

**CHINESE REAL ESTATE NPLS:  
ARE THEY OPPORTUNITIES FOR US OPPORTUNISTIC INVESTORS?**

by

*Gang Peng*

Master of Science in Architectural Studies, 1992  
Massachusetts Institute of Technology

Submitted to the Department of Urban Studies and Planning  
in partial fulfillment of the Degree of

*Master of Science in Real Estate Development*

at the

*Massachusetts Institute of Technology*

September, 2000

© 2000 Gang Peng  
All Rights Reserved

The author hereby grants to MIT permission to reproduce and to distribute publicly paper and electronic copies of this thesis document in whole or in part.

Signature of Author \_\_\_\_\_  
Gang Peng  
Department of Urban Studies and Planning  
August 30, 2000

Certified by \_\_\_\_\_  
Blake Eagle  
Chairman, Center for Real Estate  
Thesis Advisor

Accepted by \_\_\_\_\_  
William C. Wheaton  
Chairman, Interdisciplinary Degree Program in Real Estate

**CHINESE REAL ESTATE NPLS:  
ARE THEY OPPORTUNITIES FOR US OPPORTUNISTIC INVESTORS?**

by

*Gang Peng*

Submitted to the Department of Urban Studies and Planning  
on August 30th, 2000 in partial fulfillment of the Degree of

*Master of Science in Real Estate Development*

at the

*Massachusetts Institute of Technology*

**ABSTRACT**

After explosive development during the early 1990s, China now faces an oversupplied real estate market. State-owned banks, the main financiers of these developments, are burdened with vast amounts of non-performing loans (NPLs). As China prepares for its entry into the World Trade Organization (WTO), it has begun to reform its finance and banking system. Aiming at transforming the state-owned banks into more commercially oriented enterprises, the Chinese government has initiated a major effort to help the banks resolve their NPLs, many of which have been made to real estate development companies. As in the Savings & Loans crisis in the US, within a short period of time a large volume of Chinese non-performing assets will come onto the market.

Due to the lack of opportunities in the domestic market, US opportunistic investors are looking to locate high-return investment opportunities in emerging markets. Asia is one of their major targets. US investors have recently acquired billions of dollars worth of Asian real estate NPLs and are looking for more. Would the Chinese non-performing real estate assets be good investment opportunities for US investors? This thesis attempts to answer that question.

The research for this thesis was done in three phases. The first phase is an analysis of the US investors' risk-return trade-offs in Asian real estate investment. The purpose is to

understand what the US investors look for when they invest in Asian real estate. The second phase is a comparison of China's investment environment with the environments in other Asian countries, in order to determine China's relative risk profile. The third phase is a study of the objectives and strategies of China's NPL resolution. The goal is to estimate the level of returns China's NPL sales are likely to offer.

Interviews with practitioners, including US fund managers, Chinese developers, Chinese bankers, and Chinese real estate academics are the main sources of information. Theoretical research was also conducted to help understand and analyze the information collected from interviews.

The interviews and research lead to the following findings: US investments in international real estate are made primarily by Opportunistic Funds. They seek investment opportunities that offer 20-30% returns. Their targeted investment holding periods are between three and five years. Additional returns will be required for each additional layer of risk. China's investment environment is perceived to be riskier than those of other Asian countries by US fund managers. As a result, opportunities in China have to offer higher returns than those of other Asian countries in order to be equally attractive. China's NPL resolution is not likely to be very effective, due to some fundamental flaws built into the political and economic structure of all state-owned entities, including that of the Asset Management Companies, which were set up to resolve NPLs. The thesis concludes that China's NPL resolution is going to be a slow and gradual process, which is not likely to create immediately many high-yielding opportunities that will meet the expectations of US investors.

A more distant future, however, may hold more opportunities as China becomes a member of WTO and as pressure builds on the government to sell-off its non-performing assets.

Thesis Advisor: Blake Eagle  
Title: Chairman, MIT/Center for Real Estate

## **ACKNOWLEDGEMENTS**

This study would not have been possible without the valuable inputs of all interviewees. I thank them for sparing time and sharing knowledge and insights on this subject.

Many friends provided important leads to information and materials included in this report. I am indebted to them for their generous helps.

I want to thank Mr. Blake Eagle, my thesis advisor, for his guidance and criticism.

# TABLE OF CONTENTS

<b>ABSTRACT.....</b>	<b>2</b>
<b>INTRODUCTION.....</b>	<b>6</b>
<b>CHAPTER I:</b>	
<b>WHAT DO US INVESTORS LOOK FOR?.....</b>	<b>10</b>
PREFACE.....	10
US OPPORTUNISTIC FUNDS .....	14
ASIAN FINANCIAL CRISIS .....	18
BOTTOM-FISHING OF US OPPORTUNISTIC INVESTORS.....	22
INVESTING IN ASIAN REAL ESTATE .....	26
<b>CHAPTER II:</b>	
<b>INVESTMENT ENVIRONMENTS:</b>	
<b>CHINA VS. OTHER ASIAN COUNTRIES .....</b>	<b>33</b>
PREFACE .....	33
INVESTMENT ENVIRONMENTS OF ASIAN COUNTRIES .....	35
INVESTMENT ENVIRONMENT IN CHINA .....	37
REAL ESTATE MARKET IN CHINA .....	43
<b>CHAPTER III:</b>	
<b>WHAT CAN CHINESE NPLS OFFER? .....</b>	<b>51</b>
PREFACE .....	51
CHINA’S FINANCE AND BANKING SYSTEM .....	53
REFORM PRESSURES .....	56
NON-PERFORMING LOANS (NPLS).....	59
ASSET MANAGEMENT COMPANIES (AMCs) .....	61
REAL ESTATE NON-PERFORMING LOANS .....	64
NPL RESOLUTION STRATEGIES .....	65
CHINA’S NPL RESOLUTION PROBLEMS .....	67
<b>CONCLUSIONS .....</b>	<b>71</b>
<b>BIBLIOGRAPHY .....</b>	<b>75</b>
<b>LIST OF INTERVIEWS .....</b>	<b>79</b>

# Introduction

Over the past two decades, much has been heard about the fast economic development in China, the world's most populous nation. For most of the 1990s, the country announced double-digit GDP growth and China's major cities saw massive, non-stop construction.

Less familiar were the problems hidden behind such explosive growth. In fact, most of this growth was achieved under a predominantly planned economic system. Chinese development was, for the most part, initiated and supported by the government rather than driven by market demand. As in most developing countries, infrastructure development and physical improvement were considered the first steps toward modernization, and real estate development was seen as the driving force of the country's

growing economy. Policies were formulated to expedite the construction of new hotels, offices and commercial facilities in major Chinese cities.

Development was financed primarily by the state-owned banks that advanced money as a matter of policy rather than on the basis of commercial lending principles. These banks, which dominate China's capital market, functioned mainly as the government's cashiers, not as profit-making banking enterprises.

The results of such practice include an oversupplied real estate market and huge volume of bad loans carried by the state-owned banks. Currently, office vacancy rates in China's major cities run between 20% and 55%. It is estimated that at the end of 1999, more than RMB 2 trillion (US\$250 billion) in accumulated non-performing loans (NPLs) was owed to China's "Big Four" banks. Of those loans, 15%--about RMB 300 billion (US\$37 billion)--were loans to real estate development companies.

China has recently lined up majority support from member countries for its entry into the World Trade Organization (WTO). Approval of its membership is almost certain in the near future. As part of China's agreements with its supporting countries, foreign banks will be allowed full access to the Chinese market five years after the country joins the WTO. The astronomical number of bad loans held by China's state-owned banks puts these banks at a disadvantage when competing with the foreign banks. To help transform the state-owned banks into more commercially oriented banks as quickly as possible, the Chinese government launched a program in 1999 to recapitalize the Big Four state-owned

banks, freeing them from the burden of NPLs made under government's directions. The central government created four new entities, known as asset management companies (AMCs), to take over the duty of resolving the banks' bad debts while guaranteeing the banks full return of the face value of the loans within a relatively short period of time.

The disposition of NPLs under pressure can usually create lucrative opportunities for the high-risk, high-return driven investors. High-risk pools of capital in the US--known as "Opportunistic Funds"--are looking for new investment markets, particularly distressed real estate. These same pools of capital were major buyers of NPLs and distressed properties in the US in the 1990s when the US real estate markets crashed from over investment.

Does the Chinese NPL resolution represent opportunities for the US investors? This paper will attempt to answer that question.

Research for this paper was conducted in three phases. The first phase was a study of US opportunistic real estate investors. The goal was to understand what they seek in investments as well as what risks they are willing to take and which risks they seek to avoid. Analysis of the Asian real estate economy and data on US investments in Asian real estate helps to illustrate how US investors might balance risks and returns in Asian real estate investments.

The second phase was a study of different investment environments in various Asian countries. Opinions of a half dozen US investors on Asian markets were collected. Based on their opinions, a general ranking of the investment environments of Asian countries was established. Interviews with Chinese real estate developers and researchers yielded a composite assessment of China's investment environment compared to those of other Asian countries. This comparison helped produce an estimate of the returns required for Chinese investment opportunities that will justify their risks.

The third phase is an analysis of China's NPL resolution program. The objective is to find out whether Chinese NPL sales can potentially offer the kind of returns expected by US opportunistic investors. Since the newly established asset management companies (AMCs) have started collecting non-performing assets, no sales to foreign buyers have been concluded and no prices yet determined. Information on China's banking system and the magnitude of NPL problems was obtained in order to understand the driving forces of China's NPL resolution. Interviews with high-ranking officials of one of the Big Four banks and one of the four AMCs provided most of the information and insights.

I have documented my finding in the next four chapters. Chapter I covers the investment objectives of US opportunistic investors. Chapter II compares China's investment environment with those of other Asian countries. Chapter III reviews China's NPL resolution and the potential opportunities it offers. The last chapter is the conclusion.

# Chapter I:

## *What do US Investors Look For?*

### **Preface**

To determine whether Chinese real estate non-performing loans (NPLs) are buying opportunities for US investors requires an understanding of the opportunities US investors look for. Which groups of investors are most likely to invest in Chinese real estate? What are their investment objectives and strategies? In an investment environment like China, what opportunities would US investors consider worth the risks involved?

During the past two years, US investments in Asian real estate increased dramatically. An estimated US\$30 billion worth of Asian real estate properties and loans have been acquired by US investors<sup>1</sup>. Who are these buyers? What are the reasons for this sudden increase of US real estate investments in Asia? Will Chinese real estate NPLs be equally attractive to these US buyers?

With these questions in mind, I researched related studies on US opportunistic real estate investment and the Asian Financial Crisis. Then I interviewed ten individuals from six well-known US real estate investment firms, most of which are currently investing in the Asian markets.

*AEW Capital Management, L.P.*

Founded in 1981 in Boston, AEW is one of the world's leading real estate investment advisory firm. It currently manages approximately US\$5.9 billion in capital, which is invested in US\$9.7 billion of real estate assets and portfolios. AEW's clients include many of the nation's leading public and private retirement programs, university endowments, foundations and Taft-Hartley pension plans, as well as international private investors. AEW Partners Fund, with aggregate equity capitalization of US\$1.7 billion, is a private-equity, opportunistic-styled fund with significant exposure to non-US real estate investments. AEW is not investing in Asian real estate as it currently has no established presence or affiliations in that market. Interview with fund manager at AEW, however, was instrumental in the research of US opportunistic real estate investors.

---

<sup>1</sup> Petrakis, Alexis "*The Brave New World of Offshore Investments*" Real Estate Forum, 10/99, Page 38, Real Estate Media, Inc.

*Colony Capital, LLC*

Colony Capital, Inc. is a private, Los Angeles-based international investment firm focusing primarily on real estate-related assets and operating companies. The firm was one of America's largest acquirers and financiers of real estate-related assets during the 1990s, having invested more than \$6 billion in more than 60 distinct property, corporate and portfolio transactions worldwide. Over 40 institutional investors participate in Colony funds, including some of America's largest public and corporate pension funds, financial institutions, endowments, foundations, and family trusts. The Colony funds are all opportunistic funds. Colony has a branch office in Singapore, and over the past two years has invested approximately US\$550 million in Asian real estate.

