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# POLY DEVELOPMENTS: REIT Securitization in China's Rental Housing Market



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*As China's residential real estate prices continue to rise, home ownership has become increasingly out of reach for many people. Yet rental housing is not a reliable option for most because of lack of development and other challenges. Meanwhile, many homes sit empty with owners reluctant to rent them out; the vacancy rate is at least 10% across China's mid-sized and large cities.<sup>1</sup> These puzzling trends exemplify the fundamental economic and social dilemma in the real estate sector facing China's policymakers, who already see a need to tamp down on speculative investments but cannot use methods that would depreciate properties of existing homeowners. Solutions necessarily start with China's top real estate developers, but thus far few are finding enough incentives to pursue greenfield rental housing projects.*

A step in the right direction could be the establishment of a Real Estate Investment Trust (REIT) by China's Poly Developments and Holdings Group Co. Ltd. For investors, REITs provide a return on their real estate investment without direct ownership, which could cut down on housing speculation. For developers, REITs offer another route for the financing of their projects so they don't have to be over-reliant on bank financing. However, major reform of China's policy environment is

needed before increased securitization of the housing market can take hold. Until then, the road towards a mature, consumer-friendly rental market is likely to remain bumpy.

## FROM HOUSING BOOM TO HOUSING WOES

Now in its 40th year, China's economic reform and market-oriented growth strategy cannot be understood

<sup>1</sup> "A Fifth of China's Homes Are Empty. That's 50 Million Apartments." Bloomberg.com. November 8, 2018. Accessed January 20, 2019. <https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments>.

fully without considering the key role played by the housing market. Today, this sector remains the focus of the government's macro-economic strategies, which are continually tasked with balancing the needs of social stability with economic growth.

China's transformation to a more market-oriented housing allocation system dates to the earliest days of economic reform, beginning with Deng Xiaoping's 1980 statement that urbanites should have the right to purchase or build homes of their own.<sup>2</sup> But most people sat on the sidelines, wary of weak legal protections, uncertain about the nascent financial markets, and reluctant to pass up the welfare benefits of workplace-based housing allocations (the 'danwei' system).

In the mid-1990s, some workplaces began making changes. But things took a turn in 1998, when privatization of state-allocated housing became mandatory. Households either had to buy their allocated housing — at a considerable discount, however — or expect to pay rent. Within 18 months, 60% of all urban public housing was sold. By 2002, 80% was in private hands. The once cushy benefits associated with workplace-based housing ceased to exist.<sup>3</sup>

By 2010, challenges in managing a more market-based housing allocation system became clear. Urban housing prices had jumped over the past decade, averaging nearly 13% per year, according to a survey of 35 major cities. In China's largest cities, the increase was even higher. In Beijing and Shanghai, for example, housing prices rose annually by nearly 16% between 2002 and 2010.<sup>4</sup> However, price hikes were not the result of a housing shortage. Indeed, China's real estate developers built the equivalent of Europe's entire existing housing stock in just the first decade of the 21st century.<sup>5</sup> But demand still grew hotter.

In recent years, the local and central governments unveiled a long list of initiatives to cool down demand. These policy measures, however, are no match for the demographic and financial drivers that continue to push housing prices upward. They include a dramatic rise in

urban population, a lack of equally robust alternative investment channels available to households, a gender imbalance that encourages home ownership as a mark of male suitability for marriage, and, until recently, the absence of a national landownership database. The latter had made 'home accumulation' an attractive channel for, and possibly enable the hiding of, family wealth.<sup>6</sup> Interest in multiple-home ownership persists in China, despite regulations that require as much as a 50% down payment for anyone seeking a mortgage for a second or third home purchase.<sup>7</sup>

As a result, China's average housing price-to-income ratio of 8 to 10 is higher than those found in most advanced economies. The United States, for example, only had an average housing-to-income ratio of 3 even during its most recent housing bubble. Today, China is on par with Japan's experience during its own housing bubble.<sup>8</sup> The result of all this accumulation: an extremely large stock of urban housing in China of which 22% — 50 million apartments — is owned but sits vacant.<sup>9</sup> Little wonder there is much talk about when China's housing bubble might burst.

Meanwhile, government efforts to cool the market continue to face deep challenges. For one, insisting that developers allocate a share of any new housing project for low-income housing is not an adequate solution to China's growing gap between the rich and poor. Low affordability means that home ownership will remain out of reach for China's younger generation and the millions of long-term rural-to-urban folks who now regard the largest cities as their home. And the rental market is not robust enough to meet their needs.

