

Vicious circle

Overcapacity will continue to plague real estate developers in 2009

In Shanghai, Zhou Lin almost has it all. The 27-year-old has a steady job with an auditing firm and a new husband. Now she and her spouse are looking for the next piece of the newlywed puzzle. Her husband already owns an apartment in Beijing, but Zhou's family wants them to buy something close to home in Shanghai and she's been scouring the city's Putuo district for deals.

"We want to buy a house as soon as possible, but I don't think now is a good time. We may have to wait until next year when the price is more acceptable," she told CHINA ECONOMIC REVIEW.

While Zhou is waiting for prices to bottom out, others have already seized upon bargains. Stella Ye, a Beijing-based public relations consultant, purchased an apartment in her native Chengdu in December. Ye said the timing of her purchase was driven in large part by price cuts.

"I planned to buy an apartment in 2007, but now the price has dropped sharply, although it is still not very cheap," she said.

The waiting game

Zhou and Ye provide a glimpse into the stalemate being played out in China's property markets. Overextended developers are struggling to entice buyers at a price that will help salvage what many believe will be another challenging year. Buyers are waiting to see the market's floor before they purchase.

While a rebound in China's property markets won't singlehandedly counter the country's slowing economic growth, it would provide a welcome boost to a flagging economy. A study by brokerage Nomura International in Hong Kong found that China's property sectors ac-

Also in this section

- ▶ **ONES TO WATCH:** Property firms to back in a downturn, p32
- ▶ **URBAN FUTURE:** Property demand will be robust in the long term, p34
- ▶ **ACTION POINTS:** What Beijing has done to boost the market, p36
- ▶ **M&A:** Opportunities to pick up real estate assets on the cheap, p37
- ▶ **CAPITAL CONTROLS:** Foreigners kept out by hot money concerns, p39



Built to last: Shelter for the individual investor

Analysts recommend blue-chip property stocks with strong state ties, renowned brand names and proven management. Top tips include:

China Resources Land (1109.HK)

Land bank: 21.94 million square meters (according to 2008 interim report)

2008 interim results: Net profit US\$106.9 million (up 44.3% year-on-year); Revenue US\$358.6 million (up 58.4%)

Analyst take: In a class of its own. China Resources is one of the only property developers with a stable of mature retail and office investment



Photorex

properties, including its crown jewel, the Shenzhen Crossing Phase 1. The power of the brand also spills over into its popular residential assets. Unparalleled support from parent company means the firm can avoid huge cash outflows when acquiring assets.

China Overseas Land and Investment (0688.HK)

Land bank: 24.78 million square meters (according to 2008 interim report)
2008 interim results: Net profit US\$298 million (up 68.8% year-on-year); Revenue US\$1.4 billion (up 125.2%)
Analyst take: Only getting stronger. The announced US\$131.7 billion government spending on low-end housing should hit mid-range property developers such as Agile, Country Garden and China Vanke, thus widening COLI's lead in the medium

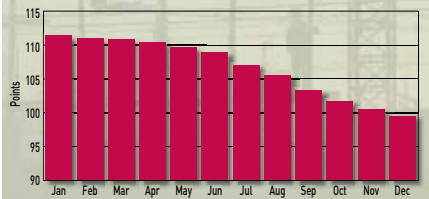
term, according to a report by Citi. Total contracted sales for the first 11 months of 2008 grew by 34.3% year-on-year.

Sino-Ocean Land (3377.HK)

Land bank: 10.6 million square meters (according to 2008 interim report)
2008 interim results: Gross profit US\$206.3 million (up 180% year-on-year); Revenue US\$475.5 million (up 78%)
Analyst take: Punching above its weight. Analysts say the "King of Beijing" boasts one of the highest-quality land banks in China, 80% of which is in the high-growth Bohai Rim region. Contracted sales as of December had skyrocketed to US\$1 billion, 130% of its full-year target. With a relatively low net gearing ratio of 40-45% and 45% of estimated 2009 revenues already locked in, Citi sees Sino-Ocean as an antidote to real estate naysayers.

Eroded confidence

Housing price index 2008



Source: NBS

count for 8% of nominal GDP and 10% of the country's total employment.