*Hines*

Founded in 1956 in Houston, Hines is one of the world's largest international real estate firms, with branch offices in 14 countries. Hines develops and manages a portfolio of 188 million square feet of commercial real estate across the US and in 11 foreign markets. Although development is its core business, Hines raised \$1 billion between 1997 and 1999 to explore investment opportunities in emerging markets. Hines Emerging Market Fund is equally divided among Asia, Latin America and Europe. It is currently developing a US\$100 million upscale apartment building in Beijing.

*J.P. Morgan, Real Estate Investment Banking Group*

J.P. Morgan is one of the world's leading investment banks. Its Real Estate Investment Banking Group is an avid buyer of Japanese distressed real estate loans. It is also one of the first issuers of commercial mortgage-backed securities (CMBS) in Japan. The Group has invested over US\$1 billion in Japanese real estate non-performing loans during the past two years.

*Morgan Stanley Dean Witter (MSDW), Realty Group*

MSDW is another leading Wall Street investment bank. It handles real estate-related investment services through its Morgan Stanley Realty group (MSR), which has the longest uninterrupted real estate industry presence of any Wall Street firm. As part of MSR's Private Equity Division, the Morgan Stanley Real Estate Funds (MSREF) were created in 1991 to pursue opportunistic real estate investments worldwide. MSREF was one of the first "opportunity funds" and has subsequently raised four funds aggregating to more than US\$3.6 billion and has purchased over US\$10 billion in assets. MSREF has invested close to US\$2 billion in Asian real estate in the past two years, primarily in Japanese and Korean NPLs. It has completed two Commercial-Mortgage-Backed securities offerings in Japan and is working on its first in Korea.

*Prudential Real Estate Investors*

Prudential Real Estate Investors (PREI) is a unit of The Prudential Insurance Company of America and operates through the Prudential Investment Corporation, a registered investment advisor. PREI provides global real estate money management services to clients in the United States, Europe, Asia and Latin America. Comprised of a group of

specialized operating units, PREI manages more than US\$14.6 billion in assets on behalf of more than 300 institutional clients. PREI invests in Asian real estate through its subsidiary, Global Realty Advisor (GRA) in Singapore. GRA has over US\$1.2 billion under management, all of which is invested in Asian real estate, about 85% of it in opportunistic funds.

The findings of my interviews are summarized in this chapter. (Names of interviewees are listed at the end of the paper)

## **US Opportunistic Funds**

US funds that are actively investing in international real estate are primarily known as “Opportunistic Funds”. These funds raise money from wealthy individuals and institutions around the world, with the goal of generating high risk-adjusted returns for their investors within a relatively short period of time. Most of these funds look for investment opportunities that offer, at a minimum, 20% returns. Their targeted investment hold periods are for between three and five years.

Generating abnormally high returns through risky ventures is the objective of Opportunistic Funds. They achieve such objectives through quickly identifying and making risky bets on investment opportunities that involve financial arbitrages, market supply/demand imbalances, technological breakthroughs, etc. Opportunistic investors seek to make investments after a specific market sector--say real estate--has experienced

a major downward pricing correction. Such pricing corrections are usually the results of *over speculation* (an over supply of capital) and/or *over production* (an over supply of products). They buy distressed loans, and assets or businesses at relatively low prices and with the objective of selling them as market shifts towards equilibrium and as economic demand picks up.

Opportunistic investments are not limited to real estate. US Opportunistic Funds, however, discovered major buying opportunities in the real estate market during the Resolution Trust Corporation's (RTC's) savings and loan confiscation and subsequent sell-off of bank and S&L troubled real estate in the early 1990s.

In the 1970s, the US economy suffered from high levels of inflation. Inflation rates were higher than the rates banks were charging for loans, which were capped by the government. As a result, many banks became technically insolvent. Bank deregulation took place in the 1980s, eliminating interest-rate ceilings, increasing deposit insurance ceilings, and softening lending prudence requirements. Banks were encouraged to make loans at high interest rates. Bank deregulation, together with changes in tax laws (in 1981) that encouraged personal investment in real estate, led to a significant increase in funds available for real estate developments. The ability of banks and S&Ls to borrow money at rates that were not commensurate with the risks of using that capital created serious incentive problems. Underwriting standards were lowered. These changes fueled real estate speculation and speculative developments. Building stock in major US cities almost doubled between 1980 and 1989. An oversupplied real estate market and high

debt levels in real estate developments resulted in an enormous volume of real estate non-performing loans held by commercial banks and S&Ls. This led to the notorious “S&L Crisis”, during which many banking institutions failed. Since the federal government guaranteed deposits, it later ended up owning most of those real estate non-performing loans. Political solutions involved the government selling these loans quickly (through RTC) at very low prices. The government was more concerned with resolution speed than recovery rate. Opportunistic Funds quickly came into the market to take advantage of the government’s eagerness to dispose of distressed loans and bank for closed real estate. These funds bought vast amounts of non-performing loans cheaply, later making enormous profits by working out those loans and/or securitizing them into loan pools and selling mortgage-backed loans to the public fixed income markets.

In the meantime, the traditional capital sources of the real estate debt market--such as commercial banks and life insurance companies--withdrew from the market as the result of reinstatement of stiffer regulations. Over leveraged owners of real estate assets were left with no options but to accept harsh solutions for their debts. Such market conditions assisted the new owners of real estate debts, primarily Opportunistic Funds in negotiating favorable terms during loan work-outs.

As the news of success of Opportunistic Funds spread, more high-risk capital flowed into this type of investment and more managers adopted such investment strategies.

Opportunistic investing enjoyed a strong boost during the period between 1991 and 1995.

Distressed markets are where Opportunistic Funds look to find investment opportunities. Over-speculation and imprudent financial sectors cause temporary capital deficiencies. Many such funds have no geographic focuses, investing wherever capital deficiencies exist, domestically or internationally.

During the second half of 1990s, the US real estate markets gradually regained supply/demand balance. Demand rose as a result of economic growth. Having learned lessons in the 1980s, investors were more cautious, which helped restrict supply. The emergence of public capital markets increased the efficiency of real estate financing. With this balanced market came a sharp reduction in the number of high-risk, high-return opportunities for Opportunistic Funds.

US Opportunistic Funds started seeking investment opportunities actively in markets outside the US during the late 1990s. The recent Asian Financial Crisis pushed many fast-developing Asian countries into financial distress, a situation similar to the S&L crisis in the US but on a larger scale (details of the Asian Financial Crisis are discussed below). As a result, many investment opportunities opened for US Opportunistic Funds. US investors rushed in and snatched up a number of what appeared to be highly distressed real estate assets at substantial discounts to estimated market value in 1998 and 1999.

Some researchers argue that there are diversification benefits in foreign real estate investments<sup>2</sup>. According to the fund managers interviewed, however, diversification benefits are too small to consider when they make investment decisions. “Nobody invests (in international real estate) for diversification. It’s not logical. There may be some benefits from diversification, but you don’t invest for it,” said Chin-hua Loh, managing director of Global Realty Advisors, a unit of Prudential Real Estate Investors. “There is a misperception within the developing countries,” says Steve Corkin of AEW Capital Management, “that US institutional money is for long-term, strategic investment, and therefore is good for financing their infrastructure projects. As a matter of fact, US funds that are going to those places are almost exclusively for short-term total return purposes.”

### **Asian Financial Crisis**

For most of the past three decades, the East Asian "Tigers"--South Korea, Hong Kong, Taiwan and Singapore--and the "Newly Industrializing Economies"--Indonesia, Malaysia, and Thailand--had generated unprecedented GDP growth rates of 5% to 7% a year<sup>3</sup>. These seven countries, together with Japan, had collectively experienced more than twice as much growth as the rest of East Asia, and roughly three times as much as Latin America and South Asia.

---

<sup>2</sup> See Hudson-Wilson, Hartzell, Shurman, and Wurtzebach, etc.

<sup>3</sup> World Bank Report, 1993

The Asian economic “miracles” were achieved mainly through Asian countries’ expansion of exports and suppression of domestic consumption, as argued by some economists<sup>4</sup>. To promote exports, East Asian countries first liberalized their current accounts but not their capital accounts<sup>5</sup>, and made their national currencies freely convertible into foreign exchange for current-accounts transactions. Most had also pegged their national currencies to the U.S. dollar, thereby eliminating exchange risks and the cost of hedging for traders and investors. At the request of the International Monetary Fund (IMF), the United States, Japan and other capital-exporting countries, East Asian countries began to liberalize their capital accounts in the mid-1990s. These moves exposed these countries, which had weak and primitive banking systems, to large and sudden cross-border capital movements, capable of destabilizing financial sectors and entire economies.

Interest yields were higher in East Asian countries than in the industrialized countries. Since their currencies had been pegged to the US dollar, Japanese, European and American banks and other financial intermediaries began to make what they considered to be risk-free, high-yielding loans. At the same time, Asian domestic banks, corporations and a variety of other private intermediaries found that they could borrow capital more cheaply and more readily abroad than they could at home. Between 1990

---

<sup>4</sup> McGurn, William, “*Asian values: ...and wrong*” *National Review*, New York; Dec 31, 1997; Vol. 49, Issue. 25; pg. 37

<sup>5</sup> Current Accounts and Capital Accounts are parts of a system recording a country’s economic transactions with the rest of the world during a particular period of time. Current Accounts cover import or export of goods and services. Capital Accounts cover the movements of investments.

and 1997, private capital flows to developing countries rose fivefold, from \$42 billion to US\$256 billion. Nearly two-thirds of that amount went to East Asia<sup>6</sup>.

In the absence of reporting and monitoring requirements, Asian central banks had no way of tracking how much their commercial banks, businesses and individuals were borrowing overseas. Even if they had had this information, they lacked the capabilities to moderate or check excessive capital inflows. Nor did the central banks of Japan, the US, or European countries control large amounts of capital from their citizens moving electronically to East Asia. By 1996, annual net private capital inflows to East Asian nations amounted to between 5% and 15% of their annual GDPs. The Bank for International Settlements reported that in 1996 European Union banks' loans outstanding in East Asia amounted to US\$318 billion. The corresponding figure for Japanese banks was US\$261 billion, and for U.S. banks it was US\$46 billion<sup>7</sup>.

Under the Asian model, “Guided Capitalism”, governments maintain strong controls over their economies. Banks serve as policy arms of the governments and do not evaluate risk and credit as their counterparts do in the West. On paper the advantage of cheap capital was that it could be channeled where it was needed the most. In practice this meant that capital was often steered to the politically connected rather than the economically meritorious. As is being discovered today, financial institutions that did not use traditional criteria, such as risk analysis, found themselves saddled with an ever-increasing pool of non-performing loans..

---

<sup>6</sup> World Bank Report 1998

<sup>7</sup> Ibid.

Enterprises of the East Asian countries were much more highly leveraged than those of industrialized countries. Loans rather than equity had long been their main source of capital. As the volume of capital transfers grew, confidence soared. The combination of speculative domestic borrowing and abundant, but mostly short-term foreign capital overwhelmed these Asian countries' primitive financial sectors. Lenders relied on real estate and other forms of collateral at greatly inflated prices instead of due-diligence assessments of borrowers. At the same time, the quality of collateralized assets declined. With the expectation that outstanding loans would continue to be rolled over, short-term borrowing was used increasingly for long-term investments. Hotels, apartment and office buildings, which were funded largely by short-term foreign loans, were built in Seoul, Kuala Lumpur, Bangkok and Jakarta with only a slight prospect of earning positive returns in the near future.

By 1996, problems that had been obscured or ignored during the good times began to show up. The pace of economic growth slowed, and trade surpluses turned into deficits as imports rose and competitiveness fell. The flood of foreign capital stopped. When the inflated collateralized-property bubble burst, non-performing assets on the books of borrowers and lenders multiplied.

Expectations and confidence quickly switched from positive to negative as foreign bankers and money managers began to question the ability of their borrowers to service their debts and of the countries to maintain the pegged value of their currencies. Herd

mentality quickly took over, and investors were only concerned about avoiding being the last ones out. Foreign lenders refused to renew outstanding short-term loans, began to dump assets, and headed for the exits. Despite costly efforts to maintain their values, starting with the Thai *baht*, these countries' currencies began to tumble in late 1997. Property and equities prices plunged, and liquidity dried up as foreign bankers called in outstanding loans in an attempt to cover their negative asset positions.

