The significance of the introduction of REITs in China and seeking the suitable REITs for Chinese real estate industry

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Part I Introduction

The Chinese real estate industry has developed very fast in the last 30 years and has become one of the pillar industries in China. However, the real estate business model is primitive; and more importantly, the real estate enterprises have an unusual capital structure: too much reliance on bank loans, other financing sources such as bonds and trusts have very little influence. This is not conducive to the long-term development of the real estate industry, and brings a high financial risk for the financial market, thus is a potential threat to the national economy. Furthermore, China is one of the countries with the highest personal saving rate; one of the most important reasons for this is lack of investment opportunities on the financial market. China’s financial market needs more financial products.

The introduction of Real Estate Investment Trusts has an important meaning to the real estate industry and financial market. REITs can provide effective financing sources for the real estate industry, and give the investors investment opportunities with potentially high returns and low risks.

This thesis attempts to analyze the significance of the introduction of REITs for the Chinese real estate industry and financial market, and the purpose is to seek a suitable and operable REITs framework for China.

There are basically four parts of the thesis: The first part is the overview of REITs. It contains the definition of REITs; the performance of REITs as financial products; and an international comparison of REITs. The second part is the background of the Chinese real estate industry. It includes the significance of real estate industry to the Chinese national economy, the financing sources of the real estate industry, and the problems exist in the structure of financing. The third part is the significance of REITs introduction in China. In this part, the effect of the introduction on the real estate industry, the financial market and the investors will be analyzed. The fourth part attempts to seek the suitable framework for REITs in China, includes the feasibility, the development strategy, the barriers and policy recommendations for the REITs introduction and development in China.
Part II Overview of REITs

Real Estate Investment Trusts (REITs) were first introduced in the U.S. by the Real Estate Investment Trust Act of 1960. Since then, they have been introduced to other countries. REITs have a history of development for more than 40 years around the world and have become a mature investment fund.

2.1 The concept of REITs

“A real estate investment trust, or REIT, is a company that owns, and in most cases, operates income-producing real estate. Some REITs also engage in financing real estate. The shares of many REITs are traded on major stock exchanges.”\textsuperscript{1}

Real Estate Investment Trust refers to a corporation or trust that pools capital of numerous investors and uses the capital to purchase and manage income property or mortgage loans. REITs can be traded on exchanges just like stocks. REITs can bring more or less tax favorable which is also an important reason for the investors to invest in REITs.\textsuperscript{2}

A REIT is a tax-privileged corporation, whose principal business is to own property and operate. Even companies that finance real estate can be a REIT. REITs invest in all types of real estate and generate profits mainly from the rental of property.\textsuperscript{3}

2.2 Characteristics of REITs

As a fund product, REITs have a fund’s general characteristics, such as high mobility, expert management, risk diversification, investment facilitation, high transparency, etc. However, REITs are also different from other funds. Returns and risks will be compared as two primary aspects (U.S. REITs as an example).

\textsuperscript{1} NAREIT http://www.reit.com/AllAboutREITs/WhatIsAReit/tabid/59/Default.aspx
\textsuperscript{2} http://www.investorwords.com/4158/REIT.html
\textsuperscript{3} Pfitz 2007 Immobilienaktien und REITs, page 49
2.2.1 Returns

In the U.S., 90% of the income generated by REITs should be distributed as dividends. The only area for REITs to invest is the real estate industry. The tax conditions and the investment scope determine the characteristics of REITs as an investment product.4

Figure 1: 20-Year Average Annual Total Return (02.1990 – 02.2010)

Source: NAREIT®, FactSet.

Figure 1 shows that the average annual total return of REITs (for example, FTSE NAREIT All REITs and FTSE NAREIT Equity) is higher than most of the bonds and normal stocks but lower than fast-growth companies (NASDAQ).

Figure 2 illustrates that equity REITs offer strong long-term total returns. If one would invest $100 million in equity REITs in January 1978, it would have been worth more than $3,200 million in December 2008. The returns on equity REITs exceeded not only the broad equity market but also other forms of real estate investment, during the period from January 1978 to December 2008. 5

4 http://www.reit.com/AboutREITs/WhatsareIT.aspx
Figure 2: Growth of $100 Million Invested during the Period from Jan.1978 to Dec.2008

Source: NAREIT® and NCREIF

Figure 3: Equity REIT Dividend Yield v. 10-Year Constant Maturity Treasury Yield

Source: NAREIT®, FactSet.

Figure 3 compares the dividend yield of the Equity REITs with the U.S. 10-Year Treasury. We can see from the figure that the general return of equity REITs is higher than the U.S. 10-Year Treasury. The monthly equity REIT dividend yield spread

---

6 Yield spread calculated by taking the Equity REIT dividend yield less 10-year constant maturity Treasury yield
As Figure 4 shows, the total return index of equity REITs is on average higher than S&P 500 and Russell 2000, during the period 1990-2010. As mentioned above, the investment characteristics of REITs are high dividend and moderate growth. The performance of REITs is primarily affected by the economic conditions and the performance of the real estate industry. For instance, REITs had been significantly affected by the Subprime mortgage crisis since 2006.

2.2.2 Risks

The investment risk of REITs is relatively small and there is a low correlation between REITs and other financial products. Modern portfolio theory holds that diversification is the key to minimizing overall risk. To do so, investors should find different types of asset with low negative correlation. Analysts and portfolio managers are inclined to consider the low correlation investments for the diversification (approximately 60 percent or less).

Figure 5 shows that since 1992 the average correlation coefficient between equity

---

7 REITWatch, Page 8, March 2010, NAREIT
REITs and S&P 500 is 38.3%. It illustrates the high diversification potential of REITs. In contrast, most of other equity indexes have a higher correlation of more than 60% with S&P 500.

**Figure 5: Correlation between Equity REITs and S&P 500**

Similarly, REITs have lower “betas”\(^8\) compared to other investment vehicles. According to Capital Asset Pricing Model, \(E(r_p) - r_f = \beta(E(r_m) - r_f)\), the risk premium is equal \(\beta\) times market premium. \(\beta\) is the sensitivity of the expected excess asset returns to the expected excess market returns.\(^9\) For the period 1992-2007, the beta of the equity REITs indexes relative to the S&P 500 was about 30%, comparing to the most equity indexes with 50% or more.\(^10\)

**Figure 6: Equity REIT Dividend Growth vs. CPI**

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REITs can also offset inflation. As the value basis of REITs, real estate has a strong function of maintaining value. On the one hand, if inflation increases, the investors will move money to the real estate. As a securitized form of real estate, REITs will have increased demand, the share price and shareholder value will increase as well. On the other hand, as inflation increases, the rent which is the major income of REITs increases simultaneously. Hence, REITs are effective investment instruments for inflation hedging. Figure 6 and 7 illustrate the inflation hedging function of REITs.

2.3 Types of REITs

According to different criteria for the classification, REITs can be divided into different types. (Chan, Erickson and Wang, 2003)

<table>
<thead>
<tr>
<th>Criteria of Classification</th>
<th>Categories of REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Organization</td>
<td>Contractual Funds and Corporate Funds</td>
</tr>
<tr>
<td>Fund Invested</td>
<td>Equity REITs, Mortgage REITs and Hybrid REITs</td>
</tr>
<tr>
<td>Fund Raising</td>
<td>Publicly Traded REITs, Public</td>
</tr>
</tbody>
</table>
2.3.1 Equity REITs, Mortgage REITs and Hybrid REITs.

Considering the purpose of the thesis, we will primarily analyze the equity REITs, mortgage REITs and hybrid REITs.

**Equity REITs** are REITs which own and operate income-producing real estate. The portfolio of an equity REIT depends on its business strategy, but generally an equity REIT owns and operate real estate such as shopping center, apartment, office, storage, etc. The income is not only the rent, but also the appreciation of the property. There are two patterns of investment, one is purchasing the property directly and operating it; the other one is investing in other real estate companies, invest and operate indirectly. The reason for indirect investing is that it can adapt the regional differences of real estate industry, it can make multi-region operation possible, in order to achieve diversification and reduce the overall risk of the REIT.

<table>
<thead>
<tr>
<th>Table 2: Comparison of Equity, Mortgage and Hybrid REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Investment Pattern</strong></td>
</tr>
<tr>
<td>Direct or indirect purchase</td>
</tr>
<tr>
<td><strong>Investment Target</strong></td>
</tr>
<tr>
<td><strong>The main factors affecting earnings</strong></td>
</tr>
<tr>
<td><strong>Income Stability</strong></td>
</tr>
<tr>
<td><strong>Investment Risk</strong></td>
</tr>
<tr>
<td><strong>Similar Investment Target</strong></td>
</tr>
</tbody>
</table>

Note: The reason why mortgage REITs are more stable type of income and lower investment risk, is based on the professional investment managers adequacy to the
value of the collateral and liquidity to make the right judgments.

**Mortgage REITs** act as a financial intermediary, raise money and lend it to real estate owners and their operators. Mortgage REITs can also lend money indirectly through acquisition of loans or mortgage-backed securities. The income is mainly from payment of fees charged by mortgage loans and mortgage loan interest.

**Hybrid REITs**, as the name suggests, not only own properties, but also make loans to owners and operators.

### 2.4 REITs International

The concept “Real Estate Investment Trust” in many countries was taken over from the model of the U.S., but there are also different names for REIT in different countries.

**Table 3: REIT in Different Countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Appellation</th>
<th>Abbr.</th>
<th>Introduction</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S.A</td>
<td>Real Estate Investment Trust</td>
<td>REIT</td>
<td>1961</td>
</tr>
<tr>
<td>Netherlands</td>
<td>Fiscale Beleggingsinstelling</td>
<td>FBI</td>
<td>1969</td>
</tr>
<tr>
<td>Australia</td>
<td>Listed Property Trusts</td>
<td>LPT</td>
<td>1971</td>
</tr>
<tr>
<td>Canada</td>
<td>Real Estate Investment Trust</td>
<td>REIT</td>
<td>1994</td>
</tr>
<tr>
<td>Belgium</td>
<td>Société d’Investissement à Capital Fixe Immobilière</td>
<td>SICAFI</td>
<td>1995</td>
</tr>
<tr>
<td>Japan</td>
<td>Real Estate Investment Trust</td>
<td>J-REIT</td>
<td>2001</td>
</tr>
<tr>
<td>Korea</td>
<td>Korean Real Estate Investment Trust</td>
<td>K-REIT</td>
<td>2001</td>
</tr>
<tr>
<td></td>
<td>Corporate Restructuring REIT</td>
<td>CR-REIT</td>
<td>2001</td>
</tr>
<tr>
<td>Singapore</td>
<td>Singapore Real Estate Investment Trust</td>
<td>S-REIT</td>
<td>2002</td>
</tr>
<tr>
<td>France</td>
<td>Société d' Investissements Immobiliers</td>
<td>SIIC</td>
<td>2003</td>
</tr>
</tbody>
</table>

11 Note: the section 2.4 is based on:
2.4.1 U.S.A

As the motherland of REITs, the U.S. created the first REIT in 1960. Small private investors investing in large commercial real estate became possible. As investment vehicles, REITs have advantage of low risks due to diversified real estate portfolios; and stock exchange listing provides high liquidity, high transparency and better corporate governance.

