Managing global property investments

Understanding local laws and bureaucracy key to profits

Kent Richey

KENT RICHEY, a partner at Jones Day, is involved with complex real estate investments, joint ventures, real estate acquisitions and dispositions, and real estate finance. He regularly represents real estate funds as well as investment banks, private real estate companies and other institutional investors with real estate matters. He has more than a decade’s experience in the real estate industry including as general counsel to the Peabody Funds, private real estate funds, and to Allegro Resorts, an owner/operator of all-inclusive resort hotels controlled by Westbrook Real Estate Partners. Much of his work involves advising on real estate M&A and portfolio transactions and property-based financings in the US, Europe, Latin America and Asia.

What makes a foreign market attractive to a US investor? “Growth” tops the list, Kent Richey said in his address to the Global Executive Forum. “China and India have phenomenal growth rates,” he said. “They are very attractive” from that perspective.

Other contributing factors...

- Distress. When markets tumble and people are forced to sell assets, opportunities result and investors jump in. Richey referred to the RTC (Resolution Trust Corp.), a quasi-government organization created by Congress in 1989 to deal with the aftermath of the savings & loan failure. Distress doesn’t always open opportunity. “After the first Asian crisis in the 90s, even though there was huge distress in the markets, nobody was forced to sell. The banks wouldn’t foreclose on the ruling families that owned the properties and so it was very difficult to find opportunities that made sense in that environment.”

- Market inefficiency. Markets are inefficient when investors can make excess returns. “Spain and Italy were examples of market inefficiency when cap rates stood at 15 percent and the cost of debt was 3 percent.”

- Stable government. “This is the main reason why I believe investors are interested in China. It’s not particularly democratic but it’s very stable and there’s no fear that a power struggle will upset the way you do business there.”

- Currency. “If you’re going to take a currency risk, you do it in China where the only way the yuan is apt to move is in your favor. You’re not going to have a devaluation of the Chinese yuan against the dollar in the near term. Or you do it in Mexico where the currency has been so closely aligned with the US dollar that it makes sense to take that risk. Same case with India where the balance of trade with the US supports the value of the Indian rupee.”

- Rule of law. “China’s legal system is civil law which means they have a code; whereas the American and British systems are based on common law. We have codes too, but any sort of code always has some ambiguity, and as that ambiguity gets filled in with court cases you get to better understand how things are going to be decided; thus the system becomes more predictable. “One of the disadvantages of civil law is that it’s not as easy to know what the law is because there’s not a lot of case law to fill in the gaps. In Chinese law there is a lot of law but it isn’t publicly available. So you could violate a law without knowing it and be thrown in jail. I think they’re taking steps in the right direction to correct this but it’s still an opaque process in places.”

A guest asked, “In markets that don’t have a clear rule of law, how do you protect clients’ interests?” “Most investors in China don’t rely on the Chinese courts to settle disputes,” said
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Richey. Instead, a provision is inserted into the contract which calls for commercial arbitration. “The Chinese government has made it clear that they do want to honor these arbitration arrangements.”

- **Taxes.** "Real estate generally can’t bear two layers of tax at the corporate and investor levels. REITs eliminate the double taxation for US investments, but investments in a foreign country are subject to some local tax most of the time. “Even US tax-exempt investors, such as pension funds and university endowments which generally are not taxed on their US real estate investments, find that they will bear some taxes on their foreign real estate investments. “One way to reduce local taxes is to establish a lending corporation in some offshore tax haven where the taxes are very low. That corporation then lends money to the onshore company which then pays interest on the loan in addition to expenses. This reduces its local net income and results in less income tax in the local jurisdiction.

- **Repatriating funds.** “Taking funds out of a country is not an issue in most jurisdictions today but it is in China. There is a quirk in the Chinese system requiring that when you set up your company you specify exactly how much debt and equity you’re going to have in the company. “You have to register the debt, register the amount of the equity – when it comes in and when it goes out. That way, if you put in more equity than you were supposed to, you can’t take it out. “It’s important to pay attention to details when entering into contracts or partnership agreements. China is a market economy but it still has a very strong socialist approach toward things. If you’re a foreign investor, just about everything you do in China has to be approved by the government.” The rules relating to Chinese partners come with their own set of caveats. If you don’t deal with them on the front end, said Richey, they can affect your ability to sell a property and claim the profits due you.

Investment destinations

China and India, with two of the largest consumer markets in the world, are attractive destinations for foreign direct investment. “China has a huge amount of FDI, $61 billion in 2004,” said Richey. “In India, where rules for foreign investment have only recently been liberalized, the FDI is substantially lower, about $5 billion in 2004, equivalent to one month of China’s FDI.”

How do China and India compare in terms of facilitating development? “India is messier but more amenable to getting stuff done. But there are also times when you think you have something lined up and it falls apart. Recently, the private sector had plans to develop former mill sites in India but the Supreme Court ruled against development for private use saying the land had to be held for public use.”

Said Richey, “I don’t think that would happen in China because once the central government has made a decision in favor of development and foreign direct investment, it will generally stick with it.”