What had started as a problem in Thailand's financial sector quickly spread to the other economies of the East Asia. Overseas bankers and intermediaries, sensing that South Korea, Indonesia and Malaysia were also overextended--a condition they had helped to create--started the same process of financial withdrawal and economic contraction. Otherwise viable businesses, unable to obtain funds to meet ordinary operating needs, were forced to close. The result was a regional economic crisis that left neighboring countries wondering if they would be next.

### **Bottom-Fishing of US Opportunistic Investors**

The Asian Financial Crisis represented an economic environment favored by US opportunistic investors. As the US property market moved back to equilibrium, a number of US Opportunistic Funds looked to Asia to find undervalued and over-financed real estate assets. It is estimated that between 1997 and 1999, about US\$31.9 billion was earmarked for investment in Southeast Asia<sup>8</sup>, both as debt and equity. "After not doing

---

<sup>8</sup> Cavaluzzi, Joseph "Recovery, Stagnation Coexist" Real Estate Forum, 10/99, Page 66.

anything for two years, we made several large investments in Singaporean properties in 1999,” said Loh of Prudential’ GRA. Most of the investments were acquisitions of Japanese and Korean real estate NPLs.

### *Major purchases*

The chart below lists the major sales of Japanese properties/NPLs to US investors during the past three years. It does not include purchases made in other East Asian countries, such as Korea, Hong Kong, Singapore or Thailand. This partial list can, however, convey a sense of the magnitude and character of US investment in Asian real estate.

<b>Date</b>	<b>Seller</b>	<b>Buyer</b>	<b>Price (US\$ mil)</b>	<b>Type</b>
97	Bank of Tokyo-Mitsubishi	Cargill	50	NPL
97	Yamaichi Finance	Cargill	2700	NPL
97	Bank of Tokyo-Mitsubishi	LoneStar	200	NPL
97	J. R. Liquidation Agency	Pacific Century	870	Land
98	Long Term Credit Bank	Goldman Sachs	200	NPL
98	Sakura Bank	Merrill Lynch/Lone Star	4,000	NPL
98	Crown Leasing	BT/Deutsche/GMAC	2,800	NPL
98	Sanwa Bank	Deutsche Bank	1,500	NPL
98	Sanwa Bank	Secured Capital	1,500	NPL
98	Mitsui Trust & Banking	Secured Capital	1,300	NPL
98	Sumitomo Bank	NA	1,000	NPL
98	Sumitomo Bank	Goldman Sachs	400	NPL
98	Bank of Tokyo-Mitsubishi	Goldman Sachs	130	NPL
98	Bank of Tokyo-Mitsubishi	J. P. Morgan	1,000	NPL
98	Daikyo	Morgan Stanley	100	Residential
98	Yamato Life	Goldman Sachs	500	Commercial

98	Hiei Sangyo	Oak Tree Capital	50	Commercial
99	Recruit	Colony Capital /Kennedy	110	Commercial
99	Japan Energy	AIG/Mitsui Fudosan	700	Commercial
99	Dai-Ichi Kangyo Bank	NA	2,000	NPL
99	Sumitomo Bank	NA	600	NPL
99	Fuji Bank	Merrill Lynch/Lone Star	500	NPL
99	CCPC	Cerberus	800	NPL
99	Toho Life	Goldman Sachs	300	Commercial
99	Sanwa Bank	Merrill Lynch/Lone Star	300	NPL
99	Nippon Landic	DLJ, Secured Capital,	360	Commercial
Total			24,330	

Source Nikkei, Biru-Keiei

This list alone adds up to over \$24 billion of investments. A majority of the purchases have been non-performing loans. According to the fund managers interviewed, Japanese NPLs were purchased at 15 to 20 cents on the US dollar; Korean loans, at 40 to 50 cents on the dollar.

#### *Active US players in the Asian markets*

The following list of active US investors in Asia reads like a “Who’s Who” of US Opportunistic Funds<sup>9</sup>.

Apollo Real Estate Advisors, L.P.

Cerberus

Colony Capital, Inc.

Donaldson, Lufkin & Jenrette

Goldman Sachs

J. P. Morgan

Lehman Brothers

Lend Lease

Lone Star

Morgan Stanley Dean Witter

Merrill Lynch

Prudential Real Estate Investors

Security Capital

Westbrook Partners

Expected high returns have yet to be realized. Most acquisitions are still owned. “We sold about 25%. We are still holding 75%” said Kalsi. Opinions on these investments vary among fund managers interviewed. Funds that bought these NPLs share an optimistic outlook; those that did not buy have doubts about their future returns. Fund managers’ herd mentality as well as desire to invest in order to raise more funds were also criticized as reasons for this sudden increase in Asian investments. Nonetheless, the amount of capital allocated to Asian real estate by US investors is a strong indicator that US investors see Asian real estate investments as well worth the risks.

---

<sup>9</sup> Sources of this information are: AEW’s “Competitor’s List”; *Investment Property*, February, 1999; and interviews with fund managers.

## **Investing in Asian Real Estate**

Investing in foreign real estate involves more risks than investing in domestic real estate. Investors carefully review the real estate fundamentals and risk profiles of a market before making their investment decisions. With each layer of risk, additional required return is generally factored in. Compared to other foreign markets, Asian markets are seen by US investors as further away and more complex. The following summarizes US investors' opinions on Asian real estate markets.

### *Market fundamentals*

Real estate fundamentals of a market are among the top considerations of real estate investors. This is true even for opportunistic investors. Although mostly interested in short-term high returns, opportunistic investors are concerned with market fundamentals because supply/demand relationships will determine the viability of exit strategies, which involve reselling assets quickly or holding assets longer until markets recover. Most US fund managers interviewed recognize the long-term economic potential of Asian real estate. They listed the following characteristics as positive fundamentals.

#### 1. Population and economic growth

Asian countries have the fastest population growth in the world<sup>10</sup>. Although many of them suffered during the continent's financial crisis two years ago, "the current economic crisis reflects a structural adjustment of these economies after many years of breakneck

growth,” said J. P. Mei, professor of finance at New York University. Growing population coupled with growing economies will drive up the demand for housing and working space in Asian countries, most of which currently suffer from significant housing shortages.

## 2. Urbanization

Massive urbanization caused by rapid industrialization and poor infrastructure will also benefit the property market. According to a United Nations estimate, by the end of 2015, nine of the ten largest cities in the world will be in emerging markets<sup>11</sup>. Migration of rural population to urban centers will exacerbate space shortages in these cities.

## 3. Rising wages.

Real estate prices should benefit from rising real wages. Between 1991 and 1993, the cost of labor rose 50% in China and 22% in Korea<sup>12</sup>. With such increases, construction costs could double in less than five years. Rising construction costs alone should drive up property prices, benefitting today’s owners.

## *Risks*

US fund managers interviewed identified seven levels of risks.

---

<sup>10</sup> World Bank “World Development Statistics”

<sup>11</sup> Ibid.

<sup>12</sup> J.P. Mei “*Are the Foundations Solid for Emerging Market Real Estate?*” Real Estate Finance. 14(1):6-11. 1998, Winter

1. Political instability

Given its immobility, real estate is most vulnerable to government exploitation. Unstable political conditions and regulatory systems in many Asian countries can have a significant impact on the interests of real estate investors. Events such as riots in Indonesia and the return of Hong Kong and Macao to China greatly affected real estate values in those places.

2. Lack of market transparency

Most Asian markets have severe information inefficiencies—which can represent both risk and opportunity. Any foreign investor is usually at an information disadvantage compared to local players. To solve this problem, US investors often team up with reliable local partners who have strong ties to local governments. “We rely on local partners to screen opportunities,” said Charlie Pardow of Prudential.

3. Differences in real estate valuation

Significant differences separate American and Asian real estate valuations: a) Asians see the loss of control of properties as “loss of face.” They also see properties as depositories rather than generators of wealth. Asians are more likely to sacrifice current yield for residual value and to hold property longer. b) Many Asian countries use a cost- or market-data-based valuation approach rather than the yield-capitalization approach used in particular Western countries. These differences usually result in wide bid-ask price spreads when foreign investors try to negotiate with local owners.

4. Ineffective legal system

To offset a lack of local political influence, Western investors depend on an effective legal system to protect their interests. This is especially true when buying distressed assets, which involves foreclosures, loan work-outs and discounted pay-outs. Absence of foreclosure and bankruptcy laws in Asian countries such as Thailand makes it much more difficult for the US investors who bought NPLs to resolve them later.

5. Lack of well-functioning local capital markets

The maturity of a capital market relates directly to the liquidity of investments. Given their short investment time frames, Opportunistic Funds seek to resell assets as quickly as possible. Some of the assets are loans that require either securitization or a secondary financial market to recoup investments. A sophisticated and efficient local capital market is the ideal structure for secondary market executions. Aside from Japan, Korea, Hong Kong and Singapore, most Asian countries have very primitive real estate capital markets.

6. Currency convertibility and exchange risk

Now that local currencies of East Asian countries are no longer pegged to the US dollar, the currency exchange risks of Asian investments are increased substantially. These currencies are not freely convertible, making profit repatriation next to impossible.

7. Property market speculation

Years of speculative real estate developments have left major Asian cities saturated with vacant buildings. Office vacancy rates reached as high as 50% in some cities. Despite

evidence of oversupply, more new construction is adding space to some markets. These irrational--even suicidal--behaviors are hard to understand and/or predict for foreign investors. They could severely damage the returns of foreign investments.

These difficulties are the major sources of risks US investors encounter when investing in Asian real estate. Some risks are relatively easy to quantify and factor into the return requirements. For example, an investor could look at the spread between a country's bond yields and those of US Treasury bonds. That spread, at a minimum, might be added to return requirements when determining if a particular deal makes sense. Other factors, such as assessing the political climate, are more subjective and therefore should command higher yield premiums. This means that Asian opportunities must offer much higher returns than 20-30% in order to attract US capital.

The risk profile of a given market is as important a consideration as its return potential. That is why more US investments flowed to Japan and Korea. These markets are seen as less risky.

In Japan's case, heavy land speculation sent Japan's land (and real estate) prices skyrocketing. Land prices increased 2.5 to 3 times between 1985 and 1990. They have decreased ever since. Prices today are similar to those in 1985--which is about one third of prices in 1990<sup>13</sup>. During this period of speculation, the Japanese financial sector held major stakes in real estate. The Asian Financial Crisis, however, severely affected many

---

<sup>13</sup> Gelbtuch, Howard "*Land Prices Provide Clue to Cycle Status*" Real Estate Forum, 10/99, Page 37, Real Estate Media, Inc.

financial institutions. Many banks went bankrupt or were caught up in a swift wave of mergers and acquisitions. Distressed banks were extremely anxious to dispose of non-performing loans--many of which were real estate loans--in order to clean up their balance sheets. The combination of falling real estate values and a distressed financial sector created a market for cheaply priced Japanese real estate NPLs.

In Korea, property devaluation resulted from a recession in the wake of the 1997 financial crisis. Property speculation was never as widespread as in Japan. Korea's real estate capital market was closed to foreigners prior to the 1997 crisis, when the country experienced a severe shortage of cash. At the request of the International Monetary Fund as part of the crisis-rescue program, Korea opened its real estate debt market to foreign investors on July 1, 1998<sup>14</sup>. US funds have since bought billions of dollars worth of Korean real estate. As buyer interest increased, sellers held firm on asking prices. As a result, the property-value decline slowed. Due to sound economic fundamentals, Korea's economy quickly rebounded. Currently, property values stand at about 60% of the 1996 market peak<sup>15</sup>.

