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CENTER ON JAPANESE ECONOMY AND BUSINESS

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日本経済経営研究所

INVESTING IN COMMERCIAL REAL ESTATE: JAPAN VERSUS CHINA

October 27, 2004

The real estate markets of East Asia are attracting increased interest from the international investment community. Economic growth but also distress, as well as changing government regulations and other factors, have created significant new business opportunities across the region.

Japan and China, two of the world's largest economies, are both located in the East Asian region and share growing economic interests, yet in many respects offer very different real estate markets and investment opportunities. What are the similarities and differences of the Japanese and Chinese real estate markets, how are these markets evolving, and what are the implications for investors, both foreign and domestic?

To answer these and related questions, The Program on Alternative Investments invited George von Liphart, Managing Director of the Global Commercial Real Estate Group at Lehman Brothers, to offer his views on these two dynamic East Asian real estate markets. Mr. von Liphart, based in Tokyo, has played a key role in his firm's expanding real estate activities in both countries over a number of years. This report covers Mr. von Liphart's initial presentation as well as the ensuing question-and-answer session with the audience. This program was co-sponsored by the Paul Milstein Center for Real Estate.

The Program on Alternative Investments of the Center on Japanese Economy and Business analyzes three sets of alternative asset classes—private equity, hedge funds, and real estate—in Japan and elsewhere in East Asia in international perspective. The Program meets its substantive goals through a combination of research projects and seminar presentations, the latter led by leading practitioners in each of these three alternative asset classes. For information on the Center on Japanese Economy and Business, please visit www.gsb.columbia.edu/japan/. For a schedule of upcoming events and other information about The Program on Alternative Investments, please visit www.gsb.columbia.edu/japan/alternatives/.

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From left to right: Mark Mason, George von Liphart, and Hugh Patrick

MARK MASON

Director, Program on Alternative Investments, Center on Japanese Economy and Business, Columbia Business School

It is a pleasure to introduce today's speaker. George von Liphart is Managing Director of the Global Commercial Real Estate Group at Lehman Brothers. George has an impressive background in finance, real estate, and Asia, including a key position with GMAC in Tokyo prior to his current responsibilities at Lehman. I understand that George's work is now focused largely on real estate investment in China, but he has kindly agreed in his presentation today to compare and contrast key characteristics of the Chinese and Japanese real estate markets.

GEORGE VON LIPHART

Managing Director
Lehman Brothers (Japan)

Thank you. When Mark asked me to come and speak about real estate investment in Japan, I told him that I had not been actively involved for the last couple of years and so that my information might be a bit dated. Then he suggested that I do a comparison and contrast. That is a huge task, but I've assembled a collection of statistics and topics that I hope will illustrate some important points of comparison.

Let me start first by setting the context of Lehman Brothers' real estate and Asian real estate franchises. First of all, the two groups that are primarily involved with real estate–related investments in Asia are the Commercial Real Estate Finance Group and Lehman Brothers Real Estate Partners. The Commercial Real Estate Finance Group is the group that's responsible for acquiring non- and subperforming loans and for originating new loans, including both conduit-style loans and mezzanine debt. In the case of the mezzanine loans, we either hold them to maturity or sell them if the appropriate opportunity presents itself. In Asia, it is this group, not Real Estate Partners, that has made all direct real estate investments to date.

Lehman Brothers Real Estate Partners (LBREP) is Lehman's predominant

There's corruption in China, and it is one of the biggest concerns for all the Western firms. We're very concerned about our reputation.

—George von Liphart

vehicle for investing in real estate equity in North America and Europe, and it is anticipated that LBREP 2 will invest in Asia beginning in 2005.

In Asia, Lehman Brothers' Global Real Estate has five offices and 79 professionals, not counting an associated company, Capital Servicing, which is responsible for providing asset management, underwriting, and due diligence services to us throughout the region. We cover Northern and Central China primarily from Tokyo, with some assistance from Seoul. Our Hong Kong office covers South China.

I am one of the three Managing Directors in the Asian Real Estate Group. For the last two years, I've been the Country Manager for Real Estate Principal Investments in China. I spend 60 percent of my time there, and the rest of my time either in the U.S. or in the Tokyo office.

Let's now compare China and Japan. First of all, in population terms it is no surprise that China is ten times larger. There are 100 million Japanese who live in urban environments, and, presently, there are 500 million Chinese in such settings. But here's the really interesting thing about this statistic: the Chinese plan to have an additional 350 to 500 million people move into the existing cities, and probably some new cities, over the next 10 to 15 years. As it is, right now there are approximately 100 cities in China with populations of more than one million and about 40 cities with populations of five to six million. So, obviously, there is going to be a need for new residential real estate, for shopping, for leisure, and, essentially, for everything.

Now, real estate opportunities in Japan are going to be different. They're certainly not going to be driven by the same kind of growth. We'll come back to that later.

China has a much larger physical area than Japan (25 times larger). This emphasizes the fact that if you are an investor and an operator in Japan you have a relatively simple environment. You have essentially one city: Tokyo. Tokyo is the city favored by all investors, and for good reason. It is likely that your investments will be mainly there, perhaps some in Osaka, or in Fukuoka, in the case of Colony Capital, but, essentially, you will be Tokyo-centric. In that sense, Japan is very similar to France or the United Kingdom or some of the other Asian countries such as Korea, Taiwan, or Thailand, all of which are dominated by one major metropolis.

China, on the other hand, is very much more like the United States geographically. You have multiple markets—some 40 cities with five million people or more. Most international investors focus on three key areas: the Beijing/Tiajin megalopolis, which is located on the northern coast; the Shanghai/Yangtze delta region on the central coast; and the Pearl River delta, which includes Shenzhen, Guangzhou, and Guandong province in the south.

Other areas that investors look at include the northeast: the Chinese "Rust Belt," where old industry predominates. Because this region of

China is in severe recession, similar to old industrial areas anywhere else in the world, the government has made a determination to invest lots of new money and create tax incentives to induce investors to go there. One consequence is that you will hear about the three northeastern provinces as being favorites for nonperforming loan investments in China.

