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INSIGHT

VIEWPOINT

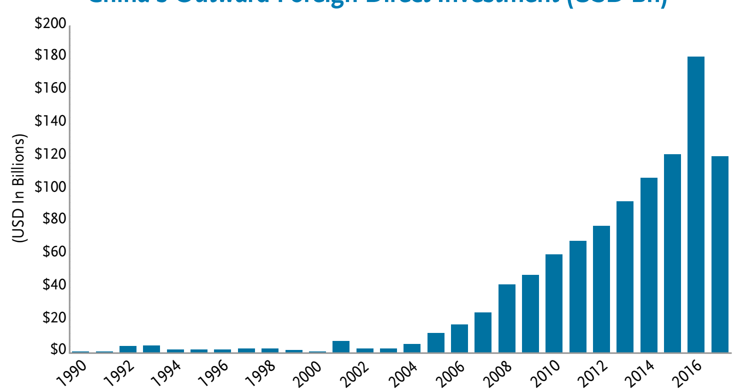
Chinese Investment in U.S. Commercial Real Estate (EB-5 and Capital Controls)

ELIZABETH CRAWFORD | JANUARY 23, 2018

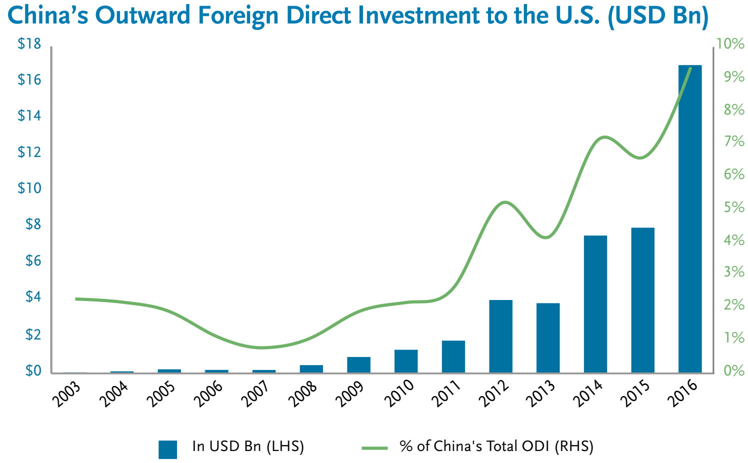
Chinese Focus on Foreign Investment and Post-Crisis Expansion into U.S. Real Estate

At the turn of the century, China introduced a "Going Out" policy that encouraged outward foreign direct investment (ODI) by state-owned enterprises and Chinese businesses. By deploying the country's significant build-up of foreign reserves, Chinese policymakers aimed to relieve upward pressure on the yuan, establish China as a global economic leader, and endeavor to qualify the yuan for reserve-currency status by the International Monetary Fund (IMF). The focus of Chinese foreign investment shifted over time, starting with energy and natural resource extraction in developing countries (early-to-mid 2000s), then extending into more advanced products and services in developed markets (late 2000s), before expanding into financial instruments and global real estate after the Global Financial Crisis (GFC).[1]

China's Outward Foreign Direct Investment (USD Bn)



China's Outward Foreign Direct Investment to the U.S. (USD Bn)



Source: China Ministry of Commerce, United Nations Conference on Trade and Development (UNCTAD), Morgan Stanley Research

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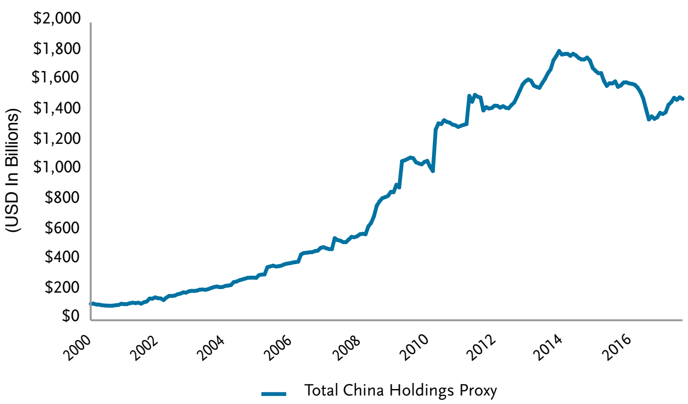
Chinese Investment in U.S. Commercial Real Estate (EB-5 and Capital Controls)

