Guarantees. This provision will advance convertibility under the capital account in an orderly manner, which will help Chinese institutional investors get cheaper bank loans from foreign banks more easily.

c. QDII and QDIE

As mentioned in Chapter 2, Qualified Domestic Institutional Investor (QDII) and Qualified Domestic Institutional Enterprise (QDIE) are two of the most famous programs issued by Shenzhen Qianhai Pilot Free Trade Zone. By investing in government-approved QDII or QDIE programs, domestic investors will get access to foreign investment markets.

QDII permits qualified domestic institutions to raise funds from domestic investors for the purposes of investing in foreign securities. This program is only available for commercial banks, trust companies, asset management companies, insurance companies, and the national social security fund. The investment

product is only available for security investment. So QDII is not really useful for Chinese institutional investors as a financing source because QDII can't be used to fund private real estate projects.

In comparison, QDIE is an institutional agreement that allows asset management enterprises approved by Chinese government (qualified as "Overseas Investment Fund Management Enterprise") to raise funds from "Qualified Domestic Investors" and then through "Overseas Investment Enterprise" to directly invest in overseas asset markets. As QDIE extends the scope of investment from purely security to almost all asset types, Chinese institutional investors can use QDIE to finance their U.S. real estate investments. Even though the QDIE program has been approved for a $1 billion foreign exchange quota by the State Administration of Foreign Exchange, both asset management enterprises and domestic investors have to meet certain requirements to qualify the QDIE program.

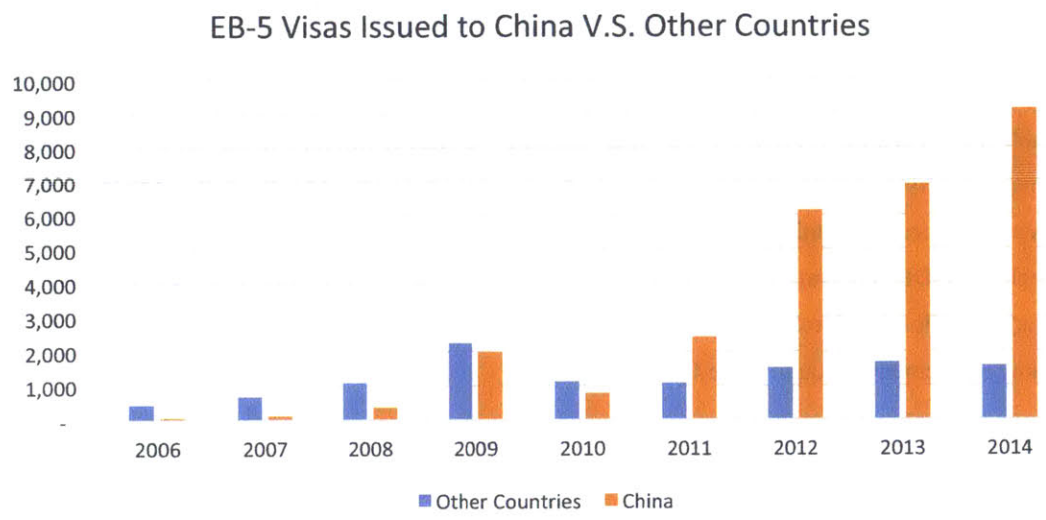
Also, since this QDIE program only started a short time ago, and therefore most qualified institutions are publicly funded management companies, trust companies, or security companies, not many domestic private investment asset management companies. So it may take longer for other institutional investors to finance through the QDIE program.

d. EB-5 Financing

The EB-5 program was established by the U.S. Congress in 1990, and its purpose is to stimulate the economy through job creation and capital investment by foreign investors, and, it is administered by the U.S. Citizenship and Immigration Service. The minimum direct investment requirement is $1 million in an ongoing project or a new business, which can create 10 or more jobs for U.S. people. The minimum requirement can be reduced to $0.5 million if investors would like to invest in an EB-5 regional center, which is a private or public entity involved in promotion of increased domestic capital, job creation, and increased economic growth. EB-5 Regional Center helps investors indirectly invest in investment projects and indirectly create 10 or more jobs.

Many real estate developers like EB-5 financing due to its low return requirements and no personal guarantee characteristics (i.e., no guaranteed return, all investments are at risk). The required return could be as low as 1% with a typical investment term of around five years. Even though EB-5 processing time could be longer than other financing method, its low required return is worth the wait. Also, the strong trend, shows in Exhibit 17, of EB-5 applications from Chinese investors makes EB-5 financing even easier for real estate developers.

Exhibit 20. EB-5 Visas Issued to Chinese and Other Countries' Investors



Data Source: Courtesy of the U.S. Department of State

A perfect example is Related Companies: A famous U.S. developer raised around $600 million through EB-5 to finance the massive Hudson Yard project in New York City. In addition, Forest City has raised $475 million through EB-5 for its Atlantic Yard project near the Barclay Center in New York City.

A typical way of using EB-5 financing is to put it as a mezzanine loan into a project to fill the gap and increase the financial leverage. In general, two regular ways of using financial leverage are through senior debt or senior debt plus mezzanine debt (the required return is relatively higher than senior debt but lower than equity). However, due to the low required return for EB-5 financing, real estate developers can bring in more EB-5 money as mezzanine debt to help equity investors leverage their returns. Exhibit 15 shows the difference between different financing methods: compared with the first three methods, super leverage is the one highly used EB-5 financing to promote the mezzanine part from a regular of 5%-15% to super 20%-45%.

For example, assume total project costs $1 million, annual net operating income is $100,000. Senior debt interest rate is 6%, regular mezzanine interest rate is 10%, and EB-5 supper mezzanine rate is 2%. Exhibit 16 shows the return difference for equity investors. Apparently, supper mezzanine leverage could bring much higher equity return than others under good market.

