

How to Squeeze Through the Financing Logjam

Choosing a Suitable Real Estate Trust

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Property developers in China have had trouble obtaining financing in the current environment of monetary tightening and declining real estate prices and transaction volumes. Since January of this year, developers have increasingly turned to trust companies for financing, and trust companies have responded by issuing a creative array of useful products. Through the end of July, the volume of trust products issued in regard to real estate projects accounted for 48% of all trust products issued. By contrast, only 5.8% of real estate projects were financed using trust products last year.

As trust companies are non-bank financial institutions, they are permitted to invest in capital markets, money market funds and various industry sectors. Trust companies also have certain institutional advantages, as well as the flexibility to develop innovative products. These factors make trust companies and their products less vulnerable to regulatory hurdles and to other systemic risks when compared with other financial institutions. As traditional financing channels are restricted or even blocked, real estate developers are falling over each other to take full advantage of the financing opportunities offered by trust companies.

From the perspective of property developers in China, the most important factor in securing financing from a trust company is how to squeeze through the mighty logjam of demand. To accomplish this goal, developers need to thoroughly understand the various types of real estate trust products available and determine which ones offer the most suitable solutions to their particular financing needs.

In practice, the main types of real estate trust products are the equity trust, the bond trust, the exchange trust and other interest trusts.

Equity Trusts

In this type of trust arrangement, a trust company injects capital into an enterprise that owns a property development project but that lacks the ability to fund the project and is unable to meet the lending requirements of a commercial bank. The trust company must be satisfied that the project enjoys favourable prospects and that the enterprise is well managed and has clear ownership over the project and other assets. The trust company normally seeks control when purchasing an equity interest in a real estate development enterprise. Although the trust company generally does not involve itself in the daily management of the project enterprise, as the controlling shareholder it often requires certain share preferences and repurchase guarantees as preconditions to its willingness to provide financing.

Bond Trusts

Under this scenario, a trust company raises capital and directs the funds to a real estate company that is unable to obtain a commercial loan. The trust company often will provide this type of debt financing to a development enterprise that has short-term liquidity issues due to a specific cause or causes but where the company's future cash flow and its solvency are reasonably certain. In most cases, the trust company raises the capital from a single client and identifies the borrower in accordance with the client's instructions. To ensure the proper use of the funds, the trust company generally designates a commercial bank as its monitoring agent and requires the property developer to provide collateral.

Exchange Trusts

If the development of a project has entered the pre-sales stage and the property developer's cash flow is insufficient due to the project development cycle, a trust company can assist the developer by purchasing a portion of the properties. In an exchange trust situation, the property developer agrees to buy back the properties that are sold to the trust company once the funds become available to the developer through revenues generated by pre-sales. Normally, the trust company purchases the properties at a below-market price and obtains the right to dispose of the properties if the developer fails to perform its repurchase obligations within a specified time.

Other Interests Trusts

Trust arrangements in this category generally involve the financing of non-residential property. For example, a developer may wish on the one hand to retain its rights in a commercial or industrial property development and to collect rent, but on the other hand it may not be satisfied with the slow investment return available under a lease. In such a situation, the property owner assesses the rental value of the property over a certain period of time and sells the right to collect rent for such period in exchange for a fixed amount that the trust company pays to the owner in advance. The maximum period permitted under the Contract Law for such an arrangement is 20 years, and the trust company often requires the property owner to make certain commitments to the trust company in regard to rent collection and payment.

In practice, most trust companies arrange to raise capital and obtain security for the financing based on the actual needs of a particular cooperation with a specific developer. For example, the equity trust and bond trust models may be combined to finance a single. Another point to be emphasized is that in the current severe financing environment, due to external competition and the pressures inherent in an excessively tight capital market, developers often behave hastily, even ravenously, and act as soon as a financing opportunity is presented and before they have considered in sufficient detail the issues and choices involved in the various financing channels that may be available. In recent real estate trust financing cases, trust companies appear to have enjoyed a dominant position and a wide degree of freedom to unilaterally determine which property developers they wish to cooperate with, as well as the methods and terms for such cooperation, while the developers appear to have been relatively powerless.

In reality, however, property developers can take steps to level the playing field. Real estate development enterprises not only need to understand and grasp the types of real estate trusts and the normal terms and conditions involved in real estate trust financing, but also need to learn how to maintain a positive interaction with trust companies, to take the initiative to communicate with trust companies in designing the trust product and to introduce various alternative trust schemes, as well as the methods for raising and using the funds, security measures, etc., and they need to put forward constructive ideas in accordance with their financing needs, to improve the efficiency of their financing and to lower their financing costs and project transaction risks to the extent possible under the premise that a reasonable trust financing arrangement can be achieved.

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