RECOGNITION OF BUSINESS OPPORTUNITIES FOR CHINESE PRIVATE INVESTORS IN U.S. REAL ESTATE MARKET

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ABSTRACT

Real estate investment is becoming increasingly international. As China's economy rises as a major force in the world, its continuous growth in fiscal surpluses and accumulation of wealth are making up an expanding segment of the capital market. Traditionally, state-owned enterprises (SOE) and banks were important sources of international real estate investment from China; more recently, increasing high-net-worth individuals and private real estate equity funds have merged and are seeking opportunities around the world.

This paper identifies the important policy indicators that are pertinent to Chinese private investors' activities in the U.S. real estate market, examines the investment landscape in both countries, gives particular attention to associated challenges, barriers and risks, and finally explores the potential business opportunities that can be recognized and turned into meaningful strategies.

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1. INTRODUCTION:

The thesis starts by identifying the investment landscape in both domestic and target foreign countries to illustrate the timeframe, policy, market and economic environments that are applicable to private real estate investments from China to the U.S., and elucidates stark different and common factors in both markets. The real estate market in China has provided investors with high yields and returns prior to a series of governmental housing market cooling measures in 2010. In addition to these, regulatory controls in China, limited domestic investment opportunities and saturated first-tier-city market also greatly constrained the investment diversification and channels for available capital in the country. Meanwhile, as the U.S. real estate market began to recover from the 2008-2011 recession period, plummeting property prices, transparent market environments and high quality long-term rent-generating assets became more attractive to the Chinese private investors seeking for risk adjusted returns and effective diversification for their domestic portfolio. The business opportunity emerges between the demand for capital to boost the economy in the U.S. real estate market and the supply of Chinese private outflowing capital.

This thesis then analyzes the ebb and flow of Chinese private investments to the U.S. real estate market, with specific focus to the barriers and risks associated with these markets, and further examines challenges that impact the Chinese private investor community. These Challenges include capital controls for foreign investments, recent financial liberalization policies, and regulatory environment regarding the entry to the U.S. market.

After identifying the important policy indicators, this thesis examines the investment vehicles and structuring issues facing the Chinese private investors, such as constraints for setting up a business in the U.S. by recounting the most used legal, financial and tax strategies of the current investments that are taking place.

Finally, Conclusions are drawn from this research and analysis, that this thesis recognizes the existence of business opportunities for the Chinese private investors in the U.S. real estate market and proposes three business models and a conceptual framework to implement the initial model. As the business opportunities are still unfolding, the purpose of a business plan, addressed in this thesis, is to fill the limitations of few best practices in the field of successful business models. Moreover, the business plan is largely determined by observed dynamics between the characteristics of the Chinese investors and the anticipated changing investment landscapes, domestically and abroad.

Policy and regulation supports from both countries' governments are crucial to the success of the business plan and the effectiveness of its implementation, as these factors help to align interests and connect the demand and supply chain of capital. It is also implied that investors who are capable to overcome the barriers will have the market advantages to succeed.

1.1 The purpose of the thesis:

Although the underlying motives of Chinese private sector to invest in the U.S. real estate market are by no means clear-cut for various entities, this thesis intends to provide an overview of the policy indicators and investment landscape situated in both the Chinese home market and the destination market in the United States. The purpose of this thesis is to explore the viability of such business opportunities; the findings of this thesis will assist and aid investors to recognize complex challenges and risks, and to strategize their business planning respectively. Findings from this thesis should also benefit local partners who may decide to sponsor or work with a Chinese investor.

1.2 Methodology:

The following paragraphs describe the methodology that is used in this thesis. The research methodology is mostly qualitative investigations. Research tools employed are listed below:

Literature reviews:

This thesis research covered relevant and accessible current literatures issued by the Chinese government. Much of the referenced literature illustrates governmental policies regarding real estate market cooling measures and affordable housing price control programs. Other academic literature and documents created by academic or industry entities have been reviewed to ascertain the impacts of economic growth and activity on Chinese home market and the investment destination market in the United States. Additionally, governmental documents regarding taxation, regulations for foreign investments in the U.S. and EB-5 Investor Program have been reviewed to illustrate current regulatory issues.

Interviews:

Eight interviews among industry practitioners were conducted. The practitioners represented multiple disciplines of professionals, who had worked with investors from China. The purposed of these interviews were to understand the profiles of these investors, the types of properties they mostly are interested for investment opportunities, and to identify their common concerns and challenges. The interviews among the industry practitioners included professionals from real estate private funds, real estate brokerage agencies, immigration law firms (for EB-5 Investor Program), fund tax services, and Chinese real estate developers and investors. The Chinese professionals provided valuable insights of Chinese domestic real estate market and capital control policies.

Case study:

I paid particular attention to the case of Wenzhou, a city that is undergoing a series of financial liberalization experimental policies. Wenzhou is considered the birthplace of China's private economy and the entrepreneurship capitalism. It has the history of underground lending and capital flows. The new policy composed of two major parts—allowance of private lending and lift of direct oversea investment limit to 200 million USD—is seen as the legalization for the current underground capital flows and liberalization of the deficit financial system. This case study examines the potential investment opportunities that might be brought by the policy changes.

1.3 Definitions:

The group of investors that are studied in this thesis is from the private sector, and specific criteria and definitions are listed as below:

Ownerships:

The Chinese private investors referred in this thesis are defined as high-net-worth individuals or Chinese private real estate equity funds. Each of the categories has its own characters, preference and strategies; however, they are all characterized by complete private ownerships, and are differentiated from the current Chinese mainstream outward investors--the state owned enterprises (SOE) in the urban areas and the collectively-owned enterprises in the rural areas, which are strictly sponsored and regulated by the Chinese government. Additionally, these investors' operating companies are not publicly traded on a stock exchange.

Currently, Chinese domestic private equities (PE) are divided into four major categories[1] based on the source of the equity: 1. PEs funded or partially funded by the government and/or state owned entities; 2. PEs funded by foreign (non-Chinese) enterprises; 3. PEs funded by bonds; and 4. PEs funded by private-owned entities or wealthy individuals. (Dr. He, Hualiang, 2012) This thesis examines the last subject, privately owned PEs.

Size:

The size of the funds discussed in this thesis varies from the individual level investors, whose fund size is to meet the minimal requirement of 500,000 USD for the EB-5 Investor Program, to real estate private equity that are looking for more substantial investment options or development ventures.

Types of investments:

Investments referred in this thesis are market driven activities. Investments with intent of immigration only and other personal goals are not included for examination in this thesis.

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[1] Dr. He, Hualiang summarized the PE funds that are active in the Chinese market into four types including: foreign resource equity, state-owned equity, bond equity, and privately owned equity. Bond equity is also owned by the state.
Source: Dr. He, Hualiang (2009) *The Development and the Future of Chinese Private Equities.*

2. CURRENT POLICIES AND INVESTMENT MOTIVATIONS:

Unlike those in the free and open market, the investment activates in the Chinese real estate market are often largely impacted by the political power of the government. This following section explores the recent policy changes and potential impact of the private outward investments by identifying the source of the capitals, the policy pressure of the outward capital flows and the incentives in the destination market.

2.1 Economic growth and the source of private capitals

Based on the Xinhua News (Chinese state owned media agency) in early 2012, the government domestic product (GDP) growth in China will remain at 8.5% for 2012, indicating a steady pace of the economy development as a predictor for the near future. Fiscal surplus and accumulation of the wealth will continue to grow. The Chinese foreign exchange reserves, the world's largest stock, hit 3.2 trillion in the late 2011, and Ren Min Bi (RMB)[2] has continued to rise for more than 7% against the dollar since June 2010, as has the number of China's wealthiest individuals. The number of high-net-worth individuals is also expected to grow at 9.7 % annually[3]. The past development and growth trends both imply the availability of private capital that can be invested overseas.

2.1.1 High-net-worth individuals

As China's economy booms, the number of high-net-worth individuals and the accumulated wealth have grown drastically and become an important capital

[2] Chinese currency
[3] PRWeb, 2012 http://www.prweb.com/releases/2012/5/prweb9479241.htm

segment. Preserving wealth has become increasingly important to many of the wealthy individuals. According to the study done by Mr. He, Hualiang at Wuhan Technology Institute, outstanding deposits of households reached 15.5 trillion RMB (approximate 2.4 trillion USD) by the second quarter of 2006, while the 20% account holders owned 80% of the wealth.[4] In 2012, the Chinese Luxury Consumer White Paper stated that there are 2.7 million high-net-worth individuals in China with personal assets of more than 6 million RMB (approximate 950,000 USD). There are also 63,500 ultra-high-net-worth individuals with assets of more than 100 million RMB (15.4 million USD), an increase of 10% compared with the previous year. The continuous growth in fiscal surpluses, the accumulation and disparity of wealth are making up an expanding segment of the capital market.

As the investment options are quite limited domestically, the report surveyed to investors to track how money was spent across various goods: as much as 60% of survey respondents said they spent money on real estate such as multiple home purchases; 41% to 46% of the respondents purchased low yield Chinese bonds; and 30% to 65% of respondents spent their money on luxury goods[5].

Findings from the survey imply that real estate and safe investments are the major asset classes for high-net-worth individuals to preserve and sureties their capitals. In general, real estate has always been the major investment consideration

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[4] He, Hualiang (2009) *The Development and the Future of Chinese Private Equities. 中国私募基金发展现状与前景，* Business China 2009-02.

[5] Hurun Report, *The Chinese Luxury Consumer White Paper 2012, jointly published by the Industrial Bank and Hurun Report*

economically, culturally and behaviorally for Chinese private investors. It is not only because rapid urbanization of the past decades has provided investors considerably high returns comparing to other assets classes in China, but also because real estate has always been perceived as an effective hedging for inflation and other risks. Within the top 50 richest Chinese published by Hurun China, 24 wealthy Chinese engaged in the business of real estate. Additionally, Merrill Lynch and Capgemini's Asia-Pacific Wealth Report 2008[6] shows that in 2007 high net-worth individuals in China placed 21% of their assets in real estate versus a worldwide average of 14%. "The preference the wealthy Chinese show in real estate, along with the current drop in housing prices and a steady RMB, have made real estate investment in the U.S. more appealing than ever before."[7]

2.1.2 Private real estate equities

Private real estate equities are another source of the private capitals. However, the development of Chinese real estate capital market has a very short history; guidelines and frameworks were lacking for the legal setup of these funds until the announcement of "*Company Law of People's Republic of China*" and "*Partnership Enterprise Law of People's Republic of China*" revision in 2006. Since then, the private real estate equities have shown increasing activities and rapid growth.

Although real estate has been the most popular investment option for these

[6] Capgemini and Merrill Lynch, *Asia Pacific Wealth Report 2008,* 2008
[7] PRWeb, 2012 http://www.prweb.com/releases/2012/5/prweb9479241.htm

funds, the way of conducting real estate business today is still very literal and simple; the developer borrow to auction for land, build and then sell the buildings, and loans are repaid by the sale proceeds; this process is repeated over and over for various projects. In the study of “Current Chinese Real Estate Private Equities’ Issues and Solutions” by Li, Jiangtao (2010), it is stated that the development of Chinese real estate private equities are still limited by the lack of legal systems, financial market environment, immaturity of the real estate industry and the iniquity of exiting the market. These factors have led to the inference that the Chinese private real estate equity funds are in need of the development stage and have great potential for growth.

2.2 Policy indicators and the flow of private capitals

The following paragraphs illustrate the policy-led real estate market in china and its effects on the capital flows:

2.2.1 Market transparency

Transparency is important to an efficient and healthy market, however, it has been lacking in Chinese real estate market. The Chinese market does not exhibit free flow of good-quality market data, stringent regulation enforcement and open transactions that are easily accessible to the investors in the free and open market. The real effects of market inefficiency lead to the misallocation of the investments.

Another implication of policy-led market is high volatility. It is not only difficult for the investors to reach a consensus on the market conditions today, but also impossible for them to anticipate what is going to happen in the future. For example, the most recent housing cooling measures were implemented without any warning. It's said in *China real estate investment handbook*[8] "the government has deliberately engineered a fall in real estate prices to address wide spread concerns about housing affordability, and has used mostly administrative tools to do so". Vanke, the largest real estate developer, claimed that they have 11 months of unsold housing stock in three major cities as the effect of the sudden policy change. It is becoming an unspoken rule of the business for real estate investors who always have to plan ahead in anticipation of such sudden policy implementation, and who can hardly gain confidence over the ever-shifting market conditions.

2.2.2 Chinese government market cooling policies and the implications

As stated in the previous section, high returns are also associated with high risks in real estate market in China; and most of the risks have traits that are unique in China due to the political and regulatory power from the central government. This section further elaborates the recent policy changes including three major movements stipulated by the government in the recent years: limitation on real estate purchase, affordable housing program and property tax act.

Ongoing real estate purchase limitation policy

In order to control the soaring property sale prices caused by speculating and

[8] Deloitte, *China real estate Investment handbook: The details that make a difference*, 2011

windfall profit that were recognized by the developers and investors in housing property market, the Chinese government released a new round of macro control measures in April 2010. Major policies include: an increase in the down payment requirement for second home mortgages from 40% to 50 %; an increase in the down payment requirement for the first homes above 90 square meters from 20% to 30%; and suspension on loans to non-local residents without at least one year of social security contributions or tax payments.