As was described in the introduction, China has large backlog of real estate NPLs in need of disposition due to government-directed over-development in the early 1990s. Are these loans good opportunities for US investors? How do they compare to the NPLs of other Asian countries? The answer to this question lies in a comparison of the potential

---

<sup>14</sup> Katz, S Stanley, "The Asian crisis, the IMF and the critics" Eastern Economic Journal, Bloomsburg; Fall 1999; Vol. 25, Iss. 4; pg. 421

<sup>15</sup> Cavaluzzi, Joseph "Recovery, Stagnation Coexist" Real Estate Forum, 10/99, pg. 66, Real Estate Media, Inc.

returns as well as risks of these Chinese opportunities with those of other East Asian countries. The next two chapters will address the risks and returns respectively of Chinese NPLs.

## **Chapter II:**

# ***Investment Environments: China vs. Other Asian Countries***

### **Preface**

Does China's NPL resolution represent investment opportunities that are as attractive as those in other East Asian countries? Comparing investment opportunities in different markets requires not only the comparison of their returns but also their risks. This chapter compares the risk profile of the Chinese real estate market to those of other East Asian countries in order to determine how much additional (or less) risk premium is needed for the Chinese opportunities to be equally attractive. A general ranking of the investment environments in various East Asian countries was established based on opinions of US fund managers working in Asia. To understand the Chinese real estate

market in more details, I went to China and interviewed the following local and foreign developers and real estate researchers.

*Red Stone Industries, Ltd.*

Red Stone is a real estate development company in Beijing. Established in 1987, it has developed over 10 million square feet of office, retail and residential properties. In 1999, Red Stone was rated the city's top development company by real estate professionals for the successful development of New Town residential project (4 million square feet, 3000 apartments and RMB 4 billion [US\$500 million] in total sales).

*China Homes, Ltd.*

China Homes is a foreign-owned start-up development company headquartered in Beijing. Prudential Insurance Company of the US is its majority shareholder. Top management consists mostly of foreign expatriates with Western development and management experiences. Established in 1998, China Home is developing its first residential project in Beijing.

*Tsinghua University, Institute of Real Estate Studies (IRES)*

Tsinghua is China's leading university. Its Institute of Real Estate Studies, founded in 1992, provides an intellectual focus for research on issues affecting the real estate market regulation, development process, real estate investment and property valuation. The Institute is an active participant in the discussion of China's real estate policies. It has

published numerous articles on real estate policies, regulations, economy, market analysis, finance and investments.

## **Investment Environments of Asian Countries**

Asian real estate markets range from the highly regulated and efficient--such as Japan's and Korea's--to the very primitive and chaotic--such as Vietnam's and Indonesia's.

When asked about their opinions of the Asian investment environments, US fund managers interviewed shared similar views. According to their evaluations, Asian markets can be categorized into three tiers based on their levels of political stability, market fundamentals, legal environments, degrees of currency convertibility and levels of efficiency in secondary property and capital markets.

### *First tier*

*Japan* and *Korea* are considered to be the top tier, with the most developed real estate markets. Kalsi of Morgan Stanley summarized the opinions of the majority of US fund managers about Japan and Korea: "They have very strong legal systems, great protection of land-lord rights and easily convertible currencies. The market fundamentals are relatively good as Japan never had an overbuilt market. Japan's office vacancy rates are as low as 5%, even though its real estate prices dropped 60-70% from their peaks in 1990 due to the burst of Japan's economic bubble. There are efficient secondary property and capital markets in Japan, making property and paper trading very liquid. Korea is similar to Japan. It has a legal system that is as strong as, or even stronger than that of Japan's.

Real estate fundamentals are relatively healthy. Average office vacancy rate is 11%, one of the lowest in Asia. The economy has shown signs of recovery. Property prices are beginning to rise.”

### *Second tier*

*Hong Kong* and *Singapore* are considered to be the second-tier markets. They fall behind Japan and Korea due to poorer market fundamentals. They were among the first to receive attention from Western investors, but were hit badly by the Asian Financial Crisis. Property prices dropped dramatically. Economic recovery has been slow and the outlook is unclear. Severe property oversupply has slowed a rebound in the real estate market. Overall business environments are seen as lagging behind those of Japan’s and Korea’s. They are, however, catching up quickly. As pointed out by Loh of Prudential, “Japan and Korea were developed earlier. But Hong Kong and Singapore are much more progressive.” Western businesses see Hong Kong and Singapore as the gateways to Asia and feel comfortable with their “Westernized” legal systems.

### *Third tier*

The third-tier includes *Malaysia*, *Indonesia*, and *Thailand*. These markets are considered much less developed. “Indonesia is a mess [because of their political instability and corrupted legal system],” said Kalsi, “Thailand is politically stable but has bad market fundamentals. Demand drops but supply continues. It has a legal system that is as weak and corrupted as that of Indonesia’s.” Bob Zulkoski of Colony added, “Those who bought NPLs in Thailand have faced a lot more difficulties resolving them than they

expected, due to the fact that there is no legal standing to [help them] collect these loans efficiently.”

According to Cushman & Wakefield, the average office vacancy rate in Thailand is above 30%. In downtown CBDs, it reaches 45%. Even under such market conditions, new constructions are still adding more space to the market, for reasons that are hard to understand. Five million square feet of new office space came onto Bangkok market in 1999, representing a 15% increase in the entire inventory<sup>16</sup>.

In Malaysia and Indonesia, similar patterns are observed. Office vacancies are 20% and 24% in Kuala Lumpur and Jakarta respectively. Kuala Lumpur is expecting another 9.1 million square feet of new office space by the end of 2001. Jakarta experienced significant negative office absorption in 1999. Vacancy rates in both countries are expected to rise even further due to slow economic recoveries and continued supplies.

## **Investment Environment in China**

Which tier does China fall into? How does China compare to the Asian countries discussed above? It has a vast real estate market with huge demand, yet most US investors consider it too immature to invest in. It is considered to be even behind the third-tier markets. Opinions about investment environment in China were unanimously

---

<sup>16</sup> Cavaluzzi, Joseph “*Recovery, Stagnation Coexist*” *Real Estate Forum*, 10/99, Page 66, Real Estate Media, Inc.

negative among US fund managers interviewed. Several major shortcomings have kept foreign investors at bay.

*1. Weak legal system and tactical abidance of international rules*

China has been a communist country since 1949, with power highly centralized in the hands of the Communist Party. Although the People's Congress formulates laws, the party has absolute control over the People's Congress; in reality, the power of the party supercedes that of the legal system. Under such a centralized political system, a fully independent judiciary is an impossibility. Laws are modified frequently to meet governmental interest. In addition, Chinese laws lack concrete detail, leaving ample room for bureaucratic rules that are even easier than laws to revise in order to facilitate government policies.

With regards to international rules, China tactically participates in international regimes to take full advantage of the benefits while avoiding responsibilities<sup>17</sup>. Compliance with the rules of these international regimes--including abiding by norms and treaties of international trades--depends on a cost-benefit calculus. Protection of national interests is one of the fundamental principles of all Chinese laws and regulations governing Sino-foreign economic activities.

Under such a legal framework, foreign investors may find themselves at disadvantages when settling disputes with Chinese counterparts.

---

<sup>17</sup> This point is further explained in the book of Elizabeth Economy, and Michael Oksenberg's "*China Joins the World, Progress and Prospect*" Council for Foreign Relations Press, 1999

China's entry into WTO, in theory, will further integrate China into the global economy. China will increase its dependence upon various international regimes, which will force the country to increase its level of compliance with international rules. These changes will create more safety nets for foreign businesses in China..

### *2. Inconsistent government policies and regulations*

Real estate development as a commercial activity has a very short history in the Communist China--after the Communists' take-over in 1949. Not until the late 1980s did the Chinese government start to draft rules to regulate this business. Since then, real estate laws and regulations have been revised and expanded constantly. These regulations change to reflect fluctuations in government policies toward real estate development. Some changes are so dramatic that they can make or break a development project since changes of rules during the development process can make anticipated profits disappear. In addition, the ambiguous wording of these regulations gives local governments high levels of discretion over their implementations. In my interviews, the chronological and geographical inconsistencies of government policies are listed by real estate developers and investors (especially foreign investors) as the number-one risk in China's real estate business.

### *3. Opaque and undisciplined governmental practices*

Government and business are more inter-linked in China than in countries with more democratic political and economic systems. This is especially true in the area of

international business, where the government has other agendas--diplomatic politics--to protect in addition to economic interests. Exclusion from international regimes is painful, but so are the constraints arising from the inclusion in these regimes. Secrecy and opacity help facilitate the desired flexible participation in international trades. As a result, China intentionally withholds information from foreign investors. Such retention of critical information puts foreign investors at great risks when investing in China.

In 1994, the default on trade credits by Chinese SOEs resulted in an alleged loss to a US brokerage firm, Lehman Brothers, of almost US\$100 million. Ambiguous laws and misleading signals from Chinese government officials led Lehman to believe that these credits to Chinese state-owned trading companies were guaranteed by the Chinese government. But the Chinese government later denied that assumption<sup>18</sup>.

Again starting in 1994, several dozen foreign telecommunication companies made equity investments of US\$1.4 billion in China's second-largest telecommunication giant, China Unicom, with Chinese government officials intentionally looking the other way. Foreign stakes in the company exceeded 50%. China Unicom boosted its business with the newly injected capital. In 1999, the government denied the legitimacy of foreign majority equity investment in China's telecommunication business and forced the refund of foreign capital with small returns of between 6% to 20% instead of multiple folds of returns they deserve under equity investment agreements<sup>19</sup>.

---

<sup>18</sup> Page, Nigel, "*Lehman Brothers' Chinese Puzzle*" International Commercial Litigation; London; June 1995

<sup>19</sup> Roberts, Dexter, "*Unplugged by Beijing*" Business Week; New York; August 1999; The McGraw-Hill company

These behaviors have already led to the credit downgrading of China, by the International Intelligence Unit, from B to C, a non-investment grade. Naoto Ichiki of J.P. Morgan said in the interview: “The government guaranteed the credit, but later turned around and said you have to be responsible for your own investment losses. You are basically screwed at that point.”

#### *4. Illiquid property and capital market*

Due to the lack of institutional real estate investors, a secondary market for real properties does not exist. Most projects are either sold to property users after development or become non-performing assets of the banks that financed them. A market for secondary commercial property has not been established. Sales of large-scale, second-hand commercial properties have been very rare. Finding a domestic buyer for such properties will remain a difficult task for many years.

China’s stock exchange is still very primitive, with limited financial products. Real estate trust funds and mortgage-backed securities are just now being studied by academics and policy makers. It will take a long time before they become available to investors. An unsophisticated capital market and an inefficient property market make it very hard for foreign investors to liquidate investments.

#### *5. Restrictions on foreign currency conversion*

Chinese currency, Ren Min Bi (people's money), is not freely convertible to hard currencies, making it difficult for foreign investors to repatriate capital. This is one of the most offputting restrictions on the market for US fund managers.

To buy Chinese real properties, a foreign investor must first register a foreign-owned company in China, with a certain amount of initial capital under registration. This capital is part of the company registration and must stay with the company until the company dissolves. It must be deposited in a Chinese bank. The use of this capital within China is unrestricted, but its repatriation is allowed only when the company is dissolved or applies for downsizing. Lengthy bureaucratic procedures are required for both actions.

The capital under registration can be smaller than the value of real properties purchased. The balance can be loans from local banks or from foreign shareholders. When a property is sold, funds that are needed to pay back loans and profits of the investor's are allowed to be repatriated without dissolving the company. But the original capital under registration cannot leave the country as long as the company exists. Setting up a company for each property purchased is a way of creating flexibility for foreign currency maneuvers. The drawbacks are, however, increased overhead and additional management costs.

Operating profits of a company can be repatriated after all taxes and duties have been paid. If the proceeds are in local currency, however, converting them to hard currencies is subject to the availability of hard currencies at the local Foreign Exchange Bureau.

Some foreign companies have had to wait for years to completely repatriate their money<sup>20</sup>.

These shortcomings in China's real estate environment put China behind even the third-tier Asian countries in term of risk profile. While realizing the great potentials of China's real estate market, many US investors think it's too early to enter the market now. As stated by Kalsi: "It's going to be a long while before we can invest there in any meaningful way." Lend Lease/PricewaterhouseCoopers summarized China as "too big to ignore but too early to appear on the radar screen."<sup>21</sup>

## **Real Estate Market in China**

China's real estate market is relatively new. Developments account for the majority of activities in that market. There have not been many buying-and-sellings of commercial real estate so far. Developments, however, have been occurring at very fast paces. Government-influenced over-speculation has led to a severely oversupplied real estate market.

