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Real Estate Investment under China's New Land Use Laws: Best Practices in Mitigating Investment Risk

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Putting the Requirements Together: Deal Structuring Considerations

- “Green fields” projects involve acquiring land use rights directly from the government and as such, demand considerable government relations capabilities because the prospective developer will spend time negotiating with local authorities to craft an auction bid likely to favor the developer’s strengths.
- Developers not willing or able to take on these challenges, will instead acquire a project after a local developer has first gone through the auction process and has rights in an ‘entitled’ project to sell.

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Putting the Requirements Together: Deal Structuring Considerations

- However, the seller will not typically sell the land use rights. Rather, most real property acquisitions are structured as corporate M&A transactions.
- Why is this? Transfers of real property require payment of the following taxes:
  - Seller's tax liabilities
    - 5% Business Tax on gain derived from transfer of real property, or 5% Business Tax on gross income derived from transfer of real property;

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- 25% Corporate Income Tax on gain derived from transfer of real property;
- 30% to 60% Land Value Added Tax on taxable gain derived from the transfer of real property;
- 0.05% Stamp Duty on the transfer price.

– Buyer's tax liabilities

- 0.05% Stamp Duty on the transfer price;
- 3% to 5% Deed Tax on the transfer price.

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- Therefore, foreign investors wishing to acquire a project will typically want to structure it as an acquisition of equity in the company owning the LUR.
- This requires considering how the rules applicable to foreign M&A will impact the proposed acquisition.
- Notwithstanding the fact that a project is entitled, the specter of dealing with government relations cannot be entirely avoided, because as will be discussed below, various agencies will have a say in the M&A process.

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Deal Structuring Considerations

- **Synthesizing various requirements:**
  - The "**Regulations on Merger and Acquisition of Domestic Enterprises by Foreign Investors**" (the "M&A Regulations") apply to mergers by foreign investors and domestic companies and require approval by **Ministry of Commerce** counterparts.
  - The "**Interim Measures for the Administration of Examination and Approving Foreign Investment Projects**" (aka "Order 22") state that **National Development & Reform Commission** approval is required for projects in the restricted sector as specified by the Catalogue of Industries Guiding Foreign Investment (real estate is so specified) or where certain dollar thresholds are met.

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Deal Structuring Considerations

- **Order 22 - NDRC Approval (cont.):**
  - For example, Beijing NDRC is responsible for approving real estate projects in the restricted category with total investment less than US$50,000,000.
  - If the project involves real estate investment activity in the restricted category in Beijing and the total investment size is US$50,000,000 or more, then the project must be examined and approved by the national-level NDRC and also reported to the State Council for verification.

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Deal Structuring Considerations

- **Synthesizing requirements – location matters!**
  - MOFCOM: Under the M&A regulations whether provincial-level COFCOM agency approval is sufficient or national MOFCOM approval is needed is determined by the size of the investment and whether it is in a restricted sector. Each locality uses a different basis for assessing the relevant cut-off points, so you need to check with the COFCOM where the target project is located to see what they are. For example, Shanghai COFCOM refers to the levels specified in Order 22 (even though Order 22 applies to NDRC action, not MOFCOM action). In Shanghai, if investment is in the encouraged or allowed category, COFCOM approval is sufficient if total investment is below $100,000,000.
  - However, Circular 50 requires that if a foreign-invested real estate development company will be established (which would be the result of the acquisition), then reporting by COFCOM to MOFCOM is required.

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Deal Structuring Considerations

- **Synthesizing various requirements – Standard of Review:**
  - The "Circular regarding Market Access and Administration of Foreign Investment in Real Estate Market" promulgated in July 2006 (the "Circular") states MOFCOM is supposed to conduct a "**strict review**" of an acquisition transaction by a foreign investor.
  - Approval will generally depend on the following factors:
    - Whether the Chinese company is fully in compliance with law, e.g., whether the company has timely paid land use right fees;
    - The reputation and capital sufficiency of the foreign investor, e.g. the foreign company must prove that it has enough money to fund the project and it has no bad record in China;
    - The scale and importance of the project;
    - The nature of the project, e.g., commercial, residential, etc. (generally residential projects are less likely to be approved).