In addition, there is the West. Chungqing is now a Special Administrative Region (SAR), the same as Beijing and Shanghai. The government created the SAR several years ago as a countermagnet to the coast to attract people coming off the farms, so that they wouldn't all go east. Chungqing is now generally referred to as the largest city in the world, with a population of 30 million people. It's not quite that simple. It's similar to Indianapolis in the United States when it expanded its boundaries to include the entire county. The city itself is probably only 12 million. Also in the West is Chengdu, which is the capital of Sichuan province. Several investors have also expressed an interest in the resort island of Hainan (see Table A).

TABLE A

Comparing Japan and China

Comparing Japan and China

Selected Macro Indicators[1]

127 million	POPULATION	1.3 billion
79%	URBAN POPULATION	39%
0.378 million sq km	AREA	9.6 million sq km
$4.3 trillion	NOMINAL GDP	$1.5 trillion
$33,858	NOMINAL GDP PER CAPITA	$1,154
$3.6 trillion	PPP GDP	$6.5 trillion
$28,200	PPP GDP PER CAPITA	$5,000
3.3%	REAL GDP GROWTH	9.1%

1. Source: National Bureau of Statistics of China, *CIA Fact Book 2004* (figures as of December 2003), Bank of Japan

LEHMAN BROTHERS

As for nominal GDP, Japan has a much larger economy than China's. On a per capita basis, there is a vast difference, and this tells us that we're dealing with two entirely different types of economic environments. Some of China's key coastal cities are now experiencing per-capita GDP in the $5,000 range—but that's still a long way from Japan's.

If you adjust for purchasing power parity (PPP), the gross GDP flips, and while the per capita GDP is still terribly low, we now see that the Chinese economy measured this way becomes significantly larger. I'm not really sure PPP is going to be as relevant a measurement in the future as it has been in the past. Housing, for example, is now very much a market-driven private enterprise, so I think that to some extent that adjustment loses its validity.

Here's the real story: The Japanese economy has been experiencing 3.3 percent growth this year. But Japan has been in recession for much of the recent past. In point of fact, you see that the nominal GDP is $4.3 trillion. When I first came to Japan in 1997, the number we were using was $4.8 trillion. As a matter of fact, at that point the United States' GDP was about 160 percent of Japan's, but because Japan's has declined in the last eight years, the gap has widened considerably.

Now, China's 9.1 percent growth reflects the fact that the Chinese economy has been growing consistently at 8 to 10 percent per year. The major cities have been growing at 12 to 15 percent. If you look at a segment of those markets to get a sense for what is happening in terms of the emergence of a middle class, and for that you use the proxies of such items such as automobiles, housing, and mortgages, those growth rates run in the 20s and 30s in percentage points (see Table B).

Let's move on to one major business for Lehman Brothers and for a lot of the Western investors, which is nonperforming loans (NPLs). Now, my source for this is predominantly the annual Ernst & Young report—the "bible" of the nonperforming loan industry. Its estimate for Japan has always exceeded $1 trillion dollars. It's generally been between $1 trillion and $1.5 trillion.

In China, the estimates have ranged from $400 to $600 billion, and as of two years ago, Ernst & Young said it was $480 billion. Now, Ernst & Young has just come out with its 2004 report, which estimates Japan's at $442 billion and China's down to $414 billion. Essentially, what the report is saying is that nonperforming loans are well on their way to becoming a dinosaur in Japan. Do I believe this? Not exactly. Ernst &

TABLE B

Comparing Japan and China

Comparing Japan and China

Nonperforming Loans

Japan		China
$1,200 billion	EST. NPLS 2002[2]	$480 billion
$442 billion	EST. NPLS 2003[3]	$414 billion
$4.6 trillion	BANK LOANS	$1.5 trillion
9.6%	NPL/BANK LOANS	27.6%
10.3%	NPL/NOMINAL GDP	27.6%
12.3%	NPL/PPP GDP	6.4%
1200+	EST. # OF NPL TRADES TO DATE	3
10+	EST. # OF CURRENT ACTIVE SELLERS	2

2. Source: Ernst & Young Global Nonperforming Loan Report 2002
3. Source: Ernst & Young Global Nonperforming Loan Report 2004

LEHMAN BROTHERS

Young's report states that $600 billion has been resolved, but by "resolved" it means moving it off the books of the banks. The actual resolution of the individual assets happens later—perhaps much later. If you subtract the $600 billion from $1.2 to $1.3 trillion, the current estimate for Japan is probably somewhere in the area of $600 to $700 billion.

In the case of China, I'm sure that Ernest & Young's methodology was to take the published resolution statistics of the four Chinese Asset Management Corporations (AMCs) and deduct this amount from the prior year's total of NPLs held by the AMCs, plus the estimates of remaining NPLs in the four main Chinese state-owned banks. There has been no attempt to somehow rationalize the fact that loan growth in China has been increasing by 25 to 30 percent a year and that some of these new loans may be heading for nonperforming status.

The next group of statistics just reflects what NPLs represent as a proportion of bank loans and GDP.

Now, here is the interesting statistic: somewhere along the line, and I must have been sleeping when it happened, the Japanese all of a sudden embraced the concept of selling nonperforming loans. For a very long time, since I have been in Japan, there has been a serious cultural struggle. Selling NPLs was deemed to be a practice not necessarily in harmony with the goals of Japan, but to date there have been at least 1,200 nonperforming loan transactions in Japan—since 1997— but really only in the last three to four years.

Now, I'm sure you have read in the newspapers that China is working to solve its nonperforming loan problem. It is true that, on the domestic level, Chinese banks have arranged resolutions by selling loans to Chinese state-owned enterprises (SOEs), but the total number of NPL sales in China to international purchasers that have actually closed, to date, is . . . three. You may have read about Morgan Stanley and China Construction Bank, Goldman Sachs and ICBC, and Lone Star and Great Wall Asset Management Corporation, but these are deals that either have gone sideways, in which case of course they're not reported as having gone sideways, or they're still in the approval process.