### *Brief history*

China did not have a real estate market until the mid-1980s. Before that, real properties were all owned by the state and assigned to SOEs with no market values attached. Since

---

<sup>20</sup> Refer to "*Laws on Sino-foreign Economic Cooperation*" for further information on China's foreign currency control.

China's economic reform in the 1980s, the private sector has enjoyed significant growth and become a more important player in the country's economy. Private property rights are more protected. At the same time, reform attracted a growing number of foreign enterprises to open their businesses in China. Private and foreign companies are not granted properties by the state as the SOEs are. They have to pay for office space, and their employees have to pay for housing. This has encouraged the emergence and growth of a real estate market. Even today, private-sector and foreign enterprises are still the major customers of Chinese commercial real estate.

Physical improvement was seen as the first step toward modernization. Real estate development, with the government's support, became the driving force of China's booming economy in the early 1990s. Several events promoted the development of China's real estate market.

In 1992, China's then president Deng Xiaoping visited Shenzhen, a special economic zone established in 1982 to test the Chinese model of market economy, and praised its achievements over the decade. He then confirmed the government's determination to develop further the "Socialist Market Economy" in China. Real estate speculation surged in the following years, especially in the southern provinces. The focuses of development during this period were hotels, office buildings and luxury housing.

In 1996, the central government decided to develop Shanghai into the new financial center of Asia. Pudong's Lujiazui was chosen to become the new central business district

---

<sup>21</sup> "Emerging Trend in Real Estate 2000" Lend Lease and PricewaterhouseCoopers October 9, 1999

in Shanghai. 20 million square feet of office space were built during the following four years. In the meantime, development continued in Beijing, where more than 22 million square feet were added to the market.<sup>22</sup>

Between 1998 and 1999, China started to implement housing reform, which terminated institutional housing sponsorships and promoted the development of first and secondary private housing markets. Residential developments of various price-levels now account for the majority of real estate developments in China.

### *Current market fundamentals*

#### Office sector

Shanghai and Beijing have led the world in the volume of new construction over the past several years. Intense speculation, driven by government policies instead of market demand, has left these cities saturated with product. Office vacancy rates in Beijing were as high as 37% (see exhibit 1). Half of the new office buildings built in Shanghai's Pudong are empty. Rents of class "A" office buildings have dropped as much as 68% in Shanghai and 65% in Beijing from their peaks<sup>23</sup> (see exhibit 3).

Office development is now tightly restricted by the government. In Beijing, only 1.2 million square feet of new office space has come onto the market so far this year, 25%

---

<sup>22</sup> Seek, N.H., "Institutional Participation in the Asia Pacific Real Estate Markets: Are the Benefits Worth the Risks?" *Real Estate Finance*, 12(4):51-58, 1996, Winter

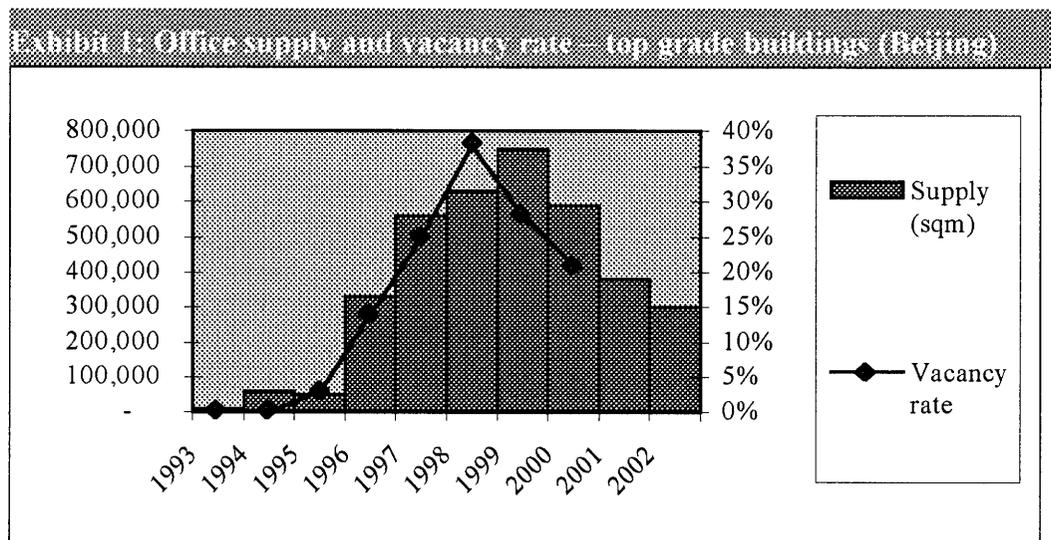
<sup>23</sup> Cavaluzzi, Joseph "Recovery, Stagnation Coexist" *Real Estate Forum*, 10/99, Page 66, Real Estate Media, Inc

less new supply from the same period in 1999, and the office vacancy rates stand at 20%.

In Pudong, new office developments were almost prohibited after 1998 (see exhibit 2).

Office rents in Beijing have been falling from their peak of US\$100/sqft/yr in 1995 to

US\$22/sqft/yr in 2000 (see exhibit 3). In Shanghai, rents are around US\$14/sqft/yr.

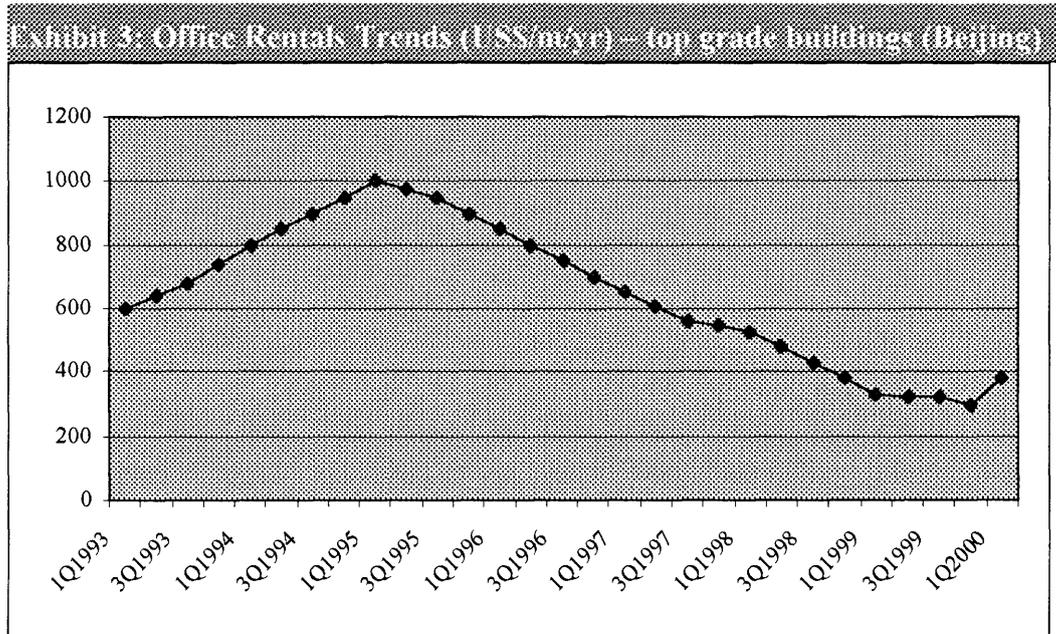


Source: Jones Lang LaSalle and CLSA GEM

**Exhibit 2: Summary of office market – Beijing & Shanghai (1Q00)**

City	New supply (sqft)	Vacancy rate	Rentals (US\$/sqft/yr)
Beijing	1,200,000	20%	22
Shanghai -Puxi	300,000	35%	14
Shanghai - Pudong	0	55%	11

Source: Jones Land LaSalle's report



Source: Jones Lang LaSalle and CLSA GEM

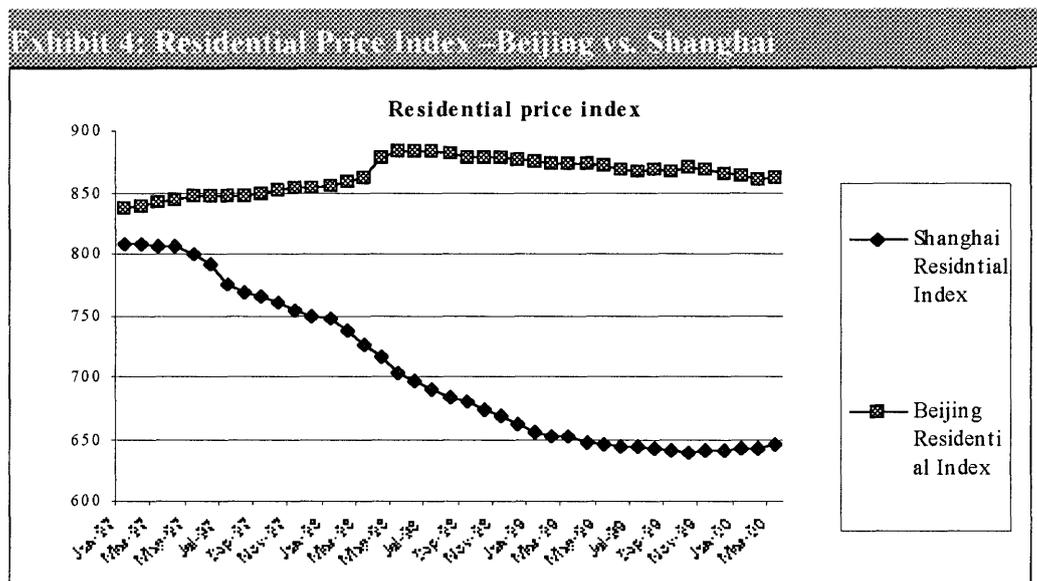
### Hotel sector

As the development focus of the first real estate boom (1992-1996), luxury hotels were severely overbuilt in China's major cities. The slowing of China's economy and the declining volume of tourist from financially distressed Asian countries have significantly lowered the occupancy rate and room prices of Chinese hotels.

### Residential sector

The properties on the residential market were primarily luxury residences for foreign expatriates working in China during the late 1980s and early 1990s. These foreigners had no housing options other than living in luxury hotels on a relatively long-term basis. This situation helped create the market for serviced apartments targeted at these foreigners. They offered much more comfortable accommodations at rents that were almost equal to monthly hotel bills. Once again, over-building of such apartments quickly satisfied

demand; rents fell dramatically and vacancy rates soared. Prices of Shanghai apartments today are 80% of their peak in 1997 (see exhibit 4). This pattern is more clearly observed in Shanghai than it is in Beijing as Shanghai had more speculation than Beijing during the early 90s. The concentration of foreign companies in Beijing also helped maintain a more steady demand for commercial housing.



In 1998, the Chinese government started implementing housing reform. SOEs will no longer build or purchase as well as maintain housing for their employees. Housing stipend will be added to employees' salaries, and all state workers may purchase commercial housing at their own wishes.

The 1998 housing reform and newly available residential mortgage programs have created significant domestic demand for commercial housing. Residential market saw significant improvements in 1999 and 2000. Much vacancy of expatriate housing was

absorbed by domestic demand. 80 million square feet of housing is expected to enter the market this year. The majority of them will be priced between RMB 6000 to 8000 per square meter (US\$80-100/sqft).

Most local developers feel optimistic about the residential property market in the near future. The current living area per person in Beijing is 9.5 square meters (95 square feet), much lower than the 15 square meter (150 square feet) goal set by the government.

Uncontrolled supply and the inconsistency of government policies, however, remain to be their main concerns.

Government-influenced development in the 1980s and early 1990s resulted in a severely oversupplied real estate market in China. Such oversupply has resulted in vast investment losses. Most of these losses, however, are unrealized, as these vacant properties have yet to change hands. The values of these properties--as valued by costs plus hypothetical profits--are still on the developers' books. "Mainland Chinese don't understand cash flow valuation," said Colony's Zulkoski. "as they turn around and sell these vacant properties, they ask for prices that are way higher than most people are willing to bid for." New projects keep coming to the market without clear signs of increasing demand.

