

An Asia Society Special Report



EXECUTIVE SUMMARY

Breaking Ground:

Chinese Investment in U.S. Real Estate

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**AN ASIA SOCIETY SPECIAL REPORT
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FOREWORD

AS THE WORLD'S SECOND-LARGEST ECONOMY, China's influence on the global economy is expanding at a furious pace, thanks in part to the surge in outward foreign investment. In the United States, China is now a major source of foreign investment with capital flowing into virtually every industry and market. For many Chinese firms and individuals, the United States is a prime destination for their investments because the prospects for stable returns are high.

Policy makers, business leaders, and the general public in the United States still do not have a comprehensive understanding of the patterns and implications of Chinese investment in the United States. While foreign investment has been a critical piece of this country's economic success, the recent boom of Chinese capital flowing into the United States has stoked fears of job loss and disruptions to local and regional economies and markets, and even threats to national security.

Chinese investment into U.S. real estate, in both the commercial and residential sectors, stirs up these misgivings and sparks debate about the domestic costs of these investments. Concerns range from anxieties over the potential inflationary effects of deep-pocketed firms and investors in the residential real estate market to more pronounced anxieties over property acquisitions that can endanger national security. The reality, as this landmark study makes clear, is much more complex.

This report, *Breaking Ground: Chinese Investment in U.S. Real Estate*, paints a clearer picture of what these investments mean for this country. Our intention is not to dismiss or ignore domestic anxieties over Chinese (as well as other countries') real estate investment but to ground the debate in an authoritative and comprehensive analysis of the investment trends and motivations. We believe that doing so will provide a clearer assessment of the true impact and implications of Chinese real estate investment in the United States and support the ongoing dialogue on the economic relationship between the two countries.

The report reinforces Asia Society's ongoing effort to study the broader phenomenon of Chinese investment in the United States. It is the fourth in a series of reports dating back to 2011. Our past reports were drafted in partnership with the Rhodium Group, whose Chinese Investment Monitor remains the gold standard in tracking the currents of Chinese investment in the United States. The first report, *An American Open Door? Maximizing the Benefits of Chinese Foreign Direct Investment*, outlined Chinese investment on a national level. A year later in 2012, we provided a state-level look with *Chinese Direct Investment in California*, followed by *High Tech: The Next Wave of Chinese Investment in America* in 2014, which homed in on one of the fastest-growing sectors targeted by investors from China. Through these reports, we found that while some of the misgivings about Chinese investment were warranted, Chinese investment in the United States has been and will continue to be an overall benefit for the economy. We believe that the United States has much to gain from ensuring our doors remain

open to foreign investment, not only from China but also globally. The conclusions we reach in this report are no different.

We are pleased to be presenting this report with Rosen Consulting Group (RCG), one of the most influential independent real estate consulting, research, and analysis firms in the United States. As one of the most established voices in the U.S. real estate industry, RCG's deep understanding of U.S. real estate markets, coupled with its unparalleled access to industry data, puts it in a unique position for this effort. We are deeply grateful to Ken Rosen, RCG's chairman; Arthur Margon, a partner at RCG; and Randall Sakamoto and John Taylor for leading this partnership effort between Asia Society and RCG. We also would like to thank Alan Pomerantz at the international law firm Pillsbury Winthrop Shaw Pittman for helping establish the groundwork for this partnership in the early stages of this project.

We also would like to thank the staff at Asia Society for their hard work in conceiving this project and producing the final product: Robert W. Hsu, Jennifer Choo, Wendy Soone-Broder, Makenna Martinez, Melissa La Bouff, and Eve Cary. Special thanks also to Robert Bullock, who helped lay the groundwork for this report.

This project would not be possible without the generous support of our sponsors, including AREAA, Blank Rome, Crescent Heights, East West Bank, Mansion Global, Gensler, and TMG. We are also grateful to our strategic partners at ChinaSF and its executive director, Darlene Chiu Bryant, who has been a champion of San Francisco's efforts to elevate the city's status as a premier destination for Chinese investment, as well as Jim Wunderman and his colleagues at the Bay Area Council, one of the most important voices for business in California.

Finally, we are grateful for the time, advice, and feedback we received on earlier drafts from the various experts, business leaders, and academics who participated in our consultative roundtables, which we organized in New York, San Francisco, and Los Angeles over the past year. The roundtables were an essential part of the process in the drafting of this report.