There are three choices for the REITs’ legal form to be: a legal corporation, trust or association. A REIT must be guided by the management board and supervisory board or a trustee. But a stock exchange is not necessary.

Seventy-five percent of the total asset must be invested in real estate, cash positions, government bonds or mortgages. The investment in subsidiaries is limited to 20% of the total assets of the REITs. Shareholdings in other companies with no closer integration may not exceed 10% of the share capital. In addition, such a holding in a single company may not exceed 5% of the total asset. Insurance or other financial service providers may not be converted to a REIT.12

Seventy-five percent of revenue must be earned from rental and leasing, thereto, mortgage interest rates, real estate disposals, interest rates from government bonds or demand deposit will be also expected. The income from the core business of real estate must be at 95%. To the core, beside the actual real estate transactions, is the income from subsidiaries and the stock of third company taken account. The revenue from transactions that do not belong to the real estate sector may be not more than 5%.

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The minimum payout is 90%. A loan borrowing is possible without restriction. A company that meets the prerequisite of REIT status can deduct business expenses from the corporation tax as undistributed profits. Due to this advantageous regulation, most of the REITs pay out one hundred percent of the taxable profit to the shareholders. The payment of corporation tax no longer applies. The majority of the federal states accept this taxation on REITs on the federal level.

Figure 8: REITs Invest in All Property Types in the U.S.

Around 190 REITs were registered on the American Securities and Exchange Commission (SEC) in 2007; most of them are traded on the major stock exchanges such as New York Stock Exchange, only about 20SEC-registered REITs were not listed. The total market capitalization of listed REITs was 400 billion USD. In addition, there are approximately 800 REITs operated as “private REITs”, that are neither registered on the SEC nor public traded.

In the U.S., REITs has a very diverse profile, they are across a broad range of specific real estate property sectors. The investors have many alternatives.

As figure 8 shows, properties such as apartments, health care, office buildings, and shopping centers are the common areas for REITs. (62% of the REITs invest).
2.4.2 Australia

The introduction of REITs in Australia was in 1971, Australia is one of the first countries that introduced REITs after the U.S. The Australian REITs are so-called “Listed Property Trusts”, now known as A-REITs. There are more than 70 A-REITs listed on the Australian Securities Exchange.\footnote{http://www.incomeinvesthome.com/growth/reit/areit/} The market capitalization as Figure 9 shows.

![Figure 9: A-REITs market capitalization on ASE](source: Australian Securities Exchange)

The legislations for REITs in Australia are relatively liberal. Stock market listing is not necessary; the minimum proportion of real estate transaction is not stipulated; credit raising is unlimited; foreign investment is unlimited. The income of the REITs is tax-free, as long as the REITs pay 90% (minimum payout ratio) dividend to the shareholders.

The major income of the A-REITs is from rental. In practice, the A-REITs invest in both domestic and foreign real estate, such as properties in the United States, the UK and New Zealand.

2.4.3 United Kingdom

The introduction of REITs in the UK took place in 2007. For a UK-REIT, a public company is required and the stock exchange listing is obligatory. Similar to the REITs
in the U.S., at least 75% of all proceeds must be generated from real estate, and 75% of all investments have to be located in real estate. The total annual income must be a quarter higher than the annual interest on borrowed capital, which means leverage is limited. A single object can have a maximum proportion of 40 percent of the portfolio. The issuance of convertible debt is not allowed. The minimum payout ratio is also 90%. Income on the company’s level is tax-free. The shareholders’ dividend tax rate is 20%. The share of a single shareholder is limited to 10% of the share capital or the dividends paid. All income from the non-real estate sector will be burdened with corporate tax. Foreign shareholders will also be levied with 20%.

2.4.4 Hong Kong

Hong Kong REITs (H-REITs) were introduced in Hong Kong in 2003. Similar to the UK-REITs, an investment company as the legal form and stock exchange listing are required for an H-REITs. The REITs regulation in Hong Kong is relatively strict. At least 90% of the money must be invested in real estate, with a long-term investment of at least two years. Foreign investment is not allowed (only in Hong Kong). The borrowing is limited to 35% of the gross value of fixed assets. Interestingly, H-REITs are not tax-favorable, which is quite different to other countries; the minimum payout ratio is 90% of the net profit after tax. In 2008, there were 3 H-REITs with total market capitalization of 7.56 billion U.S. dollars.

2.4.5 Japan

Japan is the first Asian country for the REITs introduction. J-REITs exist there since 2001. The Japanese system of REITs is quite different from other countries. There are two types of J-REITs: independent real estate companies (Corporate Style) and

http://www.landsecurities.com/investors/shareholder-investor-information/uk-reit-taxation
http://www.cnfre.com/contents/953/47710.html
investment trusts (Contract Style).

Corporate Style J-REITs are the independent real estate companies that specialize in real estate management; and investors have shares in such companies.

Contract Style J-REITs consist of direct and indirect investment trusts. The direct investment trusts gather money from the investors and invest it in real estate, play a role as investment banks. In contrast, with the indirect investment trusts, investors’ money will be gathered and invest in investment banks which pay dividend to the shareholders.

The majority of J-REITs are Corporate Style. A stock exchange listing is not necessary for both Corporate and Contract Style of J-REITs. In 2007, there were 41 J-REITs with a total market capitalization of about 6.2 trillion JPY. Most of the J-REITs are traded on Tokyo Stock Exchange and the main participants are foreign investment banks and Japanese conglomerates.

The minimum payout ratio is 90% for J-REITs. At least 75% of the total assets must in real estate business and more than 50% of the income must be generated from real estate transactions. The minimum investment volume for a J-REIT is 5 billion yen; an individual stock must be at least 50,000 yen. Leverage is unlimited.

In order to ensure a liquid trading turnover on the stock market, each J-REIT must have at least 1,000 shareholders and at least 4,000 shares on the stock exchange after the company being listed. The total shares that hold by the three largest shareholders are not allowed to be more than half of the share capital, the ten largest shareholders’ share shall not exceed the limit of 75% of the total share capital, so that it will be enough float for the small investors.

2.4.6 South Korea

REITs were introduced into South Korea in 2001. Similar to J-REITs, there are two categories for REITs in South Korea: the Korean Real Estate Investment Trust (K-REIT) and the Corporate Restructuring REITs (CR-REIT). Table 4 displays these

characteristics.

<table>
<thead>
<tr>
<th>Organization</th>
<th>K-REITs</th>
<th>CR-REITs</th>
</tr>
</thead>
<tbody>
<tr>
<td>Real entity with infinite-life</td>
<td>Paper company with finite-life</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Object of investment</th>
<th>Real estate</th>
<th>Real estate subject to corporate restructuring</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Asset management</th>
<th>Self managed</th>
<th>Assets must be managed by independent companies</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Requirement of establishment</th>
<th>Minimum capital requirement</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>50 billion won</td>
<td>Less than or equal to 10% per capita</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Requirement of asset management</th>
<th>Asset requirement</th>
<th>Requirement of asset management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Asset requirement</td>
<td>At least 70% of the value of a REITs must consist of real estate assets</td>
<td>At least 70% of the value of a REITs must consist of real estate assets</td>
</tr>
<tr>
<td></td>
<td>At least 90% of the value of a REITs must consist of real estate assets</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income requirement</th>
<th>None</th>
<th>None</th>
</tr>
</thead>
</table>

| Distribution requirement | At least 90% of distributable income has to be distributed to shareholders | At least 90% of distributable income has to be distributed to shareholders, only if exempt business tax |

<table>
<thead>
<tr>
<th>Limitation on asset management</th>
<th>Limitation maximum (30%) on the development of real estate</th>
<th>Limitation maximum (30%) on the development of real estate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Prohibition of borrowing</td>
<td>Prohibition of borrowing</td>
</tr>
<tr>
<td></td>
<td>Limitation of asset disposal</td>
<td></td>
</tr>
</tbody>
</table>

| Corporate tax exempt | None | 100% exempt if at least 90% of distributable income has to be distributed to shareholders |

Source: Park, W., 2002. Characteristics of Korean REITs and their Economic Impacts

### 2.4.7 Singapore

The REIT in Singapore is called Singapore Real Estate Investment Trust (S-REIT) which is launched in 2002. S-REIT can take the form of a corporation or an investment trust and the listing is required. In 2005, there were six S-REITs in Singapore and the market capitalization reached a value of 5.5 billion Euros. (Zhou
and Lin, 2006) The minimum payout is in Singapore amazing one hundred percent. 70 percent of all assets must be real property or real estate related assets such as real estate corporations, real estate funds or Mortgage Backed Securities. Only 20 percent will be allowed to invest in the development project in Singapore or abroad. The borrowing is limited to 35 percent of total assets.

S-REIT which is a very good credit rating (A-category) suggested by international rating agencies and h can extend the credit line. In order to get a good free float, S-REIT must have at least 500 shareholders. S-REITs which have a legal form of investment trusts receive from the tax authorities in Singapore an indirect relief in the form of tax credits for the shareholders once they get the distribution. S-REITs which operate as corporations have no tax exemption. For the foreign shareholders, the withholding tax rate is 10%.