Exhibit 21: Different Financing Structures in Project Financing

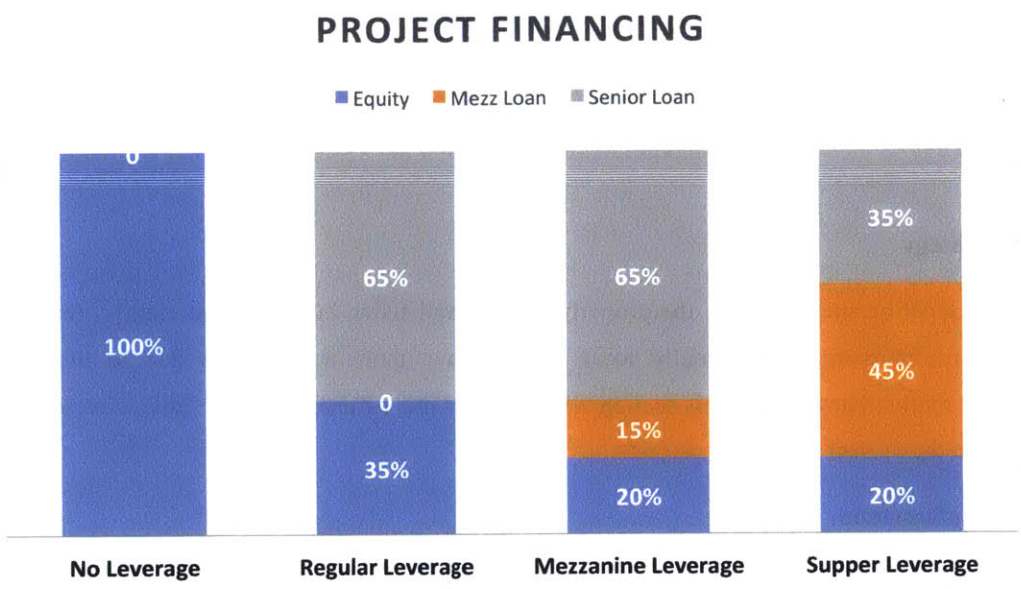
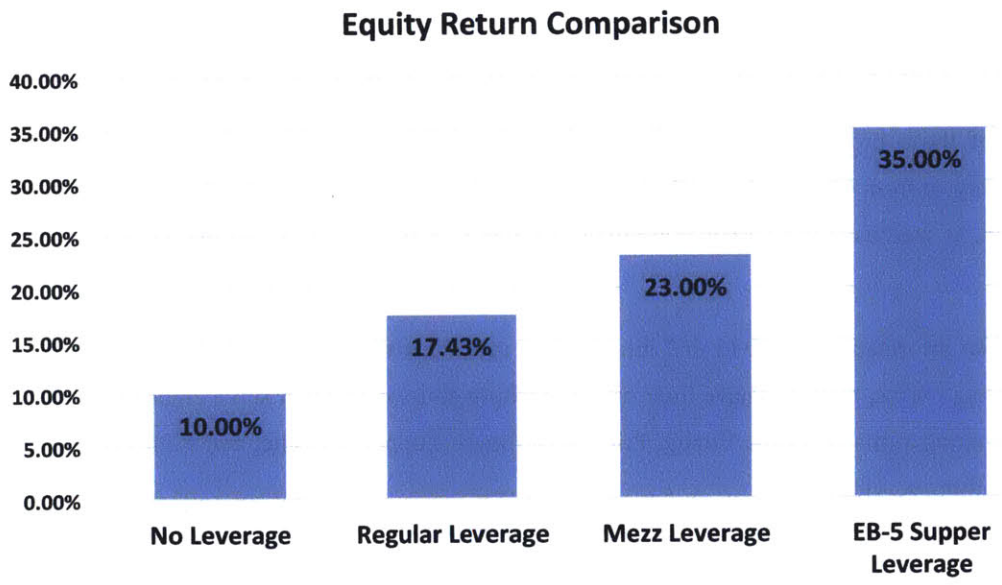


Exhibit 22. Equity Return Differences for Different Financing Structures.



Real estate developers like EB-5 real estate projects, as do individual EB-5 investors. Due to the relatively long investment horizon, labor intensity, and tangible character of real estate, EB-5 investors can easily meet the requirement of hiring more than 10 U.S. employees for a minimum of two years; in addition, investors can easily inspect the project and see the progress, so they can have more confidence about their investments.

C. Project Strategy

Real estate is a local business because the property is local and fixed, but most importantly, real estate information is un-transparent and usually local players have more access to it due to their local connections and market knowledge. This section will discuss some general points Chinese investors need to consider when they select real estate projects.

a. Sources of Information

In order for Chinese investors to play well in the U.S. market, it is crucial to know where to find information sources, which include general market conditions and project-specific information.

For general market information, the most common source is from large real estate brokerage firms. All of our interviewees mentioned they have considered brokerage firms as their market information source. Based on National Real Estate Investor's ranking for 2014, the top 10 real estate brokerage firms (from 1 to 10) are: CBRE Group, Jones Lang LaSalle, Cushman & Wakefield, Newmark Grubb Knight Frank, Colliers International, Eastdil Secured, Savills Studley, iCore Global, TCN Worldwide, and Cassidy Turley. Most of these brokerage firms have their own market research reports based on their own transaction history or from other sources. These annual or quarterly market reports cover general U.S. real estate condition, as well as cover market conditions for major geographic locations and specific product types.

The second major information source (5 of 7 interviewees mentioned) is from real estate consulting firms. For most brokerage firms, they also have their own consulting division to better serve clients. In addition, many big accounting firms (Ernst & Young, Price Waterhouse Copper, Deloitte, and KPMG) also have real estate consulting services.

Other information sources about market conditions are from real estate data providers (3 of 7 interviewees considered). CoStar and Real Capital Analytics are the major data providers in the United States in terms of large transactions, and many real estate consulting companies use data from these two companies. In

addition, online real estate listing platforms like Zillow, Redfin, and Trulia have their own data sources from listing services.

For project specific information, the top three sources are from real estate brokerage/consulting firms, joint venture (JV) partners, and in-house information. Usually, passive institutional investors, like insurance companies, will use real estate brokerage/consulting firm as their major deal sources due to the passive character and product types (landmark or trophy assets) they want. For active investors like real estate developers and real estate investment fund, they usually rely more on their JV partners. After years of operation, many institutional investors will start to source deals by themselves once they built the local network.

b. Project Selection

In terms of deal sourcing, Chinese institutional investors are considering move their major project sourcing from brokerage/consulting firms to JV partners and in-house. The reason is simple: most of great deals won't wait until they are publicly announced, and local players can uncover these underwater deals from local connections.

In terms of product and geographic area, active investors (real estate developers, investment companies, and real estate funds) focus more on residential in top tier cities with strong growing potential, while passive investors (insurance companies, and banks) focus more on office and hotel in mature top cities. For active investors like real estate investment funds, one of interviewee mentioned that residential projects are not only easier to control through JV structure but also more stable in terms of demand, plus they are easier to adjust based on market conditions. In addition, the return will be much higher by taking a little more risk to invest in the top growing markets. For passive investors like insurance companies, because of their longer investment horizon, stricter regulations, and lower return requirement, trophy assets in major cities are more suitable.

An interviewee who has many years of U.S. local experience also mentioned that in terms of control and monitoring, investors should select projects in reachable areas. The reason is that investors can easily evaluate the market condition by physically feeling it and quickly reacting to a market downturn. Also, property managers will pay more attention to properties if they know they will be watched.

c. Due Diligence

All interviewees mentioned that due diligence is very important during the interview process for project selection. Due diligence is a research process to make sure buyers are satisfied with deal conditions

before signing a contract. In general, Chinese investors should focus on the following areas: title review, zoning, property inspection, environmental inspection, and appraisal.

The first thing investors should review is the title. The title is the transferable right to the property, and it is important to know whether the seller actually has the right. Investors should review all claims against the property before purchasing; in addition, investors should purchase a title insurance to protect them in case the title search misses a claim against the property.

Another important due diligence step is research about zoning. Investors should first make sure the building is currently in compliance with existing zoning regulation; second, if they have any renovation or development, investors should learn whether that will be allowed; third, investors should learn of any planned zoning changes that could adversely affect the intended use of property.

Before purchasing, all building inspection should be finished by a certified third-party company to ensure the property is up to code and structurally sound. During the process, inspector will typically check the structure, HVAC system, electrical, plumbing, interior/exterior, chimney, roof and other parts.