In September 2010, the government introduced another round of tightening measures; a requirement for a 30% mortgage down payment for first-time home buyers regardless of the property size and the complete suspension of third-home mortgage approvals. "These measures have led to a decrease in sales transactions for residential properties in both primary and secondary markets" stated in the Deloitte's *Chine Real Estate Investment Handbook.* [9]

Further stringent measures were announced in January 2011 including a series of higher requirements on down payments for mortgages and interest rates for second home mortgage. Beijing was one of the cities that stipulated the regulations most strictly, as the local market was considered overheated prior to the policies. Residents without a Beijing permanent residency must previously have paid their social security contribution or income tax for 5 consecutive years to be eligible for purchasing their first and only homes in the city. "The market believes that the

[9] Deloitte, *China real estate Investment handbook: The details that make a difference*, 2011

government will continue to introduce further measures to cool down the property market along with the introduction for the property tax." [10]

Experimental property tax policy

Another regulatory risk comes from the property taxes on home ownerships, which are common elsewhere in the world, but have been absent in China, as the city land is owned by the state and the rural land is owned collectively by farmers. The government expected the taxation policies to curb the speculative transactions in the housing market, as it would be more costly to hold multiple properties on rising prices; at the same time, the government is expecting to ease the drying fiscal revenue from the decrease in the land sales. Property tax policies are being implemented in two large pilot cities, Chongqing and Shanghai, on a small amount of high-end single-family properties. Many real estate investors are hugely concerned by the future implementation of the policy at its fullest since it will require the exposure of the asset value and income resource that weren't clear at the beginning.

New affordable housing policy

With the growth in private housing to be slowed down, the Chinese Government is putting a vast effort into building subsidized affordable housing for growing numbers of low-income households. During the interview with a Chinese local developer based in Hainan, he suggested that subsidized housing presented great competition to private housing developers on top of the cooling measures, as

[10] Deloitte, *China real estate Investment handbook: The details that make a difference*, 2011

social housing projects are subsidized on the land price and usually financed by the central and mostly local governments, whose revenue depends much on the land sale to the private developers.

The effectiveness and real impacts of these curbing measures are still up to debate. In the report by Deloitte,[11] it's said, "speculative transactions may still be growing as long as there is liquidity through the ready availability of credit". According to Bloomberg, "fixed asset investment, much of it in real estate, has grown more than 40 percent annually for the past eight years",[12] however, the market began to slow starting September in 2012, " home sale dropped 10 percent in the first quarter, while housing prices in more than half of the top 70 cities fell in March, the six straight month of declines", and " construction activities stalled."[13]

What can be definitely derived from the series of governmental measures is that the Chinese investors are extremely sensitive and greatly exposed to regulatory risks; more importantly, it's difficult to anticipate these risks and mitigate their impact.

2.2.3 Policy-led market and limited investment options

China's real estate market is geographically diverse and imbalanced, and the imbalance is largely driven by the policy tilt in favor of certain areas and cities. The rapid transformation of Shenzhen and Shanghai Pu Dong are the best manifestations for the success of the policy-led market. It's always a risky guess for the investors to

[11] Deloitte, *China real estate Investment Handbook: The details that make a difference*, 2011
[12] Bloomberg News, *China Seeks Boost From Low-Income Housing as Real Estate Slows*, 2012
[13] Bloomberg News, *China Seeks Boost From Low-Income Housing as Real Estate Slows*, 2012

anticipate what the next government moves are and where the next hot markets are. The investment strategies heavily rely on the control over the timing of getting into and rolling out of the projects in time with the policy changes.

"First-tier cities such as Beijing, Shanghai, Guangzhou and Shenzhen were in the past always the prime choices".[14] Based on the data published by Zero2IPO, Beijing, Shanghai and Guangdong province attracted 2.276 billion USD, 2.124 billion USD and 1.2 billion USD of real estate private equities, amounting the majority of the private real estate investments. Hainan province, Guangzhou, and Zhejiang province follow as 4th to the 6th largest private equity investments in the nation.

However, the regulatory issues stated previously were more predominant in these first-tier cities as the urban land is more costly and policies are more stringently implemented prior to many other cities in relation to investment and ownership. Investors are therefore forced to shift their frontiers to more distant cities like Tianjin, Wuhan, Qingdao, Dalian etc., where they will have less restricted regulation, but more local competitors. The high volatilities and geographical constraints are forcing the investors to look elsewhere and other asset classes.

2.3 Investment incentives in the U.S. market

As it's becoming more restrictive to invest domestically, the Chinese private investors are seeking for alternative markets around the world. "America offers low interest rates, discounted prices and a safe harbor for their money."[15] Many constraints

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[14] Deloitte, *China real estate Investment Handbook: The details that make a difference*, 2011
[15] Schuker, Lauren A. E., *Courting the Chinese Buyer*, The Wall Street Journal, June 21, 2012

that limit the investment activities in China are encouraging investors to look outside of the country, and the following sections examine the market incentives in U.S. real estate market that are attractive to the Chinese investors.

2.3.1 Safe assets and diversifications

Based on the interview results with three brokerage firm managers who work with Chinese investors on regular basis and facilitate the transaction process, the single most important incentive for Chinese investors in the U.S. real estate market is that the U.S. market provides them with a safe option to diversify the regulatory risks they are not able to anticipate in the domestic market. The expected returns on real estate investment in China may look very high, but not high enough to compensate the borne risks. While the average returns in the U.S. Market seem to be low, however, they are adjusted to the risks they have to carry and provide long-term incomes.

What qualify as safe assets is also consenting between multiple interviews. Investors are usually looking for opportunities in large metropolitan areas, such as New York, Boston, Washington DC, Los Angeles and San Francisco; larger size of funds favor healthy core commercial assets with steady rental incomes, including some Class B office assets within the urban area; small individual investors mostly are looking for residential properties including multi-families; investors that are going through EB5 program mostly favor hotel properties as they provide job creation required by the program. Further illustration on EB5 program will follow in the later sessions.

Secondly, as inflation rate continually goes up and the properties in China continues to appreciate in value, Chinese investors also perceive the investment in real estate as a way to transfer their cash deposit and preserve their wealth hedging against inflation and other risks.

Lastly, it is believed by many of the investors and the interviewed brokerage firms, the current market conditions in the U.S. markets are potentially making for more attractive opportunities, which may demand a lower risk premium.

2.3.2 Immigration policy as an incentive

Another predominant incentive for the Chinese investors is the immigration opportunity the destination countries provide. Many of the investments took place in the real estate market of cities like Toronto and Vancouver, where the local government incentivizes such capital by providing legal residence in the country. U.S. Government has been quite stringent with its investment immigration policy. As the country's economy was going through recession and in need of the boosts of capitals, the investment immigration policies have been relieved since. The first pilot investment pilot program was enacted in 1992 and became increasing popular during recent years.

USCIS (U.S. Citizenship and Immigration Services) administers "the Immigration Act of 1990 (IMMACT 90) "also known as EB-5. The intent of the EB-5 program is to stimulate the U.S. economy through job creation and capital investment by offering immigrants the benefits of permanent residency in the United States. "This was the first time a category specifically facilitated the admission of immigrant investors as lawful permanent residents and currently remains the only such category to do so." quoting a U.S. based immigration attorney.

EB-5 Immigrant Investor Program is available to investors who offer at least one million USD in a new commercial enterprise and employees at least 10-full time US workers. According to Zhang & Attorneys, L.P.,[16] participation in EB-5 program had traditionally been far below capacity with 300-400 issued visa over approximate 10,000 allocated capacity annually. In 1993, the Congress passed additional Regional Center Investor Program to attract more foreign investors to fund business in more economically distress areas, and to ease the economic hardship and high unemployment. The entry criteria were lowered to 500,000 USD.

With lowered entry requirements, EB-5 visa issues in 2009 amounted to over 4000, and half of these came directly from China due to the economic growth that created many wealthy individuals. With the current economic downturn and more relaxed USCIS requirements for the EB-5 program, more foreign investments in such category are expected.

Many of the investment took place in the real estate market, and compose a large segment of the direct investment and direct homebuyers. Besides the economic returns and high-quality assets, these investments also provide the Chinese private investors the opportunity for high-quality education and health care in the United State, and becoming increasingly popular. As said by PRWeb,[17] "In the U.S., the Chinese are now the second-largest foreign buyers of homes, behind Canadians,

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16 http://www.hooyou.com/eb-5/index.htm

17 http://www.prweb.com

accounting for $7.4 billion of sales in the 12 months ended March 2011, up 24% from the previous 12 months, according to the National Association of Realtors. Buyers from China and Hong Kong also spent $1.71 billion on commercial property in the U.S. in 2011, more than quadruple their investment in 2008, says Real Capital Analytics."

In a summary, the business opportunity emerges between the demand for capital to boost the economy in the U.S. real estate market and the supply of Chinese private outflowing capital. Many of the policy changes have intensified the investment incentives situated in both the Chinese home market and the destination market in the United States.

3. FUTURE POLICY INDICATORS AND CHALLENGES

This section discusses the specific barriers associated with Chinese private investments to the U.S. real estate market, pays particular attention to the issue of capital outflow control in China and the possibilities of future policy changes that can ease these barriers. The latter part of this chapter examines certain legal and regulatory issue for the entry of the U.S. market.

3.1 Capital control policy in China

As stated in the previous chapter, market transparency is lacking in the property market in China; one of the consequential effects is the misallocation of the capital as the Chinese government has the administrative power over the flow and the allocation of the capital. The government is able to invest cheap capitals at very low interest rates from the banks into state owned enterprises (SOE) prior to the private sectors to ensure the economic development goals of the country. The government also controls the capital outflows, and prevents substantial investments abroad from happening. Private sectors are not only discriminated in the domestic investments but also limited from the foreign investments.

3.1.1 Private investment sector and the current policy for capital control:

Individual investors who are seeking for international investments are extremely sensitive to the foreign exchange limit and the capital control regulations in China. Under the current regulations announced by the State Administration of

Foreign Exchange (SAFE), the total annual amount that shall apply to individual settlement and domestic individual purchase of foreign exchange is 50,000 USD per year. This limitation was 8,000 USD before 2006 (The Measures for the Administration of Individual Foreign Exchange, 2007). Additionally, the purchase of foreign currency requires identification verification for the purchasers and a sets of complex application documents. Such strict limitation on foreign currency exchange essentially has prevented any meaningful foreign investments in large real estate transactions from the individual capital source.

For the privately owned enterprises, the ban of the outward foreign direct investment was not officially lifted until 2003; complex application process must be satisfied for government approvals.[18] Therefore, private companies including private real estate equity have been kept away from cross-border investments mainly for this reason.

The government has always strictly controlled outward foreign investments ever since the economic reform in late 1970s, because outward investments were seen as the substitute for domestic investments (Buckley, Cross, Tan, Xin, Voss, 2008). The government regulates the capital outflows to prevent the loss of the state assets that might undermine the development goals domestically. As referred in *China's Outward Direct Investment: Expanding Worldwide*,[19] besides the lacking of strong policy support being the main barrier for outward investments, there is no specific government body assigned to facilitate such businesses; thirdly, there is very

[18] A flow chart of China's approval procedure for overseas investment projects is provided in Appendix III. The threshold for state approval project has been increased from 1 million USD to 10 million USD since 2004.

[19] Wong, Chan, *China's Outward Direct Investment: Expanding Worldwide*, 2003

little official information available to the public, and oversea investment projects are often recorded in the form of classified documents that are not easy to obtain; and lastly, the procedures for firms that are seeking such approvals are very complicated; it requires the applicants to go through many layers of government entities.

Substantial research has paid attention to China's position as a resource of foreign direct investment, the conclusions are all pointing out that China's private outward investment is extremely controlled and remains very small relative to the economy's size. [20]As regards to overseas real estate investments, they have faced the same challenges and also have been pulled away by the higher growth rate domestically in the past decades.

The capital control policy has been and is still one of the greatest barriers for private foreign investments, including those in the foreign real estate markets. However, many investors and funds have maneuvered their ways out through other channels. With limited information promulgated, detailed transaction records are hard to access for these investment activities. Based on many literature review and interviews, the prevailing methods are categorized as below depending upon the size of the investments:

Smaller investment capital is usually divided into multiple pieces to stay under the cap of 50,000 USD, carried overseas by individuals and pooled together once it is off-shored at the destination country. The pitfalls of such method are the

[20] "The biggest sources of Chinese outward FDI are highly profitable listed SOEs. Lenovo and Huawei are the only FDI heavyweights not explicitly state controlled. Private-sector firms may well conduct some outward FDI, but the scale is too small to register." Randall Morck, Bernard Yeung, Minyuan Zhao, *Perspectives on China's Outward Foreign Direct Investment*, Journal of International Business Studies, 2008

limitation on the size of the investments and the involved personnel trips to transfer cash.

With certain ease on the capital control over the years, Hong Kong[21] became the springboard for more substantial international investments, as China has been creating channels to allow two-way cross-border flow of RMB funds to internationalize its currency. Chinese enterprises (mostly state owned) can establish legal domicile in Hong Kong by setting up branches or forming joint ventures with Hong Kong-based companies; the branches then will serve as holding companies to reserve their foreign exchange and raise capital for oversea investments.[22] According to the study done by Deliotte in 2011, "offshore RMB deposits in Hong Kong have increased exponentially from 54.4 billion RMB (9 billion USD) at the end of January 2009 to RMB 370.6 billion (57 billion USD) at the end of January 2011" [23]

As the policy is more in favor of the state owned enterprises (SOE), there are very few private firms that were able to use this method to funnel their capitals. Lenovo was one of successful example for private enterprise to invest overseas in the case of acquiring IBM.[24] The success largely relied on its ability in the early year to establish legal domicile in Hong Kong by forming a joint venture with a Hong Kong-based company that reserved its foreign exchange holdings. [25]The success of Lenovo

[21] The outward capital flow initiated by state owned enterprises was mostly towards tax havens and Southeast Asian courtiers or districts, which provided the confidentiality to avoid the preview of tax authorities, in the earlier period of economic reform. Source: Wong, Chan, *China's Outward Direct Investment: Expanding Worldwide*, 2003

[22] Wong, Chan, *China's Outward Direct Investment: Expanding Worldwide*, 2003

[23] Deloitte, *China real estate□investment handbook□The details that make a difference*, 2011

[24] China-based Lenovo Group acquired IBM's PC division with 1.75 billion USD.

