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Can China Succeed Where the Japanese Failed Investing in US Real Estate?

July 13th, 2016

Chinese money is cascading like a waterfall into the US real estate market. Chinese institutional money, individual money, state-owned companies and private sector ones, Chinese billionaires to ordinary middle-class wage-earners, everyone wants in on the action. This year, the amount of Chinese money invested in US real estate assets is almost certain to break new records, surpassing last year's total of over $40 billion, and continue to provide upward momentum to prices in the markets where Chinese most like to buy, the golden trio of major cities New York, Los Angeles and San Francisco, plus residential housing on both coasts.

To many, it summons up memories of an earlier period 25 years ago when it was Japanese money that flooded in, lifting prices spectacularly. For the Japanese, as we know, it all ended rather catastrophically, with huge losses from midtown Manhattan to the Monterrey Peninsula.

There is no other more important new force in US real estate than Chinese investors. Will they make the same mistakes, suffer the same losses and then retreat as the Japanese did? Certainly a lot of US real estate pros think so. There is some evidence to suggest things are moving in a similar direction.

But, there are also this year more signs Chinese are starting to adapt far more quickly to the dynamics of the US market and adjusting their strategies. They also are trying now to dissect why things went so wrong for the Japanese, to learn the lessons rather than repeat them.

This week, one of China's leading business magazines, Caijing Magazine, published a detailed article on Chinese real estate investing in the US. I wrote it together with China First Capital's COO, Dr. Yansong Wang. It looks at how Chinese are now assessing US real estate investing. What kinds of investment approaches are they considering or discarding?

Here is an English version I adapted from the Chinese. It is also published this week in a widely-read US commercial real estate news website, Bisnow. The original Chinese version, as published in Caijing, can be read by clicking here.

SPECIAL REPORT: HOW CHINESE INVESTORS CAN FIND LONG-TERM SUCCESS IN US REAL ESTATE

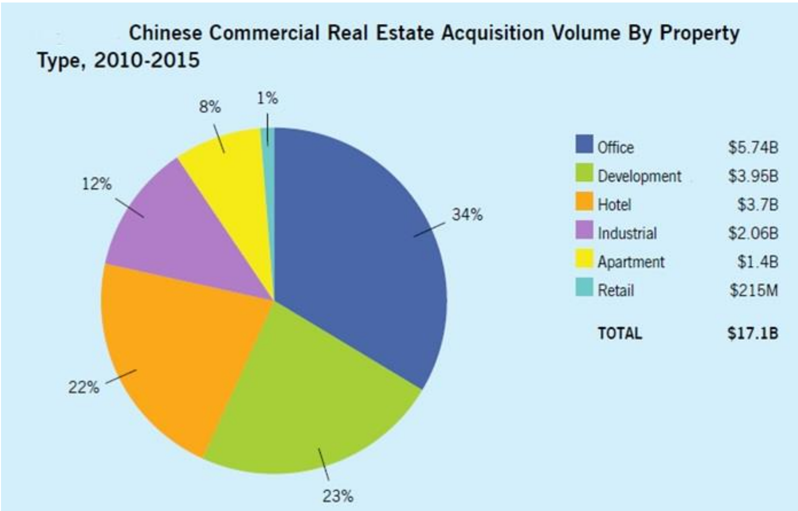
Jul 13, 2016 | Peter Fuhrman, Chairman and CEO, China First Capital

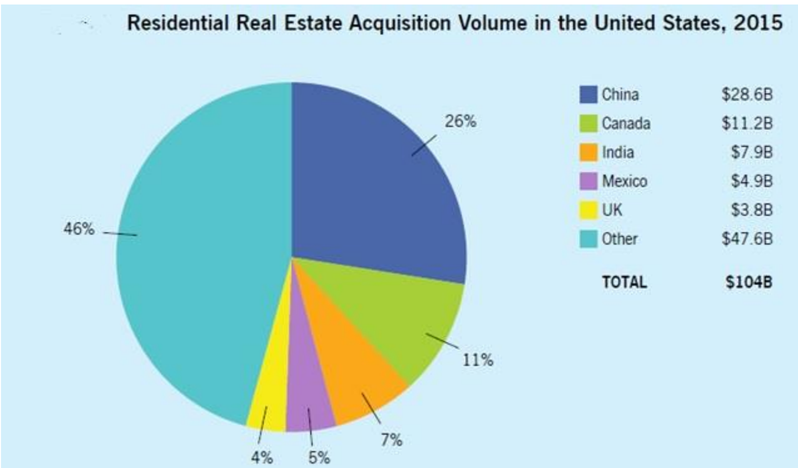
Some of the biggest investors in America's biggest industry are certain history is repeating itself. The Americans believe that Chinese real estate investors will invest as recklessly and lose as much money as quickly in the US as Japanese real estate investors did 25 years ago. The Japanese lost – and Americans made — over ten billion dollars first selling US buildings to the Japanese at inflated prices, then buying them back at large discounts after the Japanese investors failed to earn the profits they expected.