At present, a lot of the Japanese NPL business has rationalized itself. We think of there being ten fundamental and consistent sellers in the market, not counting a handful of regional banks that come in and out of the market. Here's the problem with China: it's essentially monopoly or oligopoly selling. The situation here is that the second and third NPL trades to international investors that occurred in China were based on the first Huarong Asset Management Corporation sale, which was bid and negotiated in November of 2001 and which finally closed with all approvals in March 2003.

There were two buyers in that transaction. The first was the consortium led by Morgan Stanley, of which Lehman Brothers is an integral part. As a result of that trade, the word went around the investment community that Huarong was the only real seller in China. It proceeded to live up to that reputation by holding another auction last fall, again appointing Ernst & Young as financial adviser. Huarong decided to organize into 23 separate pools, delineated geographically by province. Of those 23 trades, only about three bidders cleared the reserve price. It then invited back the highest bidders who did not reach the reserve price and negotiated directly with them, picking up another seven or eight transactions in this way. Then it negotiated joint ventures in which, using very creative accounting, it was able to claim higher values for the nonperforming loan trades than it would have, had the deals simply been done for a cash price.

Incidentally, we won two pools—Beijing and one other province. Now, all of these pools are presently in the approval process. So Huarong has always been our favorite seller, that is, until recently, when Cinda, which was the AMC that came out of Construction Bank—by the way, Huarong came out of ICBC—was given the nod in an incredible series of transactions. It acquired three portfolios from Bank of Communications, Bank of China, and Construction Bank that totaled something on the order of $80 billion at face value. This was with the proviso that Cinda was responsible for moving the assets off its books by the end of 2005. All of a sudden, the heart rate of every international investor beat faster. Everyone was thinking that finally there was going to be a more liquid market for which we've been waiting since 2001, and that there would soon be an active NPL business in China.

Last week in the *South China Morning Post,* there were two very interesting articles. The front page of the business section read, "China Cuts Red Tape to Ease NPL Purchases by Foreigners." Hooray. It talked about the six different entities that an investor goes through to get approvals being reduced to a couple. But then if you turn to Page B2, "Cinda Bad Loan Resale Leaves Foreign Players Out in Cold," this article says that the other three AMCs are going to have first pick at the Cinda assets; if they can't sell them, then, at Cinda's option, they can invite the foreign players in. So who knows? Since it's such an important business for us and for many other firms, I imagine we will just stick it out.

The distressed loan story in China is somewhat artificial—an accident of economic history. I recently took a trip to Russia and I asked the Ernst & Young man in Moscow to tell me about the nonperforming loan story in Russia. He said, "There isn't any." I said, "Really, why?" He said, "Because there are no loans." The difference is that in China, they set up the four state-owned banks and then set up this incredibly large group of state-owned enterprises. Then they had the four banks lend to the SOEs. But these weren't really commercially-based loans; they were basically policy-driven directives to fund these groups. In Russia, comparable operations were funded as direct investments by various state ministries. In China, now they were owned and operated by SOEs and financed by state-owned banks.

But it is interesting that today Russia doesn't have a mortgage system and yet China does. So, ironically, there appears to have been method to China's madness.

Let's talk about the residential real estate market (see Table C). Here we're comparing Tokyo to Shanghai.

TABLE C

Comparing Japan and China

Comparing Japan and China

Real Estate Statistics[3]

Apartments		
84,955 (Tokyo)	TOTAL NEW INVENTORY (UNITS)	210,000 (Shanghai)
64,920 (Tokyo)	NUMBER OF UNITS SOLD	222,400 (Shanghai)
-2.9% (Tokyo)	APARTMENT SALES GROWTH OVER 2002	21% (Shanghai)
$809 billion	OUTSTANDING RESIDENTIAL MORTGAGE	$133 billion
6–7%	RESIDENTIAL MORTGAGE GROWTH	60%
Office		
55 mil sq m (Tokyo 63%)	TOTAL INVENTORY (GFA)	9 mil sq m (Beijing 42%)
Retail		
24 mil sq m	TOTAL INVENTORY (GFA)	8.2 mil sq m
Hospitality		
650,000	TOTAL INVENTORY (ROOMS)	700,000

3. Source: Lehman Brothers research (figures as of December 2003)

LEHMAN BROTHERS

So these first two lines indicate what was built and what was sold in Tokyo last year and what was built and what was sold in Shanghai. As you can see, a lot more people are buying in Shanghai than in Tokyo. Admittedly, they're paying a lot more in Tokyo, so that on a dollar volume basis, Tokyo has the more expensive housing because it is a developed economy and is clearly far ahead of Shanghai. But in terms of number of units, that's the story. Then look at the growth rates. These are 2003 numbers. The total outstanding residential mortgage balances are for all of Japan and China.

There is one real similarity in the residential real estate markets. The Japanese have limited options in fixed income instruments because interest rates are so low. The Chinese have no place to invest because there are no fixed income instruments to speak of.

So with the high savings rate, the Chinese have chosen to invest in real

TABLE D

Comparing Japan and China

Comparing Japan and China

Issues Involving Real Estate Investment

Japan		China
Tokyo Dominates	GEOGRAPHY	Multiple Markets
Low to Moderate	POLITICAL RISK	Moderate to High
Moderate	GOVERNMENT INVOLVEMENT	High
Low to Moderate	CORRUPTION	Moderate to High
Moderate	TRANSPARENCY	Low
Mature, Generally Fair	LEGAL SYSTEM	Evolving, Inconsistent
Freehold	PROPERTY OWNERSHIP	Land Use Rights
Domestic RE Companies and Funds, REITS, Foreign Investors	MAJOR PLAYERS	SOEs
Good/Stable	CREDITOR RIGHTS	Evolving/Inconsistent
Convertible, Freely Tradable	CURRENCY	Controls
Generally Available/High	FINANCING AND LIQUIDITY	Constrained/Limited
6–9%	RETURNS (IRR UNLEVERED)	20–30%+
Sales and Refinance	EXIT STRATEGY—REAL ESTATE	Sale to Individuals, IPO?
NAP	EXIT STRATEGY—COUNTRY	Liquidate, monetize registered capital, entity sale

LEHMAN BROTHERS

estate. As long as mortgages are available, you can get 70 to 80 percent financing, and if it's legitimately your first residence, there are very few restrictions. There always have been income and affordability tests, but they haven't always been strictly observed and adhered to. I think that part of the crackdown you've been hearing about in the Chinese financial credit system is about getting the Chinese banks to actually observe those rules that are already on the books.

