

An Asia Society Special Report



Breaking Ground:

Chinese Investment in U.S. Real Estate

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**AN ASIA SOCIETY SPECIAL REPORT
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FOREWORD

AS THE WORLD'S SECOND-LARGEST ECONOMY, China's influence on the global economy is expanding at a furious pace, thanks in part to the surge in outward foreign investment. In the United States, China is now a major source of foreign investment with capital flowing into virtually every industry and market. For many Chinese firms and individuals, the United States is a prime destination for their investments because the prospects for stable returns are high.

Policy makers, business leaders, and the general public in the United States still do not have a comprehensive understanding of the patterns and implications of Chinese investment in the United States. While foreign investment has been a critical piece of this country's economic success, the recent boom of Chinese capital flowing into the United States has stoked fears of job loss and disruptions to local and regional economies and markets, and even threats to national security.

Chinese investment into U.S. real estate, in both the commercial and residential sectors, stirs up these misgivings and sparks debate about the domestic costs of these investments. Concerns range from anxieties over the potential inflationary effects of deep-pocketed firms and investors in the residential real estate market to more pronounced anxieties over property acquisitions that can endanger national security. The reality, as this landmark study makes clear, is much more complex.

This report, *Breaking Ground: Chinese Investment in U.S. Real Estate*, paints a clearer picture of what these investments mean for this country. Our intention is not to dismiss or ignore domestic anxieties over Chinese (as well as other countries') real estate investment but to ground the debate in an authoritative and comprehensive analysis of the investment trends and motivations. We believe that doing so will provide a clearer assessment of the true impact and implications of Chinese real estate investment in the United States and support the ongoing dialogue on the economic relationship between the two countries.

The report reinforces Asia Society's ongoing effort to study the broader phenomenon of Chinese investment in the United States. It is the fourth in a series of reports dating back to 2011. Our past reports were drafted in partnership with the Rhodium Group, whose Chinese Investment Monitor remains the gold standard in tracking the currents of Chinese investment in the United States. The first report, *An American Open Door? Maximizing the Benefits of Chinese Foreign Direct Investment*, outlined Chinese investment on a national level. A year later in 2012, we provided a state-level look with *Chinese Direct Investment in California*, followed by *High Tech: The Next Wave of Chinese Investment in America* in 2014, which homed in on one of the fastest-growing sectors targeted by investors from China. Through these reports, we found that while some of the misgivings about Chinese investment were warranted, Chinese investment in the United States has been and will continue to be an overall benefit for the economy. We believe that the United States has much to gain from ensuring our doors remain

open to foreign investment, not only from China but also globally. The conclusions we reach in this report are no different.

We are pleased to be presenting this report with Rosen Consulting Group (RCG), one of the most influential independent real estate consulting, research, and analysis firms in the United States. As one of the most established voices in the U.S. real estate industry, RCG's deep understanding of U.S. real estate markets, coupled with its unparalleled access to industry data, puts it in a unique position for this effort. We are deeply grateful to Ken Rosen, RCG's chairman; Arthur Margon, a partner at RCG; and Randall Sakamoto and John Taylor for leading this partnership effort between Asia Society and RCG. We also would like to thank Alan Pomerantz at the international law firm Pillsbury Winthrop Shaw Pittman for helping establish the groundwork for this partnership in the early stages of this project.

We also would like to thank the staff at Asia Society for their hard work in conceiving this project and producing the final product: Robert W. Hsu, Jennifer Choo, Wendy Soone-Broder, Makenna Martinez, Melissa La Bouff, and Eve Cary. Special thanks also to Robert Bullock, who helped lay the groundwork for this report.

This project would not be possible without the generous support of our sponsors, including AREAA, Blank Rome, Crescent Heights, East West Bank, Mansion Global, Gensler, and TMG. We are also grateful to our strategic partners at ChinaSF and its executive director, Darlene Chiu Bryant, who has been a champion of San Francisco's efforts to elevate the city's status as a premier destination for Chinese investment, as well as Jim Wunderman and his colleagues at the Bay Area Council, one of the most important voices for business in California.

Finally, we are grateful for the time, advice, and feedback we received on earlier drafts from the various experts, business leaders, and academics who participated in our consultative roundtables, which we organized in New York, San Francisco, and Los Angeles over the past year. The roundtables were an essential part of the process in the drafting of this report.

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AT THE OUTSET OF THE STUDY, we understood the daunting task ahead of us in examining such a rapidly evolving and accelerating subject as Chinese investment in U.S. real estate. Luckily, we underestimated the difficulties in gathering factual information from and analyzing motivations of both large and individual investors, not to mention the geopolitical motivations and policy shifts; otherwise, we might not have written what has come to be the first study bringing together data on the flow of capital from China, the motivations behind investments, and the implications for the real estate market.

Asia Society has been and remains a leader in bridging the ocean between Asia and the United States. Its support and interest in cultural, educational, and commercial topics promote government, individual, and business cooperation and understanding across borders. The enthusiastic support of Asia Society Northern California truly made this report possible. We would also like to add our appreciation to Asia Society's partners and sponsors of this study for their generous support, financial and otherwise: ChinaSF, Bay Area Council, AREAA, Blank Rome, Crescent Heights, East West Bank, Mansion Global, Gensler, and TMG.

We owe a great deal of gratitude to a large number of individuals, government officials, interested parties, and companies in China and the United States that fielded our requests for data and answered myriad questions. These individuals shall remain anonymous; however, they know who they are and we greatly appreciate their assistance and guidance.

A number of government officials, business leaders, and academics contributed to our understanding through a series of roundtables and information reviews coordinated by Asia Society. We sincerely appreciate the time and effort provided by these groups in guiding our research.

Our colleagues at Rosen Consulting Group contributed significant hours to research, data collecting and scrubbing, and manuscript reviews and served as sounding boards for our ideas. We owe a large thank you for balancing our singular focus on Chinese investment to David Bank, Dan Van Dyke, Kimberley Player, Brett Fawley, Avani Patel, Heather Belfor, Anisha Gade, Lydia Lightsey, Cora Bahl, Colleen Miller, and Fred Massell.

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EXECUTIVE SUMMARY

CHINESE INVESTMENT AROUND THE WORLD SURGED IN THE PAST DECADE, expanding from an early focus on natural resource extraction and energy in developing countries to broader industries and advanced products and services in developed markets. In 2014, Chinese outward FDI flows totaled \$116 billion, and approximately \$18.1 billion flowed into the United States. In 2015, Chinese outward FDI flows totaled \$118 billion, and Chinese foreign direct investment flows into the United States increased to \$22.3 billion. Still, China accounts for less than 10% of all foreign direct investment in the United States.

Chinese direct investment in U.S. real estate was negligible until 2010 but has since grown dramatically and visibly. In 2015, China ranked third in U.S. commercial real estate acquisition volume, trailing only Canada and Singapore and tied with Norway. Chinese developers are building multi-billion-dollar projects in several major cities. A Chinese insurance firm bought the prized Waldorf Astoria hotel in New York City in 2015 and struck a \$6.5 billion deal for Strategic Hotels & Resorts in early 2016. Chinese investors dominate an immigrant investor program known as EB-5, and in 2015, China overtook Canada as the biggest foreign buyer of U.S. homes.

This anecdotal portrait reveals the rapid and widespread entry of Chinese investors, both firms and individuals, into the U.S. real estate market, but it also underscores how real estate differs from other investment sectors. It defies the traditional definition of foreign direct investment – ownership of at least a 10% stake in a U.S. company – with a broad range of entry points. Buying a home, for example, does not have an analogue in the technology industry but is critical in painting a full picture of Chinese capital flows into the U.S. real estate market. Furthermore, in addition to the unique channels of real estate development and EB-5 capital, Chinese investors are also increasing investment in portfolios of U.S. assets through real estate investment trusts and private equity funds.

These real estate investments come on top of China's position as the biggest holder of mortgage-backed securities issued by U.S. government-sponsored enterprises such as Fannie Mae and Freddie Mac. Like U.S. Treasuries, these bonds are important investments for Chinese government finances, because they allow for recirculation of dollars gained by the trade imbalance, and for the U.S. housing market, because they help ensure liquidity and mortgage rate stability. Chinese banks have also become major sources of debt capital in the U.S. real estate market, primarily for U.S. firms. To fully understand the role of Chinese capital in the U.S. real estate market, it is vital to look beyond direct investment. More than any foreign investor other than Canada, China stands out for the breadth, depth, and speed of its participation in the U.S. real estate market.

Rosen Consulting Group, on behalf of Asia Society, has examined this broad range of direct and indirect investment – including our own proprietary dataset – to produce the most

comprehensive analysis to date of Chinese capital in U.S. real estate. Our findings are that from a modest base in 2010, China was the source in aggregate of at least \$350 billion in U.S. real estate holdings and investments by the end of 2015. This figure includes the direct purchase of real property and indirect investment through the purchase of agency mortgage-backed securities and provision of debt financing, among other channels. In addition, we estimate that Chinese entities managing U.S. real estate operations and individual investment through vehicles including the EB-5 program may have created or sustained 200,000 jobs. For commercial and residential real estate, China has been an important source of capital as the U.S. economy recovered from the recent financial crisis and Great Recession.

Chinese investment in U.S. real estate is a recent development with considerable growth potential. While it is not as politically sensitive and does not directly impact national security as does Chinese investment in U.S. technology or telecommunications, real estate affects more people and communities and involves policy makers at multiple levels. This report aims to objectively present the following:

- Sources of Chinese capital flowing into U.S. real estate;
- Motivations and drivers for various Chinese investors;
- Benefits and impediments posed by this wave of investment;
- Analysis and projections of the sustainability of Chinese investment in commercial and residential property; and
- Recommendations for U.S. and Chinese investors, policy makers, and stakeholders to keep investment channels open.

Combining information from public records, reports, and trade groups with Rosen Consulting Group's database – based in part on gathering of data and interviews with industry sources – this report assembles a unique information set, providing the first comprehensive analysis and understanding of Chinese inbound investment into all facets of U.S. real estate.* The reported investment data are not perfect, a result of the combination of the particulars of real estate investment avenues and the ability of government and third-party sources to accurately measure capital flows. Furthermore, a significant portion of investment from offshore locations, including China, comes in the form of minority interests in projects sponsored by U.S. entities and is not directly traceable to the capital country of origin. The study is focused on investment from mainland China, but the flow of capital through intermediary destinations sometimes necessitates the inclusion of capital from Hong Kong, Macau, or Taiwan. Moreover, the task is complicated by the multiple channels for investment, ranging from purchases of homes and apartments to business investment in commercial assets to development and construction, as well as through provision of debt to both residential and commercial property investors. The myriad ways in which to record real estate ownership can also obscure the true country of origin of the buyer. With this in mind, this report presents the data as minimum investment volumes. While

* The analyses of investment data, individual transactions and in aggregate, were derived from several third-party public and private data sources. We have generally cited statistics from these sources that are publicly available so as to maintain legal confidentiality requirements. The views and interpretations of the data are ours and do not reflect opinions or positions, except as noted, of the data sources.

acknowledging these data limitations, we have made every effort to compile data and insight that provide a more complete reflection of actual Chinese investment activity across the entire spectrum of the U.S. real estate market than previously published. This includes enhancing investment volumes reported publicly as well as confirming the reported data via industry participants.

The investment flow has come into the United States through several channels:

- **Residential property:** Between 2010 and 2015, Chinese buyers spent at least \$93 billion on homes, including condominiums, for occupancy and investment. Spending rose at an annual rate of 20% and provided important demand in many local markets hit hard by the housing crisis. Chinese buyers paid substantially more, on average, per home than other international buyers because of their concentration in prime neighborhoods in California and New York.
- **Commercial property:** Between 2010 and 2015, Chinese investors acquired at least \$17.1 billion of existing office towers, hotels, and other commercial buildings, representing an annual growth rate of 70%. Half of that investment came in 2015 alone. The buyers were mainly large Chinese companies, including real estate firms and institutional investors.
- **Development:** By the end of 2015, Chinese-funded projects under construction or planned totaled at least \$15 billion. These range from multi-billion-dollar mixed-use projects in Los Angeles and the San Francisco Bay Area to smaller-scale developments in secondary markets. These investors include Chinese developers, builders, and construction companies, some of which have set up U.S. offices, creating local jobs for ongoing operations beyond the construction phase.
- **EB-5 visa program:** Since 2010, Chinese nationals have been the most numerous investors in the EB-5 U.S. visa program. The program enables a foreign national who invests at least \$500,000 in projects that create a minimum of 10 jobs to receive a U.S. visa and, on completion of the project, a green card for permanent residency status. Detailed data on these investments and the actual number of jobs created are not generally available. But based on the minimum investment and job creation requirements, and assuming all investments are successful, Rosen Consulting Group estimates that since 2010, nearly 20,000 Chinese EB-5 investors have generated at least \$9.5 billion of investment capital and contributed to the creation of 200,000 jobs.
- **Residential mortgage-backed securities (RMBS):** Chinese government entities began purchasing U.S. government agency-backed RMBS in the early 2000s to diversify beyond U.S. Treasuries. As of June 30, 2015, China held \$207.9 billion in agency-backed mortgage bonds, more than any other country, according to preliminary U.S. Department of the Treasury data. These holdings contribute to enhanced liquidity in the U.S. housing finance market.
- **Real estate loans:** In recent years, Chinese banks increased activity in lending for real estate acquisitions, recapitalizations, and construction and development. The banks have amassed at least \$8 billion in loans and have become a major source of funding for large commercial real estate projects. This loan portfolio extends beyond Chinese investors and projects with Chinese partners, as leading Chinese banks are active competitors with U.S. and international banks and private sources of capital in the commercial property market. Residential mortgage lending by Chinese banks in the United States is more limited, but growing.

As in other industries, Chinese investment in overseas real estate is driven by a combination of policy reform, economic conditions, and opportunities for growth. Real estate offers a range of Chinese entities opportunities to diversify, whether in financial assets or real property. Real estate as an investment may be particularly attractive given the likelihood that the Chinese currency will weaken against the dollar and other global currencies. Chinese builders and developers are looking to expand into attractive global markets for the long term, as the Chinese economy slows, and to improve their competitiveness, global stature, and brand recognition. China's growing financial sector – banks, insurance companies, and emerging private equity groups – are looking to invest globally as they accumulate capital from businesses and consumers in China. Similarly, high net-worth Chinese may also view overseas real estate as a means to provide international opportunities for their children, and a safe haven from political and economic uncertainty in China. Finally, real estate investment and ownership can potentially offer an expedited path to Chinese families who want U.S. residency for work and educational opportunities.

OUTLOOK

We believe China's economic turbulence will create a short-term speed bump for real estate investment overseas, including in the United States. In the near term, a 6- to 24-month temporary period of increased capital controls is likely – either formally via policy announcements or informally through administrative processing – until the Chinese currency can be re-aligned with that of global partners. However, this does not mean investment will cease during this period. Furthermore, the long-term investment drivers remain: strong U.S. demand for capital; a widening and deepening pool of Chinese investors, many of whom have not ventured into U.S. real estate; increasing global appetite by Chinese developers and construction companies; a \$1.6-trillion insurance industry that has become active overseas but invested just a fraction of funds available for real estate projects; and new Chinese investment vehicles, such as private equity funds, which have only recently become a factor in the U.S. market.

We project that Chinese direct investment across existing U.S. commercial real estate assets and residential purchases, excluding new development projects, could total at least \$218 billion, cumulatively, from 2016 through 2020. In the short term, capital controls will likely slow individual purchases of U.S. homes, the biggest component of Chinese real estate investment, and slow the growth rate of commercial property acquisitions. Chinese-backed development projects are likely to remain a substantial component of the commercial real estate market even as the economic cycle in the United States slows the overall pace of new development announcements. Beyond 2020, Chinese investment in U.S. real estate could accelerate further.

RECOMMENDATIONS

These large capital flows, accelerating substantially in a short period of time, do not come without challenges in both countries. In the United States, several policy areas will need attention in the next several years:

1. **Rationalization of taxes affecting foreign investment:** The Foreign Investment in Real Property Tax Act (FIRPTA), while perhaps well intentioned at inception, is an onerous structure that creates an impediment to international investors in real estate. Every effort should be made so that there is a level field for taxes on foreign investors regardless of their domicile.
2. **Continuation of the EB-5 program:** While the program was extended through the summer of 2016, renewal is by no means a certainty. It has been a successful bridge builder, bringing capital into the marketplace, growing or retaining jobs in the United States, and allowing Chinese citizens and families access to visas and residency. The EB-5 program will likely undergo reform, but it should not be altered so dramatically as to cut off access to international capital and immigration, including those from China.
3. **Continued implementation of existing security policy:** Offshore investors are understandably screened for security risks and legitimacy of capital sources. So far, such concerns have not been an impediment to investment in U.S. property, as it has been in technology platforms, manufacturing firms, or natural resources extraction and processing. Any proposal to restrict U.S. government occupancy, including those of certain government contractors, in foreign-owned buildings – as is being discussed in congressional circles – should be carefully monitored.

On the Chinese side, the issues that deserve attention include the following:

1. **Continued development of legal and financial rules to encourage private sector investment in overseas property:** Chinese companies and individuals can benefit themselves and the Chinese economy by diversifying assets globally. It is critical that China develop a robust domestic legal framework for foreign investment, as many countries expect reciprocal treatment of foreign investors. Likewise, reforms that reduce bureaucratic bottlenecks and expedite outward investment should continue.
2. **Enhanced transparency in capital ownership:** The United States and other global financial centers are increasingly monitoring the identities of foreign investors and business operations. While China is not the only country that raises concerns, Chinese businesses historically have been less open regarding origination of capital and ties to government or military officials. Continuing progress toward the transparency required by international agencies – many of which are welcoming China as a significant participant – will be an important step.
3. **Avoidance of capital controls:** China's economic growth rate has slowed, and its currency is re-aligning with that of other major economies. Chinese concern over capital outflows is understandable, but a hard capital-control regime could negatively impact the financial institutions the government nurtured over the past two decades.

4. **Development of professional education on U.S. real estate practices:** Many aspects from land approval procedures to partnership agreements to local market valuation practices differ in the United States, and efforts to support increased education and awareness will benefit Chinese investors – particularly smaller companies and individuals – as they play a greater role in the global investment community.

INTRODUCTION

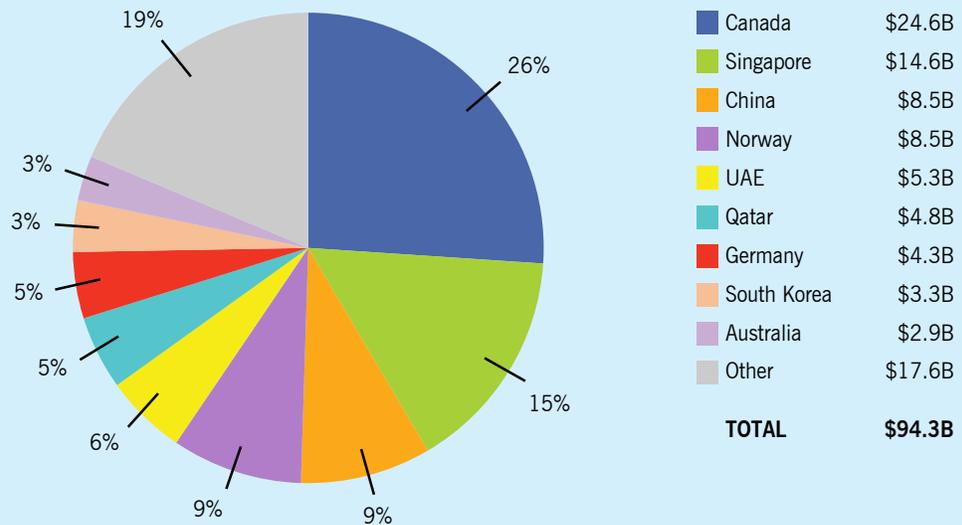
CHINESE OUTWARD FOREIGN INVESTMENT ACCELERATED RAPIDLY OVER THE PAST DECADE, with capital flowing into a range of industries and countries. Real estate has been one of the most targeted sectors, and the United States has been a prime destination in recent years. Like other global investors, Chinese state-owned enterprises, private companies, and individuals are attracted to U.S. real estate because of the return potential, array of investment opportunities, economic and property market stability, strong foundation of property rights, and the sheer size and maturity of the market. Beyond financial motivations for investors, Chinese individuals, in particular, seek U.S. property purchases as a path to residency and educational opportunities for their children.

China is the largest holder of residential mortgage-backed securities issued by U.S. government-sponsored enterprises, and Chinese nationals are the largest buyers of U.S. homes. And now, China has rapidly vaulted into the top ranks of foreign investors in commercial real estate. From \$585 million in 2010, the first year of notable activity, Chinese acquisitions of commercial property soared to \$8.5 billion in 2015, a compound annual growth rate of 70%. In 2015, China was the third-largest foreign source of commercial real estate acquisitions by dollar volume in the United States, trailing only Canada and Singapore, and tied with Norway (Figure 1). Cumulative Chinese purchases of commercial properties since 2010 totaled approximately \$17.1 billion.¹

The foray into commercial real estate investment is a key component of China's entry into the United States, but it is one of several prongs, highlighting the broad appeal and range of investment opportunities of real estate. Unlike other industries, where companies dominate investment activity, real estate offers opportunities for individual investors via acquisition of homes. Chinese purchases of residential properties have also increased rapidly, from \$11.2 billion in 2010 to \$28.6 billion in 2015, a 20% annual growth rate. In 2015, China was the largest foreign source of residential purchases in the United States, outpacing Canada, India, Mexico, and the United Kingdom (Figure 2). Between 2010 and 2015, Chinese nationals bought homes in the United States valued at a cumulative total of \$93 billion.

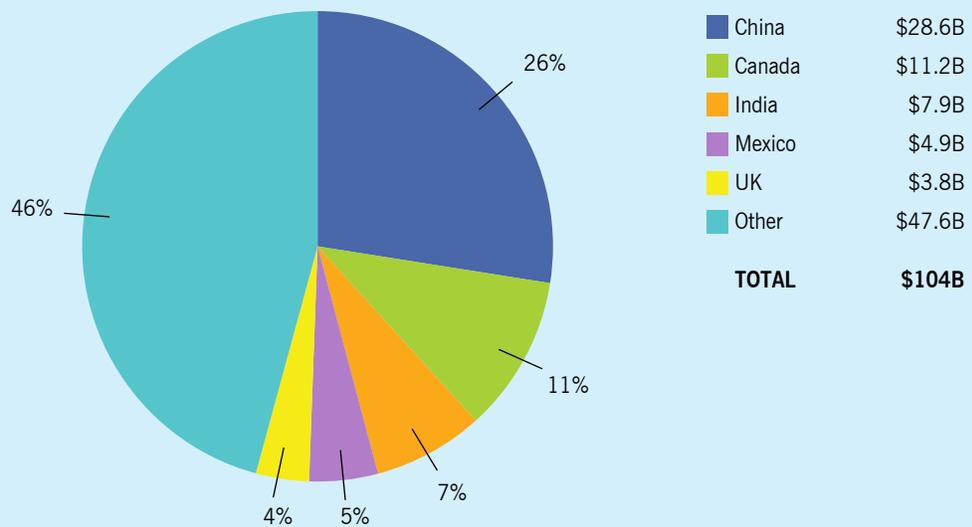
China is a relative newcomer to the U.S. real estate market, joining a long list of global investors that have been active in the market for decades. In previous years, investors from Australia, Canada, Japan, the Middle East, Norway, Singapore, and the United Kingdom have invested in U.S. real estate. With varying degrees of success, volume, and longevity, each group of investors has been attracted by a similar set of qualities – the growth potential of the economy and the fact that the U.S. real estate market is the largest and most transparent in the world, offering opportunities for all types of investment strategies on an unrivaled scale. Some countries are big players in one type of property or with a specific geographic focus. Others may invest primarily through sovereign wealth funds. What makes China different and noteworthy is the combination of the high volume of investment; the breadth of its participation across all real estate categories; the somewhat unique entry into residential purchases; and the range of Chinese investors: government, corporate, and

Figure 1: Commercial Real Estate Acquisition Volume in the United States, 2015



Source: Real Capital Analytics, Rosen Consulting Group

Figure 2: Residential Real Estate Acquisition Volume in the United States, 2015



Source: National Association of Realtors

individual. The volume and breadth of Chinese investment into U.S. real estate is not yet to the level of Canadian investment – which is ubiquitous throughout the U.S. real estate spectrum – but is more diverse than investment from other leading sources such as Norway and countries in the Middle East. Furthermore, this broad scope of Chinese investment has come to fruition in the span of just a few years.

Beyond acquisition of existing commercial and residential properties, this broad universe of Chinese real estate investment in the United States includes (i) significant development activity, (ii) increasing investment in portfolios of U.S. assets through real estate investment trusts and private equity funds, (iii) financing of development projects through an investor visa program (EB-5), and (iv) lending by Chinese banks. These real estate investments come on top of China's significant position in the U.S. residential mortgage market: Chinese holdings of U.S. agency-backed securitized debt rose from \$20 billion in 2000 to \$207.9 billion in 2015, according to the most recent U.S. Treasury data.* Roughly combining the range of real estate-related investments, China was the source of at least \$350 billion in U.S. real estate investments, both direct and indirect, by the end of 2015.²

Quantifying U.S. real estate investment volume is difficult for reasons not unique to Chinese investors. While property records are maintained by local government entities in the United States, ownership records and detailed transaction data are not uniformly collected or disseminated. Local jurisdictions have different regulations regarding the reporting of real estate sales, with some excluding the specific purchase price. Fair housing laws restrict the collection and dissemination of some data, such as the ethnicities of buyers. Furthermore, the ultimate cost of real estate projects may differ from publicly announced or reported figures. Piecing together the full picture of all the avenues through which investment flows into U.S. real estate is also complicated by the fragmentation and opaqueness of the market. For tax and other business purposes, many real estate investors hold assets in corporate and partnership structures. Many individuals and families hold their homes in trusts. Furthermore, many foreign investors – including Chinese investors – often enter the U.S. market through subsidiaries and an array of partnerships with U.S. entities. Joint ventures are commonplace in U.S. real estate, but they do give parties the legal right to keep their shares of contributions private, making it difficult to quantify the full flow of Chinese investment.

TYPES OF REAL ESTATE OWNERSHIP VEHICLES IN THE UNITED STATES

A number of ownership structures are commonly used for investing in commercial and residential real estate. These are generally open to domestic and foreign investors, though tax implications may be different depending on the investor's domicile. Each ownership structure provides a different balance of risks and benefits. Examples include the following:

*Mortgage-backed securities (MBS) are a type of bond that is backed by a pool of real estate mortgages. While the underlying collateral for these securities is real estate, the risk and return characteristics for these investments are more typical of interest-paying, fixed-income investments such as corporate bonds than other forms of real estate ownership. The securities can be backed by either residential or commercial real estate loans and are known as residential mortgage-backed securities (RMBS) or commercial mortgage-backed securities (CMBS). While Fannie Mae and Freddie Mac issue many of the residential securities, investment banks may also issue them.

Direct ownership, in which a company or individual directly owns a specific property outright, is perhaps the most clear-cut form of private investment in real estate. It provides the owner with the most control over the property but also the greatest potential risk since the entire investment is held in the entity's name.

Forming a **corporation, limited liability corporation (LLC), limited partnership, or family trust** can be similar to direct ownership in that assets are held directly, but the entities themselves provide some recourse protection to the individuals involved. For individual investors of commercial real estate and families purchasing single family homes or condos, these structures offer some tax and legal benefits.

A **joint venture** provides an opportunity for an investor to own real estate with a partner and is typically used for commercial real estate investments and developments. One partner, the operating partner, is responsible for daily control and management and typically receives a fee for these responsibilities. The second partner tends to have more limited authority in decision making, primarily on major factors such as a sale or refinancing of the asset. Profits are shared between the investors according to the relative ownership share. The risk profile in a joint venture is somewhat reduced because ownership is shared. An additional benefit of this structure is that it allows a partner with limited experience in a particular market to join forces with an investor with established ties to a market.

A **private partnership** or fund provides an opportunity to pool capital from multiple investors. Private partnerships are frequently led by a general partner (GP), while the other contributors, or limited partners (LPs), remain passive investors providing the capital for the fund. Generally, the LPs do not have decision-making abilities once the capital has been invested in the fund. Profits are shared between the general partner, who is responsible for the day-to-day management of assets, and the limited partners. Funds can reduce the risks for investors by diversifying the portfolio and pooling capital, and they limit the need for extensive direct real estate knowledge in a particular market.

Similarly, a **fund of funds** is a fund that makes investments in other funds or private partnerships. Once again, the investors provide the capital and decisions are made by the general partner, who typically charges a management fee. However, the fund of funds structure makes it possible for investors with smaller amounts of capital to gain access to high-quality funds, while also diversifying their investment portfolio.

Established in the 1960s, the **real estate investment trust (REIT)** is a corporate structure that enables individual investors to purchase equity shares in a company that owns real estate. Large investors and corporate investors can also invest in REITs through purchasing shares or preferred stock or providing debt. REITs can be privately held (non-listed) or publicly traded, in which case investors can buy and sell shares in REITs on major exchanges similar to stock in a corporation. REITs allow investors to diversify investments into numerous real estate assets. In addition, the special tax structure requires REITs to distribute 90%

of income directly to investors each year, which can translate into a relatively high yield compared with other investment alternatives.

A **real estate operating company (REOC)** uses real estate for its core business, such as a commercial developer or a homebuilder. Investors in REOCs generally purchase shares on a public exchange. An important distinction is that shareholders are investing in a business platform and the profitability of the company, as opposed to a REIT where the value of the company comes primarily from direct real estate holdings. In addition, while the tax structure is less advantageous than that for a REIT, companies have greater flexibility to reinvest earnings and expand the business.

With the complexity of this universe of investment, coupled with the learning process of working with any new group of investors, many questions remain about the wave of Chinese real estate activity. Industry insiders and the general public are intensely interested in what is driving Chinese investment in U.S. real estate, as well as the future trajectory of that investment. If Chinese investment continues at a similar or faster pace, what impact – positive or negative – should we expect on the U.S. real estate market and economy?

Countless news articles report individual transactions and companies, and a number of existing reports address a particular aspect of Chinese investment in U.S. real estate. This study paints a comprehensive picture of these investments, addressing not only the volume but also the motivations, sustainability, and implications behind the investment decisions. After the recent surge, Chinese investment is at an important inflection point. Chinese investment strategies continue to evolve, as some investors have moved from acquisitions of individual assets to small portfolios to the operating platforms managing those portfolios.³ Chinese firms, individuals, government entities, and banks are utilizing a full suite of real estate investment options that few foreign investors have deployed.

To date, protectionist sentiment around Chinese investment in U.S. real estate has been relatively muted and localized, compared with other globalization issues and past waves of foreign real estate investment from other countries. Furthermore, the U.S. real estate community – particularly developers – has been very open to Chinese investors, not just as a capital source but also as genuine partners, a relationship that has not been the norm with previous waves of foreign investors in real estate. Chinese firms and individuals are not trying to control the U.S. market; rather, they are following a well-worn path of other foreign investors in real estate, attracted to the U.S. real estate market because of its depth, liquidity, and strength as the top global destination for capital.

Chapter 1 provides a macro-level perspective on total Chinese outward investment, as the wave of real estate investment fits within this broader narrative. Chapter 2 discusses the capital sources and volume of Chinese investment across various investment vehicles for U.S. commercial and residential real estate. The following two chapters look at the myriad investment motivations for Chinese firms and individuals, with Chapter 3 focused on nonregulatory

drivers and Chapter 4 on regulations and reforms in China and the United States that play a role in real estate investment. Chapter 5 assesses the sustainability of Chinese investment in U.S. real estate, whereas Chapter 6 examines some of the impacts in the United States of sustained Chinese investment as well as a set of recommendations for policy makers and real estate professionals in China and the United States.