Given the high risks perceived by US institutional investors with regard to investing in Chinese real estate, the returns offered by any real estate investment opportunities there have to be very high to justify those risks. Can China's NPL resolution offer such

returns? The next chapter investigates the background, objectives, current progress, and planned strategies of China's NPL resolution.

## **Chapter III:**

### ***What Can Chinese NPLs Offer?***

#### **Preface**

Since the late 1980s, China has enjoyed explosive economic growth. Real estate development was chosen by the central government--master planner of China's economy--to be the driving force of that growth. During the first ten years--1986 to 1996--of China's "Economic Reform", massive non-stop construction was evident throughout China's major cities.

The Chinese state-owned banks, which dominate China's banking industry, were the primary source of capital for China's real estate developments. Most lending decisions,

however, were made to support governmental policies rather than to generate profits for the banks. Non-commercially-oriented underwriting practices and an over-supplied real estate market led to vast numbers of non-performing real estate loans held by state-owned banks.

Real estate loans are only one-fifth of the total non-performing loans (NPLs) burdening Chinese banks. The astronomical number of NPLs in China's financial system, which were made to support numerous money-losing state-owned enterprises (SOEs), is a major threat to the country's economy. The problem has become even more urgent as China prepares for its entry into the World Trade Organization (WTO), which will give foreign banks full access to the Chinese market. To help Chinese banks stay competitive, the central government has started a program to transform state-owned banks into more commercially oriented banks. The first step was to relieve state-owned banks of the burdens of NPLs that were made under the government's influence. Starting in 1999, an asset management company (AMC), which is similar to the RTC in the US during the S&L resolution, was set up to take over NPL resolution for each of the "Big Four" state-owned banks.

Does China's NPL resolution represent opportunities for US Opportunistic Funds as the S&L crisis and Asian financial crisis did? This chapter addresses this question through an analysis of the motivations and limitations behind China's NPL resolution.

To study the objectives and strategies of China's NPL resolution, I went to China and interviewed officials from China Construction Bank and Cinda Asset Management Corporation.

*China Construction Banks (CCB)* is the third largest state-owned bank in China. As inferred by its name, CCB has issued the most real estate loans among the Big Four banks and as a result, owns the most real estate NPLs. *Cinda* is the asset management company set up to resolve NPLs held by CCB. The English name *Cinda* is a phonetic translation of its Chinese name, which means "Trust and Prosperity". Details of both organizations will be introduced later in this chapter.

## **China's Finance and Banking System**

To understand China's NPL problem, it is necessary to understand China's finance and banking system first.

China's financial assets are concentrated in its banking system. Capital markets are relatively small and bank loans remain the dominant source (above 80%) of funding for Chinese companies<sup>24</sup>. A formal corporate debt market does not exist.

The Big Four banks, all owned solely by China's Ministry of Finance, represent between 60% and 70% of domestic banking assets<sup>25</sup>. These Big Four banks are:

---

<sup>24</sup> Lardy, Nicholas R., "*China's Unfinished Economic Revolution*" The Brookings Institution Press, 1998

<sup>25</sup> Ibid.

1. *The Industrial and Commercial Bank of China,*

The largest of the Big Four banks originally specialized in lending to the industrial sector.

2. *The Bank of China*

The second-largest bank, it is most responsible for foreign-exchange activity and the financing of imports and exports, and it maintains a large overseas branch network.

3. *China Construction Bank*

The third-largest bank, which traditionally focused on financing infrastructure development.

4. *The Agricultural Bank of China,*

The smallest of the Big Four, it has traditionally focused on agricultural lending and rural development. This bank is generally perceived to be the weakest of the banks, with a capital-to-asset ratio of around 2.5% (compared to more than 5% at the other three banks).

The Big Four banks are now fully diversified, and no longer specialize in lending activities. Their total assets exceed US\$1 trillion; they have more than 200,000 branches and more than 2 million employees<sup>26</sup>.

---

<sup>26</sup> Walker, John L. "Financial Reform in China" [ChinaOnline.com](http://ChinaOnline.com), 6/13/2000, Commentary, ChinaOnline, LLC.

Other participants altogether account for about 30% of domestic banking industry. These participants are:

- *The Bank of Communications*, which was founded in 1985 and has approximately 5% of the domestic banking business.
- Ten national commercial banks, including *CITIC Industrial Bank* and *Everbright Bank*, which have approximately 9% of the domestic banking business.
- Three development or "policy" banks, which were founded by the government in 1994 and do not take deposits. Among them, the *China Development Bank*, the *Agricultural Development Bank*, and the *Export-Import Bank of China* share approximately 5% of the domestic banking business.

The three policy banks were created to take over the role of policy lending in China. They are required to support government objectives, ranging from the expansion of priority sectors to the maintenance of unprofitable state-owned enterprises. However, the Big Four banks continue to participate in directed lending to state-owned enterprises and national projects, and they purchase bonds issued by the policy banks.

- More than 80 city commercial banks, which divide approximately 4% of the domestic banking market. Urban credit cooperatives share another 5% of domestic banking

business. Numerous rural credit cooperatives and other small institutions account for approximately 9% of the market.

- More than 160 foreign banks maintain branches or representative offices in China, which have approximately 2% of total banking assets in China. Their operations are highly restricted. China's entry into the WTO will liberalize foreign bank involvement in the banking sector<sup>27</sup>, and the threat of increased competition from foreign banks will force Chinese banks to quicken the pace of reform.

## **Reform Pressures**

As China's economic reform continues, the following problems in the country's banking system are forcing the central government to begin its Banking Reform.

### *1. Competition from foreign banks*

Under the US-China WTO accession agreement, foreign banks may conduct local-currency business with Chinese enterprises starting two years after accession. Starting five years after accession, foreign banks may conduct local-currency business of any kind throughout China<sup>28</sup>. Due to lack of experience in commercial banking, it will be hard for state-owned banks to stay competitive.

### *2. Obligations to state-owned enterprises (SOEs)*

Most Chinese banks are state-owned. It is their duty to support other SOEs. Reform of the Chinese banking system is inextricably linked to the reform of Chinese SOEs.

Nicholas Lardy, senior fellow in the Foreign Policy Studies program at the Brookings Institution, found that between 1980 and 1995, more than 90% of all fixed-asset loans by the Industrial and Commercial Bank of China were made to SOE<sup>29</sup>. The traditional economic structure of SOEs, learned from the former Soviet Union, is no longer suitable to China's new market economy. Most SOEs are generating negative profits and as a result have become increasingly dependent on bank credit to finance their operations. By 1995, the outstanding borrowings of the SOEs stood at 83% of all bank loans outstanding. SOEs' decreasing return on assets and their inability to service their debt has made them huge burdens of state-owned banks. Obligations to support SOEs will significantly lower the competitiveness of Chinese banks.

### *3. Lack of commercial underwriting experience*

For the most part, Chinese banks offer customers only basic banking services, such as taking deposits, making loans, and providing payment and clearance services.

Government regulations have impeded the development of new products, and interest rates on loans remain subject to government control. The banks have virtually no experience in commercial underwriting. To compete with foreign banks, Chinese banks realized that they must begin transforming themselves into commercially oriented banks that operate on market principles.

---

<sup>27</sup> The White House Office of Public Liaison, "*Summary of U.S.-China Bilateral WTO Agreement*" [ChinaOnline.com](http://ChinaOnline.com), 11/17/1999, WTO, ChinaOnline, LLC.

<sup>28</sup> Ibid.

<sup>29</sup> Lardy, Nicholas R., "*China's Unfinished Economic Revolution*" The Brookings Institution Press, 1998

#### 4. *Threat of lowering liquidity*

As repository for money, the only alternatives to banks for the general public are the stock market and treasury bonds. Their sizes are currently rather small. Boxed in by this lack of investment vehicles and driven by a fear that prosperity will not last, the general public has reduced consumption and stores most of its savings in banks, especially in state-owned banks which are perceived as being more secure. By the end of 1999, household deposits in all banks had reached RMB 6.22 trillion (US\$758.5 billion), which is RMB 348.7 billion (US\$42.1 billion) more than at the end of the previous year. Household deposits account for approximately 60% of all bank deposits<sup>30</sup>.

Chinese banks generally have more deposits than they can profitably deploy; thus they are quite liquid, although they are technically insolvent due to the high level of NPLs at book value. To encourage consumer spending in an effort to expand the economy, the government imposed, in November of 1999, new taxes on interest income to discourage personal savings. In an effort to sell off interests in state-owned enterprises, the government is also encouraging the general public, many of them state employees, to purchase shares of SOEs with their money in the banks. Foreign banks' entry into the Chinese market would draw more deposits away from Chinese banks. These changes could significantly reduce Chinese banks' liquidity as well as expose the banks' hidden insolvency.

---

<sup>30</sup> "CONVERSION DIVERSION: No Timetable Set to Float Renminbi, China's central banker exhorts" [ChinaOnline.com](http://ChinaOnline.com), 7/17/2000, Finance, ChinaOnline, LLC.

### 5. *Low level of profitability*

Bank profitability should be measured by return on assets. The profitability of state-owned banks in China has been poor and is declining due to their vast number of NPLs, which is included in banks' assets. The officially reported profits of Chinese state-owned banks rose from a collective \$1.5 billion in 1985 to \$2.5 billion in 1997. However, their return on assets decreased from 1.4% in 1985-87 to 0.3% in 1995-97. These profit figures are calculated using Chinese accounting rules, which greatly overstate interest income<sup>31</sup>. Chinese accounting rules allow banks to accrue interests for two years after the loan becomes "past due". The provisions for loan losses in the biggest Chinese banks are capped between 0.13% and 0.39% of loan outstanding in 1997, dropped from between 0.47% and 0.70% in 1996, forcing banks to accumulate NPLs on their books. These measures significantly overstate bank profits. By Western standards, which use stricter bad-loan classification and allow higher loss provisions, the Big Four banks are probably experiencing large losses.

### **Non-Performing Loans (NPLs)**

Non-performing loans are another major driving force to China's banking reform. The high proportion of non-performing assets is most threatening to the major banks. In fact, each of the Big Four banks has a serious asset-quality problem<sup>32</sup>.

China uses a three-classification loan system:

---

<sup>31</sup> Lardy,

<sup>32</sup> Ibid.

- a. Past-due Loans: Loans that are not repaid when due or not repaid after the due date has been extended.
- b. Doubtful Loans: Loans that have been past due for two or more years, or loans for which repayment deadlines have been extended.
- c. Bad debt: Value of loans that have not been repaid after the borrower has declared bankruptcy and has liquidated.

This system contrasts sharply with Western banking standards. For example, in international practice, a loan is considered bad when any interest payment is overdue by 180 days or more. Under Chinese accounting rules, a loan is not declared a bad debt until after the borrower has declared bankruptcy and gone through liquidation. Central bank governor Dai Xianglong and other high-ranking banking officials have stated that NPLs, as a share of total loans, increased from 20% in 1994 to 22% in 1995 and then to 25% in 1997<sup>33</sup>, which represented an estimated RMB 860 billion (US\$100 billion). If international standards were applied, NPLs of the Chinese banks might account for 50% of total loans, or approximately RMB 2 trillion (US\$250 billion) out of RMB 4 trillion (US\$500 billion) total<sup>34</sup>. The banks are moving to classify their loan portfolios in accordance with international standards modeled after U.S. practice. Details of reform are still being studied.

A large portion (about 20%) of total NPLs are loans to real estate companies.

Approximately two-thirds of NPLs are industrial or infrastructure loans, of which about

---

<sup>33</sup> Lardy.

<sup>34</sup> Ibid.

half are loans to SOEs and half to private companies. Roughly one-third of NPLs are policy loans made under the instructions of the central government, and another one-third is made under the influence of provincial governments.

### **Asset Management Companies (AMCs)**

In October 1998 Premier Zhu Rongji decided to set up an asset management company to acquire non-performing loans from China Construction Bank as a pilot project. In April 1999 this company, known as Cinda Asset Management Corporation, was established. The other Big Four banks have since followed suit, but no AMC is being planned for any other financial institution.

