SHENZHEN: THE CURTAIN IS RISING
Searching for your next deal in China’s hottest city
Under the Greater Bay Area Outline Development Plan, Shenzhen is one of the four core cities. Leveraging a rapidly growing economy, Shenzhen’s property market is ready to become the next gateway city for international institutional investors. However, a lack of properties owned by off-shore companies, very little en-bloc investment opportunities, and a limited pool of active international investors have capped Shenzhen’s potential.

We recommend investors interested in Shenzhen closely follow the latest development in the office, business park and long-term residential leasing markets. As Shenzhen is very sensitive to the ongoing US-China trade disputes, the result of the current round of negotiations could affect the investment market sentiment.

Domestic landlords seeking foreign debt and equity investment should, according to the current legal and regulatory framework, make their corporate and project structures more favorable for incorporating foreign institutional investors at the early stages of the development cycle. This is especially true for those seeking to use Foreign Invested Real Estate Enterprises (FIREEs) to obtain foreign capital.

RMB2.4 trillion

7.6%

By 2018, Shenzhen’s GDP had reached RMB2.4 trillion (USD353 billion) with 2018’s GDP growth at 7.6%, the highest among all Tier 1 cities in China and leading most major cities in the Asia Pacific region.

Alpha –

In 2018, Shenzhen was ranked an Alpha minus city by the Globalization and World Cities Research Network (GaWC) for the first time, alongside San Francisco, Amsterdam and Washington D.C. [Source: www.lboro.ac.uk/gawc/world2018t.html]

Shenzhen has experienced an economic miracle in turning itself from a rural backwater town to a dynamic metropolis with a population of 12.8 million. The Greater Bay Area Plan and a strong economy based on innovation and technology should continue to turn Shenzhen into an international innovation hub, attracting new foreign investment and talent. While Shenzhen’s property market has been dominated by domestic investors, moving forward, with a growing office stock and the development of a long-term residential leasing market, we believe Shenzhen offers more opportunities for international institutional investors.

Summary & Recommendations

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Shenzhen has been undergoing tremendous growth for 40 years and is now recognized as an Alpha city by GaWC. Global companies have leveraged Shenzhen’s manufacturing capabilities and have a growing presence in R&D.

However, Shenzhen’s property market has been dominated by domestic investors and strata-title sales. The depth of Shenzhen’s market for international investors is still lagging behind Shanghai and Beijing.

The development of the GBA and the current liquidity tightening make this a good time for international investors to enter Shenzhen, which is a new gateway city in China.

For domestic developers

Domestic developers looking to obtain foreign funding or to attract foreign investors need to pay attention to the restrictions on the ability of FIREEs to obtain foreign capital.

While it is very rare for foreign funds to invest during the development process, Hong Kong based developers would probably prefer sites for residential development.

Hence, domestic developers should review their corporate structure and make arrangements at the initial stage of land acquisition to facilitate foreign equity or asset acquisition.

For foreign investors

Shenzhen’s real estate market presents both opportunities and challenges. We see great opportunities in the office, business/industrial park, and long-term residential rental markets. However, investors should be aware of the potential legal, policy and market risks.

Compared to Beijing and Shanghai, there are less off-shore deals possibilities in Shenzhen. We believe the situation will change with Shenzhen’s government encouraging long-term holdings by developers and restrictions on strata-title sales. With more foreign institutional investors entering Shenzhen, the depth of liquidity would also increase in the next few years.
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GREATER BAY AREA PLAN TO FACILITATE MORE INVESTMENT IN SHENZHEN

The GBA plan has moved beyond new infrastructure and emphasises greater flows of capital, business and people among GBA cities. As a result, we expect the rising interest to benefit the Shenzhen property market the most, with convenient access to capital in Hong Kong.

In the Colliers Annual Investor Survey 2018, Hong Kong based institutional investors expressed increasing interest in the GBA, about 40% of the survey participants would like to invest in GBA cities in 2019. We believe the completion of two major infrastructure projects in Q3 2018, the Hong Kong-Shenzhen-Guangzhou Express Rail (XRL) and the Hong Kong-Zhuhai-Macau Bridge (HZMB), coupled with the GBA Plan, have increasingly made the GBA a more popular destination for Hong Kong based investors.

