ISSN: 2688-9323

Analysis on the Operation Mode of China's Real Estate Investment Trusts

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Abstract

China's real estate has played a crucial role in the national economy and also a key carrier for the wealth of the Chinese residents nowadays. In consideration of the financing difficulty, which has become the real estate industry's main problem in recent years along with the promulgation of the policy for "purchasing an apartment for living instead of speculating", all real estate enterprises endeavor to explore new financing channels and real estate investment trusts (REITs) have been further developed under such a special background. This paper sorts the concept and advantages of REITs, and analyzes the operation mode of China's REITs.

Keywords

REITs; Trust; Operation Mode.

1. Introduction

Under the policies of "purchasing an apartment for living instead of speculating and speeding up the development of house rental market" proposed in the 19^{th} CPC national congress, REITs have become an effective way that the Chinese real estate enterprises use to reduce their debt management and transform towards asset-light strategy in recent years. As a kind of innovative financing mode for expanding real estate enterprises' financing channels, REITs indeed connote great significance. To study the operation mode of China's REITs in depth actually could bring positive significance to real estate enterprises' market and capital market.

2. Concept of the REITs

REITs can gather the funds from many investors to purchase and hold income real estate by using such organizational forms as company, trust or association. As REITs haven't been established formally in China, they are mostly called real estate investment trust but the two are largely different. REITs refer to a kind of investment system in a broad sense or a kind of organization form in a narrow sense. With the general features of trust, they are different from trust and essentially fall into the scope of fund. Different from other general investment funds, REITs have an investment scope limited to real estate only according to the concept. According to REITs, the idle funds of investors from small and medium-sized enterprises are generally collected for professional investment, and then these funds are used for real estate investment, development, sales, leasing, etc. REITs are also a kind of investment system, which ensures sufficient liquidity through expert management, professional operation and special trust as well as listing. Compared with the general investment funds, REITs have a longer term and a larger scale. REITs are duly established to raise funds, disperse the financing risk of real estate industry, obtain higher scale benefits, and promote the sustainable development of the real estate market.

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3. Advantages of the REITs

3.1. Strong Liquidity and Marketability

As known by all, real estate industry has a low liquidity. If investors make investment in real estate directly, it will be difficult and long to realize the investment and the price will be lowered dramatically if realization is urgently needed. Differently, REITs refer to a kind of fund, where funds are raised by issuing shares or unit beneficiary certificates to most social investors. Shares or beneficiary certificates are assets that investors can sell at any time, which finally contributes to a high liquidity. For the investors making an investment in real estate industry, it will be very difficult and highly expensive to realize their investment. However, REITs can be listed and issued, which finally changes the real estate assets from fixed assets to liquid ones. Real estate investment belongs to immovable property investment featured by a relatively long investment cycle. REITs make it possible to make real estate, a kind of immovable property, become more liquid.

3.2. Lower Investment Risk

Many small businesses and social funds have emerged into China's real estate market, which has been popular for years. However, as an industry entailing substantial capital investment, the real estate industry cannot realize sustainable development with the capitals from small businesses alone, which also leads to the inefficiency of the following steps of real estate projects. By contrast, REITs raise funds by certificates or shares, and obtain real estate income through the professional management of the professionals. The funds of REITs can be used for investment not only in real estate directly, but also in securitization real estate assets with low risk and the real estate assets with strong liquidity such as shares and bonds issued by listed real estate enterprises. Furthermore, managers can reduce the real estate risks through various investment portfolios, and managers' responsibility and risk can also be relieved due to the different shareholders.

3.3. Modernize Management Mode

According to the REITs, real estates are managed by professional institutions and individuals. The senior management holds certain share in REITs, so that the management and the shareholders share highly consistent interests and the conflicts between them can be avoided effectively. Investors have to get involved in the real estate business if investment is made in real estate directly, which consumes labor, material, financial strength and other social resources dramatically. If investors hand over the business to others, conflicts easily happen with managers and managers' moral risk cannot be avoided as well. If investors make management personally, they cannot receive support from professionals, finally leading to financing difficulty. Therefore, REITs mean a win-win choice.

3.4. Stable Income and High Bonus

There are two main sources of income for REITs, of which, one is the interest bonus. The bonus of REITs means the real estate industry's operating incomes distributed to REITs investors in the form of interest after the investment of REITs investment in real estate industry. However, the specific provisions vary in different countries, especially in US where 90% of incomes must be distributed in the form of bonus as per the provisions, which brings stable and rich returns to investors. At the same time, the investors also bear a low investment risk due to the advantages of professional financing and investment diversification, which is suitable for the fund product bringing medium income to small and medium-sized enterprises investors and with lower risks. The other is capital appreciation, which means the value gained or lost due to the appreciation or depreciation of existing assets and properties. If REITs run well, their net assets will rise, and the appreciated fund will also be owned by investors ultimately.

ISSN: 2688-9323

3.5. Popularization of Investment Subject

As a fund-intensive industry, the real estate industry is characterized by a large scale and a long investment cycle, making ordinary small enterprises dare not to make investment easily. Therefore, a large number of social idle funds can't be effectively used. By contrast, REITs change the real estate deal with a considerable amount into petty portfolio investment. In this way, all investors can invest in large real estate projects and become a shareholder. Furthermore, real estate financing is also not that difficult.

