



观韬律师事务所

GUANTAO LAW FIRM

Tel: 86 10 66578066 Fax: 86 10 66578016  
E-mail: guantao@guantao.com  
http: // www.guantao.com

中国北京市西城区金融大街 28 号  
盈泰中心 2 号楼 17 层  
邮编: 100140

17/F, Tower 2, Yingtai Center, No.28  
Finance Street, Xicheng District, Beijing  
100140, China

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## Financial Strategy Adopted by Real Estate Companies and REITs

By Dong Jianjin

**R**eal Estate Investment Trusts ("REITs") have become a financial innovation area closely watched by real estate and financial industries since they were confirmed by the State Council in December 2008. REITs have also been recognized and understood by more and more people in China. After two years' rigorous study of REITs by the relevant supervision departments, pilot rules and supporting regulations have taken shape and are expected to come into effect in China within this year.

However, there are certain differences between Chinese REITs to be launched and internationally-recognized REITs in the structure and rules. In consideration of the complexity of this product itself, a large number of participants and the multiple supervisions in financial industry, most real estate companies have no idea as to whether they are ready for REITs and how to carry out the business. Here are some tips:

### **I. See if the company has suitable property for REITs.**

REITs are in fact asset securitization, the key factor of which is the quality of the underlying property. Therefore, a real estate company who intends to carry out REITs business needs to check:

1. Whether it has a certain amount of holding property.

Holding property refers to unsold property, held and operated by real estate enterprises for rental income, such as office buildings, stores, hotels, industrial premises, residential property. Generally speaking, holding property mainly includes commercial property and industrial property, as residential property only for rent makes up a very small proportion in the market.

Most of the real estate enterprises in China engage in the traditional development of residential property and get the money back at one time by the way of sale. Especially in the last few years, real estate enterprises benefit a lot from the vigorous growth in the housing price. Compared with the high price of real estate transaction, the rental income is relatively low and kept at a stable level. Moreover, real estate enterprises are reluctant to do housing rental business in consideration of the costs of funds being tied up.

The prerequisite for REITs is to hold a certain amount of property, the title of which is good and complete without any split sale. Thus, a whole block of building whose ownership is complicated and dispersed is not fit for REITs pool.

2. Whether the holding property is mature enough to be capable of generating stable cash flow.

With the lingering fear of the financial crisis, risk control rises as the primary concern to launch REITs although the Chinese Government has determined to continue financial innovation with asset securitization as the core. For REITs, the quality of the underlying property is the first checkpoint of risk control, especially to assess its ability to generate future cash flow.

The purpose of investing in REITs for investors is to share rental income from the property. In USA, 90 percent of the collected rent from REITs goes to investors. Therefore, rental yield is a key factor in REITs' pricing. REITs are only fit for mature property. However, at the current property price level, rental yield is generally low. The rent-year yield of REITs should equal that of other bonds at the

same time. As a result, there is not much holding property that may satisfy such requirements for REITs on the market.

Consequently, at the beginning of the performance of REITs pilot, there must be rigid requirements for the quality of real estate. First of all, there should be steady rental income. Secondly, the rental yield should be relatively low. Thirdly, most likely the transfer price of real estate to REITs should be lower than the market price by then. Companies should have knowledge of all the requirements and make necessary preparations in advance.

## **II. See if the intent to engage in REITs business matches its long-term development strategy.**

News tells us that “the launch of REITs expands finance channels and is good for real estate companies.” It is right but not entirely accurate. Financing is only one of its functions, and REITs is not always better than other existing finance channels. That is why many managers of real estate companies discuss it with a lot of interests but then feel disappointed after having in-depth knowledge about REITs. As a result, it is necessary for companies to assess the applicability of REITs.

Real estate companies, especially companies with holding property, are in high demand for funds. The existing finance channels include bank loans, issuing shares or bonds, as well as sale of property. No matter they are debt REITs (to be adopted by the Central Bank) or equity REITs (to be adopted by the stock exchanges), the loan-to-value (LTV) ratio is likely to be lower than 70%. This means bank loans may be more effective in the scale of financing. Nevertheless, considering the cost of financing for debt REITs will be much lower than that of bank loans, and even lower than that of issuing of bonds, debt REITs might be a good choice for companies who are not eager to seek plenty of funds but hope to seek new finance channels with lower costs.

However, it is clear that equity REITs have more features of real REITs. Equity

REITs are similar to making underlying assets listed so that the shares can be publicly traded. This is an excellent way for investors to invest in real estate. While for real estate companies, considering the transfer price of properties to REITs may be lower than the market price, equity REITs may not be a good way to raise money, but they can expand another way of development for real estate companies. The companies can raise funds by selling property developed by them to REITs. In the meantime, they may hold partial units of REITs so as to keep enjoying benefits from the property. In addition, they can manage the REITs funds and receive certain management fees. By this means, the real estate companies can revitalize the capital chain by not only selling their property but also enjoying benefits generated from the property in a more sustainable way. As we can tell from oversea REITs practices, many companies have turned from simply developing real property into a real estate financial company through engaging in REITs business. As now in China, the profit from real property development sees a growing decline and it has become more and more difficult for the real property companies to gain financial support from banks, companies with foresight should consider equity REITs to complete the business transformation.

In conclusion, when deciding whether to carry out REITs business and which market to choose, the companies should first of all be clear about their development strategy and the demand for REITs. Companies considering expanding corporate finance channels are advised to issue debt REITs, while companies considering expanding new business are advised to issue equity REITs.



*Dong Jianjin:*  
*E-mail: [jdong@guantao.com](mailto:jdong@guantao.com)*

**Dong Jianjin,**  
**Partner,**  
**Guantao Law Firm**

This information has been prepared by Guantao Law Firm.

For further information, please contact Ms. Xu Ling ([xuling@guantao.com](mailto:xuling@guantao.com))

or your usual adviser.