S-REITs have stable investment return. They cut huge real estate investment into small pieces using the form of bond so that they have better liquidity and ability anti inflation. (Yang and Wang, 2005)
Part III The Background of Chinese Real Estate Industry

3.1 The background of the Chinese economy

The Chinese economy has been developing very rapidly since 1978. From 1978 to 2008, the GDP increased from 364.52 billion Yuan to 30.07 trillion Yuan, with an average growth rate of 9.85% p.a. In 2009, China has become the third largest economy in the world. Because of the rapid economy development and large population, China is one of the most important emerging markets.

Figure 10: China’s GDP in the last 30 years

Source: China Statistic Year Book 2009

Figure 11: China’s GDP per capita in the last 30 years

Source: China Statistic Year Book 2009

Figure 10 and 11 illustrate the rapid development of the Chinese economy, the

17 National Bureau of Statistics of China
GDP in year 2008 was 83 times of the GDP in 1978, GDP per capita in 2008 was nearly 60 times more than in 1978. This has been recognized as an “economic miracle”.

Table 5: International comparison of GDP

<table>
<thead>
<tr>
<th>Countries of Regions</th>
<th>2008 GDP 100 Million USD</th>
<th>GDP Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2004</td>
</tr>
<tr>
<td>World</td>
<td>606898</td>
<td>3.96</td>
</tr>
<tr>
<td>Australia</td>
<td>10107</td>
<td>3.85</td>
</tr>
<tr>
<td>Brazil</td>
<td>15728</td>
<td>5.71</td>
</tr>
<tr>
<td>China</td>
<td>44016</td>
<td>10.11</td>
</tr>
<tr>
<td>France</td>
<td>28657</td>
<td>2.22</td>
</tr>
<tr>
<td>Germany</td>
<td>36675</td>
<td>1.18</td>
</tr>
<tr>
<td>India</td>
<td>12097</td>
<td>7.90</td>
</tr>
<tr>
<td>Italy</td>
<td>23139</td>
<td>1.53</td>
</tr>
<tr>
<td>Japan</td>
<td>49238</td>
<td>2.74</td>
</tr>
<tr>
<td>Russian Fed.</td>
<td>16766</td>
<td>7.20</td>
</tr>
<tr>
<td>United Kingdom</td>
<td>26741</td>
<td>2.76</td>
</tr>
<tr>
<td>United States</td>
<td>142646</td>
<td>3.64</td>
</tr>
</tbody>
</table>

Source: China Statistic Year Book 2009

With the rapid economic development, the urbanization is very fast. In 1978, the proportion of the urban population to the total population was 18%, and in 2008 it had been 46%. The rapid urbanization creates strong real estate demand. (Figure 12)

For the development of the Chinese economy, the financial market plays only a limited and inefficient role in allocating resources. Banks play a more important role than the financial market in China. However, the Chinese banking system is under-developed and inefficient; it is controlled by the four largest state-owned banks that have a large amount of non-performing loan. This brings a high potential risk for the long-term development of the Chinese economy. Further development of the

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18 International Monetary Fund Database
19 China Statistic Year Book 2009
The Chinese economy has made a rapid development in the recent 30 years. It has become the world's third largest economy after the United States and Japan. On average, investing $100 can generate demand of $170-200 in related industries; every $100 residential sales can lift $130-150 demand for other goods. The Chinese real estate industry has developed very rapidly, and becomes more and more significant for the national economy.

Figure 13 illustrates the rapid development of the Chinese real estate industry. From 1998 to 2008, the real estate investment increased from 361.4 billion Yuan to 3.12 trillion Yuan, with an average annual growth rate of 23.8%. The proportion of the real estate investment to GDP showed a rising trend, from 4.28% in 1998 to 10.38% in 2008.

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20 China Real Estate Industry Annual Report 2009, China Economic Information Network.
As figure 14 shows, the investment on real estate had an average growth rate of 23.2% during the period 1998-2008, compared to average GDP growth rate of 9.2% and average growth rate of total investment of fixed assets of 19.5%. The growth rate of
real estate investment was significantly higher than the GDP growth rate. The proportion of real estate investment to total investment of fixed assets was 17.45%. There are more than 70 industries that are related to the real estate. The real estate industry is playing an important driving role for the national economy in China.

3.3 Financing channels of the Chinese real estate industry

3.3.1 Overview of real estate financing in China

From a structural point of view, the domestic loans, self-raising and other funds are the major parts of the sources of funds of enterprises for real estate development, accounted for more than 98%.

The main financing channels of Chinese real estate business are bank loans, issuing shares, cooperative development and pre-paying from the customers etc. Commercial bank loan is still the main financing channel.

Table 6: Sources of Funds of Enterprises for Real Estate Development (10,000 Yuan)

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Funds</th>
<th>Domestic Loans</th>
<th>Foreign Investment</th>
<th>Self-raising Funds</th>
<th>Others</th>
</tr>
</thead>
<tbody>
<tr>
<td>1997</td>
<td>38170650</td>
<td>9111902</td>
<td>4608565</td>
<td>9728831</td>
<td>14547872</td>
</tr>
<tr>
<td>1998</td>
<td>44149422</td>
<td>10531712</td>
<td>3617581</td>
<td>11669821</td>
<td>18118509</td>
</tr>
<tr>
<td>1999</td>
<td>47959012</td>
<td>11115664</td>
<td>2566022</td>
<td>13446210</td>
<td>20631956</td>
</tr>
<tr>
<td>2000</td>
<td>59976309</td>
<td>13850756</td>
<td>1687046</td>
<td>16142122</td>
<td>28192905</td>
</tr>
<tr>
<td>2001</td>
<td>76963877</td>
<td>16921968</td>
<td>1357044</td>
<td>21839587</td>
<td>36705562</td>
</tr>
<tr>
<td>2002</td>
<td>97499536</td>
<td>22203357</td>
<td>1572284</td>
<td>27384451</td>
<td>46198961</td>
</tr>
<tr>
<td>2003</td>
<td>131969224</td>
<td>31382699</td>
<td>1700040</td>
<td>37706891</td>
<td>61060503</td>
</tr>
<tr>
<td>2004</td>
<td>171687669</td>
<td>31584126</td>
<td>2282001</td>
<td>52075627</td>
<td>85625867</td>
</tr>
<tr>
<td>2005</td>
<td>213978389</td>
<td>39180778</td>
<td>2578111</td>
<td>70003924</td>
<td>102215576</td>
</tr>
<tr>
<td>2006</td>
<td>271355516</td>
<td>53569795</td>
<td>4001541</td>
<td>85970853</td>
<td>127813327</td>
</tr>
<tr>
<td>2007</td>
<td>374779610</td>
<td>70156355</td>
<td>6410425</td>
<td>117725316</td>
<td>180487514</td>
</tr>
</tbody>
</table>
According to the “2004 China Real Estate Finance Report” which is released by the Chinese Central Bank on August 15th 2005, the self-raising funds are mainly from the sales of commercial properties, 70% of the sales of commercial properties is consist of buyer’s mortgage loans; the “deposit and pre-payment” (other sources of funds) has
30% bank loans as well. Thus, near 50% of the total funds that finance real estate industry are essentially from bank loans. The commercial bank lending is still the most important financing channel; the real estate’s reliance on bank is too large, and it is not conducive to prevent risks.

Figure 17: The Proportion of Bank Loans on Real Estate Financing (After Adjustment)\(^{21}\)

![Pie chart showing the proportion of bank loans, foreign investment, self-raising funds, and others in real estate financing.](image)

Source: National Bureau of Statistics of China

3.3.2 Analysis of the status of various real estate financing channels in China

3.3.2.1 Bank loans

China’s financial system is dominated by a large but inefficient banking system (Allen, Qian and Qian 2007). Bank lending has been always the main channel for China’s real estate financing. Since 1998, banks support real estate companies both in investments and sales. The mortgage loans have been one of the most important driving forces for the real estate development. Up to end 2009, the commercial loans on real estate industry were 7.33 trillion Yuan, increased by 38.1% over the same period the previous year, the growth rate increased by 27.7% over the previous year. The mortgage loans were 4.76 trillion Yuan, increased by 43.3% over the same period the previous year, 33.3% higher than end 2008. The loans for real estate development were 2.53 trillion Yuan. Compare to the year 1998, the loans for real estate

\(^{21}\) Calculation according to the data from National Bureau of Statistics of China in 2007
development in 2009 were 11.23 times more, and the mortgage loans were 110.11 times.\textsuperscript{22}

There are several reasons for the fast growth of the bank loans for the real estate industry.

1. Excess liquidity in the banking system in China. In recent years, the rapid growth of China's foreign exchange reserves has led to excess liquidity in the banking system. A persistent excess liquidity exists in China's banking system; the main reason for this situation is a serious imbalance in international payments. The huge foreign exchange reserves have become not only an important channel of money supply, but also endogenous variables that the central bank cannot control under the current exchange rate system. Meanwhile, the increasing household savings in China also increased the liquidity of the banking system. China’s household saving rate was 51.3% in 2008, compared to 12% in the U.S.\textsuperscript{23}

2. Mortgage loans are good quality assets for the banks. The Chinese manufacturing industry has a lack of Technology as the core competitiveness; it reduced the Chinese firms’ profitability and ability to resist risks. In contrast, the banks generally consider mortgage loans as assets with stable earning and low default risk. Basically, there are two reasons for their consideration: the first is the rapid urbanization in China; the strong demand on real estate makes the price to rise persistently and thus makes the mortgage more riskless; the second is the rapid development of the national economy, the rapid growth of people’s income reduces the risk of default.

3. The Chinese commercial banks have not changed their traditional profit model; interest spread is still the main source of income for Chinese commercial banks.

3.3.2.2 Public listing

Theoretically, going public is the best way for real estate financing. Because it can reduce financial risks and improve capital structure. Through public trading, the

\textsuperscript{22} Calculation according to the China Monetary Policy Report, released by china central bank, 2009

\textsuperscript{23} http://money.163.com/09/0704/23/5DDQS0I000253B0H.html
company can raise huge amount of money, and the raised funds can be used as registered capital for permanent use, there is no fixed repayment period. Therefore, it has great advantage for commercial real estate development. There are mainly three forms for public listing: domestic IPO, foreign IPO, and RTO (Reverse Takeover). There are only a few companies that are traded in foreign countries; most of them are traded domestically.

