Advances in Economics, Business and Management Research, volume 203
Proceedings of the 2021 3rd International Conference on Economic Management and Cultural Industry (ICEMCI 2021)

Analysis of China's REITs Factors and Development Suggestions

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ABSTRACT
Recently, China has launched an infrastructure sector of real estate investment trusts (REITs) pilot related work in developed areas of China. China has great potential in REITs in terms of future market size. This paper aims to explore the limited factors for China to develop REITs by focusing on internal flaws and external obstacle. This paper also lists some recommendations for the development of REITs in China in terms of formulation of relevant regulatory, the introduction of qualified foreign REITs to operate in China, tax incentives and government support. China's REITs have internal and external flaws to overcome. Once achieved, REITs could help local governments to optimize capital structure lower financial leverage.

Keywords: *REITs, Real estate, Investments, Trusts, Securities, China*

1. INTRODUCTION

In 2020, NDRC and CSRC joint release the circular on promoting the infrastructure sector of real estate investment trusts (REITs) pilot related work. China aims to introduce new capital into infrastructure projects and revitalize the market. A study believes that by 2018 theoretical value of China's REITs market is around 1.9-2.6 trillion yuan and eventually there could be 60-90 REITs products, therefore, China's future REITs market is likely to exceed Japan and become the world's second largest REITs market preceded only by the United States[8]. According to a report generated by the Guanghua school of management of Peking University, the potential size of China's standardized public REITS market should be between 4 trillion and 12 trillion yuan[1]. These research show that China has a huge potential market for REITs. If REITs have successfully launched in China, it is beneficial for the infrastructure projects to expand financing channels and investors could gain profit from the wave of China's infrastructure construction. Due to years of infrastructure construction, local governments' financial leverage has reached a significant level. REITs allow governments to follow the market principles and adhere to the equity orientation and break the situation of debt financing as the main source of financing activities[9]. At present, China's infrastructure construction has entered the era of stock, a huge real estate market. From 2015 to 2016, due to the diversification of local government borrowing, the growth rate of infrastructure investment was maintained at a high level. However, in 2017, with the launch of financial de-leverage work, the growth rate of infrastructure investment A sharp drop. The year-on-year growth rate in 2018 was 1.79%, and the year-on-year growth rate in 2019 was 3.33%[9]. The funding sources of infrastructure become insufficient. Therefore, China seeks for private capital to stimulate next around of infrastructure construction. This thesis aims to introduce China's REITs Factors and development suggestions in the light of the development and characteristics of China's REITs, internal restriction, external restriction, and recommendations. This thesis helps to understand the current research about China's REITs and analyse existing problems. It also provides recommendations for further development.

2. OVERVIEW

2.1 Current development of China's REITs

This paragraph will briefly introduce some related background of China's REITs. China's asset securitization market started in 2005, and it is still in its infancy. Securitization projects mainly focus on industrial securities rather than real estate assets. The

People's Bank of China issued Circular 121 on 13 June 2003 which impose stricter regulatory on issuing bank loan to real estate activities[6]. Due to stricter control on a commercial bank loan for the real estate industry. Developers tend to find alternative financing sources to support their business and Real estate trust companies become emerge in China. A study conducted by Guanghua School of Management of Peking University shows that China has issued REIT-like products that are functionally similar to standard REITs in mature markets have been launched as an alternative financing source[2]. In 2017, the cumulative rate of return of the domestic "REITs" product market has increased by more than 40 billion of which the self-owned transaction volume that occurred in 2016 exceeded 17.4 billion[2].

2.2 Characteristics of China's REITs with comparison.

This part will discuss the characteristics of China's REITs with comparison. REITs (Real Estate Investment Trusts) is a form of companies, trusts and other organizations that issued beneficiary certificates from the market to raise funds, the funds invest primarily in real estate and related fields, and in accordance with the proportion of investment income allocated to the holders of the Trust Fund voucher. First, depending on whether the transaction certificate is issued by publicly traded, REITs can be divided into the public offering and private REITs. Second, according to the different organizational forms of REITs, REITs can be divided into company type and contract type. Corporate REITs use companies as the carrier of REITs, and their shares are reflected in stocks. Most of the REITs in the US market are corporate REITs. Asian markets (such as Singapore and Hong Kong) are mainly contract REITs. Contract REITs, trust, or contractual plan funds as REITs carrier, as reflected in its share of the trust beneficiary certificates or fund units[4]. Third, according to whether they hold the property rights of the target property, REITs are divided into equity REITs and mortgage REITs. Equity REITs can be divided into partial equity REITs and partial debt REITs. Partial debt REITs have a priority right to buy-back, the whole architecture is more inclined to temporarily transferring ownership of debt financing instruments. However, the trading structure design of partial equity REITs is biased towards long-term investment in the underlying property rights[4]. Therefore, the return of partial debt REITs is similar to a fixed return in a short-term period, while the return of partial equity REITs is fluctuant which depends on the performance of long-term as shares. Also, partial debt REITs have priority Investors who have the priority to be paid back. A research mentioned that in the European and American markets there is no differentiate between partial debt REITs or partial equity REITs while in China REITs are divided into partial debt or partial equity due to REITs in China apply mechanically the structure of ABS (Asset Backed Securitization)[4].