[25] "Lenovo owes much of its success to its ability, early on, to establish legal domicile and raise capital in Hong Kong, arguably the world's most free-wheeling market economy.

may be an exceptional case, however, it implies that supporting policies that allow for convenient cross-border capital flows would bring enormous business opportunities and meet the increasing market seeking demands from the private sector.

The suppressing policy on capital flow is not effective on controlling capital flights and unauthorized transactions through gorged trade documents, under-invoicing and underground banking. On the other hand, it induces corruptions and nepotism in the state owned enterprises, where private investors try to take advantage of the established SOE funnels by insider-trading and self-dealing. The Sate Administration of Foreign Exchange (SAFE) estimated that China's illegal capital outflow from 1997 to 1999 reached 53 billion RMB (approximate 8 Billion USD), about 2% of China's GDP per year on average, and that number has increased since then.

3.1.2 Demands for ease on the policies

Evidently, the control of the capital outflows didn't stop the oversea investments in the foreign real estate markets. Buyers from China and Hong Kong accounted for $9 billion of U.S. home sales in the 12 months ending in March, making

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Lenovo got its initial financing from the Chinese Academy of Sciences, in 1984, but thereafter secured all of its significant investment from Hong Kong. In 1988, the company received HK$900,000 (116,000USD) from the Hong Kong-based company China Technology to invest in a joint venture that would enable Lenovo to claim the city as its legal domicile. In 1993, Hong Long Lenovo went public on Hong Kong Stock Exchange in a US $ 12 million IPO. Lenovo is a success story of Hong Kong's market-based financial and legal system, not of China's state-controlled financial system." Source: Huang, Yasheng, *Private Ownership: The Real Source of China's Economic Miracle*, 2009. Lu, Qiwen, *China's Leap into the Information Age: Innovation and Organization in the Computer Industry*, New York: Oxford University Press, 2000.

them the second-largest group of foreign buyers of homes in the U.S. behind Canadians, according to data released by the National Association of Realtors. Chinese real estate investment companies like SOHO China purchased 49 percent share of the 1.2 million-square-foot Park Plazas plus another building at 49 East 52nd Street from Rockpoint with USD 569.1 million. Similar transactions are done in a quiet way with limited information promulgated.

Although the focus of this paper is not on the investigation of outward capital flows, it is to explore the pressing needs for policy changes to ease the barriers. As pointed out by Li Jing in *hot money Behind: capital outflow roadmap Secret*, "capital outflows are largely economic policy distortions and institutional weaknesses of the response." Regulatory and administrative interventions in the interest rates, market access, and investment restrictions should be eased as demanded. Policy changes on foreign exchange system, relaxation of capital control for business and individuals are the major indicators that the private real estate investors should be observing closely. Market-oriented systems are anticipated to displace the policy-controlled system in order to truly transform the current way of business and create meaningful investment opportunities in the U.S and other foreign countries for the private sector.

3.2 Wenzhou pilot policy reform and its implementations

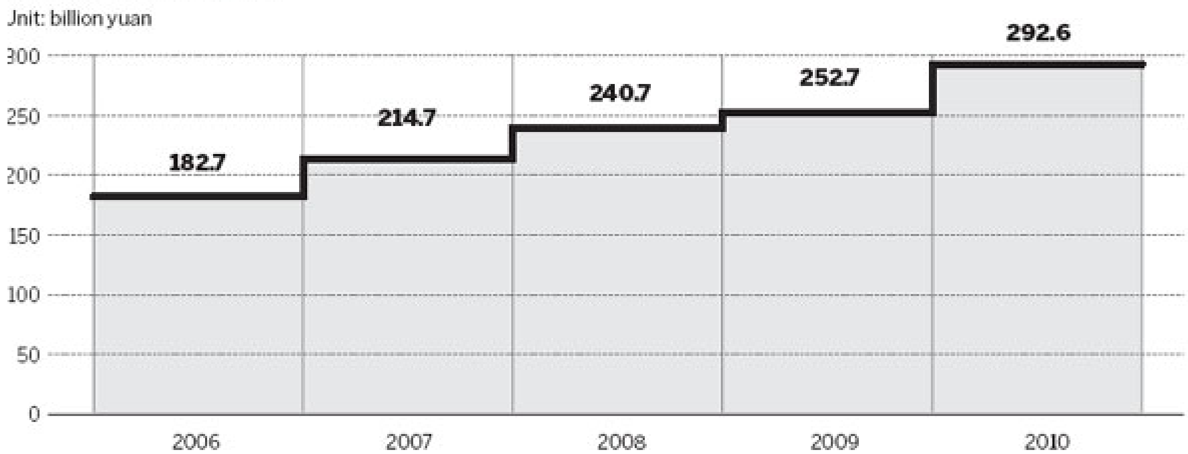
An interesting case concurrent with this thesis might be providing future policy indications for the foreign investments. In the most recent news, China State Council announced the approval of a set of financial reforms in the city of Wenzhou, which will be the testing ground for these measurements. According to the regulation announced during the early 2012, two major experimental financial policy reforms will take place: 1) private lenders in Wenzhou are allowed to operate as investment companies to provide financing; 2) Wenzhou residents[26] are allowed to invest directly overseas; 200 million USD per year or maximum 3 million USD a person are allowed to set up, acquire, or invest in nonfinancial companies in foreign countries; additionally, any profits generated abroad are allowed to be reinvested internationally.

Before elaborating on the implication of the policy change, a background of the city is necessary for understanding the motivation and prelude of such an effort. Wenzhou was a small coastal city a few hundred miles to the south of Shanghai in Zhejiang province before the economic reform in the early 1980s. It then became the center of the light manufacturing with more than 500 companies for clothing, toys and other products that dominate the global market in the late 1980s and 1990s.

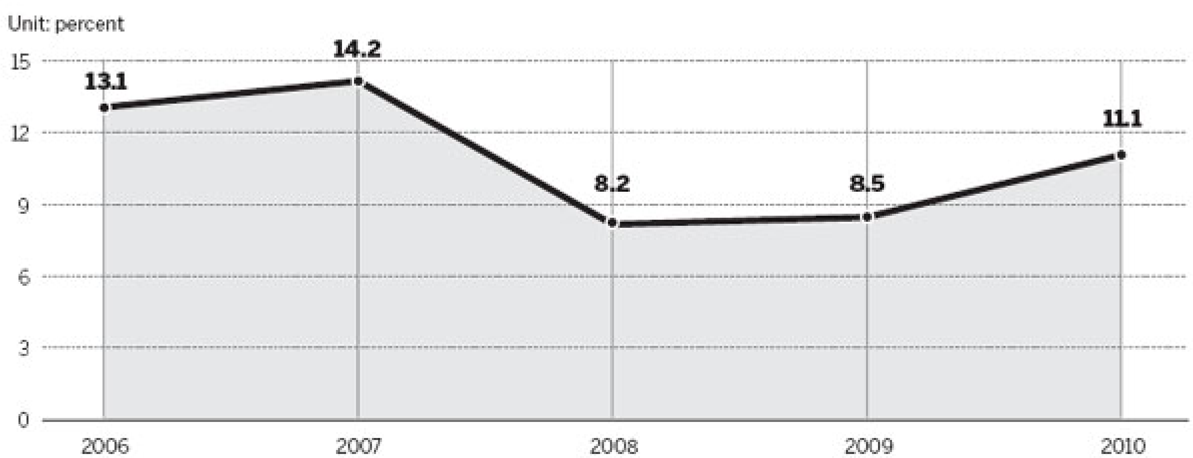
[26] "Residents of the Chinese mainland are currently unable to make direct overseas investments. They can put their money into financial institutions that, in turn, can invest it overseas through the Qualified Domestic Institutional Investor arrangement, which allows banks and fund managers to invest clients' money overseas within set limits."
Gao, Changxin ,*Investment Policy May Spread*, China Daily, 2012

Map of China
Retrieved from www.freeworldmaps.net on July 10, 2012

Wenzhou is considered the birthplace of China's private economy, and is not only known for entrepreneurship capitalism, but also the underground lending that really transformed the economy of the city. The local officials started to experiment "private lending, liberalized interest rates, cross-regional competition by savings and loans organizations and lending to private-sector companies." (Huang, 2011) It is unclear how big Chinas underground lending might be, but in October UBS estimated it could be between two trillion Yuan and four trillion Yuan (316 billion USD to 632 billion USD). In early 2011, the Wenzhou government tries to let locals invest overseas, but the policy was not implemented due to a lack of consent by the central government until the visit of Wen, Jiabao in 2011. [27]



Wenzhou's GDP
Source: Wenzhou Municipal Bureau of Statistics



Wenzhou's GDP Growth Rate
Source: Wenzhou Municipal Bureau of Statistics

According to the interviews with several practitioners in the U.S. real estate industry, the policy change is seen as the legalization of the current underground capital

[27] During a visit to Wenzhou in 2011, Chinese Premier Wen Jiabao said that the government should allow private capital to enter the financial sector and make the process "standardized and open", indicating the government's support on the pilot financial reform program.

flows, and is expected to liberalize the already creaking financial system. What is more pertinent to this thesis is the policy change regarding the foreign investment limitation lift and the potential business opportunities it can bring to the real estate investments in the foreign countries. Traditionally, Chinese investors have high preference for acquiring real estate, which has also been one of the major investment channels for Wenzhou investors; many of them have made millions of purchase in fixed assets and bought hundreds of apartment properties across the country in China. For example, a few residential developments, including one of the most expensive residential properties on Yangzi River, Shimao Riverside Garden, in Shanghai were bought in wholesale by investors from Wenzhou. "Wenzhou investors played a disproportionately large role in the market." [28]As the government started to cool down the real estate market from speculations, Wenzhou investors were also the first to look oversea opportunities. It is anticipated by the interviewees that there is a strong desire among these high-net-worth Wenzhou residents to allocate a portion of their wealth to the United States.

Although it is too early to discern the real impact of this policy, it at least indicates to many of the market observers "an symbolic step toward overhauling a system long seen as a barrier to developing a more substantial and sustainable growth model for the country's economy." [29]Other cities like Shanghai and Tianjin are applying for such policy lift through the central government as well. It can be concluded that the available capitals that can be attracted to the U.S. real estate market will increase and become more accessible in the future.

[28] Li, Qian, *Chinese Speculators eye property overseas*, China Daily, 2012
[29] Wei, Lingling, McMahon, Dinny, Orlik, Tom, *China Tests Financial Relaxation In Wenzhou*, Wall Street Journal, March 28, 2012

3.3 U.S. regulations for the entry of the market

Compared to the complication of the home country regulation control, the entry of the U.S. market in terms of the regulations and legal setups is quite straightforward. The information is transparent and accessible to the public. Most U.S. Secretary of States provide the information on the requirements for the needed registration documents for doing business in that particular state.

Another piece of legislation regarding the entry of the foreign business is "The Foreign Investment and National Security Act of 2007 (FINSA)", which became effective October 24, 2007, and was substantially revised in section 721. It should have very little impact on Chinese private investors as the focus of the legislation is to provide national security review of foreign investments with certain mergers, acquisitions and takeovers that might result in foreign control of a U.S. business. For example, foreign-government controlled transactions and business involving critical technologies and infrastructures. The Chinese private investments discussed in this thesis should be excluded from the review scope; however, the existence of this legislation should be made aware to the investors, and more information can be found at U.S. Department of the Treasury website.[30]

In summary, investment activities involved with doing business in China and/or from China have strong ties with the governmental policy changes, as the market is not completely open and free like that in the western countries. These administrative policies not only stimulate the market and create demands in a positive way, but also present great

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[30] *The Foreign Investment and National Security Act of 2007 (FINSA),* U.S. Department of the Treasury.
http://www.treasury.gov/resource-center/international/foreign-investment/Pages/cfius-legislation.aspx

constraints and difficulties to the investors. Investors should stay alert as observing the market and the policy change indicators that are discussed in the previous sections, and plan ahead in order to cope with regulatory risks and seize opportunities when they do emerge.

4. EVALUATION OF CURRENT INVESTMENT VEHICLES AND EFFECTS OF TAXATIONS

After identifying the important policy indicators, this section further examines the investment vehicles that currently take place in the U.S. real estate market for the Chinese private investors by recounting the most used legal, financial and tax setups. It also evaluates how these investments are structured, utilized and strategized to maximize the benefits for investors.

Due to the large variety of the investors' profiles, project size, investment time frames, expected returns and previous experience in the U.S. real estate market, it is not possible to contemplate the ideal structures to address all needs and purposes. The intent of this section is to explore the current structures and their abilities to channel capital to the right target to achieve maximum returns, and the means to minimize legal and financial liabilities as well as tax obligations.

4.1 The different U.S. taxes that affect the current investment vehicles

When setting up investment projects in the U.S., taxation is often one of the major concerns addressed first as the Chinese private investors are mostly taxable. For example, if the main concern in the tax perspective is the avoidance[31] of double taxation, Limited Partnership (L.P.) and limited liability Companies (L.L.C.) may be preferred as they are flow-through entities for tax purposes, while traditional C Corporations are taxed at both corporate level and the shareholder level.[32] The following paragraphs identify the types of taxations that commonly apply to foreign real estate investments, including income tax,

[31] Tax avoidance refers to legal means of reducing taxes.

[32]

property tax, estate tax and gift tax. Additionally, Chinese private investors should also pay attention to the effects of the Foreign Investment Real Property Tax Act (FIRPTA) that is only pertinent to foreign real estate investment in the U.S..

4.1.1 Income tax

According to the interview with a fund tax service manager, all investors are subjected to the federal and state income tax generated by the fixed assets including rental income (income state taxes are exempt in Florida, Texas, Washington state and Nevada), interest, and dividends at the ordinary income tax rate of about 35%. The income generated by the sale of real property is taxed at capital gain tax rate of 15% if the holding period is longer than one year; the sale of the property is subjected to ordinary income tax rate of 35% if the holding period is less than one year. Foreign investors that are subjected to the U.S. income tax include individuals who are non-citizens and non-permanent residents, and lived less than 183 days in the states within a year.