## **MAKING A RENTAL MARKET: A NEW PARTNERSHIP OF GOVERNMENT AND BUSINESS**

Chinese President Xi Jinping has been quick to respond. In October 2017, as part of his political report to the 19th National Party Congress, he declared that "houses are built for living, not for [economic] speculating." Xi promised that the government would "make rental

2 Yang, Zan, and Jie Chen. "Housing Reform and the Housing Market in Urban China." *Springer Briefs in Economics Housing Affordability and Housing Policy in Urban China*, 2014, 16. doi:10.1007/978-3-642-54044-8\_2.

3 Ibid., p.23

4 Ibid., p.25

5 "Building Rome in a Day." Economist Intelligence Unit, 2011, [www.eiu.com](http://www.eiu.com), Accessed January 20, 2019

6 Bradsher, Keith. "China's Housing Market Is Like a Casino. Can a Property Tax Tame It?" *The New York Times*. January 22, 2018. Accessed January 20, 2019. <https://www.nytimes.com/2018/01/22/business/china-housing-property-tax.html>.

7 Yang, Zan, and Jie Chen. "Housing Reform and the Housing Market in Urban China." *SpringerBriefs in Economics Housing Affordability and Housing Policy in Urban China*, 2014, 30. doi:10.1007/978-3-642-54044-8\_2.

8 Chen, Kaiji, and Yi Wen. "China's Great Housing Boom." *VoxChina*. October 11, 2017. Accessed January 20, 2019. <http://vochina.org/show-3-50.html>.

9 "A Fifth of China's Homes Are Empty. That's 50 Million Apartments." *Bloomberg.com*. November 8, 2018. Accessed January 24, 2019. <https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments>.



housing as important as home purchasing.”<sup>10</sup> Doing so, however, requires cooperation between business and government, as well as significant changes to existing policies as a means to encourage rental property development. Stronger trust between landlords and tenants is also needed.

With less than 12% of the population living in rented housing, China remains far behind other countries in its ability to house those who cannot afford to purchase a home or wish not to do so because of lifestyle preferences.<sup>11</sup> As of late 2017, fewer than two million rooms-for-rent were under the ownership or management of either developers or rental companies.<sup>12</sup> Demand nonetheless continues to rise. For many Chinese, especially those with lower incomes, finding a rental is often the result of direct negotiation with a landlord, with little guarantee of contract or service provisions.<sup>13</sup>

Affordable rental housing is especially in demand in China’s largest cities. To support its development, the government has put forth a number of policies, which include tax breaks to developers allocating a segment of their housing stock as rentals. The government has also increased land sales for rental-only housing developments. In addition, the central government selected 12 cities where local governments are permitted to pilot reforms in support of a more robust, soundly managed rental market. They include Guangzhou, Shenzhen, and Hangzhou.

As a result, a wide range of related policy innovations are now underway.<sup>14</sup> In Guangzhou, the local government has granted renters the same rights as homeowners,

allowing both equal access to schools for their children.<sup>15</sup> In Shenzhen, the China Construction Bank now offers rental housing loans at very favorable rates. Similar to mortgages, these loans are targeted at individuals who otherwise cannot afford to secure a rental.<sup>16</sup> Such properties usually require a large escrow deposit and these can be as much as a year’s rent in advance, in some places. In Hangzhou, Alibaba and Ant Financial partnered with the local government to develop a platform to lower the high transaction costs faced by both renters and landlords. Now registered landlords have access to a vetted pool of prospective tenants. Moreover, those with strong credit scores may no longer be required to offer large escrow deposits.<sup>17</sup>

China’s rental housing sector is now valued at around 1.1 trillion RMB (US \$163 billion\*), with a promise of 252 million renters by 2025, and market value of 4 trillion RMB (US \$596 billion) by 2030.<sup>18</sup> One of its earliest pioneers, Vanke, first tapped the rental market in 2007 by developing small rental apartments. By September 2017, Vanke operated 24,000 rental units in 24 cities.<sup>19</sup> Yu Liang, Vanke’s chairman and former chief executive officer, said in November 2017 that the company is set on becoming the leading player in the rental housing market.<sup>20</sup>

To do so, however, Vanke will need to beat both Ziroom and Xiangyu. By late 2017, these leading rental property management firms held 30% and 27%, respectively, of the rental market under management.<sup>21</sup> Their recipe for success has been simple: Source units from independent small-scale property owners and provide renters with housing options that feel customized to their needs. In exchange, these firms collect service fees which are used

10 Che, Pan. “Regulators Give Developers of Rented Housing a Financial Boost.” Caixin Global. October 25, 2017. Accessed January 24, 2019. <https://www.caixinglobal.com/2017-10-25/101160993.html>.

