KEYS TO... CHINA

Developing and Investing in China's Hotel Industry

DLA PIPER

CUSHMAN & WAKEFIELD

It is with great pleasure that the hospitality teams of Cushman & Wakefield and DLA Piper jointly present the 1st in a series of publications. Many people would these days believe that Consultants/Brokers and Lawyers would be fighting for the same space, but this collaboration shows that we can co-exist and bring to the table a formidable combination of knowledge and expertise. The idea behind each of these publications will be to highlight some key issues that we have each identified in the major markets around the region. Given the location of HICAP we thought that China was the most appropriate place to begin.

We hope you find this useful and informative. For those of you attending HICAP – we will hopefully see many of you and get your reactions. For those around the world do let us know how we can improve it. Have a great last quarter of the year and watch this space for more from us.

COMPLEXITY IN PROCESS FROM LAND ACQUISITION TO HOTEL OPENING

Cushman & Wakefield: Foreign developers wanting a slice of China's hospitality sector need to understand the complexities of the development process from land acquisition and hotel construction to hotel opening as well as the issues related to project management.

Land in China is either state-owned or collective-owned, although developers can apply for land use rights which carry tenures between 40 and 70 years. Hotels have typically 40-year land tenure, which are among the shortest tenures in Asia.

DLA Piper: One measure incorporated under the 2007 PRC Property Rights Law to minimize the risk of corruption in the acquisition of land use rights was the requirement for the acquisition process to be by way of bidding, auction or quotation. Land use rights are capable of being sold, leased or assigned so long as certain conditions are fulfilled – including that the land has been suitably developed pursuant to the land grant contract. From a practical point of view, this is often avoided through the sale of equity in the holding company of the property, rather than by dealing with the property itself.

Beware of 'allocated land use rights'. A significant amount of land held by state bodies is deemed to be allocated, theoretically at least, for the public interest and allocated land use rights cannot be assigned or leased unless they are first converted into granted use rights – which can be a very difficult and uncertain process. Where allocated land use rights are assigned without approval the land could be taken back or fines imposed. Banks will not lend money against allocated land.

Cushman & Wakefield: After the site acquisition, developers need to gather various permits, e.g. planning and construction permits, building construction license etc., from various authorities before construction can commence. New large-scale hotel openings can present major logistical challenges associated with construction management such as in adherence to specifications, problems in design and construction, fire and life safety and licensing issues, non-compliance with brand standards, so on. Hence, owners and developers should adopt effective project management processes to track development progress and reduce inefficiencies and development risks involved.

GUANXI, CULTURAL SENSITIVITIES AND DEALING WITH THE LOCAL GOVERNMENT

Developing strong *guanxi* (loosely translated as networked relationships), especially with the local government is essential in doing successful business in China. Local governments often award sites to large State-Owned Enterprises (SOEs) and experienced Hong Kong developers when planning for real estate developments in their cities or provinces and foreign developers find it difficult to compete. Developing *guanxi* is a serious business and should be regarded as a forethought and observing the right cultural protocols can make all the difference between success and failure.

DLA Piper: Local government relationships are crucial. Hotels require an array of licences in order to operate and frequently only those with strong local connections will know exactly which local licensing authorities need to be dealt with and which decision makers to talk to within those authorities. This is not about corruption but knowing how to manage the process effectively and how to get realistic estimates of the time frames involved. International law firms will often have connections with local bodies in some of the top tier cities while in second or third tier cities will try to develop good relationships with local agents whose knowledge and networks can be invaluable.

It is also important for companies in China to respond to any governmental requests for assistance in the delivery of social objectives and companies should be proactive in offering such assistance. The concept of 'corporate social responsibility' is not yet well developed in China but in its infancy it is taking the form of government bodies expecting international companies to manage and contribute towards government fronted projects.