4.1.2 Property tax

Property tax is calculated based on the asset value each year. The tax is administered at the local government level. Since it is tied to the property itself, therefore, it is applicable to foreigner owners or investors as well.

4.1.3 Estate tax

According to the interview with a fund tax service manager, many inexperienced investors often overlook the planning for estate tax and gift tax, which potentially have significant impact on the structure of investment project. These two types of taxes are particularly pertinent to high net-worth individual investors.

The official definition for "foreign" investor in terms of estate tax and gift tax does not exist as they do for income taxes. [33]The taxation is decided by the IRS on a case-by-case basis depending upon the asset distribution, residence location and whether the individual intent to stay in the United States for long term, etc. Therefore, the investors should scrutinize how the investment is planned and the economic model utilized in determining their tax position.

For investors with Chinese citizenship, the tax exemption for estate tax is 60,000 USD for entire asset values held within the United States when the assets are passed to the successor upon the death of the asset holder, and it is a very low exemption; anything above 60,000 USD will be taxed at the current estate tax rate of 35%. For investors with Chinese citizenship and the US permanent residence, the tax exemption for estate tax is 5,000,000 (as of 2012)[34] for the lifetime, however, the tax

[33] "Foreigners and nonresident aliens for income tax purpose mean individuals who are neither U.S. citizens, green card holders, nor U.S. tax residents by virtue of the number of days they are present in the United State under the substantial presence test. For estate and gift tax purposes the terms mean persons who are not domiciled in the United States at time of death of at the time of making a gift. The definition of U.S. resident for income tax purposes is based on measurable standards. The definition of domicile is a facts and circumstances test. It is quite possible to be a U.S. tax resident for income tax purpose and a non-domiciliary for estate tax purpose. A foreign corporation is a corporation not organized under the laws of any U.S. state." – Richard L. Herrmann, *Planning for Foreign Investment in U.S. Real Estate*, 2010

[34] Source: United States IRS, http://www.irs.gov/businesses/small/article/0,,id=164871,00.html

base is the asset value held across the globe as opposed to the asset value held within the U.S. according to the U.S. global taxation rules.

4.1.4 Gift tax

Chinese investors are also subject to gift tax at the rate of 35% (2012) with the exemption of 13,000 USD per year. Again, there is not official definition for "foreign" investor as to gift taxation rules; IRS decides it on a case-by-case basis.

4.1.5 Foreign Investment Real Property Tax Act (FIRPTA)

Additional to the previous taxes, foreign investors are exposed to the effects of Foreign Investment Real Property Tax Act (FIRPTA). FIRPTA is in effect when the foreign investors dispose the assets. It is enacted because there is a risk of tax not being collected when the foreign investors realize their gains from the disposition of the property and return to the home country. It is also because that there is no jurisdiction to tax foreign investors on capital gains within the country.[35] The FIRPTA was enacted in 1980 to stipulate the disposition of a U.S. real property interest (USRPI)[36] being effectively connected with a U.S. trade or business, and essentially mandates a tax withholding on all real estate income earned by foreign investors when selling the property. "FIRPTA creates a withholding mechanism under which the buyer of any U.S. property purchased from a foreign person must withhold 10%

[35] Bert J. Zarb, *Foreign Investment in U.S. Real Property Complying with FIRPTA and Using 1031 Exchange*, The CPA Journal, 2007

[36] A full definition of USRPI can be found at US IRS website: http://www.irs.gov/irm/part4/irm_04-061-012.html#d0e10

of the purchase price at closing and remit it to the IRS within 20 days instead of paying the full amount to the foreign seller." [37] The withholdings is to be claimed by filing an income tax return for the year that the property is sold.

A "disposition" includes (but is not limited to) a sale or exchange, liquidation, redemption, gift, transfers, etc.[38], and FIRPTA stipulates that the buyer is the withholding agent. If the Chinese investors were buying properties from a foreign owner from another country, the Chinese investors should also withhold; otherwise, they are liable for taxed owned.

The 10% withholding that applies to the amount realized, usually the sale price, is irrespective of the gain on neither the sale, nor the tax amount owned. Depending upon the fair market value of the transaction, the withholdings can be substantial, and the foreign investors should be aware of it.

4.2 Commonly used investment vehicles

Structuring real estate investment in the U.S. with consideration of taxation and legal setup involved trade-offs and making choices based on the profiles of different investors. The goal is to minimize legal and financial liability, as well as to create an optimally efficient investment vehicle for tax purpose.

For example, certain high-net-worth investors are sensitive to estate tax as it can be very high in the U.S.; however, the possible disadvantages in income tax should be made aware when choosing a corporation structure. Based on the interview with fund tax

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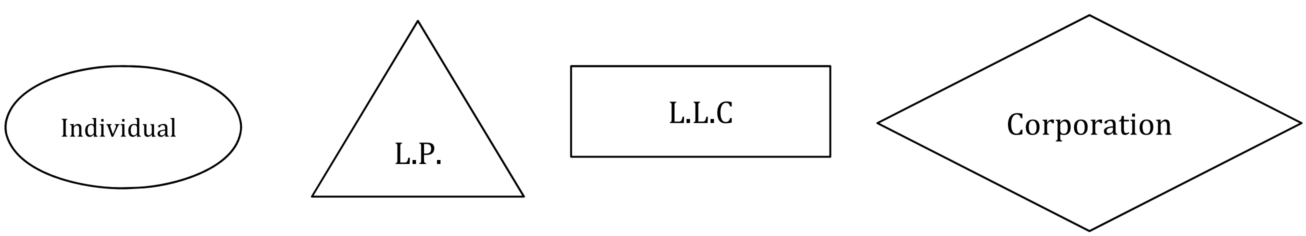
[37] Bert J. Zarb, 2007

[38] A full definition of disposition can be found at US IRS website: http://www.irs.gov/businesses/small/international/article/0,,id=105000,00.html/

services for foreign investors, direct investment, foreign corporation and foreign irrevocable trust are the most commonly used forms of investment vehicles in the market today.[39]

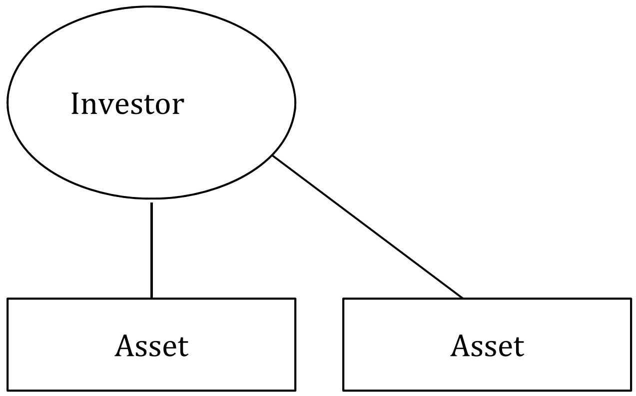
4.2.1 Direct investment

Direct Investment is the simplest and most straightforward method utilized within the Chinese private investor community. The investor owns the properties under his or her personal name. The advantages of this structure are 1) it requires less legal and business planning; 2) there is no second layer of corporate tax, and the owner can take advantage of the lower capital gain tax rate of 15%. The disadvantages are: 1) the individual investor is subjected to estate tax upon death; 2) the highest individual income tax rate can be higher than the corporate tax rate of 35%; 3) the investor needs to file tax returns and reveal his or her identity to IRS; and 4) lastly and most importantly, the investor as the direct owner is exposed to unlimited personal liabilities to his or her properties if those properties are not for personal uses.



Legend

[39] A comparison sheet is provided at the end of this section; however, detailed tax and business planning are required for any of the structure used based on individual profile and investment goals. More detailed information can be found in "*Planning For Foreign Investment in U.S. Real Estate*", by Richard L. Herrmann.



Structure of Direct Investment

4.2.2 Foreign corporation (Foreign corporation with U.S. subsidiaries) [40]

Some Chinese private investors set up foreign corporations to operate the real estate investments, and are subject to the corporate tax rate of 35%. The advantages are: 1) The investor is not subject to the estate tax upon death; 2) The investor has limited liability to his properties. The most predominant disadvantage is that the corporation is subject to double taxation for income that is not reinvested in the business, such as rental incomes and dividends paid out, including the sale of the property, which is subject to the branch profit tax at 30% rate, unless the corporation can liquidate after the sale, in this case, repatriation of the profit is free of withholding of U.S. tax. If the liquidation failed because the corporation owes multiple properties that cannot be sold at the same time, then the sale proceeds are double taxed and subject to the withholding tax. [41]

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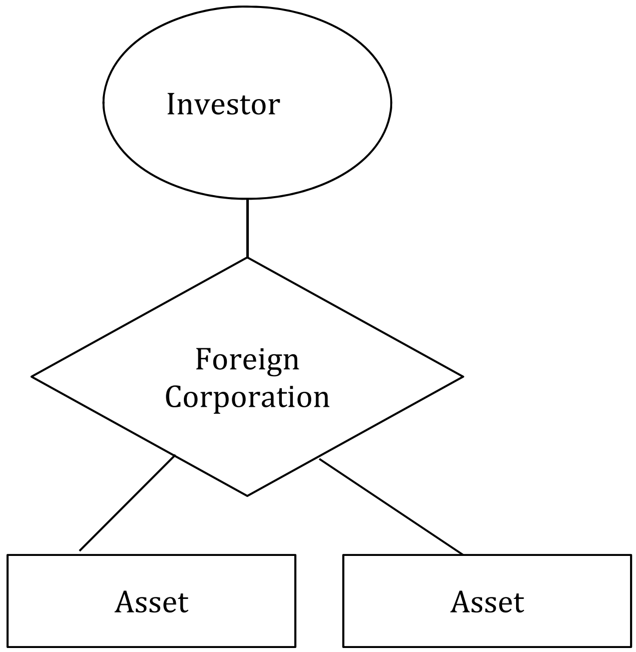
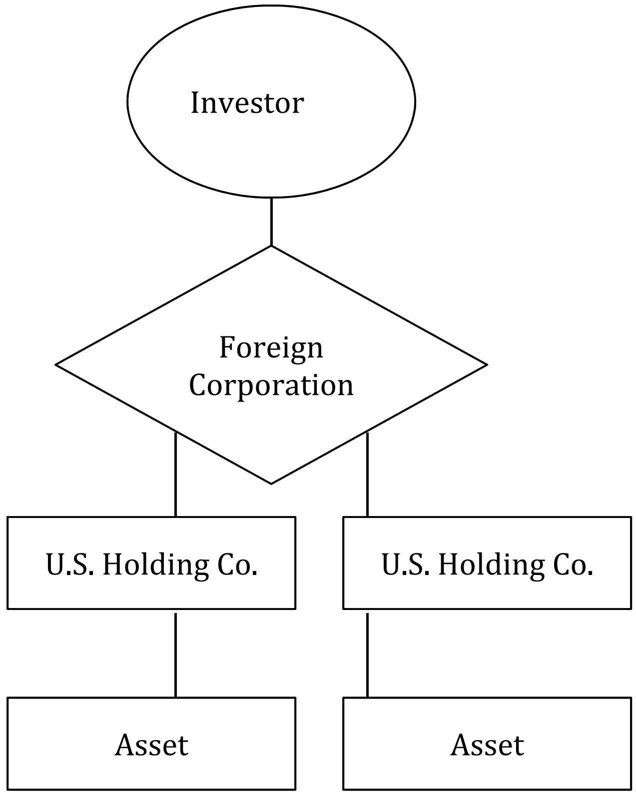
[40] A foreign corporation is a corporation not organized under the laws of any U.S. state.
[41] Richard L. Herrmann, *Planning for Foreign Investment in U.S. Real Estate*, 2010



Foreign Corporation

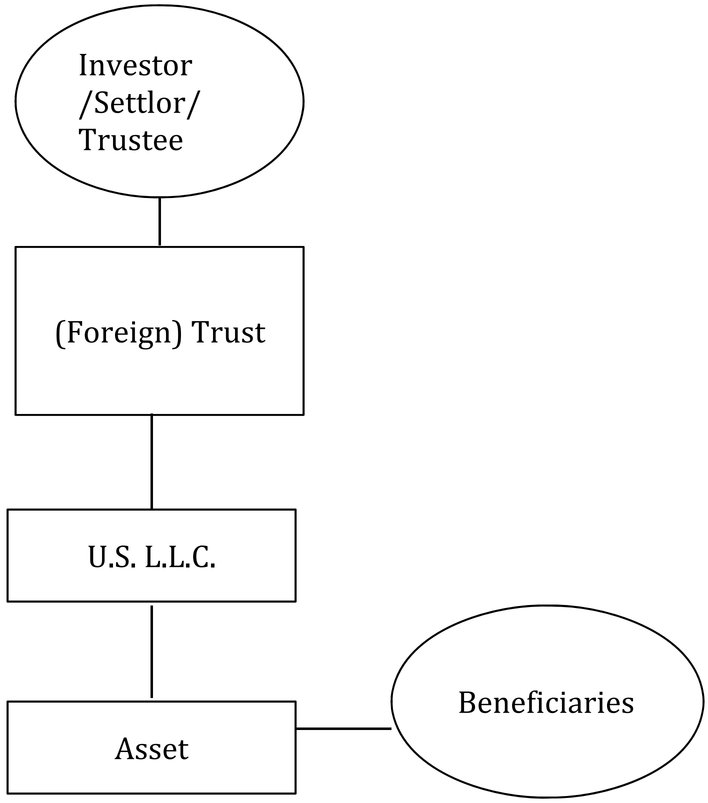
Many of the foreign corporations are set up in the tax haven for privacy protection and their business locations in the U.S. are set up as a U.S. property holding company. The tiered structure is more desired for the avoidance of revealing personal identification, U.S. estate and gift taxes. It's always preferable to have only one property for one holding company, so that upon sale of the property, the U.S. holding company can be liquidated and the sale proceeds are repatriated to the foreign corporation free of U.S. withholding tax.



