Exploring REITs for Community-Based Retail Development in China:
A New Strategy to Create Better Places to Live

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

In the last decade, mainland China has encouraged diverse experiments of real estate asset securitization in different sub-sectors, such as rental, industrial, and retail markets. However, little research has focused on the community-based retail, and few experiments of community-based retail asset securitization have taken place. The paper attempts to propose a new strategy for China's community-based retail development, with the belief that, by utilizing innovative real estate securitization as an alternative financing tool, community-based retail development will exploit its economic and social potential to make better neighborhoods in cities. The paper will discuss the opportunities and the challenges in community-based retail development in China, examine the key features of alternative financing tools that could be utilized, and develop a hypothetical strategy to integrate these concepts and make an example of a feasible system for the applications of REITs in China's real estate market.

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TABLE OF CONTENTS

1. Introduction

1.1. Context

Community-based retail is the base of a society's commerce system. Its typical form is a neighborhood-level retail cluster providing day-to-day services for surrounding residents. Two cores are intertwined within the identity of the community-based retail, the community development, and the retail business. The former provides the customer base of the latter, while the latter, in turn, increases the value of the former. This interaction between the community-based retail and its neighborhood has distinguished the community-based retail from other property sectors, even the retail sector in general.

In the last decade, China has seen the growing potential of community-based retail, which has been driven by both the business and the social value, to improve the quality of life. As China's government and developers paying more attention to community-based retail, greater opportunities, as well as challenges, have emerged. In this context, key players in the process cannot avoid considering how to carve the niche in the unique community-based retail market sector individually and collaboratively. For instance, how developers will get incentives to coordinate their business value with the social value; how the investor will respond to the evolving industry; how the government will make supportive actions to pave the way for collaboration; how the overall system will be sustainable and continuously benefit the improvement of the living environment; and finally what approaches can take these perspectives into account.

One possible approach is to utilize the real estate investment trusts (REITs) for community-based retail development, combining the advantage of REIT system and the uniqueness of the community-based retail market to achieve the social and economic goals. The basic rationale lies in the REITs' ability to bind capital and projects together and to integrate the real estate industry vertically, as well as in the dependence of investors' confidence and the fiscal and political support from the government.

1.2. Related Work

On one hand, several researchers have discussed the potential and limitations of applying real estate asset securitization in China's real estate market (Fu, 2015). Some have given general suggestions on how to tear down the barriers of developing new financing tools for China's rental apartments (He, 2018), affordable housing (Huang, 2010), and senior housing development (Cai, 2017).

On the other hand, researchers have investigated the potential of community-based retail as new-growth-point in the economy, and as community-value-creator in society (Zhu, 2013). Others have discussed existing problems, future trends, and possible solutions in China's community-based retail development (Chen, 2018; Chen, 2016; Zhang et al., 2018). Moreover, some researchers have asserted the easy access to more diverse life needs of the community life circle plays an important role in creating a more sustainable society and satisfying the people's expectation of life quality in the more market-oriented urban China (Liu & Chai, 2015; Zhang et al., 2018).

However, little research on China’s real estate asset securitization has a focus on the retail sub-market, not to mention touching on the topic of community-based retail development. Also, research on China’s community-based retail development tends to give general suggestions instead of specific solutions. No one has considered a new model that combines the two perspectives to address identified problems and capture potential opportunities.

1.3. Paper Structure

The paper attempts to bridge the gap and explore community-based retail REITs in China. The strategy proposed in the paper will hopefully become a piece of the puzzle in cooperating different parties in the process, and to some extent, enable the achievement of the greater economic and social potential of community-based retail development.

After a brief context and related work review in Chapter 1, the paper will investigate the opportunities and challenges of community-based retail development in China in Chapter 2. In Chapter 3, the paper will answer why and how to apply REITs in China’s community-based retail development after reviewing the key features of typical REITs. In Chapter 4, the paper will make comparative case studies of neighborhood center REITs in the U.S. and China, identifying the underlying differences between the typical REITs in the U.S. and the quasi-REITs in. In the final chapter, conclusion will be made based on all the analysis in the previous chapters, the outlook of launching community-based retail REITs in China will be discussed with thoughts of future work.

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2. Community-Based Retail Development in China

To make a convincing argument for launching community-based retail REITs in future China, we first need to understand what community-based retail is and what opportunities and challenges are involved in this real estate sector.

2.1. Definition

2.1.1. Community-Based Retail in China

In China, community-based retail has long been subordinate to the residential development. As required in the urban planning and related policies in China, community-level retail and service should at least represent 7 percent (10 percent since 2018) of the total building area of the residential community. Although a successful retail business will increase the value of the residential properties, developers have been reluctant to develop the community services over the benchmark since less retail units mean more residential units that are more profitable. Not until the recent decade, community-based retail in China has expanded its definition from basic retail at the bottom of the residential buildings to more diverse business and physical formats (Li, 2018).

i. Ground-floor Retail

Small scale clusters of retail usually within a community, providing daily necessities and under 10,000 square meters. The majority of the existing ground-floor retail clusters have been passively required instead of actively produced. Chaos are not uncommon since there is normally no collective business plan and overall operation.

ii. Neighborhood Center

Larger than ground-level retail clusters, usually between 10,000 to 40,000 square meters, providing day-to-day goods and services to one or several residential communities over the benchmark applied to all residential related retail development. With a service radius of 1 to 2 kilometers, neighborhood center has escaped, to some extent, the limits of subordination of residential elements while still closely related to its original community. From an operating perspective, it is typical for the neighborhood center to be directly held after the construction or re-purchased after the sale by the developer, who is responsible for the overall management and operation.

iii. Neighborhood Mall

An upgraded version of a neighborhood center while a small version of a regional mall, relatively independent from the residential units, with a service radius over 3 kilometers and usually over 40,000 square meters, providing diverse businesses and lifestyle experience to neighborhoods in surrounding areas. Notice that a neighborhood mall carries more commerce characteristics than a neighborhood center or ground-level retail, since restaurants, retail, recreation, and education take a much more significant percentage of the total business over the required community services. Similar to the neighborhood center, many developers tend to hold and manage the neighborhood center on their own.

2.1.2. Definition in the Paper

The development of community-based retail is critical to determine the life quality of people and making a better neighborhood in the cities. Looking forward, the paper attempts to depict the future of community-based retail, which should be genuinely rooted in the communities, deeply needed by society, and economically making sense. Therefore, in this paper, the development of community-based retail mainly refers to the development, including renovation, of the neighborhood center and the equivalent in urban China.

More specifically, the service radius of the community-based retail discussed in the paper is typical within 1.5 kilometers and its total building area is no more than 50,000 square meters. The major categories of business that the community-based retail will cover are:

i. daily necessities, which may include grocery, convenience store, supermarket, and breakfast shop;
ii. premium services, which may include education, recreation, and healthcare services.

The paper believes that the premium services today will become the normal format of community-based retail in the future. Although the community-bases retail is involved in an evident upgrading trend, it should be clear that the development of community-based retail is still subject to the legal requirement of community development ("government-supervised") and limited by the intention and capability of developers ("developer-oriented").

2.2. Opportunities

2.2.1. Optimistic Economic Trends

China has seen a growing potential in community-based retail since the last decade. Some even consider that, in 2020, the capitalization of the community-based retail market may be over a trillion RMB. According to the international practices, community-based retail revenue typically takes up to 60% of the overall commerce revenue in a society with GDP per person over USD 3,000; while in China, even in the first tier city Shanghai, the number merely reaches 30% (Zhu, 2018). The demand gap in China becomes more apparent as the economy grows, urbanization expands, and life-quality improves. It is the primary driver of the future development of community-based retail, also indicates the unfulfilled economic and social value underlying the community-based retail development in China.

2.2.2. On-going Upgrade and Growing Appeal

Traditional commerce, in general, is severely challenged by E-commerce. However, community-based retail has been embracing the evolving technology and the changing lifestyle to upgrade and enhance its market niche. For instance, levered by Online-to-Offline (O2O) system, the community-based retail has proven to have the potential to maximize its advantage of proximity to residents, linking the online platform to the doorstep of the consumers and creating a stable and competitive trading area within 1-mile distance to surrounding neighborhoods. By combining E-commerce, community-based retail will provide an actual one-stop experience, which is the enduring appeal of it.

Moreover, the focus on the close-to-the-door retail business and the relatively compact format of community-based retail will allow it to sense and respond to the changing demand of the consumers more quickly than large malls. In addition, rooted in neighborhoods that are composed by different resident groups thereby carrying unique characteristics, community-based retail has the potential to upgrade its business more targeted, obtain more positive feedback, and achieve more effective improvement than large malls.

2.2.3. Potential Social Benefits

Community-based retail has great potential to play a more significant role in creating better places for people to live. In the past, community-based retail in China was subordinated to the residential community development (Chen, 2016), in which the retail elements are limited and viewed as the required basic community services. However, nowadays, both the government and developers realize that community-based retail development is crucial to meet the demand for more diverse community-level services thereby improving customer satisfaction and the structure of the general commerce. Moreover, community-based retail development is essential to create the self-efficient community life circle, which will help to reduce the cost of commute, consumption of energy, and pollution involved in the process, thus to build a more sustainable and desirable living environment. Notice that these social benefits related to the development of community-based retail can, but not yet, be capitalized into the market value of the neighborhoods, which provides another opportunity that comes as a revelation.

2.3. Limitation

As stated before, community-based retail is driven by both business and social value and has the potential to capitalize on both perspectives. The unique advantages over the general retail sector also provide community-based retail development a market niche with underlying opportunities. However, challenges always emerge with opportunities.

2.3.1. Unsystematic Development

Traditionally, the development of community-level retail in China lacks systematic urban planning and regulations of the retail business (Chen, 2016; Zhu, 2013). Most of the development is affiliated with residential development, following a building area benchmark relative to the whole community. It is the developers that finally decide how much, what types, and how well the retail clusters are built. They usually do not have much incentive to consider the improvement of the long-term operating performance of each and overall retail clusters.

Moreover, it is even harder for developers to voluntarily consider how their small-scale retail clusters fit into the larger commerce system of surrounding districts. For example, developers of adjacent communities may only consider their individual responsibility to provide the required amount of retail space and build for typical business types such as restaurants and regular stores. They may not think that in a larger district, there might be a need for a special place with a larger footprint for a grocery store. As a result, in many communities, the role of existing community-level retail to improve residents' life quality is very limited.