Yin Zhongli, vice director of the institute for finance and banking at the Chinese Academy of Social Sciences in Beijing, is pessimistic about the difference property might make this year, however. "Reviving the real estate market in 2009 is impossible, because there is an imbalance in supply and demand," he said.

Residential real estate prices had been on a steady climb for years, to the glee of many. Local governments, which derive much of their revenue from land sales, courted developers while raising land prices. Developers financed their projects with debt from willing state-run banks.

One expert referred to the cycle as "the greater fool theory," in which developers, investors and individual homebuyers could flip their property at a higher price to the next buyer. All the while, the inventory of unoccupied homes grew.

But years of aggressive expansion collided with economic uncertainty in the second half of 2008, dragging the property market into a slump. "China has run out of fools," the expert said.

Overstretched

Residential vacancy rates ballooned by 47% over the course of 2008, reaching 90.7 million square meters. China's housing price index stood at 99.6 at the end of December, down from 111.3 in January, and analysts say official figures paint a rosy picture of the current situation.

While there is some evidence of a slight turnaround, most predict that 2009 will be tumultuous year for China's property markets as well as developers.

Although keen to promote the long-term view of urbanization-fueled demand, Xiao Li, vice president of China Vanke, the country's largest real estate developer, admitted that "short-term market fluctuations in supply and demand may exist."

Xiao said that Vanke last year slowed its development activity to 5.7 million square meters of ground floor area >>



A PLACE IN THE CITY:
The upwardly mobile rural dweller's dream

PHOTO: EX

The long view: China's urban future

If you thought China's cities were big now, just wait a few decades. A study released late last year by McKinsey & Company estimated that the country's urban population would reach 1 billion by 2030, up from 572 million in 2005. This means that China will add more people to its cities than the entire population of the US over the 25-year period.

Analysts see this drive to urbanization as one of the key fundamental strengths underpinning China's residential property markets. McKinsey estimates that 40 billion square meters of ground floor area will be built in 5 million buildings to accommodate this influx of new residents.

"We have always believed that the slowdown in the mass market residential [market] is a temporary phenomenon because the underlying fundamentals of the market are phenomenal. That's not necessarily the case in a place like the US or the UK or Australia," said Michael Klibaner, national director and head of research for property consultancy Jones Lang LaSalle in Shanghai.

The trend is one of both necessity and central government policy as China seeks to quadruple per capita GDP by 2020 from its 2000 level and move its workers from labor-intensive industries to service industries. In addition, changes to the laws governing land-use rights will in theory incentivize farmers to migrate to the cities, hopefully with

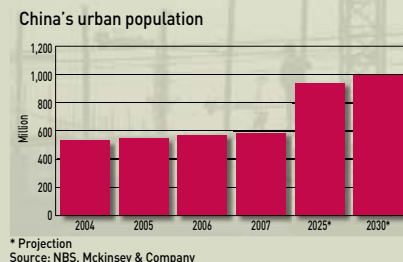
cash in their pockets.

This wave of migration will create eight "megacities" with populations of over 10 million, up from the current two. Furthermore, 81 new urban centers with a total population of 27 million will emerge between 2006 and 2025, most located within 50 kilometers of current cities.

While not all of these new urban dwellers will be able to afford to buy houses, the long-term growth story for residential markets remains in place, according to Rong Ren, CEO of Harvest Capital, which has about US\$1 billion under management in two Greater China-focused real estate funds.

"These people, though many will not be our consumers for the time being, they will come up in the future," he said, adding that if one estimates a modest 20 square meters per head, the required amount of housing will be "massive" for the next 15 years.

Migrant hordes



>> (GFA) compared to a planned 8.48 million in response to market conditions.

Vanke isn't alone in curbing development. According to official statistics, GFA under construction in China grew by 16% from January to December of last year, to 2.74 billion square meters. This is down sharply on the 23% rise for the first 11 months of 2007 (full-year figures for 2007 were not available).

Such cutbacks, though needed, do little to address the current situation.