However, the reality is that public financing of real estate enterprises in China only account for small proportion of all listed companies. “China’s stock market is highly speculative and driven by insider trading”(Allen, Qian and Qian 2007). From 1994 to 2001, the China Securities Regulatory Commission decided to refuse all listing applications for real estate enterprises. The ban was removed in early 2001, but almost all companies that listed between 2001 and 2005 are state owned companies, private real estate had no chance that time. After the “Regulation for the security issuance by listed companies” released on May 8th 2006, both state owned and private real estate companies started to move forward quickly for public listing. Most of them preferred RTO rather than IPO, because of the high threshold of IPO. The Chinese stock market is very immature, there are many problems such as disordered stock valuation, asymmetric information, no strict supervision, are very obvious. In general, it is not easy for the real estate enterprises to raise money through the stock market.

3.3.2.3 Bond financing

Since many years, the bond financing always has small proportion of the real estate financing in China. The proportion of the fund raised by bond to the total funds raised for real estate was only 0.001% in 2004. The slow development of bond financing has some reasons:

1. Inefficient approval system, too many authorities related, this restricts the supply of the corporate bonds.

2. Non-market-oriented, rigid interest rate system. It causes that bond rates cannot

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reflect the real changes of supply and demand for the bonds and risk differences of different firms.

3. Lack of secondary market. It leads to low liquidity of the bonds and distort the price signal of the corporate bonds.

4. Bond rating agencies have a lack of independence and impartiality. This makes the rating less authoritative.

5. Related laws and regulations are not sound.

### 3.3.2.4 Trust financing

China’s first trust company was established in Shanghai in early 20th century, but the real development of trusts is since 1978 in China. In 2001, new laws and regulations for trust were introduced and enforced. After that, China’s trusts have made a rapid expansion. In 2003, the amount of real estate trust schemes was only 6.95 billion Yuan; but it was 12.95 billion in 2004 and has been 235.13 billion in the first quarter 2010.\(^{25}\) However, the problems exist in China’s trust industry are still the bottleneck of this financing channel for the real estate enterprises. Basically, China’s trust industry has a homogeneous competition with the bank loans. The trust loan has been always the most important form for the trust property. China’s trusts are like semi-banks, and trusts are the substitutions for the bank loans. It makes China’s trusts much dependent from the interest rate and monetary policy. Furthermore, size, duration and liquidity are also problems for real estate trusts in China. Most of the existing real estate trusts are with duration for less than five years and with a size for less than 500 million Yuan, for the real estate industry, it seems a little harsh. There is no domestic trading platform for the trusts in China currently and it causes liquidity problems for the trusts.

### 3.3.2.5 Foreign funds

The Chinese real estate is attractive for the foreign funds. It is mainly because of the

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high-return of the Chinese real estate industry and the expected appreciation of RMB (China’s currency). As figure 18 shows, since 2001 the foreign investment on Chinese real estate industry has been increasing very rapidly. In 2008 the total investment by foreign funds on Chinese real estate was 72.8 billion Yuan, with direct investment of 63.5 billion Yuan.

Foreign funds that owned by some financial institute such as Mogen Stanley, ING, CapitaLand, Macquarie Group, Merrill Lynch Investment Bank etc., have invested in Chinese real estate. As a financing channel for the Chinese real estate industry, foreign funds usually choose the large domestic firms for cooperation, they have high requirement about the reputation and size of the domestic firms. Furthermore, the costs of raising funds through foreign funds are normally higher banks loans and trusts. Hence, the influence of foreign funds as a financing channel for Chinese real estate industry is not large yet.

Interestingly, some foreign REITs have already had business in China. GZI Real Estate Trust Fund (stock code: 0405 HK), which is listed in Hong Kong since 2005, is the first REITs from the mainland china and traded in Hong Kong. At the time of its inception, it had four properties in Guangdong Province in China, with gross floor area of 160,651 square meters.26 Capita Retail China Trust (CRCT) that is owned by CapitaLand was listed in Singapore in 2006, with seven Properties of shopping centers in different cities in China. The involvement of foreign REITs in Chinese real estate market illustrate that it is the time to develop domestic REITs.

3.3.3 Problems of the real estate financing in China

Chinese real estate market has developed for over 30 years, so has the real estate financing. Chinese real estate financing has made a great progress from scratch. Overall, however, the following problems still exist in the real estate financing:

1. Immature financial market for real estate.
   
   A mature real estate financial market should include real estate credit market, real estate mortgage market, real estate security market and real estate insurance market. The Chinese financial market is not market-oriented yet. The market supervision system is unadvanced; the market is subject to the government’s intervention and control. Demand and supply cannot be reflected in the financial market, it makes the Chinese financial market inefficient.

   In a mature financial market (like in the U.S.), the major holders of the securities of real estate assets are institutional investors. Most of the institutional investors are immature; they are usually too speculative, and constrained by the government’s policies.

2. Unusual financing structure
   
   In the process of economic transformation, China's real estate financing has made a
profound change. However, compared with developed countries, China's real estate financing structure is still in a non-equilibrium state.

1) Imbalance between direct and indirect financing

With the rise of the securities financing, direct financing increases very fast, but its proportion to the total financing is still relatively small, the proportion of bank credit is still predominant. Bank loans and advance payment is the main source of funds supporting the market, causing the real estate business high debt ratio for more than 70%. This financing structure will inevitably lead to serious results in two areas: on the one hand, residents have lack of investment channels and have to put money into banks. It causes the whole society credit concentration and increased risk, and it is difficult to achieve socialization of capital and risk. On the other hand, real estate financing is too attached to banks; it raises the bank's credit risk. Once the government’s policy on bank loans changes, the real estate enterprises are easily to have problem in financing, this is not conducive to the development of the real estate industry.

2) The monopoly position of the state-owned banks in indirect financing

Currently, financial assets and financial business are concentrated in four major state-owned commercial banks (Industrial and Commercial Bank of China, Bank of China, China Construction Bank and Agricultural Bank of China), their financial assets account for 70% of all financial assets, and holds more than 60% market share of deposits and loans, the state-owned banks have absolute control on financial assets and financial market. The monopoly of the state-owned banks causes a lack of effective competition, impedes the development of enterprises

2) Unusual structure of the sources of bank loans

In China, sources of credit funds of banks are deposits, including corporate deposits and personal deposits. Deposits are dispersed and liquid, it results that long-term credits have a lack of sources. In order to prevent risks, banks can only reduce the proportion of long-term credits to total assets; for the real estate business, it means issuing less long-term loans or shortening the term of the loans. Hence, the consequence is a serious constraint on the real estate development.
Part IV The Significance of the Introduction of REITs in China

4.1 For the real estate industry
The Chinese real estate industry has developed for about 30 years, and has achieved a great success. However, compared to mature real estate market like in the U.S., the Chinese real estate industry seems very immature, both on market development and enterprises management. In a mature real estate market, real estate investment returns are stable; but in China, real estate investments often evolve to speculation, short-term speculations replace stable and long-term investments, this brings high market risks.

4.1.1 Impact on real estate prices
With the rapid development of the Chinese economy and real estate industry, the real estate price has been increasing dramatically. Real estate bubble is very obvious and has been a huge problem for the whole country. According to the report released by Ministry of Land and Resource of the People’s Republic of China, the average house price in 2009 had increased by 25.1% over 2008. Buying a house or a flat has become an enormous pressure for most of the residents in the big cities in China. How to deal with the real estate bubble has been a significant issue for the government and the whole society. Although the government has realized that, in despite of macroeconomic regulation and control on the real estate industry, the real estate price still rose rapidly.
The introduction of REITs can stabilize the high real estate price. A very important reason of the high house price is lack of investment channel in China. Huge amount of idle money increases the demand of the houses and therefore raises house price. As an ideal investment instrument in many countries, REITs invest primarily in commercial rental properties with stable cash flows, such as office buildings, shopping malls and hotels, etc. On one hand, REITs can guide the idle money into the commerce and
infrastructure area, the diversion of idle money can reduce the “pseudo demand” of houses; on the other hand, REITs can increase the supply of rental housing, the residents who cannot afford houses will consider rental housing, thus it is conducive to stabilizing real estate price.

4.1.2 Impact on the real estate enterprises

4.1.2.1 Effective financing sources

As mentioned in section 3.3., Chinese real estate industry has a problem with the financing channels: high dependence to the bank loans, other financing sources such as bonds and stocks are very weak. This is not conducive to the development of the real estate industry.

In order to suppress overheated real estate investment and prevent bank credit risk, the Chinese government has introduced a series of macro control policies; bank credit threshold has increased significantly. Many real estate enterprises have serious financing problem, they are eager to open up new financing channels.

Generally, real estate sale and letting require a long time process, so a shortage of funds is a long-term status. REITs can raise capital with bonds or stocks in the open market; it provides the enterprises an effective financing channel, to ease their financing pressure. However, REITs market cannot be the place that the enterprises can raise money with secondary or inferior assets, it has very high standards; there are stringent requirements on project size, profitability, property rights and maturity. Therefore, REITs can provide a sustainable and effective circulating financing system for the real estate industry.

4.1.2.2 Changes in real estate business model

The current business model of the real estate is so-called “Hong Kong Model”\(^2^9\). The development of REITs will have an important impact on the real estate business

\(^{28}\) Li, Q., 2008.  
\(^{29}\) It means the real estate businesses, from land acquisition, development and construction to marketing, sales, property management, all completed by an enterprise.
model; it can promote the real estate industry from the current “Hong Kong Model” to the “American Model”\(^{30}\). According to international practice, REITs invest primarily in the quality properties for long-term holding. The properties such as office buildings, shopping centers and hotels have normally low risks and stable returns. This mode of operation will inevitably lead to changes in the real estate business. The real estate firms will become professional real estate investment companies, rather than the current “almighty enterprises”.

The “American Model” has two advantages over “Hong Kong Model”:

1. **Shorter financial cycle.** For the “Hong Kong Model”, it requires a long financial cycle from the land acquisition to the sales completion. One project needs normally 2-3 years, during this time, the market and financial situations may change a lot, the enterprise undertakes considerable risks. In contrast, in the “American Model”, the real estate enterprise plays a role as a general developer, it subcontracts the specific projects to other small developers; from the general developer to the small developer, the financial cycle ends, and it is much easier to control risks.

2. **More specified divisions of work.** The “Hong Kong Model” requires “almighty enterprises”, the enterprises need resources for all sections of the real estate business. In contrast, in the “American Model”, every section of the business is done by specialized company, the enterprises do not need to pay attention to every section, and this brings higher efficiency.