CHAPTER 1. MACRO PERSPECTIVE ON TOTAL CHINESE INVESTMENT

RECENT CHINESE INVESTMENT INTO THE U.S. REAL ESTATE MARKET fits within a longer, broader narrative of Chinese investment overseas.⁴ A significant part of this outward investment includes Chinese government activity in U.S. housing financial markets, one of China's first forays into U.S. real estate writ large, and a segment of real estate activity that remains substantial. However, even the subsequent expansion by China into more diverse outward foreign direct investment (OFDI) – starting with extractive industries in developing countries and moving to more advanced industries in developed countries – illustrates the sophisticated, methodical evolution of Chinese foreign investment, in many ways mirrored by the evolution in Chinese real estate investment.

This chapter will examine China's initial entry into U.S. and global markets and look at the broader evolution of Chinese outward investment over the past decade and more. During this period, the nature of Chinese overseas investment has transitioned from extractive to more advanced industries, which has paved the way for investment into the U.S. real estate market.

INITIAL ENTRY TO U.S. AND GLOBAL MARKETS

The first significant wave of outward investment started in the 1990s and accelerated in the 2000s as China rapidly expanded its holding of foreign exchange reserves. With high levels of inward foreign direct investment and massive trade surpluses, Chinese businesses earning U.S. dollars and other foreign currencies were required to exchange foreign currency for yuan to manage the exchange rate. Direct intervention in the foreign exchange market, as well as the imposition of capital controls to manage the yuan while maintaining independent monetary policy, quickly made China the world's largest holder of foreign exchange reserves. The majority of China's accumulated foreign assets stay as cash reserves. As of June 2014, the peak period of China's foreign exchange holdings, foreign exchange reserves accounted for 63.3% of China's total foreign assets. The People's Bank of China (PBOC) held \$3.99 trillion in foreign exchange reserves at that peak period in June 2014, compared with just \$170 billion in 2000 and representing a compound annual growth rate of 25.3% during that period.⁵ China held more total reserves (including gold) than the next six largest reserve holders (including the United States) at the end of 2013.⁶

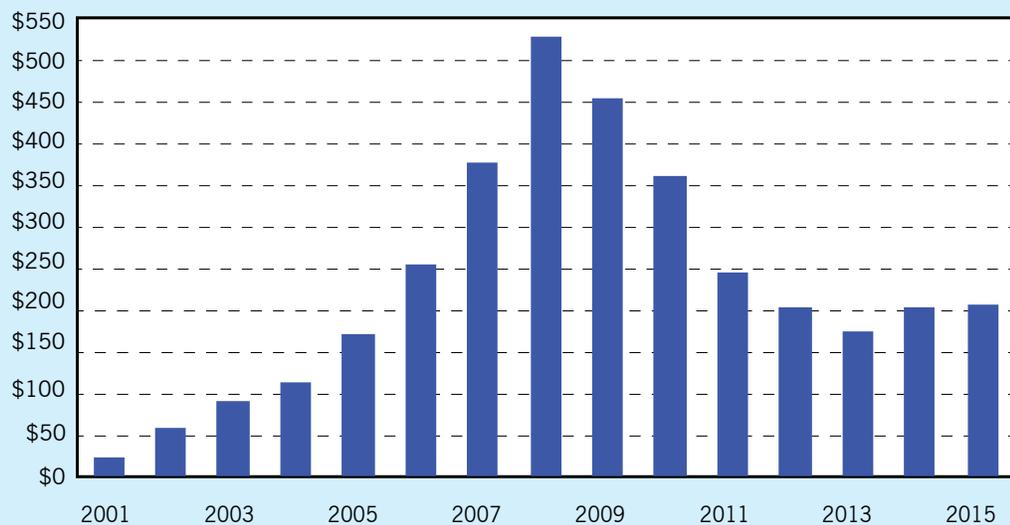
During China's buildup of foreign exchange reserves in the past two decades, U.S. Treasury bonds emerged as a primary investment vehicle. After years of inward investment by the United States into China, rapid growth in Chinese holdings of U.S. Treasury bonds represented the first real outward flow from China into the United States and was an important step by China into the global economy. With large reserves of U.S. dollars, China subsequently became the largest holder of U.S. government debt during the 2000s. Chinese holdings of long-term U.S. Treasury debt rose from \$71 billion in 2000 to \$1.26 trillion in 2015, a compound annual

growth rate of 19.5% and representing 23% of total outstanding long-term U.S. Treasury debt.⁷

Another preferred dollar-denominated investment vehicle was, and remains, U.S. government agency bonds. Although this includes bonds from a number of government agencies, the vast majority of agency debt is represented by mortgage-backed securities issued by the government-sponsored enterprises Fannie Mae and Freddie Mac.⁸ Chinese holdings of U.S. residential securitized debt increased from \$20 billion in 2000 to \$207.9 billion in 2015, a compound annual growth rate of 17% and representing 28% of outstanding residential securitized debt (Figure 3).⁹ More importantly, if investment in U.S. Treasury bonds was China's first major foray into the U.S. economy, investment in agency mortgage-backed securities represented the first entry into the U.S. real estate market and continues to represent a significant, albeit indirect, Chinese position in the U.S. real estate market.

Figure 3: Chinese Holdings of U.S. Residential Agency Debt

\$Bil.



Note: Periods end in June
Source: U.S. Treasury

SURGE IN OUTWARD FOREIGN DIRECT INVESTMENT

While China became the largest holder of U.S. debt, the low returns and concentration in one asset type helped encourage asset diversification. Since 2000, the Chinese government has promoted its “Going Out” policy, encouraging outward foreign direct investment by state-owned enterprises and Chinese businesses. The investment initially focused on natural resources, mining, and energy in developing countries throughout Africa, Asia, and the Americas, accelerating rapidly starting in 2004. Direct investment in developing countries provided not only access to materials needed by China but also access to new markets for

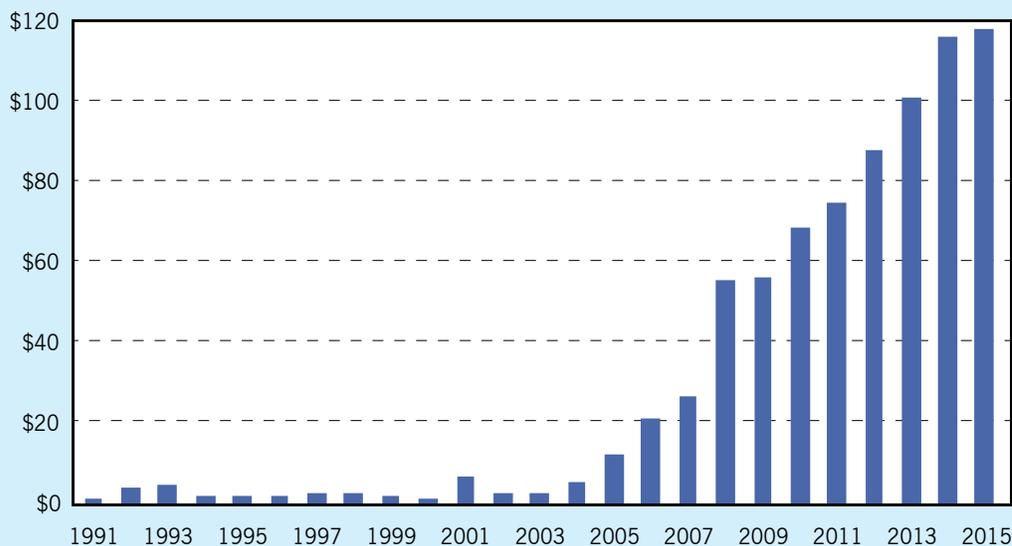
Chinese construction and engineering firms, design firms, and conglomerates. This direct investment throughout the developing world helped with China's goal to become more of a global economic leader.

By the late 2000s, Chinese OFDI expanded beyond developing economies, and Chinese investment into the United States surged. Chinese corporate investors moved into more advanced products and industries – not simply resource extraction – including industrial equipment, consumer electronics, aerospace, biotechnology, communications equipment, and renewable energy. This post-2008 wave of investment targeted the manufacturing components of these industries, but Chinese investors are increasingly targeting high-value-added service components, from trade services to software development. Chinese investors are also targeting financial instruments and real estate as entry points into developed economies. Along with other initiatives such as China's efforts to make the yuan a reserve currency of the International Monetary Fund, the evolution in foreign investment helped promote Chinese economic leadership not only in developing economies but also in developed economies as well.

In 2014, Chinese OFDI flows totaled \$116 billion, up from approximately \$1 billion in 2000.¹⁰ Approximately \$18.1 billion of China's OFDI in 2014 flowed into the United States. In 2015, Chinese OFDI flows totaled \$118 billion, and approximately \$22.3 billion flowed into the United States.¹¹ While Chinese investment now represents a higher share of inward FDI in the United States than in years past, it was still only 7.5% of the \$241.3 billion in total inward FDI in the United States in 2014 (Figures 4, 5, and 6).¹²

Figure 4: Chinese Outward FDI

\$Bil.

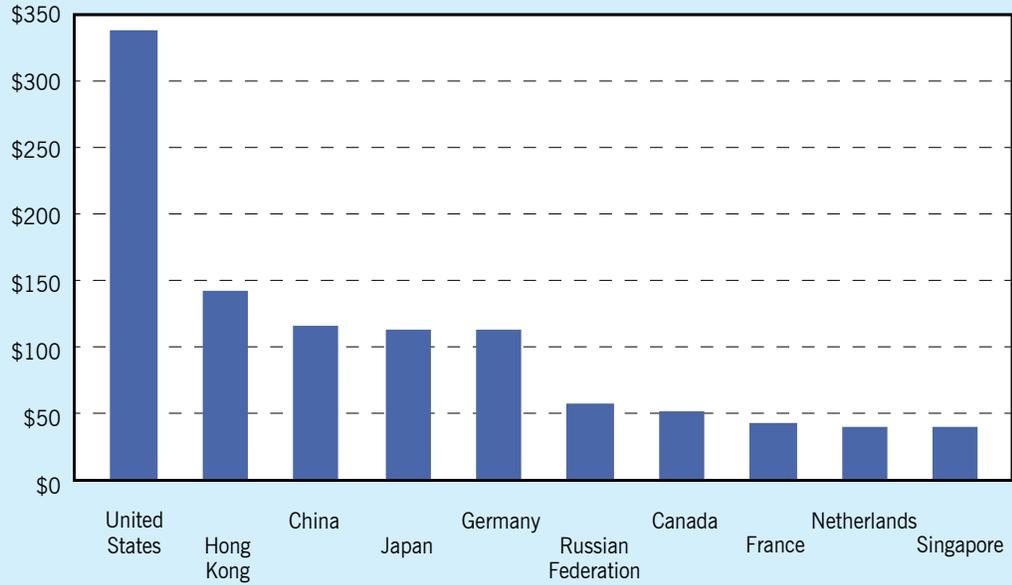


Note: Mainland China only

Source: UN Conference on Trade and Development

Figure 5: Global Outward FDI, 2014

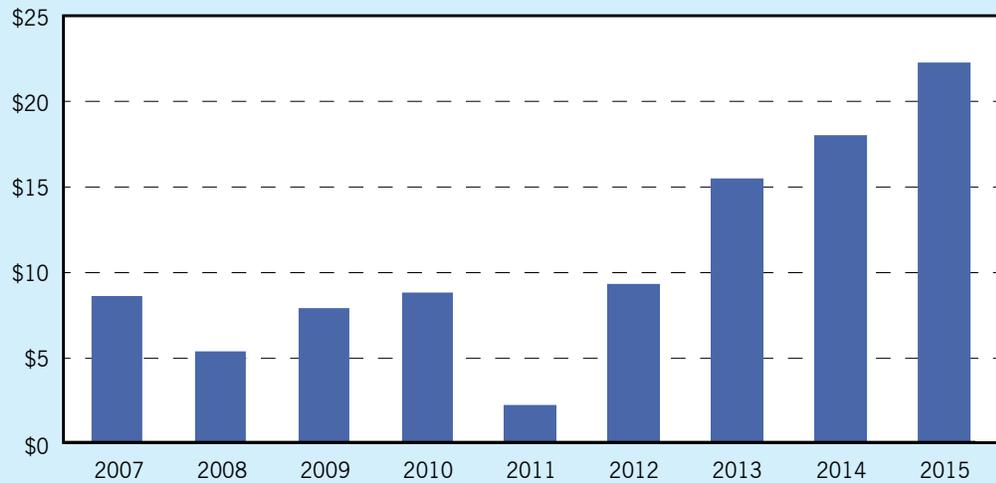
\$Bil.



Source: UN Conference on Trade and Development

Figure 6: Chinese FDI in the United States

\$Bil.



Source: American Enterprise Institute, Heritage Foundation

TAKEAWAYS

- China's foreign exchange reserves have increased rapidly since 2000, peaking at \$3.99 trillion in June 2014 from \$170 billion in 2000, representing a compound annual growth rate of 25.3%.
- Chinese holdings of U.S. Treasury bonds represented the first real outward flow from China into the United States. China became the largest holder of U.S. debt during the 2000s, as Chinese holdings of long-term U.S. Treasury debt reached \$1.26 trillion in 2015 up from \$71 billion in 2000, a compound annual growth rate of 19.5%.
- Chinese investment in U.S. agency mortgage-backed securities from Fannie Mae and Freddie Mac represented the first entry into the U.S. real estate market. Chinese holdings of U.S. residential securitized debt increased from \$20 billion in 2000 to \$207.9 billion in 2015, a compound annual growth rate of 17%.
- By the late 2000s, Chinese investment evolved beyond U.S. debt holdings and resource extraction, with outward foreign direct investment expanding into more advanced products and industries globally, including in the United States. Total Chinese OFDI flows totaled \$116 billion in 2014 and \$118 billion in 2015 up from \$1 billion in 2000. Approximately \$18.1 billion of China's OFDI went to the United States in 2014, increasing to \$22.3 billion in 2015.

CHAPTER 2. CAPITAL SOURCES AND VOLUME OF CHINESE INVESTMENT IN U.S. REAL ESTATE

REAL ESTATE INVESTMENT WAS THE NEXT STEP in an evolution of Chinese international economic activity for several reasons. Chinese developers, both state-owned and private, had gained significant experience in the booming domestic real estate market and looked to expand their activities. Sovereign wealth funds had significant funds to invest and sought to diversify portfolios, while insurance companies – a relatively new group in China – also sought diversification. Furthermore, the growing pool of Chinese high net-worth individuals and a broader upper middle class sought stable investments that also could confer benefits of foreign residency and educational opportunities for their children. In many cases, these firms and investors had a growing supply of dollar-denominated capital that could be invested outside of China. As an asset class, real estate meets the range of criteria from these investors. Chinese companies and individuals are acquiring commercial and residential real estate throughout much of the developed world, and the pace has accelerated rapidly in recent years. However, the U.S. real estate market is particularly attractive, owing primarily to its position as the largest, most liquid, and most stable in the world.

This chapter will first examine the sources of Chinese capital active in the U.S. commercial and residential real estate markets. Investment has come via waves of different Chinese capital sources, with each successive wave using new investment vehicles and adding to the rich complexity of Chinese investment in the broader U.S. real estate market. We will then examine more specifically the patterns and volume of investment into commercial real estate. These types of investments tend to evolve, beginning with direct acquisition of existing real estate assets to a broader range of vehicles, such as development, lending, and private equity funds. Chinese investment has followed a similar evolutionary pattern, supplemented by the unique EB-5 investment vehicle. We will conclude with a look at investments in the residential market, a unique path of real estate investment by the Chinese compared to other waves of global investment into the United States.

CAPITAL SOURCES

Chinese investment in U.S. real estate has come from a diverse set of capital sources, which can broadly be categorized into two groups: institutional investors and individual investors. Among institutional investors, capital has flowed from China in distinct waves, with the experience of firms in each wave – on top of regulatory changes in China encouraging investment – helping pave the way for subsequent waves of investors. Individuals have also been a significant source of investment, not only in the residential real estate market but also increasingly in the commercial real estate market as more investment vehicles are made available. The increasing diversity of capital sources – the type of mix found among countries that have

long invested in real estate as an asset class – not only illustrates the evolution and increasing maturity of Chinese investment but also the rapid pace of adoption of sophisticated investment strategies by Chinese investors. This diversity can also help provide long-term stability, as the level of investment is not tied to one particular investor class.

Institutional Investors

China's sovereign wealth funds were part of the first wave of investment into the U.S. real estate market. China Investment Corporation (CIC), SAFE Investment Company (SAFE), and the National Social Security Fund (NSSF) are the third-, fourth-, and ninth-largest sovereign wealth funds in the world, respectively, with nearly \$1.5 trillion in combined assets as of 2015.¹³ Thus far, U.S. investment by sovereign wealth funds has primarily consisted of investment in U.S.-based real estate funds, although direct investment has been part of the strategy as well. For example, CIC was part of one of the first major commercial real estate acquisitions in the United States through a joint venture with AREA Property Partners, acquiring an unspecified equity stake in a Manhattan office tower at 650 Madison Avenue. After a five-year hiatus, in early 2016 CIC acquired a Chicago office building in a joint venture with LaSalle Investment Management.

Real estate developers and operating companies led the second wave of investment into U.S. commercial real estate. This group primarily includes some of the largest Chinese developers, such as China Vanke, Greenland Group, Dalian Wanda Group, Landsea, Oceanwide, and several other major firms. The collection of Chinese developers is particularly fragmented – the top 20 developers hold only 20% market share in China – and a multitude of smaller developers have also been active in the United States.¹⁴

The third wave of investment was driven by the emergence of insurance companies as active participants in the U.S. commercial real estate market. The primary catalyst of investment among insurance firms was the 2012 decision from the China Insurance Regulatory Commission to allow direct real estate investment abroad, which was previously prohibited. Chinese insurance firms invest funds from insurance premiums as well as wealth management products. Anbang Insurance, a relatively small life insurance company based on assets under management compared with China's top insurers such as Ping An and China Life, made perhaps the most noteworthy acquisition in early 2015 by purchasing the Waldorf Astoria in Manhattan for \$1.95 billion. Since then, Anbang has announced plans to acquire hotel assets in multiple multi-billion-dollar transactions and was particularly active in early 2016 (see Platform Investments, page 32). Many other insurance firms are also active in the United States with significant acquisitions of their own, including Ping An Insurance, China Life Insurance, Taiping Life Insurance, and Sunshine Insurance, among others. Other active institutional investors include investment funds such as China Cinda Asset Management and Grand China Fund. Chinese banks, particularly Bank of China, have been major lenders for the past few years for U.S. commercial real estate transactions but are also moving toward asset acquisition – Bank of China purchased 7 Bryant Park in Manhattan in 2014. Other large investors that are also ramping up U.S. real estate activity, specifically development projects, include construction companies and design firms.

Individual Investors

High net-worth individuals and family offices make up an even larger segment of Chinese investors seeking real estate assets in the United States. Wealth management is underdeveloped in China, although the industry is growing as the new high-income class continues to emerge. Individuals and families are increasingly seeking investment vehicles to preserve wealth and diversify portfolios, and foreign real estate – particularly in the United States – is an attractive means.

Individual purchases of residential real estate are one means of real estate investment in the United States. To date, this has been the predominant investment avenue for high net-worth individuals and increasingly among middle- and upper-middle-class individuals and families. Other individual investors are also active in commercial real estate, mostly acquiring small commercial properties. However, the tools available to individuals are becoming increasingly sophisticated. The evolution from all-cash purchases to utilization of debt instruments to finance acquisitions highlights the increasing maturity of real estate investment techniques. Similarly, individual investment in real estate investment trusts (REITs) is another investment path that could accelerate. The first Chinese REITs were listed in 2015; as investors in Chinese REITs become more acclimated to the concept, investment in U.S. REITs by this group could soon follow suit. New ventures to professionalize family office portfolio management in China are eyeing new private equity funds consisting of U.S. real estate assets. Furthermore, individuals can invest indirectly in U.S. commercial real estate through equity funds and the EB-5 investor visa program.

GLOBAL TRENDS IN CHINESE REAL ESTATE INVESTMENT

Although the United States real estate market has become a preferred destination for Chinese capital, Chinese investors have also been particularly active in Australia, the United Kingdom, and Canada, among others.

In Australia, Sydney and Melbourne are magnets for investment, with their developed real estate markets and proximity to China. In Canada, investment has largely been concentrated in Vancouver, although that trend is changing with some accelerated levels of investing in Toronto and other cities. In the UK, London is the primary target for investment. Although there has been some increased investment into secondary markets within Australia, including Brisbane, the Gold Coast, and Perth, Chinese investors remain largely attracted to gateway cities. The concentration in these major gateway cities owes partly to the shortage of alternative local real estate markets in these countries – particularly in the UK, where the bulk of all foreign investment is centered in London. Markets such as Vancouver, however, also have an element of familiarity, as the city had attracted a major wave of investment from Hong Kong in the late 1980s and early 1990s, with nearly one-third of Vancouver's population ethnically Chinese. Investment in Toronto and Montreal, among other cities, has picked up slightly but is still significantly less than on Canada's Pacific coast.

Sovereign wealth funds and private funds led the first wave of commercial real estate investment in these global markets, followed by major developers seeking new markets. Most recently, insurance firms have been in the vanguard. During the entirety of these waves of new investment in commercial real estate, Chinese individuals have been acquiring residential property – including single family homes and condominiums – with Sydney and Vancouver being premier destinations. Immigration from China also accelerated in many places through investment visa programs similar to EB-5. Many high net-worth individuals are now expanding beyond residential purchases, constituting a new wave of commercial real estate investors along with smaller developers and smaller state-owned enterprises.

Of course, these countries have had a variety of reactions as Chinese investment surged. While there is often public scrutiny for commercial real estate investment, the most vocal opposition has been in the residential sector. The current wave of Chinese investment into Vancouver, like the wave from Hong Kong 25 years before, has caused intense public outcry against what many Canadians believe is speculative real estate investment by wealthy Chinese that is contributing to bubble-like conditions of inflated home prices and pricing out many local residents. Moreover, there are some legal concerns about the origin of Chinese funds; protestations that nonresident, property-owning Chinese evade Canadian taxes; and allegations of empty investment homes exacerbating the housing crisis. The same sentiment is seen in Sydney and Melbourne and is even translating into more difficulty in the lending market for Chinese to obtain loans from Australian banks. Australia enacted new regulations to drive investment into new, instead of existing, stock, while Canada has made onerous changes to its immigrant investor program. However, some locals have acknowledged the benefits of increased investment, highlighting that without it many projects would not be viable, while an Australian parliamentary report concluded that the regulations to encourage investment in new supply were a net positive for the economy and stimulated needed new supply. The relatively small size of some of these cities magnifies the impact that external investors, regardless of nationality, can appear to have on a market. Consequently, the backlash to increased levels of investment, whether warranted or not, has driven some Chinese investors to invest in the United States. The sheer size of the real estate market, coupled with the openness of the investment culture, makes the United States particularly attractive in a global context.

COMMERCIAL REAL ESTATE INVESTMENT

Similar to the evolution in capital sources, Chinese investment into commercial real estate has rapidly grown not only in volume but also in breadth of entry points. Direct acquisition of existing assets, across property types and metropolitan markets, is often an early point of entry as a country enters a foreign commercial real estate market, and this was the case with Chinese investors. However, as with foreign investment by other countries, Chinese investment into U.S. commercial real estate has expanded into development, from both traditional developers and investors and the unique capital source of EB-5. Investment is also increasingly coming

through debt lending and private equity. Each of these new layers have been additive. They have brought new investors and expanded the pie of Chinese investment, but without diminishing investment in the prior layers.

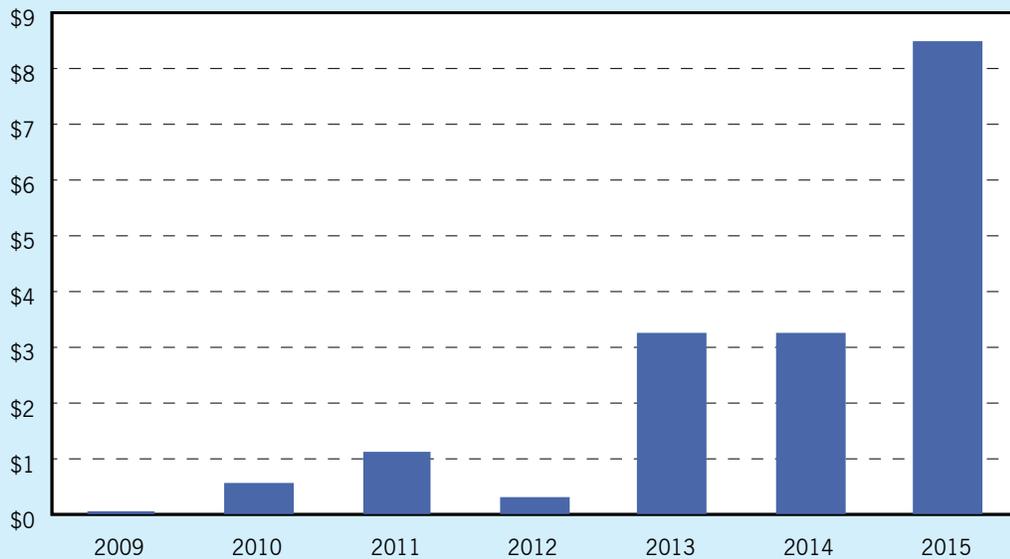
Acquisitions

Acquisitions of existing commercial real estate assets in the United States have been a significant, and high profile, avenue of Chinese investment. Following negligible investment activity from 2005 to 2009, in 2010 Chinese acquisition of existing U.S. commercial real estate assets surged to \$585 million and has increased exponentially since then. Five years on, annual transaction volume was more than 10 times greater, with at least \$8.5 billion of direct real estate acquisitions by Chinese investors in 2015, a compound annual growth rate of 70% since 2010. In aggregate, Chinese investors acquired at least \$17.1 billion in U.S. commercial real estate from 2010 through 2015 (Figure 7).¹⁵

However, the full volume is likely even higher because of commonly used investment structures that real estate investors – including, but not limited to, Chinese investors – use for tax and business purposes, as well as the intermediary countries through which Chinese real estate investment flows into the United States. This adds to the difficulty of tracking acquisitions and accounting for the full investment volume. These structures are not intended to obfuscate ownership or avoid taxes; instead, they are used by domestic and foreign investors

Figure 7: Chinese Commercial Real Estate Acquisition Volume

\$Bil.



Source: Rosen Consulting Group

to appropriately manage real estate investment portfolios and provide legal protection to the individuals similar to how incorporating a small business affords recourse protection to the individual owner. Furthermore, real estate industry professionals acknowledge that there is notable activity from much smaller Chinese investors, who for various reasons do not want to publicize that the investment is from a Chinese capital source and use friends, relatives, or brokers in the United States as a conduit.

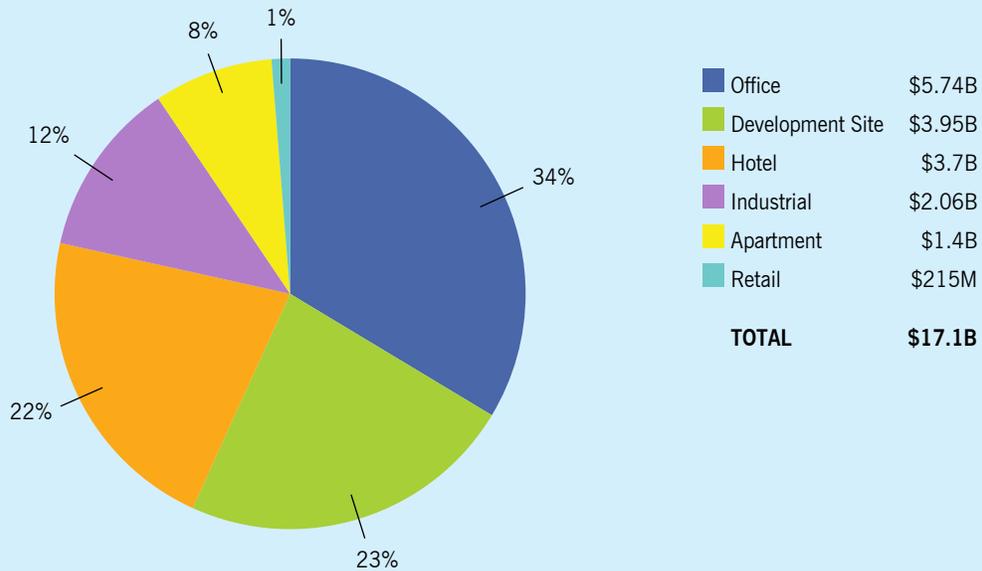
Property Types

Although Chinese investors have invested in all types of commercial real estate, approximately one-third of aggregate transaction volume was concentrated in office properties from 2010 through 2015, as these property types offer the core assets that are attractive to major institutional investors, and Chinese investors in particular. Hotel assets are also major targets, representing approximately 22% of aggregate transaction volume. Both of these property types are suitable for long-term holds, and the higher pricing of core office and hotel properties compared with other property types is more suitable for many of the large-scale institutional Chinese investors.

Development sites represented approximately 23% of total Chinese transaction volume from 2010 through 2015. This is partly attributable to the high share of development companies among Chinese investors, but it also highlights the increasing trend of Chinese institutional investors utilizing investment strategies such as building-to-core like their peer American institutional investors. With high asset pricing for core properties – meaning high-quality, substantially leased properties in major metropolitan markets – investors look to build properties they expect will become core properties, which can generate higher investment returns compared with simply buying a similar existing property.

Apartment and industrial acquisitions each represent approximately 10% of aggregate transaction volume from 2010 through 2015. Apartment acquisitions have been relatively limited among Chinese investors, compared with U.S. and other foreign investors who have focused largely on apartment properties during the current cycle. However, interest in apartments accelerated in 2015, with apartment acquisition volume eclipsing the cumulative volume from the prior four years. For the industrial segment, the vast majority of investment came from two major portfolio acquisitions in 2015. One was China Life Insurance's approximate 30% stake in November 2015 in the GLP industrial portfolio, composed of 575 properties throughout the United States. The second was Ping An Insurance's acquisition of logistics assets with partner Blumberg Investment Partners for \$600 million, with an additional \$400 million future commitment for additional acquisitions. Retail remains a small component of Chinese acquisitions, accounting for less than 2% of aggregate transaction volume. However, retail is still a component in many mixed-use office and multifamily properties, providing Chinese investors additional exposure to retail in the United States (Figure 8).