Chinese investors are now pouring into the US to buy real estate just as the Japanese did between 1988-1993. To American eyes, it all looks very familiar. Like the Japanese, the Chinese almost overnight became one of the largest foreign buyers of US real estate. Also like the Japanese, the Chinese are mainly still targeting the same small group of assets — big, well-known office buildings and plots of land in just three cities: New York, San Francisco and Los Angeles. Pushed up by all the Chinese money, the price of Manhattan office buildings is now at a record high, above $1,400 square foot, or the equivalent of Rmb 100,000 per square meter.

The term “China price” has taken on a new meaning in the US. It used to mean that goods could be manufactured in China at least 33% cheaper. Now it means that US real estate can be sold to Chinese buyers for at least 33% more. Convincing US sellers to agree a fair price, rather than a Chinese price, takes up more time than anything else we do when representing Chinese institutional buyers in US real estate transactions.

While there are similarities between Chinese real estate investors today and Japanese investors 25 years ago, we also see some large differences. American investors should not start counting their money before its made. Based on our experience, we see Chinese investors are becoming more disciplined, more aware of the risks, more professional in evaluating US real estate. There is still room to improve. The key to avoiding potential disaster: Chinese investors must learn the lessons of why the Japanese failed, and how to do things differently.





Twenty-five years ago, many economists in the US believed the booming Japanese investment in US real estate was proof that Japan's economy would soon overtake America's as the world's largest. Instead, we now know that Japanese buying of US property was one of the final triggers of Japanese economic collapse. The stock market, property prices both fell by over 70%. GDP shrunk, wages fell. Japanese banks, then the world's largest, basically were brought close to bankruptcy by $700 billion in losses. To try to keep the economy from sinking even further, the Japanese government borrowed and spent at a level no other government ever has. Japan is now the most indebted country in the developed world, with total debt approaching 2.5X its gdp. There are some parallels with China's macroeconomic condition today — banks filled with bad loans, GDP growth falling, domestic property prices at astronomical levels.

Just how much money are Chinese investors spending to buy US property? Precise data can be difficult to obtain. Many Chinese investors are buying US assets without using official channels in China to exchange Renminbi for dollars. But, the Asia Society in the US just completed the first comprehensive study of total Chinese real estate investment in the US. They estimate between 2010-2015 Chinese investors spent at least $135 billion on US property. Other experts calculate total Chinese purchases of US commercial real estate last year rose fourfold. Chinese last year became the largest buyers of office buildings in Manhattan, the world's largest commercial real estate market.

This year is likely to see the largest amount ever in Chinese investment in the US. While most Chinese purchases aren't disclosed, large Chinese state-owned investors, including China Life and China Investment Corporation have announced they made large purchases this year in Manhattan. While the Chinese government has recently tried to restrict flow of money leaving China, a lot of Chinese money is still reaching the US. One reason: many Chinese investors, both institutional and individual, expect the Renminbi to decline further against the dollar. Buying US property is way to profit from the Renminbi's fall. Other large foreign buyers of US real estate — European insurance companies, Middle East sovereign wealth funds — cannot keep up with the pace of Chinese spending.

With all this Chinese money targeting the US, many US real estate companies are in fever mode, trying to attract Chinese buyers. The large real estate brokers are hiring Chinese and preparing Chinese-language deal sheets. Some larger deals are now first being shown to Chinese investors. The reason: like the Japanese 25 years ago, Chinese investors have gained a reputation for being willing to pay prices at least 25% higher than other foreign investors and 40% above domestic US investors.

Twenty-five years ago, anyone with a building to sell at a full price flew to Japan in search of a buyer. Today, something similar is occurring. Major US real estate groups are now frequent visitors to China. Their first stop is usually the downtown Beijing headquarters of Anbang Insurance.

Eighteen months ago, just about no one in US knew Anbang's name. Now they are among US commercial real estate owner's ideal potential customer. The reason: last year, Anbang Insurance paid $2bn for the Waldorf Astoria Hotel. The seller was Blackstone, the world's largest and most successful real estate investor. No one is better at timing when to buy and sell. A frequentlyfollowed investment rule in the US Chinese investors would be wise to keep in mind: don't be the buyer when Blackstone is the seller.