11 Ko, Tin-yau. “Xi’s ‘go Rental’ Message Could Alter China Housing Dynamics.” EJ Insight. October 23, 2017. Accessed January 24, 2019. <http://www.ejinsight.com/20171023-xis-go-rental-message-could-alter-china-housing-dynamics/>.

12 Chen, Yawen, Shu Zhang, and John Ruwitch. “How China’s Plan to Develop Rental Housing Backfired.” Reuters. September 14, 2018. Accessed January 24, 2019. <https://www.reuters.com/article/us-china-economy-houseprices-rent-analys-idUSKCN1LU0JA>.

13 Zheng, Yangpeng. “Long Road to Maturity for China’s Stratified Rental Housing Market.” South China Morning Post. December 19, 2018. Accessed January 24, 2019. <https://www.scmp.com/property/hong-kong-china/article/2178464/long-road-maturity-ahead-chinas-12-trillion-yuan-stratified>.

14 The full list includes Guangzhou, Shenzhen, Nanjing, Hangzhou, Xiamen, Wuhan, Chengdu, Shenyang, Hefei, Zhengzhou, Foshan and Zhaoqing: “50城房租收入比研究报告：北上深人均房租超2000元。” QQ Finance. July 23, 2017. Accessed January 24, 2019. <https://finance.qq.com/a/20170723/013331.htm>.

15 “China Moves to Boost Home Rental Market in Large, Medium Cities.” XinhuaNet. July 20, 2017. Accessed January 24, 2019. [http://www.xinhuanet.com/english/2017-07/20/c\\_136459297.htm](http://www.xinhuanet.com/english/2017-07/20/c_136459297.htm).

16 Zhang, Shu, and Ryan Woo. “China Pushes State Banks into Home Rental Market at Their Own Risk.” Reuters. June 04, 2018. Accessed January 24, 2019. <https://www.reuters.com/article/us-china-rentals-banks/china-pushes-state-banks-into-home-rental-market-at-their-own-risk-idUSKCN1J031N>.

17 Chen, Na. “Hangzhou Partners With Alibaba to Improve Rental Market.” Sixth Tone. August 10, 2017. Accessed January 24, 2019. <http://www.sixthtone.com/news/1000657/hangzhou-partners-with-alibaba-to-improve-rental-market>; <https://www.caixinglobal.com/2017-08-10/101128781.html>.

18 Li, Ran. “Why It’s Time for China’s Cities to Embrace Rental Housing.” Sixth Tone. September 18, 2017. Accessed January 24, 2019. <http://www.sixthtone.com/news/1000863/why-its-time-for-chinas-cities-to-embrace-rental-housing>.

19 Zhang, Xin, and Jiang, Xinyi. “China Vanke Bets on Growth in Rental Market.” Caixin. November 23, 2017. Accessed February 17, 2019. <https://www.caixinglobal.com/2017-11-23/china-vanke-bets-on-growth-in-rental-market-101174916.html>

20 Ibid.

21 Chen, Yawen, Shu Zhang, and John Ruwitch. “How China’s Plan to Develop Rental Housing Backfired.” Reuters. September 14, 2018. Accessed January 24, 2019. <https://www.reuters.com/article/us-china-economy-houseprices-rent-analys-idUSKCN1LU0JA>.

to develop additional proprietary offerings to secure brand differentiation.

But their model for success also points to a fundamental dilemma. Rental housing needs to be a scale-up business owing to its thin margins, which average 1% to 2% only. To boost rental housing stock, some firms have taken bank loans, and in extreme cases, even used a tenant's name to obtain them.<sup>22</sup> Ziroom, in contrast, has had the backing of domestic and international venture capital firms to support its rapid expansion. In 2018, with overall competition intensifying, a wave of overbidding on land and rental properties took hold. Highly leveraged landlords, in turn, passed these costs to tenants. In some cities, rents increased by as much as 30% between 2017 and 2018.