FINDING THE RIGHT PARTNERSHIP AND DEVELOPMENT TYPE

Cushman & Wakefield: A very popular reason to put up a hotel in China is the mixed-use scheme where a whole area or complex is built up, including offices, housing, shopping malls, leisure park, and to add value and prestige, a hotel is fitted in, almost as an afterthought. Developers may be required to bring in for example international retail expertise and tenants together with a well-known hotel brand in order to negotiate preferential land deals and loan arrangements. Mixed-use residential and hotel projects are another favored development scheme, whereby large profits made from residential sales can counteract the normally low returns made from the hotel components. These require developers to seek suitable local partners, which can be a challenging affair. From the operator's point of view, they generally want to sign up with experienced domestic developers with strong financial background, whereas but local developers mostly see the hotel brand as a leverage to sell their residential components.

DLA Piper: Mixed use schemes in China may be popular with developers but they can be a legal minefield. Different uses may suit the developers (and also the hotel operators who may want to make their hotel site attractive by having nearby retail or entertainment) but under China's legal regime, the government identifies different parcels of land for different uses such as 'commercial uses', 'residential use' and 'commercial and residential use'. As a consequence it is vital that any mixed use project is constructed on land that is designated for 'commercial and residential use'.

If developing branded residences potential issues arise from the fact that where a developer sells a flat to a purchaser the purchaser becomes the owner of the apartment and at law enjoys full property rights. Service operators may have difficulty enforcing control or management even through a contractual arrangement with the apartment's purchaser because a homeowner's full property rights are deemed to be paramount – and in some circumstances this means that even if they breach a contract damages may not be forthcoming. A key concern for the operator in this scenario is the potential damage to the brand where proper standards cannot be enforced throughout the development.

One way in which operators have sought to control residential occupiers in branded residence schemes is through granting long term leases however the maximum term of real estate leases in China is 20 years so the market price of a leases branded residence may be lower than a residence that is sold.

INVESTMENT METHODS, APPROVALS, CONTROLS AND FINANCING

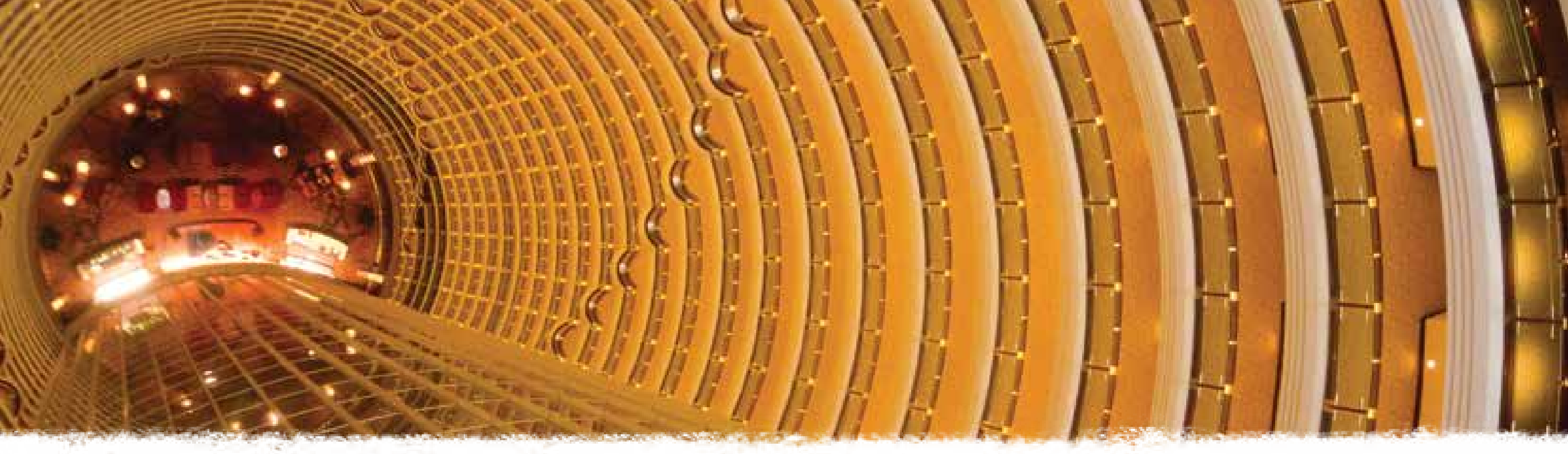
Cushman & Wakefield: Hotel investment has its challenges concerning investment approvals and controls. Firstly, foreign investors are not allowed to use offshore investment vehicles to directly control properties in China; instead they must register an onshore Foreign Investment Enterprise (FIE) to do so. The registered capital of the FIE is required to exceed 50% of the total investment value for any investment in real estate exceeding USD10 million. Secondly, a FIE investing capital in and repatriating money out of China must obtain approval from the Ministry of Commerce or the State Administration of Foreign Exchange (SAFE). A foreign company cannot convert USD into RMB – whether to open a bank account, hire an employee or lease an office – without first getting investment approval from the local branch of the Ministry of Commerce. For repatriation, an FIE must apply for registration of foreign exchange with the authorities, and once they have complied with corporate tax regulations and payments, will they be allowed to repatriate the money. In practice, the procedures could be more complicated than described.