"There is oversupply across the board," said Jing Ulrich, chairman of China Equities at J.P. Morgan, speaking to reporters in February. Based on 2008 sales levels, she estimates it will take one-and-a-half years to clear unsold inventory in Beijing, Shanghai, Shenzhen and Guangzhou. In this environment, developers are struggling to make ends meet.

"Funding is a common trouble for Chinese real estate enterprises in 2009, no matter if they are state-owned or non-state-owned, listed or non-listed," said Pan Shiyi, CEO of developer Soho China, responding to questions submitted by CHINA ECONOMIC REVIEW via his blog.

Austerity out

For the past three years, restrictions on bank lending to developers have been at the heart of government efforts to cool the property sector. These restrictions were reversed late last year alongside the introduction of a raft of policies to entice homebuyers back into the market (See: "Stimulus: Market boosting measures"). Chinese banks went on a lending spree in January, extending US\$237 million in loans, more than doubling lending from the year before.

Policymakers hope the surge in lending bolsters developers, but this is unlikely, according to David Ng, head of regional property research for Royal Bank of Scotland (RBS) in Hong Kong.

"Developers are very cautious, which makes me believe that loan growth and credit easing won't be that attractive for developers. When nobody's buying the existing inventory, why would they want to borrow money to build more?"

Some believe that statistics on overcapacity might be overstating the problem, however. Nomura International in Hong Kong has found that November's vacancy rate of 70.8 million square meters, while representing an increase of around 15% since March, is one of the lowest rates seen in the past 10 years.

Market share for top 10 national developers, 2008

Vanke (000002.SZ)	2.29%
China Overseas (688.HK)	1.30%
Poly (600048.SH)	1.04%
Greentown (3900.HK)	0.79%
R&F (2777.HK)	0.79%
Gemdale (600383.SH)	0.56%
Agile (3383.HK)	0.37%
Forté (2337.HK)	0.26%
China Resources (1109.HK)	0.22%
China Merchants (000024.SZ)	0.21%

Source: Centaline

Kenneth Gaw, president and co-founder of Gaw Capital Partners, a private equity firm with around US\$1 billion under management in the Asia-Pacific region, said he expects a sharp drop off in supply over the next two years due to lack of funding, while core demand remains unchanged. This will lead to opportunities for those investors who have the stomach to ride out the current downturn.

This is the case that believers in China's residential market make time and again. Despite short-term fluctuations in supply, a low base of modern housing, as well as a vast population and continued urbanization will fuel robust residential demand for years to come (See "The long view: China's urban future").

There may already have been signs of a shift in market sentiment. Residential transaction volumes received a small

bump in November 2008, rising to 40.3 million square meters, from 39.64 million in October. The significance of this figure is widely disputed. Some believe it marks the beginning of a recovery, while others see it as a monthly anomaly.

Soho China's Pan is in the latter camp and notes that more than 50% of November's transaction volumes in Beijing was driven by low-income housing.

"The sharp downturn in transaction volumes did not change," he said.

The year ahead

The conventional wisdom among many analysts who spoke to CHINA ECONOMIC REVIEW is that housing prices will fall in 2009 while transaction volumes increase – meaning that larger developers who can survive on volume sales while forsaking margins will be best suited to weather the storm.

But RBS's Ng is cautious about volume growth this year. While price cuts may have been effective in boosting transaction volumes in 2008, he expects the strategy to yield diminishing returns.

"The effect of price cuts may not be replicable in 2009. People have seen the price cuts last year and now everyone is cutting prices. It's become more competitive," Ng said.

Analysts believe that purchases by "end users" – those who intend to use the house as their primary residence – will drive volume growth this year. But market watchers are anxiously await-

ing the return of people to buy additional residences for investment purposes, to know that the market is back on track.

Stella Ye may be ahead of the curve in this respect. Her apartment in Chengdu was her third home purchase, the other two being in Beijing. Ye bought the apartment primarily as a residence for her parents and for her frequent visits home.

