The great Chinese workaround

Faced with a regulatory crackdown on capital outflows, Chinese investors are finding ways to bypass controls on outbound investing, writes Arshiya Khullar

Curbs to spending: Chinese regulators are scrutinizing the yuan's conversion into foreign currencies

From shopping centers, theme parks and cinema chains to the Hollywood production company behind Jurassic World, Chinese developer Dalian Wanda has cast a wide net with its global acquisitions.

But in March, the firm's ambitious overseas crusade hit a bump when its $1 billion buyout of Dick Clark Productions, the operator of the Golden Globe movie awards, was aborted. In media interviews that followed, the group's founder Wang Jianlin unflinchingly blamed China's clampdown on overseas investments as a deal-breaker.

Last November, Chinese regulators introduced controls on capital outflows to stabilize the yuan. The impact was immediate. In the first three months of 2017, total overseas mergers and acquisitions activity by Chinese firms fell 64 percent to $31 billion, according to McKinsey.

In Asia-Pacific alone, Chinese property investment dropped 76 percent to $550 million, property services firm CBRE estimated in its first quarter market research.

This is not the first time Beijing has restricted the movement of capital. But with a now expanded purview, some Chinese investors are having to explore alternative ways to fund their overseas real estate purchases that see them circumvent these curbs. For institutional investors and their managers, one setback has been the increased scrutiny on all outbound investments of more than $10 billion in any sector.

Chinese authorities have also announced a list of sectors in which the 102 centrally-governed state-owned enterprises are prohibited from investing in, according to a paper published by law firm De Brauw Blackstone Westbroek in February. Real estate is on the list.

Robert Fong, director of research for Asia-Pacific at CBRE, says there were several examples of Chinese investors pursuing smaller deals, below $250 million, in the first quarter of this year, to avoid scrutiny on mega transactions.

Retail investors have also found their offshore investing practices come under government scrutiny. Until late last year, every Chinese citizen could freely convert and remit up to $50,000 worth of currency, but according to lawyers *PERE* spoke with, the State Administration of Foreign Exchange is now regulating these personal allowances. To contend with this added oversight, some retail investors and high-net-worth clients are aggregating their capital into larger sums to be placed in overseas deals, says Greg Peng, chief executive of Beijing-based firm Cindat Capital Management, a business aimed at

investing Chinese money overseas. That is a risky solution, he cautions. Peng says investors can be penalized and lose their foreign currency quota for two years if Chinese regulators find multiple deposits made to the same overseas accounts for group investments. Additionally, previous government-backed schemes devised to encourage outbound investments for retail and institutional investors have effectively been stopped. The Qualified Domestic Limited Partner and Qualified Domestic Institutional Investor licenses allowed managers to set up funds in domestic free-trade zones from which they could raise capital and then convert it into foreign currency within a specified quota.

Peng says his firm has mostly been investing dollar capital for overseas deals of late, except for some converted through the Shanghai Free Trade Zone. "In 2016, this was almost the main channel of conversions," he says. "However, conversion is definitely a 'no' at this point for limited partnership companies registered in free trade zones."

Some managers are exploring alternative capital raising destinations to the free trade zones. According to a person familiar with the matter, Ping An Trust, the asset management subsidiary of Chinese insurer Ping An, this year established a small Cayman Island-domiciled private equity fund to raise $20 million from Chinese high-net-worth investors for a real estate fund of funds investment. This was possible because the capital was already being held on the Caribbean territory.

Show me the money

Chinese managers not fortunate enough to be able to call on existing offshore pools of capital have found the going harder, according to anecdotes shared with *PERE*. In one, a manager missed a $30 million payment for a US student housing portfolio it agreed to acquire last December because it failed to expatriate the funds before the government regulatory gates shut. Though binding agreements were signed, the deal was halted. In another instance, one lawyer, who spoke on condition of anonymity, says the gates have been shut ever since – his firm has failed to get conversion approval for a single outbound deal in the past six months.

The stemming of capital from China is not limited to equity deals. With a few exceptions, there are also constraints on domestic banks' lending for offshore real estate projects. As Paul Guan, partner at law firm Paul Hastings, explains, a Chinese bank can sanction dollar funding locally only if it can generate the same amount of foreign direct investment to balance its reserves. "Until last year, when we were taking on a new deal, we would usually never ask where the client's money is. But now this is the first question we ask, because if the client doesn't have the capital offshore, the closing risk will be huge. We must advise them not to include a break fee in the contract unless they are 100 percent comfortable that they have ready offshore capital," he says.

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This uncertainty over the source of funding has become a disadvantage for Chinese investors when bidding on assets.