DLA Piper: Acquisition of hotel assets will be by way of share or asset purchase.

Share acquisitions are typically structured by using either an offshore or onshore deal model. Both models are similar however in an offshore deal the purchaser will purchase the share capital of another offshore 'holding company' that owns a China project company which subsequently owns the target land or property. An onshore purchase will involve buying the equity of a China holding/project company. For offshore companies based in Hong Kong the transaction/ stamp duty cost would be 0.2% of the share transfer price for an offshore and 0.1% for an onshore structured deal.

Asset transfers in China offer the benefit of 'cherry-picking' desirable assets, and with it negate any risk of purchasing hidden liabilities which can be a problem in share purchases. However, such a transfer could mean more disruption to the target entity and importantly carry one major flaw: high taxes – stamp duty, deed tax, and land appreciation tax of 30% to 60% of the gain are all payable following the asset transfer.

Note that FIEs with Real Estate interests cannot borrow funds until (i) their registered capital is fully paid up, (ii) their land use rights and various construction licenses have been obtained have been obtained and (iii) capital funds are available for development of at least 35% of the total investment amount for the project. SAFE will not process any foreign offshore loans for real estate FIEs so borrowing is limited to onshore loans – which in practice can be very hard to obtain especially when the company has no track record or financial statements.



CHINA'S HIGH-END HOTELS: TOO MUCH OF A GOOD THING?

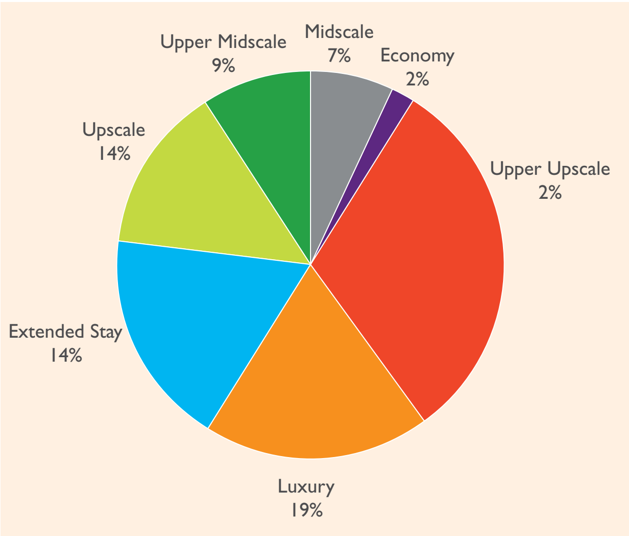
Cushman & Wakefield: Much of the investment capital in China's hotel market has been focused on the upscale and luxury segments. In the past year, hotel assets have seen strong appreciation in capital values and it is becoming increasingly difficult for investors to find suitable assets due to aggressive asking prices.