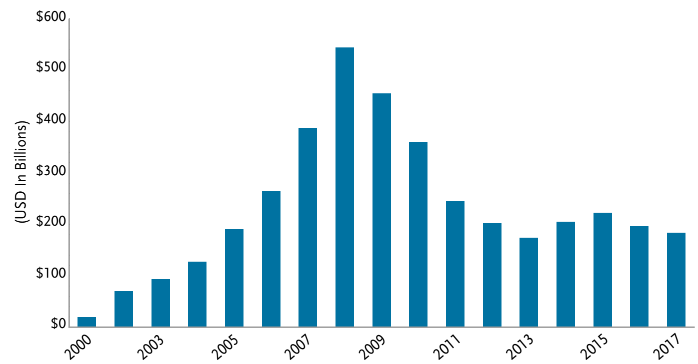
Within the U.S. market, Chinese investment initially focused on purchasing U.S. Treasuries and government agency debt, including Agency Mortgaged-Backed Securities (MBS). However, following the GFC, Chinese investment extended into direct and indirect U.S. commercial real estate (CRE) investments (beyond MBS) – including lending and development projects.

Approximate Chinese Holdings of U.S. Treasuries (USD Bn)



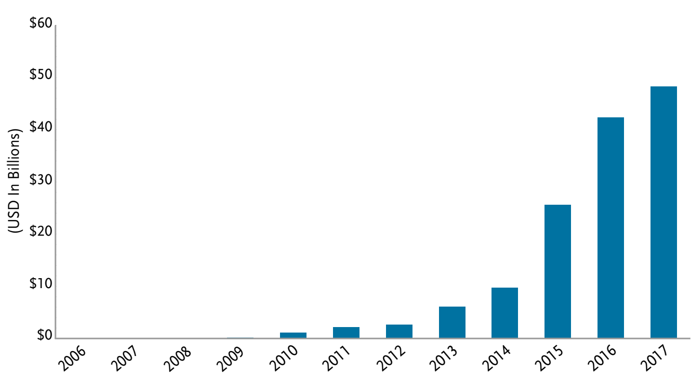
Source: U.S. Treasury, Bloomberg, Morgan Stanley Research

Chinese Holdings of U.S. Agency Securities (USD Bn)

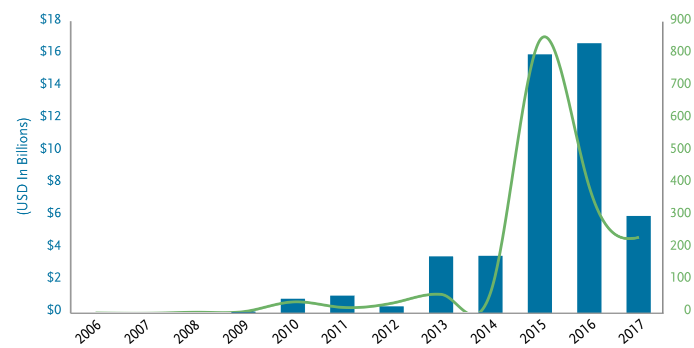


Source: Treasury International Capital (TIC) data, Morgan Stanley Research

Cumulative Chinese Investment in U.S. CRE* (USD Bn)



Chinese Investment (UDS Bn) in U.S. CRE* and Property Count Per Year



*Includes Office, Industrial, Retail, Hotel/Lodging, Multifamily, Manufacture Housing, Self-Storage, and Development Sites