3. RESTRICTION ON DEVELOPMENT OF CHINA'S REITS

3.1 Internal flaws of China's REITs

This paragraph will discuss the internal flaws of China's REITs. These REIT-like products have several flaws which restrict its development. First, as mentioned above China's REITs are REIT-like products based on ABS, therefore, most REITs products are contract REITs not corporate REITs. Thus, it is hard to expand the scale. It suggests that corporate REITs could expand its scale through acquired new assets while contract REITs is hard to enlarge its scale because the special asset management plan cannot directly acquire the equity of the property company[4]. Hence, the current contract-based issuance scale of REITs-like products is generally fixed. Second, from the view of financing, China's REITs are private, which means relatively high barriers to entry for investors. It argues that the public offering attribute of the capital market is the basic means for the capital market to release liquidity and greatly reduce the cost of investment and financing[4], however, privately raised REITs cannot fully reflect the attribute of releasing liquidity. Third, Because of the structure is developed from ABS, it has a priority and secondary hierarchical pay back and repurchase structure. This type of REITs-like product is equivalent to a debt product and is quite different from standard REITs. As a result, it is more inclined to fixed-income financing tools. The return is mainly realized through rental income and asset appreciation, rather than real standard REITs[4]. This paragraph demonstrates three internal flaws of current China's REITs in terms of issuance scale, investors' barrier, and source of income.

3.2 External obstacles of China's REITs

This part would discuss some external obstacles of China's REITs development. First, in China, there is no regulatory or legislation related to REITs. The vacancy of legal protection increases the potential risk with investors. White Paper on the Development of Public REITs in China illustrates that at the current stage, there is still no unified regulation for the issued REITs products in terms of the investment period, investment scope, income sources, responsibility restrictions, information disclosure, related transactions, distribution methods, etc[2]. A study believed that if legislation is not sound, the legal title of acquired properties cannot be ensured. If the seller disappears or does not cooperate after receiving the price, the investor may face huge obstacles in obtaining the property ownership certificate. Also, the vendor may use the purchase price for other purposes, instead of releasing the

mortgages[6]. Therefore, the legal barrier is very high in China because of the lack of regulatory or legislations. Second, although REITs as a mature product has existed in the financial market for decades, it is unfamiliar to Chinese investors. At the current stage, Chinese investors mainly invest in real estate industrial by purchasing housing property, the entry is very high. Also, China's real estate market still grows at a relatively high rate in major cities. Citizens may not understand the concept of REITs and lack awareness. A research mentions two factors that restrict the development of China's REITs that the main way for domestic individuals to invest in real estate is to purchase real estate, and it is mainly residential; while the proportion of product-type real estate such as retail, office, and hotel, etc. is low, therefore, the incentive for ownership transfer is low. In addition, the sale and rental ratio in China is significantly lower than the international standards, which limits the development of China's REITs[4]. These two factors demonstrate a major issue that the domestic market generally does not has an accurate perception about the function and nature of REITs which is the second external obstacle for China's REITs development. Third, at present, China lacks professional institutions to manage assets and raise funds. A study explains that the development of REITs needs a skilled pool of professional fund and asset management expertise. It recommends that allow foreign REITs to operate in mainland China could facilitate the knowledge transfer[6]. Thus, these knowledges from a mature market could be learned to develop China's path. The White Paper on the Development of Public REITs in China also mentions the development of China's real estate grows rapidly, however, the related financial development is relatively lagging[2]. China urgently needs professional knowledge and expertise to frame China's own REITs regulatory which suit for Chinese national conditions. Forth, in terms of income tax, the current domestic tax policy requires that trust assets be taxed during the establishment and termination of trusts, and corporate income tax must be paid during the existence of the trust, and the beneficiary must pay personal income tax on the distributed trust income. There is a problem of double taxation[4]. The cost of REITs is still high in China, due to double taxation issues. Eventually, it would harm the development of REITs in China.