### 4.2 For the investors

Lack of investment opportunities is the problem faced by most investors in China. China is one of the countries with the highest saving ratio. A significant reason for the high saving ratio is the lack of investment opportunities.

The introduction of REITs can bring a good investment opportunity for the investors,

\(^{30}\) American Model means that all sections of the real estate development are not completed by one enterprise, but by highly specialized companies, the funds are mainly raised publicly. It can diversify the risks both for the enterprises and market.

http://blog.soufun.com/5871857/9763510/articledetail.htm
because REITs have advantages such as stable returns, diversified risks, ability to withstand inflation and high payout ratio etc. Moreover, Real estate is a capital intensive industry, it requires large amount of capital and a long investment horizon; ordinary small investors almost have no chance to participate. REITs can change the large real estate investment into small investment in securities. Almost all investors can participate in real estate business.

Furthermore, real estate properties are normally owned directly and concentratedly, REITs can change the ownership to indirect and dispersed. The securitization makes the ownership transaction much easier, it requires no physical delivery but only securities. This change can improve the market liquidity substantially, and thus

### 4.3 For the financial market

#### 4.3.1 Promote financial innovations

Liberalization, internationalization, integration, securitization are trend for the global financial market currently. Traditional commercial banks face more and more challenges, because non-bank financial institutions have more and more innovative financial products, and it guides the money to move from bank deposits to other financial assets and marketable securities which are more attractive in return and liquidity. And REITs are generally considered as satisfactory investment instruments for safety and profitability.

The Chinese financial market is immature. Not only real estate enterprises, but also the enterprises in other industries have problems with financing: high reliance on bank loans, stock market instability, and few financing channels etc.

We have mentioned the problems of the Chinese trust industry. The introduction of RETIs can expand the trust companies’ business area; it is an important opportunity for the rapid development of the Chinese trust industry. China needs more financial products, both for the investors and the firms that need capital. The introduction of REITs can be a good try for financial innovations.
4.3.2 Redistribution of financial risks

Commercial bank deposits and loans always have important positions in the financial system. Deposits are the source of the operating funds for commercial banks, and have to be repaid on time with principal and interest. However, the debtors that get the loans from the bank may have problem with the on time repayment, or even lose the ability to repay. This means that there is a risk of disequilibrium.

In recent years, the deposits have increased rapidly in China. Up to the end of 2008, the total deposits in China had been 46.62 trillion Yuan, and household savings deposits had been 21.79 trillion Yuan.\(^{31}\) The financial risks have been accumulated in commercial banks continuously, and the risks are too concentrated.

Trust as a direct financing, can convert the indirect financing into direct financing, and thus can diversify the risks, in other words, convert the banks’ risk into market’s risk. The risks will be taken by the investors. This can avoid the accumulation of bank risk, reduce the probability of bank run and financial crises. Therefore, trust financing process can achieve the redistribution of financial risks; reduce the risk of financial operations.

4.3.3 Meet the demand of the securities market for low-risk investment products

Compared to mature securities market as in the U.S., the securities market in China has two major drawbacks:

1. Irrational financial product mix and risk structure, high-risk products predominate.
   
   Around 80% of all products are equity products, which have relative high risks. Bond market is undeveloped; there are only small amount of Treasury bond with poor liquidity, and small amount of corporate bonds, financial bonds, and convertible bonds. The status of the product mix in Chinese securities market cannot match the demand of investors.

2. Low-risk products have too few varieties, small market size and poor liquidity.

\(^{31}\) China's statistical yearbook 2009
How to develop the low-risk products, in order to make the market structure more rational, is one of the most important tasks for Chinese securities market. For the investors, REITs provides higher return than normal stocks and bonds generally; moreover, REITs have lower risk than normal stock, as mentioned in section 2.2.2. Therefore, REITs should be the right products for China’s securities market.
Part V Seeking the Right Forms of REITs in China

5.1 The feasibility of REITs development in China

Compared to other innovative financing instrument for real estate on the market, REITs have outstanding advantages. But the feasibility of REITs needs to be proved in China’s current market environment. The feasibility of RETIs can be determined by many factors: investors, policy, legislation, development of real estate industry, development of trust companies and technology etc.

5.1.1 Investors for REITs

1. Ordinary investors

China has very large savings deposits of residents and a higher savings ratio. According to China’s Central Bank "Monetary Policy Report" in December 2009, at the end of 2009 the deposit balance of RMB was 59.7 trillion Yuan compared to 46.6 trillion Yuan in December 2008. The deposits of residents were 26.1 trillion Yuan in 2009 compared to 21.8 trillion Yuan in 2008. The saving ratio at the end of 2008 was nearly 51%.

Figure 19: China’s resident deposits

![Graph showing resident deposits from 2003 to 2009.](http://money.163.com/09/0704/23/5DDQSIQE00253B0H.html)
Such a huge stock of financial assets and the steady stream from increment of financial assets increase huge investment demand. People need investment products with good security, liquidity and profitability. If REITS established, its long-term value added features will attract a part of household savings; and the huge amount of idle funds will provide sufficient funds for REITS development.

2. Domestic institutional investors

From the experience of U.S. REITs market development, institutional investors are the main players in this market. The development of the insurance market and the reformation of the pension system have created China’s domestic institutional investors. Insurance companies, pension funds, annuity, banking funds and pension funds which become quite powerful institutional investors have large investment demands. Because China's capital market is not mature, the investment channels for institutional investors are limited in stock market, bond market and currency market. In recent years, stock market is in downturn, bond market and currency market bring low investment return. Institutional investors’ requirement of high investment returns could not be met. In this approach, REITs can satisfy institutional investors with stable income, low risk and high liquidity. In finance market institutional investors have its competitive advantages for REITs: 1) they can gain low cost capital. The demand of REITs from institutional investors can enhance funds premium to decrease dividend yields, cost of equity capital and cost of debt. 2) There would be stable stock prices, because the institutional investors hold REITs as long term strategic investment. 3) If REITs get their strategic objects and meet the excepted requirement of investors, the institutional investors would be pleased to help financing for REITs in the future. This can save costs in financing market. 4) If REITs have connection with institutional investors, REITs can get more diversified trade opportunities, for example let institutional investors participate in the financing process of ordinary shares or let institutional investors join portfolio investment.

3. Foreign funds

Many foreign funds join China’s real estate market. In 2008, direct investment from foreign funds in China’s real estate market was 63.5 billion Yuan and the growth rate
was 23.6%. Foreign funds will be potentially strong investors in China’s REITs market.

5.1.2 Policy and legislation

“China’s financial market development report 2007” of China’s Central Bank point out that real estate investment trust products should be launched in right time. In 2008, “Pilot Regulation Plan for REITs (draft)” is drafted out by 5 most famous Chinese trust and investment corporations. This draft was reported to central government and is in discussion process.

Since China has not yet promulgated any laws for REITs, there is no real sense of REITs in domestic real estate market. In recent years, the government department has promulgated a number of administrative rules and regulation for real estate finance. The new “Corporate Law”, “Securities Law” and regulations for trust corporations or trust capitals are playing a guiding role for building policies and legal frameworks of REITs.

5.1.3 Development of real estate market

According to the experience of other countries, a large number of commercial real estate is an important condition for REITs birth and rapid development. Real Estate is developing into the leading industry for economic development in China.

In 1998, the floor space of commercialized buildings was 121.8 million m². This number increased to 659.7 million m² in 2008, nearly increased 542%. The sale of commercialized buildings increased nearly 10 fold from 251 billion Yuan to 2500 billion Yuan between year 1998 and 2008. Real estate development and investment made great contributions to GDP growth. Many local governments maintain the appropriate real estate investment scale and growth rate which is an important measure for steady regional economic growth. China’s real estate market has still

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33 China statistic year book 2009
large potentiality. As living standard improved, real estate in the consumption structure has been increasing. The potential demand must convert to real market demand.

Table 7: Sale of Commercialized Buildings

<table>
<thead>
<tr>
<th>Year</th>
<th>Floor Space of Commercialized Buildings Sold (10,000 sq.m)</th>
<th>Residential Total Sale of Commercialized Buildings (10,000 Yuan)</th>
<th>Residential Buildings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1991</td>
<td>3025.46</td>
<td>2745.17</td>
<td>2378597</td>
</tr>
<tr>
<td>1992</td>
<td>4288.86</td>
<td>3812.21</td>
<td>4265938</td>
</tr>
<tr>
<td>1993</td>
<td>6687.91</td>
<td>6035.19</td>
<td>8637141</td>
</tr>
<tr>
<td>1994</td>
<td>7230.35</td>
<td>6118.03</td>
<td>10184950</td>
</tr>
<tr>
<td>1995</td>
<td>7905.94</td>
<td>6787.03</td>
<td>12577269</td>
</tr>
<tr>
<td>1996</td>
<td>7900.41</td>
<td>6898.46</td>
<td>14271292</td>
</tr>
<tr>
<td>1997</td>
<td>9010.17</td>
<td>7864.30</td>
<td>17994763</td>
</tr>
<tr>
<td>1998</td>
<td>12185.30</td>
<td>10827.10</td>
<td>25133027</td>
</tr>
<tr>
<td>1999</td>
<td>14556.53</td>
<td>12997.87</td>
<td>29878734</td>
</tr>
<tr>
<td>2000</td>
<td>18637.13</td>
<td>16570.28</td>
<td>39354423</td>
</tr>
<tr>
<td>2001</td>
<td>22411.90</td>
<td>19938.75</td>
<td>48627517</td>
</tr>
<tr>
<td>2002</td>
<td>26808.29</td>
<td>23702.31</td>
<td>60323413</td>
</tr>
<tr>
<td>2003</td>
<td>33717.63</td>
<td>29778.85</td>
<td>79566627</td>
</tr>
<tr>
<td>2004</td>
<td>38231.64</td>
<td>33819.89</td>
<td>10375069</td>
</tr>
<tr>
<td>2005</td>
<td>55486.22</td>
<td>49587.83</td>
<td>175761325</td>
</tr>
<tr>
<td>2006</td>
<td>61857.07</td>
<td>55422.95</td>
<td>208259631</td>
</tr>
<tr>
<td>2007</td>
<td>77354.72</td>
<td>70135.88</td>
<td>298891189</td>
</tr>
<tr>
<td>2008</td>
<td>65969.83</td>
<td>59280.35</td>
<td>250681830</td>
</tr>
</tbody>
</table>

Source: China statistic year book 2009
5.1.4 Development of trust companies

Before 2007, trust companies in China were versatile companies. Trust companies could invest in many industries including real estate market. In year 2007, the trust companies have been separating their business. The trust companies would focus more on trust business. The previous investments and assets on other industries must be stripped. In year 2006, the interest income of trust asset of all trust companies was 973 million Yuan and this number increased to 2097 million Yuan (Liu, 2009). The scale of trust asset and efficient using of trust asset increased. The previous business on real estate market could be translated into REITs step by step. Trust companies who were operator and developer of real estate can translate the investment on real estate market into the share of REITs and become strategic REITs investors. If trust company does not want to keep the ownership of its real estate, it can set up a consultant group of real estate and join the operation of REITs as an extern consultant. The development of trust companies provides good opportunities for development of REITs.