As such, banks were discouraged from commercial lending to firms that were borrowing with the sole purpose of increasing their rental housing stock. This was no easy fix, however. A larger issue remains: Rental housing is a 'build and hold' low-margin business. Traditional Chinese developers, in contrast, amassed their wealth using the 'quickly build-and-quickly sell' model. To get there, many relied on costly short-term debt. Given the high bond yields that even some of China's largest developers must now pay to attract investors, they have little incentive to rent out, no less 'build and hold' housing stock instead of just selling it as quickly as possible.<sup>23</sup>

Private real estate firms, as such, needed a project finance model that would allow them to heed the government's call to expand the rental housing market, but without making their own debt problems worse. Vanke's novel solution is indicative of this challenge. In exchange for agreeing to prepay a 10-year lease upfront, prospective tenants of its new rental housing project outside Beijing are guaranteed no further rental increases during the same period. Even if Vanke found such tenants, with a reported net operating income to market value below 3%, it will be decades before Vanke recovers its investment in this rental property development.<sup>24</sup>

In effect, the challenge of fueling rental housing property development in China without weakening corporate balance sheets or transferring the full cost of these developments onto renters remains.

Securitization, which entails the transformation of either contractual debt or illiquid assets and their related cash flows into dividend-paying securities, has emerged as a growing solution, one that opens a new financing avenue to China's real estate developers.

## ON THE ROAD TO SECURITIZATION

For years, residential property developers and investors alike have been waiting for the launch of residential housing securitization products on the Chinese mainland. Securitization of commercial properties, in contrast, has been underway for some time. Only now, with the push from the central government, are residential quasi-REITs and asset-backed products hitting the market.

Supporters of this trend have argued that REITs not only offer a new means of financing, but also have the potential to cool China's property market once these products become available to retail investors.<sup>25</sup> Specifically, in lieu of directly buying additional residential property for investment purposes, retail investors might instead invest in a REIT, the portfolio of which would be comprised of housing properties. REITs, as such, have important social policy implications for China. They open the possibility that the financial gains from China's rapid urbanization might be more evenly distributed.

Perhaps the government is getting the message. By mid-2018, it had approved 17 rental apartment securitization products. In January 2017, Shanghai-based Mofang Service Apartment Group was the first to issue an asset-backed security (ABS) in the rental apartments sector. Ziroom quickly followed. The size of the issuance was about 385 million and 500 million yuan (US \$57 million and \$75 million), respectively.<sup>26</sup> But compared to international-standard REITs, the underlying assets of an ABS typically do not include ownership rights of the underlying properties.

22 Gopalan, Nisha. "China's Rental Surge Is a Gordian Knot." Bloomberg.com. October 8, 2018. Accessed January 24, 2019. <https://www.bloomberg.com/opinion/articles/2018-10-08/china-s-property-rental-surge-is-a-gordian-knot-for-beijing>.

23 Hong, Carrie. "Default Risks Rise in \$355 Billion China Builder Bond Market." Bloomberg.com. November 4, 2018. Accessed January 24, 2019. <https://www.bloomberg.com/news/articles/2018-11-04/default-risks-rise-in-355-billion-china-property-bond-market>.; Balding, Christopher. "Why China Can't Fix Its Housing Bubble." Bloomberg.com. June 24, 2018. Accessed January 24, 2019. <https://www.bloomberg.com/opinion/articles/2018-06-24/why-china-can-t-fix-its-housing-bubble>.

24 Zheng, Yangpeng. "China Vanke's Rental Challenge: 'We Freeze If You Prepay for a Decade.'" South China Morning Post. April 18, 2018. Accessed January 24, 2019. <https://www.scmp.com/property/hong-kong-china/article/2141998/china-vankes-y18m-rental-challenge-we-freeze-monthly-rents>.

25 For an in-depth overview of the development of China REITs, please see: He, Ken. "China REITs: Property Landlords to Shine." DBS Asian Insights, May 2018.; He, Sihang. *REITs for Residential Rental Markets in China*. Master's thesis, Massachusetts Institute of Technology, 2018.