2.3.2. Shortsighted Operation

Similarly, in terms of tenant selection and lease strategy, the property owners (usually developers themselves) of community-based retail tend to focus on short-run outcomes. For many property owners, the primary goal of the operation is to reduce the lease-up time and guarantee to reach a certain occupancy benchmark as soon as possible. With such short-term lease-up benchmark in mind, property owners tend to leave the long-term performance issues, such as adjusting the combination of types of business to maximize the overall retail performance, to tomorrow.

For example, in order to lease the retail space as soon as possible, the property owners prefer to lease individual spaces to "typical tenants" such as small restaurants and cafes. As a result, a large portion of the retail businesses is foods and beverage, causing unnecessary competition and affecting the long-run performance of the retail clusters as a whole. Once these happen, because of lacking outstanding retail performance record, even if the property owners decide to solve the problems by changing the combination of tenants, it would already become more difficult to release the space to more qualified tenants.

Even if the property owners have the incentive to wisely choose tenants at the very beginning and to continuously update the combination of tenants according to the changing demand of customers, without the help of experienced operating professionals and market analysis team, it is still hard to rightly position the long-term expectation and bridge the gap between what they could provide and what the market indeed needs.

2.3.3. Limited Financing Sources

As China's real estate market evolves, available financing sources, traditional ones or innovative ones, for development have become more diversified now than before. However, evidence shows that most of the new investment in China's real estate projects still lies in the three traditional sources: pre-sale payment, bank loans, and residual internal cash (Zeng, 2018). Therefore, developers have to bear more financing pressure while the authorities in China have tightened the credit controls on real estate development since the last decade, restricting development companies borrowing money from banks (Wei, 2014).

Consequently, developers have actively explored alternative financing sources other than these major traditional financing sources. For example, real estate private equity showed a strong growth trend in the early 2010s, when the government decided to escalate the financial system reforms and encourage the private equity funding system (Fu, 2015). However, in 2011, China Banking Regulatory Commission (CBRC) began to apply higher threshold and restrict the issue of real estate private equity, limiting the financing sources of real estate development (Zeng, 2018).

In addition, in the last decade, sporadic experiments on varied real asset securitization tools have begun to take place in China (Fu, 2015). However, compared with the relatively matured and developed foreign real estate markets, the real estate asset securitization in China has yet become an essential tool for real estate development (Guo, 2018). There is a long way to go for this innovative financing category to generate transformative power to China's real estate market.

3. Why Launch Community-Based Retail REITs in China

The previous discussion has conveyed a sense of complexity for both opportunities and challenges involved in the future community-based retail development in China. It is clear that in order to make a breakthrough in the future and achieve the ultimate goal of creating communities of higher quality, critical participants in the process—government, developer, investor, operator—should not avoid attempting alternative approach and making collaborative efforts. Inspired by what have happened in the history of the U.S. real estate market, which is better developed and more matured than current real estate market in China, the paper argues that by utilizing real estate investment trusts (REITs) as innovative financing sources in the future development of community-based retail in China could be a good starting point.

Currently, in China, there is no fully-fledged REITs product as in the U.S. market. Combining previous analysis of the opportunities and limitations of community-based retail in China and the lessons given by typical neighborhood center REITs in the U.S., this chapter will elaborate on the motivation of launching community-based retail REITs in China. In other words, this chapter attempts to answer the following key questions:

What is unique for community-based retail, and how do REITs accord with the future of community-based retail development in China?

What is the potential and market niche of community-based retail REITs, and how do they fit into the goal of creating better neighborhoods in the cities?

3.1. Introduction of Typical Neighborhood Center REITs

3.1.1. Overview of Typical REITs

REIT system was born in the U.S. in 1960, as large sums of real estate equity and mortgage funds in demand, and today it has become the dominant fund real estate securitization product in the world. National Association of Real Estate Investment Trusts (NAREIT) defines real estate investment trusts (REITs)—as "companies that own or finance income-producing real estate in a range of property sectors" ("What Is A REIT?" n.d.). REITs provide a channel for individual investors with narrow capital sources and offering a liquid way to invest in a diversified portfolio of commercial property, and in the meantime facilitate commercial properties to obtain equity capital financing from the public stock market (Geltner, 2014). Every investor is provided the opportunity to own valuable asset and obtain dividend-based income through REITs ("What Is A REIT?" n.d.), and the avoidance of double taxation embedded in the pass-through structure has given REITs the edge over other investment vehicles. Congress exempts REITs from the federal income tax as long as they meet the certain requirement of asset, income, distribution, stock, and ownership (Brueggeman & Fisher, 2011).

Except for the non-listed "private" REITs, the majority of publicly-traded REITs can be divided into two principal types: equity REITs (dominant REIT type) and mortgage REITs. An equity REIT collects property interests, acquiring, managing, renovating, and even developing properties. A mortgage REIT is under mortgage obligations that are secured by real estate properties (Block, 2012).

Equity REITs are considered more appealing than mortgage REITs, which may provide more attractive dividend yields and investment returns, not only because equity trusts are less vulnerable to the fluctuation of interest rates but also because of their better historical records and relatively more active investment approach (Block, 2012). Equity REITs diversify by either property type[1] or geographic location (or both), and the "specialization" shows their concentrative effort to make a niche (Brueggeman & Fisher, 2011).

3.1.2. Evolution of Typical REITs

REITs have been evolving with the changing market conditions. Several milestones of the REITs industry should be noted to understand how REITs become what they are today. Up until the late 1980s, REITs were legally obliged to outsource the property leasing and management services. However, the Tax Reform Act of 1986 has greatly changed the landscape of the REIT industry and therefore, the real estate investment market. This legislation allowed REITs to keep the leasing and management activities within their own organizations, which makes sense since profitable and outstanding property ownership relies crucially on professional, efficient, and forward-looking leasing and management strategies. The tax reform was so important that it led the REITs industry towards an entirely new chapter, the Modern REITs Era.

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[1] In 2019, NAREIT categorizes equity REITs into the following property types—office, industrial, retail, residential, diversified, lodging/resorts, self storage, health care, timber, infrastructure, data centers, and specialty—which reflects the current real estate market

The introduction of UPREIT (umbrella partnership REIT) in 1992 further facilitated the boom of REITs market in the 1990s, as this structure has the potential to reduce the cost for real estate firms. Instead of selling properties to a new REIT and paying significant capital gains taxes, real estate operating companies can transfer their properties into the new REIT under UPREIT structure (Block, 2012). Rather than directly own the underlying physical properties, a UPREIT owns units in a partnership, which implies its direct or indirect ownership of the physical properties.

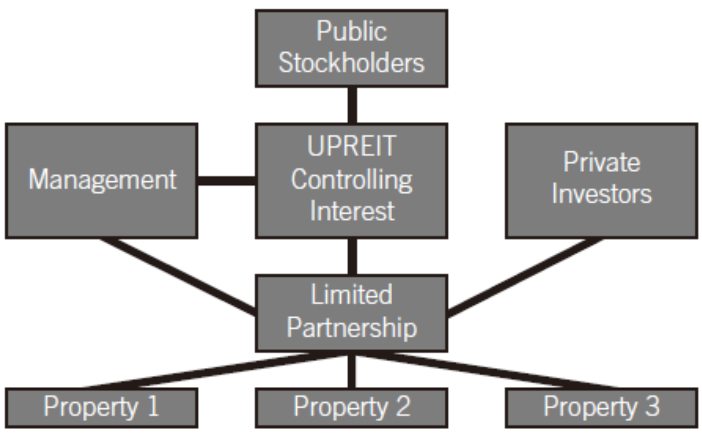

Exhibit 1. Typical Corporate and Property Structure of UPREIT
Source: Block, 2012, P35

Around the 2000s, the REIT Modernization Act, along with subsequent legislation, has made it possible for REITs to be involved in more diverse real estate businesses through taxable subsidiaries. A typical REIT today is featured by the "vertical articulation" covering the "food chain" from raw land acquisition, development, asset management, to operational management (Geltner, 2014). In addition, REITs usually engage in large and geographically diversified real estate portfolios (Brueggeman & Fisher, 2011).

3.1.3. Neighborhood Center REITs

Retail REITs have been a major sector through the history of REITs; although retail industry suffers a downturn these years, in 2019, retail REITs are the third largest sector, following Infrastructure and residential sectors.

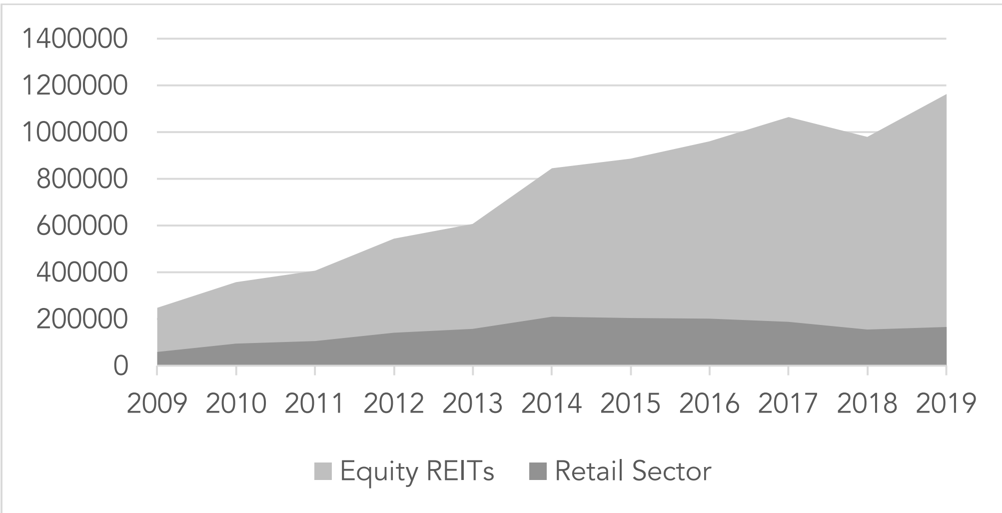

Exhibit 2. Retail Sector Capitalization (Millions of dollars)
Source: FTSE Nareit All REIT Index

Retail REIT is the product of the noticeable shift of equity financing in the retail industry—substantial securitized investment instruments have taken the place of traditional financing sources over past few decades—following a series of tax reforms and gradually more conservative mortgage practices. The shift reflects the respondent of investors to the retail industry, and the profitability of the underlying retail properties is one of the essential considerations for investors to align their interest.

The two primary sub-sectors within retail REITs are the neighborhood shopping center and the regional mall. The former shares great similarities with the community-based retail discussed in the paper, therefore, will be the focus of this section.