In addition, environmental inspections should be done carefully, especially for commercial property previously used for industrial purposes. Environmental inspections usually include phase I and phase II processes. In phase I, inspectors will issue a report to indicate whether there are serious issues requiring remediation. If there are issues, a phase II inspection will be needed to test the property further.

One of the other important processes is real estate appraisal, especially for financing purpose. If investors need a mortgage from a financial institution, the appraisal value is crucial because this will decide the amount investors can get and the financing cost for the property. Also, after the purchase, real estate property tax will be charged based on appraisal value.

D. Joint Venture Strategy

For most Chinese institutional investors, forming a joint venture (JV) with a local U.S. partner is usually the best way to operate real estate business, especially for the first few deals for learning, one of the interviewee who works for real estate fund mentioned that. However, just like finding a good project, finding a good JV partner and making it work is hard.

Among all the JVs that Chinese institutional investors formed, there are generally two types: with a famous international/national partner or a strong local partner. In general, passive investors like to find famous international/national partners because these partners usually deliver a stable return, have similar

investment horizon, and have strong financials. In addition, large Chinese developers like Vanke and Greenland like to partner with famous international developers because of similar business cultures and for the purpose of the learning development process in the United States. For other active investors, strong local partners are always their favorite. Reasons include stronger local connection, better projects, more favorite deal structure, and cheaper fees compared with famous international/national partners. Actually, more and more large passive investors have switched to work with strong local partners.

a. Partner Selection Criteria

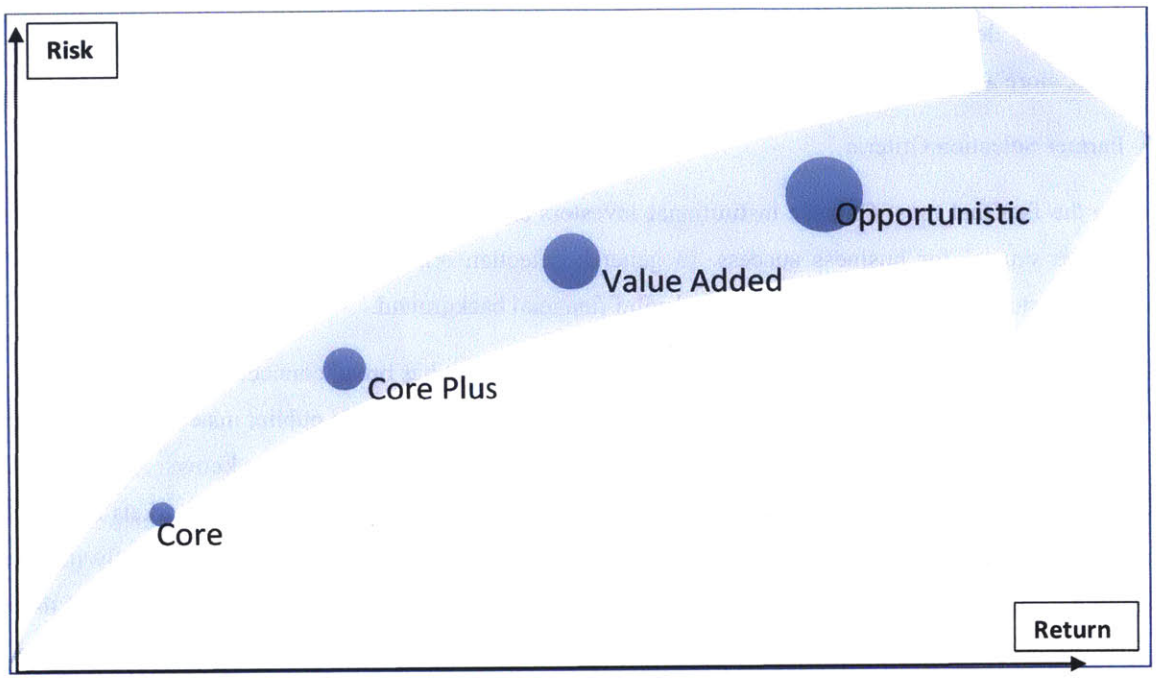
Due to the fact that most Chinese institutional investors are limited partners, finding good local general partners is crucial for business success. In general, selection criteria include broad local connection, similar investment strategy, strong team, and solid financial background.

First, Chinese investors need to evaluate whether the local partner has broad connections in local markets. In the current real estate market, most of the good deals are not published in public; instead, partners with wide range of deep relationships can access these opportunities before everyone else knows. As one of the most important project sourcing strategy, local JV partners know their local real estate markets and have strong intuition about market changes. The ways to evaluate partners' local connections usually include checking local news about the company or its executives, past transactions, and company history. If there is a lot of positive news about company or its executives, many transactions within a relative short period of time, and long company history, this usually means the local partner has pretty good local connections.

Second, Chinese investors need to find general partners whose investment strategy matches with theirs. In terms of sector, most U.S. local real estate companies have their own focused sectors, and that makes them survive and become better during competition. For instance, Grand China Fund partnered with Gaia Real Estate, which is a local real estate company focused on multi-family residential property in Texas, to better service their fund performance. In terms of geographic area, Chinese investors also need to find experienced local partners, who have local knowledge, connections, and a management office. In terms of risk and return characteristics, Chinese limited partners need to be careful about local general partner's investment style. Generally, there are four types of investment styles: core, core plus, value added, and opportunistic. For core investments, the investor usually owns the whole property with 100% equity or very low leverage; the property is substantially leased to generate stable cash flow with high certainty. For core plus, the investor usually forms a JV with other investors, as well as uses a low to moderate level of leverage. The property is substantially leased and is subject to minor renovations to keep its value. For the value-added style, the investor uses a moderate level of leverage, the property is about 50% to 75% leased, and is subject to redevelopment to add value. For the opportunistic type, investors use high

leverage with no limitations on ownership structure, 50% or less of the property is leased, and sometimes it is subject to major re-development.

Exhibit 23: Real Estate Investment Styles



Third, a strong team with consistent investment performance is always a good sign of future success. A strong team doesn't mean an all-star team, but it needs to have good team dynamics and cohesiveness, which usually need a running-in period and well-established work culture. When Chinese investors evaluate this team environment, they make sure to check senior team members' working years, as well as junior team members' job duty segregation and integration. Unless it is a young company, senior members with a limited working period within the company and an unclear duty structure usually indicate a weak team environment that needs to be frequently monitored to avoid potential risk.

Forty, even though general partners don't provide as much funding as LPs, GPs with strong financials usually provide more confidence to LPs. For the reason of protecting downside risk, LPs usually would like to see GPs keep clean and good records of all investments; moreover, because GPs face unlimited liability if JVs are formed as a limited partnership, GPs with higher total assets and lower liabilities can bring in more protection against a downside market and lower interest rate for mortgages.