26 Hong, David. "Four Tap into Asset-backed Securities on Rental Flats – Who'll be Next." South China Morning Post. July 20, 2018. Accessed February 17, 2019. <https://www.scmp.com/property/hong-kong-china/article/2118862/four-tap-asset-backed-securities-rental-flats-wholl-be-next>

China's quasi-REITs bear more resemblance to internationally-recognized REIT products owing to their equity-like nature, but they are not yet being made available to retail investors. In October 2017, China Young Professional Apartments (CYPA) issued a quasi-REIT product, with an issuance size of 270 million yuan (US \$40 million). The security comprised a senior tranche and an equity tranche with maturities of five years.<sup>27</sup>

Because of the quasi-REIT's equity-like nature, it lets issuers raise more funds as compared to asset-backed securities. Issuers also receive off-balance sheet treatment for such financing, whereas asset-backed securities do not. Quasi-REITs thus increase liquidity for and reduce the debt burden of the issuer. They also have some tax advantages in cases where the quasi-REIT is a mix of equity and debt, but not in the same way as an international standard REIT.<sup>28</sup>

China's Poly Developments is the first state-owned enterprise to secure financing in this way. In March 2018, Poly Developments introduced its own quasi-REIT product, with an issuance size of up to 5 billion yuan (US \$745 million)<sup>29</sup> — indicative of the government's support of Poly's financing strategy.

## CHINA'S POLY DEVELOPMENTS AND HOLDINGS GROUP

Starting out in the early 1980s as a subsidiary of the China International Trust and Investment Corporation (CITIC), the China Poly Group today is among the 102 central state-owned enterprises that fall under the direct supervision of the State-owned Assets Supervision and Administration Commission of the State Council (SASAC).<sup>30</sup> It is engaged in a diverse array of businesses in sectors such as energy, culture and the arts, defense manufacturing and trade, as well as real estate. In total, this conglomerate comprises 600 subsidiaries, with 60,000 employees. Real estate is one of its major lines of business.<sup>31</sup>

The Poly Real Estate (Group) Co. Ltd., established in 1992, engages in everything from real estate

development to architectural design, construction, property management, and hotel management. It is well known for the uniquely designed 'Poly Plaza' in Beijing, which also houses the Poly Museum. Other projects include apartment buildings, private homes, office buildings, as well as shopping centers and luxury offerings.<sup>32</sup> In 2006, this subsidiary listed on the Shanghai exchange. Poly remains China's number one state-owned real estate developer.

For the first half of 2018, Poly Real Estate recorded revenues of 59.5 billion yuan (US \$9 billion) and a profit of 6.5 billion yuan (US \$968 million). Its 337 billion yuan (US \$50 billion) contracted sales during January to October 2018 also secured its position as a top-five property developer in China, in terms of sales.<sup>33</sup> The company first entered the rental market in response to the central government's call to develop rental housing. Currently, it manages more than 30 rental apartment projects under four brands: Yujing Pavilion, Noyah, Hexi Club and N+, with the latter catering mostly to young people, the demographic group which comprises the bulk of China's rental housing demand.

To support these projects, Poly favored securitization in the form of a Real Estate Investment Trust (REIT). While not the first Chinese company to use this financial instrument, the Poly REIT has been taken as a sign that the Chinese government is moving toward the introduction of an international standard REIT policy regime. Until then, this form of financial innovation as it operates in China continues to be referred to as a 'quasi-REIT' or 'REIT with Chinese Characteristics' — also known as 'C-REITs'.

## POLY DEVELOPMENTS' QUASI-REIT ISSUANCE

Poly Developments' quasi-REIT product, officially called 'Zhonglian Qianhai Kaiyuan – Poly Developments Rental Housing No. 1 Asset-backed Specific Plan,' was implemented jointly with Zhonglian Qianyuan Real Asset Fund Management (Zhonglian Fund). In October 2017, the Shanghai Stock Exchange approved an initial issuance batch of 1.717 billion yuan (US \$257 million), which

27 “五十亿REITs能给楼市带来什么.” Xinhua Net, March 30, 2018. Accessed February 17, 2019. [http://www.xinhuanet.com/fortune/2018-03/30/c\\_1122614544.htm](http://www.xinhuanet.com/fortune/2018-03/30/c_1122614544.htm)

28 He, Ken. “China REITs: Property Landlords to Shine.” DBS Asian Insights, May 2018.; “Quasi-REITs' Catch on in China.” Reuters. February 20, 2017. Accessed January 24, 2019. <https://www.reuters.com/article/china-reits-idUSL8N1G503G>.