Foreign Corporation with U.S Holding Companies

4.2.3 Irrevocable trust

Another form of investment commonly seen in the Chinese private investment community is irrevocable trust that is used to avoid paying for estate tax and revealing of personal identification. The trust is taxed at personal rate; therefore, the sale of the property is subjected to long-term capital gains tax rate of 15%, as opposed to the corporate tax rate of 35%. The trust also can be structured as tiered companies, and is more often used for family estate investment planning. The tiered structure also ensures the limited personal liabilities.



Irrevocable trust

4.3 Summary

Among the above three structures, the direct investment is still the most utilized mean for the Chinese private investors in the U.S. real estate market today, according to the interviews with fund tax services in New York.. Evidently, the investment activities from the Chinese private sector are small-scaled, and the investors are mostly high-net-worth individuals; the investment business structure is quite simple and unsophisticated.

The following section looks into the potential business opportunities where the private foreign investments can be expanded with the policy changes discussed earlier, and how the proposed businesses can be strategized and structured respectively.

	Direct Investment	Foreign Corp.	Foreign Trust
Personal Liabilities	Full	Limited	Limited
Estate tax	Yes	No	No
Gift Tax * (For real property)	Yes	Yes	Yes
Long Term Capital Gain at 15%	Yes	No	Yes
Corporate Tax of 35%	No	Yes	No
Revealing of Personal Identity	Yes	No	No
Business Operation	Less costly	More costly	More Costly
Business Setup	Simple	More Complex	More Complex
Sale of the property	Long term capital gain rate of 15%	Higher tax rate	Higher tax rate
Withholding tax on incomes that are not reinvested such as sale proceeds	No	Yes. If the foreign corporation cannot liquidate after the sale of the property	No
FIRPTA	Applies	Applies	Applies

* Gift tax is treated differently for real properties and shares of corporation (including shares in a co-op). This thesis only looks at the transaction involved with real property.

Legal and Tax Structure Matrix

5. PROPOSED BUSINESS MODEL AND ITS CONCEPTUAL IMPLEMENTATIONS

Section 2 and Section 3 define the policy indicators, barriers and investment landscapes for the Chinese private investors in the U.S. real estate market; section 4 examines the current investment vehicles and how they are structured legally and financially. What can be concluded from the previous analysis are: 1) the demand for capital to boost U.S. real estate market and the supply of capital from increasing fiscal surplus and wealth accumulation in China create the potential viable business opportunities; 2) the full growth of the business relies on the supporting policies, especially the ease on the capital control policy in China; 3) the current business practices are simple and less sophisticated; 4) the size of current investments is mostly unsubstantial; 5) the growth of the private investments from China to the U.S. real estate is anticipated to increase as the Chinese government liberates its financial market and cross-border capital flow policies. In this section, the thesis explores potential business models and strategies that can be created to take advantage of the future policy changes. The proposed business is referred as "the business" in the following sections.

5.1 Opportunities in the market place

Although the U.S. as the destination country doesn't present many regulation obstacles for the entry to the market, many of the Chinese investors are still concerned with the business and market climate as they venture abroad. Based on the interviews with three major brokerage firms and many Chinese domestic real estate investors, predominate concerns are summarized as below:

5.1.1 Complexities and misgauge of the market:

The U.S. real estate market is much more developed and mature than the Chinese real estate market; the level of sophistication and complexity often can be overwhelming to local experts, and much more challenging to foreign investors without previous business experience in this country. Although most investment information is accessible, the vast amount of data, broad based sources and various geographical differences make it difficult for foreign investors to start new businesses. At a micro level, understanding the specific character of one particular market or one type of asset requires even fine-tuned knowledge and skills. Local real estate customs and practices add another layer of complexity.

In February of 2012, more than 70 Chinese investors, led by the Department of Commerce of China, visited multiple U.S. cities to promote investments in the country; one third of the group was specifically seeking opportunities in the fixed asset market. Based on the interviews with some of those real estate investors, the most predominate concern was insufficient understanding about the market climate in the hosting country.

The unfamiliarity results in misgauge of the market in many cases. One interviewee from a large real estate brokerage firm claimed that many Chinese investors came without clear goals and expectations for their investments. Often, they put money into wrong products that they didn’t intend to acquire, and therefore anticipate unrealistic returns. Some of the misgauges are also caused by language and terminology differences between the two markets. For example, Class B office in downtown Manhattan clearly represents different product type from

Class B office in central Beijing; therefore, mismatching between the anticipation, purchase price and final products are quite common. Another misgauge comes from the additional cost associated with marketing, transaction and service fee etc., which are often underestimated by the investors. For example, mansion tax of 1% of the total contract price (if the price is above one million) applies to all real estate transactions in the New York City, and often overlooked by investors.[42]

5.1.2 Complexities of the legal and regulatory environment:

Other risks also include differences between the home country and the destination country in terms of legal and regulatory environment, taxation and its implications and different forms of investment vehicles. For example, a lawyer is not an essential part of a real estate transaction in China, but is required in the U.S.. Many business concepts can be very foreign to the Chinese Investors, and create steep learning curves in managing foreign business and operations. A few successful cases, such as Soho China's acquisition for Park Plaza was largely due to the facilitation of specialized consulting firms and the expertise and foreign business experience of the investor herself. This further implies the importance of the local expertise.

5.1.3 Differences in business practice:

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[42] Richard L. Herrmann, *Planning for Foreign Investment in U.S. Real Estate*, 2010

Finally, cultural and behavior factors play significant roles that might have prevented the investors from meaningful foreign real estate investments. Chinese investors tend to run business as if they were in China: provisions in business contracts are not always strictly followed. The investors are less aware of prospective competitions and management efficiency, as they can be slow in decision-making and lose competitive advantages as the market turns quickly. Lastly, they are less experienced when working with joint venture partners with contractual business relationships; behaviorally, many of the Chinese business relationships are conducted in a more personal and casual manner.

5.2 Proposed business concept:

Evidently, a disconnection exists between the U.S. real estate market side and the Chinese private investor community side. The proposed business would be based on a Chinese citizen as a trusted real estate adviser who could target real estate investment opportunities in the U.S., assemble a group of private investors from China, and facilitate and manage their investment activities in the U.S..

The qualifications of the advisor should include but not limited to:

1) Understanding of the home market conditions in China and the investment destination market in the U.S.;
2) Understanding of the business custom and local practice of both countries;
3) Understanding of the Chinese clients' needs and assumptions that they might bring from the home country;

4) Expertise in legal and business issues that may rise during the course of the investment and ability to counsel about options and respective consequences;
5) Ability to assemble and lead a multi-disciplinary team that could provide comprehensive consulting services as needed by the clients;
6) Ability to speak, write and communicate in both languages.

The development of the proposed business is divided into three stages, including:

1) Beginning state: fee-based real estate advisory service business

In the absence of track records and available capital, the business would start as a fee-based real estate advisory servicing business focusing on aligning existing real estate in the U.S. with potential interested buyers from China. The business can be started with two steps: 1a) the advisor would focus on assembling investor group in China by identifying potential projects and performing due diligence work on behalf of the investors, and the advisor would be the sole representative for the Chinese investors; 1b) the advisor could then include the service of executing the investment process and managing the purchased asset over the course of the investment on behalf of the investors.

2) Expansion stage: real estate Joint venture for one-off real estate deals

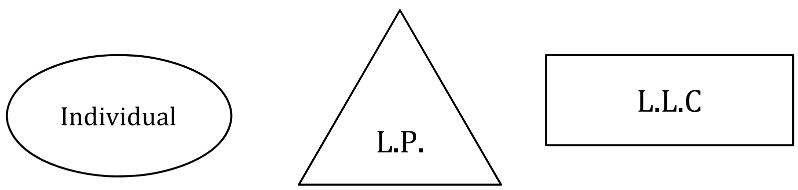
The service business then can be expanded to joint venture for one-off deals once there are enough accumulated equity and track records. The expanded business would focus on acquisition of larger-scale and more complex properties in terms of leasing structures, as well as new developments.

3) Mature stage: foreign private real estate opportunity fund

Eventually, the business can mature into a foreign private real estate opportunity fund.

The following paragraphs examine the business models in terms of structuring issues, target clients, target projects, fund raising, marketability, competition and profitability. However, the foreign private real estate opportunity fund has many established business models, and will not be the focus of the thesis.

5.3 Fee-based real estate advisory service business--beginning stage



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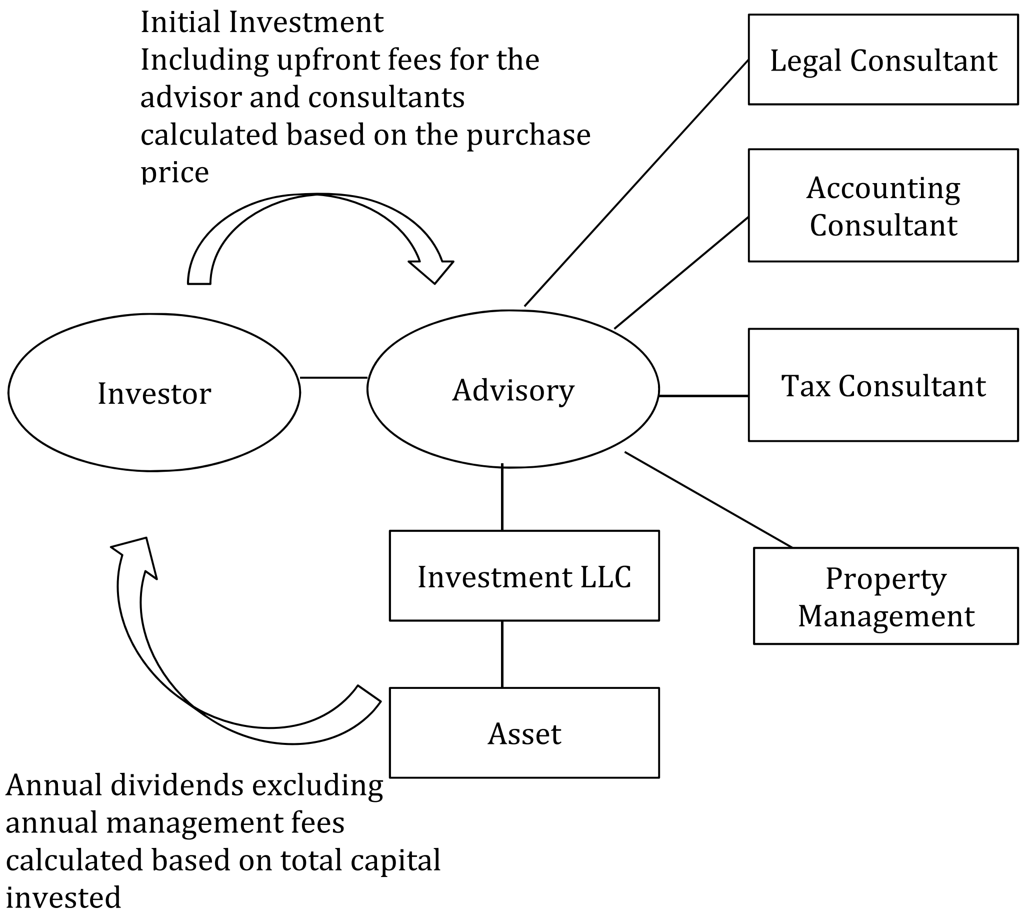
5.3.1 Business model and structure



Business Structure of Fee-based Real Estate Advisory Service

As illustrated in the above diagram, the full scope of the proposed advisory business will be at the center of the actions; the work scope of the business includes eight major components:

1) Presenting the business plan to the investors in China, finalizing the target asset(s), assembling investors and raising capital;
2) Identifying real estate assets/ investment opportunities in the U.S.;

3) Preparing or arranging for due diligence studies for the potential assets, examining the past performance of the existing assets, forecasting the future cash flows and contemplating a business plan for each specific investment[43];
4) Preparing investment agreements, setting up a business entity for acquisition in the U.S. for each asset and managing the process of acquisition;
5) Assembling a team of consultants including but not limited to: a legal consultant, an accountant, and a tax consultant;
6) Hiring third-party management company to oversee the operation of the asset purchased;
7) Reporting profit or loss to the investors periodically; and,
8) Managing the disposition process of the asset.

The advisory business is fee-based and deal-oriented business. While each deal is different and depends on size, complexity, and myriad other factors, generally the investor is charged at the upfront of the acquisition at 2.5%-4%[44] of the purchase price for advisory services and the payments to the other hired consultants.[45] Thereafter, the net operating income each year would cover annual managing fee for the advisor at 1% of the capital invested[46] and payments to ongoing services

[43] The work scope for stage 1a includes component 1 though component 3.
[44] Commission is adjustable based on the size of the project; it includes the added fee for other consultants.
[45] Consultants are hired under the name of the established L.L.C. General liability of non-performance insurance may be purchased to offset the risk for the under-performance of the consultants hired and ensure the limited financial liability of the advisory business.
[46] Capital invested can be larger than the purchase price as it includes capital expenditures and other potential expenses during the course of the investment; it also includes the debt obtained for the project.

provided by other consultants during the course of investment. Upon the sale of the asset, sale proceeds cover the service fee of the advisor and other consultants; excess profits will go to the investors entirely.