These buying patterns were once common in Chengdu, according to Eddie >>



NEW TERRITORY:
Many developers have expanded unwisely



DRAGONFLY
Dragonfly Real Estate

Chinese Massage
Japanese Massage
Aroma Oil Massage
Oriental Foot Massage
Manicure
Pedicure
Waxing
Facial
Tanning

*Your inner voice
rings loud in a quiet Retreat...*

www.dragonfly.net.cn

SHANGHAI BEIJING SUZHOU HANGZHOU QINGDAO CHONGQING DSELD DUBAI

SHANGHAI
DRAGONFLY PETITE @ DONGHU
Tel: +86 21 5405-0008
20 Donghu Road

DRAGONFLY @ XINLE
Tel: +86 21 5403-9982
206 Xinle Road

DRAGONFLY @ HONGMEI
Tel: +86 21 6242-4328
Villa 5, 3911 Hongmei Road

DRAGONFLY @ KERRY GYM
Tel: +86 21 6279-4625
Shanghai Kerry Center

DRAGONFLY @ JINGAN
Tel: +86 21 6327-1193
458 Diegu Road

DRAGONFLY @ SRCA
Tel: +86 21 2201-0899
555 Jinfeng Road

DRAGONFLY @ FUXING PARK
Tel: +86 21 5385-0060
84 Nanchang Road

DRAGONFLY @ BIYUN
Tel: +86 21 5030-7382
817-20, 633 Biyun Road, JinQiao

DRAGONFLY @ CHANGYI
Tel: +86 21 5878-4755
No.29-31 Changyi Road, LuJiazui

DRAGONFLY @ LIANYANG
Tel: +86 21 5833-7549
1110 Yingchun Road

>> Ng, the managing director of property consultancy Jones Lang LaSalle's office there. Buyers would purchase multiple homes with the expectation that the price would increase between pre-sale and occupancy. The downturn in the market, combined with a weak leasing market, has scared many of those buyers away.

"At the start of 2006, every week there was some investor coming to my office. But in the last four to five months I've only had visitors once a month or once every two months," he said.

Flight to quality

According to Greg Penn, senior managing director of investment properties for CB Richard Ellis in Hong Kong, it is not unusual for investors to leave second- and third-tier cities in a downturn and return to the first tier for deals. Rising prices and unfavorable government policies pushed many investors into the lower-tier cities for deals in 2006 and 2007. But this has changed as prices have dropped to affordable levels. Cash-strapped local developers, often with attractive assets but limited funding options, also are beginning to look more seriously at selling off their portfolios to raise money.

"A couple of years ago we were looking at secondary and tertiary cities, [but] today we're mostly focused on major cities," said Robert Zulkoski, managing director of US private equity firm Oaktree Capital Management's office in Singapore.

He describes the allure of the first-tier cities in one word: comfort. Although opportunities exist throughout China, the first tier has the veneer of reliability. Zulkoski said Oaktree was likely to close a deal in China in the second quarter.

Analysts say that this return to comfort should also guide individual investors looking to invest in China's listed real estate developers. They suggest taking shelter in big brand names with national exposure and strong ties to the state – the likes of China Resources Land and China Overseas Land Investment (See "Built to

last: Shelter for the individual investor").

These developers have geographically diversified assets as well as war chests that put them in a position to weather the expected industry consolidation.

That consolidation is coming is beyond dispute. But the shape it will take and its long-term implications remain a matter of debate. Between 2,000-3,000 property developers are active in each city, many with only one or two properties. Manfred Ho, an analyst with Bank of China International in Hong Kong expects this inefficiency to be rectified, but not as drastically as some might believe.

"I actually won't expect to see 30-40% of developers [disappearing] in a year or something like this. I think it will be a longer-term procedure," he said.

Nonetheless, M&A activity is expected to pick up in the second half of the year, encouraged by M&A laws released in December that allow banks to extend loans for acquisitions. Such lending will almost certainly favor larger developers and they will have plenty of targets to choose from, many of whom had no business getting into real estate in the first place.

"Ten years ago, everybody wanted to be a real estate developer ... Everyone from autos to steel to cement companies have been active in real estate," said Michael Harris, chief operating and investment officer at Beijing-based Gao Fei Consulting, which works with private equity firms investing in real estate assets.

Hand of the state

These "part-time developers" would be the likely first victims in any wave of industry consolidation, although takeover candidates with strong ties to local governments may have a staying power beyond their commercial viability.