We have a family friend who lived in San Francisco for a long time. She grew up as an expat in Taiwan and became fluent in Mandarin. She moved to Hong Kong and then to Shanghai. She was in Shanghai about four weeks, and I asked her where she was living. She said she had rented a flat but that she was going to be moving into an apartment that she was buying. I said, "Excuse me, you're there four weeks, and you're buying an apartment? How exactly?" She was going to get a mortgage. Now, for those of you who have lived in Japan or have been in Japan for any time, you will understand my surprise. I'm a permanent Japanese resident, I've lived there seven years now, and I'm not exactly sure how many lenders there would be willing to lend to me, if I wanted to purchase residential property. But that's what's happening in China: tremendous liquidity in the residential mortgage market.

For office inventory figures, we're using Tokyo and Beijing as the proxies: 55 million square meters in Tokyo, only 9 million in Beijing (which represents 42 percent of the class A office space in the country). The percentage probably is understated, because the major international brokerage firms from whom these numbers come only cover a certain number of markets in China. So this is 42 percent of the markets they cover, but on the other hand there probably isn't a lot of class A in most of the other 40 cities.

But, interestingly, if you look at office absorption, in 2003 there were 854,000 square meters absorbed in Tokyo. In Beijing, the comparable number was 210,000 (in 2003). And, in 2004, to date it is 580,000. So building is occurring of all real estate property types.

This is reportedly the national inventory for retail. My sense is that it won't be too long before China overtakes Japan. Wal-Mart is expanding in Japan through acquisitions and through trying to be a rehabilitation sponsor for Daiei, but it has 30 development deals that are set to start in the next 15 months in China.

Every major international hotel firm says that it has a plan to create a new three-star brand in China and that it's going to roll out a thousand hotels in the next ten years. Specifically, these include Holiday Inn, which I believe can do it. Hyatt, by contrast, doesn't have a three-star chain, so it would have to start from scratch.

Hospitality is clearly going to be a very interesting opportunity for someone: for franchisers, perhaps for construction companies. It is not so clear for hotel owners, because I'm sure there will be much overbuilding (see Table D).

There isn't a lot of political risk in Japan. If [Prime Minister] Koizumi fails to get reelected and if regimes change in the United States, I'm not sure that would really make a difference in Japan. China is perceived as higher risk. I do think the Chinese have been very responsible in the way they have handled the most recent phase of their government transition, but you just can't be sure. It's not transparent. Moderate government involvement in Japan is still the case for the economy, notwithstanding the economy's market aspects. In China, everything involves the government. In a sense it's a great negotiating ploy for them; once you negotiate with the highest-ranking per-

> *In Japan you can own freehold, and in China you end up owning what is known as "land-use rights."*
>
> *—George von Liphart*

son you can find, they can always come back to you and say, "Well, my boss, this ministry or the State Council, says it has to be done this way."

There's corruption in China, and it is one of the biggest concerns for all the Western firms. We're very concerned about our reputation. We don't want negative stories about us in *The Wall Street Journal.* We have to be very, very careful when we do business in China, especially with whom we're doing business. Transparency in Japan has gotten better; we're calling it moderate today. On any given day it can be low, but in China just about every day is low.

The legal system in Japan is fairly well defined, and there are many precedents. Things are generally known and generally fair, if you understand the rules. China is evolving in many areas. The footprint for the legal system exists, but it is applied inconsistently in two ways. First is by geography. The cities that have the biggest Western influence—Shanghai, Beijing, and Guangzhou—are generally the fairest. They have the most to lose, if Western firms scream too loudly over a situation in which they're clearly a legitimately aggrieved party.

Now, let's discuss creditors' rights. If you are unfortunate enough to have a nonperforming loan from an enterprise that is the only employer in the region, you will not be able to get control of the collateral—you will not be able to evict the owner of the property. In any event, even if you are dealing with surplus, noncore real estate from industrial SOEs, you will have to factor in your pricing of the redemption and fulfillment of all the promises relating to unemployment and the pension benefits of the workers.

But there is also inadequate protection in the bankruptcy laws of China. There is a new bankruptcy law that has been announced in the press. All of the Western law firms have given their predictions on what they think is going to come out, but until the fat lady sings (or, in this case, the State Council), we really don't know what's going to be included in this legislation.

We should touch on property ownership. Japan and China are similar in the sense that there are different registries for the land and for the building. So whereas in Western countries you have one registry, that's not necessarily true in either Japan or China. In both countries you can own a leasehold. But in Japan you can own freehold, and in China you end up owning what is known as "land-use rights."

There are two types of land-use rights, allocated and granted. The allocated land-use rights essentially have no rights. They typically run with the SOE that owns the resources and that operates the facility. They can't be traded or hypothecated. You can't do anything with them, but you can convert them to granted rights by paying a percentage of the market value of the property as though it possessed granted rights. Land use rights have terms. They're 70 years for residential, 40 years for commercial, and 50 years for industrial. It is a little tricky when you're talking about serviced apartments: some days it's 40 years, other days, if you can sell the actual apartments to individual owners, maybe you can argue for 70 years.