5.3.2 Target assets and clients

The target assets would be small-scale single tenant commercial or industrial properties with signed-up leases that can provide steady and guaranteed mid to long-term rental incomes for the investor. Large corporate tenants, such as a freestanding McDonald restaurant that has stabilized leases, are preferable to reduce the chance of defaults; this type of asset would almost perform like a corporate bond in the real estate format. Multi-family residential property with high percentage of leases signed up can be another option at relatively larger scale. In general, the target assets are expected to be the low-risk investments with attractive risk adjusted-returns. [47]

The target clients would mostly be high-net-worth individuals who have sufficient financial resources and are looking for safe assets in the U.S. to preserve their wealth and diversify their investment portfolio in China. Therefore, the expected return will be at the lower end and adjusted to the borne risks. Major benchmarks for comparison purposes are the bank deposit rate and the Chinese Treasury bond rate for one year and five years, as both are the most common safe assets that are available in the domestic Chinese market. The current rate for one-

[47] Feasibility study is needed for each individual project to determine the expected return rate. Decisions are made based on the purchase price and the projected profits generated over the course the investment. An example of feasibility study is provided in section 5.3.5.

year bank deposit is 2.85% and 4.75% for 5 years in China.[48] Current Chinese one-year Treasury bond rate is 3.7%, and 5-year Treasury bond is 5.32%. When choosing a client, the advisor should pay particular attention to the clients' financial recourse, international experience and technological ability, as they are critical to the success of the business. The total amount invested in the U.S. real estate market is not recommended to exceed 20% of their whole portfolio net worth[49], and the exchange fluctuation risk would be diversified by other investments they make domestically in China if that occurred.

5.3.3 Fund raising

The initial fund raising can be conducted through personal connections or family-friend-oriented trusted networks. The advisor should also get in contact with local Chinese personal wealth management advisors at the banks and present the proposed business as an alternative asset class to invest in, and gain access to the potential client pool.

5.3.4 Marketability and competitions

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[48] RMB bank deposit return rate from Bank of China: source: http://www.boc.cn/finadata/lilv/fd31/201207/t20120705_1887040.html

[49] "The diversification benefit of real estate is a major reason for substantial inclusion of real estate in many large institutional portfolios". Geltner, David, Miller, Norman G., Clayton, Jim and Eichhotlz, Piet. *Commercial Real Estate: Analysis & Investments*. South-Western: Thomas Learning, 2007. It is assumed that the non-institutional investors should also diversify his or her investment between different assets and markets in order to achieve the efficient frontier.

The marketability of the business hinges upon how it can bridge the disconnection between the Chinese investors and the local real estate market in the U.S., meanwhile simultaneously differentiating itself from other similar competing businesses.

There are many existing legal and financial service firms that practice real estate advisory in today's market; however, most of firms expressly claim that they do not provide advice or opinions regarding issues that are outside of their professions, and their services are paid on hourly rates. For example, the attorney who is hired for EB-5 Investor Program application will help the investors to gather related project information and process the legal application through the government, but will not provide service regarding how to choose an EB-5 investment project that are profitable. A fund tax service will plan the tax strategies for the investment projects chosen by the clients but will not help them to identify deals and process other legal issues. Furthermore, the consultation tends to provide generic solutions rather than customized strategies based on the specific deals and client profiles. The investor himself or herself is essentially in charge of coordinating all disciplines and putting everything together.

The proposed real estate advisory business would proactively seek for opportunities for potential investors and provide a one-stop shop that not only helps the clients to assemble and organize a team of consultants to deal with the execution of the investments, but also identify deals, conduct feasibility studies and strategize the optimal financial solutions on behalf of the clients during the entire course of the service.

Compared with large real estate advisory firms, the proposed business would avoid direct competition with them by targeting investment projects that are around 10,000000 USD million[50]. 1% annual management fee for the proposed business is also attractive, as most private real estate equity funds charge typically at 1.5 % of total capital invested for annual management fee, and hedge funds charge typically 2% of total capital invested respectively.[51] Additionally, the excess profit generated after reaching the target return rate (if any) would all benefit the investor.

5.3.5 Profitability

A business financial analysis model is built based on series of assumptions to evaluate the viability of the business.

Profitability for stage 1A

During stage 1A, the business would be operated on a very lean budget at the beginning with the single task of identifying potential projects and performing due diligence work, the projected operating expenses would only cover minimal business expenses and one personnel overhead.

Operating expenses and fees for the full scope of the advisory business

Once the advisory service expands to the full scope, the business operation is assumed to start with a low budget of 10,000 USD and two advisors; each would be paid at 100,000 USD per year, and the salaries would grow with the inflation rate at 3%. The total operating expense for the first year is 260,000 USD.

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[50] Investment project size are determined in section 5.3.5

[51] Andrew Moylan, *Private Equity Real Estate Fund Management Fees*, Preqin, 2010

Business Oporating Expenses		
Employee Salary	$	200,000
Employee Benefits	$	50,000
Rent	$	-
Other	$	10,000
Total Operating Expenses	*$*	*260,000*

Business Operating Expense Budget for the Initial Year

If the managing fee were charged at 1% of the purchase price, the minimum total project size would be 26,000,000 USD in order to break even for the business operation in the initial year. However, based on the previous analysis on the target client group, it may be difficult to raise enough capital at the beginning stage. Therefore, the business models are built based on the initial investment project of 10,000,000 USD that are more realistic to achieve. [52]

As mentioned previously, the business charges 2.5% to 4% commissions at upfront for acquisition and at the end for disposition of the assets, including the cost of third-party consultants. The annual management fee is 1% to 2%. Below are the assumptions that are used in this particular model: 1% asset management fee, 2% acquisition fee and disposition fee.

Asset Management Fee	1.00%
Acquisition Fee	2.00%
Disposition Fee	2.00%

Fee Assumptions

[52] Three scenarios are provided in the section based on the initial investment project of 10,000,000 USD.

Investment project cash flows and profitability

Inflation Rate	3%
Initial Yield	5.0%
Terminal Cap Rate	5.25%
Holding Pediod	5yr

Investment Project Cash Flow Model Assumptions

It's assumed that the investors would hold the project for at least 5 years. The advisory business would acquire the asset on behalf of the investor at time 0, and manage the asset through year 1 to year 5, and disposition the asset at year 5. Based on the cash flow generated by 10,000,000 USD of investment at 5% initial yield, 3% inflation rate and the terminal cap rate of 5.25%, the investment project level return can be achieved at 7.1%. At the investor level, the internal rate of return is 5.1% after subtracting the management fee, acquisition fee and disposition fee from the cash flows. The current rate for one-year bank deposit in China is 2.85% and 4.75% for 5-year deposit. Current Chinese one-year Treasury bond rate is 3.7%, and 5-year Treasury bond is 5.32%. Therefore, the investment projects would perform comparably well as the most common safe assets in China as the returns of the project would be obligated contractually without fluctuations, and can be attractive to the investors.

Year	0	1	2	3	4	5
Investment Cash Flow (initial)						
Acquisition Cost	$ (10,000,000)	$ -	$ -	$ -	$ -	$ -
Investment Cash Flow	$ -	$ 500,000	$ 515,000	$ 530,450	$ 546,364	$ 562,754
Terminal Value	$ -	$ -	$ -	$ -	$ -	$ 11,040,705
Total project Cash Flow	$ (10,000,000)	$ 500,000	$ 515,000	$ 530,450	$ 546,364	$ 11,603,460
Project IRR	**7.1%**					
Investor Cash Flow	$ (10,300,000)	$ 400,000	$ 415,000	$ 430,450	$ 446,364	$ 11,282,646
Investor IRR	**5.1%**					
Fees						
Management Fee	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000
Acquisition Fee	$ 200,000	$ -	$ -	$ -	$ -	$ -
Disposition Fee	$ -	$ -	$ -	$ -	$ -	$ 220,814
Total	$ 300,000	$ 100,000	$ 100,000	$ 100,000	$ 100,000	$ 320,814

Project Level and Investor Level Cash Flows

After ensuring the viability of the invested project, the next step is to evaluate the profitability of the advisory business itself. Three scenarios are performed to examine the minimal revenue needed each year for the business to break even and grow. All scenario models are built based on the initial investment of 10,000,000 USD as discussed previously. Scenario 1 looks at the possibility for the business to break even in the shortest amount of time with more optimistic forecasting on investment project size; scenario 2 takes a more conservative and pessimistic approach for forecasting with no growth after the initial project; scenario 3 proposes a middle ground between scenario 1 and scenario 2, and forecasts the future business with 5% growth rate after the initial year for the project size.

Scenario 1:

In scenario 1, the business would start with a loss of 160,000 USD, and barely break even in the following year if the project size increases to 16,000,000 USD, which would definitely provide the business with substantial return and growth, and is anticipated to be achievable during a market upward growth period. However, 60% increase in project size seems to be over ambitious in adverse market conditions.

Year	0	1	2	3	4	5	6	7	8	9
New Project Aquired	$ 10,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000
Project Disposed						$ 10,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000	$ 16,000,000
Ongoing Project	$ 10,000,000	$ 26,000,000	$ 42,000,000	$ 58,000,000	$ 74,000,000	$ 80,000,000	$ 80,000,000	$ 80,000,000	$ 80,000,000	$ 80,000,000
Value of Project Disposed					$ 10,143,648	$ 16,229,837	$ 16,229,837	$ 16,229,837	$ 16,229,837	$ 16,229,837
Consultant Fee										
Acquisition Fee	$ 200,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000	$ 320,000
Disposition Fee	$ -	$ -	$ -	$ -	$ 202,873	$ 324,597	$ 324,597	$ 324,597	$ 324,597	$ 324,597
Total	$ 200,000	$ 320,000	$ 320,000	$ 320,000	$ 522,873	$ 644,597	$ 644,597	$ 644,597	$ 644,597	$ 644,597
Fee Income										
Management Fee	$ 100,000	$ 260,000	$ 420,000	$ 580,000	$ 740,000	$ 800,000	$ 800,000	$ 800,000	$ 800,000	$ 800,000
Business Oporating Expenses										
Employee Salary	$ 200,000	$ 206,000	$ 212,180	$ 218,545	$ 225,102	$ 231,855	$ 238,810	$ 245,975	$ 253,354	$ 260,955
Employee Benefits	$ 50,000	$ 51,500	$ 53,045	$ 54,636	$ 56,275	$ 57,964	$ 59,703	$ 61,494	$ 63,339	$ 65,239
Rent	$ -	$ -	$ -	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000
Other	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000
Total Operating Expenses	*$ 260,000*	*$ 267,500*	*$ 275,225*	*$ 323,182*	*$ 331,377*	*$ 339,819*	*$ 348,513*	*$ 357,468*	*$ 366,693*	*$ 376,193*
Profit	**$ (160,000)**	**$ (7,500)**	**$ 144,775**	**$ 256,818**	**$ 408,623**	**$ 460,181**	**$ 451,487**	**$ 442,532**	**$ 433,307**	**$ 423,807**
NPV	**$ 1,054,681**									
Cost of Capital	**14.8%**									
IRR	**84.1%**									

Scenario 1: Business Cash Flows

Scenario 2:

In scenario 2, it's assumed that the business would be maintained at the same size of 10,000,000 USD each year after the initial investment, the business would suffer 160,000 USD and 67,500 USD losses in year 0 and year 1. However, the business would turn profitable in year 2 and maintain a healthy growth in the following years.

Year	0	1	2	3	4	5	6	7	8	9
New Project Aquired	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Project Disposed						$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Ongoing Project	$ 10,000,000	$ 20,000,000	$ 30,000,000	$ 40,000,000	$ 50,000,000	$ 50,000,000	$ 50,000,000	$ 50,000,000	$ 50,000,000	$ 50,000,000
Value of Project Disposed					$ 10,143,648	$ 10,143,648	$ 10,143,648	$ 10,143,648	$ 10,143,648	$ 10,143,648
Consultant Fee										
Acquisition Fee	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Disposition Fee	$ -	$ -	$ -	$ -	$ 202,873	$ 202,873	$ 202,873	$ 202,873	$ 202,873	$ 202,873
Total	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 402,873	$ 402,873	$ 402,873	$ 402,873	$ 402,873	$ 402,873
Fee Income										
Management Fee	$ 100,000	$ 200,000	$ 300,000	$ 400,000	$ 500,000	$ 500,000	$ 500,000	$ 500,000	$ 500,000	$ 500,000
Business Oporating Expenses										
Employee Salary	$ 200,000	$ 206,000	$ 212,180	$ 218,545	$ 225,102	$ 231,855	$ 238,810	$ 245,975	$ 253,354	$ 260,955
Employee Benefits	$ 50,000	$ 51,500	$ 53,045	$ 54,636	$ 56,275	$ 57,964	$ 59,703	$ 61,494	$ 63,339	$ 65,239
Rent	$ -	$ -	$ -	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000
Other	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000
Total Operating Expenses	*$ 260,000*	*$ 267,500*	*$ 275,225*	*$ 323,182*	*$ 331,377*	*$ 339,819*	*$ 348,513*	*$ 357,468*	*$ 366,693*	*$ 376,193*
Profit	**$ (160,000)**	**$ (67,500)**	**$ 24,775**	**$ 76,818**	**$ 168,623**	**$ 160,181**	**$ 151,487**	**$ 142,532**	**$ 133,307**	**$ 123,807**
NPV	**$ 199,087**									
Cost of Capital	**14.8%**									
IRR	**32.7%**									

Scenario 2: Business Cash Flows

A NPV study is conducted for the projected 10-year future cash inflows at the business level. It's assumed that the business is all equity financing,[53] and the cost of capital of the proposed business is 14.8%.[54] Respectively, the NPV of the business would be 199,087 USD. Therefore, it can be concluded that the business model is viable if the project size maintains at 10 million USD per year after the initial year.

Scenario 3:

In scenario 3, the business is assumed to grow at 5% rate each year, the investment becomes more attractive, (using same assumptions for going-in cap rate of 5.0% and

[53] Since the profile of the investors is risk adverse, it's assumed that these investors would not use leverage in their investments.

[54] Cost of capital is calculated based on the following formula: Cost of capital=risk free rate + company beta x risk premium; current risk free rate is 1.75 % according to Bloomberg.com; and the company beta 2.175 is estimated based on other the real estate advisory firms' company beta, including CBRE (2.50) and JLL (1.85).
Source: http://www.bloomberg.com/markets/rates-bonds/government-bonds/us/
http://www.google.com/finance
Robert C. Higgins, *Analysis for Financial Management*, Tenth Edition

terminal cap rate of 5.25%) the project IRR would reach 15.4%, and the investor IRR would reach 12.7% as the effect of the growth rate.