Based on the price Anbang paid and Waldorf's current profits, Anbang's cap rate is probably under 2.5%. US investors generally require a cap rate of at least double that. Anbang hopes eventually to make money by converting some of the Waldorf Astoria to residential. It agreed to pay $149mn to the hotel's union workers to get their approval to the conversion plan.

Earlier this year, Blackstone sold a group of sixteen other US hotels to Anbang for $6.5bn. Blackstone had bought the hotels three months earlier for $6bn. "*Ka-Ching"*.

Anbang's chairman Wu Xiaogang now calls Blackstone chairman Steve Schwarzman his "good friend".

Another Chinese insurance company, Sunshine, paid an even higher price per room for its US hotel assets than Anbang. Sunshine paid Barry Sternlicht's Starwood Capital Group $2 million per room for the Baccarat Hotel. It is still most ever paid for a hotel. In order to make a return above 4% a year, the hotel will need to charge the highest price per room, on average, of just about any hotel in the US.

Another famous New York hotel, the Plaza, is also now for sale. The Plaza's Indian owners, who bought the hotel four years ago, are now facing bankruptcy. They are aggressively seeking a

Chinese buyer. We've seen the confidential financials. Our view: only a madman should consider buying at the $700mn price the Indians are asking for.

The common view in the US now — the Chinese are, like the Japanese before, buying at the top of the cycle. Prices have reached a point where some deals no longer make fundamental economic sense. At current prices, many buildings being marketed to Chinese have negative leverage. It was similar in the late 1980s. Japanese paid so much to buy there was never any real possibility to make money except if prices continue to rise strongly. Few US investors expect them to. That's why so many are convinced it's a good time to sell to Chinese buyers.

No deal better symbolized the mistakes Japanese real estate investors made than the purchase in 1989 of New York's Rockefeller Center, a group of 12 commercial buildings in the center of Manhattan. Since the time it was built by John Rockefeller in 1930, it's been among the most famous high-end real estate projects in the world.

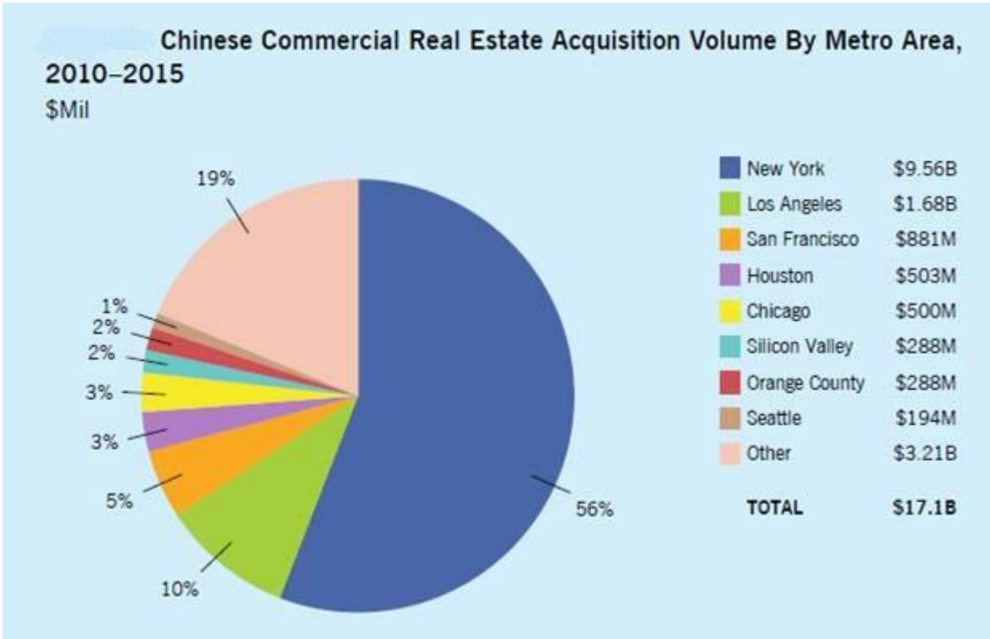
In 1989, Mitsubishi Estate, the real estate arms of Mitsubishi Group, bought the majority of Rockefeller Center from the Rockefeller family for $1.4 billion. At the time, the Rockefeller family needed cash and they went looking for it in Japan. Mitsubishi made a preemptive bid. They bought quickly, then invested another $500mn to upgrade the building. The Japanese analysis at the time: prime Manhattan real estate on Fifth Avenue was a scarce asset that would only ever increase in value.