However, the survey shows the number one concern for potential investors in the GBA is policy and regulatory uncertainties, and the tightly regulated housing market. A lack of market knowledge and RMB-dominated transactions are also major factors deterring more investment in the GBA.

Shenzhen, Top Of The List

More investors have put Shenzhen on their radar and it is the second most popular city for property investment outside of Hong Kong. Given the 59.2 million sq feet (5.5 million sq meters) of new Grade A office supply scheduled between now and 2022, we expect new investment opportunities to appear, notably in urban renewal projects and the conversion of old industrial zones into new business parks. Shenzhen’s government is promoting the housing rental market, which will likely make this sector a new focus for investment.

In the next five years, we expect Shenzhen to see an increase in the number of active foreign and Hong Kong based investors, as well as an increase in the number of transactions involving foreign investors.
WHY IS SHENZHEN THE RIGHT DESTINATION TO INVEST?

Rapid economic growth momentum to continue

Shenzhen’s strong economy has attracted global attention. In 2018, 120 of the Fortune Global 500 companies were Chinese (source: http://fortune.com/global500/). According to Fortune Global 500, seven of these are headquartered in Shenzhen and account for 13.7% of the total profit generated by these 120 Chinese companies. Further, the Shenzhen Stock Exchange is the home for more than 280 companies with total aggregate assets exceeding RMB21 trillion (USD3.0 trillion). The robust growth and development of Shenzhen’s economy makes it particularly attractive to overseas companies, and Shenzhen’s FDI more than doubled between 2009 and 2018.

The rise of emerging industries to spur future growth

Shenzhen's GDP growth rate was 7.6% in 2018. Emerging industries, a classification coined by the Shenzhen government and comprised of 10 tech-related industrial sectors (including artificial intelligence (AI), internet, and culture & innovation, among other sectors), accounted for about 40% of total GDP; the added value of these industries increased by 11.4% yoy.
SHENZHEN + HONG KONG

The twin engine for the GBA

Shenzhen has China’s most dynamic economy with private companies constituting over 90% of registered businesses. This market dynamic has helped establish Shenzhen as the region’s front runner in globalization, technological innovation and a sustainable economic base.

Shenzhen’s unique city position is bolstered by its synergy with Hong Kong, a global financial center, which helps draw interest from the rest of the world.

As Shenzhen develops its new innovation driven economy, there are more complimentary opportunities with Hong Kong’s finance, professional services, education and healthcare sectors. Both Shenzhen and Hong Kong should further enhance cross-border collaborations, such as Qianhai Free Trade Zone and the upcoming Hong Kong-Shenzhen Innovation Technology Park.

In the 2018 ranking the by the GaWC, Shenzhen was recognized for the first time as an Alpha – level city, alongside cities like San Francisco, Amsterdam and Washington D.C. Future integration between Shenzhen and its neighboring GBA cities should strengthen its attractiveness to foreign institutional investors.

| Key economic indicators, Shenzhen, Hong Kong, and the GBA |
|---------------------------------|----------|----------|----------|
| DEMOGRAPHIC                     | Shenzhen| Hong Kong| GBA      |
| Population growth (2017)        | 4.6%    | 0.8%     | 2.3%     |
| ECONOMIC                        |         |          |          |
| GDP (RMB trillion, 2017)        | 2.24    | 2.15     | 10.22    |
| GDP Growth (%, 2017)            | 8.8%    | 3.8%     | 7.6%     |
| Manufacturing sector growth (%, 2017) | 8.8% | 4.1%     | 6.0%     |
| Services sector growth (%, 2017) | 8.8%    | 5.8%     | 7.8%     |
| Fixed asset investment growth (%, 2017) | 23.8% | 4.1%     | 5.2%     |
| Domestic consumption growth (%, 2017) | 9.1% | 2.9%     | 5.1%     |
| External Trade Value Growth (%, 2017) | 6.4% | 4.7%     | 5.4%     |
| PROPERTY MARKET                 |         |          |          |
| Grade A Office Property Price (RMB per sq m) | 70,094 | 275,428 | NA       |
| Grade A Office Rent (RMB per sq m per month) | 231    | 900      | NA       |
| Grade A Office rent CAGR (2007-2017) | 5.4%   | 2.5%     | NA       |
| Grade A Office gross yield 2017 | 3.9%    | 2.5%     | NA       |