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EXECUTIVE SUMMARY

CHINESE INVESTMENT AROUND THE WORLD SURGED IN THE PAST DECADE, expanding from an early focus on natural resource extraction and energy in developing countries to broader industries and advanced products and services in developed markets. In 2014, Chinese outward FDI flows totaled \$116 billion, and approximately \$18.1 billion flowed into the United States. In 2015, Chinese outward FDI flows totaled \$118 billion, and Chinese foreign direct investment flows into the United States increased to \$22.3 billion. Still, China accounts for less than 10% of all foreign direct investment in the United States.

Chinese direct investment in U.S. real estate was negligible until 2010 but has since grown dramatically and visibly. In 2015, China ranked third in U.S. commercial real estate acquisition volume, trailing only Canada and Singapore and tied with Norway. Chinese developers are building multi-billion-dollar projects in several major cities. A Chinese insurance firm bought the prized Waldorf Astoria hotel in New York City in 2015 and struck a \$6.5 billion deal for Strategic Hotels & Resorts in early 2016. Chinese investors dominate an immigrant investor program known as EB-5, and in 2015, China overtook Canada as the biggest foreign buyer of U.S. homes.

This anecdotal portrait reveals the rapid and widespread entry of Chinese investors, both firms and individuals, into the U.S. real estate market, but it also underscores how real estate differs from other investment sectors. It defies the traditional definition of foreign direct investment – ownership of at least a 10% stake in a U.S. company – with a broad range of entry points. Buying a home, for example, does not have an analogue in the technology industry but is critical in painting a full picture of Chinese capital flows into the U.S. real estate market. Furthermore, in addition to the unique channels of real estate development and EB-5 capital, Chinese investors are also increasing investment in portfolios of U.S. assets through real estate investment trusts and private equity funds.

These real estate investments come on top of China's position as the biggest holder of mortgage-backed securities issued by U.S. government-sponsored enterprises such as Fannie Mae and Freddie Mac. Like U.S. Treasuries, these bonds are important investments for Chinese government finances, because they allow for recirculation of dollars gained by the trade imbalance, and for the U.S. housing market, because they help ensure liquidity and mortgage rate stability. Chinese banks have also become major sources of debt capital in the U.S. real estate market, primarily for U.S. firms. To fully understand the role of Chinese capital in the U.S. real estate market, it is vital to look beyond direct investment. More than any foreign investor other than Canada, China stands out for the breadth, depth, and speed of its participation in the U.S. real estate market.

Rosen Consulting Group, on behalf of Asia Society, has examined this broad range of direct and indirect investment – including our own proprietary dataset – to produce the most

comprehensive analysis to date of Chinese capital in U.S. real estate. Our findings are that from a modest base in 2010, China was the source in aggregate of at least \$350 billion in U.S. real estate holdings and investments by the end of 2015. This figure includes the direct purchase of real property and indirect investment through the purchase of agency mortgage-backed securities and provision of debt financing, among other channels. In addition, we estimate that Chinese entities managing U.S. real estate operations and individual investment through vehicles including the EB-5 program may have created or sustained 200,000 jobs. For commercial and residential real estate, China has been an important source of capital as the U.S. economy recovered from the recent financial crisis and Great Recession.

Chinese investment in U.S. real estate is a recent development with considerable growth potential. While it is not as politically sensitive and does not directly impact national security as does Chinese investment in U.S. technology or telecommunications, real estate affects more people and communities and involves policy makers at multiple levels. This report aims to objectively present the following:

- Sources of Chinese capital flowing into U.S. real estate;
- Motivations and drivers for various Chinese investors;
- Benefits and impediments posed by this wave of investment;
- Analysis and projections of the sustainability of Chinese investment in commercial and residential property; and
- Recommendations for U.S. and Chinese investors, policy makers, and stakeholders to keep investment channels open.

Combining information from public records, reports, and trade groups with Rosen Consulting Group's database – based in part on gathering of data and interviews with industry sources – this report assembles a unique information set, providing the first comprehensive analysis and understanding of Chinese inbound investment into all facets of U.S. real estate.* The reported investment data are not perfect, a result of the combination of the particulars of real estate investment avenues and the ability of government and third-party sources to accurately measure capital flows. Furthermore, a significant portion of investment from offshore locations, including China, comes in the form of minority interests in projects sponsored by U.S. entities and is not directly traceable to the capital country of origin. The study is focused on investment from mainland China, but the flow of capital through intermediary destinations sometimes necessitates the inclusion of capital from Hong Kong, Macau, or Taiwan. Moreover, the task is complicated by the multiple channels for investment, ranging from purchases of homes and apartments to business investment in commercial assets to development and construction, as well as through provision of debt to both residential and commercial property investors. The myriad ways in which to record real estate ownership can also obscure the true country of origin of the buyer. With this in mind, this report presents the data as minimum investment volumes. While