Capital for Cinda and the other AMCs has been provided by the Ministry of Finance, and Cinda's management has been drawn from China Construction Bank. NPLs made under the central government's direction before 1996 are being transferred to Cinda and the other AMCs at face value; no write-offs are being taken. By transferring these policy loans, but not removing non-performing, non-policy loans made by the banks themselves, Chinese authorities are holding the banks responsible for their own poor lending decisions.

The AMCs are wholly owned by the central government and not by the respective Big Four banks. Cinda was initially capitalized with RMB 10 billion (US\$1.2 billion) from the Ministry of Finance. Its president was appointed by the State Council, the highest

administrative body of the Chinese central government and headed by the Premier. A board of supervisors of Cinda, its highest governing body, includes representatives from the Ministry of Finance (the Chairman of the Board is the Vice Minister of Finance), the People's Bank of China (China's central bank), the China Securities Regulatory Commission, the National Auditing Office, and China Construction Bank. Cinda is under the supervision of the People's Bank of China, and the company is in the process of setting up 31 regional offices.

Cinda will issue RMB 250 billion (US\$31 billion) in bonds to China Construction Bank in return for an equal face amount of China Construction Bank NPLs. Assets classified as "normal" or "past due" will remain with China Construction Bank. Assets classified as "doubtful" or "bad debt" will be transferred to Cinda and assets classified as "loss" are to be written off by China Construction Bank. Problem-loan transfers began in the second half of 1999 and by the end of June 2000, the four AMC's had completed transfers of bad loans that totaled RMB 1.3 trillion (US\$157 billion). AMC's have just started the NPL resolution after the completion of transfers. Cinda expects to be in operation for at least ten years.

Chinese authorities believe that the purchase by foreigners of a portion of non-performing assets may be necessary for resolving the NPL problem. The country itself has limited resources for dealing with the massive accumulation of NPLs. The total annual revenues of the Chinese government equal only 11% of GDP (compared with 20% in the United States). The total NPLs transferred to all four AMC's is RMB 1.3 trillion (US\$157

billion)<sup>35</sup>, about 65% of the total estimated NPLs of the Big Four banks (approximately RMB 2 trillion, as mentioned above). This represents about 15.6% of China's GDP and about 140% of the government's annual revenues<sup>36</sup>. In fact, the actual amount of NPLs at the banks could turn out to be twice as high. The Ministry of Finance expects the AMC's to recover about 50% of the NPLs they assume. Officials from the AMC's, however, estimated that 15% is a more realistic number. According to Wen Ma, executive associate director of Cinda's Debt Management Department, about one-third of the non-performing loans transferred will be swapped for equities of borrowers and another third was lent to companies already bankrupted, leaving only the last third to be collected. The expected recovery rate for this final third is approximately 50%.

By comparison, the US savings and loan crisis cost American taxpayers about US\$150 billion, representing less than 3% of US GDP<sup>37</sup>. The cost to the Chinese will be realized when the bonds issued by the AMC's mature in 10 to 30 years. The cost will ultimately be borne by the Chinese in the form of higher taxes and lower economic growth. Servicing the bonds will likely put a strain on the government's fiscal resources.

Profits of the Big Four banks should be boosted by the interest received on the bonds issued by the AMC's (approximately RMB 20 to 40 billion, US\$2.5 to 5 billion, a year). This interest revenue should help the banks absorb additional losses. Furthermore, selling the bonds on the secondary market would improve the banks' liquidity and help to

---

<sup>35</sup> "CONVERSION DIVERSION: No Timetable Set to Float Renminbi, China's central banker exhorts" [ChinaOnline.com](http://ChinaOnline.com), 7/17/2000, Finance, ChinaOnline, LLC.

<sup>36</sup> Calculated from figures presented in a Lardy report at BIS/PBC conference in Beijing, China. 1-2 March 1999

develop China's capital markets. Given the uncertainty of NPL recovery, however this interest income may well not materialize. In addition, AMCs will have to deduct their operating expense before they can service their debts to the banks.

The goal of the AMC program is to "leave the Big Four banks healthy," even by international standards. It is important to recognize, however, that the AMC program does not address the quality of the banks' future lending.

### **Real Estate Non-Performing Loans**

Among all NPLs transferred from China Construction Bank, loans to real estate development companies account for roughly 20%, or RMB 50 billion (US\$6 billion). Cinda has the highest share of real estate loans among all AMCs. If real estate loans represent 15% of all NPLs transferred to four AMCs, total real estate NPLs would reach RMB 195 billion (US\$24 billion)<sup>38</sup>. According to Xiaozhou Chen, executive director of Cinda's Investment Banking Division, most Chinese real estate loans were made to development companies and not to specific projects. The collateral of these loans are finished and/or unfinished development projects. In addition to loans to real estate companies, some loans to SOEs that later declared bankruptcy may end up being paid back with their real estate assets. Therefore the total real estate assets collected by AMCs will be more than RMB 195 billion (US\$24 billion).

---

<sup>37</sup> Walker, John L. "Financial Reform in China" [ChinaOnline.com](http://ChinaOnline.com), 6/13/2000, Commentary, ChinaOnline, LLC.

These real estate assets cover a wide range, from bare land to operating properties. AMCs have not yet categorized these properties or published the percentages of each type, but according to Cinda's Ma, bare land and unfinished projects constitute the majority, especially in the southern provinces. Only a small portion of the real estate assets are operating properties. Hotels and office buildings are the predominant building types. There are few residential properties.

### **NPL Resolution Strategies**

Cinda and other AMCs have adopted at least three strategies for resolving NPLs. Statistics on the percentages of each method are not yet available, and these approaches are still in a very early stage. The result of each method remains to be seen.

#### *1. Loan re-organization*

Under this strategy, the most widely applied so far, AMCs renegotiate with the loan borrowers to create new loan terms. In most cases, AMCs lower the loan balance or extend the payment schedule. For enterprises with improved management or promising market prospects, but which are burdened by accumulated debts, temporary debt relief offers a chance at revival. Similar logic applies to well-developed real estate projects that cannot be finished due to construction delays or temporary cash shortages. Since banks are not in the development business and are not interested in managing property, it is more beneficial to delay interest income and allow a developer to finish a project or wait for the market to turn around. There is apparently no political or economical pressure for

---

<sup>38</sup> 15% of RMB 1.3 trillion.

AMCs to pursue quick but limited recoveries. For those enterprises with out-of-date technologies, inefficient management or heavy liability to workers, discounted loans will not improve the business, but can help maintain the welfare of workers. Such decisions generally reflect political and/or social motives.

### *2. Debt-equity swap*

A debt-equity swap is the second most widely used strategy for bad loans made by many SOEs. Under this strategy, a bank trades their debt claims for stock of the borrower.

Only a small portion of the non-performing real estate loans is handled this way. This method does not bring immediate cash to the AMCs, nor will their equities be worth much in the end, as those borrowers are mostly money-losing enterprises anyway.

Helping healthy enterprises to go public is one valid exit strategy.

Owning equities does give AMCs control over the borrowers' management. That is, however, neither the expertise nor the interest of the AMCs; their involvement in the operations will not necessarily bring profits.

### *3. Selling loans and/or collected properties*

AMCs have sold a small number of loans to the Chinese private sector. Recovery rates range between 20% and 60%. They have also exchanged, auctioned and/or sold collected properties. According to Ma, however, "We (AMCs) prefer not to take ownership of properties in order to avoid property transfer fees charged by local (provincial and municipal) governments. We like to broker the transactions instead." AMCs are

required to pay local governments transaction fees of up to 20% of the original loan amount, regardless of the market value of a property, if they transfer property to their names. The elimination of property-transfer fees is currently being negotiated between the Ministry of Finance and local governments.

Many assets have complex claims issues due to lack of legal specifications in loan documents. It is more effective for these state-run AMC's to deal with asset collections because they can leverage their political and administrative powers in this process. After clearing titles and fixing claim problems, more straightforward sales can be conducted.

Both domestic and foreign capital sources are the anticipated buyers of these assets. According to Xiaozhou Chen, Cinda is contemplating a road show to the United States to market some of its collected assets.

#### *4. Loan securitization*

Securitization of non-performing loans is also under study, but the preliminary conclusion is that his method would not be viable, given the high percentage of loans producing no cash flow.

### **China's NPL Resolution Problems**

There are technicality issues with regard to the direct sales of Chinese NPLs. Besides, AMC's have little motivation to liquidate non-performing assets quickly, due to the

incentive problems built into the political and economic structure of Chinese SOEs, which include AMCs. Although AMCs are set up to expedite the resolution of NPLs, at least three practical issues greatly undermine their effectiveness.

*1. Difficulty in selling Chinese loans*

Chinese capital markets are still closed to foreigners. Because Chinese enterprises are generally not allowed to take loans from foreign banks--a prohibition that may be lifted after China's accession to WTO--Chinese banks cannot sell their loans to foreign investors directly.

The Chinese government, however, does recognize the need for foreign capital to resolve its NPL problem. Officials from both Cinda and China Construction Bank stated that limited sales of NPLs to foreign banks will be permitted.

There would remain, still, a salability issue. According to Xiaozhou Chen, foreign banks may not feel comfortable buying Chinese NPLs, as "the terms of most Chinese loans are far below the Western standards in terms of protection for creditors' rights." "Don't forget that those loans were made to support SOEs as instructed by the central government, and protection of the banks' interests was never a major issue," he added, "I think it will be very hard for foreign banks to buy these loans. Many of them have contractual problems. The only way for foreign banks to buy them is for them to negotiate new loans with the borrower."

2. *Conflicting objectives of AMCs*

In theory, the AMCs have two objectives: to collect cash by liquidating non-performing assets quickly and to help troubled SOEs improve their performances. The two objectives are somewhat conflicting. Since AMC personnel are all former bankers with little interest and/or expertise in industry-specific management, they can offer only limited help to the enterprises, except for the temporary relief of debt burdens and an additional layer of disciplinary supervision. The second objective is not only hard to meet, but it creates obstacles to reaching the first one. Both AMCs and SOEs are owned by the state. The state wants non-performing assets liquidated quickly, but it cannot afford the social impact of massive SOE bankruptcies. As a result, AMCs can not function purely as debt collection agencies and no clear targets can be set to measure their performances.

3. *Wrong incentive system*

The effectiveness of AMCs is neither clearly measured nor properly rewarded. AMC managers must juggle between recovery rate and speed. These companies operate on a fixed budget. A higher recovery rate brings them no economic benefits. Speedy resolution hurts the recovery rate. Besides, the top management may be blamed later for creating too many losses and pressuring too many SOEs to declare bankruptcy. As a result, they all operate conservatively, which slows collections and resolutions.

Ineffective collection means that AMCs will not be able to meet their debt obligations to the Big Four banks, especially after deducting operating expenses. The result will be

either delayed interest payment to the banks or further funding injections from the Ministry of Finance. Due to the magnitude of NPL problems, the Ministry of Finance will have a hard time making these payments. The Ministry will eventually have to raise more cash by selling treasury bonds or pressure AMC's to collect harder. But that will only happen when the central government feels that there is the need to do so. AMC management currently has no incentive to take any initiatives in aggressive collections.

Although China has taken steps to deal with the accumulated NPL problems, their effectiveness is questionable. By transferring NPLs to AMC's, the central governments tries to free the banks while delaying the realization of losses at the same time. Fundamental flaws in the economic structure of all state-owned entities mean the NPL resolution effort may not be very effective. In the end, more drastic measures will be required to solve the problems completely, but with greater cost. The low motivation of AMC's to liquidate NPLs means high and firm asking prices for the non-performing assets, which translate into limited opportunities for opportunistic US investors. When time runs out and financial pressures build, the central government may lower its loan recovery expectations and instruct the AMC's to conduct more urgent sales. In theory, this situation should present ample investment opportunities.

## Conclusion

US investments in international real estate are predominantly made by opportunistic funds looking for higher risk-adjusted returns. Target returns are between 20% and 30%. Investment time frames are between three and five years. Due to the lack of high-yielding opportunities in the domestic real estate markets, these funds are searching for new opportunities in emerging markets.

The recent Asian financial crisis has created many opportunities for US investors in several East Asian countries. Large urbanizing populations and rapid economic development in many Asian countries make them promising lands of opportunity for US real estate investors.