Source: Shenzhen Municipal Statistics Bureau, Hong Kong Census, Colliers International
EXPLORING REAL ESTATE OPPORTUNITIES IN SHENZHEN

Shenzhen property market: Flying under the radar

Compared to Shenzhen’s economic size, its property investment market is relatively small and dominated by domestic investors. In 2017, Shenzhen’s en-bloc real estate investment market was the least active compared with other Tier 1 cities such as Chengdu. This is especially true for the level of participation of overseas capital in en-bloc transactions.

Due to a lack of supply and complicated legacy issues (including collective ownership, land use changes and partial ownership) the market for en-bloc property sales in Shenzhen has been relatively limited. The growth of the en-bloc market has been further suppressed by the traditional approach of developers focusing on strata-title sales in order to realize quick profits.

Further, rapid urbanization and fast capital appreciation have made owners less likely to dispose of property in the absence of compelling price appreciation.

New en-bloc investment opportunities

In 2017, the Shenzhen government announced several new policies, presenting new opportunities for foreign investors interested in en-bloc investment:

- A shift in focus to the residential long-term leasing market created new investment products for investors interested in en-bloc residential condominiums with a minimum five year holding period.

- New requirements in the commercial market for self-occupation, a 10 year holding period, and single ownership have restricted strata-title sales in the secondary market for newly developed office and commercial mixed use projects. We expect the new set of policy would lead to an increase of the supply of en-bloc properties for investment.
EXPLORING REAL ESTATE OPPORTUNITIES IN SHENZHEN

Office Sector

Affected by the US-China trade war, the leasing market of Grade A offices in Shenzhen has decelerated and the full year rental growth was -0.6% in 2018. Looking forward, we expect the most promising submarkets to be:

> Qianhai: Despite Qianhai having the largest new supply in Shenzhen, exceeding 2 million sq meters (21.5 million sq feet), we expect a large portion to be owner occupied, leaving limited new supply available for leasing. As the future CBD of Shenzhen, we expect that rents will continue to increase following the completion of new infrastructure, with yields likely to improve gradually. Investors can also look forward to capital appreciation in the longer term.

> Luohu: As Shenzhen’s oldest office district, Luohu is currently undergoing a large scale urban renewal. For example, the Caiwuwei area has three skyscrapers planned, each having a building height in excess of 600 meters. We expect a large amount of new supply to become available over the next 5-10 years, which should drive the demand for quality office space, as well as rental growth.

Over the next three years, we expect economic growth to spur office demand, pushing the city’s net absorption to an average of 1 million sq meters annually (10.8 million sq feet). By the end of 2018, Grade A stock had increased to 5.79 million sq meters (58.6 million sq feet). From 2018 to 2021, we expect the new supply in Shenzhen to exceed 6 million sq meters (64.6 million sq feet), more than half of which is planned in Qianhai. Although the vacancy rate would temporarily increase to 29% in 2019, the excess stock should be quickly absorbed by the market. We therefore expect office rent to continue to rise steadily at about 5% annually for the next five years.

Selected office transactions in Shenzhen 2018

<table>
<thead>
<tr>
<th>Date</th>
<th>Address</th>
<th>GFA/NFA (sq meter)</th>
<th>Transaction Price (USD)</th>
<th>Unit Price (USD per sq meter)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nov-18</td>
<td>Jinyun Shiji Mansion 10A-10L</td>
<td>19,956</td>
<td>10.8 Million</td>
<td>541</td>
</tr>
<tr>
<td>Jul-18</td>
<td>International Chamber Center</td>
<td>96,858</td>
<td>78.9 Million</td>
<td>814</td>
</tr>
<tr>
<td>Jul-18</td>
<td>Fangda Plaza Phase 1</td>
<td>15,785</td>
<td>20.7 Million</td>
<td>1,311</td>
</tr>
<tr>
<td>Mar-18</td>
<td>Shenzhen Centre Business Bldg</td>
<td>16,898</td>
<td>10.3 Million</td>
<td>611</td>
</tr>
<tr>
<td>Mar-18</td>
<td>International Chamber Center</td>
<td>45,706</td>
<td>41.2 Million</td>
<td>901</td>
</tr>
<tr>
<td>Jan-18</td>
<td>Ziyun Building</td>
<td>20,333</td>
<td>13.4 Million</td>
<td>658</td>
</tr>
</tbody>
</table>
Industrial & Business Parks

