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China launches pilot scheme for C-REITs: the era of REITs "with Chinese characteristics" begins

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On 30 April 2020 the People's Republic of China (China or the PRC) announced a pilot scheme for establishing real estate investment trusts (REITs) dedicated to the infrastructure sector, dubbed as the "real" China REITs (C-REITs) to differentiate them from the "quasi-REITs" structure currently used in China (akin to a securitization structure). The C-REITs scheme allows the issuance and listing of securities offered by infrastructure-based investment funds (pilot scheme). After years of discussion and multiple false starts, the pilot scheme officially inaugurates the use of REITs (with Chinese characteristics) in China and potentially creates an enormous market for investors, developers, and fund managers.

REITs have become a major financing tool for real estate projects globally. They are currently available in about 40 countries and regions, including in all the Group of Seven (G7) countries as well as some emerging economies, with a cumulative market capitalization approaching US$2 trillion. The pilot scheme was introduced as an alternative funding tool for infrastructure projects to facilitate investment in the infrastructure sector and reduce the large debt burden of local governments and boost domestic capital markets as China navigates its way out of the COVID-19 crisis and prepares to relaunch its economy.

The pilot scheme is focused on infrastructure assets and expressly excludes the creation of REITs using residential and commercial real estate assets, making the C-REIT a somewhat distinct animal from its U.S. or even Hong Kong cousins. Also missing from the C-REIT vehicle is the favorable tax treatment, which underpins the popularity of REITs in many jurisdictions, notably the United States, as discussed further below. Although there has not yet been any firm indication from the Chinese government, assuming that the pilot scheme is a success, it is possible that the scope of C-REITs will be expanded to other asset classes in the future in line with the regime applicable in other jurisdictions. Goldman Sachs has estimated that the value of C-REITs in the commercial real estate asset class could reach US$0.2 to US$1.1 trillion (based on market value at the end of 2018), thereby becoming the world's second largest commercial real estate REITs market, and the overall value of C-REITs across all asset classes may eventually exceed US$3 trillion, thereby becoming the world's largest REITs market (more than twice the size of the U.S. REITs market).

C-REITs pilot circular and draft infrastructure mutual funds guidelines

On 30 April 2020 the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) jointly released the "Circular to Promote the Relevant Work for Real Estate Investment Trusts in the Infrastructure Sector Pilot Scheme" (C-REITs pilot circular), officially launching the pilot scheme.

In furtherance of the C-REITs pilot circular, on the same day, the CSRC promulgated the draft "Securities Investment in Infrastructure Mutual Funds Guidelines (for trial operation)" for public comment (draft infrastructure mutual funds guidelines). The public consultation period ended on 30 May 2020. The draft infrastructure mutual funds guidelines are expected to be issued in final form, subject to any revisions to be made to address the comments received during the public consultation period.

The C-REITs pilot circular and the draft infrastructure mutual funds guidelines set out the basic overall legal framework for C-REITs. However, it should not be forgotten that it is in its early days still, and the latter is still a draft and the pilot scheme will only really become operative upon the issuance of implementing regulations to the C-REITs pilot circular and the promulgation of the final version of the draft infrastructure mutual funds guidelines. No clear time frame has been provided in this regard.

Main features of C-REITs under the pilot scheme

The following are the main features of C-REITs as set out in the C-REITs pilot circular and the draft infrastructure mutual funds guidelines.

Establishment

A C-REIT must be established in the form of a closed-end mutual fund registered with the CSRC distributing at least 90 percent of its distributable profits, with a minimum offering size of RMB 200 million or with at least 1,000 investors.

The NDRC is responsible for reviewing the infrastructure assets underlying the C-REIT; determining whether they are consistent with major state strategies, macroeconomic adjustment policies, industry policies, and fixed asset investment management regulation; and encouraging recovered capital to be invested in infrastructure in areas where it is lacking and other such like aspects. The NDRC puts this all into a conformity opinion, which is made in the form of a recommendation to the CSRC before the establishment of the C-REIT. The C-REITs pilot circular and the draft infrastructure mutual funds guidelines do not provide any further details regarding what the NDRC review procedures entail, and how they are conducted, including whether this will constitute a formal administrative approval or something less formal.

Asset class

Unlike REITs in other jurisdictions, which typically also include commercial property assets (such as hotels, shopping malls, and office buildings) and residential property assets, C-REITs are only permitted for infrastructure assets. As noted above, the draft infrastructure mutual funds guidelines explicitly exclude residential and commercial real estate assets from the types of assets in which C-REITs may invest. This is a significant point of difference with most other worldwide REITs. It is possible that China may have been concerned about the more speculative nature of many real estate investments in China attracting the "wrong kind" of investor in C-REITs, whereas infrastructure assets tend to provide a longer term, perhaps less explosive but steadier return that appeals more to longer term, institutional investors.