Year	0	1	2	3	4	5
Investment Cash Flow (initial)						
Acquisition Cost	$ (10,000,000)					
Investment Cash Flow		$ 700,000	$ 721,000	$ 742,630	$ 764,909	$ 787,856
Terminal Value						$ 15,456,988
Total project Cash Flow	$ (10,000,000)	$ 700,000	$ 721,000	$ 742,630	$ 764,909	$ 16,244,844
Project IRR	15.4%					
Investor Cash Flow	$ (10,360,000)	$ 540,000	$ 561,000	$ 582,630	$ 604,909	$ 15,775,704
Investor IRR	12.7%					
Fees						
Management Fee	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 160,000
Acquisition Fee	$ 200,000			$ -	$ -	
Disposition Fee	$ -	$ -	$ -	$ -		$ 309,140
Total	$ 360,000	$ 160,000	$ 160,000	$ 160,000	$ 160,000	$ 469,140

With 5% growth rate, the business itself would still turn profitable in year 2 with better returns each year respectively. 5% growth rate is quite conservative projection based on the previous analysis of the market demand for future investments from Chinese private sectors.

Year	0	1	2	3	4	5	6	7	8	9
New Project Aqcuired	$ 10,000,000	$ 10,500,000	$ 11,025,000	$ 11,576,250	$ 12,155,063	$ 12,762,816	$ 13,400,956	$ 14,071,004	$ 14,774,554	$ 15,513,282
Project Dispositioned					$ 10,000,000	$ 10,500,000	$ 11,025,000	$ 11,576,250	$ 12,155,063	$ 12,762,816
Ongoing Project	$ 10,000,000	$ 20,500,000	$ 31,525,000	$ 43,101,250	$ 45,256,313	$ 47,519,128	$ 49,895,085	$ 52,389,839	$ 55,009,331	$ 57,759,797
Value of Project Dispositioned					$ 10,143,648	$ 10,650,831	$ 11,183,372	$ 11,742,541	$ 12,329,668	$ 12,946,151
Consultant Fee										
Acquisition Fee	$ 200,000	$ 210,000	$ 220,500	$ 231,525	$ 243,101	$ 255,256	$ 268,019	$ 281,420	$ 295,491	$ 310,266
Disposition Fee	$ -	$ -	$ -	$ -	$ 202,873	$ 213,017	$ 223,667	$ 234,851	$ 246,593	$ 258,923
Total	$ 200,000	$ 210,000	$ 220,500	$ 231,525	$ 445,974	$ 468,273	$ 491,687	$ 516,271	$ 542,084	$ 569,189
Fee Income										
Management Fee	$ 100,000	$ 205,000	$ 315,250	$ 431,013	$ 452,563	$ 475,191	$ 498,951	$ 523,898	$ 550,093	$ 577,598
Business Oporating Expenses										
Employee Salary	$ 200,000	$ 206,000	$ 212,180	$ 218,545	$ 225,102	$ 231,855	$ 238,810	$ 245,975	$ 253,354	$ 260,955
Employee Benefits	$ 50,000	$ 51,500	$ 53,045	$ 54,636	$ 56,275	$ 57,964	$ 59,703	$ 61,494	$ 63,339	$ 65,239
Rent	$ -	$ -	$ -	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000
Other	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000
Total Operating Expenses	*$ 260,000*	*$ 267,500*	*$ 275,225*	*$ 323,182*	*$ 331,377*	*$ 339,819*	*$ 348,513*	*$ 357,468*	*$ 366,693*	*$ 376,193*
Profit	**$ (160,000)**	**$ (62,500)**	**$ 40,025**	**$ 107,831**	**$ 121,186**	**$ 135,373**	**$ 150,438**	**$ 166,430**	**$ 183,401**	**$ 201,405**
NPV	**$ 368,544**									
Cost of Capital	**14.8%**									
IRR	**35.2%**									

Scenario 3: Business Cash Flows

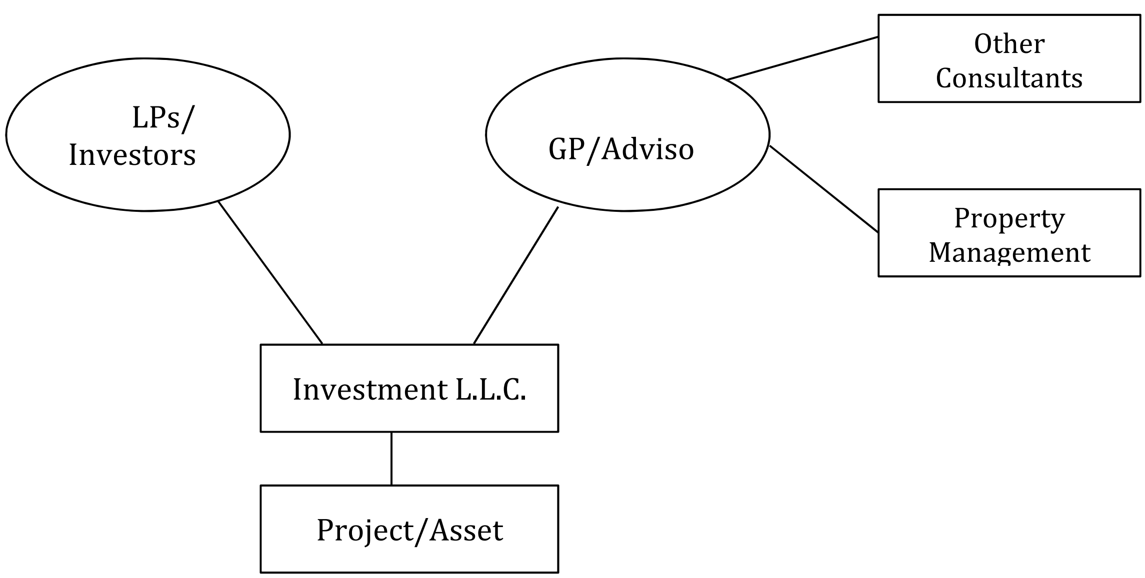
Minimal project size to start the business:

It may be arguable that the initial project size of 10,000,000 USD may be too ambitious to achieve. Based on an analysis of initial project size of 7,000,000 USD where the NPV of the project is nearly zero, and the loss at year 0 would be 190,000 USD, 97,500 in year 1 and 5,225 in year 2. Since it's such a small-scale business, continuous loss in profit over 3-year course probably would make the business non-viable. In summary, an initial project size of 10,000,000 USD to 16,000,000 USD is ideal and also essential for the viability of the business.

Year	0	1	2	3	4	5	6	7	8	9
New Project Aquired	$ 7,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Project Disposed						$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000	$ 10,000,000
Ongoing Project	$ 7,000,000	$ 17,000,000	$ 27,000,000	$ 37,000,000	$ 47,000,000	$ 47,000,000	$ 47,000,000	$ 47,000,000	$ 47,000,000	$ 47,000,000
Value of Project Disposed					$ 7,100,554	$ 10,143,648	$ 10,143,648	$ 10,143,648	$ 10,143,648	$ 10,143,648
Consultant Fee										
Acquisition Fee	$ 140,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000	$ 200,000
Disposition Fee	$ -	$ -	$ -	$ -	$ 142,011	$ 202,873	$ 202,873	$ 202,873	$ 202,873	$ 202,873
Total	$ 140,000	$ 200,000	$ 200,000	$ 200,000	$ 342,011	$ 402,873	$ 402,873	$ 402,873	$ 402,873	$ 402,873
Fee Income										
Management Fee	$ 70,000	$ 170,000	$ 270,000	$ 370,000	$ 470,000	$ 470,000	$ 470,000	$ 470,000	$ 470,000	$ 470,000
Business Oporating Expenses										
Employee Salary	$ 200,000	$ 206,000	$ 212,180	$ 218,545	$ 225,102	$ 231,855	$ 238,810	$ 245,975	$ 253,354	$ 260,955
Employee Benefits	$ 50,000	$ 51,500	$ 53,045	$ 54,636	$ 56,275	$ 57,964	$ 59,703	$ 61,494	$ 63,339	$ 65,239
Rent	$ -	$ -	$ -	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000	$ 40,000
Other	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000	$ 10,000
Total Operating Expenses	*$ 260,000*	*$ 267,500*	*$ 275,225*	*$ 323,182*	*$ 331,377*	*$ 339,819*	*$ 348,513*	*$ 357,468*	*$ 366,693*	*$ 376,193*
Profit	**$ (190,000)**	**$ (97,500)**	**$ (5,225)**	**$ 46,818**	**$ 138,623**	**$ 130,181**	**$ 121,487**	**$ 112,532**	**$ 103,307**	**$ 93,807**
NPV	**$ 47,369**									
Cost of Capital	**14.8%**									
IRR	**18.8%**									

Minimal project size to start the business

5.4 Joint venture for one-off real estate deals-- expanding stage



Business Structure of one-off real estate deals

5.4.1 Business model and structure

Once there are enough accumulated equity and track records, the service business then can be expanded to a joint venture for one-off deals; it would focus on acquisition of larger-scale assets and more complex properties in terms of leasing structures, as well as new developments.

As illustrated in the above diagram, the real estate advisor will be the general partner (GP), and the investor(s) would be the limited partner(s) in the joint venture; the work scope of the general partner includes nine major components:

1) Presenting the business plan to the investors in China, finalizing the target asset(s) or project(s), assembling investors and raising capital;
2) Identifying real estate assets/ investment opportunities in the U.S. that matches the investor's requirements;
3) In the case of acquisition, preparing or arranging due diligence studies for the potential assets, examining the past performance of the existing assets, forecasting the future cash flow and contemplating a business plan for each specific investment; in the case of new development, preparing market study, conducting feasibility study of the new development project, strategizing for entitlements;
4) Preparing investment agreements, setting up business entity for acquisition or development in the U.S.;
5) Assembling a team of consultants including but not limited to: legal consultant, accountant, tax consultant;
6) Managing the process of acquisition or the process of construction;

7) Hiring of a third-party management company to oversee the operation of the asset purchased;
8) Reporting profit or loss to the investors periodically; and,
9) Managing the disposition process of the asset.

The general partner/ advisor will participate in the deal and contribute up to 10% of equity. The general partner would profit from the development fee, and the preferred returns negotiated with the investors. If excess profit were achieved, the general partner would receive a significant percentage of promoted benefit. As the asset acquisitions become more complex, and the development of new project has the highest risk regime, the investors would expect higher risk-adjusted-returns.

Individual Limited Liability Company will be formed for each project, and be disposed once the project is completed for the partners to exit. As discussed in the previous section, the sale of the L.L.C will avoid the withholding tax in the U.S. for the sale proceeds.

One-off deals are project specific and guided by contractual business agreements. Each deal is structured based on a unique mix of investors, preferred returns and promote structure. The timing and the character of each project shall be defined in the joint venture agreement.

5.4.2 Target assets/project and clients

Some of the previous clients established during the advisory service period are anticipated to continue the collaboration with the joint venture business. The investor base would also be expanded through word-of-mouth on the previous track records. As the size of the projects and the involved risks grow, the profiles of the investors are expected to change. The investors would look for higher risk-adjusted returns on top of an alternative asset to diversify their portfolio.

The target project would be multi-tenant commercial buildings, including office, retail and market rate multi-family buildings in large metropolitan areas such as New York, DC, Boston, San Francisco and Los Angeles. If the joint venture is set up for EB-5 investor program, the potential target assets could also include hotel and senior housing that can provide job creation during the course of the investment.[55] The joint venture would also take on new development projects that range from small to mid-size. The general partner would provide the local development expertise and manage the course of the development.

5.4.3 Fund raising

As the size of the project grows, the business can start to establish Chinese local contact office. The advisor himself/herself would spend more time networking with Chinese investors through business clubs, executive business seminars, and government-organized investment forums etc. As mentioned in the previous sections that Wenzhou opens up as the first city to test the personal direct overseas investment, a local office can be set up in the city for better access to the investors' community locally.

5.4.4 Marketability and competitions

[55] More detailed information for EB-5 program is provided in Appendix III.

The challenges for one-off deal joint venture come from the uniqueness of each deal that requires thorough research and due diligent work from the general partner side. The business would anticipate a lot of overhead expense on searching and preparing for potential opportunities, and the manager himself/herself would dedicate large amount of time to assemble the deal, communicate with the investors and organize the team. Proficient management skills, experience and local networks would add into the interplays of the various essential elements required for the success of the business.

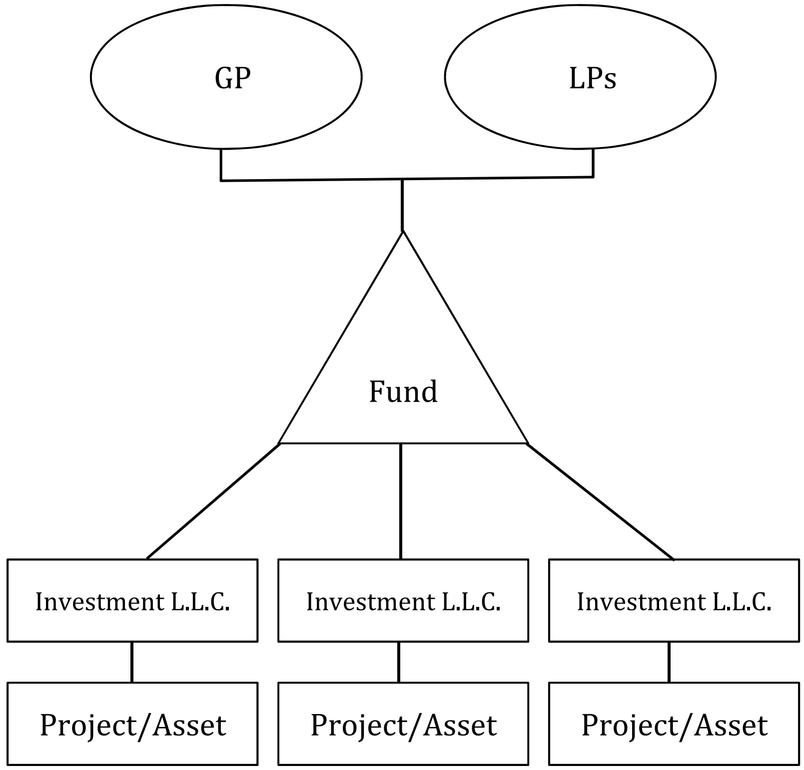
As discussed in the previous sections, current Chinese real estate investments in the U.S. are mostly from the state owned enterprises (SOE). Joint ventures between Chinese private investors and U.S. local partners are not often seen in the market. The firstly established joint ventures would benefit from the absence of competitions.