Currently, there are more than 200 business parks in Shenzhen, comprising different types of properties including decentralized industrial campuses and Grade A office buildings. The distinction between a business park and office building developments has become less clear. At present, a business park generally refers to properties that are:

> Built within an industrial zone.
> Office space use is focused on R&D activities.

Business park developments have followed Shenzhen’s industrial development policy. Individual parks must target a set of industrial activities and, as a result, have become an aggregation of tenants sharing similar industrial backgrounds, such as AI or the technology, media and telecommunications sectors.

Over the next five years, urban renewal should convert 100 traditional industrial areas and release 6.75 million sq meters (72.6 million sq feet) of new land for emerging industries in the form of business parks. We believe Che Gong Miao in Futian District is one of the most promising submarkets. After the Futian CBD, Che Gong Miao has already achieved rents comparable to nearby Grade A offices. Over the next five years, more than 3 million sq metres (32.2 million sq feet) of top quality new office space is schedule to enter the market from different business parks, focusing on tenants in finance, fintech and business services.

The government imposed restrictions on business park investments, including looking at the backgrounds of tenants and buyers, maintaining strict regulations on future transactions, and limits on future property upgrades to discourage speculation. Hence, we expect the property price will only increase moderately with the gross yield for business parks to be about 5% for the next five years with a steady rental growth potential.
Long-Term Leasing Market - Regulation

Shenzhen’s residential market price has recorded the fastest growth among all Chinese cities in the past five years. To restrain property price growth, on July 31, 2018, the Shenzhen government announced the so-called 731 policy which can be summarized in the following four key points:

> Enterprises are prohibited from purchasing residential properties.
> Any newly purchased condo property, or residential units in a commercial zone, cannot be sold within five years of acquisition.
> Residential properties, whether first-hand or second-hand, cannot be sold within three years of acquisition.
> Newly developed condo properties will have to be operated as leased residential property and no strata-unit sales are allowed.

In 2018, the new policy and strong leasing demand drove the long-term leasing market into high gear. Developers have quickly become the key players in the long-term leasing market. Brokers and residential property management companies, the downstream players in the chain, have also found a way to pitch in. Although this market has just emerged, the participants have already made some aggressive moves to secure their market share.

The new 731 policy specifically stipulates that developers of newly developed condo properties have to retain the ownership and operate as leasing units. The new policy has encouraged an en-bloc holding approach to the newly developed condo properties and further encouraged the transfer of such properties into long term leasing arrangements.

We believe the new policy provides another entry opportunity for foreign investors confident in Shenzhen’s long term growth prospect. Shenzhen should see a strong influx of highly-educated employees who are looking to lease quality properties. Although the market is relatively nascent, we expect the long-term residential leasing market to grow to be one of the most promising markets in Shenzhen.
OVERVIEW OF REAL ESTATE TRANSACTION STRUCTURES IN CHINA

Land vs Developed Property Investment

In general, foreign investment in Chinese real estate can adopt one of two investment approaches:

> acquiring land for commercial or residential development, followed by either the sale or leasing of the developed property; or
> acquiring developed property for the purpose of generating rental income.

The approach of acquiring land for development entails significant risk, with long development periods and onerous regulatory requirements. For this reason, foreign investors with a relatively lower risk appetite generally tend to opt to acquire developed property, which also provides more expedient exposure to the real estate market.

Acquisition of Equity vs Asset

Both the acquisition of land for development and the acquisition of developed property can be structured as either an equity acquisition or an asset acquisition.

An equity acquisition involves acquiring all or part of the equity interests in a vehicle that holds title to a real estate asset, which is referred to as the Target Company. It is therefore the acquisition of an indirect interest in the underlying real estate asset. In contrast, an asset acquisition involves the direct acquisition of title to the real estate asset.