There are a number of major players in Japan: the big domestic real estate companies like Mitsui Fudosan, Mitsubishi Estate, Nomura, which are now a variety of REITs (real estate investment trust) and funds. I read in the *International Herald Tribune* recently that the number of private equity funds in Japan has gone from 15 in 1999 to something like 390 in

Mark Mason

2004. A number of these are real estate funds, and they are driven by the fact or the perception that there is an economic recovery in Japan (which, by the way, is in Tokyo primarily). These funds and REITs yield far in excess of any kind of fixed income equivalent. Then you have the foreign investors. So it's basically a very liquid, competitive market in Japan right now. The foreign investors who have been there for a number of years are now going into more exotic investments (we'll come to that when I talk about what I think the real estate opportunities are in Japan). Most now participate in development and in platform acquisitions on a regular basis.

In China there really are only the SOEs. There are private real estate companies as well, but they are definitely in the minority. When we invest, we have to find a partner. We try to pick the SOE that we think is the right partner for that specific deal, for example, a district government-owned developer for a project in that district. Shanghai has about 13 districts, just as Tokyo has 21 *kus*. Each district has its own development company. You definitely want to be a partner with the district development company.

Many of the Chinese real estate SOEs are now also in the market to attract strategic institutional investors and then to eventually do an IPO (initial public offering), either in Hong Kong or in New York, in rare cases.

Financing is readily available in Japan. If you go to aggressive mezzanine lenders, you can sometimes finance up to 90 percent of acquisition cost. In China, as part of the credit crackdown—they really are serious about this—the maximum you can borrow in a conventional sort of way is 65 to 70 percent. From the financing perspective, there aren't a lot of choices. The Chinese state banks are the primary ones, and now we're seeing foreign lenders permitted to lend in local currency in China.

With regard to the range of returns as measured by IRR (internal rate of return), they are very low in Japan, and that's because of the tremendous competition. In China, we won't do a deal if we don't think we have a chance of getting 20 percent, but I could probably put out a billion dollars in six months if I were willing to take 15 percent. For 25 percent or above, the amount I'm going to be able to invest goes down dramatically.

For exit strategy in Japan, again because of the plethora of available players, you can sell to a variety of sources—to the funds, to domestic institutions, and to international investors, etc.—and you have the ability to refinance out as well. You can refinance not only conventionally but also through the dramatically increased CMBS (commercial mortgage-backed securities) market in Japan.

As for China, you know there are buyers for residential units out there and that there is a big investor market for retail, where you sell retail units to investors who lease out the units to small "mom-and-pop" stores, the core of the Chinese retail community. But there really is no institutional for-sale market in China yet. That will come. Will it come this year? I don't know. Will it come next year? Then, of course, you can try to aggregate a portfolio and then find a way to make an IPO somewhere, somehow. In theory you can list as a REIT in Singapore. Nobody has done that yet, but I'm sure everybody is going to try.

You don't need an exit strategy from Japan, but you do in China because of the currency controls. The way it works in China is that when you finish a transaction, you apply to wind up your venture. After your wind-up has been approved, then you apply to remit the registered capital of your venture.

Foreign investors are all creatively trying to find ways to monetize registered capital. As part of a Chinese joint venture structure, you're required to have a minimum of 35 percent per registered capital and then the remaining 65 percent in either bank loans or self-funded as a shareholder loan from offshore. You can repatriate that shareholder loan easily, without too much trouble both in terms of interest and in repayment of principal, but then you've got that last 35 percent. Then there are profits and dividends that are also exportable. If you own a nonperforming loan portfolio, the accounting for that is essentially cost recovery. So before you can say you're making a profit and before you can generate dividends that you can export, you have to recover your full basis, including that last 35 percent of registered capital, plus all accrued expenses that you have incurred. You have to bring your total basis down to zero. Then you are profitable; you can start declaring dividends once a year and take them out. But you still have your registered capital "trapped" in China.

So clearly all of the bright feverish minds are trying to solve the question, "Though we have zillions of RMB (renminbi) here in the Bank of Shanghai, why can't we monetize them somehow?" That's the cutting edge right now, and we're working on that.

Then there is the possibility to sell the entity or your interest in it, but you have to find someone who wants to buy it. It may be that you can sell it to your partner in the Chinese joint venture, or maybe not. In any event, this is another dimension in China that Japan does not have, and it is one of the major impediments to getting enthusiastic investment committee approval (see Table E).

TABLE E

Where Are the Real Estate Opportunities in Japan?

Real Estate Opportunities in Japan

Corporates and Niche Markets

- Core and Value Added (?)
  - –Available Leverage Generates Acceptable Returns (if you're domestic)
- Corporate Distress
  - –Sponsorship in Corporate Reorganizations
  - –DPO Financing
- Platform Investments
  - –Specialty Operators (Hospitality, Golf, Ski)
- Niche Markets
  - –Hospitality
  - –Health Care
  - –"Mansions"
  - –Mezzanine Financing

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In Japan, I think that core and value added—depending on the value added—are probably only going to work if you're a domestic investor. All the major international players are focused on corporate distressed—meaning situations where you act as a sponsor for a company that's insolvent.

The most attractive targets tend to be real estate leasing subsidiaries of some of the financial institutions.

Another opportunity is what we're calling DPO, or "discounted payoff." For example, in the case of the troubled UFJ bank, many of its borrowers need to find ways to pay off their loans. UFJ is willing to make a deal with these borrowers today to clean up its balance sheet, so you finance them. You structure some sort of participation that allows you to get a majority of the proceeds of a subsequent sale of the asset, and in a hot real estate market that works.

In terms of platforms, you're familiar with Shinsei Bank, a financial platform. You've heard about the golf plays. Right now there's a ski platform in play. We have done a hospitality platform called "Weekly Mansion" in Tokyo. There are market niches in Japan based on opportunities to upgrade facilities, both in terms of larger living units, creating functional hotel operations, and developing health care facilities that we all feel demographically have got to be an opportunity. Mezzanine financing is not per se a niche, but the way you play the game is a niche. In our case, we've identified a few borrowers, and if they call us up on a Wednesday and say "we need funding by next Wednesday" we say, "okay," and that's how we keep the clients (see Table F).