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Deal Structuring Considerations

- Additional M&A-related constraints:
  - **Appraisal -** Under the M&A Regulations, the parties must retain a qualified appraisal institution to appraise the shares proposed to be transferred and that the purchase price should not be unreasonably lower than the appraised value of the shares.
  - **Registered Capital –** the level of registered capital will likely need to be increased to exceed 50% of the total investment, as required under Circular 171.
  - **Payment –** The M&A regulations also provide that the purchase price must be paid in a lump sum within 3 months after the new business license for the target company (which will be converted to a Sino-foreign JV as a result of the acquisition) is issued.

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Which Agencies are Relevant?

- If a transaction involves an acquisition of equity in a real estate development company, then the relevant agencies are:
  - **Provincial-level DRC** if total investment is less than US$50 million; **or**
  - **National-level DRC** if over US$50 million; **and**
  - **COFCOM** in the locality where the company is registered *or* **MOFCOM**; **and**
  - COFCOM must report it to **MOFCOM**; and
  - **AIC** where the company is registered (which will issue a new business license after the domestic company becomes an FIE).

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Timing?

- Given these considerations, how long can it take to complete a deal?
  - Formation of offshore SPV: 1-2 weeks (optional, but common)
  - Obtaining authenticated articles of association for SPV: 2-3 weeks:
  - Appraisal of PRC target: 3-4 weeks
  - NDRC approval process: 3-4 weeks
  - MOFCOM approval process: 8-10 weeks
  - AIC registration: 1-2 weeks
  - Post-AIC filings: 2-3 weeks

  Plus, add time to conduct legal and financial due diligence, which can take 2-4 weeks, depending on complexity of project.

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“Take Aways” and Strategic Considerations

- At a macro level, the Central Government wishes to limit the flow of investment (foreign and domestic) into the real estate sector, therefore, prospective investors need carefully to consider whether their proposed project **satisfies policy considerations** favoring its development (e.g., development in Western China sought, improvement of amenities in newly redeveloped areas desired) (see standard of review discussed at Slide 9).

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“Take Aways” and Strategic Considerations

- Because of the benefits of structuring real estate investments as M&A transactions, investors should focus on identifying target projects that are already placed in SPVs, rather than mixed in with other assets. Otherwise, unrelated liabilities will be a risk and costs associated with spinning off other assets will be a challenge.
- Due diligence is **vital**! Too many projects are riddled with non-compliance and the cost of remedying the defects needs to be assessed and fully understood.

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“Take Aways” and Strategic Considerations

- Sellers will typically sell only if an investor is going to pay a premium over what the seller has previously invested. And, as FIE real estate development companies must have 50% equity as against total investment, if the target company is capitalized with considerable equity, then the amount the foreign investor will need to invest within 3 months after closing will be quite high. Therefore, targets that have been funded using low levels of equity and the balance from loans (often from shareholders) are desirable, as a portion of loans can be converted to equity to satisfy the minimum requirements for Circular 171.

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“Take Aways” and Strategic Considerations

- **Government Relations:** which is the critical agency in this process and the greatest potential roadblock depends on **locality** and **project type** (for example, in green fields projects, the NDRC plays a strong role in deciding on whether to ‘green light’ the project; and the Beijing DRC has a say in real estate-related M&A, regardless of deal size, but in Shanghai, the DRC only plays a role if the deal size limits are triggered); early communications with relevant officers to share why the project is beneficial/desirable in the investors’ view and whether they share this assessment, are important;

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“Take Aways” and Strategic Considerations

- **Timing**: completion of the due diligence, entity formation, capitalization, appraisal and approval steps all take time, so need to bear this in mind when evaluating a project and negotiating with seller. Expect the *minimum* time period to complete steps described here to be 4-5 months.
- If your company really wants to do a ‘green fields’ project, but is not confident of your government relations capabilities, consider working with a local partner through a **joint venture.**

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Contact

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