Market watchers also expect the central government to step in before any major developer goes bust, as such an incident would further deteriorate shaky market sentiment. As such, some believe much of the consolidation will occur under the radar, rather than via mass selloffs of portfolios by collapsing developers.

"Consolidation doesn't mean firesale," said Rong Ren, chief executive of private equity firm Harvest Capital in Hong Kong, which has about US\$1 billion under management in two Greater China-focused real estate funds. "I think the consolidation will be gradual, face driven, more partnership-driven. That's part of the Chinese philosophy."



► Stimulus: Market boosting measures

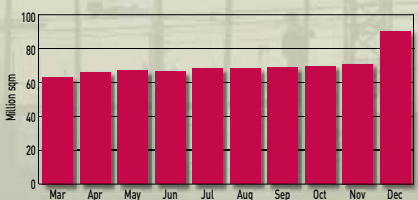
The central government, as well as many local governments, enacted measures to boost property markets in 2008.

Central government measures:

- Stamp duty of 0.05% waived.
- Land value-added tax of 0.5% of selling price waived.
- Down payment for first-time homebuyers reduced to 20% from 30% of price; Mortgage rate set at 0.7 times

Room to spare

Residential vacancies 2008



Source: NBS



FINE BALANCE: Beijing wants the buyers, not the speculators

Photo: Rex

the benchmark interest rate.

- Deed tax for first-time buyers of residential units below 90 square meters lowered to 1% from 1.5% .
- Buyers of second homes given same favorable mortgage rates as first-time buyers if their current home is smaller than the city average on a per capita basis.
- Business tax of 5.5% on property sales waived if the unit has been held for two years. The period was previously five years.
- Five interest rate cuts over four months, bringing the benchmark one-year lending and deposit rates to 5.31% and 2.25%, respectively.

At an impasse

China's property developers need cash. Foreign investors are waiting for the right moment to step in

Twelve months ago, Evergrande Real Estate was sitting on top of the world. The Guangzhou-based developer was honing in on an initial public offering in Hong Kong worth US\$2.1 billion, the largest ever by a Chinese property firm. Now it is fighting for its future.

Evergrande lost its shine when weakness in the Hong Kong equities market led to the IPO being axed in March, midway through the marketing process. But the company had been undermined by its own ambition months earlier.

"They acquired too much land before they did the IPO because that was advocated by the sponsors," said Carol Wu, an analyst at DBS Vickers in Hong Kong. "At the time, the larger the land bank you had, the better chance you had of raising funds from the equity market."

Evergrande's expansion was bankrolled by debt – including money from pre-IPO investors said to include Merrill Lynch and Deutsche Bank – that the company expected to pay off with its listing windfall. Pre-IPO investments are typically structured as bonds, which turn from debt to equity once a company lists.

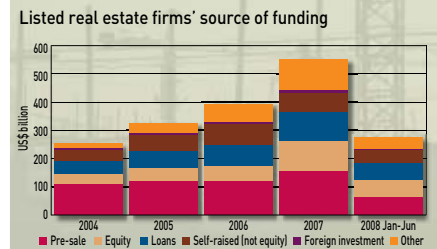
Evergrande wasn't dissuaded by the initial setback in March. Thinking it could resume its IPO preparations later in the year, the company renegotiated its position with existing investors and took on additional debt from new ones. Investors were promised greater equity exposure as a reflection of the greater risk.

As projects continue to generate losses due to dried up sales, and with an IPO looking unlikely, Evergrande is back in negotiations with investors, according to lawyers familiar with the situation. The fear is that investors will call in their debts and liquidate the company.

"They have to find some way or compromise if the developer is to have a chance to survive," said a Beijing-based lawyer who represents one of Evergrande's creditors. "If they don't, something very bad might happen to the market."

As it is, the market remains precariously balanced. While Evergrande's big

Capital quest



payday hinged on a successful IPO, listed developers placed their faith in the uninterrupted growth of China's property market. With banks and the debt and equity markets clamoring to satisfy their financing needs, these developers aggressively pursued new projects.