Neighborhood shopping centers provide day-to-day goods and services to their nearby residential neighborhoods, such as grocery, bakery, drugstore, dry cleaning, pet care, and shoe repair. The key competitiveness of a neighborhood shopping center is convenience and necessity, which allows it to survive and thrive even in recessions.

According to FTSE Nareit All REIT Index, compared with the regional mall REITs sector, shopping center REITs sector (where neighborhood shopping center is dominant) has a more stable share of capitalization over the last decade. Even when the retail REITs enter a continuing downturn in recent years with a shrinking contribution to equity REITs market, shopping center REITs sector has suffered less.

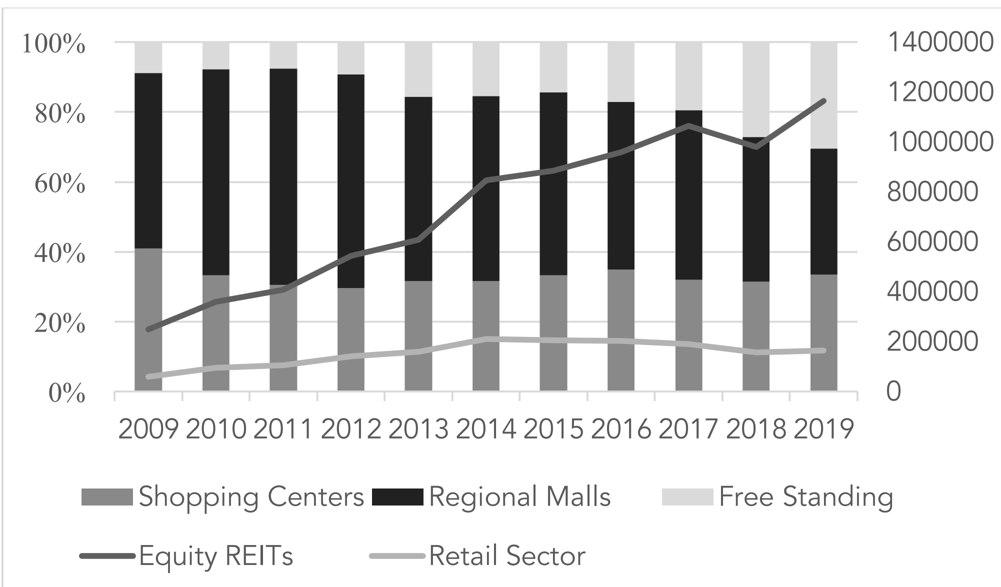

Exhibit 3. Retail Sub-sector Capitalization Distribution
Source: FTSE Nareit All REIT Index

In addition, compared with regional malls that fit better in private market ownership, neighborhood shopping centers could be more appropriate for REIT ownership and more appealing to public REITs investors. Regional malls are appreciated more on the long-term growth of the properties, even at the cost of current return; in contrast, neighborhood shopping centers have a relatively limited growth prospect (partly because of the market size and business scale) but provide more attractive current returns. This relatively higher current returns rather than outstanding higher long-term rewards accord with the perspective of public REITs investors, who require visible dividend in a shorter-term (White & Gray, 1996).

3.1.4. `

i. Appealing and Compelling Investment

REITs, in general, provide small or large investors with steady and predictable cash flows with common stock's liquidity. REITs also have a low correlation with other asset classes and act as a hedge to the inflation and the fluctuation of the interest rate.

For retail REITs, it is the confidence in the returns generated by the retail sector that has led the capital markets to embrace the retail REITs as equity owners. Several concerns have long existed over the performance of retail properties, among which, are the economic situation of the society and the purchasing power of the consumers, the challenges from competitive E-commerce and the changing appetite of customers, and the unavoidable cost of continuous capital expenditure to maintain the value of the property. These considerations are applied to the neighborhood center, as well.

However, despite the fact of more intense competition and visible failure cases in the general retail industry, neighborhood centers can still do well if they maintain the market niche of convenience and necessity through proper management—location decisions, leasing strategies, and property maintenance. In other words, whether a neighborhood center will thrive, thus making a good REIT investment is determined primarily by the location[2] and management.

ii. Integrated and Growing System

The sophisticated and integrated system of U.S. REIT today and its widespread influence have been developed through various adaptations, among which are supportive legislation and tax reforms, innovative structure exploration which enables the more transferable system, and in-depth market penetration which bridges various real estate businesses.

Alike other typical REITs, neighborhood center REITs involve in vertical integrated real estate business and can increase the value with limited free cash flow after paying out 90 percent of the earnings, mainly through operational methods of financial engineering, providing services, and growing income from existing properties, acquisitions or development (Brueggeman & Fisher, 2011).

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[2] Proximity to major residential communities and substantial regular customers base will ensure enough sales per square foot, which is a vital signal of the performance of a neighborhood center.

For instance, because of the ready access to capital, neighborhood center REITs can acquire, develop and renovate additional properties as part of their ongoing real estate business, adapting to the return expectation of REITs investors and changing situation of the retail industry. Notably, prolific developers have played a considerable role in neighborhood center REITs and developers have created substantial value by catching the spread between the cost of construction and the value after the lease-up (Block, 2012).

In sum, the growing and vertical integrated scheme of the neighborhood center REITs promotes a positive feedback loop that helps to align the expectation of REITs investors, the updating trends in the market and the operation strategy of the properties.

3.2. Motivations

3.2.1. What is unique for community-based retail in China?

Similar to U.S. neighborhood center, the community-based retail in China can gain its competitiveness from convenience and necessity that are needed by the residents and embedded in the very nature of community-based retail business. Slightly different from the U.S. retail market, the Chinese counterpart enjoys a currently greater gap between the demand and supply of quality community-based retail, more urgent need to upgrade and diversify the community-based services, and more rapid integration of the internet and E-commerce into the traditional retail format. The market penitential of community-based retail in China is calling for additional effort to promote the development and fulfill the unrealized benefit underlying it.

However, as opposed to the U.S. neighborhood center development, which is more market-oriented, current community-based retail development in China carries a more government-supervised and developer-oriented feature. Looking backward, although a successful retail business will increase the value of the residential properties, developers have been reluctant to develop the community-based retail over the benchmark set by the government, because less retail units in a community will leave more room for residential units that are more profitable. Looking forward, although the community-based retail development in China will and has to respond to the growing market more directly; it will still be led by developers who focus more on the profitability of individual community project and guided by the government representing the social value.

In this sense, for community-based retail development in China, to achieve the ultimate goal of improving the quality of life and creating better communities in cities, not only the social demand and market driver matter, but also an effective system in which developer will have the incentive to respond and benefit from the market and social trend, and government will have a channel to convert the social value to business incentives.

3.2.2. How do REITs match the uniqueness?

In order to link and utilize the unique and intertwined economic and social drivers stated before, it is worthwhile for the future development of community-based retail in China to invite an alternative approach. Generally speaking, the primary motivation of launching REITs in China is their potential to "couple the twin goals of encouraging real estate development while democratizing the wealth that development generates," which aligns with the social and economic goals of China's future development plan (Hill, 2017).

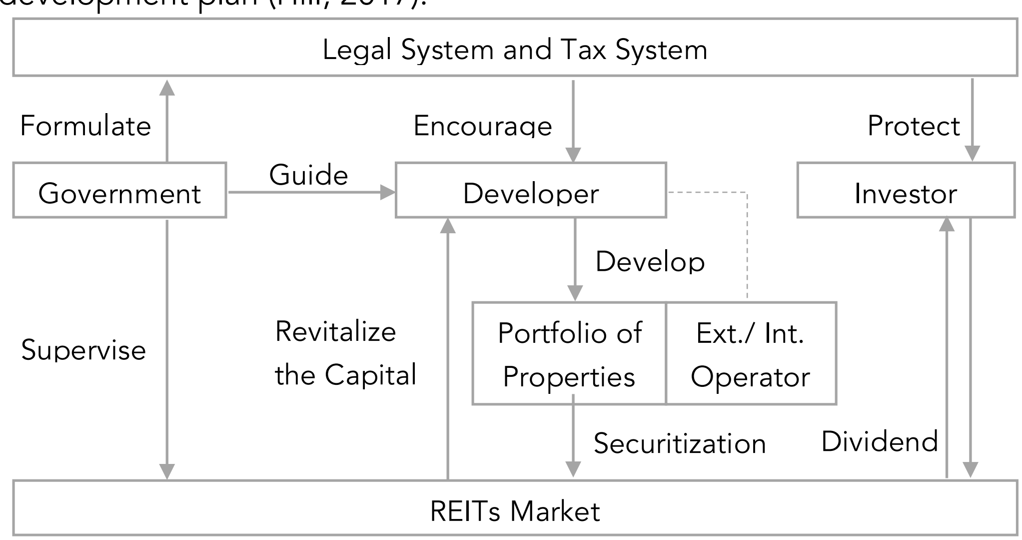

Exhibit 4. Collaborative Platform of Community-based Retail REITS
Reference: Cai, 2017, P66

In particular, the establishment of a fully-fledged REIT system that wears more typical characteristic than current quasi-REITs will accord with the uniqueness of community-based retail development in China. It will involve more market forces into the future development of community-based retail in China, assisting in capitalizing both the business value and social value; it will link the capital market and the community-based retail space market in a relatively liquid way thereby partially solving the current financing limitation that currently hinders development; and it will promote vertical integration through the food chain of the community-based retail sector to fulfill the underlying potential of creating better communities in urban China.

Inspired by the typical REITs, theoretically, a community-based retail REIT will play its positive role through the collaborative platform and the integrated system. As shown in the exhibit, through the REIT system, the major participants—the developer, the investor, and the government—of the community-based retail development may align their interests and make a collaborative effort to catch the opportunities and solve the challenges involved in the future community-based retail development in China. In addition, the key processes—financing, landholding, development, ownership, operation, and tenant services—of the community-based retail development may be integrated vertically and sustainably to create a positive feedback loop where business value can be coupled with social value. More specifically, the rationale behind the argument lies in the following perspectives.

i. Project Perspective

Because of the tightened credit control and the restricted bank loan, the developers have more incentive to plow back their profits quickly into more profitable residential development, to directly benefit from the spread between the cost of construction and sale proceeds. They are, therefore, relatively reluctant to put new effort on community-based retail and benefit indirectly from the value appreciation of the community as a whole. However, under a REIT scheme, the ready access to the additional capital source and relatively low cost of financing for community-based retail, along with the obligation to produce qualified underlying assets, will provide the developers with the fund and incentive to take on more responsibility of community-making instead of housing-production.