5.1.5 Technology

Since the Shanghai Stock Exchange established in 1990, China's securities market has entered a rapid development period. Although there is no trading platform for trust products yet, the exchange products include stock, treasury bonds, enterprise bond, convertible bonds, closed-end funds, open-end funds and warrants. The development of the stock market and stock exchanges has created a technological condition for the development of REITs. 35

5.2 Analysis of the development strategy of REITs in China

5.2.1 Possible forms of REITs

The internationally accepted REITs are the securitized financial products that are

Shenzhen Stock Exchange: http://www.szse.cn/
designed for the investment in the properties with stable cash incomes and earnings.
There are some differences between REITs and China’s current real estate trusts. The differences are mainly in the requirements on investment objective, income distribution and liquidity. The investment objective of REITs has to be the properties that generate income; most of the income has to be distributed to the investors; and the REITs have to be traded on the market. In China, the real estate trust market is 40 years behind the United States; it takes long time to develop mature REITs. (Wang, 2006)

Based on the status of the Chinese real estate industry and the legal system for the financial market, there are three possible forms for the development of REITs in China:

1. Trust

Basically, REITs are the financial products that collect money and then invest. Trust is the most popular form for REITs globally. Since 2002, China has developed real estate trusts products, which raise money only for specific real estate project. Although the real estate trusts on the market are short-term products, with a duration of 1-3 years, they have the same form as trusts like the mainstream products in the U.S.

Trust form accords with not only the global mainstream real estate investment fund management structure, but also China's reality. Thus, for the long-term development of the REITs in China, trust form should be the preferred strategy.

According to the “Trust Products Research Report, May 2010” released by PUYI Wealth, in May 2010, there were totally 36 trusts with 90 products issued in China; the real estate trusts had the highest average return of 9.66%, which was 2.18% and 1.39% higher than trusts in industry and infrastructure area respectively.36 It is much higher than the deposit interest rates and the yields of treasury bonds. Currently, real estate trusts products are attractive for the investors.

The success of the real estate trusts products in recent years has not only proved the

36 http://money.163.com/10/0621/08/69MIV4FM00252V0H.html
strong demand of the real estate financing, but also illustrated that the securities market has a strong demand of low-risk financial products. However, there are also certain difficulties for the transformation of the Chinese current real estate trusts products to REITs. Firstly, there are huge differences between the current real estate trusts and REITs, the products have to be redesigned. Most of the current real estate trusts products are secured fixed-income products, with maturity and expected return. They are more like bonds. The U.S. REITs are the tax privilege investment products that invest in real estate (mostly in quality properties), and pay dividend to the investors; most of them are equity products. Secondly, the current legal system has no clear legal status for the trust certificates and beneficial rights of trusts. Thirdly, trusts products need to be more standardized. At present, there is no strict requirement about the investment objective of the trusts products; the products have normally short durations and lack of liquidity and standardization. Fourthly, there is no unified trading platform for the trusts products; serious liquidity problem exists in the secondary market. Fifthly, there is no specific authority for trusts products, collaborative supervision brings high costs.

2. Closed-end fund
As a form for REITs, closed-end fund is similar to trust. It consists of fund management company (core trustee), the fund, and custodian (one of the trustees, e.g. banks). The fund management company may consist of some shareholders; they manage the fund and charge fees. The difference of this form to the trust form is that the fund management company does not need to be the financial institutions which are approved by the financial regulators, just like the most private equity funds in China. Fund management companies can form their own real estate management team; or they can hire professional real estate management company for the investment,
business expansion and other aspects of management. The advantages of closed-end fund are: 1) there are already operating and management experience for closed-end fund; 2) professional real estate managers can brought into the investment and management. The biggest obstacle for the development of this form is the imperfect laws and regulations, it could even be suspected as illegal fund-raising in China.

3. Public trading as a real estate enterprise

REIT going to public as a real estate enterprise is also a possible form for the development of Chinese REITs. It is supported by the current legal system such as “Corporate Law” and “Securities Law”. In addition, special legislations need to be made, such as the provisions about company structure, business scope, asset requirements, and debt ratio, etc. The legislation also has to make it clear about the investment objective (holding and running real estate) and income distribution (proportion of the dividend payout to earning).

Under the current legal system in China, developing REITs as public traded real estate enterprises has following advantages:
Firstly, it can basically base on the current laws such as “Corporate Law” and “Securities Law”, with relatively few legal obstacles;
Secondly, there are already experiences for the management and supervision of the public traded real estate enterprises.
Thirdly, the shareholders of the real estate enterprises are the shareholders of the REITs, it could avoid the interest conflict which exists between the fund managers and fund shareholders in the closed-end fund form.
However, there are also some problems for this form:
Firstly, the “Corporate Law” has some requirements on shareholder numbers and company's operating performance; it may also be a legal constraint.
Secondly, if REITs are traded on the market as real estate enterprises, it will be difficult to differentiate between REITs and public traded real estate enterprises.
Thirdly, the form of REITs as real estate enterprises will raise the management costs. In order to remain the trust structure of the REITs, REITs generally do not manage the real estate property by themselves (not like the normal real estate companies), but hire some professional management. Thus, for a company, it will increase management costs and reduce the shareholders’ benefits.

Fourthly, because of the enterprise form, the management of the real estate project for the REITs will be combined with the management of the company; the potential interest conflict is a difficult problem.

Fifthly, real estate enterprises are not financial institutions, they have lack of financial human resource and experience, a real estate company as a fund manager is hard to be approved by the Regulatory authorities.

Finally, there is no “Industry Funds Law”; the establishment of corporate type funds has still some legal barriers.

5.2.2 Trust is the best form for the development of REITs in China

As we can see from the three above possible forms for REITs, each of them has advantages and disadvantages, but with comprehensive comparison, trust is the best, most realistic and meaningful form. (Wang, 2006; Liu, 2009)

In the U.S. and other developed countries, trust is the preferred form for REITs. Compared to trust type of REIT, a REIT as a real estate enterprise is a juridical person, it has problems such as asymmetric information between the REIT manager and the shareholders of the company, interest conflict between the REIT manager and shareholders, and most importantly, double taxations (corporation income taxes and personal income tax).

<table>
<thead>
<tr>
<th>Form</th>
<th>Advantages</th>
<th>Disadvantages</th>
</tr>
</thead>
<tbody>
<tr>
<td>Trust</td>
<td>➢ Current trusts products have the major</td>
<td>➢ No clear legal status</td>
</tr>
<tr>
<td></td>
<td></td>
<td>about the trusts products;</td>
</tr>
<tr>
<td>Real Estate Enterprise</td>
<td>Characteristics of Funds;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Most of the REITs on the world are trusts;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Preliminary experiences for trust products.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Current trusts product need to be standardized and innovated;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ No unified trading platform.</td>
<td></td>
</tr>
<tr>
<td>Closed-end Fund</td>
<td>Experiences for public traded companies.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Potential interest conflict;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Double taxation.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Experiences for closed-end funds;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Professional operation possible.</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Imperfect legal system;</td>
<td></td>
</tr>
<tr>
<td></td>
<td>➢ Legal problems for fund raising and using;</td>
<td></td>
</tr>
</tbody>
</table>

The projects of REITs usually have long investment cycle and strong requirement on stability. For open-end REITs, in order to determine the share price, the existing assets must be evaluated for every time of new share issuing; repetitious assessment brings high costs. Moreover, there are already experiences of closed-end securities investment funds. Therefore, compared to open-end REITs, closed-end REITs is more suitable for China.

### 5.2.3 Fund raising for REITs in China

How to raise funds for REITs, privately or publicly depends on the development level of domestic capital and real estate market. It also depends on domestic policy and legal system. In U.S. REITs raise fund most publicly. Because the liquidity of real estate is relative lower and the return of investment is stable in U.S., it is appropriate to raise funds publicly. The capital market and legal system is mature which can protect minority investors who have small risk tolerance. In China, REITs are totally new instrument for most domestic investors. The legal system for funds and REITs is not integrated. There is still lack of government regulation for funds. So there must be a long development process for REITs. It is not easy to say which way to raise funds for REITs is better. Based on current status, raising funds privately is appropriate for
China. China’s real estate industry still need improvement, the potential risk is high, the relationship between REITs and real estate industry is not very clear. If REITs raise funds publicly, minority investors would face more uncertain risk. China’s public raising funds faces many intern governance problems: the conflict between fund holder and fund manager due to manager motivation mechanisms; unequally distributed risk; self-constraint of fund managers is lower. Private raised REITs are more flexible. It is better for China to first develop private raised REITs. After all conditions are mature, then improve public raised REITs. (Wang 2006)

Investment on real estate need large amount of money. Shortage of funds appears when domestic real state develops very fast. Sometimes, foreign raised funds are also necessary. As mentioned before, domestic and foreign investors have big interest in China’s real estate market. REITs would be a good choice for them. Foreign investors who come from developed countries can bring not only the money but also experiences on REITs. Cooperate with foreign institution and raised fund privately or publicly to invest in China’s real estate can solve financing problem of REITs.

5.2.4 The fund sources for REITs

Financing is not only the first important step but also a difficult step for REITs. REITs which belong to buyer finance are kind of financial system combining the financing and investment together. While the process is to raise fund first and invest later, so if there is no funds, there is no investment. In a word, stable fund sources are significant for development of REITs. The structure of fund source (the structure of investors) will affect the governance structure of REITs and determine the effect of REITs in real estate industry.