5.4.5 Profitability

The structure of the investment vehicle would work like most other joint ventures in the market today. The general partner would contribute up to 10% of equity, and receive preferred returns as the hurdle rates achieved; excess profits would be split between the general partner and the investor based on the promote agreement. Debt can be obtained, as there is established legal entity with substantial equity held for the project in the U.S.. However, it's essential to understand the expected returns from the investor side in order to perform a profitability study, and the lack of enough existing transactions and deals during the past requires further investigations. The market would also play an important role in the development of the business, as China's real estate market cools down, it will eventually alternate the expectations of the Chinese investors on real estate investments. Lastly, the financial ability of the proposed business itself would impact the profitability as well.

5.5 Foreign private real estate opportunity fund-- mature stage

The business planning for the opportunity fund is not the focus of this thesis. Like most of the domestic real estate opportunity funds, the proposed business as the general partner would participate in the deal with 1% to 5% equity contribution, and the passive investor group contributes the reaming equity. The profit is spilt based on preferred hurdle rate and promotes mechanics for the excess earnings. One thing to be noted is the taxation for foreign investors can be treated differently from the domestic investors as discussed in section 4. A generic business model is illustrated as below.



Business Structure for Foreign Private Real Estate Opportunity Funds

5.6 Conclusions and future research

As the business development plan is divided into three stages, the viability of the business shall be evaluated separately. The initial advisory business, where the advisor solely represents the investors, is the safest and achievable approach. The viability of the business is high as the only cost would be one personnel overhead. Depending on how the market would react, the business can exit at many levels to a mature fund or a full-scope real estate advisory business.

Based on the profitability study, the full-scope real estate advisory business would be a profitable if the kick-off transactions in the first year can reach 10,000,000 USD to 16,000,000 USD. As the business grows over the course of the investment, incoming projects of minimal 10,000,000 USD each year would be able to sustain the business with generous profits.

As the business turns into one-off deal model and foreign real estate opportunity fund, the structure of the investment vehicle would work like most other joint ventures and opportunity funds in the U.S. market today. The evaluation of the business profitability would require future studies based on individual deals and contractual provisions. It is also going to be impacted by the policies, when they are lifted for more free capital outflows from China and more participating investors that can form a recognizable client group.

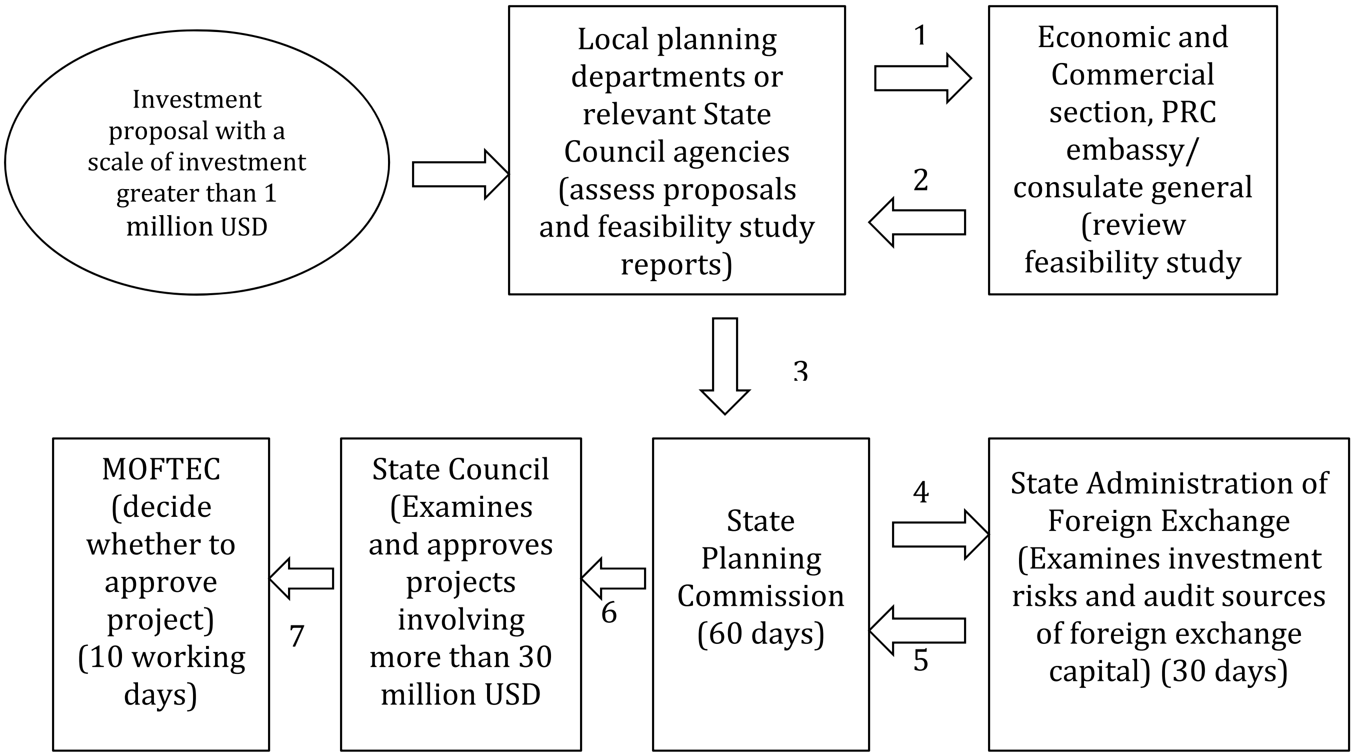
APPENDICES:

Appendix I: Interview questionnaires:

1. What are the incentives for Chinese private investors to invest in the U.S. real estate market besides market transparency, risk-adjusted return and income-generating assets, considering the investment returns in real estate market in China are much higher than that in the U.S.?
2. Did the Chinese regulations on cooling the market impact the domestic investment activities? Did these cooling measures promote the investments to the oversea markets?
3. What are the other policies that have impacted the outward real estate investments? These may include housing purchase limitation, property tax and affordable housing programs. How do you or your organization quantify these factors to evaluate the magnitudes of the impacts?
4. Are there any governmental promotion programs in China for oversea investments?
5. Have you heard of the financial relaxation policies Wenzhou? What do you think the implications of these policy changes are?
6. What are the current Chinese policies and regulations in terms of oversea investment at the private fund level?
7. What is the trend of oversea real estate investment from China?
8. What are the types of oversea real estate investors?
9. What kind of assets are the oversea investors looking for and why?

10. What are the markets geographically the oversea investors in favor of?
11. What are the concerns for the oversea investors have for the U.S. real estate market? How are the concerns addresses?
12. What are the major risks involved with such investments? Do they include currency exchange rate volatility and interest rate changes?
13. What are the implications of the taxation for the foreign investors in both home country and target country?
14. How do the foreign investors usually structure their funds in the U.S.?
15. How do the investors exit the fund invested in the U.S.?
16. What are the current most popular investment vehicles that are taking place in the U.S. real estate market when the Chinese investors set up their business?
17. Are there any regulations or legislations in the U.S. that prevent or promote foreign investments, especially from China?
18. What is the trend of the immigration investor program? Have you seen an increase of applicants over the past years?
19. What are the most challenging requirements for the EB-5 Investors to get approvals?

Appendix II: China's Approval Procedure for Overseas Investment Projects:[56]



[56] This is a general approval procedure for all types of overseas investment projects that are above 1 million USD and trigger the application process for State Council's approval. Overseas investment projects under this threshold can be approved by provincial and local governmental entities. This threshold was 1 million dollars before 2004 when National Development and Reform Commission (NDRC) lifted to 10 million dollars, and has remained since then. Source: "*China's outward Direct Investment: Expanding worldwide*" by Wong, John ad Chan, Sarah 2003

Appendix III: EB-5 Investor Program

EB-5 Investor Program has become more widely accepted in the recent years as China's economy rises, and there are more high-net-worth individuals who have immigration intentions and good financial resources. EB5 as an investment incentive is discussed in Chapter 2; this appendix provides a detailed look at how the program can be taken advantaged specifically as an investment vehicle for real estate deals.

Individual investors vs. regional center investors:

There are two methods to apply for the investment immigration visa though EB-5 Program: Individual Investor Programs and Regional Center Program:

Individual investors:

EB-5 Investor Program (individual) was erected to attract individual investors who can offer one million USD in a new business enterprise and create minimal 10-full time U.S. jobs. In this basic program, the term "new business enterprise" includes the action of creating a new business, buying an existing business, and expending an existing business. Multiple investors can pool their money to invest in any of the above business and infuse the requirement individually. If the new business is troubled business[57], the fund requirement is lowered to 500,000 USD per person. In the term of real estate, many of the distresses assets or businesses could fit into the category. The Individual investor program fund requirement is also lowered to 500,000 USD per person if the investment is made in a

[57] Troubled business is one that has existed for minimum 2 years and incurred a lost of at least 20% of the total net worth one to two year prior to the application.

business that locates in a Target Employment Area (TEA)[58]. Besides creating 10 full-time jobs (foot note), the investors are also required to live where the investment locates and play an active role in running their business.

Regional Center Investors:

Regional Center Investor Pilot Program was created by USCIS to specifically help economic stressed areas. These centers initiate business plans and pool the money from the investors. The fund requirement is lowered to 500,000 USD per person, and the investors are exempted from 10 direct job creations and the participation of the day-to-day management of the business.

This option essentially is created for people whose sole intent of the investment is immigration, and who potentially do not have any business and investment experience and expertise. Although the program sometimes channels the pooled money to a real estate limited partnership program, the substance of the program is geared towards a carefree business model for immigration purpose, and the investors are not involved in the operation of the business. Therefore, it is not ideal for creating business with the intent of meaningful real estate investment, nor is the focus of the paper.

The table below shows the different characters of the Individual Investor Program and the Regional Center Investor Program:

[58] TEAs are defined as either: (1) rural areas (areas with populations of less than 20,000), or (2) areas with unemployment rates 150% or more of the national rate. If the investment is made in a TEA, a reduced $500,000 investment is allowed. In the past, TEAs have been focused on the development of rural locations. With the economic downturn in recent years, typically prosperous metropolitan neighborhoods may now qualify for the reduced threshold investment based on increased unemployment rates.

	Individual Investor Program	**Regional Center Investor Program**
Fund Requirement	1,000,000 USD	1,000,000 USD
	500,000 USD in TEA	500,000 USD in TEA (most Regional Centers locate in TEA)
Job Creation	10 full-time jobs up front prior filling for initial application	No requirement
Time Frame	2 Years	2 Years
Investment Intent	Start and manage a business in the U.S. and maximize the profits from the investments	Obtain an U.S. permanent residence Visa
Investment Management	Fully control over the investment, and are required to participate day-to-day management of the business/investment	No requirement
Investor Experience	Business and investment background required	No requirement
Business structure	Corporations Limited Liability Companies Limited Partners	Most regional centers are Limited partners, management of the business is performed by the general partner at the center
Geographic Location	Stay at the place where the investment takes place	Geographically mobile (Many investors chose to stay outside of the US during the process)

Individual Investor Program and Regional Center Investor Program

Meeting the hurdle requirements:

After identifying the individual investors as the target client group for the proposed business, there are two major hurdles that the investors need to overcome to be eligible for the program. Based on an interview with an immigration attorney, most disapproved cases in pursuing individual EB-5 program are related two problems: 1) failure to provide funds; and 2) failure to create jobs as required.

1) Sufficient Funds:

   Individual EB-5 investments are either 500,000 USD or 1,000,000 USD depending upon whether the investment project locates in a TEA or whether the invested business is a troubled business. If the proposal is based on the reduced $500,000 investment threshold, it must clearly identify the TEA. In order to prove that the proposed regional center is located in an area of high unemployment, the proposal must either submit unemployment rate data or obtain a letter from an authorized State agent certifying that the area has been designated as having a high rate of unemployment. Unemployment statistics can be obtained from the U.S. Census Bureau (http://quickfacts.census.gov/qfd/index.html) and the Bureau of Labor Statistics (www.bls.gov/lau/). States, the District of Columbia, and the U.S. territories may also publish local area unemployment statistics on their government websites. Certification letters can be obtained from State governors, unless the governor has chosen another governmental entity for this purpose. (For example, the Texas Workforce Commission has been designated to certify TEAs in the State of Texas.) (Source: Zhang & Attorneys, L.P.)

Lastly, USCIS is very strict about the legitimacy of the fund resource. Many private Chinese investors are reluctant to reveal their personal identities and income source, and may not be eligible for the program.

2) Failure to create jobs:

The investor must scrutinize the process of job creation with sufficient documentation and proof. An economic model or business plan must be provided to demonstrate the methodologies utilized for determining job creation. Current EB-5 investors favor hotels, as they can easily create jobs that are required for the application.

USCIS now considers direct and indirect construction jobs created by the investor that last at for at least 2 years. For instance, if a petitioner can reasonably prove the need for construction work for 35 hours a week over the course of at least two years, such positions will meet the full-time requirement. However, if on the same project, the petitioner hires electricians who only came intermittently for three or four-week periods over the course of the project, such positions would not meet the full-time requirement. (Source: Zhang & Attorneys, L.P.)

In the case of one-off joint venture deals for new development, construction job creation requirements are definitely achievable.

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