Not only financially support the new development, but a community-based retail REIT will also fund the capital expenditure that is continuously required to maintain a properly functioning community-based retail, which in turn will increase the value of the base residential development. Therefore, the developer can enjoy a greater profit margin though the reduced financing cost and the appreciated value of the whole community development project.

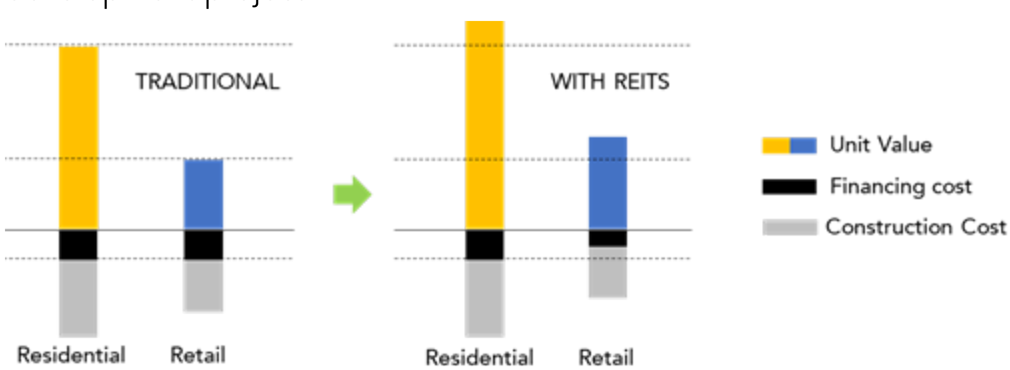

Exhibit 5. Reduced Financing Cost and Increased Profit Margin

Moreover, a community-based retail REIT will provide developers with a way to minimize and exit their equity investment, promoting the transition from an asset-heavy approach emphasizing the ownership to an asset-light business model focusing more on the operation and management of community-based retail properties, which to a great extent determine the capability and sustainability of the community-based retail to serve the neighborhood.

ii. Investment Perspective

Through the scheme of a community-based retail REIT, domestic and even international investors, who may not have particular expertise in retail or real estate industry, will be invited to participate into the originally developer-oriented game to achieve the goal that would be too far away if relying on the unilateral effort of the developers.

As stated before, convenience, necessity, demand-supply gap, and O2O opportunity have defined the advantages of community-based retail over other retail sectors, which allows the community-based retail to survive and thrive even in recessions. Therefore, it is reasonable to assume that a community-based retail REIT will offer the investors relatively stable returns even during a downturn in the general retail market, with more liquidity, transparency and professional management support as well.

In terms of portfolio management, as the individual community-based retail property is to small a scale to enter a REIT scheme, it is typical to select many assets into one package to achieve a proper investment scale. As opposed to other REITs sectors, such as office REITs, which may have a larger size of individual property and involve less complexity of the portfolio, a community-base retail REIT may need additional management effort to deal with the portfolio medley. However, it is worthwhile since the smaller size of the individual property offers the REIT the flexibility to adjust the underlying components without suffering risky and radical changes.

Moreover, the conflicts among the management and the investors are usually minimized through the design of a REIT scheme. This alignment of interests accords with the particular need of community-based retail to be intensively and adaptively operated. With relatively long term investment schedule, a community-based retail REIT will encourage the property holder and operating partner to maintain the business properly in the long-run, which in turn, will enhance the confidence of REIT investors.

iii. Supervision Perspective

Authority support is indispensable for launching community-based retail REITs in China, which offers the government a good position to negotiate better benchmarks of community-based development and an opportunity to utilize the power of the market to switch the passive requirement of social benefits to positive incentive system. In other words, through the scheme of community-based retail REITs, the government will indeed assist in capitalizing the social value embedded in the development and investment of community-based retail.

For instance, the government may set specific criteria, such as property size, location, business type, and service radius, for approving the tax credits and even tax exemption to a community-based retail REIT. In this way, the government can provide developers with a great incentive to follow the instruction of urban planning and even make voluntary decisions on better serving the society by developing or renovating the community-based retail as people need. The capitalized social value will finally be reflected in the improved balance sheet of the property holders and the dividend gained by the investors of the community-based retail REITs.

3.2.3. Why will Community-based Retail REITs make a niche?

To extend the discussion of how REITs match with the development of community-based retail in China and how a community-based retail REIT scheme will work, this section highlights the major advantages that a community-based retail REIT can have over other sectors in China.

i. Its stable performance will be guaranteed by the constant demand for necessity and convenience, and a stable, even growing, customer base composed of neighborhood residents.
ii. It is easier to obtain political support and special offer that necessary to launch a typical REIT because of its embedded social benefits, which office, industrial, general retail, and other sectors do not share.
iii. It can take advantage of the boom in the rental market and the proceeding experiments of long-term apartment REITs in China, entering the community-creation fray and utilizing existing supports.
iv. It is consistent with the ongoing experiments of many residential and retail developers to switch to an asset-light business strategy.

4. Case Studies

As REITs have proved to be a popular and successful investment vehicle in the U.S. market and many other foreign markets, investors have been long waiting for the launch of REITs on mainland China. Although the discussion of REITs in China can be traced back to the dawn of this century and various regulatory maneuvering and experiments have taken place, currently in mainland China, Chinese REITs (C-REITs) are yet not considered as typical as REITs in a mature market. Habitually referred to as quasi-REITs, the REITs with "Chinese characteristics" are "beta-mode" REITs (Hill, 2017). In this chapter, specific cases of REITs are chosen from both the U.S. and China to provide a straightforward comparison, showing the gap and differences in between.

4.1. Kite Realty Group Trust

4.1.1. Overview

Kite Realty Group Trust (NYSE: KRG) operates as a publicly traded, full-service, and vertically integrated real estate investment trust, engaging in the ownership, operation, management, leasing, acquisition, construction, redevelopment and development of high-quality neighborhood and community centers in selected markets in the U.S. The company was incorporated on March 29, 2004, owning interests in diverse operating subsidiaries and joint ventures through its subsidiary, Kite Realty Group, L.P. The predecessor, Kite Property Group, is a nationally recognized real estate owner and developer.

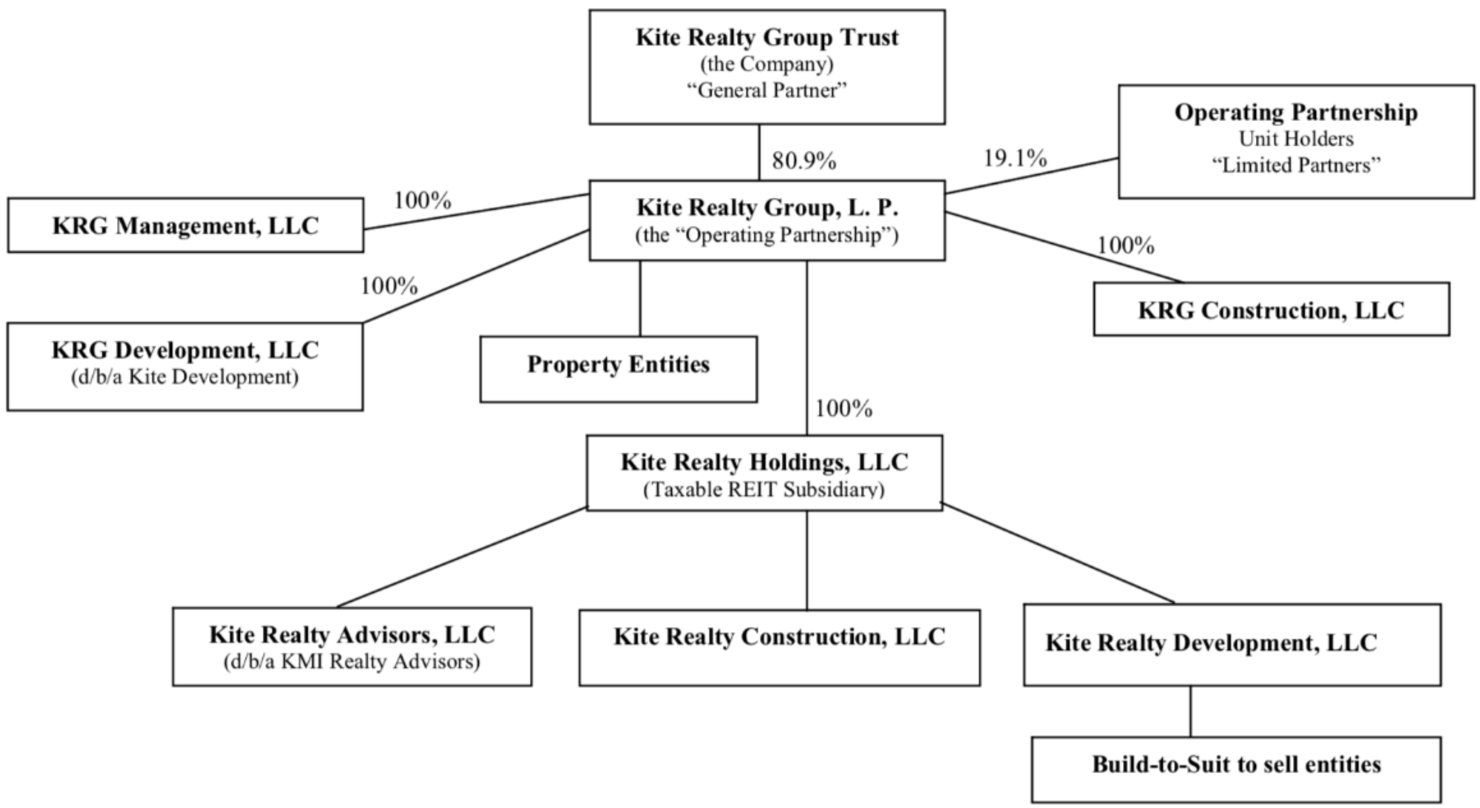

Exhibit 6. Corporate Structure (2009)

Source: Kite Realty Group

After completing the IPO (initial public offering), concurrently with the consummation of various formation transactions that consolidated the company's operating partnership, KRG commenced operations on August 16, 2004, aiming to provide communities with convenient and beneficial shopping experiences, connect consumers to tenants in desirable markets and optimize the portfolio to maximize value and return to the shareholders.