In many countries, there are many financing channel for REITs. Different from venture capital funds which are supported by government funds, REITs depend mostly on folk capital including pension fund, retirement fund, finance holding companies, insurance companies and money from individuals and families. As the personal finance system become professional, more small and medium investors want
to let institutions manage their money. So the proportion of funds from institutional investors will become higher. Big companies and rich families with high risk tolerance prefer to invest via private equity in real estate market in order to gain high profit.

Based on the status of financing and investment in China’s real estate market, the fund sources for REITs could be as following:

1. **Private capital**
   
   Since China’s economic reform, urban residents’ residual income increases. Urban resident, especially the high income group and middle class are fund provider for REITs. In some region where exist highly developed folk finance, as the investment in real estate is more reasonable, investment in real estate does not be seen as short term speculation but as long term project investment. Folk investors prefer to hire professional investment team to invest in real estate market. This form can be seen a kind of prototype of REITs in China. When China’s real estate industry is standardized and improved, this form would transfer to REITs.

2. **Insurance funds and pension funds**

   Table 9: Distribution of Investment of Insurance Funds

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Deposit in Bank</td>
<td>32.66%</td>
</tr>
<tr>
<td>National bond</td>
<td>15.78%</td>
</tr>
<tr>
<td>Financial bond</td>
<td>19.82%</td>
</tr>
<tr>
<td>Corporate bond</td>
<td>9.56%</td>
</tr>
<tr>
<td>Stock</td>
<td>11.76%</td>
</tr>
<tr>
<td>Securities investment fund</td>
<td>7.71%</td>
</tr>
<tr>
<td>Other</td>
<td>2.71%</td>
</tr>
</tbody>
</table>

   Source: China Economic Net

   Since 90th, China’s insurance market developed very fast. The total insurance fees raise about 10 billion Yuan for every year. The available insurance funds achieve 3.7 trillion Yuan in 2009.

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37 http://finance.ce.cn/
The bank deposit interest rate is always low in recent years. The five years deposit interest rate is only 3.6% in 2009 as the inflation rate is nearly 4% in 2009. The interest rate for 10-years bond issued in 2009 is 3.68%. The stock and securities market is unstable, so the rate of return for insurance fund is mostly under 2.5%. 39Insurance funds are finding a way out to increase the total rate of return. If REITs are launched in China, insurance funds would be a very important fund source.

3. Company funds

China’s listed companies which have idle fund all want to invest in real estate market. Some of them even set up their own real estate companies. But it is not very efficient for every listed company to invest directly in real estate market. REITs can provide them a channel with lower risk and good profit to invest indirectly in real estate market. In particularly, REITs help small and medium companies to invest in real estate market. Company funds can be potential fund source for REITs.

4. Foreign investors

At present, foreign investors invest in China’s real estate market via different ways: a) Invest directly, only for some investors who really understand China’s real estate market b) joint venture c) cooperate with local companies (only provide funds). Most foreign investors do not to join into China’s real estate market directly. In the future, foreign investors will prefer to be a fund source for REITs in China.

Conclusion for fund source: Resident would be the most important part of fund source of REITs in China; institutional investor i.e. insurance funds, company funds and foreign investor would be also fund source for REITs.

5.2.5 Products development of REITs

39 http://db.cei.gov.cn/
REITs provide good investment opportunities to the ordinary investors; with high returns and low risks, its unique operating mechanism can gather a large amount of capital and achieve economies of scale. As a bridge between the financial industry and real estate industry, REITs will play a tremendous role in promoting the development of both industries.

At the present situation, the trusts should continue to play an important role, and even evolve into the Japanese style of professional real estate trust and investment companies. Based on the experiences of the U.S and other Asian countries in REITs products development, China should develop the products that match the China’s current conditions: low-risk products should be the preferred product, risk prevention as the priority.

The advisable REITs products are as follows:

1. Office buildings and shopping centers (malls)
   
   As mentioned in section 2.4.1, over one third of the U.S. REITs invest in office buildings and shopping centers, which are usually quality property with stable cash income. With the rapid development of the Chinese economy and real estate industry, the number office buildings and shopping centers increase tremendously, especially in the big cities. Many foreign financial institutions such as Morgan Stanley, CapitaLand, Macquarie Group, ING, and Merrill Lynch etc. have invested in real estate in China, and their major acquisitions are large shopping centers and offices buildings in downtown area in the big cities.

   Furthermore, there are many potential investors who has willing to invest in the development and operation of office buildings and shopping centers; but because of their small amount capital, they lost a lot of investment opportunities.

   Office buildings and shopping centers can be the preferred products of Chinese REITs. These products will meet the demands of both real estate developers and investors, thus bring economic and social benefits. However, at present, not all regions in China have the conditions for the development of these products, but only the cities in the economically developed areas.

2. House renting trusts products
The trust company as the trustee, the houses as trust properties, and the house owners as trustors, the trust company gather the houses and rent them out on the market. The trust company is responsible to collect the rent from the tenants for the house owners, use legal means to safeguard the interests of the trustors, and organize regular and irregular renovation for the houses. And certainly, the trust company charge fees for these services. Compared to the ordinary house owners, the trust company has advantages in capital, marketing, and human resources etc; it can achieve economies of scale. These trusts products have low risks and stable returns, the key to success of this model is that the trust companies have to achieve the trust of the house owners, and have a sustainable profit model.

3. Equity investments in unlisted real estate companies
Using the funds of REITs to invest in some unlisted real estate enterprises, it could bring professional management to the real estate companies; improve the capital structure of the real estate companies. For the REITs, investing in some unlisted quality real estate companies, purchase the shares with relatively low price and wait for the opportunity for being listed.

4. Investment in physical assets
Beside the residential houses, REITs can also invest in some real estate which is for cheap sale because of the bad economy conditions or because of some other reasons. After the acquisition, these real estate properties will be reformed to be more valuable properties, and thus generate income for the REITs. For instance, the New Plan REIT is a REIT in the U.S. that is good at choosing some cheap-sale real estate and reforming it into shopping centers, supermarkets and warehouses etc. For years, the New Plan Realty Trust was the largest REIT in the U.S.

5. Non-performing assets disposal funds
Non-performing assets disposal funds is specialized in investment in purchasing half-way buildings or shares of the real estate companies that have land but do not have enough money to develop it. Because of the professionalism of the REITs, they have the abilities to turn the non-performing assets into quality properties.

6. Investment in other properties, like the REITs in the U.S. (Figure 8).
5.3 The barriers for the development of REITs in China

As effective investment instruments, REITs can enliven the market; as effective financing instruments, REITs can promote the development of the real estate industry. REITs have a positive meaning to the real estate industry and national economy, the development of REITs is the inexorable trend for the real estate industry. However, China does not have the perfect environment for the development of REITs; there are several barriers for the development of REITs in China. (Li and Wang 2008)

1. Imperfect legal system

The current trust industry’s business is based on “Trust Law”, “Regulations for Trust Investment Companies” and “Interim Measures for the Trust Investment Companies on Real Estate Trust business”. There is no complete “Investment Funds Law” or “Industry Funds Law”, thus establishing investment funds (include REITs) by raising funds from the ordinary investors could be illegal. Specific laws should be made for REITs, such as the legal status of REITs, how to operate REITs, the taxation for REITs, how to transfer the property rights and how to supervise the REITs etc.

2. Moral hazard

There is yet no operation model for REITs in China, and no constraint and incentive mechanisms for the trustees, it is easy to cause moral hazard of the trustees. Because of the asymmetric information, the manager of the funds can often take advantage of opportunities to seek benefits for themselves by sacrificing the interests of investors (Principle-agent Problem). The principle-agent problem has always been a big problem during the development of the investment funds in China. Transferring the funds profit to fund manager’s account, unreasonable deals……these kinds of things have been occurring frequently. Therefore, creating a mechanism or an environment, to ensure that the interests of the trustees are consistent with the interests of the investors, is very important for the development of REITs and other funds in China.

Furthermore, investments of REITs in equity of some real estate companies will also cause the moral hazard of the investors (Shareholders of the REITs). As China's
modern enterprise system has not been really established in a number of companies, the majority of enterprises are facing a lot of problems such as absence of owners (Who Owns China's State-owned Enterprises)\textsuperscript{40}, inefficient corporate governance structure etc. In 2008, there were 87562 real estate enterprises in China;\textsuperscript{41} most of them are small enterprises with irregular operation. The corporate governance problems are more serious in these small companies. After the investment in these kinds of companies, the benefits could be easily occupied. Therefore, there must be enough supervision in order to reduce the problems caused by asymmetric information.

3. Lack of professionals for REITs

Essentially, REITs emphasize more on financial management, rather than simply real estate expertise; their focus is real estate assets management, rather than specific implementation of real estate projects. For the successful management of a REIT, it must achieve the average return of the real estate industry, otherwise, it cannot receive the trusts of the investors, thus cannot raise fund successfully.

Hence, it needs a lot of professionals who have the expertise not only for real estate, but also for investment banking, financial management and related laws and regulations. The strategy of the REITs should be designed by the professionals. Since the development of REITs in China is still in the initial stage, professional investment managers are lacking in China, so there are very few REITs experts in China.

The good investment managers play a very important role for the development of REITs. For instance, the industry investment funds did not developed very well in the U.S before the 1970s; an important reason for this is that there were not enough talents for the industry investment funds. At that time, because of the restrictions on organizational forms, industry investment funds were much smaller than now, and most of them were operated by the initiators, there were no absorption of professionals. Thus, the operation and performance of the industry investment funds were poor at that time.

\textsuperscript{40} http://www.rieti.go.jp/en/china/06072801.html
\textsuperscript{41} China Statistical Yearbook 2009
In the current real estate trust business in China, the managers are mainly consist of real estate professionals who have lack in financial management capabilities, this is not conducive to long-term development of REITs.

4. Taxation system

In the United States, the fundamental reason of the successful development of REITs is the tax incentives for REITs. Firstly, there is no corporate tax for REITs; secondly, the real estate assets that REITs invest in are tax-free assets. In the early days, the REITs in the U.S. had the tax incentives as well; but because of the tax avoidance provisions of the Tax Law (such as use depreciation method), the REITs did not develop very well before the 1980s. In the end, 1980s, REITs had made a rapid development, the essential reason for it was that the Tax Law had become stricter and thus REITs’ tax incentives became a great advantage.