Figure 8: Chinese Commercial Real Estate Acquisition Volume By Property Type, 2010-2015



Source: Rosen Consulting Group

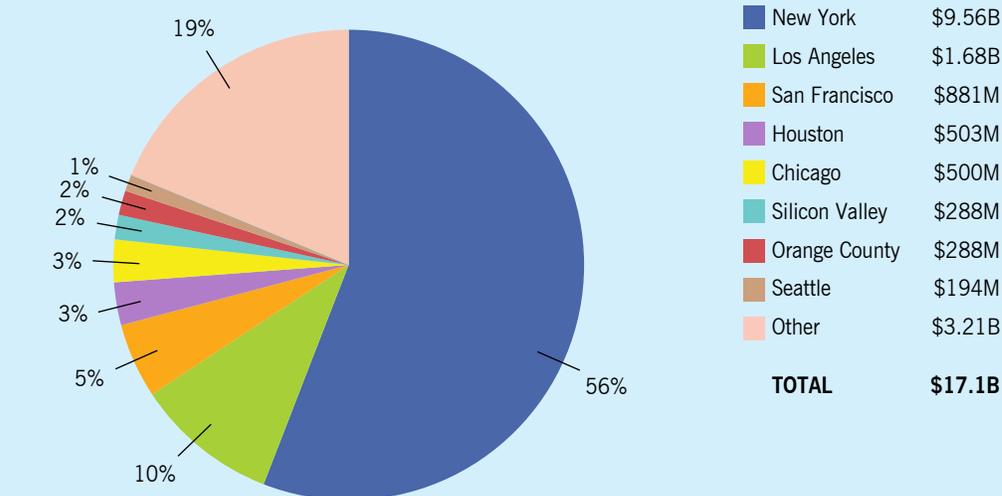
Geography

To date, Chinese investors have primarily sought major gateway markets for commercial real estate acquisitions in the United States. Investment volume, tracked in dollars, in the New York metropolitan area has outpaced that of any other U.S. market, accounting for nearly 56% of transaction volume from 2010 through 2015 (Figure 9). New York, the most expensive real estate market in the country, also attracted the greatest investment volume across each property type. Other than New York, transaction volume was largest in Los Angeles, followed by San Francisco, with more than 70% of aggregate transaction volume concentrated in these three markets. However, the remaining volume of Chinese investment has been spread widely throughout the rest of the country, including significant investment in Houston, Chicago, Silicon Valley, Orange County, and Seattle. Even beyond these markets, Chinese investors have acquired existing assets in at least 32 other markets, including Miami, Boston, and Washington, D.C., but also smaller markets such as Baltimore, Las Vegas, Phoenix, and Jacksonville.

Of course, real estate pricing in New York contributes in part to the elevated volume, and the sheer size of the commercial real estate market also largely translates into a higher number of transactions than in other markets. However, Chinese investors are keenly aware of advantages for certain property types in particular U.S. markets. The depth of the market and global interest in New York, for example, helps stabilize asset values over the longer term. Southern California – which benefits from broad tourism appeal and also its convenience for

Figure 9: Chinese Commercial Real Estate Acquisition Volume By Metro Area, 2010–2015

\$Mil



Source: Rosen Consulting Group

Chinese travelers – has been the primary target for hotel investment, while Chicago’s status as a major distribution hub has made it the leading target for industrial investment (Figure 10).

Investor Classes

The number of Chinese entities acquiring commercial real estate rose from a handful in 2010 to at least 41 in 2014, and a minimum of 39 in 2015. However, more important to the exponential growth in transaction volume has been the type of new investors entering the U.S. market. In particular, the entry of Chinese insurance firms into the U.S. real estate market in 2015 significantly shifted the trajectory of investment volume. The influx of Chinese insurers stems largely from the recent rule change by the China Insurance Regulatory Commission, which now allows insurance companies to invest up to 30% of their assets in real estate, with 15% of their total investments allowed to be offshore.¹⁶ While only a fraction of that allocation will flow to the U.S. commercial real estate market, of the approximately \$8.5 billion invested commercial real estate in 2015 by Chinese investors, more than half came via insurers, even as just seven acquisitions were by insurers. The amount of capital that insurers seek to deploy is orders of magnitude larger than that of other investor classes.

Real estate developers and operating companies have been the most active group of Chinese investors, accounting for approximately \$6.7 billion, or 40%, of aggregate investment volume from 2010 through 2015. After insurers, with \$4.5 billion, or 27%, of aggregate volume, family offices and high net-worth individuals collectively comprised the third-largest share with approximately

Figure 10: Chinese Commercial Real Estate Acquisition Volume By State, 2010-2015



\$2.7 billion, or 16%, of aggregate volume. However, nearly half of this sum came from the stake in the General Motors Building acquired by the family office of Zhang Xin, the CEO of SOHO China. Investment companies have quickly emerged as a significant capital source, accounting for \$1.2 billion of aggregate transaction volume in just two years. Banks, equity funds, construction companies, and conglomerates round out the remaining investors, with investment from each group accelerating in 2015. Chinese banks had previously been active in lending, but in 2015 Bank of China acquired its first property, the 7 Bryant Park office building in New York.

Across investment groups, non-state-owned entities accounted for roughly three-quarters of direct commercial real estate acquisitions.¹⁷ Furthermore, only about one-third of aggregate investment volume came from publicly traded companies.

PLATFORM INVESTMENTS

In addition to the many highlighted investment avenues in which real estate is the target component, other examples of Chinese investors acquiring business platforms in the United States have a secondary, yet significant, real estate component. In fact, many FDI transactions include real estate as an underlying business asset. In recent years, Chinese investors have increasingly targeted businesses in which real estate is a critical piece of the platform, representing another evolution in the wave of Chinese investment in U.S. real estate.

Recent hotel platform acquisitions have been a well-publicized example. In early 2016, Anbang Insurance acquired from Blackstone for \$6.5 billion the Strategic Hotels & Resorts Inc. portfolio, composed of 16 luxury hotels across the United States. Anbang quickly followed this with a \$14 billion takeover bid for Starwood Hotels, a public company with more than 1,300 hotels globally. Anbang is not the only firm looking at these assets. Other Chinese entities were originally interested in acquiring Starwood in 2015 before Marriott reached an initial deal, including Jin Jiang Hotel Group, which had already acquired a European hotel chain in 2015, and CIC, the sovereign wealth fund.

Cinema chains provide another example. Dalian Wanda acquired the AMC chain in 2012 for \$2.6 billion. With more than 5,000 screens in the United States, that acquisition has a sizeable real estate component. Furthermore, it set the stage for subsequent vertical integration by Wanda in the U.S. entertainment industry. In early 2016, Dalian Wanda made good on that framework when it acquired Legendary Entertainment, the first Chinese acquisition of an American film studio.

Although these represent some of the most high-profile examples, Chinese capital is entering the U.S. market through other means with real estate implications. A number of firms are establishing research and development operations in the United States across varied segments, including pharmaceuticals, automotive, and appliances. Alibaba opened two cloud data centers in Silicon Valley in 2015, while other firms such as HanHai – with capital from both Chinese institutional investors and individual investors – focus on tech incubator platforms in Boston, Silicon Valley, and Los Angeles. Although much of the space for all of these operations is leased, continued growth in these areas presents opportunities for increased acquisitions of the underlying real estate. In addition to more industrial operations, Chinese firms are also targeting U.S. agricultural entities, with vineyards proving particularly attractive to Chinese investors. At the same time, other land-intensive business platforms, such as golf courses, are appealing to Chinese investors; a number of golf courses have been acquired in California, Florida, the Carolinas, and other resort destinations in the United States.

Real estate is a component, in some way or another, of nearly every business. As global Chinese investment continues to evolve, there will be an increasing array of opportunities for investors to achieve the portfolio diversification and other benefits that real estate can provide.

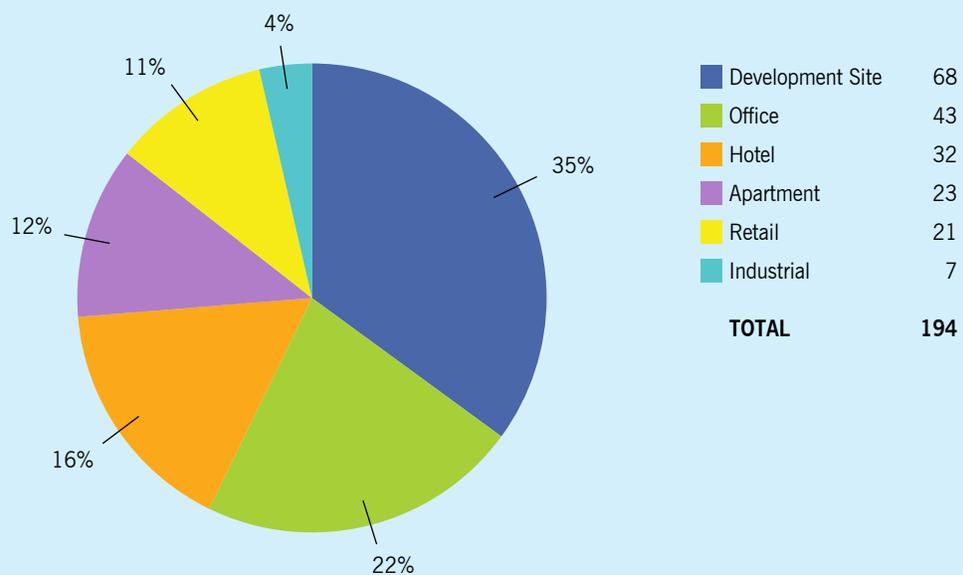
Commercial Development

Acquisition of existing assets is a significant vehicle for foreign real estate investment, but development of new assets is an even more challenging and complex undertaking. For Chinese developers entering the United States, the vastly different regulatory framework and development process add to that complexity. Chinese developers have used joint ventures and other partnership structures to gain expertise; ultimately, many of these developers seek to build independently in the United States. The surge in development activity by Chinese investors in recent years signals the maturing nature of overall Chinese investment in the U.S. real estate market.

Although the dollar volume of transactions from 2010 through 2015 was highest for existing office assets, when measured by number of transactions, development sites have been the most targeted asset by a wide margin. Chinese investors have acquired at least 68 development sites in the United States during this period (Figure 11). Simply accounting for acquisition costs of the development site land already makes development sites the second-largest asset type by dollar volume of transactions. However, acquisition costs represent only a fraction of the total development cost, making development a significant avenue for Chinese investment.

Excluding the costs of site acquisition accounted for in the prior section, which totaled approximately \$4 billion from 2010 through 2015, announced development costs for Chinese-funded projects under construction and planned have totaled at least \$15 billion cumulatively during that period, including an annual peak in 2014 of \$8.5 billion of estimated development costs.¹⁸ The vast majority of investments have flowed into three regions: New York, Los Angeles, and the San Francisco Bay Area. Nearly 80% of the dollar volume has been concentrated in those three markets, with two-thirds of development site transactions in those markets. At least six projects in these markets each have total project costs exceeding \$1 billion: Pacific Park/Atlantic Yards in New York; First and Mission and the Brooklyn Basin project in the Bay Area; and One Beverly Hills, Metropolis, and Oceanwide Plaza/Fig Central in Los Angeles. Among other markets, only Seattle, Chicago, South Florida, and Boston have generated more than one development project. In total, Chinese investors have only committed to development projects in approximately 20 markets, compared with more than 40 markets for acquisition of existing assets. While there have been fewer projects in these other markets, many individual

Figure 11: Chinese Commercial Real Estate Acquisitions, 2010-2015



Source: Rosen Consulting Group

projects are still significant undertakings with total development costs exceeding \$500 million, including Wanda Vista in Chicago, Capital at Brickell in Miami, and Pier 4 in Boston.

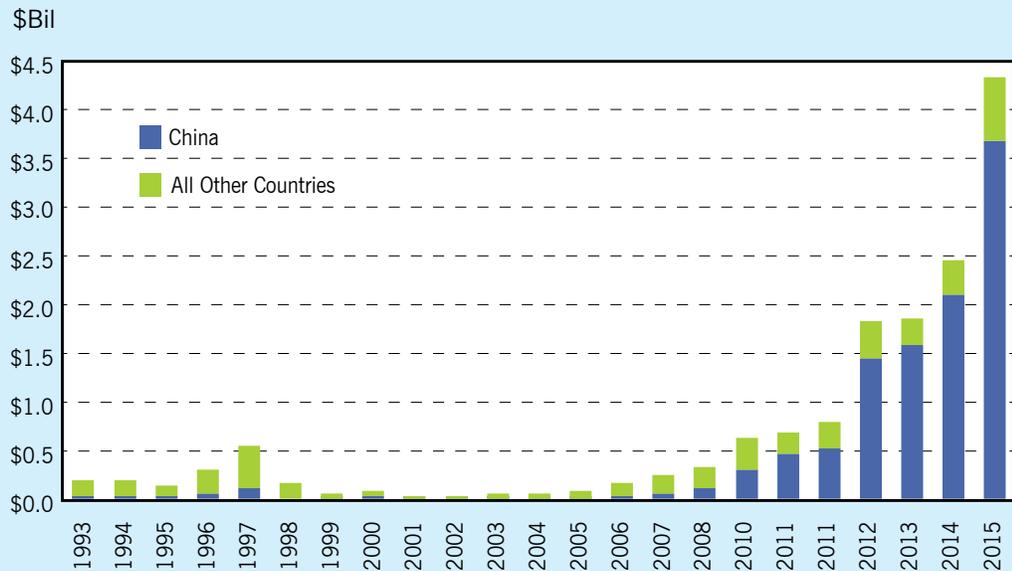
Development activity is also skewed largely to residential projects, primarily condos. More than 30 of the identified development projects are exclusively residential (save for small, ground-floor-only retail components), while nearly 20 more are mixed-use with significant residential components. Among mixed-use projects, 11 have retail components, while 8 will feature a hotel and 5 will feature office space. There are only a handful of office-only projects, two industrial projects, and one hotel-only project.

Chinese developers have been most active among investor classes, accounting for more than 80% of total development funding, but some activity has also come from construction companies and equity investments from insurers. In addition, some Chinese firms, are securing development rights. China Harbor Engineering (a subsidiary of China Communications Construction Company) recently secured development rights for land surrounding a transit station in the Bay Area.

EB-5

While development activity by Chinese firms was an evolutionary next step in the pattern of Chinese investment into U.S. real estate, development in the United States has also been aided by investors through the EB-5 Immigrant Investor Program, also known as Employment-Based Immigration: Fifth Preference or more simply “EB-5,” which was established by the U.S. Congress in 1990 in an effort to leverage capital investments by foreign investors to create jobs and stimulate the U.S. economy. The program provides an opportunity for immigrant investors to obtain visas and, ultimately, permanent residency status (i.e., a green card) for him- or herself, a spouse, and children. Individuals must invest at least \$500,000 in a new commercial enterprise and create at least 10 jobs.¹⁹ After little usage for much of its history, Chinese investors have flocked to the program in recent years. While not designed specifically to spur real estate construction, development has proven to be the most popular project type largely because of its job creation potential, the ability for investors to eschew the rigors of direct management of an enterprise, and the familiarity of real estate investment and attraction as a stable and secure asset class to Chinese investors.

Using EB-5 petition approval data, RCG estimates that in 2015 Chinese individuals invested approximately \$3.5 billion to \$4 billion in EB-5 capital.²⁰ This represents the highest total historically, up from approximately \$2 billion in 2014 and \$1.5 billion in 2013. During the 25-year history of the EB-5 program, RCG estimates that the program has resulted in nearly \$11 billion of investment from Chinese individuals, representing approximately 70% of total EB-5 investment from all countries. Since the rapid growth of Chinese EB-5 applications starting in 2008 during the recession, Chinese EB-5 investment volume has increased at a compound annual growth rate of 62% (Figure 12). Of course, this is total investment and not specifically investment in real estate. However, looking at China specifically, approximately \$9.5 billion of the \$11 billion in Chinese investment came since 2011, a period in which the vast majority of Chinese EB-5 investment flowed to real estate through the regional centers. Among the 25 largest projects funded by EB-5 capital, all but two were real estate projects.²¹

Figure 12: EB-5 Investment Volume

Sources: US Citizenship and Immigration Services, Rosen Consulting Group

Dozens of major projects and myriad smaller projects in the United States have been financed, in part, with EB-5 capital. The availability of this particular capital source, in some cases, has allowed the projects to proceed when alternative debt sources were not available. Approximately 15 projects have been backed by at least \$100 million of EB-5 capital, with the vast majority of projects located in New York and a few projects scattered in San Francisco, Los Angeles, Seattle, and Las Vegas. The largest EB-5 funded project is Hudson Yards in Manhattan, with an estimated \$600 million of EB-5 funds, followed by the Pacific Park (formerly Atlantic Yards) project in Brooklyn, with an estimated \$577 million of EB-5 funds. The Hunter's Point Shipyard project in San Francisco attracted approximately \$250 million in EB-5 financing, while the nearby Treasure Island redevelopment has attracted at least \$200 million with the potential for an additional \$240 million.

In addition to the use of EB-5 financing by U.S. developers, Chinese developers are also tapping EB-5 themselves for U.S. projects. Among them, China City Construction, a subsidiary of China Communications Construction, is a joint venture partner for a Miami development that is expected to cost \$875 million, with attempts to raise \$350 million through EB-5.²² Similarly, Chinese development group Create World is trying to utilize EB-5 financing for multiple development projects in Bellevue, Washington.²³

The EB-5 program has been subject to numerous reform proposals in the past year, but Congress renewed the program in December 2015, keeping the program in place as-is through at least September 2016. Still, uncertainty about the program's future beyond 2016 remains, which also creates uncertainty about the availability of capital to spur developments that create jobs and new buildings across the country.

EB-5 BACKGROUND

Background and Investor Benefits

To participate in the program, all EB-5 applicants are required to invest in a new commercial enterprise and create at least 10 full-time jobs within two years of admission to the United States. The required minimum investment for the program is \$1 million, except in Targeted Employment Areas (TEA) – rural areas or areas with unemployment at least 150% of the national average – where the qualifying investment must be at least \$500,000. Although TEA investments require an additional compliance cost to obtain TEA designation, considering the much smaller investment required, in practice the vast majority of EB-5 projects represent TEA investments of \$500,000.

For foreign nationals, the EB-5 program provides two primary benefits. First, investors and their families gain legal status to live and work in the United States. Once the EB-5 petition is approved, the investor and eligible family members are granted provisional green cards and can legally live anywhere in the United States for a period of two years, whereupon the investor is required to provide evidence of the project's progress and job creation to gain permanent residency. Since there are a limited number of alternatives to obtain visas, many of which have long waiting periods, the EB-5 program has typically presented the fastest option for immigrant investors and their families to gain legal permanent residency. Immigrant investors are not required to live near the location of the investment and can instead reside anywhere in the United States. Moreover, the provisional green cards provide a chance for children to attend U.S. schools and universities.

The second primary benefit is that the EB-5 program provides an opportunity for foreign nationals to diversify wealth by investing in U.S. assets, such as commercial property. Nationally, EB-5 investments have been a financing source for a large variety of investment projects including development of new commercial properties, as well as investments in infrastructure for transit, manufacturing businesses, and redevelopment efforts of former military bases.

In total, the United States issues a maximum of approximately 10,000 EB-5 visas per year, with each country's share limited to 7.1% of the immigrant visas. However, if visas are not used, then the remaining visas can flow up to a country that has already reached the 7.1% quota. Since the EB-5 program remains underutilized by many countries, China was able to absorb additional visas in recent years, with Chinese applicants accounting for 85% of available EB-5 visas in 2014. Although per-country and overall quotas had never been reached prior to 2014, owing to the rapid increase in popularity among Chinese investors, EB-5 visa issuances reached these quotas by August 2014 and the State Department was forced to stop issuing new visas until the start of the 2015 fiscal year in October. With applications accelerating still further, fiscal year 2015 visa quotas were hit by April 2015, with a backlog in excess of 17,000 applications. The time required to approve proposed investment projects has increased from about 15 months to two to three years. Potentially in response to mounting

pressure on the Chinese economy and the devaluation of the yuan, as well as the potential for the program to be revised or canceled, EB-5 applications accelerated dramatically in the three-month period between July and September 2015: more than 6,500 applications were filed, nearly as many as had been filed during the prior three quarters combined.

EB-5 and Real Estate

While the EB-5 program does not specifically provide any advantage for real estate investments over any other type of investment, real estate is currently the most common industry for EB-5 investor projects for investors from all countries. The preference is more acute for Chinese investors, primarily because these projects are conducive to meeting the requirements for investments to create new jobs and also because of the strong Chinese affinity for property ownership. For new real estate developments, not only do projects generate construction employment, but it is also possible to point to direct hiring in service-related positions, particularly in the case of new hotels and resorts, restaurants, or stadiums.

EB-5 investors can provide a valuable source of capital for new real estate development activity, particularly for underdeveloped sites or neighborhoods that may have limited access to traditional means of financing. As such, interest in the EB-5 program surged after the Great Recession, particularly reflecting the increased challenges for developers of obtaining traditional bank financing and domestic capital. Moreover, since the EB-5 program requires that the capital invested be considered “at risk,” the program does not allow for a guaranteed rate of return for investors. For development, this can make for better terms than traditional bank financing without diluting the investment, as in the case of equity financing. Offsetting these benefits, however, is the lack of certainty associated with EB-5 funding, particularly the potential for extended application processing times and the risk that the project will fail to be approved.

Commercial Lending

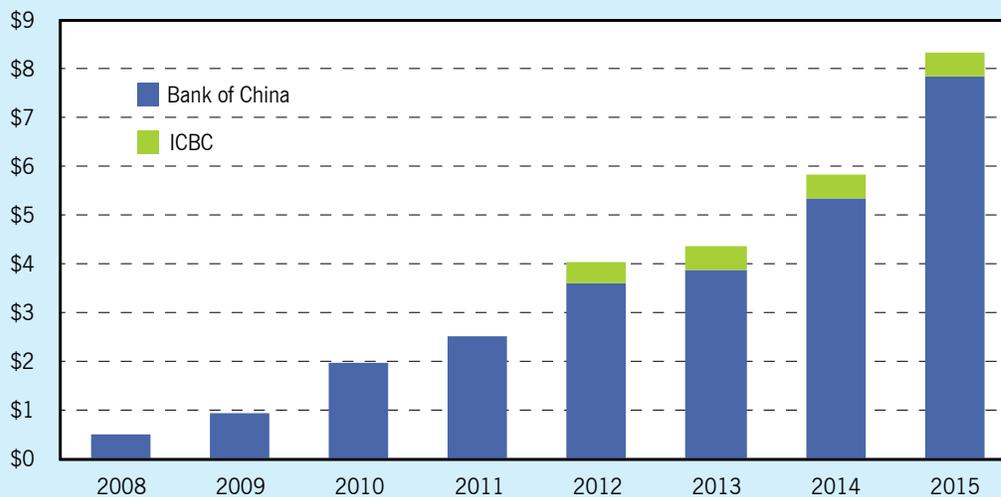
Although EB-5 financing became a popular financing vehicle in a tighter lending environment – particularly for large-scale projects – Chinese banks are also increasingly active in the U.S. commercial real estate market. This growth is another important evolution in Chinese investors’ increasing integration into the U.S. commercial real estate market. Importantly, they are not simply lending to Chinese firms but are becoming major capital sources for U.S. firms.

Bank of China and Industrial and Commercial Bank of China (ICBC), two major state-owned banks, are the FDIC-insured institutions providing the bulk of financing, both for development in the form of construction loans and permanent loans, and for acquisitions. State-owned banks can typically offer lower-cost financing for projects with Chinese developers and can serve as an arm in promulgating China’s “Going-Out” policy. Their traditionally lower cost of capital – which will be tested going forward following the lifting of the deposit rate cap in China – has also provided some advantage for lending for megaprojects. With some differences in underwriting requirements, Chinese banks can be more willing to hold loans on their books and may be willing to offer a higher loan-to-value ratio, for example.

Bank of China's U.S. commercial real estate loan portfolio reached \$7.84 billion as of year-end 2015, up from \$5.33 billion at year-end 2014 and from just \$488 million in 2008.²⁴ ICBC, in comparison, has a much smaller footprint in the United States, but it is growing. Since ICBC acquired Bank of East Asia in 2012 to bolster its U.S. presence, its total commercial real estate loan portfolio increased from \$412 million in 2012 to \$513 million as of year-end 2015. As the world's largest bank by assets, however, ICBC has the potential to accelerate lending in the same way that Bank of China has done during the past few years (Figure 13).

Figure 13: U.S. Commercial Real Estate Loan Holdings

\$Bil.



Source: Federal Deposit Insurance Corporation

Private Equity

To date, a significant portion of the capital flowing into U.S. commercial real estate has been direct, with firms acquiring or developing an individual property, individuals providing EB-5 capital for a specific project, or lenders making a loan for a specific property. Investing in funds – a much more hands-off approach that requires investors to relinquish some decision-making authority – has not been a typical investment method favored by Chinese investors. However, private equity funds are beginning to make inroads with Chinese investors and represent yet another step in the maturation of Chinese investment in U.S. real estate. In recent months, efforts to raise capital by blind pool funds have been received more positively by individual investors than they were just a year or two ago. Active Chinese investors to date have included sovereign wealth funds such as CIC and SAFE investing in real estate funds from Morgan Stanley, Blackstone, Carlyle, and KKR. However, family offices have also begun investing in real estate funds. The DLJ Real Estate Capital Partners V Fund, with Chinese investor CreditEase Wealth Management, raised \$143 million total in 2014, deploying capital

to acquire residential properties in New York, Boston, and Los Angeles.²⁵

Other real estate funds include the Elite International Real Estate Investment Fund – among the first Chinese private equity funds to invest in a U.S. real estate development – with three rounds of funding by Chinese investors that included \$26 million toward a joint venture apartment development in Los Angeles, \$28 million toward two Texas developments, and a portfolio of equity placements in 15 to 20 additional projects across the United States. The accumulated development cost of the fund’s projects is \$1.5 billion.²⁶ Other private equity funds, operating through the Qualified Domestic Institutional Investor (QDII) program that allows approved groups to sell shares of foreign financial products to domestic Chinese investors, include the Penghua United States Real Estate Fund, Lion Fund Global Real Estate, two funds from GF Fund Management, and a fund from Harvest Fund Management, among others. Programs such as QDII and the early-stage Qualified Domestic Individual Investor program (QDII2) could also allow for additional fund-like structures from insurance companies, which could target U.S. real estate as an asset class.

RESIDENTIAL REAL ESTATE INVESTMENT

In addition to the rapid growth, diversifying investment vehicles, and increasing maturity of Chinese investment into U.S. commercial real estate, the growth in Chinese investment in U.S. residential real estate has been just as impressive and is a critical piece of the comprehensive nature of Chinese investment in the United States. The aforementioned growth in Chinese holdings of residential mortgage-backed securities was one of the first entries by China into the U.S. residential real estate market – and the total U.S. real estate market more generally – but one of the most prominent trends to develop in recent years is heightened purchases of residential properties by Chinese individuals and families, with evolving trends in intended uses, locations, and financing of properties. While Chinese individuals have been instrumental in driving elevated residential investment through home purchases, Chinese homebuilders are increasingly active in the U.S. market, providing yet another avenue for Chinese investment in the U.S. real estate market.

Residential Purchases

Residential purchases by Chinese nationals have increased rapidly in recent years and have been one of the most visible elements of the multipronged flow of Chinese investment into the broader U.S. real estate market. In 2015, China surpassed Canada as the largest buyer of residential properties – including single family homes, condos, and townhomes – in the United States. China accounted for 16% of total international home purchases in the 12 months ending March 2015, up from 9% in 2010 and just 5% in 2007, according to the National Association of Realtors (NAR).²⁷ This represents more than 33,000 home purchases by Chinese individuals in 2015, compared with approximately half that level in 2011 (Figure 14). In terms of the dollar volume of home purchases, China has exceeded all other countries since 2013. Chinese buyers purchased at least \$28.6 billion of residential property in the 12-month period ending March 2015, an increase of 30% from the prior year and a compound annual growth rate of 20% since 2010. However, as with commercial real

Figure 14: Chinese Residential Purchases

Source: National Association of Realtors

estate investment, the total volume is likely even higher than this baseline figure. There are inherent limitations in collecting such data: it is self-reported by clients to realtors, the sample size is limited, and home sales can close quickly in certain markets without being listed. Furthermore, fair housing regulations limit the type of demographic information that can be collected and disseminated. Also, ownership of homes can be transferred into family trusts and other entities that shield the identities of homebuyers.

The average home purchase price for Chinese buyers is significantly greater than the average price paid by other international buyers, which itself is already nearly double the average for all buyers, according to NAR. The average home price for Chinese buyers in 2015 was \$831,800, up from \$590,800 in 2014. In comparison, the average home price for all international buyers in 2015 was \$499,600, up from \$396,180 in 2014 (Figure 15). This difference is partially attributable to the tendency of Chinese buyers to concentrate in more expensive property markets, such as coastal California and New York, as compared with the buying patterns of foreign national groups who have been active in the United States for a longer period, such as Canadian and British buyers focused on retirement destinations in the Sunbelt with lower costs of living. However, the average purchase price for Chinese buyers is also higher because they tend to target prime neighborhoods in these markets, which provide not only larger homes but also the top schools and family amenities that many buyers – both Chinese and American – seek.

Figure 15: Average Residential Purchase Price

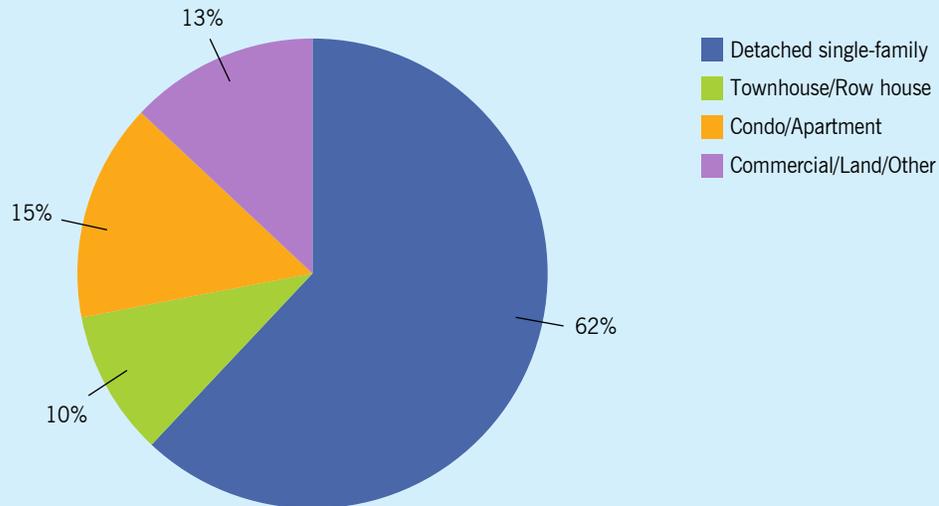
Source: National Association of Realtors

Property Types and Intended Use

Detached, single family homes constitute the majority of properties purchased by Chinese buyers, comprising 62% of purchases in 2015. Although there has been some annual fluctuation in this share during the past few years, it has generally been diminishing over the long term since 2008, when single family homes comprised 74.4% of total Chinese transactions (albeit a much smaller pool of total transactions at that time). However, the share of condo purchases has remained fairly consistent during the past four years, ranging between 11% and 17%, after peaking at 22% in 2010 (Figure 16).

In 2015, approximately half of Chinese buyers were current residents of the United States, having either immigrated within the past two years or holding a professional, educational, or other type of visa permitting the individual to live in the country for at least six months. Nonetheless, just 39% of Chinese buyers stated an intention to use the home as their primary residence, and this share is consistent with the 40% average during the past five years. Alternatively, during the same period, 23% of Chinese buyers intended to use the acquired home as a rental property, roughly 9% intended to use it solely as a vacation home, and 15% intended to use the home for a combination of vacation and rental purposes (Figure 17). In China, a large share of household wealth, much larger proportionally than in the United States, is held in real estate. This familiarity of utilizing real estate as an investment or wealth preservation tool is more prevalent in China and reflects the broader comfort of purchasing second homes in the United States by Chinese individuals and families.