4.1.2. Portfolio of Properties

KRG Quick Facts	
Number of Retail Properties	107
Total GLA (SF)	21.3mm
Operating Portfolio Percent Leased	95.0%
Annualized Base Rent (ABR) Per SF	$17.16
Equity Market Capitalization[3]	$1.4B
Enterprise Value[3]	$2.9B
2018 FFO Payout Ratio	63.5%
Net Debt to EBITDA[4]	6.6x
Moody's / S&P Ratings	Baa3 / BBB-

Why KRG?
High-quality portfolio with diverse tenant base
Covered dividend with attractive 8% yield[1]
Opportunity to exploit current public market dislocation with stock trading at material discount to consensus net asset value ("NAV")[2]
$350-500mm disposition program underway to optimize the portfolio, deleverage an already strong balance sheet and close NAV gap
Experienced, disciplined team focused on operational excellence and value creation

Exhibit 7. Kite Realty Group Snapshot
Source: KRG Investor Update 1st Quarter 2019

As of December 31, 2005, KRG owned interests in a portfolio of 40 retail operating properties (approximately 6.2 million square feet of gross leasable area) and 14 retail development properties (approximately 1.8 million square feet of total gross leasable area). In addition, the company owned interests in land parcels comprising approximately 180 acres that could be used for future development or expansion of existing properties.

Exhibit 8. Operating and Redevelopment and Development Projects
Source: Kite Realty Group Annual Report 2018

	2018	2017	2016
Operating Retail Properties	105	105	108
Operating Office Properties and Other	3	4	2
Redevelopment Properties	3	8	9
Total Operating and Redevelopment Properties	111	117	119
Development Projects:	1	2	2
Total All Properties	**112**	**119**	**121**

As of December 31, 2018, KRG owned interests in 111 operating and redevelopment properties and one development project under construction. The total operating portfolio consists of approximately 21.9 million of owned square feet in 19 states. 77 percent of the annual base rent is from the top 50 MSAs and destination locations, including high-growth markets.

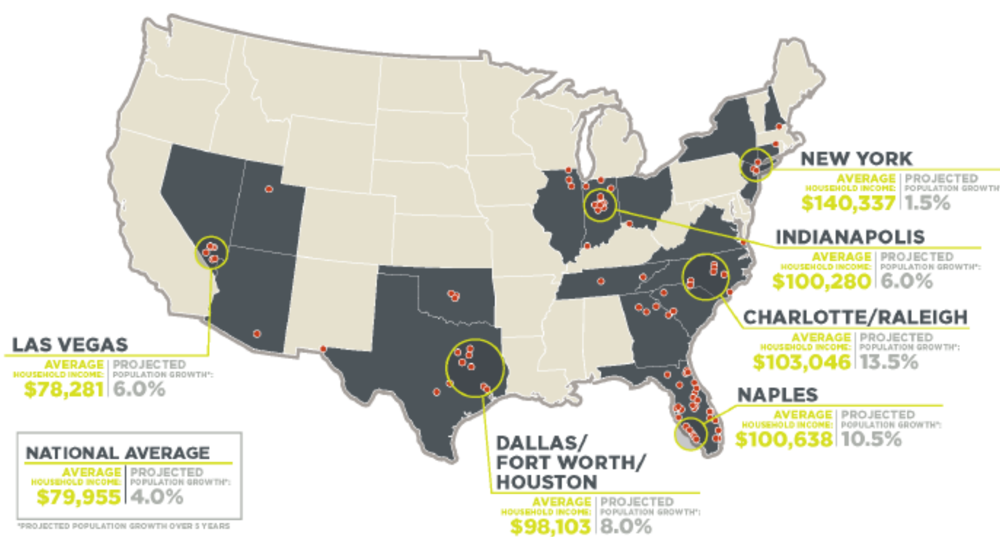

Exhibit 9. Geographic Diversification
Source: KRG Investor Update 1st Quarter 2019

According to the statistics of KGR in 2019, its primary properties categories are—community center, neighborhood center, and power center. Community center, relatively larger than neighborhood center with general merchandise or convenience-oriented offerings, contributes 56 percent of the annualized base rent (ABR). Power center, category-dominant anchors including discount, off-price and wholesale clubs with minimal small shop tenants, produces 20 percent of ABR. Neighborhood center, the convenience-oriented center often anchored by a grocery, along with other kinds of assets, generates 24 percent ABR. Notice that over 70 percent of its retail annualized base rent is from centers with a grocery component.

Exhibit 10. Property Classification by ABR
Source: KRG Investor Update 1st Quarter 2019

The retail operating portfolio of KRG was 94.6 percent leased to a diversified retail tenant base in 2018, with no single retail tenant accounting for more than 2.6 percent of the total annualized base rent. In the aggregate, the largest 25 tenants accounted for 34.1 percent ABR.

4.1.3. Ownership

Major shareholders include individual investors, mutual funds, hedge funds, or institutions. KRG currently has 315 institutional investors and shareholders, holding a total of 80,815,672 shares. Largest shareholders include BlackRock Inc., Vanguard Group Inc, State Street Corp, Macquarie Group Ltd, Fuller & Thaler Asset Management, Inc., Renaissance Technologies LLC, Invesco Ltd., American Century Companies Inc, Victory Capital Management Inc, and Investment Counselors of Maryland LLC.

Exhibit 11. Ownership Information
Source: ir,kiterealty.com

Shares Outstanding	83,910,408
Short Interest Shares	2,377,817
Float (%)	98.87
Institutional Ownership (%)	96.98
Mutual Fund Ownership (%)	60.54
Insider Ownership (%)	1.13
Top 10 Instant. Holders (%)	57.25

4.1.4. Business Strategies

The primary business objectives of KRG are to increase the cash flow and value of its properties, realize sustainable long-term growth, and maximize shareholder value through the ownership and operation, acquisition, development and redevelopment of high-quality neighborhood and community shopping centers. In order to fulfill the goals, KRG mainly applies the following strategies.

i. Operating Strategy

Maximizing the internal growth in revenue from the operating properties by leasing and re-leasing to strong and diverse group of retail tenants at increasing rental rates when possible, and redeveloping or renovating certain properties to make them more attractive to existing and prospective tenants and consumers. Notice that most of the properties are located in regional and neighborhood trade areas with attractive demographics, which allows KRG to maximize occupancy and rental rates.

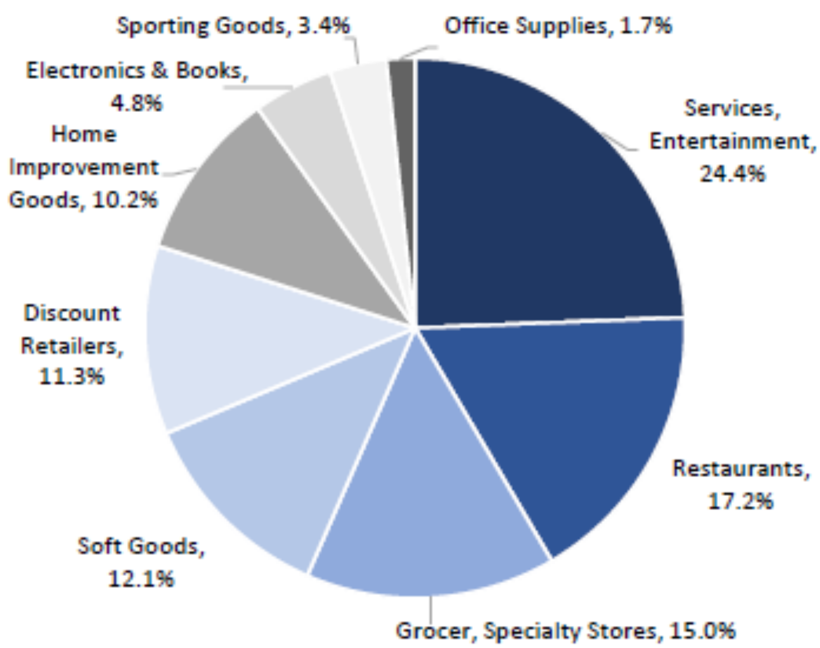

Exhibit 12. Q1 2019 ABR Tenant Mix
Source: KRG Investor Update 1st Quarter 2019

ii. Growth Strategy

Selectively acquiring additional retail properties and redeveloping or renovating the existing properties where the investment returns have the potential to meet or exceed internal benchmarks, through following ways:

Continually evaluating the operating properties to make them more attractive for leasing to new tenants, right-sizing of anchor spaces while increasing rental rates, and releasing spaces to existing tenants at increased rental rates;

Disposing of selected assets that no longer meet the long-term investment criteria and recycling the net proceeds into properties that provide attractive returns and rent growth potential or using the proceeds to repay debt, thereby reducing the leverage;

Selectively pursuing the acquisition of retail operating properties, portfolios and companies in markets where KRG can leverage its existing infrastructure and relationships to generate attractive risk-adjusted returns or otherwise in desirable trade areas. The criteria of KRG real estate include convenience/necessity-based, longer dwell time or both; ability to adapt/reconfigure to respond to changing retailer needs/ main and main locations; densification and/or diversification opportunity; strong growth or value-add opportunity; supportive local government.

iii. Financing and Capital Preservation Strategy

Maintaining a strong balance sheet with sufficient flexibility to fund operating and investment activities. Funding sources include the reinvestment of cash flows generated by operations, the sale of common or preferred shares through public offerings or private placements, the reinvestment of net proceeds from the disposition, the incurrence of additional indebtedness through secured of unsecured borrowings, and entering into real estate joint ventures.

There are factors that KRG considers when evaluating the amount and type of additional indebtedness it may elect to incur. For instance, the construction costs or purchase prices of properties to be developed or acquired, the estimated market value of the properties and the company as a whole upon consummation of the financing, and the ability to generate cash flow to cover expected debt service.

4.1.5. Performance

KRG derives revenues mainly from activities associated with the collection of contractual rents and reimbursement payments form tenants at its properties. The operating results therefore depend materially on the ability of the tenants to make required lease payments, the health and resilience of the U.S. retail sector, interest rate volatility, job growth and overall economic and real estate market conditions.