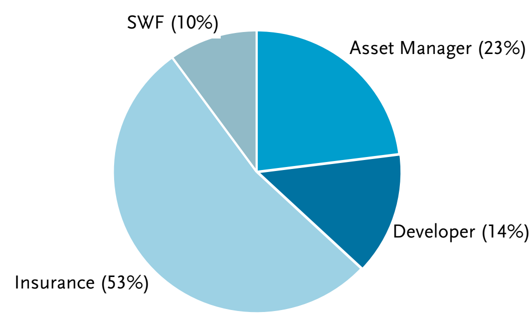
Source: RCA, Morgan Stanley Research

To date, Chinese CRE investments have focused on high-quality properties such as trophy office towers, hotels, and investment sites, located in gateway markets, such as New York, San Francisco, and Los Angeles.[2] The level of transparency, strong property rights, and scalability of U.S. dollar-denominated (USD) cash-flowing assets make the U.S. real estate market attractive to a number of Chinese asset allocators, including sovereign wealth funds (SWF), insurance companies, asset managers, lenders and developers.

Top 20 Largest Chinese Investors, July 2015-July 2017

Rank	Chinese Investor	Type	Acquisition (USD Bn)	Property Count
1	China Life	Insurance	$8,676.02	523
2	Anbang Insurance Group	Insurance	$5,500.00	15
3	HNA Group	Asset Manager	$3,920.46	9
4	China Investment Corp	SWF	$2,710.50	3
5	China Orient Asset	Asset Manager	$1,366.35	10
6	China Oceanwide Holdings	Developer	$1,102.99	5
7	Ping An Insurance	Insurance	$713.75	9
8	Shanghai Municipal	Developer	$625.00	2
9	Cindat Capital Management	Asset Manager	$534.13	10
10	Kuafu Properties	Developer	$506.28	7
11	Greenland Group	Developer	$466.95	4
12	Shanghai Const Grp	Developer	$396.92	2
13	Taikang Life Insurance	Insurance	$374.00	113
14	Han's Holdings Group	Developer	$339.05	5
15	China Huarong AM	Asset Manager	$279.38	2
16	SAFE	SWF	$268.56	24
17	Genzon Group	Developer	$260.00	1
18	LeEco	Asset Manager	$250.00	1
19	Lesso	Developer	$241.55	3
20	Wanxiang Grp	Asset Manager	$231.62	7
Total:			**$28,763.50**	**755**

Market Share % by Investor Type



Sources: Morgan Stanley Research, "Why China's Capital Controls Matter to Global Property Markets", July 2017; TCW

As the Chinese stock market experienced rather significant volatility in 2015-2016, foreign assets became natural targets for deploying capital and the U.S. saw a surge in investment. In addition to direct CRE purchases, such as Anbang's acquisition of the Waldorf Astoria in New York City for $2BN (2015) and HNA's acquisition of 245 Park Avenue in New York City for $2.3BN (2017), Chinese acquisitions included platform investments with significant real estate exposure, such as Dalian Wanda's acquisition of Legendary Entertainment for $3.5BN (2016) and Anbang's acquisition of Strategic Resorts and Hotels for $6.5BN (2016).

Capitalizing on the EB-5 Investor Program

One of the largest programs facilitating Chinese investment in the U.S. is EB-5, an immigrant investor program created in 1990 (Immigration Act of 1990) to help stimulate the U.S. economy through job creation financed by foreign investment.[3] EB-5 is administered by the U.S. Citizenship and Immigration Services (USCIS) and enables foreign nationals to receive a U.S. visa if they invest in projects that create at least ten permanent jobs, with a minimum investment amount of $500,000 in Targeted Employment Areas (TEA) – characterized by high unemployment and/or rural location – and a minimum investment amount of $1,000,000 in non-TEA areas.[4] Upon completion of the project, the foreign national receives a green card for permanent residency status. Approximately 10,000 visas are issued annually through the program – with Chinese investors accounting for over 75% of market share since 2012, largely due to underutilization by other countries. Although each country's share of EB-5 immigrant visas is limited to 7.1%, a country can claim additional unused visas.[5]