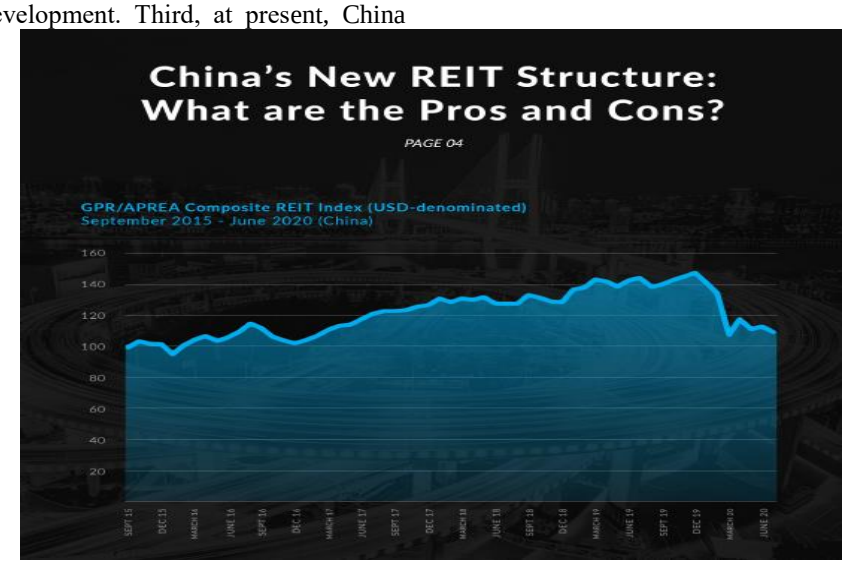

Figure 1 China's new REIT Structure

4. RECOMMENDATIONS FOR DEVELOPMENT OF CHINA'S REITS

This paragraph mainly focuses on recommendations for the development of China's REITs. First, the government should complete the formulation of relevant regulations to protect the rights and interests of related parties and stipulate their obligations to minimize the risk due to legal flaws. It argues that government should declare the development of REITs qualification requirements, procedures, management, rights and obligations, dividends, and other income[5]. Additionally, the government needs to accelerate the introduction of third-party assessment and establish an independent agency to oversee the compliance of running the fund company. Also, a clear information disclosure system is of urgent need. Second, the introduction of qualified foreign REITs to operate in China at an early stage aims to facilitate knowledge transfer to serve the development of Chinese REITs. It states that knowledge transfer and foreign expertise contribute to building a domestic talent pool for long-term development of China's REITs in terms of legislation and emerging institutions[6]. Third, tax incentives could attract more institutional investors to invest in the REITs market. The priority is solving the double taxation problem. A study recommends that China could exempt part of the income from dividends from corporate income tax when introducing and

developing the REITs market simultaneously and apply preferential taxation settings on business tax, lease tax, stamp tax, etc[5]. Last, Government support plays an important part in the development of REITs in Asia. For example, The Singapore REITs is supported by active regulatory intervention from Singapore government [3]. In Japan, the Bank of Japan is the major buyer of J-REITs to support J-REITs[7]. Thus, in a successful REITs market, government support has a significant influence on success.

5. CONCLUSION

In conclusion, the first part of the main body starts with the current development of China's REITs. Then it demonstrates the characteristic of current China's REITs with comparison. China's REITs is a REITs-like product not standard REITs with fixed dividends and short payback period mainly based on the structure of ABS. The second part examines its internal flaws such as difficultly to expand its scale after being listed, high barrier for investors, and limited source of income. The third part discusses the external actors which discourage the development of China's REITs in terms of lack of regulatory and legislation, unfamiliar market, lack of professional management experience and institutions and double taxation issue. The last part state some recommendations by focusing on relevant regulatory, the introduction of qualified foreign REITs to operate in China, tax incentives and government support. As the first paragraph shows China has a huge potential REITs market. The development of REITs could help local governments to optimize capital structure lower financial leverage. Also, standard REITs help to minimize the investor's barriers and utilize private capital to support infrastructure. Overall, development of REITs is beneficial to society. However, China still has a long road to go.

ACKNOWLEDGMENT

Firstly, I would like to show my deepest gratitude to my teachers and professors who have provided me with valuable guidance in every stage of the writing of this thesis. Also, I want to thank the company which offered me an internship. The internship inspires and taught me a lot. Further, I would like to thank all my friends and parents for their encouragement and support. I could not have completed my thesis without all their enlightening instruction and impressive kindness.

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