In China, I've said that we're not certain if NPLs are really going to be a viable business in the near term, but we're going to hang in there. In real estate it really comes down to servicing the needs of the emerging middle class. Another alternative model is, if you have housing retail, you can sell off the housing and retain the retail. Essentially, you've got a zero basis, and then you can figure out what to do with it later. With all of those hotel rooms, maybe there's an opportunity there.

One way of cutting down the development cycle, which I have here as the last series of slides (see page 15), is to basically buy a well-located building that is topped out but has been abandoned because the bank has stopped funding and is controlled by the bank.

As for financing in China, the rules aren't there to permit it by foreign investors yet, but it is a work in progress. Then, of course, we're all looking for platform investments as well that will allow us to grow with the economy.

One of the beautiful things about residential development—I'll conclude with this—is that in China you can

TABLE F

Where Are the Real Estate Opportunities in China?

Real Estate Opportunities in China

NPLs, Residential Developments, Financing

- NPLs (?)
  - The Long March
- Real Estate Investment
  - "Servicing the real estate needs of the emerging middle class"
    - Development: For-Sale Housing
    - Development: Mixed Use (Housing + Retail)
    - Hospitality
  - Distress: Partially Complete Buildings
- Financing
  - A Work in Progress
- Platform Investments

LEHMAN BROTHERS

have a binding sales contract before you complete construction. The general rule now is when you top out you can go to the purchaser, receive your 30 percent down payment from him, and within a month he goes and gets one of those wonderful mortgages I talked about. You now have 100 percent in your hand, not in escrow, of the price of the unit. Typically, in a hot market such as Shanghai's, that means you've got all the money, although of course you have an obligation to finish the building. But it's much nicer to be in that position than to be in the position of having to collect at the end of completion.

I'll conclude here.

Discussion

Mason: We've all read about the quite public decision by Lone Star to withdraw from China, yet the Morgans and Lehmans and Goldmans and so forth have chosen to remain in the Chinese market. Why did Lone Star leave—or why have the others chosen to stay?

von Liphart: Well, you probably need to ask them that question. My view is that [Lone Star] never got traction; they never won a deal.

Lone Star never won anything in China. They won big in Taiwan, so they stayed in Taiwan. They believe, and I think rightly, that they have lots of opportunities in Japan, and they just felt that it was a better use of time and management expertise. As far as the rest of us are concerned, we all have integrated financial businesses. We all see what's happening in China or what will happen over time, and we believe it's important to be there. There also is a lot of important interplay with the banks, even if they're technically not allowed to sell NPLs.

By the way, I forgot to mention this. The banks can't sell NPLs because they can only sell loans at book value. But it's all part of the integrated financial community. The regulators who are involved in NPLs are people who have things to say about other aspects of our business that we want to develop in China, and so we stay for that reason.

Question: I'm focused on China and am looking at the investment distortion bubble and various industries in China. The prime example is real estate. I'm wondering if you could comment on a possible scenario where this real estate bubble bursts, what would be a trigger, and how it might unfold? Or maybe you could describe a scenario where China is basically invulnerable to something like this because the banks are state owned and the government could always step in. I'd just be curious to hear your viewpoint on that.

von Liphart: Well, I think clearly there has been a dramatic run-up in prices in a number of the major Chinese cities. I don't think it's in the nature of a bubble, though. If you look at Japan, the bubble there really was a bubble. I mean land prices have come down 70 to 80 percent from the top. But it's really hard to see that happening in China.

There are two major issues now in residential development. The first is the relocation of the people who are on the sites that are being redeveloped, and the second is affordability of the development. On a typical block in China now there are a thousand families. Those people have to go. Now, they read the paper, they're literate. They know what's going on, and therefore it is harder and harder to relocate them. So in my view the price that you end up paying for your land use rights is now at least a 100 percent for the cost of relocation and zero percent for the "land use premium" to the government. So that's issue number one. That is slowing down development dramatically which has the effect, of course, of raising the price of the affordable stock.

Number two is affordability. The other thing we look at is that, at the end of the day, when you know what your land use premium plus relocation costs are, and then you add the construction cost and all the other soft costs to it and then figure what you want to make and what the market is, are you going to be able to actually sell those units to the emerging middle class? When you look at all of that, I think it is possible to underwrite and justify your investment. It's always possible to be stupid, but generally, if you're disciplined, I don't think you'll get hurt. I don't think you're going to see a wholesale deflation of a bubble in China.

Question: My question centers around the land use issue that you've just addressed again. One of the concerns in China is what happens when somebody shines a spotlight on the way these land uses are granted for the next three to five years. It says, "Wait a minute, these were perhaps granted as favors or in a manner that somebody might disagree with in the future, and perhaps the first mortgage holder is sort of left with this issue."

The second is the renewability of these land uses. Is this as core of an issue as it sort of appears from here?

von Liphart: With respect to your second question, you're investing in for-sale products—which is not my problem. So that solves that problem. I think people were saying the same thing about Mexico 30 years ago. If you're on the coast and you're buying a condo on a 30-year leasehold, what happens? As Mexico has become more transparent and more developed, it's essentially rolled those leases over. China is getting more transparent and friendlier every day. In the few years I've been working there, things have changed. Sometimes they don't change as fast as you want, but they do change. But as a practical matter, with the incredible number of citizens and residents of China who now own their own homes through this land-use rights formula, what is the government going to do, throw them out, take the property back? No. It's going to have to come up with some sort of accommodation.

With regard to . . . IRR, they are very low in Japan. . . . In China, we won't do a deal if we don't think we have a chance of getting 20 percent.