Equity acquisitions tend to be the preferred approach for foreign investors, for a number of reasons. Equity acquisitions are usually more tax efficient and they also minimize the need to transfer or renegotiate approvals, permits and contracts, thereby offering a more streamlined acquisition process. However, one drawback of an equity acquisition is that the foreign investor will also inherit exposure to any hidden liabilities that reside within the Target Company at the time of the acquisition.

Asset acquisitions tend not to be the preferred approach for foreign investors in Chinese real estate, as they may result in significant delays and disruptions to the operation of the target as well as adverse tax treatment. However, there are some advantages of asset acquisitions over equity acquisitions.

One advantage is that an asset acquisition will enable a foreign investor to avoid inheriting liabilities of the Target Company that exist at the acquisition date. Another advantage is that if a foreign investor wants to acquire some but not all of the assets that are held by a Target Company, an asset acquisition will more easily enable the foreign investor to cherry pick the desired assets. In contrast, an equity acquisition would require the foreign investor to acquire all of the assets of the Target Company (including the assets it does not want) unless the Target Company effects a restructure of its asset holdings.
TYPES OF INVESTMENT

Forming or Acquiring an FIREE

Foreign investors cannot directly acquire real estate assets in China (other than for their own use) without establishing a foreign-invested real estate enterprise (FIREE). Cross-border real estate investments, whether by way of asset acquisition or equity acquisition, can be structured in a number of ways including the following.

> A foreign investor can form a new wholly-foreign-owned enterprise (WFOE) or a joint venture (JV) with a local partner (often, a local partner that has existing real estate assets or projects) in China for the purpose of developing or acquiring and operating a single real estate project. In either case, the WFOE or the JV needs to be approved as a FIREE, subject to certain regulatory restrictions.

> A foreign investor can directly acquire all or part of the equity interest in an existing real estate project company. If the real estate project company does not already have foreign investment, then approval as a FIREE is necessary. If the target company is already a FIREE, the change of foreign investor identity must be registered. It may be possible for the acquisition to be structured offshore, which will minimize Chinese filing and approval requirements.

> A foreign investor can form an investment management WFOE to act as the general partner of a qualified foreign limited partnership (QFLP) which must be approved as a FIREE. QFLPs can be established in certain designated areas in accordance with the local QFLP pilot policies for the purpose of making equity investments in real estate project companies. Although real estate investment is banned under local policies in many of the areas with QFLP pilot policies, using a QFLP will enable an acquirer to make equity investments in real estate project companies. The limited partners of a QFLP may be foreign investors or domestic investors.

Approval of an FIREE or of a foreign-funded real estate investment may take between one and a half to three months and involves filings with a number of regulatory authorities including local delegates of the Ministry of Commerce (MOFCOM), the State Administration of Market Regulation (SAMR) and the State Administration of Foreign Exchange (SAFE).

On/Off-shore Financing Arrangement

FIREEs are subject to significant limitations and controls on foreign debt, and FIREEs that were established after 1 June 2007 are no longer permitted to borrow foreign debt.

The maximum amount of foreign debt funding that a FIREE established before 1 June 2007 is permitted to incur is the difference between its registered capital and the approved total investment amount. The ability of a FIREE to incur such foreign debt funding is conditional upon the satisfaction of certain conditions, including the FIREE having obtained the land use certificate(s) for the relevant real estate project and having secured funding equal to at least 35% of the total project investment amount specified in the FIREE’s approval.

All foreign debt is subject to National Development and Reform Commission (NDRC) filing and SAFE registration requirements. Foreign debt may only be used for certain specified purposes, which do not include funding working capital or project investment.

Due to the significant constraints on FIREEs obtaining foreign debt, many FIREEs structured as WFOEs choose to procure foreign funding offshore, as Chinese regulatory restrictions do not generally apply to the borrowing activities of the offshore parent company. This usually involves an offshore lender providing funding to the offshore parent company, which funding is then injected into the WFOE as an equity investment.