* The analyses of investment data, individual transactions and in aggregate, were derived from several third-party public and private data sources. We have generally cited statistics from these sources that are publicly available so as to maintain legal confidentiality requirements. The views and interpretations of the data are ours and do not reflect opinions or positions, except as noted, of the data sources.

acknowledging these data limitations, we have made every effort to compile data and insight that provide a more complete reflection of actual Chinese investment activity across the entire spectrum of the U.S. real estate market than previously published. This includes enhancing investment volumes reported publicly as well as confirming the reported data via industry participants.

The investment flow has come into the United States through several channels:

- **Residential property:** Between 2010 and 2015, Chinese buyers spent at least \$93 billion on homes, including condominiums, for occupancy and investment. Spending rose at an annual rate of 20% and provided important demand in many local markets hit hard by the housing crisis. Chinese buyers paid substantially more, on average, per home than other international buyers because of their concentration in prime neighborhoods in California and New York.
- **Commercial property:** Between 2010 and 2015, Chinese investors acquired at least \$17.1 billion of existing office towers, hotels, and other commercial buildings, representing an annual growth rate of 70%. Half of that investment came in 2015 alone. The buyers were mainly large Chinese companies, including real estate firms and institutional investors.
- **Development:** By the end of 2015, Chinese-funded projects under construction or planned totaled at least \$15 billion. These range from multi-billion-dollar mixed-use projects in Los Angeles and the San Francisco Bay Area to smaller-scale developments in secondary markets. These investors include Chinese developers, builders, and construction companies, some of which have set up U.S. offices, creating local jobs for ongoing operations beyond the construction phase.
- **EB-5 visa program:** Since 2010, Chinese nationals have been the most numerous investors in the EB-5 U.S. visa program. The program enables a foreign national who invests at least \$500,000 in projects that create a minimum of 10 jobs to receive a U.S. visa and, on completion of the project, a green card for permanent residency status. Detailed data on these investments and the actual number of jobs created are not generally available. But based on the minimum investment and job creation requirements, and assuming all investments are successful, Rosen Consulting Group estimates that since 2010, nearly 20,000 Chinese EB-5 investors have generated at least \$9.5 billion of investment capital and contributed to the creation of 200,000 jobs.
- **Residential mortgage-backed securities (RMBS):** Chinese government entities began purchasing U.S. government agency-backed RMBS in the early 2000s to diversify beyond U.S. Treasuries. As of June 30, 2015, China held \$207.9 billion in agency-backed mortgage bonds, more than any other country, according to preliminary U.S. Department of the Treasury data. These holdings contribute to enhanced liquidity in the U.S. housing finance market.
- **Real estate loans:** In recent years, Chinese banks increased activity in lending for real estate acquisitions, recapitalizations, and construction and development. The banks have amassed at least \$8 billion in loans and have become a major source of funding for large commercial real estate projects. This loan portfolio extends beyond Chinese investors and projects with Chinese partners, as leading Chinese banks are active competitors with U.S. and international banks and private sources of capital in the commercial property market. Residential mortgage lending by Chinese banks in the United States is more limited, but growing.

As in other industries, Chinese investment in overseas real estate is driven by a combination of policy reform, economic conditions, and opportunities for growth. Real estate offers a range of Chinese entities opportunities to diversify, whether in financial assets or real property. Real estate as an investment may be particularly attractive given the likelihood that the Chinese currency will weaken against the dollar and other global currencies. Chinese builders and developers are looking to expand into attractive global markets for the long term, as the Chinese economy slows, and to improve their competitiveness, global stature, and brand recognition. China's growing financial sector – banks, insurance companies, and emerging private equity groups – are looking to invest globally as they accumulate capital from businesses and consumers in China. Similarly, high net-worth Chinese may also view overseas real estate as a means to provide international opportunities for their children, and a safe haven from political and economic uncertainty in China. Finally, real estate investment and ownership can potentially offer an expedited path to Chinese families who want U.S. residency for work and educational opportunities.