29 “五十亿REITs能给楼市带来什么.” Xinhua Net, March 30, 2018. Accessed February 17, 2019. [http://www.xinhuanet.com/fortune/2018-03/30/c\\_1122614544.htm](http://www.xinhuanet.com/fortune/2018-03/30/c_1122614544.htm)

30 Nunns, Cain. “China's Poly Group: The Most Important Company You've Never Heard of.” Public Radio International. February 25, 2013. Accessed January 24, 2019. <https://www.pri.org/stories/2013-02-25/chinas-poly-group-most-important-company-youve-never-heard>.

31 “Group Profile.” CHINA POLY GROUP CORPORATION. Accessed January 24, 2019. <http://www.poly.com.cn/english/1659.html>.

32 “Real Estate Business.” CHINA POLY GROUP CORPORATION. Accessed January 24, 2019. <http://www.poly.com.cn/english/1680.html>.

33 “保利房地产（集团）股份有限公司2018年半年度报告.” Page 4. Accessed February 17, 2019 at <http://www.polycn.com/upload/file/2018-08-14/8ed501bf-fdfe-4414-9bef-512498b4a9ef.pdf>; 【榜单发布】2018年1-10月中国房地产企业销售TOP100排行榜, <http://www.cricchina.com/Research/Details/8064> Accessed March 5, 2019.

## Exhibit 1: List of Properties Included in Poly Developments' Quasi-REIT[1]

Number	City	Project Name	Positioning	Brand	Gross Area (sqm)	Number of Units	Appraisal Value (Yuan)	Value/Sqm (Yuan)
1	Dalian	Xishan Linyu	Rental Apartment	N+	4,456.64	96	48,000,000	10,770
2	Changsha	Changsha International Plaza	Serviced Apartment	Yujing Pavilion	5,328.88	96	66,610,000	12,500
3	Changsha	Lugu Linyu	Rental Apartment	N+	6,017.76	152	43,330,000	7,200
4	Chongqing	Linyu Stream	Rental Apartment	N+	3,186.63	93	25,510,000	8,005
5	Beijing	Xishan Linyu	Senior Housing	Hexi Club	22,383.91	200	496,000,000	22,159
6	Chengdu	Lafite Mansion	Rental Apartment	N+	4,835.14	35	34,660,000	7,168
7	Xi'an	Gold Champagne	Rental Apartment	N+	5,536.02	116	40,350,000	7,289
8	Shenyang	Xihu Linyu	Rental Apartment	N+	7,292.78	134	35,000,000	4,799
9	Tianjin	Metropolis	Serviced Apartment	Yujing Pavilion	883.58	15	32,000,000	36,216
10	Guangzhou	Tianyue	Serviced Apartment	Noyah	19,942.33	150	857,000,000	42,974

Source: [1] "保利地产租赁住房类REITs资产证券化创新实践-20180810" Section 4.2

is scalable to up to 5 billion yuan (US \$745 million).<sup>34</sup> Besides being the first rental apartment quasi-REIT issued by a state-owned real estate developer, it is also the first quasi-REIT in China to follow a 'shelf offering' model. This means the issuance of new securities is permitted without the need to go through an approval process again for each subsequent offering, thus allowing management greater flexibility in the timing of its capital raising.

The first issuance batch comprises two tranches, preferred and subordinated securities. The preferred tranche bore more debt-like features, taking up 90% of the issuance with a size of 1.545 billion yuan (US \$230 million), and received an AAA rating from China Chengxin International Credit Rating Co., Ltd. (CCXI). The preferred tranche has a coupon of 5.5% with a maturity of 18 years.<sup>35</sup> At the end of every three years, preferred tranche investors have the option to redeem their securities. The subordinated tranche took up the remaining 10%, or about 172 million yuan (US \$25.7 million), but with the same maturity date.<sup>36</sup> Subordinated tranche investors are paid after preferred tranche

investors. As equity is built into the subordinated tranche, investors can benefit from asset appreciation.