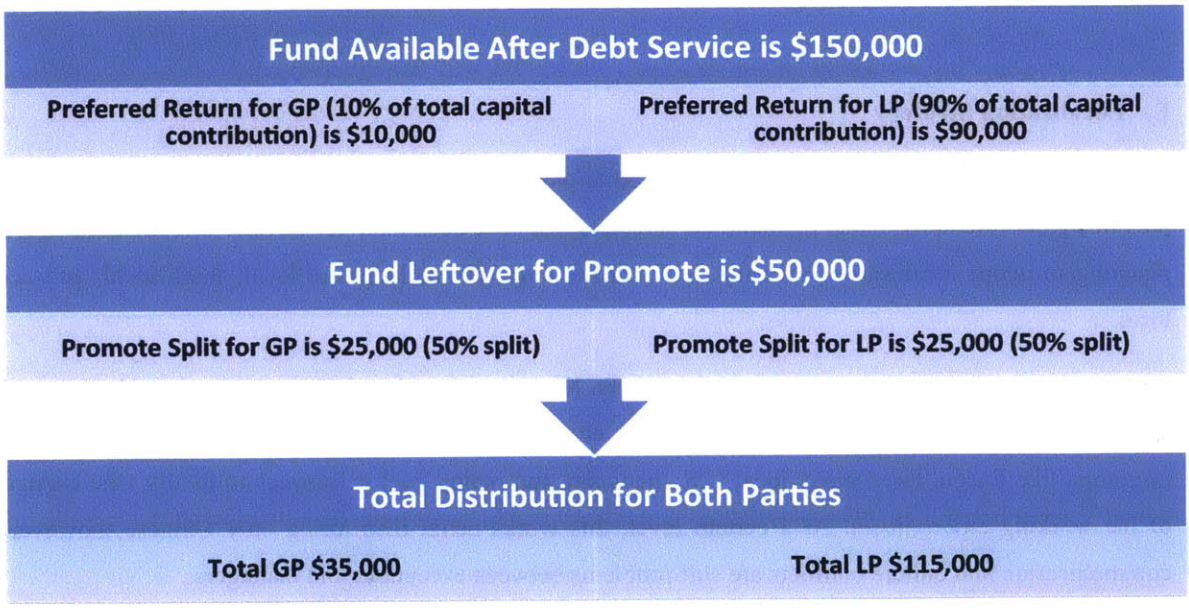
b. Partnership Structure

As far as partnership structure, the general strategy is to bring in financial incentives while keeping downside risk sharing. A good JV partner is as good as a good JV structure, especially in a market downturn.

In order to motive GPs to put more efforts into a JV project, using financing incentives is very important. Generally, the investment performance promotion is the most popular way to motivate GPs. By setting certain investment return benchmarks, LPs can setup an expectation of potential return for their money, while GPs can only get promoted benefits after reaching the benchmark.

Exhibit 16 is an example of how this strategy works. Assume total equity contribution requirement is $1 million, and general partner contributed 10% and limited partner did 90%. After paying out mortgage debt, $150,000 was left for distribution. If the partnership agreement set up as general partner can get 50%/50% split after preferred return (10% preferred return rate) paid off, then, general partner will get its preferred return of $25,000 plus its promote return of $35,000 as total distribution. Total distribution for limited partners will be $115,000. However, if fund available after mortgage payment is not enough to cover preferred return distribution, total distributions for both GP and LP will still be 10%/90% split. Chinese institutional investors should negotiate performance promote based on both target market and their own required return to effectively motivate local general partners.

Exhibit 24. Performance Promote Example



Other way of motivation were also mentioned by interviewees, such as converting option, which LPs can set up part of their initial investment as debt with an option to turn into equity; if project fails, the joint venture has to pay back the loan first.

Regarding downside risk sharing, Chinese investors need to pay attention to fairness and controlling. From the experience of Japanese investors, many local partners only commit management work and do not take any responsibility for capital calls when needed, and this unfair agreement eventually hurt Japanese investors. To better protect against downside risk, Chinese LPs need to ask local GPs to have "skin" in the deal, which means GPs need to contribute their own money to form the JV structure. Using the same example of Exhibit 16, general partner has to commit 10% of total equity contribution to form the joint venture. If project fails, GP not only won't get promoted distribution but also will lose its initial contribution.

Also, to better control a JV project, Chinese investors should try to become the primary LP in the JV structure. This way, investors will have more bargaining power in terms of financial and project control. One of interviewee from large real estate fund mentioned that been the primary limited partner is very important because he can always switch property management company, which is usually the local general partner company, and even general partner if the project is performing or under his return expectation. And because of this JV structure requirement, he turned down some good opportunities to control the risk.

E. Localization Strategy

Real estate is a local business, and investors need to work with local partners and become local to better play this game. Actually, many institutional investors that have been interviewed have already used or are planning to adopt localization strategies. The current strategies include hire local, think local, and act local.

Hire local is the hardest way compared with others. Many investors hired Chinese people with U.S. real estate knowledge and experience because it is easier to communicate and culturally match. Other investors, like Fuson, hired many local U.S. managers and junior-level employees to totally take change of the working environment. At a certain level, this works better than hiring only Chinese; however, communication and culture conflicts are still problems between executives and managers.

Think local means local managers should have more rights to make decisions. For many good projects, investors have to react quickly to capture the opportunity, but because of slow decision-making process caused by layers of hierarchies, many opportunities could be missed.

Act local means investors need to play within local rules and standards, and need to build a local reputation. To be actively involved with local real estate, Chinese investors should participate in local industry associations like the Urban Land Institute (ULI), which is a nonprofit organization representing the entire spectrum of land use and real estate development disciplines working in both private and public sectors. Attending a ULI meeting is one of the best ways to build local real estate connections. In addition, take on some social responsibility by donating money to local activities and public welfare is a good way to build a public relationship.

In conclusion, for all these investment patterns and strategies, Chinese institutional investors should consider each individual strategy at each stage of their investment process, and think about how those strategies can work together to generate an agglomeration effect for success in U.S. real estate market.

Chapter 4: Legal and Tax Issues

In addition to the local real estate market, other important knowledge Chinese investors need to have before investing is the local legal and tax regulations, because they are highly regulated and very different from the Chinese system. In this chapter, we will discuss important issues related to legal and taxation in the United States.

A. Legal Forms

There are many legal forms that Chinese institutional investors can choose to use to operate in the United States, including C corporation, S corporation, partnership, limited partnership, and limited liability company. In terms of tax return purposes, generally there are two types: tax-paying entity and pass-through entity.

a. Corporate

In general, a corporate structure is a form that can separate liability from its owner. Corporations can enjoy most of the rights and responsibility that an individual has, which include the rights to enter into contracts, borrow money, sue and be sued, hire employees, own assets, and pay taxes. However, it is more complicated to run and has more requirements from tax, reporting, and legal standpoints. To be more specific, there are two types of corporations: C corporations and S corporations.

C corporations are considered separate tax-paying entities. Entity income will be taxed on the investor's level, and on the entity's level, which is called double taxation. Even though the corporate tax rate usually is usually lower than individual tax rate, the total tax investors have to pay is higher than other types of business formation. Because of this, many newly established companies never use this form.