OUTLOOK

We believe China's economic turbulence will create a short-term speed bump for real estate investment overseas, including in the United States. In the near term, a 6- to 24-month temporary period of increased capital controls is likely – either formally via policy announcements or informally through administrative processing – until the Chinese currency can be re-aligned with that of global partners. However, this does not mean investment will cease during this period. Furthermore, the long-term investment drivers remain: strong U.S. demand for capital; a widening and deepening pool of Chinese investors, many of whom have not ventured into U.S. real estate; increasing global appetite by Chinese developers and construction companies; a \$1.6-trillion insurance industry that has become active overseas but invested just a fraction of funds available for real estate projects; and new Chinese investment vehicles, such as private equity funds, which have only recently become a factor in the U.S. market.

We project that Chinese direct investment across existing U.S. commercial real estate assets and residential purchases, excluding new development projects, could total at least \$218 billion, cumulatively, from 2016 through 2020. In the short term, capital controls will likely slow individual purchases of U.S. homes, the biggest component of Chinese real estate investment, and slow the growth rate of commercial property acquisitions. Chinese-backed development projects are likely to remain a substantial component of the commercial real estate market even as the economic cycle in the United States slows the overall pace of new development announcements. Beyond 2020, Chinese investment in U.S. real estate could accelerate further.

RECOMMENDATIONS

These large capital flows, accelerating substantially in a short period of time, do not come without challenges in both countries. In the United States, several policy areas will need attention in the next several years:

1. **Rationalization of taxes affecting foreign investment:** The Foreign Investment in Real Property Tax Act (FIRPTA), while perhaps well intentioned at inception, is an onerous structure that creates an impediment to international investors in real estate. Every effort should be made so that there is a level field for taxes on foreign investors regardless of their domicile.
2. **Continuation of the EB-5 program:** While the program was extended through the summer of 2016, renewal is by no means a certainty. It has been a successful bridge builder, bringing capital into the marketplace, growing or retaining jobs in the United States, and allowing Chinese citizens and families access to visas and residency. The EB-5 program will likely undergo reform, but it should not be altered so dramatically as to cut off access to international capital and immigration, including those from China.
3. **Continued implementation of existing security policy:** Offshore investors are understandably screened for security risks and legitimacy of capital sources. So far, such concerns have not been an impediment to investment in U.S. property, as it has been in technology platforms, manufacturing firms, or natural resources extraction and processing. Any proposal to restrict U.S. government occupancy, including those of certain government contractors, in foreign-owned buildings – as is being discussed in congressional circles – should be carefully monitored.

On the Chinese side, the issues that deserve attention include the following:

1. **Continued development of legal and financial rules to encourage private sector investment in overseas property:** Chinese companies and individuals can benefit themselves and the Chinese economy by diversifying assets globally. It is critical that China develop a robust domestic legal framework for foreign investment, as many countries expect reciprocal treatment of foreign investors. Likewise, reforms that reduce bureaucratic bottlenecks and expedite outward investment should continue.
2. **Enhanced transparency in capital ownership:** The United States and other global financial centers are increasingly monitoring the identities of foreign investors and business operations. While China is not the only country that raises concerns, Chinese businesses historically have been less open regarding origination of capital and ties to government or military officials. Continuing progress toward the transparency required by international agencies – many of which are welcoming China as a significant participant – will be an important step.
3. **Avoidance of capital controls:** China's economic growth rate has slowed, and its currency is re-aligning with that of other major economies. Chinese concern over capital outflows is understandable, but a hard capital-control regime could negatively impact the financial institutions the government nurtured over the past two decades.

4. **Development of professional education on U.S. real estate practices:** Many aspects from land approval procedures to partnership agreements to local market valuation practices differ in the United States, and efforts to support increased education and awareness will benefit Chinese investors – particularly smaller companies and individuals – as they play a greater role in the global investment community.

ACKNOWLEDGMENTS

AT THE OUTSET OF THE STUDY, we understood the daunting task ahead of us in examining such a rapidly evolving and accelerating subject as Chinese investment in U.S. real estate. Luckily, we underestimated the difficulties in gathering factual information from and analyzing motivations of both large and individual investors, not to mention the geopolitical motivations and policy shifts; otherwise, we might not have written what has come to be the first study bringing together data on the flow of capital from China, the motivations behind investments, and the implications for the real estate market.

Asia Society has been and remains a leader in bridging the ocean between Asia and the United States. Its support and interest in cultural, educational, and commercial topics promote government, individual, and business cooperation and understanding across borders. The enthusiastic support of Asia Society Northern California truly made this report possible. We would also like to add our appreciation to Asia Society's partners and sponsors of this study for their generous support, financial and otherwise: ChinaSF, Bay Area Council, AREAA, Blank Rome, Crescent Heights, East West Bank, Mansion Global, Gensler, and TMG.

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