Mitsubishi had no real experience managing large commercial real estate projects in Manhattan. They forecasted large increases in rent income that never occurred. The idea to bring in a lot of Japanese tenants also failed. Rockefeller Center began losing money, a little at first. By 1995, with over $600 million in overdue payments to its lenders, Rockefeller Center filed for bankruptcy. Mitsubishi lost almost all its investment, and also ended up paying a big tax penalty to the US government.

A group of smart US investors took over. Today Rockefeller Center, if it were for sale, would be worth at least $8 billion.

It was a similar story with most Japanese real estate investments in the US. They paid too much, borrowed too much, made unrealistically optimistic financial projections, acted as passive landlords and focused on too narrow a group of targets in New York, San Francisco and Los Angeles.

According to Asia Society figures, over 70% of Chinese commercial real estate purchases have been in those same three cities. If you add in Silicon Valley and Orange County, the areas next to Los Angeles and San Francisco, then over 85% of Chinese investment in US real estate is going into these areas of the US. Prices in all these locations are now at highest level of all time. They are also the places where it's hardest to get permission to build something new or change the use of the building you own.



It's easy enough to understand why almost all Chinese money is invested in these three places. They have the largest number of Chinese immigrants, the most flights to China, the deepest business ties to PRC companies. They are also great places for Chinese to visit or live.

But, all this doesn't prove these are best places to invest profitably, especially for less-experienced Chinese investors. In fact, the Japanese relied on a similar local logic to justify their failed investment strategy. These are also the places with the largest number of Japanese-Americans. A quick look through financial history confirms that no two places in the world have made more money from foolish foreign investors than New York and California.

Many of the largest US real estate groups are selling properties in New York and California to reinvest in other parts of the country where the financial returns and overall economy are better. Most of the gdp and job growth in the US comes from states in the South, especially Texas, Arizona and Florida.

Chinese investors should consider following the US smart money and shift some of their focus to these faster-growing markets. Another good strategy — partner with an experienced US real estate investor. The Japanese never did this and paid a very high price trying to learn how to buy, rent and manage profitably real estate in the US. In their most recent deals in Manhattan, both Fosun and China Life have chosen well-known US partners.

Another important difference: Japanese real estate investment in the US was almost entirely done by that country's banks, insurance companies and developers. With Chinese, the biggest amount of money is from individuals buying residential property. According to the Asia Society report, last year, Chinese spent $28.6bn buying homes in the US. That's more than double the amount Chinese institutional investors spent buying commercial property. Residential prices, in most parts of the US, have still not returned to their levels before the financial crash of 2008.

Another big pool of Chinese money, almost $10bn last year, went into buying US real estate through the US government-administered EB-5 program. In the last two years, 90% of the EB-5 green cards went to Chinese citizens.

The original intention of the EB-5 program was to increase investment and jobs in small companies in America's poorest urban and rural districts. Instead, some major US real estate developers, working with their lawyers, created loopholes that let them use the EB-5 program as a cheap way to raise capital to finance big money-making projects in rich major cities, mainly New York, Chicago and Los Angeles. Congress is now deciding if it should reform or kill the EB-5 program.

Chinese are by far the largest source of EB5- cash. Even so, Chinese should probably be happy to see the EB-5 program either changed or eliminated. There's also been a lot of criticism about the unethical way some EB5 agents operate within China. They are paid big fees by US developers to find Chinese investors and persuade them to become EB-5 investors. Many of these agents never properly inform Chinese investors that once they get a Green Card, they have to pay full US taxes, even if they continue to live in China. The concept of worldwide taxation is an alien one for most Chinese.