In comparison, S corporations are pass-through entities, which mean all the income, expenses, gains, and losses will pass through the company level and directly to shareholders. Then shareholders file their own individual tax return to include those items that have been passed through to them. This way, S corporations can avoid the double taxation issue that C corporations have. However, because of this tax benefit, IRS has some special requirements like the corporation has to be a domestic corporation, without resident alien shareholders, no more than 100 shareholders, and etc., so international investors need to consider these requirements before setting up an organization this way.

b. General Partnership

A partnership is the relationship existing between two or more persons who join to carry on a trade or business. In a partnership structure, a partnership agreement must be in writing in some states in order to

keep the business longer than one year. In many states, the Uniform Partnership Act requires showing the principal aspects of doing business, which includes the criteria to form the partnership and the relationship between partners for taking on partnership obligations. Each member of the partnership has unlimited liability for the partnership's debt, and each partner could be held jointly responsible for all partnership obligations. If one partner wants to transfer his/her interest, other partners' approval may be needed. A general partnership is considered as a pass-through entity, in which foreign partners are allowed.

c. Limited Partnership

Similar to a general partnership, a limited partnership is also an association of partners to run a business together. However, a limited partnership needs at least one general partner and at least one limited partner. For general partners, the liability for the partnership's obligation is unlimited, but usually they are the sole partners to manage the partnership's business. For limited partners, their liability is limited to the amount that each partner invested in the partnership, and they cannot manage the business or let their name be used in the partnership's name. A limited partnership is also a pass-through entity and foreign partners can join.

d. Limited Liability Company

A limited liability company (LLC) is a hybrid type of legal structure that provides limited liability like a corporation and the tax efficiencies and operational flexibility of a partnership. So an LLC attracts investors because of liability protection, and avoid double taxation. Partners of an LLC can include individuals, corporations, and other LLCs. To create an LLC, an Articles of Organization is required by all states, and some states also need an Operating Agreement to be filed. Generally, LLC is the preferred business entity form for a real estate ownership.

Exhibit 25. Pros and Cons for Different Business Structures

Business Structure	**Pros**	**Cons**
C Corporation	-Ownership easy to transfer -Required format for IPO -Limited personal liability, separate responsibility -Easy to raise capital	-Double taxation -Expensive to form and maintain
S Corporation	-Limited personal liability	-More expensive to create

	-Pass through entity -Ownership easy to transfer	-Limited number of investors -No foreign investors -Only have one stock type
General Partnership	-Pass through entity -Flexible allocation of profit/loss -No limit on partner numbers and types	-Partners are personally liable for other partners -Partners need to file self-employment tax -Difficult to change ownership
Limited Partnership	-LP have limited personal liability -Pass through entity -GP have control of management	-GP is exposed to unlimited personal liability - LP loss control of business -Restriction on partners based on entity type
Limited Liability Company	-Limited liability -Pass through entity -Flexible for partners to share profit	-Limited life (30 years) -Members need to pay self-employment tax -Could be hard to raise capital

B. Taxation for International Investors

As discussed in part A, Chinese institutional investors can choose to form different business entities when they make acquisitions of real estate assets or real estate companies. Based on KPMG's report about China's inbound investing, the general rules are that a foreign company's tax situation could be simplified from an operational level if a company chooses corporate status. First, it will be easier to raise capital from debt markets; second, it will be easier to integrate this new entity with other U.S. entities. However, if the U.S. business is setup as a branch, international investors need to consider interest expenses allocation, as debt is infused from a parent company into a U.S. branch, which should be in compliance with U.S. branch tax rules.

If a U.S. business is set up as pass-through entity, depending on the partner's foreign jurisdiction, losses from operating can be used to offset domestic income. If Chinese institutional investors have been taxed on their U.S. investment income, then they can use this as a tax credit in China to avoid double taxation from both countries.

a. Tax treatment for different entity types

If the entity has been set up as a U.S. corporation, then it is generally subject to a 35% tax rate on the federal level and state and local taxes would also apply. The corporation has tax-filing requirements, but foreign investors don't need to file a U.S. income tax return. All the earnings to foreign investors are subject to double taxation, and dividends paid are subject to a 30% withholding tax absent a treaty reduction. Corporations must file Form 1120, the annual tax return form, to claim the tax return.

If the entity has been setup as foreign corporation, none of the earnings are liable for taxation in the United States. However, the foreign corporation may need to pay a 30% branch profit tax for doing business in the United States. Stock of foreign corporation can be sold without the application of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), which states "any foreign investor investing in a U.S. real property interest is deemed to conduct a U.S. trade or business and the gain or loss would deemed to be effectively connected with a U.S. trade or business and therefore subject to taxation on a net basis."

For an entity set up as a direct ownership, the individual owner will get the advantage of lower long-term capital gain tax rates and direct ownership can avoid double taxation. The current long-term capital gain tax rate is either 15% or 20% for individuals. And individuals need to file Form 1040 as their annual tax return. However, as most institutional investors are not one person, an individual has to face the risk of unlimited liabilities, so this individual direct ownership is rarely used.

If an investment has been set up as a partnership, a foreign partner will be subject to taxation on its share of U.S. income and this will be withheld upon the Fixed, Determinable, Annual, and Periodical Income (FDAP) and Effectively Connected Income (ECI) rules. The FDAP rule mentioned that FDAP income or gain from U.S. sources would be taxed at 30% (or a lower treaty) rate. However, if foreign investors engage in trade or business in the United States, then all income from the trade or business is considered Effectively Connected Income, which will be taxed at the graduated rate. Because gain from the sale of U.S. property is generally considered as ECI, it is subject to be taxed at the graduated rates. The highest rate is 35% for corporate and 39.6% for individuals plus an additional 3.8% on net investment income, applicable to foreign partners. In general, a partnership needs to file Form 1065 for tax return purposes.

b. FIRPTA Withholding

When a foreign investor disposes of a U.S. real property interest, the sales price is subject to the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA) income tax withholding. FIRPTA authorized the United States to tax foreign investors on dispositions of U.S. real property interests.

According to the IRS, U.S. real property interest is any interest (including land and improvement, mines, wells, natural deposits and personal property associated with real property) located in the United States or U.S. Virgin Islands, and any interest in a domestic corporation that is a U.S. real property holding corporation. Also, this act defines disposition as, not limited to, sales or exchange, liquidation, redemption, gift, transfers, etc.

The transferee or buyer must deduct a withholding tax equal to 10% of the total amount realized by a foreign investor on the disposition of the property and remit it to the IRS. And the IRS defines the realized amount is the sum of (1) the cash paid, or to be paid, (2) the fair market value of other property transferred, or to be transferred, and (3) the amount of any liability assumed by the buyers. If U.S. and foreign investors jointly owned the disposed property, the realized amount is allocated based on capital contributions of each transferor or seller.

C. U.S. Bankruptcy Law

It is really important for Chinese institutional real estate investors to understand the basics of U.S. bankruptcy law, due to the fact that the U.S. bankruptcy code generally favors creditors over lenders and owners, and tenants over landlords. Also, from a culture standpoint, Chinese people try to avoid any kind of legal conflict, especially bankruptcy case, which they consider as a sign of failure and shameful. However, in U.S., filing for bankruptcy is considered part of a business strategy to limit liability.