Typically, the offshore lender is granted a security interest over the offshore assets of the offshore parent. Any security that is granted by a WFOE (including the equity interest in the WFOE), whether as collateral for offshore funding that is obtained by the offshore parent or as collateral for foreign debt that is obtained by the WFOE directly, is subject to certain filing obligations, including an obligation to file the loan documents with SAFE.
**Example One: Equity Investment Structure**

A China-based developer owned 100% of several real estate assets in China. The developer had the opportunity to acquire several additional real estate assets in China, but it did not have sufficient available capital to execute further investments and experienced difficulty in securing debt financing in China, so the developer sought an equity investment from an offshore partner to enable expansion of the investment portfolio.

The developer formed a JV co-investment platform with an offshore real estate fund. The structure chart depicts the final structure of the JV co-investment platform.

Forming the JV co-investment platform involved:

- Forming an offshore JV entity to act as the holding company for all real estate assets acquired by the platform. The offshore real estate fund held a majority shareholding in the JV holding company while the developer held a minority shareholding.
- Prior to the JV transaction, the real estate assets owned by the developer were held through WFOEs. The parent of each WFOE was a Hong Kong incorporated holding company. To form the JV co-investment platform, title to each of the Hong Kong holding companies was transferred to the JV holding company, giving the offshore real estate fund an indirect majority ownership interest in all of the assets held by the JV holding company.
- An existing onshore entity controlled by the developer was appointed by the JV holding company to act as the property and development manager of each of the real estate assets owned by the JV holding company. In return for providing property and development management services, the manager was paid a management fee by the JV holding company.
- The developer and the real estate fund each agreed to make additional capital contributions to the JV holding company as required for the purpose of acquiring additional real estate assets. All real estate assets acquired in the future will also be held by JV holding company utilizing the existing structure.

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**Cross-border equity investment structure**

<table>
<thead>
<tr>
<th>Offshore</th>
<th>Onshore</th>
</tr>
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<tbody>
<tr>
<td>1. <strong>JV Holding Company</strong></td>
<td>2. <strong>Future HK Holdco</strong></td>
</tr>
<tr>
<td>HK Holdco</td>
<td>HK Holdco</td>
</tr>
<tr>
<td>FIREE (WFOE)</td>
<td>FIREE (WFOE)</td>
</tr>
<tr>
<td>Future FIREE (WFOE)</td>
<td>Future Property</td>
</tr>
</tbody>
</table>

1. A Property and Development Management Agreement is executed between JV holding company and onshore manager. The onshore manager provides property and development management services to each property owned by the JV holding company in return for a management fee.
2. The JV holding company can acquire additional real estate assets in the future, utilising the existing structure.

Source: Sidley Austin
Example Two: Offshore Debt Funding Structure

A developer needed debt funding for a development asset in China. The development asset was held by a WFOE with the offshore parent company being a Hong Kong company. The parent of the Hong Kong company was a Cayman Islands company, which was controlled by the developer.

An offshore debt fund agreed to provide offshore mezzanine financing to finance development of the development asset.

The debt fund subscribed for convertible debt securities issued by the Cayman holding company. The subscription proceeds received by the Cayman holding company from the issue of convertible debt securities were injected into the Hong Kong holding company as an equity investment and then injected by the Hong Kong holding into the WFOE as an equity investment.

The convertible debt securities entitled the debt fund to receive a semi-annual coupon and also entitled the debt fund to convert the debt securities into ordinary shares of the Cayman holding company in certain circumstances.

The assets of both the Cayman holding company and the Hong Kong holding company (including the equity interest held by the Hong Kong company in the WFOE) were provided as collateral to secure the payment obligations attached to the convertible debt securities.

As this funding structure is wholly offshore, no regulatory filings are required in China other than registration with the local SAMR of the pledge over the equity interest in the WFOE. If the assets of the WFOE were provided as security, additional filing obligations would be triggered including an obligation to file the transaction documents with SAFE.

Source: Sidley Austin
KEY ISSUES FOR DOMESTIC DEVELOPERS

Domestic developers wanting foreign debt funding or foreign equity investors should pay particular attention to the following key issues.

> Only FIREEs established prior to 1 June 2007 may obtain foreign debt. The ability of FIREEs to obtain foreign debt is subject to significant constraints, including the maximum amount of debt funding that may be obtained and the purpose for which foreign debt funding may be used.