Now that these sources of capital have dried up, the developers need to find a way to tide themselves over until retail demand returns to the market. For many, this means only one thing: an asset sale. Prospective buyers are watching.

"We are helping clients look into purchases – sometimes it's for projects that need finishing; sometimes it's for projects that are already finished, but not yet sold," said Maurice Hoo, a partner in the Asia private equity group at Paul Hastings.

Much talk, little action

So far there has been very little deal-making. According to Rong Ren, CEO of private equity firm Harvest Capital, which has US\$1 billion under management in two Greater China real estate funds, this is because things have not got "down to the 'wow' stage in terms of price."

"There is a standoff in the market," said Harry Du, a partner at law firm King & Wood in Beijing. "Some people say it will end early this year, but others expect it to take another six months. They are waiting to see who dies first, and then they go after the assets."

As Du admits, though, things are rarely that simple. While in the US, failure to keep up with payments leads directly to foreclosure, in China the process is slower. Developers are not selling off >>

>> assets for 30 cents on the dollar because they don't have to – at least not yet.

Evergrande and others may have got in over their heads with foreign investors, but Wu of DBS Vickers estimates that overseas money accounts for just 2% of total real estate investment in China. The bulk of financing comes from Chinese banks and, on the whole, they are not known for pressuring borrowers.

“There have been times when banks in effect help out borrowers or just don't do much in terms of enforcing when re-financed loans are not being paid,” said Ben Fanger, co-founder and managing director of Shoreline Capital, a private equity firm that has spent US\$160 million on distressed assets in China since it was set up four years ago.

Smaller developers may ultimately be forced into discounted sell-offs, but Wu argues that some large players have reason to believe they can outlast the downturn. Even if it takes longer than expected for retail demand to return, developers can count on government support and banks that are being encouraged to lend more, rather than chase up existing debts.

To Jack Rodman, Beijing-based senior advisor to Westport Capital Partners, a US private equity firm that focuses on distressed real estate, the disconnect between developers and financial reality is responsible for many of the ills in China's property market. He points to an unwillingness to follow the rest of the world in properly re-pricing assets and oversupply throughout the market as particular problems.



NOTHING TO SMILE ABOUT:
Evergrande Chairman Xu Jiayin



IN STASIS: Distressed asset investors help stalled projects get back on track

“In March 2006 I looked out of my window, saw all these cranes, and said there was a wave of non-performing loans (NPLs) looming on the horizon,” Rodman said. “Now it's a sea of ‘see-through’ buildings which could become a new wave of NPLs if the banks got tough.”

Revolving doors

Although Rodman has little appetite for real estate investment in China at present, he believes there is potential in restructuring investments made by foreign investors, essentially “straightening out the other guy's mistakes.”

These clients are often hedge funds looking to liquidate their holdings in developers that failed to come good on IPO plans, or private equity firms with short investment horizons that are unwilling to wait for improvements in the market. In some cases, the reasoning isn't related to China specifically: The global financial crisis has left investment banks under pressure to add liquidity to their balance sheets while hedge funds are subject to increasing redemptions.

Market watchers report considerably less activity from hedge funds such as Och Ziff Capital Management, Citadel Investment and Stark Capital. Similarly, it is frequently reported that the likes of Morgan Stanley and Macquarie are putting assets up for sale. Property developers and sovereign wealth funds – basically anyone with a longer-term outlook – are often touted as potential buyers.

“In the last four months, we have seen

a large increase in the number of opportunities coming from distressed Western sellers,” said Fanger of Shoreline Capital.

Despite Chinese banks' hesitance over foreclosures, distressed asset specialists insist there is money to be made, leveraging their expertise in extracting value from seemingly lost causes. Phil Groves, founder and president of DAC Management, which has about US\$450 million invested in distressed assets in China, points out that although the amount of assets put up for sale is a fraction of the total, this fraction may still be larger than that of a smaller country with a fully functioning distressed debt market.

DAC's biggest deal in China arose after a bank foreclosed on debts owed by a company that held a 50% stake in the Ramada Inn in the northeastern city of Dalian. DAC acquired the stake through the bankruptcy courts, bought out the other shareholder to gain full ownership of the hotel, and then set about upgrading it into a five-star property.