The U.S. bankruptcy code includes all details about rights and obligations of debtors, creditors, equity holders and other parties upon the commencement of bankruptcy proceedings. All the codes provide relief for debtors, and the two most common are liquidation (Chapter 7) and reorganization (Chapter 11).

a. Chapter 7

For Chapter 7 liquidation cases, the goal is to make distribution to the creditors through a quick sale of the debtor's assets, and a trustee will be appointed to administer the process of sale and payment to creditors. After the liquidation, creditors with higher priority, like secured creditor, will get paid first, and then lower-level creditors will get paid second until all the sale proceeds are used up. For debtors, one of the primary purposes of bankruptcy is to be discharged from certain debts. Once the debt has been discharged, the debtor will have no liability for it. However, a discharge is only available to individual debtors and not to partnerships or corporations.

b. Chapter 11

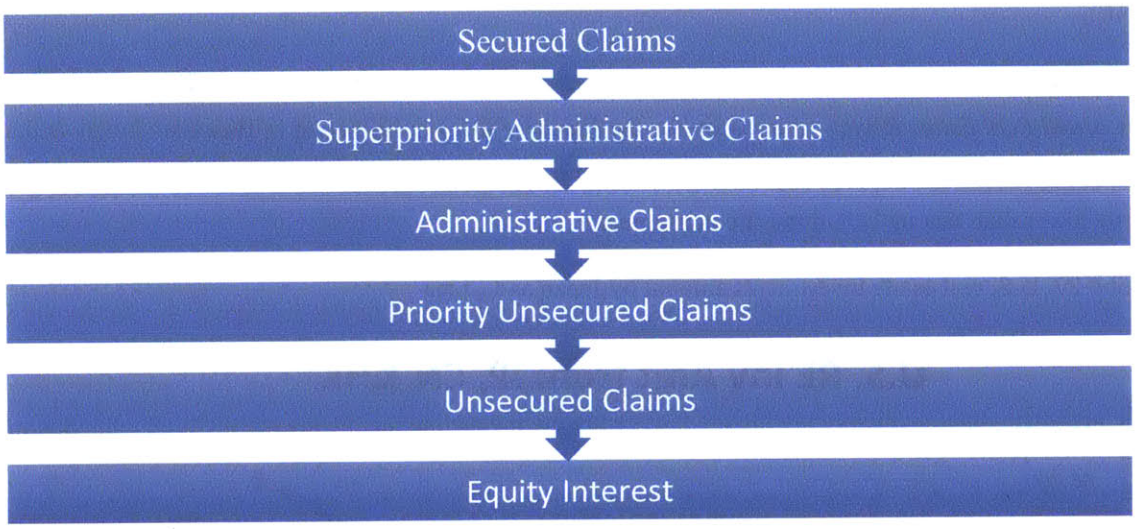
For Chapter 11 cases, the debtor's primary goal is to reorganize the business so that it may emerge as a viable entity through court-approved plan of reorganization, which sets forth a scheme for distribution to

creditors. The bankruptcy code permits the debtor to remain in possession of its business and assets and to administer its own bankruptcy estate; however, if the debtor wants to sell the asset, there are certain restrictions.

In order to sell the property, the debtor needs the approval from a bankruptcy court, from which debtor usually will be required to hold an auction to sell the asset in the highest and best offer price. Once the asset is sold, the bankruptcy process will distribute proceed for the benefit of creditors in whole or in part. The bankruptcy code establishes a hierarchy for the payment of claims based on their priority: secured claims will get paid first, and equity will be paid after all other claims are paid in full.

Also, debtors must be paid in full for post-petition claims, which are the claims arises after the debtor filed for Chapter 11; however, the debtor is not required to pay pre-petition claims, which are the claims before the debtor filed Chapter 11, in full.

Exhibit 26. Hierarchy for Bankruptcy Payments



In this chapter, we have discussed different ways of entity setups and all the tax implications associated with each way of entity setup. In addition, tax issues only related to foreign real estate investors were also discussed. For better investment results, Chinese investors should select the entity and tax structure that matches with their investment strategies. Also, as part of localization strategy, consultation with U.S. local attorneys and tax professionals who are specialized in real estate will better help Chinese investors to success in the United States.

Chapter 5: Another Japan?

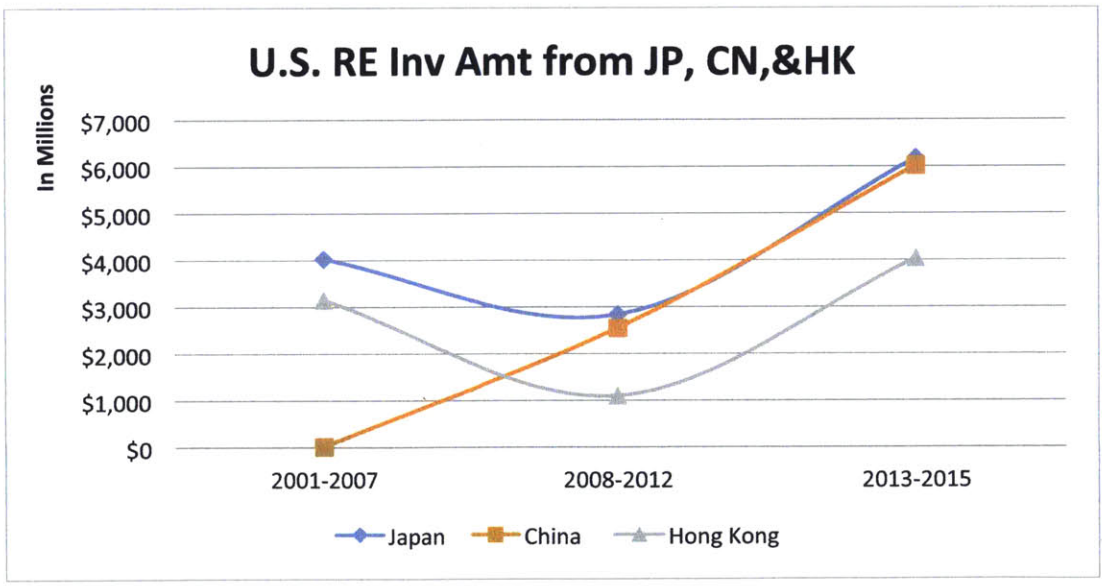
For the current Chinese institutional real estate investment boom, many people started to concern whether Chinese investors would be the same as Japanese investors. In the 1980s, there were a lot of media reporting on large-scale real estate investments by Japanese investors, and people even started to be concerned that Japan would buy all of America. However, as everyone already knows, Japanese investors suffered huge losses at the bottom of one of the most severe recessions. So this chapter will focus on Japanese investment in the U.S. real estate market. To be more specific, two topics will be discussed: current condition of Japanese investment in U.S. real estate market, and similarity and differences between Japanese and Chinese investments

A. Current Investment Conditions

From *Cornell Real Estate Review* about Asian capital investing in U.S. real estate, even though Chinese direct investment is growing tremendously, Japan is still the top country in terms of deal size and deal count.