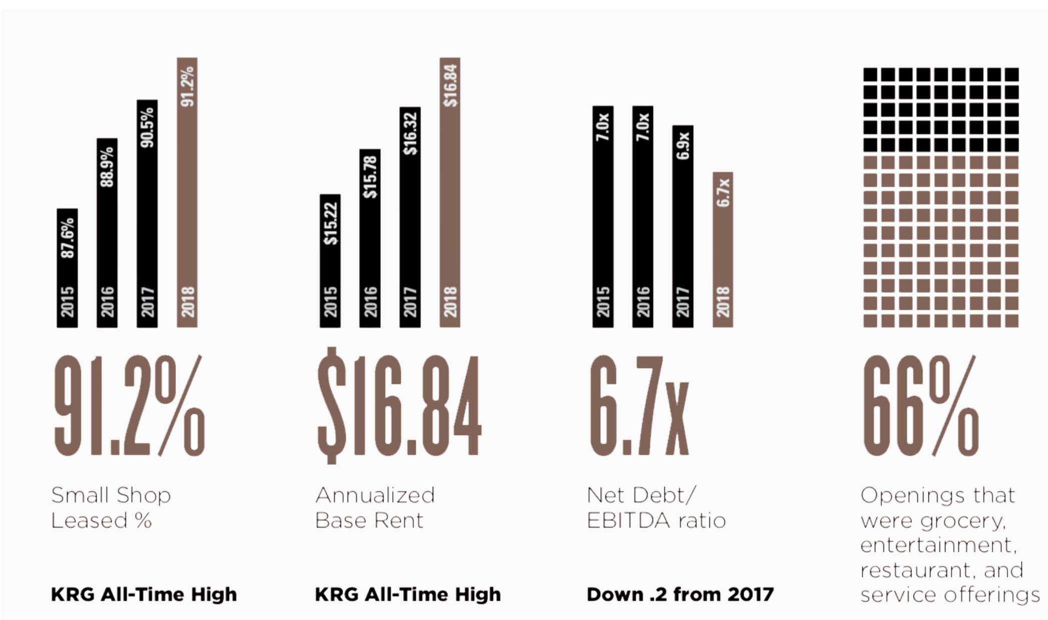

Exhibit 13. Performance Highlights
Source: Kite Realty Group Annual Report 2018

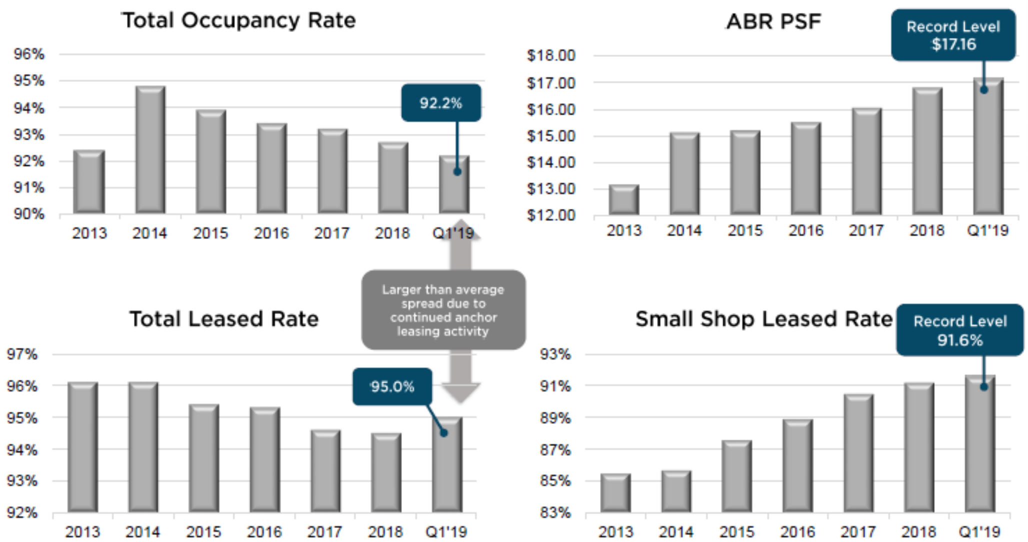

Exhibit 14. Occupancy Statistics
Source: KRG Investor Update 1st Quarter 2019

Over the half decades, the annualized base rent and shop space occupancy of KRG's operating properties of KRG have continued to grow while the overall occupancy remains steady. Compared with the peer competitors, KRG has improved metrics presented below.

ABR PSF		Net Debt / EBITDA		Net Debt + Pref / EBITDA		Avg Debt Duration (Yrs)	
AKR	$ 29.31	CDR	8.4x	CDR	10.4x	KIM	10.2
FRT	$ 27.79	ROIC	7.3x	ROIC	7.3x	FRT	10.0
REG	$ 22.10	**KRG (Today)[3]**	**6.6x**	RPT	7.3x	REG	8.0
ROIC	$ 21.28	RPT	6.6x	KIM	7.0x	**KRG (Proforma)**	**7.0**
WRI	$ 19.45	BRX	6.4x	SITC	6.8x	UE	6.4
RPAI	$ 19.17	AKR	6.1x	**KRG (Today)[3]**	**6.6x**	SITC	6.0
UE	$ 18.28	**KRG (Proforma)**	**~5.9x**	BRX	6.4x	**KRG (Today)**	**5.5**
KRG (Proforma)	**$ 18.00+**	KIM	5.7x	AKR	6.1x	RPT	5.5
SITC	$ 17.92	SITC	5.5x	**KRG (Proforma)**	**~5.9x**	ROIC	5.5
KRG (Today)	**$ 17.16**	RPAI	5.4x	FRT	5.5x	WRI	5.4
KIM	$ 16.43	FRT	5.3x	RPAI	5.4x	BRX	5.0
RPT	$ 15.35	WRI	5.3x	WRI	5.3x	CDR	4.8
BRX	$ 14.32	REG	5.3x	REG	5.3x	AKR	4.6
CDR	$ 13.80	UE	5.1x	UE	5.1x	RPAI	4.5

Exhibit 15. Improved Metrics
Source: KRG Investor Update 1st Quarter 2019

4.2. GSUMDONGWU-SUNGENT Neighborhood Center Subordinated Asset-Backed Security

4.2.1. Overview

GSUMDONGWU-SUNGENT Neighborhood Center Subordinated Asset-Backed Security (referred to as "GS REIT" in the thesis) is the first community-based quasi-REIT in China. Different from typical REIT mentioned in the previous section, the quasi-REIT with Chinese characteristics, prevailing currently in mainland China, can be viewed as a hybrid investment vehicle of asset-backed security (ABS) and private equity fund (PE Fund). In brief, the quasi-REIT aims to link the capital of PE fund to the real property investment, thereby switching the ownership to the investor from the original equity holder, who will receive the consideration.

GS REIT was listed in the E-market of Shanghai Stock Exchange for fixed income securities on April 2, 2018. The total issued amount is RMB 2.05 billion. During the 5-year duration, As part of the attempt to create a sustainable mechanism of "development—mature project—REITs—development", GS REIT is expected to invite large capital and enhance the management and service quality of the operating neighborhood centers developed by Pungent Holding Group, a comprehensive real estate developer in Suzhou Industrial Park (SIP).

Exhibit 16. Equity Structure of Sungent Holding Group (June 20, 2017)

Exhibit 17. GS REIT Information

Tranche	Ranking	Duration	Amount RMB	Interest Rate	Principle Payment
Priority	AAA	5 years	1,450 million	5.80% Fixed	End of Duration
Inferior	NA	5 years	600 million	Floating	Pass-Through

4.2.2. Portfolio of Properties

The portfolio of GS REIT contains 10 selective neighborhood centers in SIP. The properties all meet the following criteria: located in the major residential areas with convenient public transit, proper building layout and circulation, diversification of retail services, and stable retailers with sounding operational performance.

Exhibit 18. GS Portfolio of Properties
Reference: Instruction of GSUMDONGWU-SUNGENT Neighborhood Center ABS

	Property	Building Area	Land use	Leased Retail Area	Retial Occupancy
1	Xincheng	20,829 sqm	mixed-use	16,830 sqm	87%
2	Guidu	5,894 sqm	non-Residential	5,894 sqm	100%
3	Shihui	12,387 sqm	commercial	4,887 sqm	92%
4	Hudong	26,669 sqm	commercial	24,889 sqm	98%
5	Linglong	14,083 sqm	commercial	8,963 sqm	99%
6	Qinyuan	7,122 sqm	commercial	7,122 sqm	100%
7	Hanlin	12,073 sqm	commercial	11,767 sqm	100%
8	Fangzhou	16,962 sqm	commercial	16,143 sqm	95%
9	Dongshahu	38,169 sqm	commercial	31,069 sqm	98%
10	Linrui	120,219 sqm	commercial	60,331 sqm	NA

Exhibit Continued

	Year Built	Comparable Rent	Major Tanants Type
1	1998	80-130 RMB	grocery, fitness
2	2001	80-130 RMB	grocery, education
3	2004	120-160 RMB	grocery, foods
4	2004	90-120 RMB	grocery, education, lifestyle
5	2006	150-180 RMB	grocery, foods, lifestyle
6	2007	80 RMB	grocery, fitness
7	2008	210-300 RMB	hotel, lifestyle, grocery
8	2011	130-150 RMB	grocery, education
9	2012	90-130 RMB	grocery, foods, lifestyle
10	2013	150-210 RMB	lifestyle, foods, education