—George von Liphart

With respect to your first point, again as I said, China is becoming more transparent all the time. I don't know how many of you are familiar with the Xin Tian Di Project in Shanghai. Vincent Lo was able to get extraordinarily preferential rights to be able to put that whole project together, not just there but in other projects in Shanghai. We believe those days are essentially over. According to Chinese policy, as of August 31, if you haven't paid 100 percent for your land-use rights or entered a binding contract where you have funded at least 30 percent of the price of those land-use rights, those rights will be recycled and will be put up for bid. Now, as someone who has worked long and hard on it, you would in effect have a primary lien. You've spent so much money on the property, someone is going to have to overbid you by the amount of what you've spent in order to take it away from you. But it is not as certain as it once was, and there was a real flurry of activity in all the major cities, especially Beijing, which as the capital city was right under the microscope, for people to get their deals grandfathered as of August 31.

Question: Could you tell me how the local authorities treat environmental issues in China?

von Liphart: Well, generally they don't believe there's a problem. We, however, are requiring "Phase Ones" for every project. It is true that a lot of the prime choice sites from a geographic perspective in Chinese cities are owned by companies that manufacture something. So you have to look at it from a couple of perspectives. One, of course, is that you have to assume that the environmental regulations will get more rigorous as time goes on, but more importantly, for a firm like Lehman Brothers is that you want to make sure that there are no reputational issues lurking out there. Again, the acid test is how is this going to look in *The Wall Street Journal*.

Question: I've been interested in how the big Hong Kong developers sort of took an initial plunge into China 10 or 15 years ago. Nobody made any money. Even Vincent Lo sometimes didn't make money for a long time.

Well, some of the chat is that Vincent Lo would have made more money if he had invested in Hong Kong rather than in China. Do you see the Hong Kong developers doing anything to restart?

von Liphart: Sure. For example, Li Ka-Shing is all over China. It's well known that he's not making any money in the Oriental Plaza in Beijing, but I'm sure he's making money somewhere. I would say that many of the Hong Kong developers are back in now, and they're doing better.

Mason: I know there is some Japanese investment in Chinese real estate, and we've all heard about the Mori Building project, the large finance tower in Shanghai. How active are Japanese investors in China?

von Liphart: Again, it's what I would call the entrepreneurial Japanese who are putting together funds, but these are really very early days. To the best of my knowledge, they haven't done a lot yet, if anything. You mentioned Mori. Mori has one very successful building, which is the HSBC Tower. I don't know if the big building is ever going to rise out of the ground. They're making noise, but nobody in Shanghai is sure about the timing.

HUGH PATRICK
R. D. Calkins Professor Emeritus of International Business
Director, Center on Japanese Economy and Business
Columbia Business School
Earlier you said that you really wanted 20 percent or better on a project. It's my sense that many Japanese investors would be very satisfied with 15 percent, and so they're going to have a competitive edge. How are you going to be able to out-compete them, and how are you out-competing them now?

von Liphart: Well, they're not there. So that's how we out-compete them. Secondly, if you talk to senior real estate executives in Japan and you talk about China, you hear they're not ready.

Question: Outside the Hong Kong investors and entrepreneurs, how much real money has gone into China from other foreign investor groups?

> *What's the key to getting access to quality Chinese investment opportunities? . . . It's a question of hiring the people who, one way or another, have [the right] contacts.*
>
> *—George von Liphart*

von Liphart: Aside from the Hong Kong investors and GIC of Singapore, not a lot. I think that you're probably talking about a total from the usual players of maybe $200 million to date that's actually closed. Again, that's not counting the Bank of China NPL sale for Hong Kong, which Citigroup won, which was somewhere around $500 or $600 million.

Mason: Is the money that Lehman has invested in China to date all Lehman principal funds?

von Liphart: To date, it's all our principal. Lehman Brothers Real Estate Partners has not invested in Asia, but going forward it is anticipated that LBREP 2 will invest there.

Mason: Do you see much institutional investor interest in the West in putting money to work in Chinese real estate?

von Liphart: It's very limited at this point, and we see this reflected inside our own firm. There is a great deal of concern over lack of transparency, corruption, and all the things that can go wrong. Actually, the number one question that's asked is, "How do I get my money out?" Those kinds of questions are the major impediment. Those of us who have been there and worked there believe that those questions can be answered, but it's still very early. From one perspective, that's good.

Question: Could you comment more about the municipal government, the state-owned businesses that are looking to do development work in Shanghai? Can you elaborate briefly on what they look like and what their thinking is?

von Liphart: Well, one of the interesting things is that in China, which is still a Communist economy, whether it's in the genes or whatever, there is competition. For example, one of the best examples as reflected in Shanghai is the competition among the district governments for FDI (foreign direct investment). Now, in general, in China government officials

Audience members

are graded. They have a very sophisticated management scoring system for both party officials and senior government officials. One of the main drivers of that—and this determines how they get promoted every five years when the musical chairs go on—is how much FDI they have brought in.

So the districts compete heavily to get the foreign investors. Everybody wants to bring you in on a deal, because they want to say that they're partners with Lehman Brothers or because at the end of the day they want to go public in New York, Hong Kong, etc., and they want to have a strategic alliance with you. So you get that at the district level. There is likely to be competition among districts for a long time. We've done a transaction in Luwan district with the district-owned company that's responsible for development where we're a financial partner. Again, they're making a point: Shanghai is a twentieth-century city—a twentieth-century financial market player—and they want to develop all the right relationships. That's why we're in the deal.

There's another interesting company that we hope to work with in a different district that has a very interesting model. It's 50 percent owned by four governmental entities from that district and then 50 percent owned by management. It is may be the best of all worlds.

Question: I've done a lot of sourcing in Japan, but I know nothing about sourcing good deals in China. What's the key to getting access to quality Chinese investment opportunities to the extent that they exist?

von Liphart: Well, if you have a name somebody can rent, that helps, but it's a question of people. It's a question of hiring the people who, one way or another, have those contacts. I have a guy on my staff, a vice president of Lehman Brothers, who is a Columbia Business School graduate. Before he came to Columbia Business School, he worked for one of the major Hong Kong developers in both Beijing and Shanghai, and because of his personality, he knows everybody. So he's been a great help to us. I have another guy who is an associate, an M.B.A. from Chapel Hill, a lawyer from NYU who passed the New York Bar, and he's a Beijing native. He went to school with everybody in all the ministries, the state-owned enterprises, the banks, everything. So it's the old story.