This breakdown of intended uses is consistent with survey findings on buyers' expectations of how much time they will personally spend in the acquired home. Between 2010 and 2014,

Figure 16: Residential Property Type Preference, Chinese Buyers, 2015

Source: National Association of Realtors

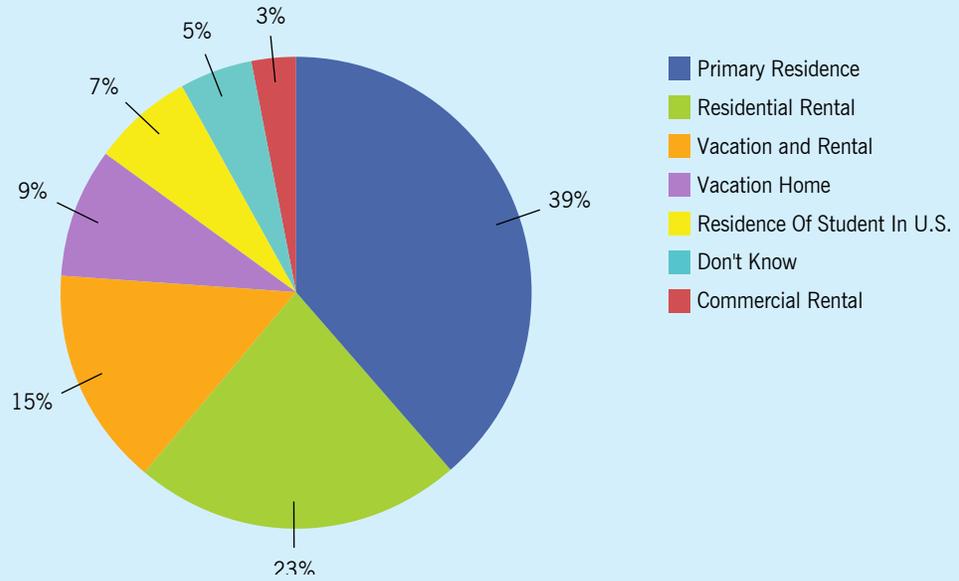
only 42% of Chinese buyers, on average, intended to use the home for more than six months per year; this figure is almost certainly higher than the actual share, since slightly more than one-quarter of survey respondents during this period did not know how long their clients expected to use the home. In contrast to some U.S. buyers of second homes, many Chinese buyers do not temporarily rent homes or condos when the property is vacant. As a result, concerns about homes sitting vacant and landlord absenteeism are increasingly common among neighboring residents, homeowners associations, and local real estate professionals. However, some condo developers and brokers are seeing Chinese buyers live in units part time. As a result, the unit could appear vacant at any given time but in reality fits within a broader global change in living patterns for many individuals – not only Chinese – in which it is not unusual to split time between multiple cities or city centers and suburban neighborhoods.

Geography

Chinese home purchases have long been concentrated heavily in California, and the state accounted for 35% of Chinese purchases in 2015. The next most popular state, Washington, accounted for 8% of sales, followed closely by New York at 7%, by total number of homes sold. Massachusetts, Illinois, Texas, and Hawaii are other prime destinations, while Chinese buyers are also increasingly purchasing homes in Florida. These markets also correlate well with availability of direct flights from China to the United States and established Chinese and Chinese American populations in these cities (Figure 18).

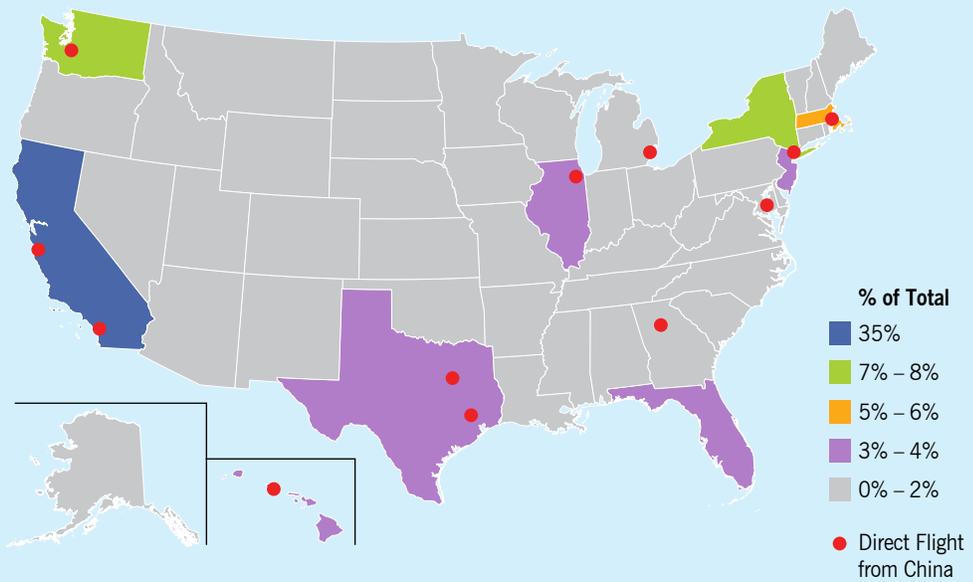
At a more micro level, it is also relatively common to have Chinese home purchases clustered within the same neighborhood. This is attributable in part to the same dynamics

Figure 17: Residential Property Intended Use, Chinese Buyers, 2015



Source: National Association of Realtors

Figure 18: Chinese Residential Purchase Volume, by State, 2015



Source: National Association of Realtors, Various Air Carriers

involved in the formation of any ethnic enclave: the desire to be near other people and, over time, goods and services that allow immigrants to retain aspects of their native language and culture.

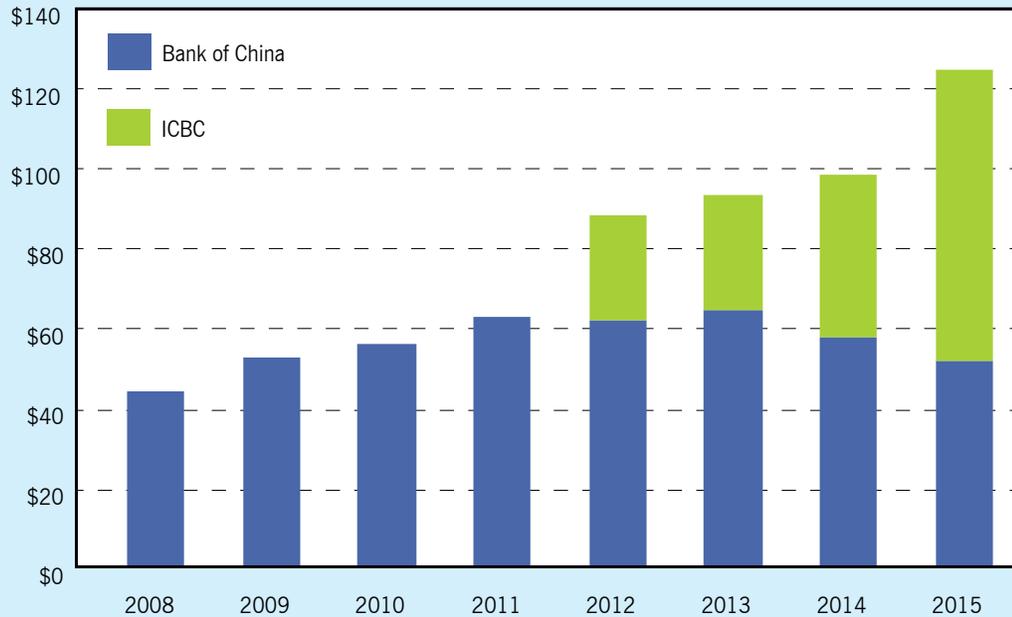
Payment Trends

A sizeable majority of home purchases by Chinese individuals are cash purchases. According to NAR, between 2013 and 2015, 71% of Chinese buyers, on average, purchased homes in the United States on an all-cash basis, a substantially higher share than the other countries comprising the top five international buyers, with the exception of Canada.

In the easy credit environment leading up to the financial crisis, foreign buyers – including Chinese individuals – could obtain financing with as high as 80%–90% loan-to-value ratios and slightly higher mortgage rates than U.S. buyers.²⁸ During and following the recession, however, the tightening of mortgage availability across the board was even more acute for foreign buyers, with many banks eliminating mortgage programs for foreigners altogether. For international banks that continued to lend to international buyers, down payment requirements could reach as high as 60% for even the most qualified buyers, in addition to a higher administrative burden of income and asset checks. Lenders perceive foreign borrowers as inherently more risky; even if a borrower has a high income and strong credit history at home, lenders often want to see a history in the United States.

The lending market has begun to open up again to foreign borrowers, with some down payment requirements as low as 30% from international banks.²⁹ However, even strong candidates can be required to deposit up to two years of mortgage and tax payments into a U.S. account. Some Chinese buyers can turn to wholesale mortgage lenders, some of which have begun lending to nonresidents in the past year on seeing the upswell in Chinese demand for U.S. residential properties. More common, however, is obtaining financing through Chinese banks operating in the United States – such as Bank of China and ICBC, the two major mainland China state-owned banks, and others – which can be willing to underwrite loans based on assets held in China and stated income in China. This provides residential purchase opportunities to individuals who may not have a credit history in the United States, but who are actually well-qualified borrowers with long and healthy credit histories in China. Although the holdings of one-to-four-family residential loans at Bank of China has decreased slightly – to \$53 million in 2015 from a peak of \$63 million in 2011 and 2012 – the holdings at ICBC have increased rapidly, reaching \$67 million in 2015 from \$40 million in 2014 and \$29 million in 2013 (Figure 19).³⁰ Another tactic used by some Chinese buyers is to purchase a first U.S. home in cash and then to take out a home-equity loan to make funds available for additional home purchases, now with a U.S. credit history to more easily access the lending market. Growing mortgage and financing availability not only expands the pool of buyers to those who would not otherwise be able to make an all-cash purchase but also provides leverage to Chinese individuals. Buyers who may have bought one house in cash can increasingly buy multiple homes, providing greater opportunities for capital preservation. As with other investment strategies, this is not a uniquely Chinese experience but is in fact a tactic utilized by many U.S.-based residential investors.

Figure 19: U.S. Residential Real Estate Loan Holdings
\$Mil.



Source: Federal Deposit Insurance Corporation

NEW U.S. TREASURY RULES

New rules introduced by the U.S. Treasury Department could have a notable impact on sales and payment trends by foreign nationals, including Chinese individuals. The rules require reporting of buyer identities for purchases of high-end homes in two initial markets, Manhattan and Miami, selling for at least \$3 million in Manhattan and \$1 million in Miami. Reportedly, other cities can also be included within this requirement. Reporting is required, however, only for all-cash purchases or purchases made through limited liability corporations or other corporate structures – a purchase form that can be used to conceal the identities of the involved parties. Money laundering facilitated by the utilization of the ownership structures and cash purchases is the primary reason for the newly implemented regulations. The program builds on a similar reporting program implemented by the City of New York in mid-2015. The initial pilot program will run through August 2016, at which time it could be introduced nationally; it remains to be seen whether the new program could drive more Chinese individuals to utilize mortgages or potentially dissuade some individuals from acquiring U.S. real estate in the first place.

Residential Development

While Chinese individuals are driving investment through residential purchases, Chinese homebuilders are increasingly active in the U.S. market and are a growing source of investment. Until the past year, much of the activity was focused on small-scale construction, building a handful of new homes on small sites and targeted primarily at Chinese buyers. However, large-scale builders are beginning to enter the market and, like their commercial development counterparts, build a trusted brand as a U.S.-based builder catering to U.S. buyers. Residential construction has not been exclusively limited to condos, with Chinese developers increasingly looking toward single family housing development in the United States.

Large-scale residential development took off with Landsea's 2014 announcement that it would invest \$1 billion into the U.S. housing market over the coming years.³¹ It was the first significant entry of a Chinese homebuilder into the U.S. market, with condo projects in Boston and New Jersey as well as single family developments in California, each with more than 100 homes. The company, which builds approximately 12,000 homes per year in China and is also active in Hong Kong and Germany, has publicly indicated its goal to become a mainstream U.S. homebuilder, as it uses local labor and materials and targets U.S. buyers.

The slowing domestic Chinese housing market is providing some impetus to diversify and portends even greater investment from Chinese builders going forward. Other developers have entered the market or have considered investments in the United States. One such firm planning large developments is Starryland USA, a subsidiary of Fuxing Huiyu Real Estate, with a planned 100-unit project in the Bay Area and 200-unit project near Seattle.³² Lelege USA, led by Beijing-based businessman Zhang Long, is building 99 mini-mansions near Dallas, although these are largely targeted at Chinese buyers.

Despite the entry of larger Chinese homebuilders into the U.S. market, the market remains dominated by small-scale Chinese builders, which are numerous and difficult to track. For example, in 2015 Bohong Inc. started its first U.S. real estate development project in Fremont, California; the project is located on half an acre, with 12 townhouse units approved.³³ While some of these smaller-scale builders are targeting Chinese buyers, most Chinese builders, large and small, are focused on U.S. buyers. The design, materials, and amenities of homes they are building are intended to appeal to U.S. buyers and to compete in quality with homes built by U.S. firms.

TAKEAWAYS

- Real estate investment was the next step in an evolution of Chinese international economic activity. China's sovereign wealth funds were part of the first wave of investment into the U.S. commercial real estate market, followed by developers and operating companies, insurance companies and investment funds, and construction and design firms. Chinese individuals and family offices are increasingly active in the U.S. commercial real estate market, but particularly in the residential market.
- Investment has flowed into the commercial real estate market through multiple channels.
 - Acquisitions of existing assets have been a significant and high-profile channel. Chinese investors acquired at least \$17.1 billion in U.S. commercial real estate from 2010

through 2015. The annual flow totaled at least \$8.5 billion in 2015 from \$585 million in 2010. Office buildings accounted for the largest share of volume, followed closely by development sites and hotels. Although New York and California are primary geographic targets, Chinese investors have acquired properties throughout the United States.

- Chinese investors have increasingly targeted development opportunities, often using partnership structures with U.S. firms. Announced development costs for Chinese-funded projects totaled at least \$15 billion cumulatively from 2010 through 2015. Nearly 80% of the dollar volume has been concentrated in the New York, Los Angeles, and Bay Area markets. In addition, at least \$11 billion of EB-5 capital (most of it since 2011) has flowed from Chinese investors, helping fund dozens of job-generating projects across the United States.
- Lending activity and indirect real estate investment are also on the rise. Bank of China's U.S. commercial real estate loan portfolio reached \$7.84 billion as of year-end 2015, from \$488 million in 2008. ICBC has a much smaller footprint in the United States; its commercial real estate loan portfolio reached \$513 million as of year-end 2015, from \$412 million in 2012. Indirect real estate investment through funds has been limited to date, but it is beginning to make inroads and represents a significant future stream of Chinese investment.
- Investment has also flowed into the U.S. residential real estate market, both through direct purchases and increasing residential development activity by Chinese firms.
 - In 2015, China surpassed Canada as the largest buyer of residential properties in the United States, with 33,000 home purchases totaling at least \$28.6 billion, an increase of 30% from the prior year and a compound annual growth rate of 20% since 2010. The average home price for Chinese buyers in 2015 was \$831,800, up from \$590,800 in 2014 – in both cases nearly 50% greater than the average home price for all international buyers.
 - Between 2013 and 2015, 71% of Chinese buyers, on average, purchased homes in the United States on an all-cash basis. The lending market has begun to open up again to foreign borrowers, and U.S. mortgages can increasingly be obtained through state-owned Chinese banks operating in the United States, which underwrite loans based on assets held in China and stated income in China.
 - Large-scale Chinese homebuilders are beginning to enter the market. Despite this, the market remains dominated by small-scale Chinese builders. Most Chinese builders, large and small, are focused on building homes designed to appeal to U.S. buyers and to compete in quality with homes built by U.S. firms.

CHAPTER 3: NONREGULATORY INVESTMENT DRIVERS AND CONDITIONS

THE RELATIVELY SHORT HISTORY OF CHINESE INVESTMENT IN U.S. REAL ESTATE, coupled with a vastly different economic and business environment in China compared to that in the United States, leads to questions about the drivers and motivations of firms and individuals investing in the United States. Although the regulatory environment (discussed in Chapter 4) is critical in shaping the form and volume of investment, there is a range of core motivations for Chinese investors borne by business goals, macroeconomic conditions, and personal reasons. However, while some of these motivations are unique to Chinese investors, many of the motivations are familiar. Chinese investors – both firms and individuals – fit squarely within a global investment environment and are weighing many of the same factors as other international investors looking at the U.S. real estate market.

This chapter will first examine motivations of Chinese institutional investors. Firms weigh criteria of risk and return for specific investment opportunities, but like other international investors they are drawn to the U.S. real estate market because of an array of advantages compared with other global real estate markets – particularly the depth and liquidity of the U.S. market. Investing in U.S. real estate also provides compelling opportunities for knowledge transfer and building global brand awareness, while providing necessary investment outlets in light of China’s slowing economy and domestic real estate market. We will subsequently review motivations for individual investors. Individuals and families are similarly weighing a range of financial considerations when investing in U.S. real estate, but many are particularly attracted to U.S. real estate for the potential ancillary benefits it can confer, including residency, educational opportunities for their children, and health advantages.

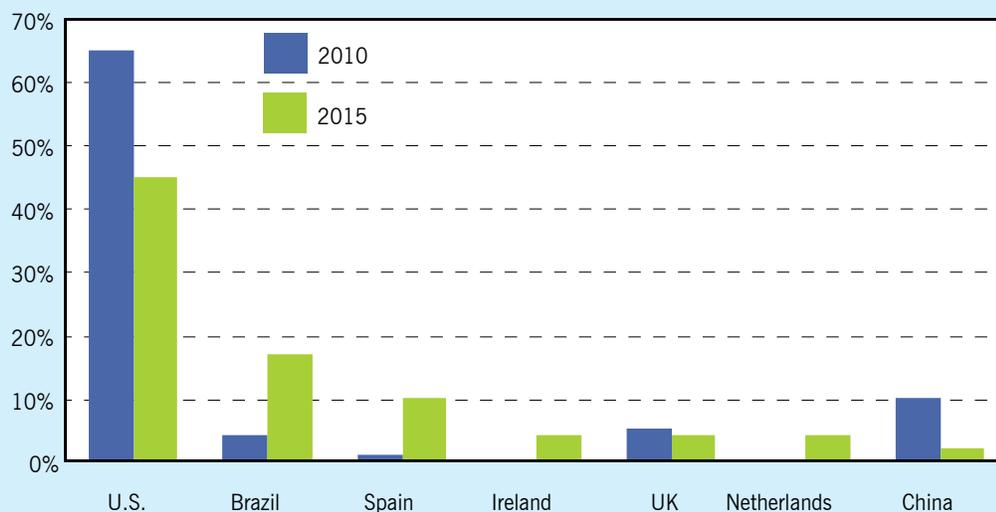
INSTITUTIONAL INVESTORS

At a basic level, Chinese institutional investors are assessing investment opportunities in a similar way as do their global counterparts, weighing risk and return considerations as part of a global investment portfolio. However, with an often long-term investment horizon, the ultimate weighting of these criteria and their components may differ from that of typical global and U.S. investors. Cash flow matters but can be weighted less heavily than capital gains for some as investors look for long-term returns. Furthermore, it can mean that potential supply-side risk from overbuilding in a given U.S. market such as New York, Los Angeles, or San Francisco – a major concern for short- to medium-term investors that need to time market decisions accurately to maximize returns – factors less heavily in investment decisions. Some look at investments such as Anbang’s spate of hotel acquisitions in 2015 and 2016 and question the pricing and cyclical timing. However, for some investors, the associated globalization and portfolio diversification benefits can outweigh the reduced return potential caused by a high purchase price.

The United States is not only the largest and deepest real estate market; it is also the most desirable from a global investment perspective. According to the 2016 survey from the Association of Foreign Investors in Real Estate (AFIRE), respondents ranked the United States as the top international real estate market for capital appreciation.³⁴ Approximately 45% of respondents ranked the United States first, with second-place Brazil trailing by nearly 30 percentage points and followed by Spain, Ireland, and the United Kingdom (Figure 20). China ranked seventh by this metric. Although the United States is viewed as the top market for capital appreciation, the share of respondents holding that view has steadily declined since 2010, as opportunities for surges in asset values in emerging market countries and parts of Europe attracted the attention of global property investors, when approximately 65% viewed the United States as the premier market for capital appreciation. Since 2010, however, Chinese investment in the United States has continued to accelerate, which would indicate that the U.S. market has other attractive features beyond capital appreciation that factor into decision making.

Still, there is a spectrum of risk and return needs across the range of Chinese investors, and sometimes a spectrum within a specific investor class or even a specific firm. For example, Chinese insurers typically have multiple capital streams that they invest with different goals. The funds they receive from insurance premiums are typically allocated toward lower-risk investments that can generate stable income, which the insurer can rely on to pay out future claims. However, balance sheet capital is often used to make different investments – still generally lower risk, but with slightly higher return requirements. Chinese insurers offering wealth management products to customers typically invest this capital in moderate- to high-

Figure 20: Country Providing the Best Opportunity for Capital Appreciation

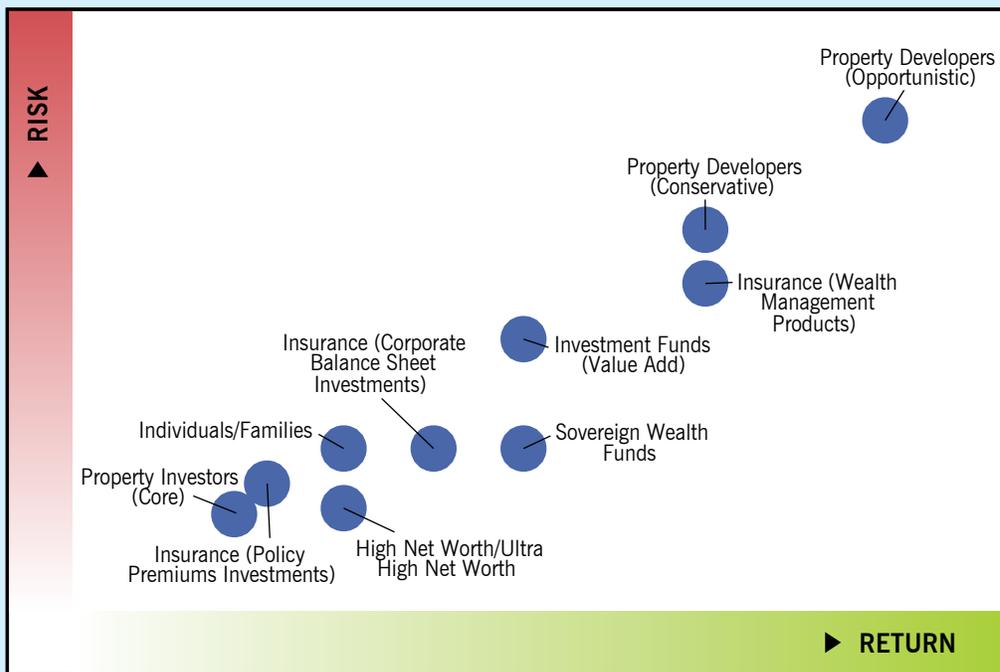


Source: Association of Foreign Investors in Real Estate

risk investments, such as value-add projects, new development, and platform investing that can generate appropriate returns to disburse to customers.

Looking beyond insurance companies, Chinese developers, largely by nature of ground-up building versus acquisition of stable assets, have the greatest risk appetite and highest return requirements, but even in this group there is some stratification between firms, with different levels of risk tolerance. Chinese investment funds and sovereign wealth funds typically occupy the middle of the spectrum of investors for return requirements, although investment funds will generally accept slightly higher risk. Families and high net-worth individuals (discussed in the subsequent section) are slightly more risk averse, although core property investors and insurance investment from premiums generally are the most risk averse and have the lowest return needs (Figure 21).³⁵

Figure 21: Chinese Investor Risk-Return Spectrum



Source: Rosen Consulting Group

More generally, though, with limited domestic investment options in China and a relatively short history of overall international investments by Chinese firms, the ramp up in global real estate activity is an important step in diversification for many Chinese investors. U.S. real estate also provides an increasingly important hedge against foreign exchange risk; the potential for further devaluation of the yuan makes dollar-denominated assets attractive to Chinese investors.

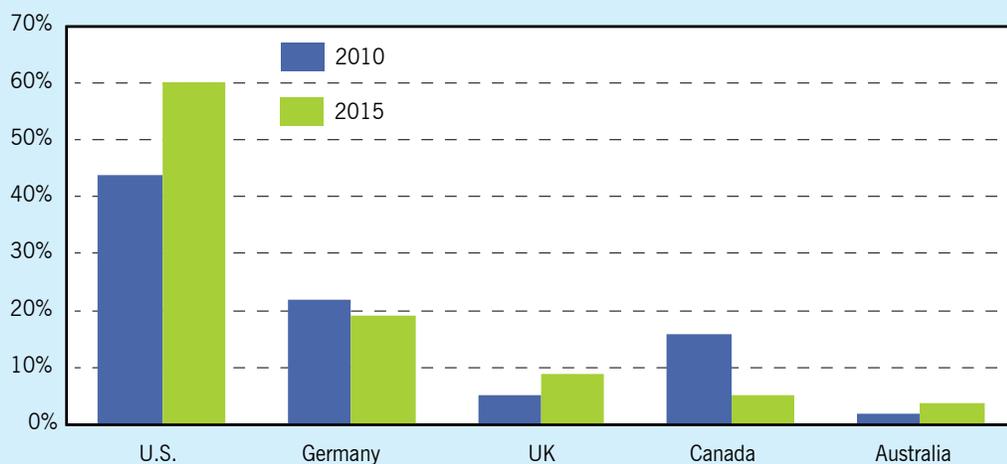
Why Invest in the United States?

Like other institutional real estate investors, Chinese firms are examining investment opportunities globally, evaluating specific properties but also the investment environment in each given country. In addition to returns, they are considering criteria such as the sophistication of business and financial services; infrastructure; deep and liquid capital markets; strong property rights; ease of doing business; and, importantly, a large real estate market with diverse investment opportunities.

The United States is viewed by foreign investors, including Chinese investors, as the top country for real estate investment across these measures and is large enough to absorb significant capital flows. Western Europe, Canada, and Australia are also attractive across these measures for global investors. However, with just a handful of large, metropolitan markets, these regions and countries do not provide the same scale of investment opportunity as the United States, or the same level of liquidity. Furthermore, some countries have begun to explore and implement measures to restrict foreign ownership of real estate.³⁶

The transparency of the market and strong property rights continue to attract global investors to the United States. In the 2016 AFIRE survey, the United States ranked as the most stable and secure country for investment, outstripping second-place Germany by more than 40 percentage points, and third-place United Kingdom by 50 percentage points (Figure 22). Canada and Australia followed in the fourth and fifth places. Interestingly, although the gap was smaller at just 20 percentage points, even in 2010 as the U.S. real estate market was just beginning to recover, the United States was still considered the most stable and secure country for real estate investment. When asked to look ahead to their near-term expectations, more than 90% of global respondents planned to maintain or increase the size of their U.S. property portfolio.

Figure 22: Country Providing the Most Stable and Secure Real Estate Investments



Source: Association of Foreign Investors in Real Estate

Among countries, the United States is consistently the top destination for real estate investment capital. Moving to the city level, global gateway cities are more evenly represented; however, it should be noted that no other country has as many large cities represented as does the United States. Among top cities for global investors, New York and London, unsurprisingly, have consistently ranked as the two most popular cities in the AFIRE survey in recent years. Los Angeles and San Francisco were also among the primary destinations, with Berlin rounding out the top five in 2015. Although real estate in the major U.S. cities in this grouping is expensive in comparison to secondary U.S. cities, an important element for international investors – including Chinese investors – is the relative value compared to peer cities in other countries. Asset pricing in U.S. gateway cities can often appear relatively inexpensive compared to global gateway cities such as London, Shanghai, Singapore, and Tokyo. Investors can acquire less expensive assets in the United States, all while benefiting from the stability, security, and capital appreciation that makes the United States an attractive market for investment.

COMPARISON TO THE JAPANESE WAVE OF INVESTMENT IN U.S. REAL ESTATE

Japan dominated world financial markets during the late-1980s as dollar-denominated reserves soared and U.S. banks were still rebuilding capital after the savings and loan crisis. Japan accounted for nearly 90% of net long-term capital outflows among G-7 countries and traditional capital exporters by 1987. Japan accounted for more than half of FDI among the same set of countries in 1989, with a Japanese land bubble and easy credit – collateralized by that land – generating large capital outflows. Japanese firms leveraged rapidly appreciating domestic real estate assets to borrow at home and invest in real estate assets abroad, particularly in the United States.

Japanese insurance companies and real estate firms were particularly active during the 1980s, as were development and construction firms. Aggregate investment in U.S. commercial real estate accelerated rapidly and reached a peak annual flow of \$16.5 billion in 1988. Nearly three-quarters of this investment was focused in California, New York, and Hawaii. Japanese investors targeted numerous trophy properties, acquiring Rockefeller Center and Pebble Beach Golf Links, and at the peak period of investment owned nearly half of all Class A office buildings in downtown Los Angeles.

However, a reversal in Japanese capital flows happened almost overnight. The Japanese land bubble burst in 1990, and values ultimately fell by more than 50%. Japanese banks faced significant issues with nonperforming loans, and Japan went from the biggest creditor nation on record to a net importer of long-term capital during the period of just one quarter in 1991. Japanese banks significantly scaled back lending because of large losses and regulatory responses and pulled back almost entirely from foreign markets and focused new lending domestically. As a result, the annual investment flow to U.S. commercial real estate fell from \$13 billion in 1990 to \$5 billion in 1991. Many Japanese investors who already held U.S.

real estate assets were forced to sell, caught between the need for greater liquidity at home and a recession in the United States that drove declines in net income and asset values.

While there are some similarities between the Japanese investment wave and the current Chinese investment wave into U.S. real estate, there are also substantial differences. Like the Japanese, the Chinese have acquired trophy properties, and pricing for some transactions has been high. In a global context, relative asset pricing can appear inexpensive when comparing U.S. real estate with global gateway cities. However, a few key differences point toward a different long-term outcome from the wave of Chinese investment. Even for those highly priced assets, the Chinese motivation is largely for capital preservation and long-term business goals, rather than an expectation of rapid capital appreciation. During the Japanese investment boom, many Japanese investors looked to the comparatively inexpensive real estate in gateway markets and expected to take advantage of a pricing arbitrage from currency exchange rates and as U.S. asset values appreciated. The geographic reach of Chinese investment throughout the United States and the diversity in property types targeted are also greater than in the Japanese experience. The individual purchases of residences and commercial real estate are driven by immigration for many Chinese also. Furthermore, the somewhat unique ability and effort by the Chinese central government to encourage global investment and promote China's economic leadership capability, not to mention the ability of the central government to support Chinese investors during a downturn, point to a longer-term investment cycle.

Knowledge Transfer and Brand Awareness

Just as investors going into China have much to learn about doing business in China, Chinese firms entering the U.S. real estate market seek to build their understanding of the U.S. market and best practices in the United States. This knowledge transfer can be used by firms to implement new business strategies or design elements in China and other parts of the world. But more importantly, firms can help build their expertise, an important factor for a global developer, so that they can operate as standalone players in the United States. Large multinational firms have the ability to enter a range of markets, and many Chinese firms that recently entered the United States have gained some expertise through previous investments in other global markets. For many global firms, not only Chinese, success in the U.S. market may not only provide corporate returns but also increase brand value substantially. To paraphrase the song, if firms can make it here, they can make it anywhere. Of course, some acquisitions of stabilized properties by Chinese firms with no U.S. partners have already occurred. However, with commercial development in particular, most Chinese developers have entered into joint ventures as a capital partner with U.S. developers as a way to gain entry into the market and to use the first few projects to gain a better understanding of how to successfully maneuver a development project through all stages in the United States. Even some large Chinese developers that have been involved with a number of U.S. projects are still surprised by certain regulatory issues and business practices and express the importance of having trusted consultants and advisors in the United States.