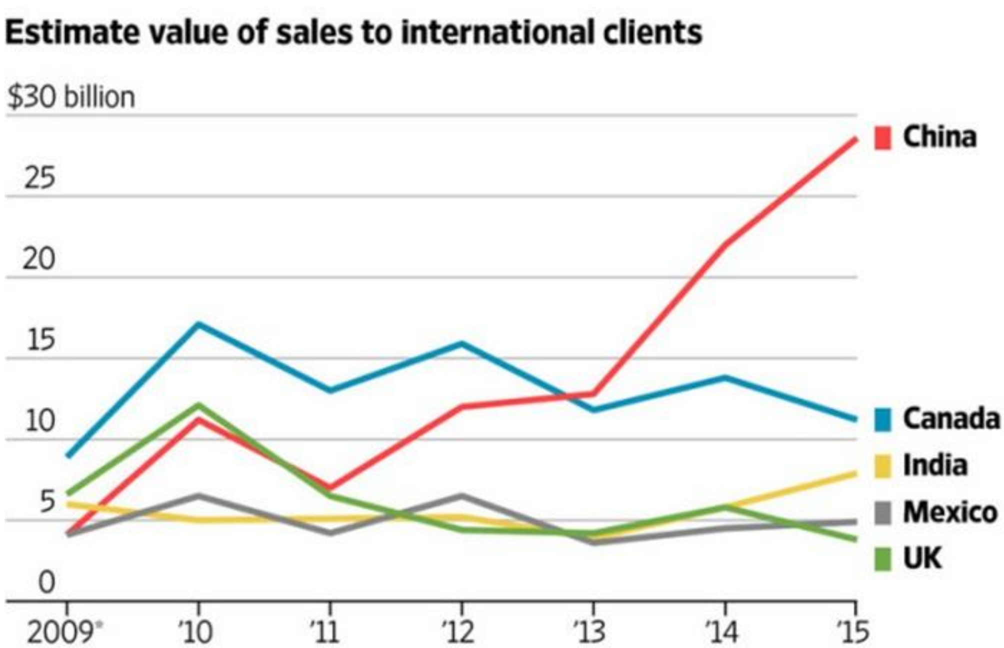
Taxes play a huge role in deciding who will and will not make money investing in US real estate. All foreign investors, including Chinese, start at a disadvantage. They aren't treated equally. They need to pay complicated withholding tax called FIRPTA whenever they sell property, either commercial or residential. To make sure the tax is paid, the US rules require the buyer to pay only 85% of the agreed price to a foreign seller, and pay the rest directly to the IRS. The foreign seller only gets this 15% if they can convince the IRS they've paid all taxes owed.

Many larger real estate investors in the US use a REIT structure to buy and manage property. It can reduce taxes substantially. Up to now, few Chinese investors have set up their own REITs in the US. They should.

Another key difference between Japanese and Chinese investors: it is very unlikely that Chinese will ever, as the Japanese did between 1995-2000, sell off most of what they own in the US. The Chinese investors we work with have a long-term view of real estate investing in the US. They say they are prepared stay calm and steadfast, even if prices either flatten out or start to fall.

This long-term view actually gives Chinese investors a competitive advantage in the US. If the US real estate industry has a weakness, it is that too few owners like to buy and hold an asset for 10 years or longer. Many, like Blackstone and GGP, are listed companies and so need to keep up a quick pace of buying and selling to keep investors happy. As a result, there are some long-term opportunities available to smart Chinese investors that could provide steady returns even if there is no big increase in overall real estate prices.

Two examples: The US, like China, is becoming a country with a large percentage of people 65 years and older. As the country ages, American biotech and pharmaceutical companies, the world's largest, are spending more each year to develop drugs to treat chronic diseases old people suffer from, like dementia and Parkinson's. There's a growing shortage of new, state-of-the-art biotech research facilities. The buildings need special construction and ventilation that require significantly higher upfront cost than building an ordinary office building. They also need to be located in nice areas, with large comfortable offices for 800 – 1,500 management and researchers. The total cost to build a biotech center is usually between $200mn-$400mn. But, rents are higher, leases are longer and there are usually tax subsidies available.



The other good way to make long-term money investing in US real estate is to take advantage of the fact American companies, unlike Chinese ones, do not like owning much real estate. It tends to hurt their stock market valuation. So, bigger US companies often build long-term partnerships with reliable real estate developers to act as landlord.   Starbucks is still growing quickly and is always interested to find more real estate partners to build and own dozens of outlets for them. Starbucks provides the design and often chooses the locations. It is happy to sign a 15-20-year lease that gives landlords a rate of return or 7%-8.% a year, higher if the developer borrows money to buy and build the new Starbucks shops. The only risk if at some point in the next 10-20 years the 2%-3% of the US population that buy a coffee at Starbucks every day stop coming.

The Japanese never developed a similar long-term strategy to make money investing in US real estate. Instead, they just spent and borrowed money to buy famous buildings they thought would only go up in value. They not only lost money, they lost face. After staying away for 20 years, Japanese investors, mainly insurance companies, have just begun investing again in New York City.

Japanese investors arrived 30 years ago confident they would be as successful buying real estate in the US as they were selling cars and tvs there. They learned a bitter lesson and left with their confidence shattered. Chinese can, should and must do better

(Charts courtesy Asia Society and National Association of Realtors)

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