4.2.3. *Structure and Highlights*

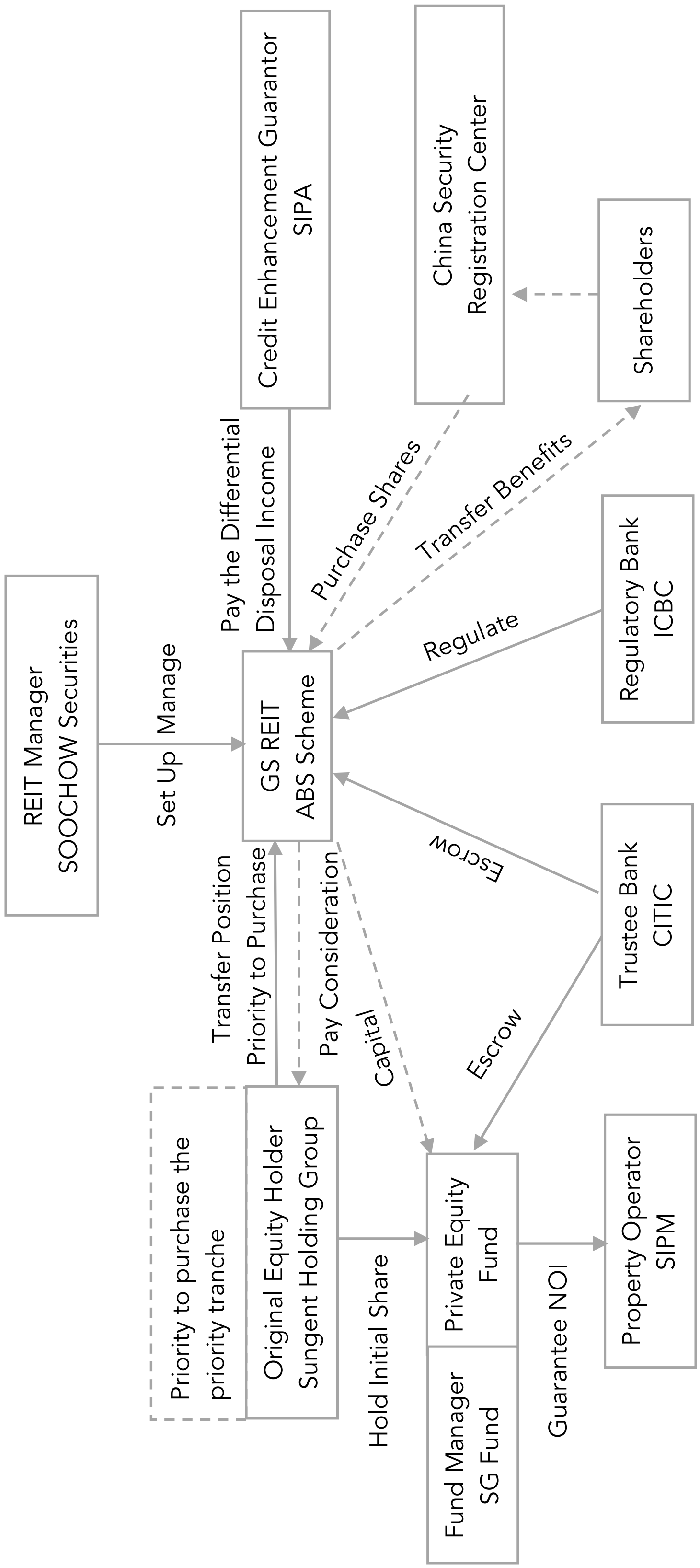

Figure 1. Deal Structure
Reference: Instruction of GSUMDONGWU-SUNGENT Neighborhood Center ABS

As shown in the diagram, the major participants in the deal structure include but not limited to the following interest partners. Sungent Holding Group is the original equity holder and underwriter. GSUM Capital is the coordinator and financial advisor. Sungent-GSUM Fund Management (SG Fund) is the fund manager, which is a joint venture created by Sungent Holding Group and GSUM Capital. SOOCHOW Securities is the REIT manager. SIP State-Owned Asset Holding (SIPA) is the credit enhancement guarantor. SIP Neighborhood Center Property Management (SIPM) is the operating company and the differential payment obligor. China CITIC Bank is the security custodian.

Credit enhancement is a crucial issue in the design of the deal structure of such equity quasi-REIT. In this case, among all the credit enhancement approaches applied, the followings are highlighted to demonstrate the features of the deal structure.

i. Performance Guarantee

The multiple of the expected net operating income (NOI) to the total tax and interest payments should be between 1.43 and 1.61, and the operating company is responsible for making up the gap between the committed NOI and the actual NOI in the downtime, to effectively align the interests of the operator and the investor.

ii. Priority to Purchase

The initial equity holder Sungent Holding Group has the right to claim the priority on the purchase of the shares of GS REIT and propose, to further ensure that the priority investors can be paid as committed.

iii. Deficiency Payment

SIP State-Owned Asset Holding (SIPA) is obliged to enhance the credit and make up the difference of the committed and the actual payment to the priority investors if unpleasant situation accrued when the REIT goes public, disposes assets, or closes, protecting the priority investors.

iv. Entrust Mortgage Loan

While the private equity fund holds 100 percent of the equity (valued as RMB 2.05 billion), it issues entrust mortgage loan (RMB 1.2196 billion in total) to each neighborhood center project company. In extreme cases, these mortgages will effectively guarantee the committed payment.

4.2.4. Performance

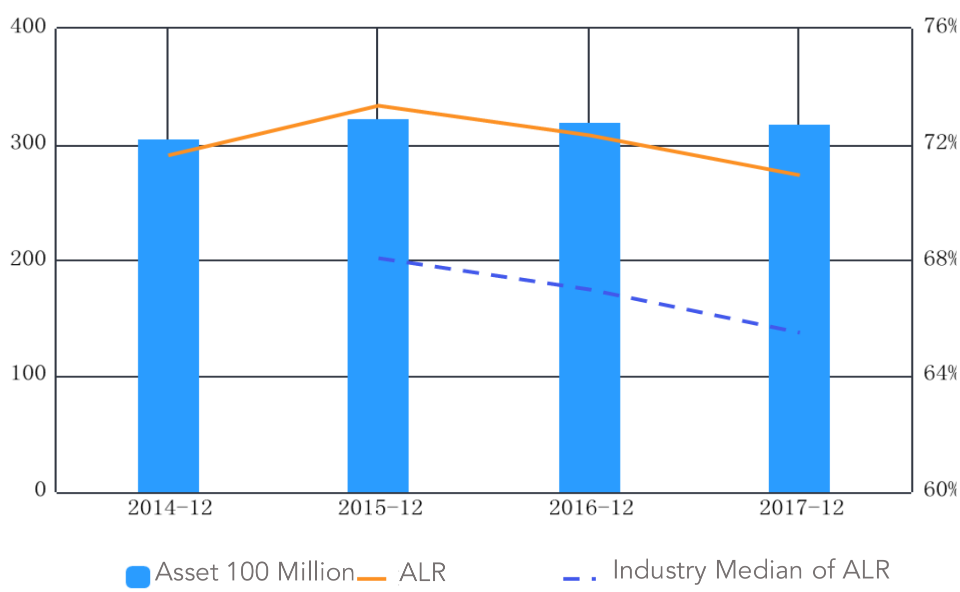

Exhibit 19. Asset-Liability Ratio
Source: www.cn-abs.com

According to the statistics provided by CNABS, the expected operating profit margin of GS REIT is desirable. Compared with the industry median, GS REIT has higher leverage and a relatively lower rate of return on equity, as shown in the charts below.

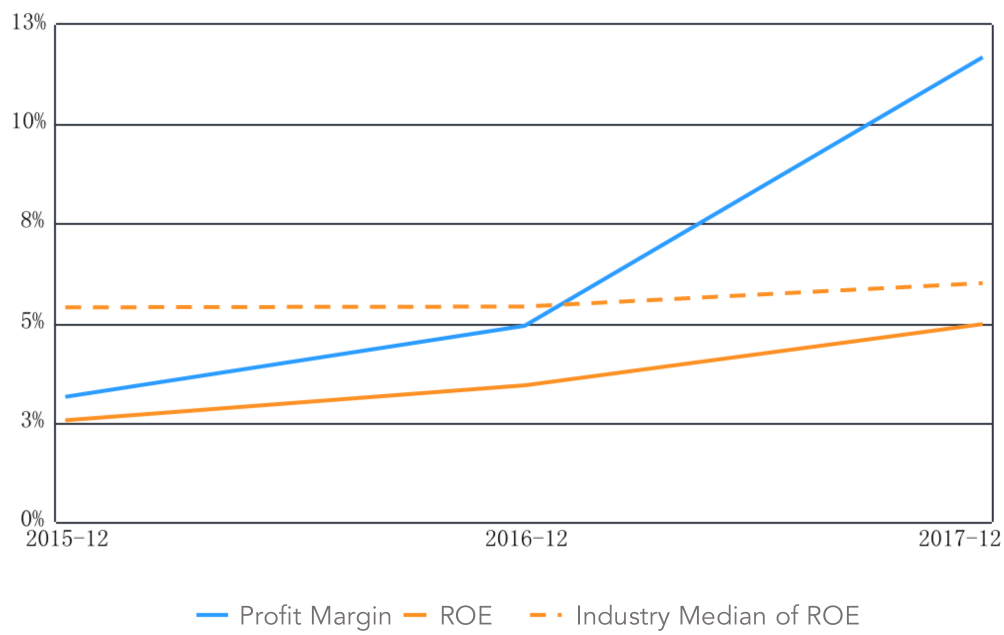

Exhibit 20. Operating Profit Margin and ROE
Source: www.cn-abs.com

4.3. Observation and Comparison

Similar intention and emphasis on the operation of community-based retail properties can be seen in both cases. However, they are indeed different in terms of the legal system, fund format, and portfolio management. This considerable distinction between the two cases of community-based retail REITs also a reflection of the differences between quasi-REITs and typical REITs in general.

4.3.1. Fund Format

Same as the majority of U.S. REITs, KRG is an internally managed REIT company. Whereas the GS REIT is not organized as a company but uses trusts as the fund vehicles to create collective investment structures with external management.

Labeled as the first and currently the only community-based equity REIT in Mainland China, GS REIT is virtually a quasi-REIT with subtle mortgage characteristics, which is quite different for the KRG with a typical equity REIT format. In the GS REIT scheme, the original equity holder is empowered to buy back its shares or purchase any other shares preferentially, which means once the original equity holder executes the priority and purchase the entire equity, and the scheme will directly come to close and the REIT shareholders will receive the committed proceeds with fixed income. In other words, to some extent, GS REIT is similar to a fixed interest rate loan, in which the original equity holder borrow money from investors and in turn pay back the principles and interests.

In addition, alike other quasi-REITs, GS REIT is not publicly traded and highly risk-averse, heavily relying on the credit enhancement approaches and the support of the state-owned company. In this case, SIP State-Owned Asset Holding (SIPA), also the joint partner of the original equity holder, Sungent Holding Group, acts as the credit enhancement guarantor, assuring the investors and partners. In contrast, KRG is publicly traded and subject to the market, and the confidence and appeal of the REIT investment are mainly rooted in the business strategies of KRG as opposed to relying on the outside institutions to provide credit enhancement.

4.3.2. Portfolio management

The flexible and more active portfolio management of KRG, which is typical in the U.S., differs from the fixed and relatively passive approach adopted by GS REIT.

In addition to adaptive leasing strategy and timely renovation of properties to keep the properties attractive to a diverse group of retail tenants, KRG selectively acquires additional retail properties or disposes of existing ones to hit better investment returns. The flexible management strategy reflects the vertically integrated system of KRG, through which sustainable long-term growth can be realized. Moreover, the portfolio of KRG is geographically diversified, which allows KRG to avoid the risk of market concentration and enjoys varied tax benefits of different states.

However, GS REIT focuses on its fixed combination of underlying assets based in Suzhou Industrial Park. The underlying properties are relatively geographically concentrated and under the supervision of the Suzhou Industrial Park Administrative Committee. The selection of qualified retail properties to enter the REIT scheme is even more crucial in this case, because once the portfolio is determined there will be no chance to change it anymore after the issue of the scheme. Carefully operating the existing properties to generate expected future cash flows is the only choice of GS REIT to achieve its return target, which is less active than the dynamic approach of KRG.

