NEWS

EQUITY/SYNDICATED LOANS/DOMESTIC BONDS

Why the PRC property sector is tanking – the legal view

While PRC officials are shutting down funding channels to China's property sector, authorities have been slowly throttling the sector with a load of new regulations and laws.

The sheer volume of rules governing this sector spins the head. Regulators and lawmakers are adding new rules every quarter and these – combined with a global downturn in investor sentiment to assets of all variety – read like a litany of damnation for PRC property.

Chinese banks, which traditionally provide the bulk of property financing, are working against a 22-year-high bank reserve requirement and explicit restrictions on lending to property companies.

Regulations tightening mortgage lending are depressing demand and driving down property prices, while mandatory land auction laws are driving up land prices.

The sector is so cash-strapped that China property can only expect to see a wave of bankruptcies and forced consolidations in 2008. Meanwhile, domestic property IPO applicants have lost favour with China Securities Regulatory Commission (CSRC), and the red-chip listing moratorium remains in force. These companies have little recourse to equity markets.

Foreign capital repelled

In the past few years, Chinese property has drawn investors looking to cash in on a market previously viewed as having only one direction: up.

Property prices in Shanghai, Beijing and Shenzhen have skyrocketed, with domestic and foreign funds pouring cash into the sector.

The IPO boom minted instant property billionaires. Property companies embarked on a land grab while individual investors borrowed against overpriced property to finance their own acquisitions. The China property market, in other words, has been firmly in bubble territory for some time now.

Chinese regulators have responded by quelling the inflow of offshore money.

It has never been easy for PRC firms to raise overseas loans. To obtain such a loan, a domestic company usually has to be a foreign-invested company (FIE). Alternately, it could convert itself into an FIE by arranging for an offshore holding company to hold itself.

Funds raised overseas can easily be injected into the offshore holding company, which in turn can inject such funds into the FIE by way of equity contributions or shareholder loans.

However, Chinese law prescribes the amount of leverage that can be achieved in an FIE by imposing a debt-to-equity ratio. For example, it caps total overseas loans at the difference between the approved total investment and the registered capital of an FIE.

Meanwhile, China's capital controls make it difficult for overseas lenders to gain access to domestic collateral, significantly cutting the funding leverage that an FIE is able to secure.

As a result, much of the security for overseas loans has to be held offshore. This can be achieved, for example, by arranging for the shareholders of the offshore holding company to pledge their equity interest in the offshore holding company against the loan.

However, this is an indirect pledge. Borrowers can only offer as security its shares in the FIE, not the assets themselves.

> "The CSRC said it would scrutinise whether each IPO applicant had complied with all policies, for example, that it reserved at least 70% of the land for low-rent units, as stipulated by the state's land usage rules. The idea that China's league of ultra-aggressive, high-growth property developers would turn themselves into suppliers of subsidised housing borders on the absurd – the CSRC announcement was essentially a message of get-lost to the developers."

An FIE is normally not allowed to provide upstream security for its offshore holding company. Even if such security is somehow approved by local authorities, who (arguably, illegally) chose not to enforce relevant laws, the maximum debt that an FIE is allowed to secure is the lesser of 50% of its net assets and of its foreign exchange income in the preceding year.

A negative pledge on the FIE subsidiary might be helpful, but this cannot meet liabilities that spring from contract damages, tort liabilities, environmental liabilities, et cetera.

It is even more difficult for property companies to raise overseas loans due to new laws that deter such borrowing.

In 2006, Regulation 171 was enacted, capping cross-border loans at 50% of the approved investment for most Chinese property companies (that is, property companies whose total investment is not less than US$10m).

To make matters more difficult, offshore loans are not allowed for all property companies set up after June 1 2007 (the so-called no-overseas-loan rule, under another new law: Regulation 130).

Regulation 130 further bars all property companies from remitting the proceeds of overseas loans into China if such companies have not registered with the Ministry of Commerce before that June 1 2007 deadline. This is referred to as the no-overseas-loan-repatriation rule.

Such a registration, on which the ministry has absolute discretion, is by no means straightforward. Only a handful of property companies have achieved the feat.

The no-overseas-loan rule and the no-overseas-loan-repatriation rule have both significantly compressed foreign investors' returns in the property sector.

Debt funding is usually cheaper than equity as interest payments to the lenders are tax deductible while dividend payments are not.

Furthermore, repatriating dividends out of China is capped at profits that the companies have made, while repatriating payment on loans out of China is not

subject to such restrictions.

That being said, the borrowers have to get around a Chinese law that caps their returns at the average market interest rate.

To avoid such a restriction, some PE firms have taken the creative step of converting loans into equity with a put option. By adopting this approach, an offshore SPV can make equity contributions to an FIE subsidiary.

The put option is exercisable at the end of the loan term, at which time the domestic partners will redeem the instrument at a pre-set level. Usually this translates into returns that are much higher than the average interest rates allowed under Chinese law.