> Chinese regulatory restrictions on the ability of FIREEs to obtain foreign debt funding do not apply to the offshore parent or shareholder of a FIREE. Many FIREEs choose to procure foreign debt funding offshore.

> Offshore lenders will look to take all security that is available offshore and onshore, to the extent permitted by applicable law. Onshore, this would typically be restricted to security over shares. Offshore, the lender would expect to take security over all shares as well as fixed and floating assets held by the offshore entities, including the equity interest in the WFOE.

> In order for a real estate project to be open to foreign equity investment, there must be a single real estate development company holding the land use rights for that project which can become a FIREE. A FIREE cannot hold multiple real estate projects, nor can a FIREE be an investment company or holding company only.

> If a wholly domestic real estate company receives any foreign equity investment (including transfer of existing equity interests from a domestic shareholder to a foreign person), the domestic developer will be converted into a FIREE and will be subject to the various filings mentioned on page 11.

> The foreign investor in a FIREE must not be ultimately controlled by a Chinese company or individual. This means that if a JV entity is established offshore to act as the foreign investor in a FIREE, the controlling interests in the JV entity must not be held by Chinese persons and companies.

> When a foreign investor acquires equity interests in a FIREE, the consideration payable in connection with that acquisition must be paid by in full within three months of the acquisition occurring. This time limit for payment by foreign investors applies whether the Chinese company issuer of the equity interests has already been approved as an existing FIREE or will be converted into a FIREE as a result of the foreign investor’s acquisition.

> Foreign currency contributed to the registered capital of a FIREE by a foreign investor cannot be converted into RMB and used for the purpose of further equity acquisitions, unless the FIREE is a qualified foreign limited partnership or has “equity investments” within its business scope.
RISKS AND LIMITATIONS OF EN-BLOC ACQUISITION IN SHENZHEN

Legal Risk

Cross-border en-bloc investment in Shenzhen is subject to legal risks, including the following:

- A number of regulatory filings and approvals are required to establish a FIREE (including from MOFCOM, SAMR, NDRC and SAFE) and the approval of SAFE is required for the repatriation of capital to offshore investors.

- The ability of FIREEs to obtain foreign funding is currently subject to significant constraints which limit the maximum amount of funding that may be obtained, the purposes for which foreign funding may be used and the duration of foreign funding.

- For FIREEs engaged in real estate development, certain conditions must be fulfilled before pre-sales can commence and pre-sales proceeds may only be used to finance the related development – not for other purposes.

- For FIREEs that pursue asset acquisitions, certain conditions need to be satisfied as a prerequisite. The conditions to be satisfied will vary depending on the progress of development at the time of acquisition. FIREEs pursuing development strategies may be subject to significant penalties if requirements (such as development within a prescribed period) are not satisfied.

- The legal system in the China has inherent uncertainties and is subject to regular policy change. These may limit the protection available to investors and may significantly impair the ability of FIREEs to obtain and deploy, and to subsequently repatriate, capital.

- Implementation of the Enterprise Income Tax Law in China and various government circulars may significantly increase the tax exposure of FIREEs.

Policy Risk

Shenzhen is a policy oriented development (POD) city with a focus on industrial development. The tremendous economic opportunities and population influx has driven the real estate price to be one of the least affordable in China.

Currently the overheated market is in check thanks to the recently released policies and regulations to restrain prices and exercise control over financing. However, as the global and domestic economies shift, there is every chance that the government may consider it necessary to implement new policies, which may create disadvantages in the interests and opportunities for overseas investors.

Market Risk

The trade war between China and the United States has brought uncertainty to the demand side of the Shenzhen market, especially for the office sector.

Manufacturing based technology is a key component of Shenzhen’s economy, a majority of which falls into the black list and could face additional tariffs from the US if a US-China trade agreement cannot be reached.

Many local companies have responded by delaying expansion plans until there is more clarity on how the situation evolves. Others have started to prioritise flexible workspaces over fixed leases due to the inherent uncertainty in the current economic and regulatory environment.

We have also observed an outflow of companies from the Futian CBD in H2 2018. Finance companies are starting to take space in Nanshan, the traditional tech center with an average savings of 22% on rents. Tech companies are moving to Bao’an district, an emerging location where rents are up to 15% lower than the market average.
Colliers International Group Inc.

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