Some of the corporate differences – such as the predominance of vertical corporate structures in China versus the utilization of multiple partner firms and contractors/subcontractors in the United States – can complicate investments and development projects. Firms will take time to adapt in ways that work for their corporate culture. Some of the small to mid-size developers that are still working on their first deals are still a few years from being able to tackle U.S. projects on their own, but some of the larger developers are likely closer. Part of the equation is time – some large developers have now been in the United States for three or more years with multiple joint venture projects in their portfolios – but beyond building their knowhow, they also need to build brand awareness and familiarity in the U.S. real estate community. For new residential developers, building consumer awareness and trust is vital to continued success in the United States. The average consumer may rely on homebuilder ratings, agent referrals, and word of mouth to determine quality of new homes, and it will be important for Chinese firms to develop brand recognition to compete with U.S. homebuilders and multifamily developers.

BUSINESS PRACTICES IN THE UNITED STATES

Prepared for Rosen Consulting Group by Alan J. Pomerantz, Esq.

Focusing on making the right economic investment in the United States property market is the first step in undertaking a successful strategy. However, as a result of the complex and invasive nature of the U.S. regulatory and tax systems and the vast cultural differences between doing business in China and doing business in the United States, the failure of a Chinese investor to properly recognize these differences and prepare for dealing with them is fraught with dangers that are not obvious at the initial stage of the investment but likely will be crucial to whether the investment is successful or a disappointment.

The Regulatory and Legal Environment

The United States has thousands of law-making bodies, often with conflicting ideas and priorities. At the federal level, there are three branches of government (executive, legislative, and judicial), 16 federal departments, and 463 federal agencies. Plus there are 50 states and the District of Columbia, and each has an executive, a law-making body, and numerous state agencies. Within each state are cities, counties, and municipalities, each with its own legislative and executive bodies. There are approximately 500,000 elected officials in the United States and many more appointed ones. More than 14.5 million people are employed by various governmental entities in the United States, and many of them have influence over investments in real estate.

Real estate may be the most highly regulated and taxed asset class in the United States, and it is considerably more regulated and taxed than in China. The tax code as it affects real estate is extensive and complex. Failure to structure an acquisition or partnership without considering the tax consequences of the deal can lead to many unpleasant surprises. And foreign investors have an additional set of tax and regulatory complexities not faced by U.S. investors. Tax planning must be done before the investment is made.

The Cultural and Structural Environment

In the United States, parties negotiate to make a deal. In China, they negotiate to build a relationship. In the United States, very little is left to “later discussions” – virtually all points are expected to be decided before the deal is made. In China, negotiations often continue after an agreement is reached. In the United States, going back over points is called “re-trading” and is considered bad form and seen as not dealing in good faith. That is not the Chinese culture.

In the United States, “business is business”; it’s not personal. Not so in China. U.S. businesspeople often want to get to the point and see if a deal can be done. They tend not to socialize with their counter-parties or members of the other “team” while negotiating a deal. Many U.S. businesspeople think spending social time before the deal is made is not productive. They think the time to socialize is after the deal is made, compared with the process employed in China of first building the relationship – developing *guanxi*. It is essential for a Chinese investor to understand the approach that will be expected by a U.S. businessperson. Otherwise, misunderstandings leading to distrust will likely infiltrate the transaction.

In addition, deals made in the United States are expected to be fully documented and usually reflect every major aspect of a transaction. U.S. businesspeople lean heavily on their lawyers to “think of everything” and document the outcome of virtually every possible future situation. That is not the case in China, where trying to address every situation before it happens, or ones that may not happen at all, is a waste of time. U.S. businesspeople’s efforts to fully negotiate and document almost every possible future event is not a sign that they distrust their partner; it is just how it is done. Therefore, documents and agreements in a typical U.S. deal are often extensive and voluminous. There is no such thing as a “standard deal.” The reason behind these efforts is that business dealings and problem solving in the United States are process driven by negotiated documentation – not through relationships, as they are in China. In China, businesspeople trust each other. In the United States, they trust each other but rely on the written agreements and the legal system.

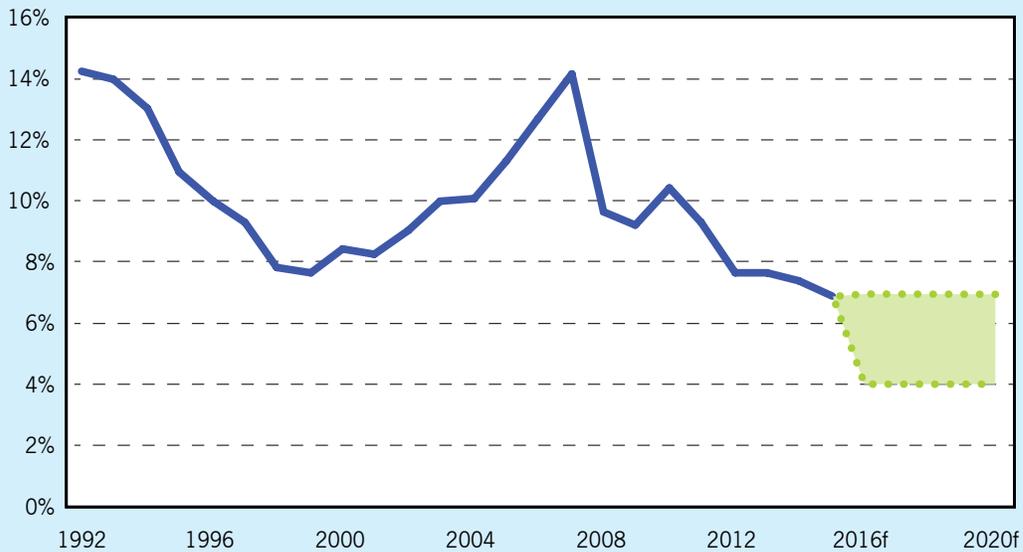
Accordingly, relationships among partners and with lenders are usually more formal than in China and can be considerably more adversarial. The cooperative relationship between a borrower and lender in China does not exist in the United States. In fact, it is prohibited by law. The legally dictated lender/borrower relationship in the United States is expected to be adversarial, and taking an aggressive, adversarial posture with a partner or a lender is generally not harmful to a U.S. business concern. In the United States, lenders and partners will not hesitate to sue each other – something that is rare in China.

The legal, regulatory, and cultural environment in the United States differs markedly from that in China. Becoming a successful investor, finding the right investment, and realizing the full potential of that investment requires a deep understanding of the U.S. regulatory scheme, tax regime, and cultural differences between the two systems.

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Figure 23: China GDP Growth

Annual Rate



Sources: World Bank, Rosen Consulting Group

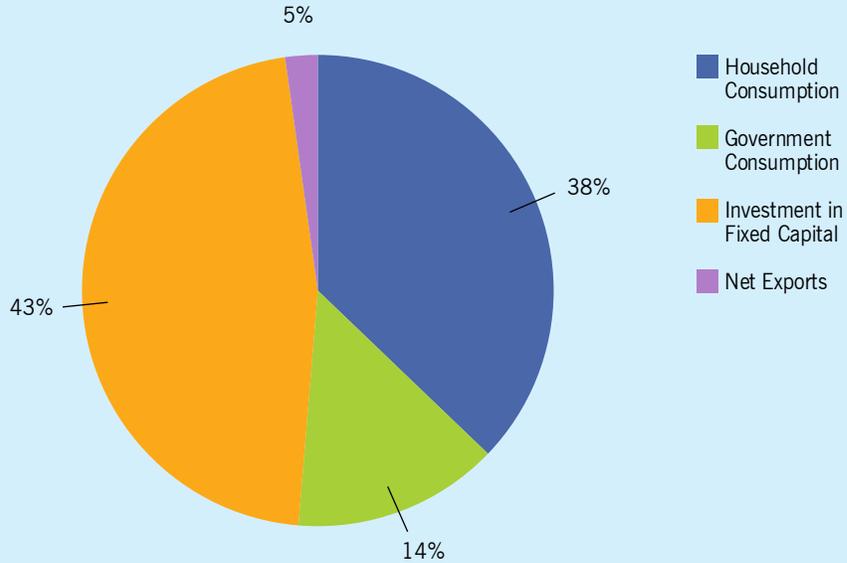
Slowing Chinese Economy, Stock Market, and Real Estate Market

While a range of firm-level motivations for Chinese firms are driving investment into the U.S. real estate market, the slowing of the Chinese economy is providing an additional impetus for firms to look abroad for investment opportunities. Chinese GDP fell to 7.4% in 2014, the first time it was below the target in recent years, and slipped to 6.9% in 2015.³⁷ While GDP growth could stabilize at 6.5% to 7% during the next five years, RCG believes GDP growth could realistically slow to as low as 4% during the next five years as the country implements structural reforms and transitions into a service- and consumer-oriented economy (Figure 23).

A benefit of the “Going Out” policy and the investment diversification it creates is that repatriating returns could provide a stimulus to the domestic economy. Beyond the potential for a devaluation of the yuan, investment returns generated across the globe could be utilized to offset reduced corporate returns in China, should the domestic economy slow. Chinese investment in stable and potentially countercyclical countries, such as the United States, could be strategically utilized to provide an alternative return stream as the Chinese economy transitions.

China is shifting toward a consumption-oriented economy, after years as a production-oriented economy. Much of the economic growth in recent years was driven in large part by the property and infrastructure boom throughout the country, including offices, highways, malls, manufacturing plants, and apartment buildings (Figure 24). However, the bubble conditions were unsustainable; once demand began to pull back, China was left with unneeded

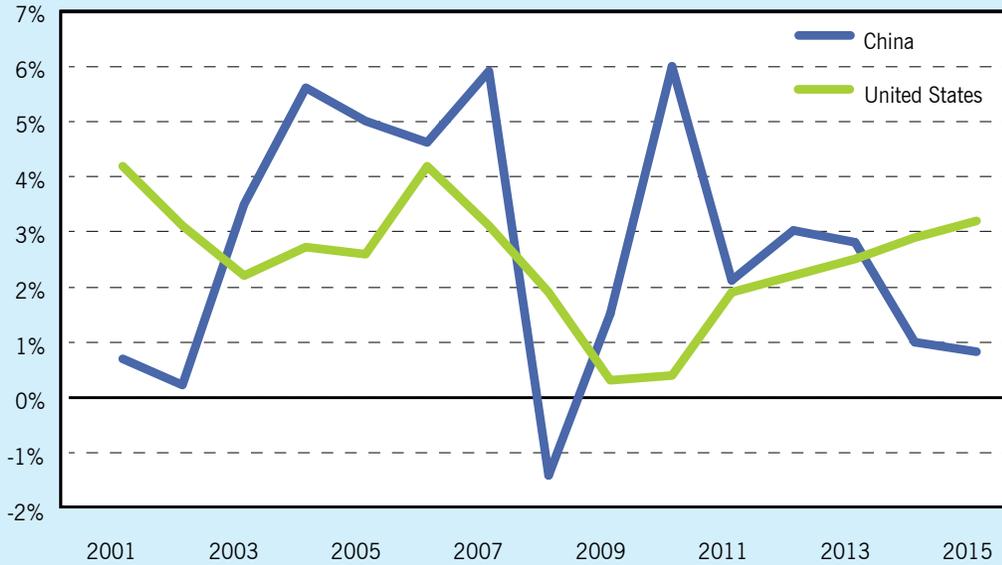
Figure 24: China GDP Composition



Note: Latest data as of 2015
Source: CIA World Fact Book

Figure 25: Annual Housing Costs

YoY % Chg.



Note: Residential component of consumer price indices.
Source: U.S. Bureau of Labor Statistics, China National Bureau of Statistics

infrastructure. Many of the new residential buildings faced extremely high vacancy, particularly in third-tier cities that became known as “ghost cities.” Interestingly, the Chinese tendency to utilize real estate as a place to park capital helped fuel the speculative boom. The degree to which individuals may lose some portion of their assets remains to be seen, and unwinding these projects will be a complex issue with potential implications for global investment trends. The slower growth trends in many secondary and tertiary cities in China constrains new development opportunities, providing motivation for Chinese developers to look to new markets to deploy capital (Figure 25).

For individuals and institutional investors, activity in foreign real estate picked up but also diversified into China’s nascent stock markets. Between 2005 and 2015, the combined market capitalization of the Shanghai and Shenzhen stock exchanges increased from \$401.9 billion to \$7.88 trillion, as the government promoted investment in China-based equities and investors eyed domestic stocks as domestic real estate investment opportunities dried up.³⁸ However, after massive gains in the Chinese stock markets even through the first half of 2015, share prices fell dramatically in August 2015 and again at the start of 2016. The stock market volatility was a shock to both individuals and institutional investors. U.S. investors would have a range of additional domestic investment options outside of stocks and real estate; in China, however, the range of investment options is much more limited, making foreign assets a natural investment target for diversification. Although U.S. real estate is not the only foreign asset class to invest in, it is certainly attractive for the aforementioned benefits of stability, liquidity, and capital appreciation, not to mention the familiarity of real estate as an asset class for Chinese investors.

INDIVIDUAL INVESTORS

Individuals have some of the same goals and motivations to invest in the U.S. real estate market as institutional investors: diversification, capital preservation, and yield. The United States is viewed as a safe haven from global volatility and a means of capital preservation, as some wealthy Chinese want to protect their assets from potential political or economic shifts.

For those individuals looking primarily at the financial component of investment, the evolving landscape of investment opportunities is a boon. Although residential purchases have been a primary vehicle for individuals to invest in to date, the number of ways to gain exposure to the U.S. real estate market, including the commercial real estate market, is growing. The spectrum of price points for investible assets in the United States allows for a range of investment opportunities to a wide number of individuals. Furthermore, high net-worth individuals can invest in private equity funds, and individuals from a broad income background have new opportunities to invest in REITs.

Although the financial motivations are important to individuals, compared with institutional investors, individuals often have a multitude of nonfinancial, more personal motivations. Alongside the expanded range of motivations are similarly more varied vehicles for investment in the U.S. real estate market. Individuals can still follow the well-worn path of purchasing single family homes or condominiums, but they can also invest in U.S. commercial real estate through the EB-5 visa program. The EB-5 program provides a direct benefit of

residency for the investor and the investor's family. Furthermore, Chinese individuals who invest in U.S. real estate through EB-5 often go on to purchase a home for occupancy as well as potentially investing in real estate once they relocate to the United States, amplifying the total investment in the broader U.S. real estate market.

Educational Opportunities

Providing a U.S. education for their children is a significant goal for many Chinese families. Representatives of EB-5 regional centers, as one example, report the common practice of prospective investors bringing their children to initial fundraising pitches, asking questions about educational opportunities for their children in the United States. Part of this motivation is the intense competition for top-tier Chinese universities. Two of the top 100 universities worldwide – Peking University and Tsinghua University – are located in China, with an additional 25 in the top 500.³⁹ Because the population of China is so large relative to the number of elite universities in China, pressure is immense for students and parents.

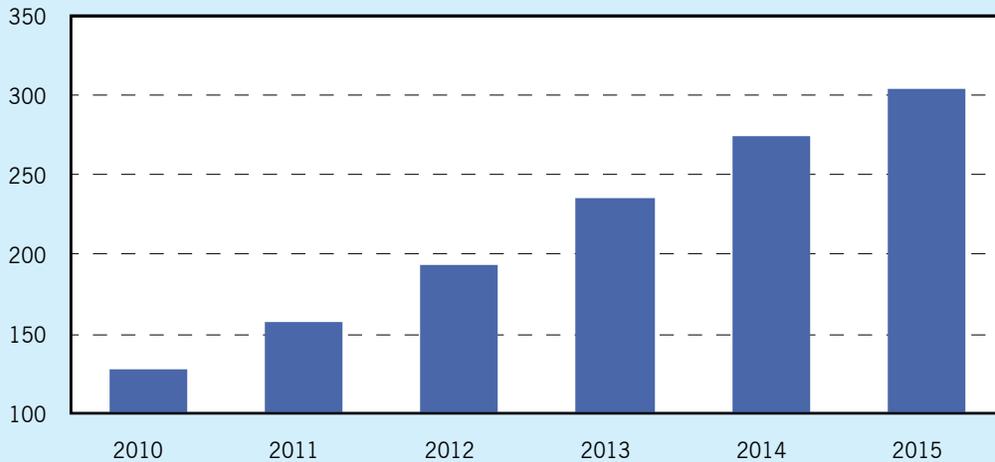
In contrast, 55 of the top 100 universities worldwide are in the United States, with nearly 100 additional universities in the top 500. Adding to the abundance of top universities in the United States, many students and employers – in the United States, China, and globally – are placing increased importance on an international perspective. Many Chinese students desire English-language fluency, and with a growing Chinese middle class, a U.S. education for children is becoming more attainable for parents. The increased ability and sheer number of Chinese families that can afford to pay full tuition coincides with revenue shortfalls at U.S. universities – particularly public institutions – that are seeking to admit more foreign students who are required to pay full tuition.

In 2015, 304,000 Chinese students enrolled in U.S. universities, according to the Institute of International Education, representing one-third of all international students at U.S. universities.⁴⁰ This figure was up from 274,000 in 2014 and 127,000 in 2010 (Figure 26). New York, California, and Massachusetts are the leading destinations for Chinese college students, although an increasing number are attending midwestern universities.

Investing in a residential property near the university that their child attends is attractive to many Chinese families. The child can live there while attending school, or it can be a beachhead for the family in the United States. The property can also provide rental income, though admittedly this tends to be a small share of activity by Chinese buyers, not to mention the property's value as a vehicle for capital preservation. However, many Chinese high net-worth individuals are increasingly concluding that sending their children to the United States only for college does not allow enough time for them to adjust to the new culture and Chinese parents want their children to attend U.S. schools at a younger age.⁴¹ Acquiring residential property at this earlier stage also allows children to establish residency prior to college application, which can help applicants gain entrance to public universities in particular. Others are attracted to the U.S. education system, which despite an increasing reliance on exams, still places emphasis on independent critical thinking and research. Furthermore, a U.S. university education is often considered highly valuable by Chinese employers, affording these graduates an important advantage in securing jobs in China at a time when the number of college graduates in China accelerates and increases

Figure 26: Chinese Students at U.S. Universities

Thousands



Source: Institute of International Education

competition for the best jobs. The higher tuition for nonresidents as well as competition for a limited number of acceptances per academic year will continue to drive some families to establish residency in the United States prior to their children enrolling in college.

Environment and Food Safety

Health-related issues in China are also a motivating factor for individuals to consider emigrating, or sending their children abroad, providing another driver for real estate investment. While the Chinese government continues to take steps to resolve these issues, it may take some time for full implementation to achieve the desired effects. Air pollution is the most visible element of China's environmental issues. Although the Chinese government has taken measures in recent years to combat severe air pollution, only 8 out of 74 major Chinese cities met the national standard of air quality in 2014.⁴² Studies suggest that in China's urban areas, the poor air quality contributes to respiratory, cardiovascular, and other health complications, as well as premature deaths. Water pollution is also a formidable issue in China. Poor water resource management practices have led to water pollution in the vast majority of underground water in Chinese cities, as well as the country's rivers and lakes. Although the lack of potable water is a more avoidable problem for Chinese individuals with sufficient wealth – compared with the air pollution that affects all residents – it is another environmental pressure that makes temporarily relocating or emigrating to the United States and other countries a more attractive option.

As with environmental quality, food safety has become a significant issue throughout parts of China. While there has been some progress in recent years, China is still dealing with food safety issues, which will take time to reform so that individuals have the same confidence in food

supply safety as in other countries. The use of toxic chemicals as preservatives, unconventional pesticides, dangerous food ingredients, and pollution of agricultural land and rivers have caused major health problems and deaths, and they certainly play some role in decision making by individuals regarding residency and investment.

Relative Value

Without compelling financial incentives, though, these advantages on their own might not be enough to motivate Chinese individuals to invest abroad or in the United States in particular. However, as with firms and commercial real estate, pricing of residential real estate in the United States is often more attractive than that for comparable properties in China. Shanghai and Beijing in particular are among the most expensive property markets globally. Even with the softness in Chinese real estate markets, and even after U.S. real estate became more expensive following the 2015 devaluation of the yuan, U.S. residential real estate is still attractive from a price and value standpoint, while also conferring strong property rights.

TAKEAWAYS

- There is a range of core motivations for Chinese investors borne by business goals, macroeconomic conditions, and personal concerns. Some motivations are unique to Chinese investors, but Chinese investors fit squarely within a global investment environment, weighing many of the same factors as other international investors looking at the U.S. real estate market.
- Chinese institutional investors are motivated by a number of factors.
 - With an often long-term investment horizon, risk and return requirements may differ from those of typical U.S. investors. Cash flow matters but can be weighted less heavily than capital gains. Some question the rich pricing and cyclical timing of investment, but globalization and portfolio diversification benefits can outweigh the needs for short-term returns.
 - The U.S. market is large enough to absorb significant capital. Other countries can be attractive but do not provide the same level of liquidity as does the United States. Furthermore, investors can acquire less expensive assets in U.S. cities relative to peer global cities, all while enjoying the market's benefits of stability, security, and capital appreciation.
 - Chinese firms are seeking to build their understanding of the U.S. market and best practices in the United States, often through partnerships with U.S. firms, to eventually operate as standalone players in the United States and to build brand awareness in the U.S. real estate community.
 - The slowing of the Chinese economy and constraints of new development opportunities in China because of oversupply are providing motivation for Chinese developers to look to new markets to deploy capital. The Chinese stock market volatility was also a shock to both individuals and institutional investors; with limited domestic investment options outside of stocks and real estate, foreign assets became natural targets.
- Chinese individuals have some similar motivations, as well as more personal drivers.
 - Individuals seek diversification, capital preservation, and yield. The U.S. real estate market – residential and commercial – is viewed as a safe haven from global volatility and a means of capital preservation.

- Providing a U.S. education for their children is a significant goal for many Chinese families. In 2015, 304,000 Chinese students enrolled in U.S. universities, up from 127,000 in 2010. Air pollution, water pollution, and food safety issues can provide other drivers for real estate investment into the U.S. real estate market.
- Pricing of residential real estate in the United States is often more attractive than comparable properties in China or in peer global cities.

CHAPTER 4: REGULATORY INVESTMENT DRIVERS AND CONDITIONS

IN ADDITION TO THE MULTITUDE OF INVESTMENT MOTIVATIONS FOR FIRMS AND INDIVIDUALS, the complex regulatory framework undergirding both China and the United States has a material effect on levels of Chinese investment in the U.S. real estate market. Of course, the regulatory environments in both countries are quite dynamic. Significant reforms have been introduced in China to encourage more global investment, with other potential reforms that could further boost investment; however, tension will remain between opening up Chinese global investment more broadly and supporting the domestic Chinese economy as it transitions toward a service- and consumption-driven economy. In the United States, a mosaic of regulations at multiple levels of government affects real estate investment. A number of specific regulations are in place for foreign investors – including but not specifically aimed at those from China. More broadly, though, various laws and processes are applicable to all investors and developers in the United States that differ significantly from practices in China and are important for Chinese investors to consider.

This chapter will examine a range of regulatory conditions and reforms in both China and the United States that affect the flow of Chinese capital into the U.S. real estate market. In China, capital controls on outward investment represent a significant regulatory barrier to increased investment for firms and individuals, but a series of enacted and potential reforms for both groups – including new reporting thresholds, increased global real estate allocations for insurers, free-trade zones, and QDII2, among others – provide greater opportunities for investment in U.S. real estate. There are also investment implications from structural reforms, including state-owned enterprise reforms, property rights and property tax issues, anti-corruption efforts, and new policies at the People's Bank of China that are similarly affecting investment decisions.

In the United States, foreign investment in U.S. real estate is regulated most directly at the federal level, through policies such as FIRPTA, and increasingly, CFIUS. Potential reform of the EB-5 program would have a significant regulatory impact on Chinese investment. There are also some restrictions at the state level on foreign ownership, as well as environmental review procedures that are an important consideration for investors. At the local level, regulatory environments – particularly for new development – vary widely across the country, with differences in permitting, zoning, and community review processes.

CHINA

Although there are, and will continue to be, regulatory barriers in China that impact investment decisions by enterprises and individuals, significant reforms in recent years have also allowed for greater autonomy in investment decision making. Many of these reforms and new policies from the Chinese government can be understood broadly through the framework of the Third Plenum goals laid out in 2013. In addition to major reform goals from the Third Plenum such as social welfare reforms and issues, the remaining major goals dealt with market

and financial reforms. The market reform agenda included a goal for markets to play a more decisive role in resource allocation; a transition to market-determined prices for water, energy, transportation, and telecommunications; and allowing private and foreign firms to better compete with state-owned enterprises. On the financial reform agenda, significant goals included interest rate and capital account liberalization, a more flexible exchange rate system, and growth in private banks.⁴³

These broad goals have not resulted in the quick elimination of all regulatory barriers that hamper investment, but incremental policy changes in a number of areas have allowed for more investment abroad. Some proposals have the potential to dramatically increase the capital flow into global investment vehicles, and real estate in particular, going forward. However, as in all countries, Chinese regulatory policies are dynamic, adjusting not only for each new administration but also to current conditions. Chinese regulatory changes can be implemented much more quickly, though, than in some Western countries, and there is always a possibility that the Chinese government will enact policies to significantly curtail outward real estate investment activity. Still, it is important to understand where policy stands currently and how it may change, and to be as informed as possible. Chinese investors are adept at navigating regulatory changes; when given new policies, investors quickly find opportunities within those new policies.

Capital Controls

Capital controls are an extremely important issue. Given the volatility of international financial and currency markets, and the slowing economic growth within China, controls imposed by the Chinese government are one of the chief barriers to increased global investment broadly, and in U.S. real estate specifically, by Chinese firms and individuals. China imposes capital controls to manage its currency while maintaining independent monetary policy, and to insulate its financial sector from international competition. China's capital controls affect both firms and individuals, although the implementation of these controls is different for each group. Significant reforms have been introduced or proposed for both groups in recent years, although the Chinese government will likely proceed cautiously going forward as it tries to balance massive capital outflows that could further weaken the domestic economy, while not alienating citizens and businesses through restrictions.

Institutional Investors

Historically, for most Chinese firms, the main capital control barrier has been the requirement of government approval for foreign direct investment, including foreign real estate acquisition or development. Prior to 2014, foreign investment projects exceeding \$100 million required approval by the National Development and Reform Commission (NDRC) and the Ministry of Commerce (MOFCOM), followed by registration with the State Administration of Foreign Exchange (SAFE), all of which could take at least six months and was a generally onerous process that discouraged investment.⁴⁴ As part of China's efforts to encourage more global investment, however, in 2014 the rules were changed so that only projects exceeding \$1 billion need NDRC approval, and MOFCOM approval is now only needed for projects of any size in sensitive countries or industries.⁴⁵ Projects below this threshold simply require some

variation of registration – not approval – with local authorities. Registration with SAFE remains the final step for all transactions. The process for most transactions can now be completed in a few weeks, compared with the months-long process earlier, creating an environment much more nimble for firms looking to invest abroad.

Although the reforms for approvals and registrations of outward foreign direct investment were a boon for investment in U.S. real estate by firms across industries in China, reform of foreign investment rules specifically for Chinese insurance companies was an even more significant development. Prior to 2012, Chinese insurers – unlike their global counterparts, which are major institutional investors in real estate – had strict caps on allocation toward real estate and could only invest in domestic assets. The China Insurance Regulatory Commission implemented two significant changes to these rules. Insurers can now invest up to 30% of assets in real estate, and 15% of total assets can be invested abroad.⁴⁶ The changes have already spurred significant investment by Chinese insurers in U.S. real estate in 2015, which should continue to accelerate going forward.

A less direct, but potentially important, reform measure in China with implications for outward investment is the introduction of free-trade zones. The first free-trade zone was established in Shanghai in 2013, originally covering an 11-square-mile area, as a way of further opening the Chinese economy to foreign investment. The primary benefit of free-trade zones, in terms of boosting cross-border investment, is the simplified process for foreign exchange conversion. Not only does it provide streamlined entryways into China for foreign firms, but the capital accounts liberalization also provides a streamlined process for Chinese firms operating in the zone to acquire overseas assets, providing additional pathways for increased outward investment by Chinese firms into global real estate and other assets. Although the small size and some tighter restrictions than expected of this first free-trade zone hampered its success, three other free-trade zones in Guangdong, Fujian, and Tianjin opened in 2015. Even if the presence of these zones does not have an immediate impact on cross-border investment flows, the fact that they exist in the first place provides targeted opportunities for the Chinese government to experiment with liberalized cross-border investment policies before introducing them more broadly elsewhere in the country.

Individual Investors

Stringent capital controls are also placed on Chinese individuals. Currently, individuals are only able to move \$50,000 per year out of the country. However, there are a number of ways for individuals to transfer considerably more than that amount. One of the more common methods, sometimes used to finance offshore home purchases as well as EB-5 investment for commercial projects in the United States, is to pool capital through friends and family, though in recent months this practice has been curtailed.

Pooling of funds has been a primary vehicle for house and condo purchases in the United States as well, but for Chinese individuals considering mortgages as opposed to all-cash purchases, there are other legitimate options to avoid the \$50,000 per year cap. Some U.S. branches of Chinese banks and other international banks with a presence in China will often permit renminbi deposits in mainland China to serve as collateral for a U.S. dollar-

denominated mortgage or other loan. However, HSBC announced in early 2016 that it would no longer continue this practice for Chinese buyers in the United States.⁴⁷ It is not known if other banks are considering a similar policy, but SAFE did announce that it would monitor foreign exchange activity at banks to flag individuals trying to circumvent capital controls. Although the capital controls have long been in place as policy, as with many developing countries an initial gap between official policy and implementation can narrow over time.

Programs have also been introduced to provide additional legitimate channels of transferring more than \$50,000 per year out of China for international real estate purchases. In 2011, the Youhuitong pilot program enabled Chinese individuals to convert larger sums of renminbi into foreign currency. The program was limited to a handful of banks in Guangdong province and was shelved in 2014 after the quiet trial program became publicized.⁴⁸ However, in 2015, China's official Securities Times reported that the government was planning to launch a new program that would allow individual Chinese citizens to invest directly in overseas assets, including stocks, bonds, mutual funds, and real estate by the end of 2015.⁴⁹ Called the Qualified Domestic Individual Investor (QDII2) program, this new option offers individuals a legal channel to exchange large amounts of yuan for foreign currency, as QDII2 transactions would not be subject to the \$50,000 limit on capital outflows.

QDII2 BACKGROUND

To be eligible for the Qualified Domestic Individual Investor program (QDII2), individuals will be required to have at least 1 million yuan of net financial assets, excluding self-occupied property, and participants' total overseas investment will be limited to 50% of their net wealth. An overall quota will also be imposed (with the exact quota not yet announced) that will place a ceiling on the total amount of capital that is allowed to be invested through the program. Initially, the program will be limited to the Shanghai Free-Trade Zone. It will then be rolled out to the rest of Shanghai and five other pilot cities: Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou. The initial goal of launching the program by year-end 2015 was delayed because of the equity and currency volatility during the second half of 2015. The new program was one in a string of policies put forward in late 2014 and early 2015 to further open China's capital account, largely to meet IMF requirements that any official reserve currency be freely usable as the country sought official reserve currency status for the yuan.