The incoming supply of upscale and luxury segments in many Chinese cities, is staggering. The current stock of 110,000 luxury hotels would experience a 45% increase from pipeline supply. Coupled with China's slowing economy and the government's austerity measures, the high-end markets could experience downward pressures on room rates, occupancy and margins.

Arguably, the greatest potential in China's future hotel market lies in the expansion of the branded mid-market which is targeted at the domestic traveler. There are over 1.9 billion domestic travelers compared to inbound international arrivals of 57 million and the rising affluence of the middle class would feed into the domestic tourism market. Currently, there are generally fewer mid-priced international branded products than the high-end ones and their margins tend to be lower. However, the scale of the domestic middle-class market is not to be ignored.

This is specially so in light of the recently issued Outline for National Tourism and Leisure (2013-2020), which promotes the taking of paid annual leave days, giving workers more freedom and flexibility on where and when to travel instead of just the 'Golden Weekends'.

HOSPITALITY INVESTMENT SALES IN CHINA, 2012-2013YTD



Source: RCA Analytics, Cushman & Wakefield

LACK OF UNDERSTANDING OF HOTEL OPERATIONS, BRANDING AND MANAGEMENT CONTRACTS

Cushman & Wakefield: Unlike the developed economies, the owners and developers' awareness and understanding of hotel brands, segmentation and management contracts is generally poor in China. Often, owners engage brands half-way through the constructions and retro-fit the hotels to try to match them to brand standards. No one really knows the extent by which management contracts are enforced. Apart from their inexperience, many local hotel owners also have limited understanding of the need to carry out a feasibility study to assess the investment.

The preference for a particular brand is often seen as a 'fashion' statement rather than a clear choice based on proven results.

The risk-returns expectations vary widely for investors and operators, largely due to the lack of transparent data and information. What the seasoned local developer perceives is quite different for the inexperienced operator managing the first property in China, and there can be a large gap between current and expected financial performance of the property.

DLA Piper: It is certainly true that negotiating management agreements in China can be a challenging process. Owners in, for example, Thailand, tend to be fairly experienced and work within usual market parameters whereas in China owners are frequently new to the business. This makes a lawyer's job one not only of negotiation but also of diplomatically educating the owner through the negotiation process. Some owners are happy to be more flexible in their approach when dealing with international five star brands. An issue such as non-disturbance agreements (agreements whereby the operator seeks agreement from an owner's bank that in the event of owner default the bank will not seek to terminate the hotel management agreement) brings this attitude to the fore. Most Chinese owners refuse to entertain an operator's request that their bank enters into a non-disturbance agreement however we know that there are some chains who always manage to get owners to agree this point. Sometimes it is simply a matter of education, sometimes it is a matter of an owner being extremely keen to sign a top brand and therefore being willing to compromise.

Another example of an issues which can be difficult to negotiate in China might be an owner's unrealistic expectation of returns – we have seen this lead an owner to introduce unrealistic competitive sets from better performing cities or areas of high demand within the same city.

Often however the main issues when negotiating hotel management agreements in China are more basic. Whether negotiations take place in Chinese or English misunderstandings can easily arise therefore it is important that good quality translations are prepared throughout the negotiation process. Furthermore it is crucial when negotiating in China that you are actually negotiating with the correct people – it always worthwhile carrying out due diligence on the owner to ensure that the dealing company does own the property and that the relevant signatories do have power to bind.

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FOR MORE INFORMATION

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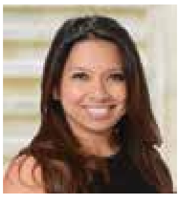

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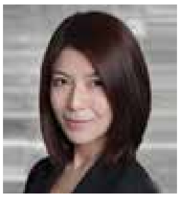

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