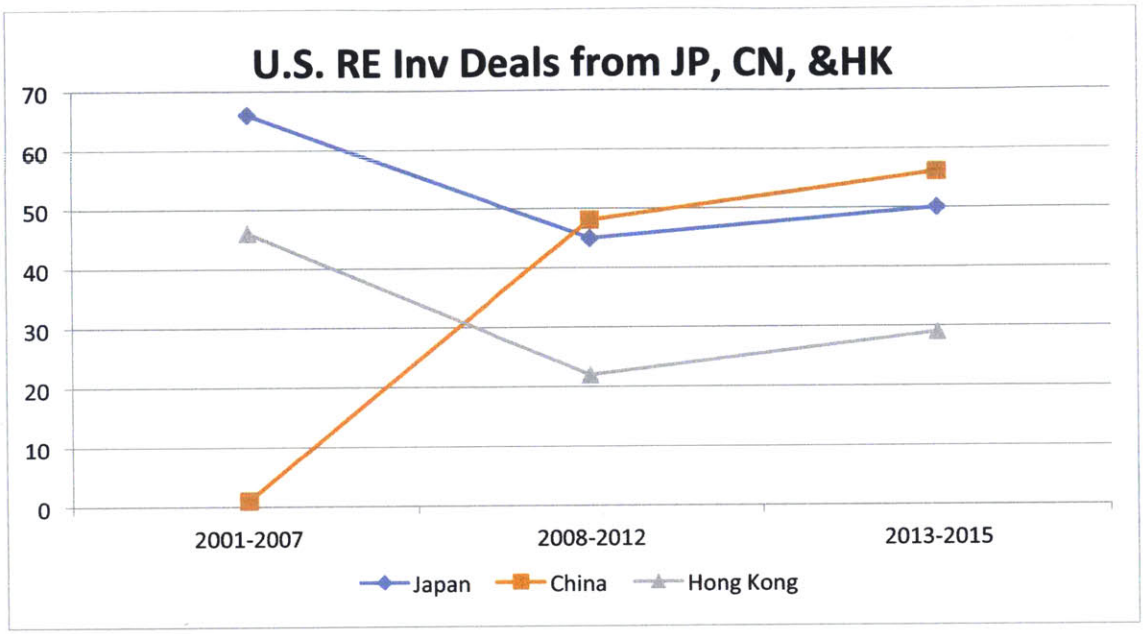
Also, there's lots of media coverage about Japanese investment in the hotel business in Hawaii. Based on the *Cornell Real Estate Review*, the reason for the Japanese focus on investing in Hawaiian hotels is that Japanese like Hawaii as their vacation place and total money spend in Hawaii was more than 17%, which is only lower than that by U.S. domestic consumers.

Exhibit 27. U.S. real estate investments amount by Japan and China



Data source: RCA

Exhibit 28. U.S. real estate investments deals by Japan and China



Data Sources: RCA

B. Similarities and Differences

As two major economic forces in Asia, China and Japan have a lot of in common, while each country has its own unique characteristics regarding overseas direct investment in U.S. real estate market. Part B will compare Japan and China in terms of investment conditions, economic reasons and investment strategies to help us understand Chinese institutional investment conditions.

Exhibit 29. Japanese & Chinese investment characteristics in U.S. real estate

	Japan	**China**
Investment Condition:		
Investor Types	1. Insurance Company 2. RE Developer/Construction 3. RE Investment Fund 4. Individual/Small Company 5. Trading Company	1. Insurance Company 2. RE Developer/Construction 3. RE Investment Fund 4. Individual/Small Company

RE Product Types	1. Developer: Hotel/Mixed Use/Residential 2. Insurance: Office/Hotel 3. Fund: Office/Hotel 4. Individual: Office/Hotel 5. Trading: Residential	1. Developer: Mixed Use/Residential 2. Insurance: Hotel/Office 3. Fund: Residential 4. Individual: Office/Residential
RE Geographic Areas	1. Developer: Hawaii/California 2. Insurance: NYC/California/Chicago/ Boston 3. Fund: Hawaii/California/NYC	1. Developer: NYC/California 2. Insurance: NYC/Oregon/Colorado 3. Fund: NYC/Texas/California
Reasons for Investment:		
Macro-Level Reasons	1. Strong economic grow 2. Japanese Yen appreciation 3. Low mortgage rate 4. Investment deregulation 5. Heated U.S. RE market	1. Strong economic grow 2. Chinese Yuan appreciation 3. High mortgage rate 4. Investment deregulation 5. Recovered U.S. RE market
Micro-Level Reasons	1. Higher investment return in U.S. 2. Lack of investment opportunity 3. Internationalization need 4. Looking for liquidity	1. More Stable investment return in U.S. 2. Lack of investment opportunity 3. Internationalization need 4. Looking for learning
Investment Strategy:		
Financing Strategy	1. Bank loan 2. Corporate free cash flow	1. Oversea bond 2. Bank loan 3. QDIE 4. EB-5 5. Corporate free cash flow
Project Selection Strategy	1. U.S. broker 2. U.S. Consultant	1. U.S. broker 2. U.S. Consultant

	3. Japanese bank 4. U.S. Developer	3. JV Partner 4. In-house
Joint Venture Strategy	1. Passive: Famous partner 2. Active: Local partner	1. Passive: strong local partner/famous partner 2. Active: local/famous partner
Localization Strategy	1. Hire local staff 2. Decision made by Japan 3. Changed property name to Japanese	1. Hire local staff 2. Decision made by China 3. Kept original name

From Exhibit 20, we can see most of these points are similar between Japanese and Chinese institutional investors, while there are a few differences. Under the investment conditions that Japanese developers do a hotel project, Chinese developers don't; Japanese real estate fund focus on hotels and offices, while Chinese focus on residential; in terms of location, Japanese like Hawaii and California, while Chinese like New York City the most. Under reasons for investment, Japanese mortgage rate is low and the U.S. real estate market is high, while Chinese mortgage rate is high and the U.S. real estate market is just recovered; Japanese look for liquidity and return, while Chinese look for learning and stability. Under investment strategy, Chinese investors have more financing options other than just bank loans, and they rely more on JV partners to find project and market information. In addition, Chinese don't put their own names on top of their property.

C. What can we learn from Japanese Investors?

Because of those similarities between Japanese and Chinese institutional investment in the United States, the failure of Japanese investment becomes a perfect lesson for Chinese to learn. First, we will discuss reasons why they failed in the 1990s, and second, we want to give advice to Chinese investors to avoid similar mistakes.

a. Why they failed

Both external and internal reasons led to Japanese failure in their U.S. real estate investments. Japanese investments were affected by external factors, including tighter monetary policy in Japan, U.S. real estate market downturn, and currency risk caused by Japanese Yen appreciation. They are also affected by

internal factors, including reply too much on bank loans, wrong product, wrong time, and bad deal structure.

Tighter monetary policy in Japan: In later 1980s, the Ministry of Finance and the Bank of Japan issued tighter monetary control due to the concerns of asset inflation. Real estate was considered as one of industries that needed to be controlled. By mid-1989, the Bank of Japan raised interest rates from below 3% to 6%; at the same time, the Ministry of Finance also tightened the control of lending to real estate industry. As the major sources of financing, Japanese real estate investors started to feel pressure.

U.S. real estate market downturn: U.S. real estate market was not only affected by a low absorption rate due to oversupply of downtown office market but also by a national recession. Under both impacts, the vacancy rates for office and hotel markets increased tremendously, and other real estate products were affected. This market downturn decreased real estate returns in the United States, which, in turn, made investors stop investing in the United States because many investors focused purely on investment returns.