Investments are often made when



Source: Wind

project debts are outstanding but not yet non-performing, such as a bridge loan for an otherwise healthy company that is temporarily unable to raise funds.

Groves says the market really opened up when Beijing imposed restrictions on pre-sale financing, making developers commit more of their own capital to projects up front. If a developer runs out of money before a project is finished, an investor may step in and see it through.

"You are seeing now a lot of Chinese developers needing more money and the storm is going to gravitate toward the largest real estate developers," said Groves. "Private equity investors and other distressed asset people will give them cash to finish their existing projects."

Fanger describes Shoreline's strategy as taking advantage of the inefficiencies in capital allocation and information arbitrage. A portfolio of real estate NPLs may include assets that are so widely dispersed or difficult to understand that the seller hasn't the time to deal with them.

"It all depends on how anxious the person is to sell – they have to be more interested in cash than they are in the assets," Fanger said.

The bad debt burden

In the current climate, few people expect Chinese banks' NPL ratios to improve.

In 2006, reports issued by several foreign investment banks and ratings agencies put the number of special mention loans (loans that are not non-performing but likely to become so) at US\$300-400 billion. Property-related lending accounts for 40% of total lending and between 2006 and 2008, lending to this sector expanded by 35% each year, said Rodman.

His concern is that a new wave of bad debts will be added to the books and they will simply be moved around without being properly addressed. As a result, real estate developers would remain oblivious to the realities of demand and supply.

According to Michael Harris, chief operating and investment officer at Beijing-based Gao Fei Consulting, Beijing's decision that banks should be more aggressive in their lending merely presented developers with a golden opportunity to borrow themselves into trouble again.

"With the possible exception of Shanghai, these guys have never gone through a real down cycle and they don't really understand the long-term ramifications of changes in real estate market dynamics," he said. ♦

▶ Hot topic: Beijing's capital controls

Alarm bells rang in Beijing in April 2008 when the State Information Center claimed hot money inflows tripled in the first quarter to US\$80 billion. Some analysts put the figure even higher at US\$100-120 billion.

That growth came despite Beijing's best efforts to stymie the tide of cash being deposited in equities, currency and property – all with a view to profiting from renminbi appreciation.

Tighter property investment controls were laid out in two notices, Circular 171 and Circular 50, released in July 2006 and May 2007, respectively, by the Ministry of Commerce (MOFCOM) and the State Administration of Foreign Exchange. Under the new rules, foreigners looking to invest in Chinese real estate must do so through foreign-invested enterprises (FIEs) registered in China. An FIE must be registered with MOFCOM and it must notify the ministry of all investments.

The amount of capital the FIE is permitted to spend must be registered – and none of the money can be backed by debt; it's a cash only business. Originally, 50% of the capital could be debt financed, but the government upped the ante when it saw that hot money inflows still weren't falling, said Maurice Hoo, a partner in the Asia private equity group at law firm Paul Hastings.

"It's a cash trap," said Hoo. "It might take two years to finish the building and begin selling and then after two-and-a-

half years you start to bring in money. The remaining capital is stuck with the company until all the units are sold and all the tax has been paid, which may take another year or so."

Problems also arise in the general structure of the business. A foreign investor usually sets up a company in the Cayman Islands that holds a controlling stake in the onshore enterprise and receives the profits via dividends. However, due to foreign exchange controls, the holding company is unable to use onshore assets as a guarantee for money raised offshore and injected into the onshore enterprise.

"It has affected investor interest," Hoo said. "When you need to keep more money in the country for longer it affects your internal rate of return. One or two years ago when the real estate market was really hot, more people were willing to overcome that. Maybe now they feel the return is insufficient."

While the rules are still in place, Jack Rodman, the Beijing-based senior advisor to property-focused private equity firm Westport Capital Partners, said the approvals process has been eased considerably in recent months.

"Now people can get things done in 30-45 days that in the past we would tell them might not get done at all," he said. "Six months ago they were writing about hot money inflows. Now that hot money is going the other way."



GOING LOCAL: It isn't easy for a foreign investor