In particular, under the pilot scheme, C-REITs are limited to investment in certain infrastructure assets, noted below:

- Those in certain specific sectors, namely warehousing, logistics, and toll roads; urban utilities; sewage and waste treatment facilities; information network infrastructure; and high-tech industrial parks and specialized industrial parks (e.g., chemical sector parks).
- Those located in the following designated economic areas: Beijing-Tianjin-Hebei Region, Yangtze River Economic Zone, Xiong'an New Area, Guangdong-Hong Kong-Macao Greater Bay Area, Hainan, Yangtze River Delta, and other state-level areas and economic and technological development zones (not specifically listed in the C-REITs pilot circular).
- Those that have been in operation for at least three years and are generating stable cash flows and a good return on investment.

Eligible infrastructure assets must meet all of the above requirements. In short, only completed, cash-stabilized, income-producing infrastructure assets in certain parts of China are permitted.

Ownership of the assets and use of funds

As emphasized by the C-REITs pilot circular, one of the key features of C-REITs is the ownership of the underlying assets, which makes them similar to equity REITs seen in other jurisdictions, although a different and more complex structure is used to achieve the ownership of such assets. In particular, under the pilot scheme, the C-REIT purchases asset-backed securities/units issued by a special asset management plan (SAMP) – a fund established pursuant to the asset securitization scheme regulated by the CSRC – into which the equity interests in the project companies holding the relevant infrastructure assets are transferred. The C-REIT is required to purchase all the asset-backed securities/units issued by the SAMP (i.e., it cannot co-invest in the SAMP with others), using for such purpose more than 80 percent of the funds raised from its investors rather than owning the underlying equity interests in the operating company or the assets used for operating the project, a departure from the REIT structure in many other jurisdictions.

Additionally, the pilot scheme encourages the owners of the assets transferred into the SAMP to reinvest the transfer proceeds in the construction of new infrastructure and public facilities. In other words, the underlying theme here is infrastructure construction: taking cash-stabilized assets off the hands of infrastructure owners with a strong message to plough the proceeds back into more infrastructure construction. Presumably, much of the infrastructure being built in China will be done by local government or government-linked corporations who may find that in practice there is quite intense pressure to reinvest the proceeds of C-REITs in additional infrastructure and public facilities.

Management

The C-REIT must be operated and managed by a fund manager who will be responsible, among others, for collecting rent and other charges that constitute the cash flows of the C-REIT. The fund manager is required to hold a license issued by the CSRC to conduct public offering business (i.e., the license generally required to conduct such business, not issued specifically for C-REITs).

To maximize the efficiency of the structure and ensure alignment of interests, the fund manager must be affiliated to the asset manager that administers the SAMP in which the C-REIT has invested.

Profit distribution

As noted above, a C-REIT must distribute at least 90 percent of the annual distributable profits to its investors. This requirement is in line with many other jurisdictions (including Hong Kong, Singapore, and the United States) and makes the C-REIT more attractive to investors seeking a regular income stream.

Borrowing limits

The total borrowings of a C-REIT cannot exceed 20 percent of the value of its assets, and any borrowings may only be incurred for project maintenance and reconstruction purposes. This limit is quite tight and provides a much lower leverage than is permitted in many other jurisdictions.

Public offering and listing

The C-REIT sponsor (i.e., original owner of the infrastructure) must participate in the strategic tranche, which must be equal to at least 20 percent of the total amount of units offered by the C-REIT by way of public offering and be subject to a lock-up period of five years to ensure the original owner has "skin in the game." At least 80 percent of the public offering (after subtracting the strategic tranche) must be sold to professional institutional investors (including, among others, securities companies, fund management companies, trust companies, finance companies, insurance companies, qualified foreign institutional investors, qualifying private equity fund managers, bank wealth management companies, social welfare funds, infrastructure investment institutions, specialist government funds, industry investment funds, and other professional investors) and the remaining part can be placed with retail investors.

The securities issued by the C-REIT can be listed on the Shanghai Stock Exchange or the Shenzhen Stock Exchange.