This kind of structure is typical of a quasi-REIT in China: two to three tranches of end securities, including one to two preferred tranches and one subordinated tranche. The preferred tranches usually resemble bonds or commercial mortgage-backed securities (CMBS). They also require high credit (onshore) ratings as well as fixed returns, while subordinated tranches (in many cases fully or mostly owned by the issuer) look like equity and usually no credit rating or guaranteed return is needed.<sup>37</sup>

The initial issuance of Poly Developments' quasi-REIT is backed by 10 rental housing properties located in first and second-tier cities, including Beijing, Guangzhou, Chongqing, Chengdu, Changsha, Dalian, Tianjin, Shenyang, and Xi'an (see Exhibit 1). These properties are not only geographically diverse, but also numerous, which further distinguishes Poly Developments' offering. Thus far, onshore quasi-REIT offerings in China typically

34 "中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书", Page 43, Zhonglian Qianhai Kaiyuan - Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus

35 "中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书", Page 43, Zhonglian Qianhai Kaiyuan - Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus

36 "中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书", pages 43 and 50, Zhonglian Qianhai Kaiyuan - Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus

37 He, Ken. "China REITs: Property Landlords to Shine." DBS Asian Insights, May 2018.; "Quasi-REITs' Catch on in China." Reuters. February 20, 2017. Accessed January 24, 2019. <https://www.reuters.com/article/china-reits-idUSL8N1G503G>.

are backed by only a single asset or assets that rely on a single tenant. Such overconcentration undermines the income stream hedging benefits of a REIT. Poly Developments' quasi-REIT, in contrast, generates rental income from 10 geographically diverse properties. Moreover, it was two Poly Developments affiliated companies that signed 20-year leases for 100% of the leasable areas.<sup>38</sup>

During the holding period, Poly Developments' quasi-REIT will be subject to stamp duty tax on its leases, value-added tax on its rental revenue, property tax on each property's original cost or rental revenue, and income tax on operating profits (zero assuming all of the profits will be used to pay the interest on shareholder loans). It also will not pay dividends until maturity of the securities. Instead, it will only pay interest on shareholder loans.<sup>39</sup>

The exit options for the quasi-REIT are a buyback from the issuer, Poly Developments, or sale to third parties. The preferred tranche could also exit through a commercial mortgage-backed security (CMBS).

## RISKS IN POLY'S QUASI-REIT AND SIMILAR SECURITIES

Despite their high credit ratings and fixed-income nature, the risk/return profile of quasi-REITs in China require careful consideration. Take Poly Developments' quasi-REIT. With a coupon of 5.5%, its debt ratio reaches 90%, compared to the FTSE Nareit Equity REIT Index's debt ratio of 31.8%.<sup>40</sup> Poly Developments' coupon is not high enough to justify the greatly increased risk. The interest coverage ratio of its quasi-REIT is also close to 1x, and thus only offers a thin cushion. In contrast, REITs listed in the U.S., Hong Kong SAR, and Singapore are usually issued at a discount to net asset value (NAV). Poly Developments' quasi-REIT was issued on par with valuation, meaning there is no buffer if asset values decline. Finally, Poly Developments' quasi-REIT has a limited investor base, similar to its quasi-REIT peers as it is not open to retail investors.

Still, with 10 current properties and the possibility of adding new assets to the portfolio, Poly Developments' quasi-REIT has low concentration risk, and certainly

when compared to Chinese quasi-REITs with single or a few underlying assets. For example, the Penghua Qianhai Vanke REIT is mainly backed by a single office complex owned by Vanke.<sup>41</sup>

## OVERVIEW OF CHINA'S QUASI-REITS

For all the fanfare surrounding the launch of onshore quasi-REITs in China, they still have a long way to go. Both the structure of these onshore quasi-REITs and the current policy regime governing this financial instrument in China do not conform to international standards.

First of all, quasi-REITs in China are usually placed privately. Mature market REITs, in contrast, are structured as corporates or trusts and are publicly traded. Retail investors thus can easily access mature market REITs, but not so in China where quasi-REITs are consumed by institutions on the stock market and the interbank market. It is also exactly because quasi-REITs are placed privately that public information about them remains very limited. Information about mature market REITs, in contrast, is publicly available.

Mature market REITs usually have unlimited scalability, which means they can acquire new assets or divest existing assets. Poly Developments' quasi-REIT issuance, while significantly large and scalable, is nonetheless capped at 5 billion yuan (US \$745 million).

Because of their debt-like nature, quasi-REITs have maturities. Usually the tenure is relatively short. Mature market REITs, like other equity, do not have maturities. Investors of mature market REITs can exit their investment by selling their shares on the stock market at any time. Quasi-REIT investors hold until maturity.

In terms of underlying assets, quasi-REITs are usually backed by debt plus some equity of target properties, whereas mature market REITs are backed only by the equity of target properties. Such a difference is important because whether investors are entitled to enjoy the appreciation of the properties depends upon which kind they own.