Thus, in order to develop REITs in China, it is necessary to learn from the American experience about the tax incentives. China’s current legal system has not clearly defined the taxation for trust incomes, there is no tax incentive for REITs yet, and it is certainly not conducive to encourage its development. There are two major problems of the tax system for REITs:

1) Too many tax items. Income tax, stamp tax, sales tax, “City Construction Tax”, “Education Supplementary Tax”, “Tax on Using Urban Land”, deed tax, land value increment tax, house property tax……

2) High income tax rate, unreasonable impositions. With 33% corporate tax and 20% personal tax, REITs will have no tax incentives.

5.4 Countermeasures for the problems and policy recommendations

5.4.1 Improve the legal system for REITs

Legislation is always the primary prerequisite for the development of REITs across the countries that already have REITs developed or have plans to introduce REITs.
Table 10: The Legislations for REITs in different Countries

<table>
<thead>
<tr>
<th>Region</th>
<th>Legislations</th>
</tr>
</thead>
<tbody>
<tr>
<td>North and South America</td>
<td>The United States (1960); Canada (1994,2003); Puerto Rico (1972,2000); Brazil (1994,FII)</td>
</tr>
<tr>
<td>Asian-Pacific</td>
<td>Japan (2000, J-REITs); Singapore (1999,2002,S-REITs); Hong Kong (2003); Malaysia (1993,2002); Taiwan (2003); South Korea (2001,K-REITs); Australia (1936,2001, ALPT)</td>
</tr>
<tr>
<td>Europe</td>
<td>Belgium (1995,SICAFI, similar to REITs ); France (2003,SIIC); Germany (1957,2002); Spain (1994,REIF, REIC); Luxemburg (1998,2000, similar to REITs)</td>
</tr>
</tbody>
</table>

Source: NAREIT

The practices made by other countries are good examples for China’s legislation; the specific laws for REITs should include provisions about capital structure, business area, investment objectives, and profit distributions etc. On one hand, the excessive competition between REITs and other institutions should be prevented; on the other hand, REITs should be encouraged to use their funds to achieve professional investment. And certainly, the investors should be protected.

Furthermore, the existing “Securities Law” should be improved. In foreign countries, trust certificate is one kind of securities. But according to China’s Securities Law which is revised in 2005, trust certificates are not securities; that means they cannot be traded publicly. If REITs cannot be traded publicly, the liquidity of REITs will be significantly weakened.

Moreover, the Securities Law only allows the securities to raise money publicly, private fund-raising is illegal. But according to other regulations, trust fund can be raised privately. As products across the Securities Law and the Trust Law, REITs have the characteristics of both securities and trusts. In foreign countries, REITs can raise fund both publicly and privately. The unlawfulness of privately offered fund will strongly hinder the development of REITs.

Thus, the Securities Law should be improved in two aspects: first, expand the types of
securities, trust certificate should be included; second, it should make a clear legal status of private placement, allow the securities to raise fund privately.

5.4.2 Set up a reasonable tax system for REITs

In the United States, as long as the REITs have distributed the incomes to the beneficiary, the REITs do not have to pay taxes, although the shareholders still have to pay the incoming taxes. 80 percent of the investment on REITs is driven by taxes incentives in foreign countries.

In contrast, China’s tax system is very inconducive to the development of REITs. The countermeasures for this problem are showed in Table 11.

Table 11: The Recommendations on the current Tax System for REITs

<table>
<thead>
<tr>
<th>Tax Items</th>
<th>Current Policy</th>
<th>Recommendation</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Income Tax</strong></td>
<td>Personal tax 20%; corporate tax 33%.</td>
<td>No corporate tax as long as the REITs has distributed the income (except the income outside REITs business scope).</td>
</tr>
<tr>
<td><strong>Sales Tax</strong></td>
<td>5% of rental income.</td>
<td>Accounted into property management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
</tr>
<tr>
<td><strong>City Construction Tax</strong></td>
<td>7% of the turnover tax</td>
<td>Accounted into property management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
</tr>
<tr>
<td><strong>Education Supplementary Tax</strong></td>
<td>3% of the turnover tax</td>
<td>Accounted into property management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
</tr>
<tr>
<td><strong>Stamp Tax</strong></td>
<td>0.1% of the rental price;</td>
<td>Accounted into property management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
</tr>
<tr>
<td>Tax on Using Urban Land</td>
<td>0.05% of the subject matter</td>
<td>management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
</tr>
<tr>
<td>-------------------------</td>
<td>-----------------------------</td>
<td>---------------------------------------------------------------------</td>
</tr>
<tr>
<td>Calculation on the actual land possession, annual tax rate for every square meter: 0.2-10 Yuan</td>
<td>Accounted into property management fee by the trustees, and the beneficiary burden the tax ultimately.</td>
<td></td>
</tr>
<tr>
<td>Deed Tax</td>
<td>3% of the house sales contract</td>
<td>Tax free for REITs’ acquisition</td>
</tr>
<tr>
<td>Land Value Increment Tax</td>
<td>Property transfers income as the tax base, 0.5%-1%</td>
<td>Tax free for REITs</td>
</tr>
<tr>
<td>House Property Tax</td>
<td>Taxation on the residual value of the houses: 1.2%; or Taxation on rental income of the houses: 12%</td>
<td>Tax free</td>
</tr>
</tbody>
</table>

Source: Liu, 2009

5.4.3 Establish the secondary market for trust products

There is currently no unified trade platform for trust products, thus a serious liquidity problem exists in the secondary market for the trust products. In fact, a main reason for this problem is the constraint on private placement by China’s legal system. However, liquidity is the characteristic of REITs; free transfer should be the basic condition for the development of REITs. Two thirds of the American REITs are traded publicly. China’s regulatory system on real estate trust products must be adjusted, in order to increase the liquidity of real estate trust products and establish an effective, transparent, comprehensive secondary market for real estate trust products.

Meantime, the credit rating system and pricing system must be improved as soon as possible. Moreover, it should allow commercial banks to provide pledged loan to the REITs holders, in order to increase the cashability of REITs.
5.4.4 Train and recruit REITs Professionals

As mentioned in section 5.3, professionals are the key to the success of REITs, and there are very few REITs professionals in China. This problem cannot be solved in a short time; the talents can be trained in practice through the development of the real estate trusts.

The second way is to recruit professionals from other countries where REITs have been developed for long time. The experts can bring much valuable experiences.

5.4.5 Establish a comprehensive supervision system

REITs require a systematic, cross-authorities monitoring system. The current trust products are approved and monitored China Banking Regulatory Commission, REITs as trust products going public, needs the corporation of other authorities (such as CSRC\textsuperscript{42}, SASAC\textsuperscript{43}, SAFE\textsuperscript{44} and Stock Exchange etc.), and this will lead to a cross-authorities problem. According to the experiences from other countries, special laws prescribe the establish conditions and supervision requirement of REITs. Thus, for REITs to trade publicly, there must be a special supervision organization for REITs which can coordinate all related authorities.

\textsuperscript{42} China Securities Regulatory Commission
\textsuperscript{43} State-owned Assets Supervision and Administration Commission
\textsuperscript{44} State Administration of Foreign Exchange
Part VI Conclusion

The Chinese real estate industry has a serious problem of financing channels, it is too much reliant on bank loans. REITs can provide an effective financing channel for the real estate industry, and promote rational development of the real estate industry. With high returns and low risks, REITs also give a good investment opportunity, especially for the ordinary investors who have little capital for the real estate investment. The outstanding advantages of REITs will have a significant impact on both real estate and financial industry. Since the real estate and financial industry are so important to the national economy, REITs will play an important role in contributing to economic growth and development.

Due to the conditions of the real estate industry, trust products and investors, the introduction of REITs is basically feasible in China. However, there are some barriers for the REITs development: imperfect legal system, lack of fair play on the market, unsuitable tax system, shortage of professionals...

In order to introduce and develop REITs in China, the legal system must be improved firstly. A suitable tax system has to be introduced for REITs, while most the REITs investments are generated by tax incentives. A comprehensive supervision system is needed, and professionals of REITs should be trained and recruited. As a recommendation of this thesis, good development of Real estate trust products can be the breakthrough of the introduction and development of REITs.

Finally, there are some questions left for the future studies:

First, the current macro-control of the Chinese government is strongly against the “overheated” real estate industry, what could be the effect to the introduction of REITs?

Second, the development of REITs will involve product design, securities issuance and trading, and listing rules etc. The whole process cannot be just copied from other countries; it has to match the reality in China. Such a suitable process needs to be researched by the future studies.
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Zusammenfassung


Die Einführung von Real Estate Investment Trusts (REITs) hat eine wichtige Bedeutung für die Immobilienwirtschaft und den Finanzmarkt. REITs können eine wirksame Finanzierungsquelle für die Immobilienwirtschaft werden, und geben den Anlegern Investitionsmöglichkeiten mit potential hohen Renditen und geringen Risiken.

Die vorliegende Arbeit versucht die Bedeutung der Einführung von REITs in der chinesischen Immobilienbranche und an den Finanzmärkten zu analysieren. Der Zweck dabei ist, einen geeigneten und bedienbaren REITs-Rahmen für China zu finden.

Grundsätzlich gliedert sich die Arbeit in 4 Abschnitte: Der Erste gibt eine Übersicht über REITs. Er enthält die Definition von REITs, die Performance von REITs als Finanzprodukt sowie ein internationaler Vergleich von REITs. Der zweite Teil beschreibt den Hintergrund der chinesischen Immobilienbranche. Er umfasst die Bedeutung der Immobilienwirtschaft für die chinesische Volkswirtschaft, die Finanzierungsquellen für die Immobilienwirtschaft, und die Probleme, die in der Struktur der Finanzierung existieren. Die Bedeutung der Einführung von REITs in
China, sowie deren Wirkung auf die Immobilienbranche, den Finanzmarkt und der Anleger wird im dritten Teil analysiert. Im letzten Abschnitt wird versucht, die geeigneten Rahmenbedingungen für REITs in China zu suchen. Weiters werden die Möglichkeiten, die Entwicklungsstrategien, die Barrieren und politischen Empfehlungen für die REITs-Einführung und deren Entwicklung in China diskutiert.
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