4. Exploration on Operation Models of China's REITs

REITs are still under an initial stage in China and a scaled development has not been formed yet. REITs have different types from different aspects. The operation model of REITs can be divided into corporate operation model and contract operation model according to the specific organization forms, which are the most commonly used way for division. It can also be divided into equity investment model mortgage investment model and hybrid investment model based on the specific investment forms.

4.1. Organization Forms

4.1.1. Corporate Type

Corporate REITs mean externally issued REITs products, the fund shares of which are issued through corporate. According to this type, the REITs issue and operation are managed by setting up the specific board department. Underlying assets are usually cash pooling of real estate projects, where internal management system is applied.

Establishment procedures: First, build a cash pooling and add the real estate portfolio into the cash pooling; then establish a REITs company managed by a dedicated board of directors or an external organization; then rate the trust fund and apply for listing finally.

4.1.2. Contract Type

Contract financing model of REITs refers to a kind of principal-agent investment fund guided by the contractual relationship. According to this model, there is no an independent legal entity and the principal-agent behavior is generally realized via contractual trust relationship. It is a kind of asset entrustment form, where investment and financing are made based on the relationship of asset managers and investors.

Establishment procedures: First, the issuing bodies issue trust units to investors and purchase real estate projects by financed assets. Then employ external management organizations to manage the assets purchased, for REITs have no independent legal person qualification. Finally use the operation interests of underlying assets to pay the investors' principal and interests.

4.1.3. Comparison of Corporate REITs and Contract REITs

The biggest differences between them is that corporate REITs are a corporate legal entity while contract REITs are a kind of agent investment behavior based on contract and trust relationship with no legal person qualification. Their differences also include:

Table 1. Comparison of Corporate REITs Financing Model and Contractual REITs Financing Model

Features	Corporate REITs	Contractual REITs
Assets Nature	Corporate assets	Trust property
Relationship with Investors	Shareholders and company	Trust deed
Benefit Distribution	Dividend distribution	Trust benefit distribution

ISSN: 2688-9323

Differences can be concluded from the above table. First, they have different asset natures. Corporate REITs, which are raised by issuing stocks essentially, belong to corporate legal person's capital and are operated according to the articles of association. Contract REITs belong to trust assets, which are operated according to contracts. Second, they have different relationships with investors. The investors of corporate REITs become the shareholders of the REITs companies and have related shareholder rights after investment while those of contract REITs become contracting parties after investment. Third, they have different forms of benefit distribution, which is subject to asset nature. In conclusion, corporate REITs are a kind of corporate legal entity, but contract REITs are a kind of agent investment behavior based on contract trust relationship with no legal person qualification, which is also the core difference between them.

According to the author's idea, China should choose contract REITs based on the considerations: First, China has no specific laws about investment and funds, but high legal requirements are posed for the application of real estate trust fund. China's fund investments mainly gather in securities industry and there is no corporate fund available yet. Therefore, corporate funds have no mature application conditions for real estate industry. The application of contract type is less restrained by laws and therefore could be boosted more smoothly. Besides, the internal management capacity of China's real estate industry is not consistent with the requirements of corporate funds. Managers would make adverse selections in face of the information asymmetry, which exerts influence on shareholders' interests. Therefore, the application of corporate fund brings larger risks.

4.2. Investment Forms

REITs can also be divided into equity REITs, mortgage REITs and hybrid REITs according to the specific investment forms. As the prominent type of REITs, equity REITs have property right of underlying assets and can provide property management services. The investors' benefits during the operation period are from rents of underlying assets and their benefits during the withdrawal period are from the added value of real estate. Mortgage REITs mean REITs issue loans to real estate owners or project companies directly with their real estates as the mortgage and the benefits of investors are from loan interests. The hybrid REITs, which combine equity REIT and mortgage REIT, own the features of both. Equity REITs are the most commonly used one in the current market.

Table 2. Comparison of Equity REIT, Mortgage REIT and Hybrid REIT

Model	Equity REITs	Hybrid REITs	Mortgage REITs
Operation model	Invest and operate real estate projects and hold the stock rights of real estates	Buy and operate property stock rights, issue mortgage loans directly or buy credits and CMBS of mortgage loans	Issue mortgage loans to commercial real estate directly or buy credits and CMBS of mortgage loans from banks
Applicable Assets	Applicable to wholly-owned real estate assets with clear ownership		Applicable to real estate assets with clear actual control rights
Financing Scale	No higher than the evaluated value of assets		No higher than 70% of the evaluated value of assets
Investors' Benefit Sources	Rents and added value of real estates	Rents, added value of real estates and loan interests	Loan interests

ISSN: 2688-9323

5. Summary

REITs have been applied extensively within the global real estate industry thanks to their merits such as broader investment groups, higher return, stronger mobility and cash performance, etc. Their operation model should be selected based on the actual development status and financing status once REITs are used in China's real estate industry. Meanwhile, as a kind of financial products, REITs have risks, which is unavoidable. Risk control in such aspects as real estate industry, project investment, market and morality, etc. should be strengthened in the future to boost fund operation more effectively.

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