QDII2 is an extension of a 2007 program called the Qualified Domestic Institutional Investor program, or QDII. QDII allowed a set of Chinese commercial banks and asset managers that had been approved by the China Securities Regulatory Commission to invest in foreign bonds and stocks and sell shares of these financial products to domestic institutions and individual investors. The program also placed heavy restrictions on the share of value represented by stocks in QDII financial products. Largely because of these limitations, QDII has not been particularly popular with Chinese investors.

Although QDII2 would allow for investment in equities, RCG anticipates that a significant share of the QDII2 investment would flow to foreign real estate – including residential and commercial real estate through pooled funds – as investors seek to diversify their portfolios and the preference among many Chinese investors for hard assets such as real estate. With the opening of a sanctioned foreign real estate investment option for China’s growing upper-middle class – not only ultra-high net-worth individuals – there is a potential for hundreds of billions of dollars in new investment in global real estate, with the United States a preferred destination. However, the Chinese government will tightly manage the actual flow through a quota determination, the time line of the rollout of the first pilot program in Shanghai, and the rollout of the program to the five additional pilot cities (Figure 27). The recent volatility of domestic Chinese markets and of the yuan in early 2016 should only serve to increase the caution around the timing and scale of QDII2 implementation. There has been little indication since October 2015 of a timeline.

Figure 27: China Free-Trade Zones and QDII2 Planned Pilot Areas



The expansion of legal methods for individuals to transfer capital out of China is a sign of efforts to implement some economic reforms from the Third Plenum and in the successful quest for reserve currency status of the yuan, but it is also a tacit acknowledgment of the vast sums of capital that are already leaving China through underground channels. One such method is the use of money changers in Hong Kong, with clients making a domestic transfer inside China and the Hong Kong money changer then transferring the equivalent in foreign

exchange into the client's Hong Kong account, less fees. Underground “banks” in China will also provide U.S. dollar checks in exchange for yuan. While traveling overseas, some individuals will buy an expensive item with a credit card and then immediately return the item, for a small fee – although rule changes in late 2015 placed an annual cap on overseas credit card usage, indicative of the broader efforts to enforce existing capital controls. Another common method is over-invoicing, through which a Chinese business owner can agree to a markup for an item sold outside of China, with the vendor refunding the difference into an offshore account. Chinese central bank officials estimate that approximately \$125 billion per year is funneled through underground “banks.”⁵⁰

Structural Reforms

Although the presence of capital controls and the various efforts to strategically allow certain investments abroad are important pieces of the Chinese regulatory environment, a number of structural reforms could also have an effect on Chinese investment in U.S. real estate.

State-Owned Enterprises

Although China has more than 150,000 state-owned enterprises – most controlled by local governments, with approximately 100 large, strategic companies controlled by the central government – the bulk of global real estate investment activity has been carried out by privately owned enterprises. This stands in contrast to the historical precedent set by China's initial forays into outward foreign direct investment, when state-owned enterprises were the central sources of foreign investment targeting resource extraction in developing countries. If state-owned enterprises became more active in the U.S. real estate market, the sheer scale of these enterprises would provide an even greater boost to aggregate Chinese investment in U.S. real estate.

However, the path toward more diverse investment strategies for state-owned enterprises – including targeting foreign real estate – is not likely to come via state directive, as China is trying to minimize dependence on state-owned enterprises. Instead, increased targeting of assets such as foreign real estate would likely come as some of these enterprises transition toward more of a public-private hybrid. The state-owned sector as a whole is massive – with \$16 trillion in assets as of year-end 2014 – but has been weak in recent years.⁵¹ State-owned enterprises experienced a 2.3% decline in profits during the first half of 2015, and it is estimated that their return on assets is only half that of China's privately owned enterprises.⁵²

Poor performance has led to calls for reform; while the Chinese government will likely not privatize these firms outright, there are indications that outside investors and management talent could be introduced to provide better strategic direction and oversight. As part of the intended reform measures, some state-owned enterprises could shift away from operations such as mining and resource extraction toward investment management. This type of reform could reduce some of the overcapacity issues in some industries while providing returns that could help support the social safety nets for workers. With a greater focus on efficiency, portfolio diversification, and more stringent requirements for investment returns, U.S. real estate could prove more attractive for some state-owned enterprises, as it has for their private sector peers.

Property Rights, Taxes, and Restrictions

For individuals, regulatory issues regarding private residential property holdings provide some incentive to consider buying homes outside of China. The first significant issue is property rights. When individuals purchase a home in China, they own the structure itself but not the land underneath the home. Instead, they obtain land-use rights for a period, typically 70 years, which are transferrable with the structure if the individual wants to sell at a later date. Furthermore, while eminent domain occurs in the United States and other developed countries, the practice is more widespread, with less recourse, in China. All things equal, stronger property rights make a residential investment more attractive, whereby individuals fully own the land and improvements and have greater legal protection over those assets.

Still, with such a rapidly growing middle class, there has been a significant level of demand for homes in China – for both primary use and investment – despite the more limited property rights. This elevated demand, however, came with significant levels of speculative investment and rapid home price appreciation during the past decade. Recognizing that the domestic real estate market was becoming overheated, China introduced restrictions on home buying activity. The central government banned purchases of a third home, while individuals looking to buy a second home faced high down payment requirements and, depending on the city, sometimes even a ban on purchasing a second home. As a result, even Chinese individuals who wanted to focus their investment in the domestic real estate market suddenly had that option eliminated, or at such a high cost that it provided a major incentive to invest abroad instead. As another tool to slow speculative investment, the government implemented pilot programs to introduce property taxes in Shanghai and Chongqing. Before this, home buyers did not face any property tax, which encouraged speculation because of the absence of holding costs. The pilot programs have been generally ineffective, amid loose enforcement by local authorities, but the central government nonetheless is considering a broader property tax law that could be implemented in coming years.

The previously mentioned policies played a role in putting the brakes on unrestrained growth in China's property markets, but they came at a time when construction was still proceeding under prior demand expectations. Now with major oversupply, particularly in second- and third-tier cities, the government is easing down payment requirements for second homes to help stimulate investment. However, with expectations that home prices will continue to decline, many individuals may still see international real estate investment as a more attractive option. Furthermore, introduction of a broader property tax would eliminate one of the attractive elements of a residential investment in China compared with the United States – the absence of holding costs – and could encourage further foreign investment, particularly when considered in tandem with the stronger property rights and stability that the U.S. market provides.

Anti-Corruption

Although a multitude of Chinese regulations and reforms affect investment decision making, perhaps the most widespread reform has been the anti-corruption crackdown by the government of President Xi Jinping. The efforts have targeted government officials at all levels, leaders of state-owned and private enterprises, and high net-worth individuals. While the effort targets corruption in the traditional sense of bribery and other improprieties by officials, it also

includes a focus on uncovering ill-gotten income, improper accounting and reporting of assets, and evasion of capital controls.

Anti-corruption reform underway in China has two competing consequences for U.S. real estate. On the one hand, there is now elevated risk in transferring capital out of China for investment. Even the use of methods of capital movement that are not strictly illegal, and perhaps ignored by the government in past years, is now presenting greater risk for individuals looking to move capital for investments abroad. Even for individuals who have already completed real estate transactions in the United States, there is concern that authorities will investigate how they obtained funds and transferred capital. The fear of public shaming or arrest could serve to dissuade individuals from future investment, or lead to liquidation of foreign assets to avoid investigations.

On the other hand, with the uncertainty caused by implementations of reforms and the potential use of anti-corruption campaigns as a political tool, the reform efforts may serve to accelerate capital outflows and real estate investment into the United States and other countries. Individuals with wealth in China may worry about the perception of the validity of their gains and seek to reduce their domestic holdings, both to lower any perception of impropriety and to gain an element of capital preservation and security, which U.S. real estate can provide.

INTRODUCTION OF NEW INVESTMENT VEHICLES

Currently, a significant portion of Chinese investment into U.S. real estate is through direct means, either by individuals purchasing homes, investing in a specific project through EB-5, or direct acquisition or development of commercial real estate. This is partly attributable to the preference among most Chinese investors for direct control over real estate assets but also because there have been limited real estate investment vehicles for Chinese investors, for either domestic or global real estate. There has been some Chinese investment in U.S. real estate through private equity funds, but a popular investment structure – the real estate investment trust – has not had an equivalent structure in China to date. As investments in REITs in China become more common, some individual investors may allocate capital to investment opportunities in U.S. REIT shares.

However, that is beginning to change. The first Chinese REIT went public in June 2015 on the Shenzhen exchange. Unlike U.S. REITs, though, in which the portfolio consists of a number of real estate assets conforming to a specific investment strategy, the investment allocation for the first Chinese REIT is slightly different, with half of the funds invested in one office property, and the other half in equities. Also, there is not an efficient tax structure in the Chinese REIT unlike U.S. REITs, with tax on rental income, capital appreciation, and the transfer of properties. Furthermore, ownership of the underlying assets is not held by the trustee as in U.S. REITs.

The major implication of recent introduction of REITs in China, as it relates to U.S. real estate investment, is the potential for some allocation of future Chinese REITs to be

directed at foreign assets. For now, all holdings are limited to Chinese properties only, with regulators still determining whether investors will be able to invest in properties outside of mainland China. However, the allocation of a small percentage of Chinese REIT capital to foreign assets could represent a significant boon to Chinese investment in the U.S. real estate market. This would allow the growing Chinese middle class to invest into the U.S. real estate market without any of the hurdles of direct acquisition, particularly with the rising risks of capital movements from the anti-corruption campaign. Growing exposure to REIT vehicles in China will also get investors more comfortable with buying U.S. REIT shares, providing another avenue for investment.

People's Bank of China

For some time, the People's Bank of China (PBOC) has been taking a number of steps to make the yuan more responsive to market forces, largely in a bid to garner reserve currency status for the yuan from the IMF. The most visible of these recent actions was the yuan devaluation in August 2015, after having cut interest rates multiple times in the prior year (Figure 28). These actions and expectations of further devaluation are resulting in high net capital outflows as Chinese investors seek international investments, of which U.S. real estate is an attractive one, and pare down dollar-denominated debt. If and when devaluation occurs, investors with non-yuan-denominated investments abroad will essentially hold assets that would appreciate in value overnight. Chinese investors still have the same personal motivations for U.S. real estate that they have had in recent years, but now their motivation is also to hedge against future currency devaluation. With devaluation, Chinese individuals and firms are at risk of having the value of their assets located in China decline instantly.

The central bank has lowered reserve ratio requirements to try to offset slower economic growth and capital outflows. Still, the currency issue will remain critical for the rest of this decade. As other countries devalue their currency to stay competitive globally, China will face increasing pressure to do the same. Thus far, some of China's neighbors and trading partners have devalued currencies to spur their domestic industries, while China has yet to fully engage in the competitive devaluations. Capital outflows would accelerate as a result and encourage stronger capital controls, but draconian restrictions on capital flows would force Chinese individuals and firms to watch as their wealth and assets steadily decline in value.

Although the currency issue is driving increased foreign investment, the recent elimination of a bank deposit ceiling by the PBOC, two years after it abolished a floor on lending rates, could negatively affect investment activity in U.S. real estate over the long term. The move could raise borrowing costs for Chinese companies, which in the context of real estate have long had the benefit of inexpensive capital at home when acquiring or developing properties in the United States. This reform was a key obstacle to making the yuan a global reserve currency but could have implications for investment activity in the U.S. real estate market.

Figure 28: China/U.S. Exchange Rate

Source: Board of Governors of the Federal Reserve System

UNITED STATES

While a number of policies in China affect the scale and ease of outward investment into the U.S. real estate market, that investment is also affected by a range of U.S. regulations and practices that cut across all levels of government, with federal, state, and local policies that can shape the form or magnitude or location of a real estate investment by Chinese entities.

Federal

Real estate investment requires significant understanding of local and regional conditions, but federal government policies have a major impact on the investment environment. Some of these regulations, such as the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), are already having a marked effect on foreign activity in the U.S. real estate market, while the potential for increased real estate review under the Committee on Foreign Investment in the United States (CFIUS) and for reform of the EB-5 program could affect Chinese investment going forward.

Foreign Investment in Real Property Tax Act

FIRPTA was enacted in response to a surge in foreign investment in real estate assets, especially agricultural land. FIRPTA established an additional tax for foreign investors as Congress sought to level the playing field for domestic and foreign investors. A foreign investor is subject to FIRPTA taxation, and a complex withholding and reporting environment, when

the ownership interest in the asset is equal to or greater than 50% of the fair market value.⁵³ While Congress amended the program in December 2015 – exempting foreign pension funds and retirement funds from certain components of the act – the tax affects investment decisions by all foreign investors. FIRPTA is largely responsible for the typical structuring of real estate investments by foreign investors, in which the foreign investor partners with a U.S. firm and keeps its investment commitment below the 50% threshold to avoid triggering FIRPTA. In this respect, Chinese investors are again behaving similarly to other foreign investors.

While the United States is a desirable market for foreign real estate investors, FIRPTA constrains the number of investors and the amount of capital for investment. The withholding requirements constrain capital and require additional expenses to manage complex transactions. FIRPTA requires sellers to have U.S. tax identification numbers and requires the utilization of transfer agents, accountants, and lawyers, which adds to the cost of ownership and investment. Current market conditions in the United States and globally continue to funnel investment into the United States; however, the recent Great Recession highlights how quickly capital flows can diminish. Greater capital availability will improve liquidity for real estate, a key factor in stabilizing market cycles.

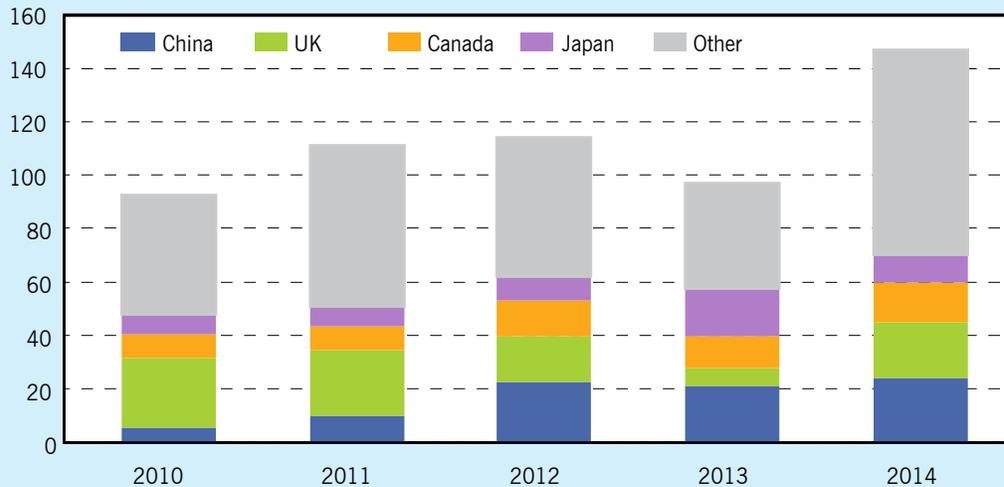
Committee on Foreign Investment in the United States

CFIUS is an interagency government committee tasked with reviewing transactions that result in the control of a U.S. business or asset by a foreign entity.⁵⁴ CFIUS review is triggered if the transaction would raise national security concerns or have an impact on critical infrastructure. Most real estate transactions do not raise national security concerns, but some Chinese real estate transactions are beginning to attract CFIUS review. The sale of the Waldorf Astoria by Hilton to Anbang Insurance triggered a CFIUS review in 2014, largely because it also entailed a full renovation that raised potential espionage concerns as the hotel served as the host for presidential visits and housed the residence for the U.S. ambassador to the United Nations. Although the transaction was approved by CFIUS, the White House later decided to abandon the hotel for presidential visits going forward because of those fears. More recently, CFIUS was also brought in to review the potential sale of the Starwood hotel chain to one of three Chinese state-owned enterprises.

Although no known real estate acquisitions have been rejected by CFIUS to date, the Waldorf review signals an evolving standard of projects requiring review. Examples of CFIUS rejection in other industries, such as the Ralls Corporation's rejected bid to acquire U.S. wind farms or even examples of withdrawn bids in the face of U.S. opposition, such as Huawei's withdrawn bid to acquire assets and technology from a U.S. firm, can make Chinese firms across industries wary of U.S. investment. In fiscal year 2014, the most recently available data, transactions involving Chinese companies represented roughly 16% of all transactions submitted to CFIUS – the most of any country – followed by the United Kingdom at 14% (Figure 29).⁵⁵ Chinese officials are keenly aware of the rise in CFIUS reviews for Chinese transactions and are wary of a potential rise in review of Chinese real estate transactions going forward, even though such transactions currently do not, and generally should not, receive significant attention. Reviews should remain tied to specific security concerns.

Figure 29: CFIUS Review by Country

Covered Transactions



Source: U.S. Department of the Treasury

FIRPTA AND CFIUS BACKGROUND

Prior to FIRPTA, a foreign investor, under certain conditions, could buy and sell real estate assets and generally not be taxed on the gain at time of sale in the United States. If a U.S. citizen purchased the same asset and sold it, he or she would be required to pay income tax on the capital gain. FIRPTA created an onerous regulatory structure and tax on foreign investors on sale or disposition of a real property interest, for those with majority interests in real estate assets. FIRPTA withholding rules require the entire amount at time of disposition, even if the asset is disposed of via an installment sale.⁵⁶ The disposition of a real property interest is subject to an income tax withholding. The FIRPTA withholding tax is 10% of the amount realized, generally the fair market value or the amount paid for the asset, on the disposition. FIRPTA withholding is also structured such that it applies even with a capital loss.

The definition of real property under FIRPTA is broad. It is defined as (1) undeveloped land and natural products of the land; (2) improvements, including buildings or permanent structures and items related to the operation or maintenance of a building; and (3) personal property associated with the use of real property, including movable walls, furnishings, and mining and farming equipment. For example, the sale of lighting fixtures or doors would qualify as structural components and could trigger FIRPTA withholding. Lodging assets or

co-working facilities, furniture, and fixtures, such as desks, beds, and refrigerators, could also trigger FIRPTA withholding. However, real estate mortgages and other real estate debt instruments are not subject to FIRPTA regulations. Furthermore, beginning in 2005, ownership and disposition of a domestically controlled real estate investment trust (REIT) would not trigger FIRPTA requirements, provided the foreign shareholder did not own more than 5% of outstanding stock at any time during the REIT's tax year. In the December 2015 amendment, Congress updated this provision so that foreign shareholders could own up to 10% without being subject to the FIRPTA tax regime.

CFIUS was created in 1975, but its scope of review was strengthened significantly in the late 1980s after the wave of Japanese foreign direct investment into the United States and strengthened further in 2007 to broaden the number of economic sectors that the committee is tasked with protecting. U.S. companies entering into mergers and acquisitions with a foreign firm or U.S. parties selling a real estate asset are responsible for notifying CFIUS of the transaction if there is a potential national security issue. Parties can even be required to file notification retroactively. CFIUS can approve the transaction, block the transaction, or require certain measures to ensure that the foreign entity does not have control over elements of the business that raise national security concerns.⁵⁷

EB-5 Reform

The tenuous status of the EB-5 program will lead to some uncertainty and likely a surge in commitments in 2016. With the EB-5 program set to expire in September 2015, congressional representatives spent months proposing reforms to the program. Some proposals sought to eliminate urban real estate development projects completely from the program, funneling investment toward rural areas, while some wanted to get rid of the program altogether, saying that it allows immigrants to purchase visas and is unfair to immigrants pursuing other pathways into the country. Under the proposal that most expected to become law, the minimum investment for a Targeted Employment Area (TEA) would have been raised from \$500,000 to \$800,000 along with more stringency for TEA designations, but otherwise many current elements would have been preserved. Ultimately, though, in December 2015 Congress simply extended the existing EB-5 program, with no modifications, through September 2016.⁵⁸

While the elimination of the program in 2016 is possible and would cut off an avenue of Chinese investment, a modest reform – such as the proposal to increase the minimum investment from \$500,000 to \$800,000 – would likely not dampen Chinese investor demand, as many individuals would still be willing to invest at the new threshold. Furthermore, the program would raise more capital in aggregate, supporting additional projects and additional U.S. jobs. Overall, and despite its shortcomings, the EB-5 program has proven to be a successful program to encourage investment by foreigners seeking to relocate to the United States.

GLOBAL IMMIGRANT INVESTOR PROGRAMS

Even with modest reforms, the EB-5 program would remain attractive compared with immigrant investor programs in other countries and, in addition to the other benefits of investing in the United States, makes the U.S. real estate market attractive for foreign investors. In 2014, Canada canceled its immigrant investor program, which in exchange for residency required an investment of C\$800,000 that the federal government would disburse to provinces and territories; the loan to the Canadian government would be interest free, but not at risk, with the full C\$800,000 returned after five years. A modified pilot program was introduced in Canada in 2015 that requires an at-risk investment of C\$2 million in a venture capital fund for 15 years and cannot be invested in real estate. In the United Kingdom, the minimum investment doubled in 2014 to £2m and similarly now excludes real estate. The Australian government also recently modified its immigrant investor program, requiring foreigners to invest A\$2 million, at risk, in qualifying private equity and venture capital funds while capping real estate investment.

Extended Visa Validity

In late 2014, the United States and China agreed to a reciprocal extension of visa lengths for citizens of both countries. As a result, U.S. nonimmigrant visas issued to Chinese citizens are now valid for ten years for business and personal travel, and five years for students. Prior to the agreement, U.S. nonimmigrant visas were valid for just one year across all traveler types. Under the old policy, visitors from China already comprised the largest share of all foreign travelers to the United States – 18% in 2014, representing 1.8 million visitors – and the considerable burden lifted by the new policy should only push that figure higher.⁵⁹

The updated policy is significant for multiple streams of Chinese investment in the U.S. real estate market. The less burdensome administrative process will encourage more return trips from China to the United States, a motivating factor for some Chinese investors acquiring U.S. hotel assets, as they can market those hotels to a growing number of repeat Chinese travelers. This expectation of being able to tap into surging numbers of Chinese business and leisure travelers is a significant reason why some Chinese investors are willing to accept such high pricing for some hotel portfolios. The policy also makes vacation homes more attractive for Chinese individuals, as they would no longer need to renew their visas annually to vacation in the United States. Furthermore, Chinese investors who buy properties or invest in funds in the United States now have an easier way to see the assets in person, often an important consideration for those willing to invest in equity funds or separate accounts.

State

In addition to regulations at the federal level, many states have additional policies that can affect real estate investment decisions by foreign entities. These state regulations come primarily in the form of ownership restrictions and environmental review processes that add to the costs and complexity of transactions and development.

Ownership Restrictions

While the United States has one of the most open real estate ownership markets in the world, states do exercise some authority over ownership and taxation. Aside from agricultural, mining, and public land restrictions, additional state regulations include residency or citizenship eligibility requirements, with some states making a distinction by providing expanded ownership rights for resident aliens as compared with nonresident aliens. States with varying degrees of restrictions specifically on nonresident ownership include Kansas, Kentucky, Mississippi, New Mexico, Oklahoma, and Wyoming. Similarly, certain states including Nebraska, North Carolina, Virginia, and Wyoming require that reciprocal property ownership rights be provided to U.S. citizens in the alien's native country.

Hawaii has imposed some of the most stringent restrictions on foreign ownership for residential lots. On the island of Oahu, where the vast majority of real estate activity is centered, the purchase or lease of residential lots is limited to U.S. citizens or aliens residing in Hawaii for at least five years, with the additional residency requirement for the purchase of a house lot in a development tract, where purchases are limited to residents of Hawaii who are required to reside on the lot.⁶⁰

Lastly, some states allow individual homeowners associations, condominium associations, cooperatives, or other forms of community associations to impose rules about who can purchase properties, though generally fair housing rules disallow any restrictions based on ethnicity. While this situation would differ on a property-by-property basis, the situation primarily affects residential properties and typically the goal for associations is to prevent absentee owners.

ADDITIONAL STATE REGULATIONS AND VOLUNTARY CERTIFICATIONS

Real estate transactions in the United States are regulated at the state level by the real estate regulatory agency for each state. While many U.S. states provide foreign buyers with the full complement of rights accorded to U.S. citizens to purchase, hold, inherit, and dispose of real property, more than half of the states have some restrictions on the ownership of land by foreigners. In particular, the most common regulations govern ownership of agricultural land, particularly in large quantities. Even within this category, however, the restrictions vary widely by state, with certain states simply requiring a disclosure or registration of a new transaction, whereas other states have fixed limits on the maximum acreage that foreign buyers can hold for either all types of land or, more commonly, agricultural land. A number of states also have varying degrees of limitations or reporting requirements specifically focused on mining and mineral extraction, including Alaska, Montana, Nevada, New York, Ohio, and Oregon, while California, Idaho, and Louisiana are among several states with restrictions on foreign leasing of public lands.

In addition to laws and regulations, a number of voluntary certifications are available throughout the United States. LEED (Leadership in Energy and Environmental Design) is a certification administered by the U.S. Green Building Council (USGBC) that a building

was designed to specific green building standards, with points awarded for sustainable site selection, water efficiency, energy efficiency, materials and resources, and indoor environment quality. Certification is available for commercial and residential buildings. New commercial development in the United States is increasingly being built to achieve LEED certification, as users are increasingly demanding such design quality. The USGBC estimated that nearly half of all commercial buildings in 2015 were constructed to LEED standards.

Energy Star is a government-backed designation for energy efficiency. It was originally introduced for appliances but is increasingly being used as a designation for entire homes and buildings. Energy Star homes can provide savings in energy costs by 30% compared with a standard home because of minimal leaks and drafts, more efficient heating and cooling systems, improved indoor air quality, and protection of materials from moisture damage.

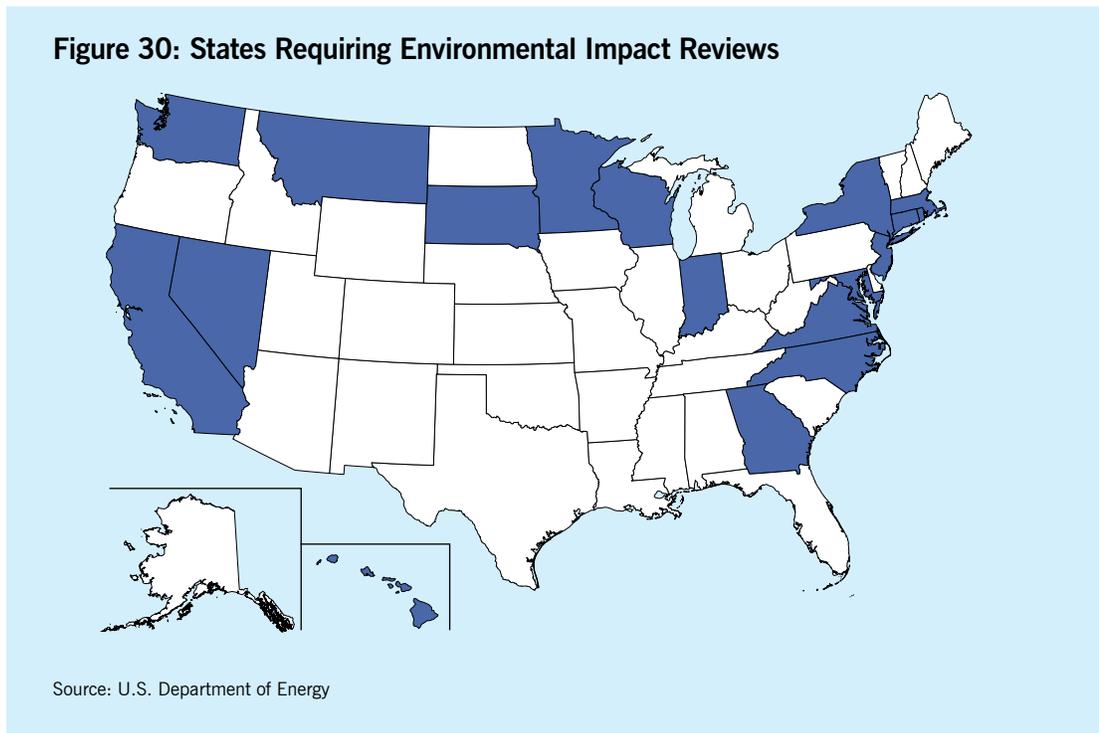
Environmental Review

In addition to previously mentioned barriers, environmental protection laws are often used to restrict development by government entities and community groups. The National Environmental Protection Act (NEPA) established an environmental review process for development at the federal level, but 17 states – including states as diverse as Georgia, Massachusetts, Washington, and Wisconsin – have enacted similar laws at the state level (Figure 30).⁶¹ Although these analyses are explicitly to mitigate environmental impacts, they are often used in practice to challenge new development. Individuals and groups can challenge an environmental impact statement in court on the basis of insufficient consideration of alternative options, often with the goal of simply delaying construction and adding enough legal costs to stop a project.

Other environmental groups and government agencies can add complexity to development as well. The California Coastal Commission, for example, plans and regulates land use along the state's shorelines, while some developers would need to coordinate with the Army Corps of Engineers if projects intersect with significant infrastructure or navigable waterways. More than 20 states, including California, Illinois, New York, and Texas, have additional building energy efficiency standards that can apply to residential and commercial properties, imposing higher costs on builders.⁶²

Local

Local regulation specifically around foreign investment is scant; regulation regarding foreign ownership is strongest at the federal level (through FIRPTA and strategic review) and in some circumstances at the state level. Property tax rates differ across localities, but that alone is unlikely to have a material effect on investment decisions. However, while there is little to impede foreign acquisition of existing assets, local conditions can have a significant effect on new development for domestic developers and foreign developers alike. Also, for

Figure 30: States Requiring Environmental Impact Reviews

individuals purchasing homes, understanding local regulations on remodeling or landscaping is key. Having a grasp on local regulatory barriers and community review processes, which can vary widely from city to city, is essential for successful real estate development in the United States.

Regulatory Barriers for Development

A number of regulations imposed at the local level are widely utilized in the United States, including exactions and impact fees that impose conditions on development, such as paying for infrastructure to handle the new resident or workplace population; paying for community benefits; or setting aside a percentage of residential units as affordable housing, often with specific resident income requirements. Impact fees can vary from state to state, although areas in the western United States tend to impose higher fees than other parts of the country.⁶³

Regulatory barriers to new development vary between cities, with significant differences in zoning codes, permit requirements, design requirements, and more. Sometimes a city requires design review on all projects and on others just past a certain square footage and/or height. Project elements open to review can include the scale of the proposed building, façade design, open space provisions, streetscape improvements, and circulation patterns for vehicles and pedestrians. Projects can also encounter problems because of complex topography, irregular lot configuration, unusual context, or other elements not addressed in a city's design standards.

Such regulatory barriers can amplify natural supply constraints, with development constrained by geographical barriers or limited available land. Although these differences do

not necessarily create obstacles specific to foreign developers or foreign capital partners, they do increase the level of complexity and can add costs and difficulties that foreign entities may not want to deal with. U.S. cities fall in a wide spectrum with regard to development barriers, although even cities with fewer apparent barriers may have obstacles that are not initially visible to foreign entities.

Along the spectrum of U.S. cities, places such as New York, Boston, and San Francisco have significant zoning restrictions, while other cities such as Houston lack explicit zoning but use other tools to guide development. In addition to these dynamics, nonlocal developers can face challenges, particularly outside the major U.S. gateway markets, where there can be implicit preferences for local development teams, especially for public-private ventures. Each market presents its own unique challenges for development, highlighting the advantage that foreign investors can create by utilizing firms with local experience to support the design, implementation, legal, and transaction processes.