Weaknesses and opportunities

To date, the Chinese tax authorities have not released specific supportive tax policies for C-REITs, unlike in other jurisdictions where preferential tax treatment of REITs is a key driver and draw of the scheme. On the face of it, this seems like a key (if deliberate) omission and weakness of the scheme. It was thought that delays in agreeing tax treatment of REITs was the reason why despite rumors and talk of REITs in China for many years, nothing has actually materialized until now. The tax regime applicable to C-REITs will play a key role in determining the success (or otherwise) of this scheme. Without specific tax breaks and exemptions, the establishment of the scheme and the transfer of the infrastructure assets could become unattractive from a tax standpoint, particularly on the way in to the SAMP where it is well known that the array of taxes payable on transfer of real estate assets (enterprise income tax on capital gains, land value-added tax, deed tax, business tax, and stamp duty to name a few) make this generally unattractive to most buyers and sellers. It seems more likely for this reason that SAMPs will end up owning shares in companies that in turn own underlying assets, but it may be difficult to do this where the project company holds multiple assets and only some of them are destined for the C-REIT.

The C-REITs pilot circular and draft infrastructure mutual funds guidelines also leave investors and participants with a number of open questions – for example, when will the pilot scheme become operative? How complex and time-consuming will the NDRC review procedures be, and will they have a specific focus or adopt a special protocol or simply follow the procedures currently applicable to record filing or approval of other infrastructure-type investment projects?[1] Will the pilot scheme be expanded to other asset classes in line with other jurisdictions?

Looking to the future and conclusion

Although these details and additional rules have yet to be revealed, it is undeniable that the C-REITs will provide investors, developers of infrastructure projects, and fund managers with

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[1] "State Council Circular on Promulgating the Catalogue of Investment Projects Subject to Government Verification and Approval" (2016 Version) (国务院关于发布政府核准的投资项目目录（2016 年本）的通知).

access to a potentially enormous new market with many valuable investment opportunities. Investors will be able to invest in a new type of asset that is expected to provide diversified, regular returns with a stock market exit at the end of it and could open the door to more lucrative returns if C-REITs will be expanded to encompass other asset classes such as commercial and residential real estate. Developers will gain access to additional financing to develop their projects. Fund managers will have the opportunity to expand their business in China into the area of managing C-REITs; in particular, following the CSRC's announcement of the removal of all equity restrictions on foreign investment in the fund management business effective 1 April 2020, it will be possible for a wholly foreign-owned fund manager to engage in the C-REITs business. Overseas skills in this area may be highly prized in the early days of C-REITs.

However the one feature that leaps out of the new scheme is that it seems that China has deliberately limited involvement of retail investors: Any increase in the size of the strategic tranche taken up by the asset original owner will effectively reduce the size of the retail portion, which is up to 20 percent of whatever is left after the strategic tranche is removed (as a minimum of 80 percent of the public offering must be subscribed by professional institutional investors). The way in which C-REITs are structured seems designed to attract institutions and not individuals, as infrastructure is not an asset class that appeals broadly to retail investors looking for short-term returns.

The more searching question that needs to be asked is whether this is truly a breakthrough or just incremental change with a new label placed on it. Without preferential tax treatment, will private sector infrastructure operators (as opposed to state-owned enterprises) feel motivated to use this as a financing vehicle? In some cases, yes, as the ability to list C-REITs makes this potentially a much more liquid investment, but where the tax burden to acquire an asset (e.g., deed tax, which is 3 to 5 percent of the value of the underlying land, depending on the local rules and which by default falls on the buyer unless otherwise agreed) can be quite high, query whether C-REITs amount to much more than a reworked and rebadged securitization scheme for infrastructure assets. At the moment, the C-REIT does not offer much in the way of asset diversity and risk spreading. The hope must be that this is something of a trial balloon using a "safer" asset class and essentially limiting the investors to institutions with only a small retail component, the expectation being that if the pilot is successful, they will expand the scope to other more attractive asset classes to retail investors and, hopefully, the preferential tax treatment will be in place by then.

Our REITs experience and how we can support you

Our U.S. REITs practice ranks Band 1 in *Chambers and Partners* and other legal directories. From the largest, most transformative and complex REITs deals to the straightforward, we have been actively involved in every aspect of the industry for more than 20 years in the United States as well as in other jurisdictions in which REITs are used. We have developed many of the legal structures that have made REITs a success in the United States and that have been replicated elsewhere, and we have been advising clients on REITs transactions across the globe. Our law firm has the necessary resources and experience to support you in evaluating and taking advantage of the nascent C-REITs.

To find out more about C-REITs and the pilot scheme, and to discuss the related opportunities for your organization, feel free to get in touch with the authors of this alert.

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