4.3.3. Typical REITs vs. Quasi-REITs

i. Taxation

In U.S. REIT investment, as long as certain legal requirements are met, there is no double taxation at the REIT level (company level) and the investor level respectively. In contrast, in a quasi-REIT investment, besides the personal income tax, the original equity holder is obliged to pay the corporate tax and even the land value increment tax if it is a real estate development company.

ii. Income

On one hand, typical U.S. REITs involve in diverse real estate related activities, among which acquisition and development are not uncommon, adopting relatively proactive operation strategies. On the other hand, quasi-REITs contains a fixed portfolio of properties without much room for growth, applying a passive investment strategy focusing on the rental revenue and the disposal of assets.

iii. Distribution

For U.S. REITs, the distributions, through a long investment term, to shareholders must equal or exceed the sum of 90 percent of REIT taxable income. In contrast, the majority of quasi-REITs are short term investment (usually 3-5 years) and distribute the benefits according to the tranches– the priority tranche is offered fixed interest returns and part of the appreciation benefit after the disposition of the assets; while the inferior tranches obtain most of the incremental benefits after the disposition of the assets.

iv. Ownership

As required, the shares in a U.S. REIT must be held by a minimum of 100 persons and fully transferable, and no more than 50 percent of REIT shares may be held by five or fewer individuals. However, the number of shareholders of a quasi-REIT is usually less than 200 and the ownership is limited within the ABS schemes, where private equity funds play an important role. Partly because of the prevailing deal structure that permits the priority tranche to purchase shares preferentially, many quasi-REITs are embedded, to some extent, the loan features thereby being hindered in the way to go public.

5. Conclusion

5.1. Summary

To recap, there is no doubt that community-based retail development will play an important role in creating better neighborhoods in urban China, while the opportunities and challenges underlying and the uniqueness embedded in the community-based retail development are calling for new approached to fulfill the goal.

Opportunities: market potential to reduce the gap between the demand and supple; on-going industry upgrade and strong growth levered by the internet; an unrealized underlying social benefits and the potential to be capitalized.

Challenges: unsystematic development caused by split social and business values; lack of incentive or capability to conduct long-term operation strategy; and further constrained traditional financing sources limits development.

Uniqueness: intertwined social and business value, developer-oriented, and government-supervised.

Inspired by the typical REITs, the paper argues that, the collaborative platform and the integrated system of a community-based retail REITs and the market power embedded are what the industry needs to address the identified issues and complexity and to fulfill the currently unrealized social and business values underlying community-based retail development.

Theoretically, through the REIT system, the major participants—the developer, the investor, and the government—of the community-based retail development can align their interests and make a collaborative effort. Among all the interactions, the developer will have more incentive to respond and benefit from both the market and the social trend, the government will have a channel to capitalize the social value and convert unwelcome obligation to business incentives, and the investor will financially support the development and enjoy stable investment returns. The intrinsic demands and the incentives that participants should obtain from the REIT scheme are summarized below.

	Intrinsic Demands	Necessary Incentives
Developer	Enough capital to support the development; Transition from asset-heavy to asset-light model.	Perform over the benchmark to meet the social needs; Take the lead in promoting a vertically integrated food chain.
Operator	At least hit the rental target to ensure the commission.	Align interests with investors and enhance performance to maximize the profit margin.
Investor	Desirable and stable returns over the long term.	Confidence to invest in community-based retail REITs.
Government	Maximize social benefits; Minimize instability.	Conduct supportive reforms of tax and legal systems.

In addition, the key processes—financing, landholding, development, ownership, operation, and tenant services—of the community-based retail development can be integrated vertically and sustainably to create a positive feedback loop where business value can be coupled with social value more directly than under current unsystematic circumstances.

Moreover, the paper points out the key market niche of community-based retail REITs over other real estate sectors, further demonstrating the motivation of launching community-based retail REITs in China: guaranteed investment performance by stale customer base; easy access to political support on the embedded social benefits; accelerated by the boom of rental market and the popularity of apartment REITs; supported by developers switching to asset-light business.

5.2. Final Thoughts

In addition to the interests-coincident structure, what features should a future community-based retail REIT in China have to play a decisive role in creating better neighborhoods in urban China?

i. Branding Portfolio Management

Packaging selective properties developed or owned by a single and capable development company is feasible and advantageous. The developers will use the pool to promote their brand of "urban service providers" and have incentives to conduct high-quality community-based retail projects. In turn, the branding portfolio will efficiently enhance the confidence of REIT investors. This approach will also reduce the operation cost of the properties since less human resource and complexity will be involved, and make it easier for the government to offer targeted tax break or apply privileged policies case by case.

ii. Progressive Format Reform

Currently, quasi-REITs with Chinese characteristics have dominated the market of mainland China. Featured by the trust format that hybrids the private equity fund and asset-backed security (ABS), quasi-REITs have a long journey to go public. In the near future, it is more feasible for a community-based retail REIT to apply a trust format that utilizes both public fund and ABS to access the public investors and take advantage of the matured and supportive system of ABS. Looking to the future, however, a company-oriented equity REIT format, if supportive legislation can be made, will better fit into the uniqueness of community-based retail development. In other words, originated from a capable development company, a community-based retail REIT will organize as a vertically integrated company to engage in and coordinate the key processes—ownership, operation, management, leasing, acquisition, construction, redevelopment, and development.

5.3. Limitation and Future Work

Further research is needed. For one thing, more empirical data and evidence need to be collected to support the strategies and concepts proposed in the paper. Currently, only two asset securitization deals backed by community-level retail properties have been issued in China to date, not enough to provide meaningful implications.

For another, the difference between the real estate and capital markets in the U.S. and China should be considered and future work needs to examine the special obstacles and unique risks that the Chinese real estate market, especially the community-based retail sector, encounters to implement innovative financing vehicles.

Moreover, horizontal comparison among different REITs sectors can be made in the future work, to demonstrate more on the advantages of community-based retail REITs over other sectors, such as apartment, office, and industrial sector. It will also be worthwhile to discuss the influence of rigid growth in the long-term rental market on the development of community-based retail.

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Appendix I. Legal Requirement of REITs

<u>Asset Requirements</u>

- At least 75 percent of the value of a REIT's assets must consist of real estate assets, cash, and government securities.
- Not more than 5 percent of the value of the assets may consist of the securities of any one issuer if the securities are not includable under the 75 percent test.
- A REIT may not hold more than 10 percent of the outstanding voting securities of any one issuer if those securities are not includable under the 75 percent test.
- Not more than 25 percent of its assets can consist of stocks in taxable REIT subsidiaries.

<u>Income Requirements</u>

- At least 95 percent of the entity's gross income must be derived from dividends, interest, rents, or gains from the sale of certain assets.
- At least 75 percent of gross income must be derived from rents, interest on obligations secured by mortgages, gains from the sale of certain assets, or income attributable to investments in other REITs.

<u>Distribution Requirements</u>

- Distributions to shareholders must equal or exceed the sum of 90 percent of REIT taxable income.

<u>Stock and Ownership Requirements</u>

- The REIT must be taxable as a corporation.
- The REIT must be managed by a board of directors or trustees.
- Shares in a REIT must be fully transferable.
- Shares in a REIT must be held by a minimum of 100 persons.
- No more than 50 percent of REIT shares may be held by five or fewer individuals during the last half of a taxable year.

Appendix II. KRG Top 10 Retail Tenants by ABR

Source: Kite Realty Group Annual Report 2018

($ in thousands, except per square foot data)

	Number of Stores			Annualized Base Rent		Annualized Base Rent per Sq. Ft.		
Tenant	**Wholly Owned**	**JV[1]**	**Leased GLA/ NRA[2]**	**Pro-Rata Share**	**100%**	**Pro-Rata Share**	**100%**	**% of Total Portfolio Annualized Base Rent[4]**
The TJX Companies, Inc.[5]	20	2	650,156	$ 6,463	$ 7,013	$ 10.60	$ 10.79	2.6 %
Publix Super Markets, Inc.	14	—	670,665	6,739	6,739	10.05	10.05	2.5 %
Bed Bath & Beyond, Inc.[6]	17	2	493,719	5,400	6,093	11.76	12.34	2.3 %
PetSmart, Inc.	16	1	351,648	5,151	5,347	15.17	15.21	2.0 %
Ross Stores, Inc.	15	1	458,520	4,979	5,224	11.35	11.39	1.9 %
Lowe's Companies, Inc.	5	—	128,997	5,080	5,080	6.52	6.52	1.9 %
Nordstrom, Inc. / Nordstrom Rack (6)	5	1	197,797	3,559	4,035	20.69	20.40	1.5 %
Michaels Stores, Inc.	13	1	296,540	3,794	3,970	13.41	13.39	1.5 %
Ascena Retail Group[7]	32	—	198,882	3,912	3,912	19.67	19.67	1.5 %
Dick's Sporting Goods, Inc.[8]	7	—	340,502	3,627	3,627	10.65	10.65	1.3 %
LA Fitness	5	—	208,209	3,574	3,574	17.16	17.16	1.3 %
Office Depot (8) / Office Max (4)	12	—	245,455	3,381	3,381	13.77	13.77	1.3 %
Best Buy Co., Inc.	6	—	213,604	3,084	3,084	14.44	14.44	1.1 %
National Amusements	1	—	80,000	2,953	2,953	36.92	36.92	1.1 %
Kohl's Corporation	5	—	184,516	2,927	2,927	6.83	6.83	1.1 %
Petco Animal Supplies, Inc.	12	—	167,455	2,819	2,819	16.83	16.83	1.0 %
Burlington Stores, Inc.	4	—	303,400	2,806	2,806	9.25	9.25	1.0 %
Walmart Stores, Inc.[9]	5	—	—	2,652	2,652	3.27	3.27	1.0 %
Ulta Beauty, Inc.	10	2	127,459	2,166	2,603	19.55	20.42	1.0 %
DSW Inc.	8	1	175,133	2,214	2,509	13.87	14.33	0.9 %
Mattress Firm Holdings Corp (15) / Sleepy's (4)	19	—	87,585	2,454	2,454	28.02	28.02	0.9 %
Stein Mart, Inc.	8	1	307,222	2,140	2,399	7.60	7.81	0.9 %
Frank Theatres	2	—	122,224	2,350	2,350	19.23	19.23	0.9 %
Hobby Lobby Stores, Inc.	5	—	271,254	2,190	2,190	8.07	8.07	0.8 %
The Kroger Co. [10]	3	—	60,268	2,099	2,099	9.19	9.19	0.8 %
TOTAL	**249**	**12**	**6,341,210**	**$ 88,513**	**$ 91,839**	**$ 11.05**	**$ 11.18**	**34.1%**