LOCAL ZONING AND PERMITTING EXAMPLES

The cities of San Francisco and Houston provide two illustrative examples of the range of local development conditions in the United States. San Francisco falls on one end of the spectrum of U.S. markets as a notoriously difficult place to build, with a detailed zoning code, lengthy permitting process, and vocal public opponents. Legal mechanisms also restrict development, including Proposition M, which limits the square footage of high-rise office space that can be approved, as well as the ability of local opponents to fight development through the ballot box via referendum. In prior cycles when the Proposition M cap was reached, developers were forced to compete with one another for the limited number of approvals, judged on architectural design, access to transit, and other criteria to select which projects could go forward. Despite the prestige factor of a city such as San Francisco, and its gateway market status, the difficulty of building there can discourage some developers and make other U.S. markets more attractive.

Houston is a market that, on its face, seems to fall on the other end of the spectrum of development barriers. The common perception is that Houston has no zoning requirements, providing a contrast to the high regulatory barriers in markets such as San Francisco and proving attractive to prospective developers. Houston is a sprawling city lacking the natural barriers to development found in places like San Francisco. Although Houston has no explicit zoning, or even a general plan for the city, a number of tools are still used to guide development. Deed restrictions are a prevalent tool in Houston, along with design standards such as minimum lot sizes, setback requirements, and parking requirements. Developers have to apply for variances to get around some of these restrictions, adding layers of bureaucracy even in a city that has some of the fewest restrictions in the United States.

Community Review

Community review can be another significant barrier for real estate development and transactions. Most cities require a review period wherein the local community can comment on a project; some cities require all projects above a certain size, height, and/or type to have a public meeting to which the community is invited to comment on the project and a project sponsor discusses it. The planning commission of a local jurisdiction as well as the city council often hold these meetings. In the public hearing stage, neighbors can provide their concerns or voice support about a project to the planning commission. After a public hearing, the planning commission may approve or disapprove the project subject to conditions. Additional requirements, modifications, and limitations may be imposed on a proposed project. Some cities allow people to appeal the decision of a planning commission after a public hearing for additional review by another board or decision-making body.

Local residents often seek to block projects for a multitude of reasons, including changing the character of the neighborhood, view obstruction, shadows cast on streets below, affordability, or environmental concerns. This “not-in-my-backyard” (NIMBY) sentiment can significantly delay projects and add costs, including potential legal costs. In many cities, these regulatory barriers and the propensity for public NIMBY opposition converge with significant supply constraints due to natural geography and little opportunity for greenfield development. The opposition to projects can, at times, be substantial. Holding meetings with community stakeholders, soliciting input prior to application and public hearings, and working with community groups or nonprofits that could benefit from new development activity can substantially improve the success and acceptance of new development projects.

TAKEAWAYS

- The regulatory frameworks in both countries impact Chinese capital flows into the U.S. real estate market.
- In China, reforms have been introduced to encourage more global investment, although tension will remain between “Going Out” and supporting the domestic Chinese economy.
 - Capital controls imposed by the Chinese government are one of the chief barriers to increased global investment broadly – and U.S. real estate specifically – but some new policies have been enacted or are being considered. For Chinese firms, the process of investing in foreign assets was streamlined considerably in 2014.
 - For individuals, capital controls limit outbound capital flow to \$50,000 per year, per person. These controls inhibit investment abroad, but potential reform may increase individuals’ ability to transfer larger amounts of capital.
 - A number of structural reforms could also have an effect on Chinese investment in U.S. real estate. Private firms have largely carried out the current wave of investment, but approximately 100 large, strategic, state-owned enterprises could bolster aggregate Chinese investment in U.S. real estate. For individuals, the potential expansion of property taxes would eliminate one of the attractive elements of a residential investment in China – the absence of holding costs – potentially making foreign real estate more attractive.

- Anti-corruption reform underway in China has two competing consequences for U.S. real estate. There is now elevated risk in getting capital out of China for investment, which could slow outward investment. However, individuals with wealth in China may worry about the perception of those gains and seek to reduce their domestic holdings, not only to reduce any perception of impropriety but also to gain an element of capital preservation and security.
- In addition, currency issues will remain critical going forward. As other countries devalue their currency to stay competitive globally, China will face increasing pressure to do the same. Capital outflows would accelerate as a result and encourage stronger capital controls, but restrictions on capital flows would force Chinese individuals and firms to watch as their domestic wealth and assets declined in value.
- In the United States, regulations cut across all levels of government, with federal, state, and local policies that can shape the form or location of real estate investment by Chinese entities.
 - At the federal level, FIRPTA established an additional tax and regulatory structure for foreign investors and constrains the number of investors and the amount of capital for investment.
 - Some Chinese real estate transactions are also beginning to attract national security review through CFIUS; while no known real estate acquisitions have been rejected to date, the Waldorf Astoria review signals an evolving standard of projects requiring review. Chinese officials are wary of a potential rise in review of Chinese real estate transactions going forward.
 - The EB-5 program faces renewed reform efforts after a temporary extension through late 2016. However, a modest reform – such as the proposal to increase the minimum investment from \$500,000 to \$800,000 – would likely not dampen Chinese investor demand, and the program would raise more capital in aggregate, supporting additional projects and additional U.S. jobs.
 - The recent extension of U.S. visa lengths (to 10 years) for Chinese citizens should encourage more return trips from China to the United States, a source of demand for Chinese investors acquiring U.S. hotel assets as well as making vacation homes more attractive for Chinese buyers.
 - States also exercise some authority over real estate ownership and taxation. Practices include residency or citizenship eligibility requirements; permission for individual homeowners associations to impose rules, largely to preclude absentee owners; and environmental protection laws that, in practice, are often used by local residents to challenge new development.
 - Local conditions can have a significant effect on new development for domestic developers and foreign developers alike. Exactions and impact fees are widely used, and there are significant differences in zoning codes, permit requirements, design requirements, and more between U.S. cities. Local residents often seek to block projects for a multitude of reasons, which can significantly delay projects and add costs.

CHAPTER 5: ASSESSING THE SUSTAINABILITY OF CHINESE INVESTMENT

CHINA IS EXPECTED TO BECOME THE LARGEST SOURCE OF CAPITAL into the U.S. real estate market in 2016 and beyond, according to two-thirds of respondents in a 2015 survey of the Association of Foreign Investors in Real Estate.⁶⁴ More than 70% of respondents indicated that they expect this investment to be a long-term, permanent inflow, which fits squarely with Chinese President Xi Jinping's declaration in a November 2014 speech that China's total outward investment would total \$1.25 trillion during the next decade.⁶⁵

However, increased global economic instability in late 2015 and early 2016 and related structural economic issues within China raise concerns about the sustainability of Chinese investment in U.S. real estate. China faces a policy dilemma that many countries have faced, with history illustrating that only two of three goals can be pursued simultaneously and successfully: keeping interest rates low, supporting the currency, and encouraging foreign investment. China has had some success in managing all three by tapping its significant foreign exchange reserves. While some estimates place the rate at more than \$80 billion per month, monthly fluctuations in export activity from China – which remains a major exporter – can soften some losses in any given month. Still, RCG expects a 6- to 24-month temporary period of increased capital controls – either formally or informally through administrative processing slowdowns – until the currency can be re-aligned with that of global partners. Of course, this implies that a devaluation of the yuan can be managed in such a way that China's trading partners do not subsequently devalue their currencies, sparking another round of competitive devaluations across the globe.

However, this does not mean investment will cease during that period, and it may serve as a motivation for accelerated investment in the very near term before capital controls tighten and the currency depreciates. While perhaps not specifically in response to these issues, recent deal activity highlights the rapid shift in investment that can occur. A rapid succession of investment forays by Anbang Insurance into the hotel sector, for example, could have resulted in more than \$20 billion in acquisitions in just the first few months of 2016 if all the deals had been completed successfully. Other platform transactions by several companies are under discussion. While there should be a slowdown in the pace of activity during the next 6 to 24 months, RCG believes the longer-term drivers of globalization of investment will remain and could be stronger once equilibrium is reestablished.

This chapter will examine a number of issues affecting the sustainability of Chinese investment in U.S. real estate going forward and projections of future investment. Chinese investment is coming from a wide and deep pool of institutional and individual investors, each with its own motivations for investing in the U.S. real estate market. Reforms in China are also facilitating greater avenues for investors seeking to enter the U.S. real estate market. Moreover, market expertise among institutional and individual investors is improving, relationships are forming, and new opportunities are beginning to emerge as the Chinese presence in the market becomes

more established. However, China's transition to a "new normal" presents a real possibility for both formal and informal capital controls in the near term. Tighter capital controls could slow investment in the next 6 to 24 months, but RCG believes Chinese investment into U.S. real estate will accelerate in the medium and long term, and there is a potential for near-term investment to surge as some companies and individuals enter the market while the window is open.

A WIDER AND DEEPER INVESTOR POOL

With each successive wave of Chinese investment into U.S. real estate by different investor classes, the potential volume of total investment has multiplied. But beyond simply having some of the largest parties from multiple groups investing in the United States – including developers, insurers, investment companies, construction companies, and high net-worth individuals – these investor classes are each extremely deep. So while only some of the top-tier insurers, construction companies, and investment companies have actually invested in U.S. real estate to date, the list of their competitors in China who have not yet invested in the United States, though many have examined opportunities already, is sizeable. Potential investors include not only other firms from Tier 1 Chinese cities but also firms from Tier 2 and Tier 3 cities.

In fact, this has already happened with Chinese developers and is instructive for analyzing potential activity by firms in other classes. The first entrants to the United States among China's developers were some of the largest players, such as Vanke and Greenland. While those large firms have not shown signs of slowing down, the real surge came as other developers followed their lead, so that now dozens of Chinese developers are active in the U.S. market. This same potential exists for other classes of Chinese investors.

Insurance Companies

Insurers present a major source of future investment in U.S. real estate. Typically, insurers have among the longest-term investment horizon of all investors and are also looking for stable, secure returns. Core U.S. commercial real estate assets fit well into this strategy and should increasingly be an investment target. Some Chinese insurance firms have a multifaceted investment strategy, with allocations of capital arising from insurance premiums, reinvestment of corporate profits, and consumer wealth management products. Each of these capital components could have differing investment return requirements and strategies. All of the commercial real estate acquisitions by Chinese insurers in the United States came in 2015 and later, following the regulatory changes allowing increased investment in real estate and foreign assets. While these represented some of the largest investments to date, still only a handful of China's approximately 100 insurers have invested in the United States. Furthermore, while stalwarts such as China Life and Ping An are among the active insurers in the United States, China Pacific, the third-largest insurer, has still not entered the market.

With the other top two insurers – People's Insurance Company of China and New China Life – the top five Chinese insurers had total assets under management of nearly \$1 trillion at year-end 2014, according to the China Insurance Regulatory Commission, out of a total of \$1.6 trillion in assets under management by all Chinese insurers at that time.⁶⁶ Still, their allocation toward real estate is currently only 1% to 2%, even though the allocation could legally rise as

high as 15%. Some smaller firms, such as Anbang, have been active as well, with multiple U.S. real estate acquisitions. In early 2016, Anbang also highlighted the growing interest in real estate-related platform investments with its acquisition of the Strategic Hotels portfolio for \$6.5 billion and its \$14 billion bid for Starwood Hotels and Resorts. Chinese insurers accounted for \$4.6 billion in U.S. real estate investment in 2015; while this is a significant sum, it only represents approximately 0.25% of total assets among Chinese insurers. With \$1.6 trillion in total assets under management at the end of 2014, a gradual rise to a realistic 4% to 5% allocation toward foreign real estate would represent between \$64 billion and \$80 billion, with a significant share potentially flowing to the United States.

Developers

Developers have been the most active investor group in the United States to date but still have vast potential to increase activity. Some of the largest developers that have invested in multiple projects are showing no signs of slowing down, and some market participants estimate that top firms could look to allocate up to a third of their investments into foreign markets. The actual allocation is unlikely to reach that high, but even a 10% or 15% allocation would provide a massive influx of capital into the United States. Although many of China's largest developers are already active in the United States, there are some notable exceptions, including Poly Real Estate Group, China Overseas Land and Investment, Country Garden and Greentown Real Estate Group, all of which are among China's 10 largest developers by revenue. Poly Real Estate Group and China Overseas Land and Investment, among other firms, are already active in other foreign real estate markets such as Sydney and London. Many Chinese developers have been in the United States for some time already looking at potential investments and assessing prospects. While some have decided not to further pursue U.S. expansion, many are still active and poised to invest in a future project that fits their business goals.

Construction Companies

Chinese construction companies are another segment in the increasingly diverse wave of Chinese parties active in the U.S. real estate market, and another group that has vast potential for increased investment going forward. Historically, Chinese construction companies operating in the United States have been focused largely on infrastructure projects. For example, China Construction America (CCA) – a subsidiary of China State Construction Engineering Corporation, the second-largest global contractor by revenue in 2015 – has served as general contractor for various infrastructure projects in the United States since the 1980s.⁶⁷ After initially partnering with local companies, CCA now operates independently for many projects as it has established its reputation in the United States. In 2015, CCA generated \$2 billion in revenue, making it the 32nd-largest contractor in the United States by revenue, up from 82nd in 2014.⁶⁸

As Chinese construction companies built their reputations in the United States, however, and as the domestic Chinese construction market slowed, firms looked to intensify operations in the United States. CCA purchased a number of development sites, while Shanghai Construction Group – the 12th-largest global contractor by revenue in 2015 – has been another large player

in the U.S. market through its subsidiary SCG America (SCGA), which has local offices and employees in New York, Los Angeles, Houston, and Washington, D.C. China Harbor Engineering, a subsidiary of the China Communications Construction Group – the fourth-largest global contractor – is expanding beyond overseas infrastructure projects and will be building a major office and retail project in Oakland, California. Another subsidiary of China Communications Construction Group recently purchased a development site in Miami, following the lead of other Chinese investors expanding beyond the primary gateway markets of New York, Los Angeles, and the San Francisco Bay Area.

Continued weakness in domestic Chinese real estate markets should put further pressure on construction companies to seek new sources of revenue and expand their international operations. There are some public perception issues about the potential quality of Chinese construction, but U.S. municipalities have been adamant in ensuring that foreign builders use the same techniques and materials and follow the same regulations as American builders. Furthermore, Chinese builders are aware of this perception, making some even more focused on building to a higher standard than code minimum, knowing that it would be difficult to receive future contracts if they did not.

Sovereign Wealth Funds

Although sovereign wealth funds have not been active in direct U.S. real estate acquisitions since the early part of the investment wave, they are a potential source of Chinese direct investment going forward. In 2015, the chairman of China Investment Corporation (CIC) stated an intention to increase its real estate holdings, particularly in the United States, Europe, and Australia, and diversify away from stocks and bonds, with CIC acquiring a portfolio of office assets in Australia for \$1.8 billion in 2015.⁶⁹ It was also a leading candidate at one point to acquire Starwood Hotels and Resorts for more than \$12 billion – not a direct real estate acquisition, but one with significant real estate assets. Some sovereign wealth funds are dissuaded from direct acquisitions in the United States because of FIRPTA issues, but whether or not Chinese sovereign wealth funds do acquire U.S. assets directly, they should remain a major source of investment through funds.

Beginning in early 2016, CIC began operating a standalone real estate division – acquiring its first U.S. property since 2010 – and doubled its real estate allocation to 10%.⁷⁰ With approximately \$740 billion in total assets under management, CIC could allocate an estimated total of \$74 billion to global real estate. The increase is in line with other global sovereign wealth funds, with Norway's sovereign wealth fund Norges Bank Investment Management recently applying to increase its real estate allocation from 5% to 10%. While details of CIC's investment strategy have yet to be fully announced, a typical sovereign wealth fund real estate concentration of 30% to 60% in the United States would lead to an investment portfolio of between \$20 and \$40 billion of U.S. real estate assets.

High Net-Worth Individuals and Family Offices

Wealthy individuals are already extremely active in the U.S. residential real estate market, but the investment to date has only scratched the surface of the potential investment pool from Chinese individuals. Chinese individuals, as opposed to larger corporate investors, have generally

accounted for most of the purchases of single family homes, condos, and small commercial properties. Estimates of the number of Chinese millionaires range from 1 to 4 million, trailing only the United States, while Boston Consulting Group estimated that the number of upper-middle-class households in China could reach 100 million by 2020.⁷¹ According to Hurun Report, real estate is already the investment of choice for Chinese high net-worth individuals, but growing residential mortgage availability for foreigners in the United States would make real estate an increasingly attractive option to the upper-middle class as well.⁷²

The growing number of investment vehicles beyond direct ownership of residential real estate should provide opportunities for this growing cohort to invest in the U.S. real estate market. As a recent example, in March 2016, Ping An announced it would raise an RMB private equity fund – targeting high net-worth individuals – to develop two U.S. residential properties in joint ventures with Pacific Eagle Real Estate Fund.⁷³ For many Chinese, particularly those in the middle and upper-middle income ranges, a significant portion of household wealth is in cash or deposit accounts and real estate. The propensity to invest in real estate combined with liquid capital is a positive indication of continued investment into foreign real estate. Furthermore, the tendency of some portion of the Chinese population to prefer real estate as an asset to preserve capital as opposed to bank deposits or the stock market, alongside the stability of the U.S. real estate market, should continue to drive acquisitions in the United States by new Chinese investors.

BROADER SCOPE OF INVESTMENT VEHICLES AND MARKETS

Going forward, a growing availability of vehicles for Chinese investors to enter the U.S. real estate market, along with increased comfort and familiarity with investing beyond U.S. gateway cities, portends well for sustained Chinese investment.

Portfolio Investment

For many foreign investors in U.S. real estate, simple and well-worn initial entry points are via a REIT with core assets in gateway markets such as New York and participating in a real estate fund. Such vehicles provide relatively simple ways to diversify a portfolio, without the complexities that come with direct ownership. They can also provide benefits from professionalized investment management.

So far, however, Chinese investors have not had many scalable options for portfolio investment in U.S. real estate. The introduction of REITs in China, a growing number of private equity funds targeting Chinese investors, and the potential of QDII2 to open up U.S. REITs and other structures to Chinese individuals could significantly grow the pie of Chinese investment into the U.S. real estate market. While Chinese investors have long preferred direct control over real estate assets, part of this stems from the lack of other options and exposure to these vehicles domestically; as portfolio investment vehicles become more widespread, investment in such vehicles from Chinese investors should grow over time, much as it has with domestic stocks in China. Furthermore, an expansion in portfolio investment does not necessarily crowd out direct real estate investment. Instead, it can attract investors who might not otherwise have entered the U.S. real estate market or result in greater volume by investors who construct a portfolio of direct and indirect real estate investments as a way to diversify investment portfolios.

Residential Opportunities

For Chinese individuals looking to acquire residential real estate directly in the United States, all-cash purchases have historically been the norm. It is a relatively safe investment and a means of capital preservation abroad. However, paying cash for a home in many prime U.S. markets, particularly California and New York, requires significant cash reserves, which restricts the pool of Chinese investors. Growing mortgage availability for Chinese buyers, from Chinese banks in the United States, American lenders, and some international banks, should expand this pool of buyers to include even more upper-middle-class families that may not be prepared to pay fully in cash but can afford a mortgage comfortably. Mortgages can also increase the leverage of high net-worth and ultra-high net-worth Chinese buyers to purchase multiple properties, as well as instances of those individuals using home equity loans to purchase a second property in the United States. These loans can certainly be riskier for lenders compared with loans to U.S. borrowers – particularly when funds held in China are used as collateral – but they provide a way for some Chinese banks to build market share in the U.S. residential mortgage market.

Expansion to New Markets

Another potential indicator of sustained investment is expansion by investors into secondary U.S. markets. Although gateway markets such as New York, Los Angeles, and San Francisco will always be attractive to institutional and individual Chinese investors, increased activity in secondary markets would signal even greater interest in long-term positioning in the U.S. market.

In commercial real estate, Chinese activity in true secondary markets is still limited, but investment in markets outside the aforementioned global gateway markets is on the rise. Seattle, with its relative proximity to China and strong economy, was already attracting investment prior to President Xi's visit in 2015, but it should likely see a further boost following that visit. Success by early entrant Chinese firms can also play a major role in attracting other Chinese firms. To date, many Chinese investors have focused on domestic Chinese real estate investments as an avenue for higher returns needed for segments of their businesses, while utilizing U.S. gateway market investments to satisfy low-risk, stable return needs in their portfolios. However, as elevated returns in China become more difficult to achieve as the economy slows, Chinese investors looking to replace those investments with U.S. real estate investments will be forced to look more closely at secondary markets for double-digit returns. Core assets in gateway U.S. markets, given current asset pricing, do not satisfy those needs.

In addition to looking at opportunities in new markets, there are examples of growing Chinese interest in cities on the periphery of gateway markets. With dwindling development opportunities in downtown Los Angeles and central Orange County, a number of investments have already been made in periphery Southern California cities. Among individuals looking to purchase homes, many follow where the major developers go, not only for the advantage of buying from a familiar brand but also because of the implicit vetting of new markets by those developers.

MARKET KNOWLEDGE, RELATIONSHIPS, AND CONNECTION TO OPPORTUNITIES

Although a significant amount of capital is expected to flow from China into the U.S. real estate market going forward – with a more diverse pool of investors and investment vehicles – relationships and understandings between Chinese and U.S. parties will continue to evolve and will play a vital role in reaching the full potential of investment. This will be true particularly for development, which for a variety of reasons – including local expertise and tax implications – should continue to take the form of joint ventures for some time. It will require continued give and take from both sides.

Partnerships

Joint ventures in commercial real estate development have not only provided an entry point into the U.S. market for Chinese developers but during the past few years have served as a critical source of financing for U.S. developers. As might be expected of any new market entrant, some Chinese developers were unprepared for the process of seeing development through from start to finish in the United States, one of the reasons for the joint venture in the first place. Although some Chinese firms that have been in the United States for a few years are becoming more familiar with the process, there are still gaps in capacity between Chinese firms. While there may be a handful that could transition to independent development in the near future, many U.S. partners still see that prospect a few years off for most Chinese firms.

Part of the learning process on both sides stems from differences in business expectations between partners. The differences in business culture are apparent, but partners on both sides can easily overlook these differences in the midst of a transaction. After deals have been negotiated and finalized, there are instances of Chinese parties coming to a partner to renegotiate a detail; but for the U.S. partner, the original contract is binding and provides the framework to be used to settle disagreements between parties going forward. Conversely, there have been occasions when the U.S. partner takes the lead role on decision making and does not enhance the relationship by keeping the Chinese partner apprised of milestones and minor issues. Although the real estate industry in the United States can be relationship driven, it still exists in the broader framework of confidence in legal systems and norms; the follow-through on deals is less about personal relationships than it is in China. In some instances, Chinese partners have been unwilling to share financial information with U.S. partners, which is rare between U.S. partners.

The use of service providers also differs between parties from each country, which can create unexpected stumbling blocks. For U.S. firms, lawyers are typically seen as advisors and are engaged throughout the development process. For many Chinese partners, lawyers are typically valued more for transactional purposes, rather than as trusted advisors with whom contact is maintained throughout the process, which can present problems for complex deals. The vertical integration that is a staple in China is not as widely utilized any longer in the United States, so it will continue to take time for Chinese investors, in aggregate, to put the same faith in third-party professional attorneys, accountants, public relations firms, architects, engineers, and marketers as they would in their in-house teams serving those functions.

Partners are also helpful for navigating political and regulatory situations, particularly before

local opposition to a project is fully organized. Unlike in China, where getting support from a local politician can often mean a developer can proceed and build, in the United States, similar support from a local politician has far less impact on the viability or pace of the project. These political relationships can help, but projects still need to go through a bevy of approvals from local government agencies and a public review process, all of which can take a significant amount of time, cost, and effort.

The structure and pace of local hiring by Chinese firms in the United States will also be something to watch going forward. Some Chinese developers hired a U.S. team to work alongside employees from China, while others have come to the United States with a small group of executives from the Chinese firm to run operations. Varying decision-making structures are similarly used; while the chairperson or executive team makes nearly all major decisions in China, some firms delegate more authority for routine decisions to the local U.S. team. Changes in investment strategy and the investment climate have caused some firms to pull back, with Dalian Wanda Group announcing in October 2015 that it would close its New York office and run its U.S. operations from Beijing.⁷⁴ Different structures work for different firms, but developing more of a local presence in the United States can certainly help in building relationships for future projects, as well as leveraging the experience and knowledge of U.S. employees and executives. The U.S. equivalent of *guanxi*, or personal relationships, that are vital to doing business in China can best be developed with a local presence that has some measure of decision-making authority.

Increasing Connections to Opportunities

Both firms and individuals are gaining access to a broader range of ways to find real estate investment opportunities, making the U.S. market more accessible. However, the increasing availability of information from myriad sources can also present challenges of sifting through information and determining the credibility of such information, particularly when done from abroad, which can be critical for the subsequent performance of these investments and the likelihood of continued investment. Developing relationships with local service providers and community members will help investors more efficiently navigate new markets.

Firms

Trade and business associations and similar public-facing organizations play an important role in facilitating Chinese real estate investment in the United States. They provide a way for Chinese companies to gain a foothold and familiarity with U.S. markets, both interacting with other Chinese firms in a U.S. context and making connections with U.S. firms and investment opportunities. Large member-based groups organize conferences and networking opportunities and provide educational resources. Other groups are geared toward facilitating specific opportunities for Chinese investors in a particular U.S. market, as well as assisting U.S. companies in that local market to expand operations into China.

Commercial real estate brokers also play a major role not only in executing transactions but also serving as a first point of contact and critical source of local market information for many investors. Many commercial brokers report increasing numbers of cold calls from potential Chinese investors. However, many Chinese investors have different expectations of service levels

and individual attention from brokers than their U.S. counterparts; in China, a prospective investor could often expect to be given a tour of the city and spend a whole day touring properties with the broker. There have also been instances – recognized by U.S. brokers and, importantly, the Chinese investors themselves – in which Chinese investors are presented with commercial properties that other investors are not interested in. While prospective investors from China become accustomed to different relationships with brokers in the United States, additional flexibility from brokers and consistent presentation of prime investment opportunities could go a long way in strengthening relationships and facilitating investment.

Online platforms have increasingly been used to introduce U.S. commercial real estate opportunities to Chinese investors. Juwai partnered with Ten-X/Auction.com in 2015 to make U.S. commercial real estate auctions available to Chinese investors.⁷⁵ Auction.com also partnered with the Asian Real Estate Association of America (AREAA) to connect Chinese investors with Mandarin-speaking brokers.⁷⁶

Individuals

The rapid growth in the number of Chinese individuals investing in U.S. real estate – including through vehicles such as EB-5, but typically residential real estate – is creating a positive feedback loop encouraging new investment. According to the 2015 National Association of Realtors survey, contacts and referrals are by far the primary sources of leads for international homebuyers in the United States. Many Chinese buyers place a special emphasis on personal connections, relying on information and advice from friends and family members to make decisions on home purchases. Chinese homeowners already established in a U.S. neighborhood can provide firsthand information about the area to their networks still in China and alert them whenever nearby properties come on the market. Concurrently, as the Chinese population grows more concentrated in a residential area, specialized real estate professionals begin to emerge, as U.S. brokers and developers learn Chinese customs and preferences, as well as acquire language skills and/or employ translators, not to mention the growing number of Chinese immigrants and Chinese Americans working as residential brokers. Despite these efforts, many prospective Chinese homebuyers choose to purchase homes without the involvement of an agent, with contacts in the area providing the information necessary for them to buy directly from the seller. Additionally, in many U.S. areas that have become popular with Chinese buyers, current residents with local expertise – often, but not exclusively, Chinese – act as informal brokers, coordinating buyers and sellers for a significant number of these areas' international home sales.⁷⁷ Each new Chinese homebuyer in the United States means a new network of friends and family members in China that reinforces the positive feedback loop for sustained investment.

Like U.S. buyers, many Chinese are also now able to research U.S. real estate listings online through services such as Juwai and Leju, which partnered with Zillow. As transformational as this has been in recent years for U.S. buyers, the advantages are even more palpable for prospective buyers half a world away. Whereas in years past, Chinese buyers would have to conduct nearly every aspect of the home search while on a visit to the United States, they can now do most of the legwork from home, making an eventual trip to visit properties relatively seamless and much more targeted. Online platforms in China continue to partner with local organizations

and companies to provide listings information. Juwai recently partnered with the New York State Multiple Listing Service, for example, to allow agents to list properties directly on Juwai for no cost, further boosting the universe of listings available to prospective buyers and increasing the utility of such sites.⁷⁸ Beyond listings, online real estate databases are also becoming sources of local U.S. market information for Chinese buyers, with data on home price appreciation, permitting activity, and other market indicators.

The growth of social media usage in China also provides another avenue for prospective Chinese individual investors; information can be found for immigration and visa services, EB-5 opportunities, residential purchase opportunities from U.S.-based real estate agents, or local market data. However, while some of the information is from reputable sources familiar to U.S. users of social media, the inherent absence of regulation of postings results in questionable information and data being promulgated that, while encouraging investment, could lead to misinformed investment decisions. It can be difficult to vet sources that appear legitimate or even more typically to sift through information on an advertisement for a property in which much of the information is correct but embellishes potential appreciation or neighborhood amenities. The vast array of information available to investors, some of which is of better accuracy, highlights the advantages that can be gained by an investor willing to utilize local service providers such as real estate agents.

DOMESTIC PRESSURES IN CHINA

The previously mentioned issues affecting the trajectory of future Chinese investment, however, do not exist in a vacuum: there are significant pressures on the Chinese economy that could affect the sustainability of capital flows into U.S. real estate. Certainly, a recession in China would have an impact on real estate investment flows into the United States, not to mention broader investment patterns. However, China's transition to a "new normal," with slower economic growth and shifting drivers of growth does not necessarily imply a pullback of Chinese investment in U.S. real estate.

As mentioned earlier, the existing glut of vacant properties has already played a part in Chinese developers looking abroad for development opportunities. Further weakening of the Chinese economy would present additional demand-side issues for housing in China and likely push developers to look for more international opportunities to increase revenue. However, it should also continue to push institutional investors seeking stable investment opportunities to other markets, and to the United States in particular. Although some Chinese investors are aware that they may be acquiring assets at the peak of the cycle in some U.S. markets, these assets still present one of the strongest alternatives available for investors that have to deploy capital somewhere, and particularly with the long-term outlook of many Chinese investors.

For individuals, the economic slowdown may depress the growth of China's middle class but should not significantly deplete the ranks of existing high net-worth individuals. At the same time, the slowdown and potential currency depreciation should incentivize those individuals to invest more of their capital outside of China. A slow and steady devaluation of the yuan against major currencies would likely accelerate capital outflows. Further devaluation of the yuan, however, would decrease purchasing power, potentially dampening investment volume even as the number

of transactions increases. Still, even as China begins to loosen rules on second-home purchases and down payment requirements domestically to try to stimulate purchase of these properties, buyers can often find better relative value, even with less purchasing power, in the United States.

The greater risk as far as U.S. real estate investment is concerned, however, is the potential for tighter capital controls in China. SAFE is requiring banks to flag clear instances of over-invoicing exports, one tool for getting around China's capital controls. State-owned banks are also beginning to more closely watch for unusual transactions indicating the pooling of funds by friends and family for an overseas real estate purchase and are looking at the source of funds for overseas accounts that received funds beyond the individual limit. SAFE has also not granted new allocations for the QDII program in months, one example of the increasing use of informal, temporary capital controls. However, this does not mean capital flows will abruptly cease through QDII: some state-owned enterprises can receive exemptions for some investments, while other firms have unused pre-allocations issued in prior years that can still be used for foreign investments going forward.