"Many Chinese companies still believe even if it is a large-ticket item, and even if it is not in the best sector, according to Chinese regulations, they will eventually be able to get their capital out of China. It is only a matter of timing," says Marcia Ellis, partner at law firm Morrison & Foerster, who deals with Chinese outbound investments. "That becomes a big issue when a Chinese company or a consortium that includes Chinese companies is in an auction contest where there are also non-Chinese bidders."

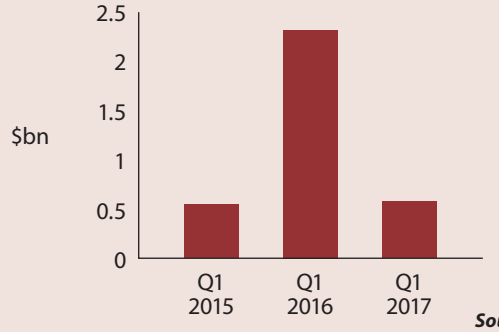
Ellis says most of her Chinese clients are now trying to line up all the cash they need from offshore sources, essentially in advance of the auction so that they can demonstrate funds to sellers and be competitive.

"For example, there will be senior lender debt coming from an offshore source – it may be the offshore branch of a Chinese bank. Then the equity plug also needs to come from offshore sources – whether that is a private equity fund providing part of the equity and investing together with Chinese company, or a debt fund that can provide mezzanine debt as a bridge until the Chinese company can get the capital offshore," she says.

Private debt managers have come to the rescue by providing bridge funding solutions to these investors. Wayne Lasky, managing director of MaxCap Group, an Australian commercial real estate debt investment manager that provides

Bearing the brunt

Chinese investment in Asia-Pacific property fell 76% in Q1



Source: *CBRE*

SOURCE: BA'GAMNAN

Legendary Entertainment: the US studio behind Jurassic World is owned by Dalian Wanda

these loans, says some Chinese investors now seek credit at a short notice mostly to settle site acquisitions.

He says historically when Chinese investors bid on sites, they also give an assurance to settle often with shorter settlement timeframes: eg, 90 days, while other non-Chinese bidders would negotiate for a six to 12-month repayment schedule. Nowadays, he is getting an increasing number of calls to provide bridging finance within 30 days, and in some cases two weeks. "Seemingly, the imposition of stricter capital controls has caught a number of Chinese investors out. Many hang on, trying every avenue to get their money out, only to realize at the last minute it is not possible in the required timeframe. Then they go to plan B and seek alternative funding because they run the risk of losing their deposit and the asset itself," he says.

Lasky agrees, however, that providing funding in such a short period puts pressure on the underwriting, so he prefers to transact only with high-quality borrowers and typically those he has worked with before.

Given the proliferation in demand because of Chinese capital curbs, being a lender of last resort has its advantages. Maria Wang, Shanghai-based partner at Morrison & Foerster, says increasing demand has enabled these offshore credit funds to better negotiate terms with Chinese borrowers and even charge higher rates and fees.

In Australia, for instance, bridging loans provided for around six to 12 months on a first mortgage basis with conservative gearing and on well-located assets are available at a rate of interest of 12-14 percent, industry observers say.

Predictably, other variants of the theme of using existing offshore equity and debt are being explored, too. For instance, some mainland companies are raising dollar-denominated bonds, or using their offshore subsidiaries' investment capital to fund deals. In that regard, state-owned enterprises, according to Shirin Tang, corporate partner at Morrison & Foerster, may have greater flexibility compared with non-state-backed property developers to issue dollar bonds because the Chinese government would like to bring back dollars into China.

Stanley Ching, senior managing director and head of real estate for Hong Kong-based investment manager CITIC Capital, agrees that operating from the special administrative region is an advantage. In April, the firm made its first corporate deal in the US, acquiring a 48 percent stake in Stockbridge Capital Holdings. "Overall, the impact of capital controls is the same for everyone. But we have our advantages," says Ching. "Most of [our] capital still originates from China, but, for us, the flexibility is that given our company is in Hong Kong, we might have ways to structure deals to make things a little easier. For example, if we have to bid for a deal that requires a deposit, we are in a better position to arrange that deposit to secure the deal. Or, if there is need for a capital injection within a very short period, we might be able to utilize banks' facilities here."

It is hard to find one answer to when these controls will ease. Some believe a retreat is imminent given improving foreign exchange reserves. China's reserves rose to $3.03 trillion in April, the third straight month of increase. Others, however, tell *PERE* any changes to current policy will only happen after the completion of the 19th Communist Party Congress in the fall.

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Marcia Ellis

What is now more universally agreed upon is the fact capital controls are today a reality that both Chinese investors, and their cross-border partners, should accept.

"There is always going to be this danger for the Chinese buyer and the perception in the minds of US sellers that Chinese buyers are subject to this cloud," says MoFo's Ellis. "Who knows when these capital controls will jump off and be [launched] again? It is going to be a continuing struggle." ◻