The arrangement is not without risk. Exercise of the put requires approval from the Ministry of Commerce, and the ministry is not always forthcoming.

In addition, should the funds be used for property development, the no-overseas-loan rule, no-overseas-loan-repatriation rule and no-new-overseas-equity-repatriation rule (to be discussed) would also apply.

In parallel with the clampdown on foreign capital, a series of laws have tightened domestic credit.

Chinese banks are prohibited from lending to property companies before the shareholders have contributed at least 35% of the total project investment and obtained four crucial permits. These are permits relating to the land use rights, zoning, project and the construction (read: Regulation 359). Obtaining the four permits is expensive and time-consuming.

Regulation 359 has also raised the minimum mortgage deposit for the buyers buying a second property to 40% of the purchase price.

Furthermore, to cut the available money that banks can lend, Chinese banks' reserve ratio has been raised to a historic high of 15.5%.

No, no, no

Meanwhile, on the IPO front, the moratorium on red-chip listings is shutting another door for capital raising by mainland property firms.

Red-chips are mainland companies that have injected their assets into an offshore SPV, and subsequently listed this offshore.

Hong Kong red-chip IPOs were on a blistering pace prior to the enactment of regulations on round-trip investment and cross-border M&As (the round-trip rules and the M&A rules, respectively), which shut down this market.

These rules placed three nearly insurmountable approval hurdles in the path of red-chip listing aspirants. The entities need permission from the Ministry of Commerce to inject domestic assets into an offshore SPV, CSRC approval to go to IPO, and, finally, registration with the foreign exchange authorities.

A red-chip listing is no longer viable for property companies that did not get these approvals prior to the enactment of the round-trip rules and the M&A rules, in 2005 and 2006 respectively.

Even if property companies were to get their red-chip approvals, they would encounter problems placing their listing proceeds into China.

Regulation 130 prohibits new equity contributed by foreign investors into property companies (for example, red-chip listing proceeds) from being repatriated into China if such property companies had not registered themselves with Ministry of Commerce prior to 1 June 2007 (the no-new-overseas-equity-repatriation rule).

Elsewhere, Regulation 171 bans foreign investors from acquiring property in China without setting up an onshore vehicle, significantly increasing foreign investors' tax and operating costs.

When an onshore vehicle is set up by a foreign investor, the foreign investor must reckon with China's 25% corporate income tax (applicable where an onshore vehicle is involved, a significant premium compared to the 10% withholding tax that is applicable where only an offshore vehicle is involved).

Foreign investors, meanwhile, are only allowed to set up onshore property companies if they are able to clear two daunting bars imposed under Regulation 171 and Regulation 130: obtaining the land-use rights and completing registration with the Ministry of Commerce.

The former involves winning a land auction and paying the full amount for land. Investors, in other words, must commit to this funding before they get approval for their onshore vehicle (and thus the means to manage their investment).

IPOs falter

China's domestic IPO boom has channelled a substantial amount of capital into the property sector, triggering a CSRC halt on new listings.

That ban was lifted on March 20 but only on the proviso that the listcos would not raise money to "hoard" land.

The CSRC said it would scrutinise whether each IPO applicant had complied with all policies, for example, that it reserved at least 70% of the land for low-rent units, as stipulated by the state's land usage rules.

The idea that China's league of ultra-aggressive, high-growth property developers would turn themselves into suppliers of subsidised housing borders on the absurd – the CSRC announcement was essentially a message of get-lost to the developers.

The provision of funds by the pre-sale of property – such as the advance sale of property before it is completed, which accounts for as much as 40% of developers' income – is dramatically dwindling.

Property transactions have been dropping and are expected to continue sliding, forcing developers to axe unit prices to clear units (triggering a vicious cycle of competitive price cutting).

Plummeting transaction volumes has created loads of trouble for the country's property brokers: One of China's largest real estate agencies – with over 1,800 outlets – has closed 800 outlets since November 2007 and has shed almost two-thirds of its 20,000 workforce.

The management of another broker company staffed with around 2,000 employees, facing bankruptcy, absconded with funds from the escrow accounts the company supervised.

Elsewhere property companies are facing new laws regulating the land market.

The laws state that all land to be used for property development must be publicly auctioned for sale in accordance with the land auction rules, significantly pushing up land prices.

The land usage rules deter developers from sitting on idle land (which regulators see as a sign of land hoarding). Any land that is undeveloped for more than one year from the date of its acquisition will be levied with an "idle land charge" of 20% of the land price.

Any land that remains undeveloped for more than two years from the date of its acquisition will be confiscated by the government. Meanwhile, value-added tax on land, which has been suspended for more than a decade, has been reinstated.

This burst of new laws and regulations have obliterated developers' profit model of hoarding land, developing at a breakneck pace, and unloading units into a climate of ever-risking prices.

This market is buckling. Financial forces are working against PRC real estate, and the thicket of mainland regulations governing the developers are eliminating whatever vitality remains.

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