Many of these differences ultimately translate into limited liquidity for quasi-REITs in China. Eliminating illiquidity risk is, however, one of the major

38 “中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书”，第182-202, 225页 Page 182-202, 225, Zhonglian Qianhai Kaiyuan – Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus

39 “中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书”，第182-202, 225页 Page 182-202, 225, Zhonglian Qianhai Kaiyuan – Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus

40 “中联前海开源-保利地产租赁住房一号第一期资产专项支持计划说明书”，第225-228页 Page 225-228, Zhonglian Qianhai Kaiyuan – Poly Developments Rental Housing No. 1 Asset-backed Specific Plan Prospectus; “REIT Industry Financial Snapshot.” Nareit. Accessed January 24, 2019. <https://www.reit.com/data-research/reit-market-data/reit-industry-financial-snapshot>.

41 “China Approves First REIT Listing of Vanke Properties.” Reuters. June 09, 2015. Accessed January 25, 2019. <https://www.reuters.com/article/china-property/china-approves-first-reit-listing-of-vanke-properties-idUSL3N0YV3NM20150609?type=companyNews>.

\*All the RMB to USD conversions in this report were based on rates as of March 6, 2019.



considerations for a mature market REIT, besides offering an efficient 'asset-light' means for investors to put their money in real estate.

In China, quasi-REITs usually require credit enhancements from their parent company or issuers, which may be beneficial to its credit ratings. REITs in mature markets, in contrast, usually have an equal or even higher credit rating than their issuers, depending on the quality of the underlying assets.

Finally, while laws vary from country to country, mature market REITs typically enjoy some form of preferential tax treatment, on the condition that they pay the bulk of their taxable income in the form of shareholder dividends each year. Quasi-REITs in China, instead, usually pay fixed coupon payments, but no shareholder dividend.

## FOSTERING A MATURE REIT REGIME

Most analysts remain highly optimistic about the utility and benefit of Chinese REITs that conform to international standards, but to get there, some changes are needed in the current policy environment with regard to this financial instrument.

Key areas for reform are the following:

**Taxes:** In mature REIT markets, preferential tax treatments are one of the most attractive features of this financial product. However, China's multiple layers of taxation pose a great challenge to the creation of international-standard REITs.

Today, the Chinese government, both local and central, charges several levels of taxes for commercial real estate transactions. In the initial phase of transferring property ownership into a REIT platform alone, the Chinese government charges a stamp duty tax, deed tax, land appreciation tax, value-added tax, and income tax. In comparison, mature REIT markets such as the U.S., Singapore, and Hong Kong SAR usually do not charge land appreciation tax and value-added tax during asset transfers.

Once the REIT is launched, the Chinese government then charges value-added tax, income tax and property tax. Income tax is the major differentiator. In mature markets, REITs are tax transparent, so the income earned by a REIT is only taxed on distribution to the investors and not at the REIT level, thereby avoiding double taxation which dampens investor yields. That is not the case in China.

The central government appears to be increasingly incentivized to lift some of these tax burdens, but it is likely that local governments will fight back. Whether China's rather complicated tax regime can be improved to encourage the development of international-standard REITs will likely require tough negotiations between the central and local governments.

**Asset quality:** Although the commercial real estate market in China has been growing rapidly, the supply of high-quality properties that can meet a REIT's income-generating ability requirement remains in question. REITs aim to include high-quality properties that generate steady cash flows and are literally 'built to last.'

**Management ability:** Management expertise also deserves careful examination. China's real estate market is still in the early stage of transitioning from a residential sales-driven market to a more mature market where asset and property management skills make all the difference. As such, the competence of management can be critical to the success of a REIT comprised of rental properties.

**Valuation and credit ratings:** To date, the valuation of properties in China remains a black box to most investors, as is the domestic credit rating system. Determining the appropriate, standardized valuation principles and instituting a transparent credit rating system remain a challenge.

## CONCLUSION

Poly Developments' quasi-REIT is an important breakthrough that illustrates how rental apartment property owners that wish to raise capital can securitize their own portfolio to tap the capital markets. An established REIT regime also gives property companies a ready market for completed projects, thus making it easier for them to recycle cash to inject into new developments.

Looking at the opportunities and risks associated with quasi-REITs and the potential inherent in an international-standard REIT regime, property companies need to consider how best to position themselves to capitalize on this new opportunity – as well as a possible new growth point that moves away from their traditionally sales-driven development business model.