PROJECTED INVESTMENT

With the larger and diversified pool of investors, new investment vehicles, greater market knowledge and connections, as well as the domestic economic pressures in China, RCG expects Chinese investment to increase in the coming years. Still, it should not be expected to rise in a linear fashion, as it is still subject to the U.S. economic and real estate cycles. Furthermore, approvals from Chinese regulators, such as SAFE and the China Insurance Regulatory Commission, can be a limiting factor in investment flows. Chinese regulatory policies can change and be implemented much more quickly than in the United States, adding another layer of complexity to long-term planning by Chinese investors.

Although there is some concern about how Chinese investors will respond to their first down cycle in the United States – which in prior foreign investment waves resulted in an exodus of capital – RCG believes that Chinese investors are better equipped to withstand a U.S. slowdown. Not only are many of these investors already making investments indicative of a long-term, strategic business decision to grow in the U.S. market; if U.S. property values fall and some Chinese investors faced a risk of default, the Chinese government may likely have more of a role than governments from other countries that have invested in U.S. real estate. For example, the Chinese government could encourage or utilize state-owned enterprises or banks to help refinance the asset in the United States or recapitalize the firm in China so it has the liquidity to deal with any problem assets. Furthermore, at a broader policy level, Chinese policy makers have long been working to increasingly encourage global investment by Chinese firms and individuals; that long-term trend is expected to continue, and the central government would likely enact policy measures to support this practice should an economic downturn threaten the health of Chinese companies.

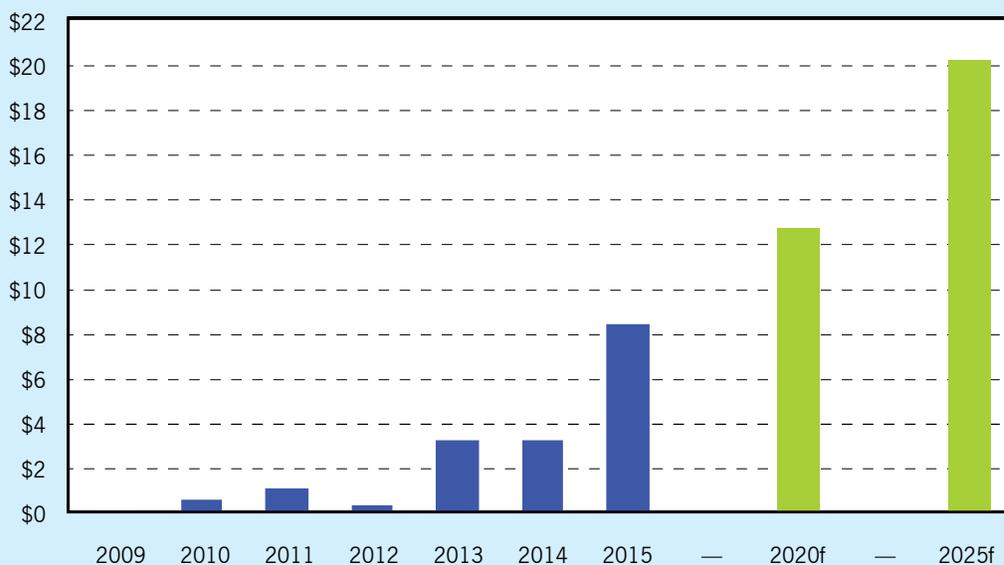
With the breadth of demand for U.S. real estate among Chinese investors, RCG projects that Chinese investment across existing commercial real estate assets and residential purchases – excluding new development – could total at least \$218 billion, cumulatively, from 2016 through 2020. As equilibrium in the Chinese economy is reestablished, investment activity should

accelerate in a nonlinear manner. Chinese investment toward new development should similarly remain robust going forward.

On the commercial real estate side, Chinese acquisitions reached at least \$8.5 billion in 2015, the largest annual flow to date and a significant increase from the prior year. While RCG anticipates that Chinese commercial acquisition volume should increase during the medium term, we expect the annual percentage growth to ease. Still, between 2016 and 2020, Chinese commercial acquisition volume could total nearly \$58 billion, cumulatively, if measures are taken to liberalize outbound investment capital from China and if the U.S. economy continues to grow as expected. If liberalized outbound investment policies hold and become more institutionalized in China going forward, coupled with openness to foreign investment from the United States, RCG expects that the annual flow of commercial acquisitions could reach as high as \$20 billion by 2025, although investment volume would be subject to economic growth patterns in both the United States and China (Figure 31).

Commercial development activity should be robust going forward, although with the development cycle peaking in most U.S. markets, the 2014 estimated project value of \$8.5 billion for Chinese-backed development projects should remain the high-water mark in the near term. RCG expects the project value of Chinese-backed development to ease through 2018 before gradually rising through 2020 in the next cycle; during the next five years, this could result in at least \$38 billion in total development costs. Over the longer-term horizon, RCG expects a broader and more experienced pool of Chinese firms could push the annual value, in strong

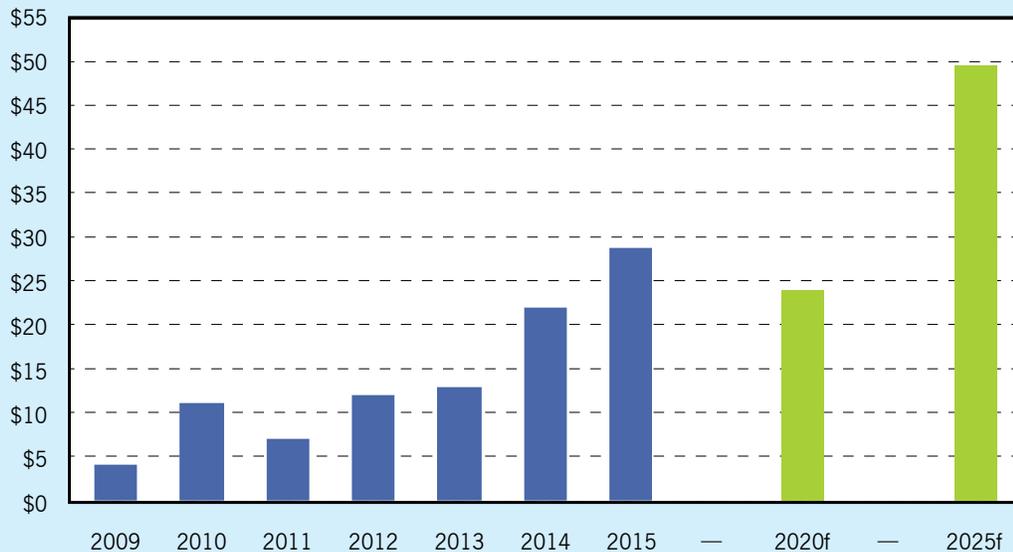
Figure 31: Projected Chinese Commercial Real Estate Acquisition Volume
\$Bil.



Source: Rosen Consulting Group

Figure 32: Projected Chinese Residential Real Estate Acquisition Volume

\$Bil.



Source: Rosen Consulting Group

property market conditions, to more than \$10 billion by 2025. The volume of capital allocated to development sites should trend higher, but ultimately economic cycles will have a substantial impact on whether the allocated funds are deployed as proposed and new projects are announced.

In the residential real estate market, Chinese purchases of U.S. houses and condos totaled \$28.6 billion in 2015, representing the highest annual figure to date. Going forward, tighter formal and informal capital controls for Chinese nationals could put some downward pressure on U.S. residential purchases in the near term. However, despite this risk, between 2016 and 2020 Chinese residential purchase volume could total \$160 billion. Over the long term, the annual flow could accelerate to as high as \$50 billion by 2025 if open capital flows become more institutionalized and the U.S. economy is as strong as it has been in recent years (Figure 32).

TAKEAWAYS

- RCG expects a short-term period of increased formal or informal capital controls (6 to 24 months) until the currency can be re-aligned with that of global partners. However, longer-term drivers of globalization of investment will remain, driving sustained Chinese investment in U.S. real estate over the long term.
- The pool of Chinese investors is wide and deep. Many have already acquired U.S. real estate assets, but the number of peer institutions in China that have not yet invested in the United States is sizeable.
 - The Chinese insurance industry, with \$1.6 trillion in assets under management at the end of 2014, represents one of the largest sources of activity and has made significant acquisitions

into 2016. Developers have been the most active investor group in the United States to date, while Chinese construction companies have also looked to intensify operations in the United States.

- Sovereign wealth funds are a potential source of Chinese direct investment going forward; CIC has stated an intention to increase its real estate holdings and in early 2016 acquired its first U.S. asset in six years. Rapid growth in the number of upper-middle-class Chinese households presents a growth driver for direct residential purchases but also indirect commercial real estate investment.
- Chinese investors have a growing number of vehicles to invest in the U.S. real estate market. The introduction of REITs in China, a growing number of private equity funds targeting Chinese investors, and the potential of QDII2 to open up U.S. REITs and other structures to Chinese individuals could significantly grow the pie of Chinese investment into the U.S. real estate market.
- Relationships and understandings between Chinese and U.S. parties, as well as access to investment opportunities, will continue to evolve and will play a role in reaching the full potential of investment.
- Although some Chinese investors are aware that they may be acquiring assets at the peak of the cycle in some U.S. markets, these assets still present one of the strongest alternatives available for investors who have to deploy capital somewhere, particularly as the Chinese economy slows.
- With the breadth of demand for U.S. real estate among Chinese investors, RCG projects that Chinese investment across existing commercial real estate assets and residential purchases – excluding new development – could total at least \$218 billion, cumulatively, from 2016 through 2020 and then accelerate through 2025 as equilibrium in the Chinese economy is reestablished. However, the speed with which capital flows from China can be liberalized and the willingness of the United States to remain open to investment, coupled with economic growth patterns in both countries, will shape the trajectory of future investment.

CHAPTER 6: IMPLICATIONS OF CHINESE INVESTMENT

BOTH THE UNITED STATES AND CHINA HAVE MANY REASONS to embrace Chinese investment into U.S. real estate. In the wake of the Great Recession, Chinese investors provided much needed capital and helped revive stalled projects. Even as the U.S. economy and real estate market recovered in recent years, Chinese investment has helped propel megaprojects across the country that may not have otherwise proceeded, eliminating the accompanying job gains and tax receipts for municipal governments and contract revenue for private firms. Still, as with past waves of foreign real estate investment in the United States, there is increasing protectionist concern about Chinese investment, as well as more fundamental questions about impacts on real estate pricing and returns for U.S. investors. Furthermore, despite the large size of the U.S. real estate market and array of investment options available, other nations are also competing to attract Chinese investment. The investment by Chinese firms into the United States highlights the “Going Out” policy and underscores China’s economic leadership capabilities and potential. The evolution of investment into developed economies and the sophisticated financial structures needed for large-scale projects underscore China’s ability to provide capital and development expertise across the globe.

This final chapter will first look at the opportunities and challenges that Chinese investment in U.S. real estate presents. Chinese investment bolsters liquidity in the U.S. commercial and residential real estate markets, supports significant U.S. job creation, allows for expansion of Chinese firms into attractive long-term markets, provides opportunities for diversification for Chinese investors, and strengthens bilateral cooperation through expanded business and individual relationships. Still, some challenges remain, particularly with localized asset price appreciation. We will then propose a series of steps that can be taken in both countries to facilitate investment, not only by policy makers but also by real estate industry professionals.

OPPORTUNITIES AND CHALLENGES

Real Estate Markets

For commercial real estate markets in the United States, the presence of new sources of investor demand can create a healthier, more stable environment. Liquidity is key for stable real estate markets. Sustained Chinese investment will create additional liquidity, creating more opportunities for owners of real estate assets to buy and sell properties. Moreover, increased liquidity can attract greater investment from other investors in the market who may not have pursued an opportunity but see the expanded opportunities to eventually sell the asset – helping create a positive feedback loop. When markets function normally, investors can better analyze opportunities and formulate strategies to buy and sell assets. In addition to expanding the pool of buyers in the commercial real estate market, Chinese activity in the United States provides greater

real estate debt availability. This has served not only to advance projects that were stalled but also to promote more competitive rates and terms from lenders.

In the residential real estate market, U.S. homeowners similarly have greater opportunities to sell their home. Chinese buyers provide a much-needed source of buyer demand for home sales. Tight mortgage credit availability, the difficulty of saving for a down payment, and millennials' proclivity to rent for longer – either by necessity or preference – have pushed the U.S. homeownership rate to the lowest level in 20 years. At the same time, first-time homebuyers accounted for just 30% of new home sales in February 2016, compared with a long-term average near 40%.⁷⁹ Although a boost in Chinese demand will have some benefit for existing home sales, the Chinese preference for new homes can provide an even greater boost to U.S. homebuilders, as new home construction in the United States remains well below historical averages.

Increased Chinese investment in the commercial and residential real estate markets also presents some potential pitfalls, chiefly around asset pricing and related impact on investment returns. Because of some unique investment drivers and the often long-term investment horizon for many Chinese investors, they are sometimes willing to pay a higher price for assets than are their U.S. counterparts with a shorter investment horizon or different investment strategy. Although this is a boon to sellers, it can lead to some price pressures as appraisers determine value in part by comparing nearby sales activity. These price effects are extremely localized, however, particularly in the residential market. High concentrations of Chinese residential purchases on one block or a specific neighborhood can drive some price appreciation, but these effects dissipate at the broader submarket or city level and have a zero or minimal effect on pricing at the county or metropolitan area level. In fact, Chinese purchases of homes have little effect, in aggregate, on pricing trends. In terms of sheer numbers, the volume of homes bought and sold by U.S. citizens vastly outnumbers that of any other group.

Economy

Increased investment and development of real estate are significant sources of job creation. The recent recession decimated the construction industry, which has yet to recover to the employment level prior to the recession. Construction jobs are often the most visible type. Although these jobs are sometimes dismissed for their temporary nature, the types of projects being funded and built by Chinese investors are major projects, often with multiyear construction time lines. The construction jobs are often unionized, well-paying jobs that require a substantial amount of skill and training. But construction jobs are only part of the picture. Development of hotel, office, and retail properties fosters new permanent jobs, while development of all types creates jobs in building management. With the EB-5 requirement of 10 jobs created for each investment, Chinese investment through the EB-5 program alone may have created at least 70,000 jobs in 2015, and more than 200,000 over the life of the program.⁸⁰ Furthermore, as more Chinese firms enter the United States, more and more will establish local offices, not only for executives coming in from China, but also the hiring of U.S. workers. Entrepreneurial immigrant investors, provided entry to the United States via real estate investment programs such as EB-5, often go on to create new businesses in the United States that employ U.S. workers in a range of industries. The profits from selling real estate assets to Chinese buyers can also strengthen the U.S. economy,

providing new capital for reinvestment.

In addition to job creation, the market stability provided by increased investment sources provides a range of broader economic benefits. Greater market stability helps some lenders better manage default risk, including local and regional banks that have a significant share of mortgages and construction/development loans. These banks are key sources of credit for small businesses across the country. Helping stabilize real estate markets will mitigate some of the risk within lending portfolios, allowing banks to increase lending to small, local businesses. It also benefits pension funds and endowments. With both groups increasing investment in real property and needing greater returns for future obligations, a broader real estate investor pool could help boost annual returns. Pension funds need elevated investment returns for unfunded liabilities, which can prove difficult in the current low interest rate environment.

Fostering Ties

As two global powers with different but partially overlapping spheres of influence, the United States and China are bound to have geopolitical disagreements going forward. However, greater economic integration between the two countries can help provide mutual security and foster relationships at the corporate and individual levels. At a macro level, the more the two economies are intertwined – with significant investment flows in both directions – the greater the imperative to deescalate any potential confrontations that would not only be destructive from a humanitarian perspective but also from an economic perspective. Real estate is but one avenue for economic integration, but it is particularly beneficial for the relationships it can help forge. This applies to individuals at firms engaged in joint ventures, Chinese bankers lending to U.S. firms, trade associations providing opportunities for business communities of both countries to develop relationships, or individuals buying and selling homes. Although there is, and likely will continue to be, some counterproductive rhetoric from politicians, stronger personal and business relationships in the real estate community can have a positive influence on easing political rhetoric.

RECOMMENDATIONS

For China, increased foreign investment – including in real estate – further boosts its standing in the global marketplace. Increased investment in U.S. real estate is providing important elements of diversification for Chinese firms and individuals and is establishing Chinese firms in new markets. For the United States, increased Chinese investment in real estate is a boon for job creation, real estate liquidity, and debt availability. However, while a growing pool of Chinese investors and U.S. partners is eager to increase Chinese investment in U.S. real estate going forward, a number of policy areas should receive attention in both countries.

In China, private sector investment in global property markets has been a positive development for the Chinese economy and should be encouraged. Reforms in recent years have removed considerable administrative roadblocks and expedited review of proposed investments. Providing a robust legal framework in China for this investment going forward will be key, both for private firms but also for state-owned enterprises, as they increasingly look toward foreign investment to compete with their private peers. In addition to a robust legal framework for investment, continuing progress toward the transparency in capital sourcing required by international

agencies – which is being tightened for all countries, not just China – will be an important step.

Concern over capital outflows and their impact on the Chinese economy is understandable, and temporary capital controls may be unavoidable. However, we caution against long-term imposition of capital controls, which would negatively impact the very financial institutions that the government has been nurturing over the past two decades. The recent inclusion of the yuan as a reserve currency by the IMF was a major step in affirming China's place in the global economy, and a recognition of numerous reforms made by the Chinese government to open up its capital markets. However, room remains for China to permit greater capital flows, which would not only allow for greater investment in U.S. real estate but would also strengthen China's position in the international economy. A quicker rollout of the QDII2 program in Shanghai and other Tier 1 and Tier 2 cities, which would permit individuals to legally invest beyond the \$50,000 annual cap, could be a boon for U.S. real estate investment and potentially strengthen the financial portfolios of Chinese citizens. Over the long term, freer movement of capital will help Chinese firms find investment opportunities with appropriate risk levels and achieve portfolio diversification, strengthening China's place in the global economy.

Facilitating capital flows between China and the United States, however, could similarly be helped along through legislative efforts in the United States. The recent reform to FIRPTA is a positive first step in making the United States more open to foreign investment but still leaves intact this unnecessary barrier and additional cost structure. Every effort should be made to make this and the rest of the tax system level for investors from wherever they are domiciled.

In addition, the protectionist rhetoric around EB-5 investment, with some lawmakers calling for a complete end to the program or eliminating urban investments from the program, comes at a political juncture when there could be bipartisan support for a boost to the U.S. economy that comes without increasing the deficit or placing an additional burden on taxpayers. The program will likely undergo reform but should not be altered so dramatically as to cut off U.S. access to Chinese capital, or Chinese citizens' access to U.S. residency. Furthermore, while increased security screening for all foreign investors in the United States make sense given global threats the United States should take care to make reasonable security adjustments. Recent congressional suggestions to restrict U.S. agency or U.S. contractor occupancy in foreign-owned buildings should be closely monitored. Such a policy would drastically limit options for government-related tenants and would make office occupancy for those tenants more costly – an expense burden that taxpayers would have to bear.

Business leaders from both countries can work to support professional education on U.S. real estate practices. Everything from land approvals processes to partnership agreements to local market valuation practices are different in the United States, and efforts to support increased education in these areas will benefit Chinese investors – particularly smaller companies and individuals. The use of service providers as trusted advisors to navigate these processes is critical, as the multitude of layers and considerations for investing in the United States, as well as other parts of the world, makes it exceedingly challenging to tackle everything independently.

The United States has historically attracted capital from around the world and, with the largest and deepest real estate market globally, has seen significant levels of real estate investment. Despite occasional instances of protectionism, the United States has largely been one of the most

open and welcoming destinations for foreign investment. The emergence of China as a new source of capital into the U.S. real estate market is the latest addition to this long history of foreign investment. The U.S. public and its policy makers have a unique opportunity to embrace this investment and the resulting benefits that come with it: job creation, real estate market stability, and increased bilateral cooperation by firms and individuals in China and the United States.

METHODOLOGY AND DATA SOURCES

TYPES OF REAL ESTATE INVESTMENT COVERED

Real estate investment is channeled through a multitude of conduits. Direct acquisition of commercial real estate and purchases of residential properties are highly prominent avenues, but to capture a more comprehensive picture of Chinese investment in U.S. real estate requires examination of Chinese purchases of residential mortgage-backed securities, portfolio investment through real estate investment trusts and private equity funds, equity investments for ground-up development of commercial and residential properties, development financing through the EB-5 investor visa program, and real estate lending by Chinese banks. To the furthest extent possible, we limited our focus to investment from mainland China. However, the flow of capital through intermediary destinations sometimes necessitates the inclusion of Hong Kong, Macau, or Taiwan, particularly for residential purchase data.

Although we cast a wide net in measuring and analyzing many forms of real estate, the one overarching requirement for an investment stream to fall within the scope of this report was that a real estate asset was the primary component of the investment. Other investments by Chinese firms include real estate assets as part of a business platform – including earlier acquisitions of companies such as Lenovo and Smithfield – where acquisition of the platform, not the associated real estate assets, is the purpose of investment. Although the line between platform investment and real estate investment is becoming grayer – most notably with Anbang’s recent acquisition of Strategic Hotels and its bid for Starwood Hotels and Resorts – we applied the more narrow view to focus on investment in real estate assets. We excluded recent acquisitions that have a secondary real estate component, such as cinema chains, hotel companies, tech incubators, and agricultural entities. Starting with that framework, we set out to compile data through a number of methods.

SUPPLEMENTAL RESEARCH AND INTERVIEWS

While the baseline for data presented in this report was an array of public and private datasets (detailed in the next section) that cover the various real estate investment streams, the report was largely shaped by extensive additional secondary research and numerous interviews conducted with industry participants. These were critical data pieces – quantitative and qualitative – that helped provide a more complete reflection of actual Chinese investment activity in the U.S. real estate market than currently exists.

Our secondary-source research identified additional transactions by Chinese investors that are not generally known publicly and improved on data for known transactions – including Chinese shares of joint venture transactions and investment in equity funds where available. This involved searching news reports from national and local news outlets, including mainstream media and industry publications. This secondary-source research also included review of more

detailed reports and data from government agencies, academia, and third-party service providers. We were also able to use these secondary sources to create a database of development projects. Public deed transfers capture the sale of development sites but not the planned projects for those sites. We cross-referenced public records of development sites with secondary sources to identify planned and under construction projects and associated project characteristics.

However, in addition to secondary-source research, we further supplemented data with dozens of interviews with industry participants. Some conversations were private while others were in a group setting; however, all interviewees were guaranteed anonymity to facilitate an open dialogue. We talked with stakeholders across all segments of the real estate industry, both China- and U.S.-based practitioners. These groups included Chinese institutional and individual investors (e.g., insurers, developers, investment funds, banks); service providers (e.g., brokers, lawyers, accountants, consultants); architects, engineers, and planners; as well as government officials and academia, among others. These interviews were invaluable, not only for quantitative data and firsthand insight into deal negotiations and investment decision making but importantly to better understand the range of motivations behind Chinese investment – across both commercial and residential sectors – and inform our expectations about the sustainability of this capital going forward.

BASELINE DATA

An initial starting point for commercial transactions was Real Capital Analytics, a global provider of real estate data, which compiles deed transfer information, including data points such as the property name, address, buyer, seller, lender, and purchase price, among others. However, because of the particular tax structures affecting real estate investment – for all domestic and foreign investors active in the U.S. real estate market – not to mention the fragmentation and opacity of the sector in the first place, these data were only a starting point. Arrangements such as joint ventures are commonplace in the U.S. real estate landscape, but they do give parties the legal right to keep their shares of contributions private, making it difficult to quantify the full flow of Chinese investment into U.S. real estate. As a result, public records only provide the contribution of each party if those parties choose to make this information available; otherwise, only the full purchase price is known. And in some cases, local jurisdictions do not disseminate the full purchase price. Ultimately, we combined these data with the aforementioned data gathered through additional secondary-source research and interviews. We performed a number of steps to clean and categorize the data by removing duplicates and false positives, identifying the type of Chinese capital (developers, insurer, high net worth, etc.), classifying private and state-owned firms, marking joint ventures, and updating transaction volumes with specific Chinese shares where available.

Some data were more readily available but were not without their own limitations. For Chinese investment in residential mortgage-backed securities, we utilized the Treasury International Capital dataset, published by the U.S. Department of the Treasury. It provides inbound capital flows by country across a number of categories. We looked at the long-term agency debt, which is roughly an approximation of residential mortgage-backed securities holdings (long-term debt held by Fannie Mae and Freddie Mac, captured in this category, dwarfs other agency debt). We limited our analysis to data for mainland China only, although there is certainly Chinese capital

in the dataset that flows through intermediary countries; however, there is no accurate way to disaggregate such data.

Data on EB-5 investor applications and visa issuances are readily available from the U.S. Citizenship and Immigration Services (USCIS). Even though visa issuances are broken out by country, they are not a reliable statistic to estimate investment volume because they include visas for family members of the investor. Instead, we relied on investor application approvals data. These data are only provided in aggregate by USCIS, but Invest in the USA (IIUSA), an independent trade association, provides these data broken out by country. Through additional research and conversations with regional center representatives and U.S. firms seeking or raising EB-5 capital, we know that the vast majority of all EB-5 investment is coming at the \$500,000 level into Targeted Employment Areas, rather than the \$1 million threshold for other areas of the United States. As a result, we could take the number of Chinese investor application approvals and apply the \$500,000 investment level to arrive at an estimate of total volume. Similarly, we could take the number of Chinese investor application approvals and apply the minimum job creation requirement of 10 jobs per investor to arrive at an estimate of job creation through the EB-5 program. These are rough estimates as some financed projects are not successful and the timing of financing and creation of jobs can occur in different calendar years than the visa application approval.

Quantitative data on debt and private equity were more limited. We were able to gather lending data for the two state-owned Chinese banks chartered in the United States, Bank of China and ICBC, through the FDIC's Statistics on Depository Institutions, which reports loan portfolio holdings for both commercial properties and one- to four-unit residential homes. Private equity investment is still a small source of Chinese investment activity in the U.S. real estate market, but we were able to use Preqin Ltd. to identify some activity, supplemented by additional secondary-source research and interviews with capital placement agents and fund managers.

For residential purchase activity, the most widely cited data are published in the Profile of International Homebuying Activity survey by the National Association of Realtors, which we relied on for some of the quantitative data in this report. We supplemented these figures with information from other third-party data providers to determine locations of sales and verify volumes. The sheer scale of U.S. housing market activity, utilization of a range of ownership structures, and legal restrictions on the type of reporting housing professionals can disseminate make it difficult to provide improved aggregate data than this survey. While we can provide robust supplementation to commercial acquisition data – where Chinese acquisitions number in the hundreds and many are large-scale investments – in the residential market, Chinese individuals purchased 33,000 homes in the United States in 2015 alone, according to NAR. Still, while the NAR survey represents a primary data source for international home purchases in the United States, it has a few notable limitations. First of all, as a survey, these data are self-reported by homebuyers, who may not be willing to participate in the survey at all or may be reticent to share all information about the purchase. Furthermore, the survey applies only to existing home purchases, so purchases of new homes are not covered. It also does not include off-market home sales where the property was not listed prior to the transaction. Finally, with respect to Chinese investment specifically, the reported data include buyers from Hong Kong and Taiwan; however, each only accounts for approximately 1% to 2% of the Chinese total.

LIMITATIONS AND MINIMUM VOLUME

We present the data in the report as minimum investment volumes. While we made substantial inroads in uncovering joint venture and non-published investment activity, we know there is additional Chinese investment (and investment from all off-shore locations) into the U.S. real estate market. The United States does not have specific reporting requirements, outside of those mentioned in this study, for foreign buyers. Besides the issue of partnership structures obscuring some transaction volume, there is significant small-scale investment, where it is possible to identify some individual transactions but no way to accurately collect aggregate data on that scale in the absence of legal reporting requirements. Furthermore, additional investment comes from intermediary countries through which Chinese real estate investment flows into the United States, adding to the difficulty of tracking acquisitions and accounting for the full investment volume. Finally, we adhered to confidentiality agreements with many individuals and firms we interviewed, whereby we agreed not to publish confidential details of transactions and thus did not incorporate these data in identifiable ways into the investment volumes.* While acknowledging data limitations, we have made every effort to compile data and insight that provide a more complete reflection of actual Chinese investment activity across the entire spectrum of the U.S. real estate market than previously published.

* The analyses of investment data, individual transactions and in aggregate, were derived from several third-party public and private data sources. We have generally cited statistics from these sources that are publicly available so as to maintain legal confidentiality requirements. The views and interpretations of the data are ours and do not reflect opinions or positions, except as noted, of the data sources.

ENDNOTES

¹ See methodology section regarding data on Chinese acquisitions of U.S. commercial real estate assets.

² The aggregate investment volume includes both direct and indirect means of investing in real estate through the purchase of real property, investment in mortgage-backed securities, and provision of mortgages and debt capital, among others.

³ See inset text on p. 32 for detailed discussion of platform investments.

⁴ See Asia Society's previous reports tracking and analyzing the growth in Chinese investment into the United States, including "An American Open Door" (2012), "Chinese Direct Investment in California" (2013), and "High Tech: The Next Wave of Chinese Investment in America" (2014).

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⁸ The Federal National Mortgage Association (Fannie Mae) and the Federal Home Loan Mortgage Corporation (Freddie Mac) – collectively referred to as government-sponsored enterprises (GSEs) – are a critical feature of the U.S. housing market. These housing GSEs, along with the Federal Home Loan Bank System, occupy a unique niche along the public-private spectrum. Fannie Mae was originally established as a government agency following the Great Depression, but both organizations were converted to for-profit companies owned by private shareholders in the 1970s and 1980s. In the midst of the recent recession, Fannie Mae and Freddie Mac came under the conservatorship of the Federal Housing Finance Agency. Fannie Mae and Freddie Mac do not originate mortgages but instead buy mortgages originated by private lenders with the intent of maintaining capital liquidity and stability in the housing market. Both entities hold some mortgages on their respective balance sheets, but most loans are pooled into mortgage-backed securities. The securities can subsequently be invested in and traded by a range of investor groups.

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¹² Although the official data show the trend of increasing Chinese OFDI, the absolute values are vastly misreported for a number of reasons. The primary challenge that affects accounting for both the Chinese and U.S. agencies tracking FDI is the use of intermediary countries and tax havens for investment flows. Largely because of capital controls in China and the global investment tradition established in Hong Kong decades ago, capital will often flow through Hong Kong en route to the United States and other countries. Furthermore, on the Chinese side, multiple FDI datasets are compiled by the State Administration of Foreign Exchange (SAFE) and the Ministry of Commerce (MOFCOM). In the United States, the Bureau of Economic Analysis reports FDI data. It suffers from the similar problem of intermediary source countries that obscure the original source country. Furthermore, for real estate investment specifically, the U.S. tax regime – largely through the Foreign Investment in Real Property Tax Act (FIRPTA) – encourages investment structures that keep foreign, including but not limited to Chinese, investors as minority investors and eliminate reporting requirements, further understating inward FDI.

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¹⁵ See methodology section for detailed explanation.

¹⁶ Koch-Weser and Ditz (2015).

¹⁷ The distinction between state-owned and non-state-owned is less clear in China, but we recognize that there are differences and believe that different entities do have different operational mandates/structures.

¹⁸ The development cycle is problematic for dollar volume purposes. It generally is standard practice to use the total estimated project value at time of announcement/commencement. It is nearly impossible to have a specific cost timeline, and cost estimates are known to change substantially as the development proceeds. As a result, an actual project cost is not available until the building delivers, and most developers will not reveal actual project costs at that time for competitive reasons. The only way to track real estate development is based on initial projection of cost.

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