Currency risk: When Japanese investors made their investments in the 1980s, the Japanese currency rate was weak (around 160 Yen: 1 Dollar), so Japanese investors needed to convert huge amounts to U.S. dollar to purchase the asset. Later in the 1990s, Japanese currency became much stronger (almost doubled), after converting income and sales proceeds from Dollars to Yen, their returns were much lower in terms of Japanese currency.

Rely too much on bank loans: Many of the external influences were caused by relying too much on bank loans as the real estate financing method. If Japanese investors had other financing options like oversea bond or self-financing, they would have had a cushion to protect them from tighten monetary policy (not limited by high bank interest rate) and currency risk (can hold U.S. dollars longer and don't need to worry paying off Japanese loans).

Wrong product: When Japanese investors first invested in the United States, most passive investors like insurance companies and financial investors liked to buy trophy assets. Due the unique characteristics of trophy assets, Japanese investors had to compete on price to get them. These competitions increased already overpriced landmark properties even more outrageously. So when the Japanese wanted to sell these assets, either there were no buyers or prices were much lower to reflect the real value.

Wrong time: U.S. real estate has a clear trend in terms of market price, and when Japanese entered U.S. market, they encountered at a relatively high price level, and that is the reason why they were affected so badly by the U.S. recession. For weak investors, they were totally wiped out; for strong investors, it took them really long time to recover their losses.

Bad deal structure: When Japanese investors formed joint ventures with partners, some to them were too optimistic about famous names, which led to only bad deals being taken over by the Japanese. Moreover, by bringing all capital into the deal, general partners didn't get enough motivation to act on behalf of LPs.

This chapter briefly mentioned about current Japanese investment in U.S. real estate, and then mainly discussed the similarities and differences between Chinese institutional investment and Japanese investment in U.S. real estate market back to 1980s. In addition, the failure reasons were discussed to help Chinese investors to avoid similar mistakes.

Conclusions

According to Knight Frank's market intelligence report as of 2014, of top 20 real estate developers in China, nine of them have already invested in the U.S. market and eight are interested in expanding to the United States. Also, of top 20 insurance companies, five of them have already made investment in the United State and seven have plans to invest in the U.S. market. Because of these potential opportunities, it is urgent and crucial to find out the best ways to help these Chinese institutional investors to quickly adapt to the U.S. real estate environment and make right investment decisions.

For current Chinese investments, the major investors are insurance companies, real estate developers, real estate investment funds, and investment companies. In terms of products, insurance companies prefer hotel and Class-A offices in New York City. Real estate developers prefer investing in residential and mixed-use properties in New York City and multiple California areas. Real estate funds show strong preference in residential properties in Texas, New York City, and California. Some investment companies are like real estate funds, but others prefer landmark offices in New York City. In general, New York City is still the first choice for almost all Chinese investors.

For investment, there are both macro- and micro-level reasons. Strong economic growth in China, the Chinese Yuan's successive appreciation, deregulation of overseas investment by Chinese government, and recovery of the U.S. real estate market are the major macro-level reasons. As far as micro-level reasons, the stable investment environment, lack of investment opportunity in China, and internationalization needs bring more Chinese overseas investments.

Regarding investment strategies, Chinese institutional investors should consider the following suggestions in Exhibit 30 when invest in the U.S. real estate market.

Exhibit 30. Investment Suggestions

	Do	Do Not
Pre-Investing Stage		
Investment Reason	1. Know both macro- and micro-level reasons why invest in the U.S.	1. Do not just follow the trend blindly
Real Estate Market	1. Do thorough research about the U.S. market. (Locations, census, culture, product types, market rents,	1. Do not underestimate market complicity 2. Do not overestimate market return

	cap rate, vacancy, etc.)	
Legal & Tax	1. Do research about the U.S. legal and tax requirements (entity setup, entity tax structures, bankruptcy rules)	1. Do not use typical Chinese strategy to setup investment plan
Investing Stage		
Financing	1. Use multiple financing sources (overseas bonds, bank loan, EB-5, and QDIE, etc.)	1. Do not rely too much on bank loan
Information Source	1. Check all sources for market information (brokerage/consulting firm, JV partner, inhouse)	1. Do not ignore local real estate information
Project Selection	1. Select products types match with return requirements (Stable V.S. Risky, Long-term V.S. Short-term, Active V.S. Passive) 2. Do due diligence very carefully (title, zoning, property inspection, environmental inspection, and appraisal) 3. Select project at reachable area	1. Do not blindly invest in trophy asset 2. Do not ignore the importance of due diligence for project 3. Do not buy property which is too far away
Joint Venture	1. Select strong local partner for Joint Venture purpose 2. Do research about potential JV partner (strong connection, matched investment strategy, strong team, strong financial) 3. Control the risk (especially downside risk sharing) 4. Set up good motivation strategy (performance promote, converting option)	1. Do not over trust big names 2. Do not contribute all requirement by limited partner 3. Do not give up control

Operating Stage		
Localization	1. Hire employees with local experience 2. Give more decision making right to local management team 3. Participate in local organizations to network 4. Show respect to the U.S. customers, communities, regulations, and all level of real estate players)	1. Do not bring the whole team from China 2. Do not set up too many layers of hierarchy for reporting 3. Do not try to change American to Chinese (don't change property name to Chinese)
Tax	1. File tax return on time (April 15th for individual, LLCs, partnerships; March 15th for corporations)	1. Do not miss deadline without filing extension

This thesis could help Chinese institutional investors better understand the U.S. market, and more institutions would feel more comfortable regarding overseas investment in the United States. Also, this thesis could help real estate companies in the United States to know more about Chinese institutional investors, and to better cooperate with them on potential projects.

Appendices:

1. Summary of answers to Interview Questions

	Real Estate Developers	Real Estate Funds	Investment Companies	Insurance Company
Investment Reasons	1.Expand Internationally 2.Meet domestic customer needs 3.Learn from partners	1.Diversify investment portfolio 2.High investment return	1.Diversify investment 2.Access to U.S. capital market	1.Stable investment return 2.Lack of investment in China
Real Estate Products	1.Mixed-use 2.Residential 3.Offices	1.Residential	1.Offices 2.Residential 3.Hotels	1.Hotels 2.Offices
Financing Pipeline	1.Overseas Bonds 2.Self-financed 3.Bank loans 4.EB-5	1.Self-financed 2.Bank loans	1.Self-financed 2.Bank Loans	1.Self-financed
Project Information	1.JV partners 2.Brokerage firms 3.Internal information	1. JV partners 2.Internal information	1.JV partners 2.Brokerage firms 3.Internal information	1.Brokerage firms 2.Advisory firms
JV Partner Selection	1. Similar in size and culture 2. Famous 3. Locally strong 4.Could learn from	1.Local experience 2.Need to have control over JV 3.Strong team	1.Strong performance history 2.Strong financials 3.Local connections	N/A
Localization Strategies	1.Hiring local employees 2.Building local reputations through JV partner	1.Hiring local employees 2.Join local organizations	1.Hiring local employees 2.Building local reputations through hosting	1.Hiring local employees

			events	
Long-term goal	1.Keep looking for opportunities	1.Long-term investment 2.Spread to other real estate products later	1.Long-term investment with potential for sales	1.Hold for real long period 2.Invest more

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