Investing in international real estate involves much more risk than investing in domestic real estate. Most of that risk comes from a lack of knowledge and experience.

Understanding the investment environment of a particular market and correctly assessing its risk profile are the keys to increasing prospects of success.

Through interviews with the US fund managers investing in Asia, most view China's investment environment unfavorably compared to other Asian countries. This research confirmed that assessment. The major drawbacks of the Chinese real estate market are: 1) a weak legal system and tactical compliance of international agreements; 2) inconsistent government regulations; 3) unreliable government behaviors; 4) primitive property and capital markets; 5) tight foreign currency controls; 6) severe market over-supplies.

The immaturity of China's investment environment means that Chinese investment opportunities have to offer much higher returns than those of other Asian countries in order to justify their risks. During the short history of the Chinese real estate market, US investors have not been able to identify such investment opportunities. This explains why of all foreign investments in Chinese real estate, which is between four and seven billion US dollars a year<sup>39</sup>, only a small portion comes from the US.

---

<sup>39</sup> *"Under Siege: Foreign Investors Throw Chinese Real Estate Market For A Loop"*, [ChinaOnline.com](http://ChinaOnline.com), 5/8/2000, Other Industries/Real Estate, ChinaOnline, LLC

Government-directed real estate speculation in China during the early 1990s generated enormous amounts of non-performing real estate assets. China's current effort to dispose of these assets should, in theory, create investment opportunities in which potentially high yields outweigh the risks.

Through research of the Chinese NPL resolution strategies and processes, however, I discovered that the NPL disposition effort would offer limited opportunities for foreign investors. The expected large discounts of Chinese NPLs and the high returns into which they translate are not likely to materialize, due to the fundamental flaws built into the resolution process: conflicting objectives of collecting bad debt and protecting SOEs, and lack of incentive and performance measurement of the AMCs. These flaws will greatly reduce the effectiveness of China's NPL-resolution while limiting the opportunities created for foreign investors.

In addition, some technical difficulties such as problematic loan contracts and a closed capital market make the direct purchase of Chinese NPLs by foreign investors impractical.

Base on these findings, the study concludes that China's current NPL resolution is not likely to create opportunities for US investors in the immediate future.

Two forces could potentially change the prospect for the more distant future. One is China's entry into the World Trade Organization, which will bring the country closer to

the international standards of business practice. More integration of China's economy into the world's will increase the safety level of foreign businesses in China, greatly improving the country's investment environment. The second force is the ineffectiveness of the NPL resolutions program itself, which will eventually build pressure within the Chinese government to liquidate non-performing assets. When such time comes, more drastic measures will be adopted to sell bad assets at discounts large enough to attract investors from all over the world, including the US.

# Bibliography

*"Beijing 1999 Real Estate Data Report"*, [ChinaOnline.com](#), 3/17/2000, Other Industries/Real Estate, ChinaOnline, LLC.

*"China economy: Money supply and interest rates"* [ChinaOnline.com](#), 3/10/2000, Finance, ChinaOnline, LLC.

*"Emerging Trend in Real Estate 2000"* Lend Lease and Price Waterhouse Coopers October 11, 1999

*"Emerging Trend in Real Estate 1999"* Lend Lease and Price Waterhouse Coopers October 9, 1998

*"Executive Forum, One World: The Global Market"* [Real Estate Forum](#), 10/99, Page 48, Real Estate Media, Inc.

*"Guidelines for Foreign Real Estate Investors in China"* [ChinaOnline.com](#), 4/28/2000, Other Industries/Real Estate, ChinaOnline, LLC.

*"New China Law On Foreigner Real Estate Taxes"* [ChinaOnline.com](#), 4/10/2000, Other Industries/Real Estate, ChinaOnline, LLC.

*"Space Jam: Beijing Internet Rush Causes Rent Explosion, Office Shortage"* [ChinaOnline.com](#), 5/25/2000, Other Industries/Real Estate, ChinaOnline, LLC.

*"The Grasskamp Roundtable"*, [PREA Quarterly](#), Spring, 21-27. Unknown

*"Under Siege: Foreign Investors Throw Chinese Real Estate Market For A Loop"*, [ChinaOnline.com](#), 5/8/2000, Other Industries/Real Estate, ChinaOnline, LLC.

Cavaluzzi, Joseph *"Recovery, Stagnation Coexist"* [Real Estate Forum](#), 10/99, Page 66, Real Estate Media, Inc.

Baum, Andrew *"Can Foreign Real Estate Investment be Successful?"* [Real Estate Finance](#). 12(1): 81-89. 1995 Spring.

Economy, Elizabeth and Oksenberg, Michael *"China Joins the World, Progress and Prospect"* Council for Foreign Relations Press, 1999

Eichholtz, Piet M.A. *"How to Invest Internationally? Region and Property Type on a Global Scale"* [Real Estate Finance](#). 14(3): 51-56. 1997 Fall.

- Gelbtuch, Howard “*Land Prices Provide Clue to Cycle Status*” Real Estate Forum, 10/99, Page 37, Real Estate Media, Inc.
- Han, Jan “*Taregeting Markets is Popular:A Survey of Pension Real Estate Advisors*” Real Estate Finance. 13(1):46-58. 1997, Winter
- Hartzell, Heknan, Miles (1986). “*Diversification Categories in Investment Real Estate*”, AREUEA, Vol. 14 (2), 230-254. American Real Estate & Urban Economics Association, Indiana University
- Hartzell, Shurman, and Wurtzebach, “*Refining the Analysis of Regional Diversification for Income Producing Real Estate*”, Journal of Real Estate Research, 85-95. American Real Estate Society
- Ibbotson, Roger et al (1984). “*Real Estate Returns: Comparison with other Investment*”, AREUEA, Vol. 12 (3), 219-242. American Real Estate & Urban Economics Association, Indiana University
- Johnson, Derek and Kiely, John, “*Current Trends in Pension fund Real Estate Investment*”, Massachusetts Institute of Technology MSRED Thesis, 1996
- Katz, S Stanley, “*The Asian crisis, the IMF and the critics*” Eastern Economic Journal, Bloomsburg; Fall 1999; Vol. 25, Iss. 4; pg. 421
- Kynge, James “*China’s Banks Face a Cultural Revolution*” Financial Times, April 27, 2000
- Lardy, Nicholas R., “*China’s Unfinished Economic Revolution*” The Brookings Institution Press, 1998
- Lee, Peter, “*The case of vanishing trader*” Euromoney; February 1995; Euromoney Publications PLC
- Leon, Alfonzo, “*International Real Estate Investment: An Analysis of the Public and Private Markets in Singapore, Thailand, China, and Indonesia*”, Massachusetts Institute of Technology MSRED Thesis, 1999
- Li, Ling Hin “*Determining Asset Values in China*” Real Estate Finance. 13(3):67-73. 1996, Fall
- Lim, Lan Yuan “*Implications of China’s New Property Law on Real Estate Investments*” Real Estate Finance. 12(3):96-102. 1995, Fall
- Lim, Lan Yuan, “*Property Acquisition and Negotiation Style: An Asian Case Study*” Real Estate Finance. 15(1): 73-78. 1998, Spring

- Liow, Kim Hiang, "Singapore Commercial Real Estate and Property Equity Market: Close Relationship?" Real Estate Finance. 15(1): 63-71. 1998, Spring
- Malkiel, Burton, and Mei, J.P. "Global Bargain Hunting: An Investor's Guide to Profits in Emerging Markets". New York: Simon & Schuster, 1998.
- McCadden, Daniel and McNally, Peter "US Pension Fund Investments in Real Estate: Current and Future Investment Strategy" Real Estate Finance. 13(4):46-58. 1997, Winter
- McGurn, William, "Asian values: ...and wrong" National Review, New York; Dec 31, 1997; Vol. 49, Issue. 25; pg. 37
- Mei, J.P. "Are the Foundations Solid for Emerging Market Real Estate?" Real Estate Finance. 14(1):6-11. 1998, Winter
- Mei, J.P. "Asian Real Estate in a Portfolio Context: Long-Term Opportunities" Real Estate Finance. 15(4):85-99. 1998, Winter
- Miles, Mike, and Mei, J.P. "China Real Estate Investment: How Risky?" Real Estate Finance. 12(1):6-11. 1995, Winter
- Page, Nigel, "Lehman Brothers' Chinese Puzzle" International Commercial Litigation; London; June 1995; Euromoney Publications PLC
- Petrakis, Alexis "The Brave New World of Offshore Investments" Real Estate Forum, 10/99, pg. 38, Real Estate Media, Inc.
- Roberts, Dexter, "Unplugged by Beijing" Business Week; New York; August 1999; The McGraw-Hill company
- Seek, N.H., "Institutional Participation in the Asia Pacific Real Estate Markets: Are the Benefits Worth the Risks?" Real Estate Finance. 12(4): 51-58. 1996, Winter
- Shale, Tony, "Lehman gets tough on China" Euromoney; London; December 1994; Euromoney Publications PLC
- The White House Office of Public Liaison, "Summary of U.S.-China Bilateral WTO Agreement" ChinaOnline.com, 11/17/1999, WTO, ChinaOnline, LLC.
- Tsui, John "Early innings for NPL Investment" Real Estate Forum, 10/99, pg. 65, Real Estate Media, Inc.
- Walker, John L. "Financial Reform in China" ChinaOnline.com, 6/13/2000, Commentary, ChinaOnline, LLC.

Worzala, Elaine. Newell, Graeme "*International Real Estate: A Review of Strategic Investment Issues*" Journal of Real Estate Portfolio Management, 3(2): 87-96. 1997

Zita, Ken, "*China closes the door*" Far East Economic Review; Hong Kong; October 1998; Dow Jones & Company

# List of Interviews

## *US FUND MANAGERS*

<b>Jim Morrison</b> <i>Senior Vice President</i> Hines	January 5
<b>Steve Corkin</b> <i>Managing Director</i> AEW Capital Management	April 5
<b>Charlie Pardoe</b> <i>Managing Director</i> Prudential Real Estate Investors	June 23
<b>Takuji Masuko</b> Amresco Japan	June 25
<b>Chin-Hua Loh</b> <i>Managing Director</i> Global Realty Advisors (Singapore) Prudential Real Estate Investors	June 28
<b>Sonny Kalsi</b> <i>Vice President</i> Morgan Stanley Dean Witter	June 26
<b>Bob Zulkoski</b> <i>Managing Director</i> Colony Capital	June 27
<b>Naoto Ichiki</b> <i>Vice President</i> J.P. Morgan	June 27

---

*CHINESE REAL ESTATE PROFESSIONALS*

**Bing Zhao** August 8  
*General Manager*  
China Home LTD.

**Xin Zhang** July 17  
*Chairman*  
Red Stone Industries

**Shiyi Pan** July 21  
*President*  
Red Stone Industries

**Hongyu Liu** July 30  
*Professor and Director*  
Institute of Real Estate Studies  
Tsinghua University

*CHINESE BANKERS*

**Xinghai Fang** July 18  
*General Manager*  
Group Coordination Committee  
Construction Banks of China

**Wen Ma** July 19  
*Executive Associate Director*  
Debt Management Department  
China Cinda Asset Management Corporation

**Xiaozhou Chen** July 23  
*Executive Director*  
Investment Banking Department  
China Cinda Asset Management Corporation.

**THANKS TO:**

<b>Barbara Cambon</b>	Colony Capital
<b>Junyu Chen</b>	Moody's Investor Service
<b>Craig Donaldson</b>	Prudential Real Estate Investors
<b>Gayle Haynes</b>	PREA
<b>Wei Hu</b>	MIT/Sloan School of Management
<b>Min Huang</b>	MIT/Sloan School of Management
<b>Roberto Ordorica</b>	J. P. Morgan
<b>Dr. Ruijue Peng</b>	Property and Portfolio Research
<b>Koichiro Taira</b>	MIT/Center for Real Estate
<b>Xiaofang Tu</b>	Jones Lang Lasalle
<b>Steve Wolf</b>	Goody Clancy & Associates
<b>Zhizhong Yang</b>	Morgan Stanley Dean Witter