Following the GFC and resulting contraction in lending, EB-5 financing became a vital funding source for developers. Accessing EB-5 capital became particularly attractive after a 2009-ruling by the USCIS that construction work – the principal occupation created through development – qualified toward a project's minimum job quota. Furthermore, the primary interest of the EB-5 investor in securing a visa (rather than a high rate of return), makes EB-5 capital a rather efficient and "patient" financing solution, crucial for large multi-phase projects that require horizontal infrastructure improvements before vertical building construction commences (i.e. projects that require financing years before realizing any revenue).[6] Multi-phase megaprojects using EB-5 financing include Hudson Yards in New York City, the Shipyard in San Francisco, and Metropolis in Los Angeles.[7]

Sample Megaprojects Using EB-5 Financing

EB-5 Project - Current Phase	Location	Lead Developer	Estimated Total Project Cost (Entire Project)	Total Project Cost -Current Phase	EB-5 Raise - Current Phase	EB-5 Raise - Previous Phases
Hudson Yards - Phase 3	New York, NY	Related	$17bn	$4.3bn	$380mm	$1.2bn
Shipyard - Phases 6 and 7	San Francisco, CA	Lennar	$8bn	NA	$76mm	$272mm
Treasure Island - Phase 1	San Francisco, CA	Lennar; Stockbridge	$6bn	$155mm	$155mm	None
Hallets Point - Phase 1	New York, NY	Durst	$6bn	$400mm	$100mm	None
Central Park Tower	New York, NY	Extell	$2.9bn	$2.9bn	$190mm	None
Domino - Phase 1	New York, NY	Two Trees	$1.5bn	$250mm	$15mm	None
Metropolis - Phase 1	Los Angeles, CA	Greenland	$1bn	NA	$210mm	None
Oceanwide Plaza	Los Angeles, CA	Oceanwide Holdings	$1.2bn	$1.2bn	$300mm	None
Vista Towers	Chicago, IL	Wanda Group	$1bn	$1bn	$200mm	None

Hudson Yards (Masterplan) in New York, NY

Source (left): NYU Stern, Center for Real Estate Finance Research, "EB-5 Project Database: 2017 Supplement with Trends and Observations"
Source (right): Designboom.com; https://www.designboom.com/architecture/hudson-yards-new-york-masterplan-shed-vessel-roundup-07-02-2017/

Despite EB-5's popularity amongst Chinese visa-seekers and U.S. real estate developers, the program faces a number of criticisms, including but not limited to: a lack of transparency with information, significant gerrymandering of TEA designations, numerous cases of investment fraud and misappropriation of funds, as well as broader uncertainty with respect to program reform and/or extension efforts.[8] Additionally, demand for EB-5 visas exceeds the annual cap, resulting in a backlog for approval (more recent reports suggest 6-10 years) that diminishes the attractiveness of EB-5 investments as an efficient path to permanent U.S. residency.[9]

Recent Chinese Capital Controls and the Medium-to-Long-Term Outlook:

After decades of accelerating foreign investment, starting with the 2000 "Going Out" policy, Chinese policymakers reversed course in 2017 with the implementation of strict capital controls.[10] The 2017 pullback of Chinese capital is evidenced by a 65% decline in Chinese investment in U.S. CRE year-over-year (from $16.1BN in 2016 to $5.5BN in 2017).[11]

Certainly, the significant acceleration of Chinese investment in U.S. CRE from 2010 to 2016, followed by the dramatic slowdown in 2017 (projected through at least 2018-2019), can be considered a cautionary tale. However, it is worth keeping in mind that Chinese investment in U.S. CRE was de minimus before 2010 – with Chinese insurance companies only active since 2015.[12]

Importantly, the elements that attract Chinese asset allocators to U.S. CRE – market transparency, clearly established property rights, scalable cash-flowing assets denominated in a reserve currency (with potential upside from rent and valuation growth), and expanded business opportunities – are likely to remain in place in the medium to long term, irrespective of shifting domestic capital control regimes and/or U.S. EB-5 reform efforts.

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