Question: It seems it takes a long time to close NPL deals. Do you expect that to change sometime soon? Do you have any strategy in terms of how to deal with those loans? Are you going to stabilize and sell it or hold it?

von Liphart: Good question. Every day is a new day in China. Everything you knew the day before may be obsolete. Supposedly they're cutting the red tape. Let's see what happens. In general, yes, because there is a belief at the top in China that foreign investors are needed to help solve this problem. The main driver is their wanting to clean up all the banks so that they can all go public. They need to clean up the NPLs. That's kind of a trap they have put themselves into.

But as you see, there haven't been a lot of deals that have actually closed; they have to streamline the process. So that's the logical side of it.

Your second point: In any environment where you cannot really rely 100 percent on creditors' rights, you have to adopt the approach of some sort of voluntary resolution to an NPL. That essentially means offering the borrower a deal he can't refuse. So if he owes 100 RMB and you bought the portfolio—let's be generous and say you bought it for 25—if you tell that borrower that he can clean up his act and his good name for 40, if he's an SOE in Beijing over on the northwest side in the high technology area, he's very interested in your offer, and those kinds of transactions happen quickly.

There are situations where you have a multibranched industrial corporation that has an ideal property downtown that, for example, it doesn't really need. They would be willing to sell that ground to the highest bidder, and you can make a deal with them in terms of who gets what when they make that sale.

Very rarely do you go all the way through foreclosure. You really don't want to do that, but it happens occasionally. You certainly don't want to roll the dice on bankruptcy, because there's too much that's unknown there, and that can stop a lot of things. The name of the game in NPLs is speed.

Question: In terms of nontransparency and, especially, corruption, if you compare China to places like Indonesia and certain other countries, would you say China is the worst?

von Liphart: Actually, we have invested in Indonesia. At one time we owned the Ritz Carlton in Bali, but it's been sold. I think that there is corruption in other places in Asia that clearly is as bad as in China (see Tables G, H, and I).

TABLE G

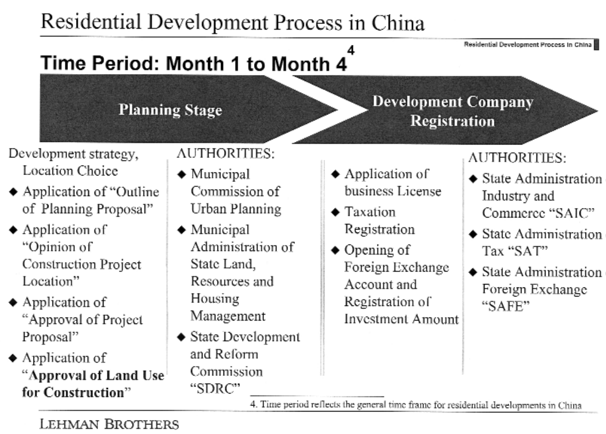

TABLE H

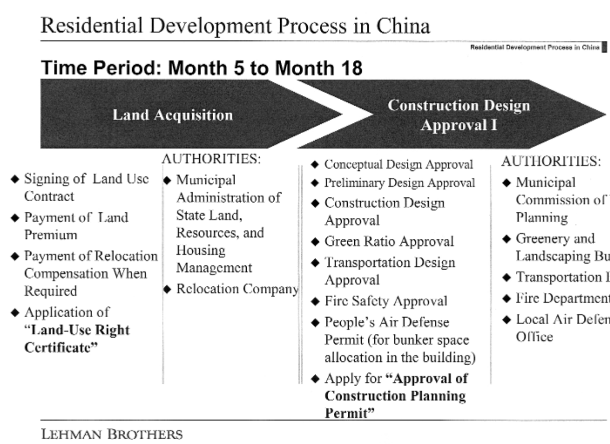

TABLE I

商業不動産投資：日本 VS 中国

リーマン・ブラザーズ

ジョージ・ヴォン・リパート氏

2004 年 10 月 27 日、コロンビア大学 日本経済経営研究所 オルタナティブ・インベストメント・プログラムと同大学のミルスタイン不動産センターが共催し、リーマン・ブラザーズのマネージング・ディレクター、ジョージ・ヴォン・リパート氏を招いて、「商業不動産投資：日本 VS 中国」と題する講演会を開催しました。 以下は氏の講演の抄訳です。

東アジア不動産市場への海外投資家の関心が高まっている。経済成長だけでなく不況、政府規制の変化およびその他の要因を受けて、当地域全体に注目すべき新しい商機が生まれてきている。 世界の経済大国である日本と中国はどちらも東アジア地域に位置し、経済的利益の共有も進みつつある、しかし不動産市場とその投資機会に関してみると多くの点で非常に異なる。日中における不動産市場の類似点、相違点は何か、各市場はどのように進化しつつあるのか、そしてそれは国内外の投資家にとって何を意味するのだろうか？

リーマン・ブラザーズのマネージング・ディレクター、ジョージ・ヴォン・リパート氏が、上記およびそれに関連する問題に答える為に、東アジアの躍動する二大不動産市場の見方を伺った。 ヴォン・リパート氏は東京を拠点に、長年にわたり日中におけるリーマン・ブラザーズの不動産事業拡大において重要な役割を果たしている。当レポートはヴォン・リパート氏のプレゼンテーションとそれに続き行われた参加者との質疑応答を収録。

ヴォン・リパート氏は、現在約 6 割の時間を中国で過ごし、それ以外は日本と米国で過ごしている。氏は中国の都市人口は大幅に増加すると見ており、今後 10－15 年間にわたり 3 億 5 千万人から 5 億万人が中国の都市部に流入するとの中国政府予想を紹介。『よって、新しい住宅不動産、ショッピング、レジャー、要するにすべてのものに対する需要が出てくることは明らか』、と氏は述べた。一方、日本の不動産市場はすでに開発がすすみ、拡大されすぎ、不動産バブル崩壊を経ており、まったく異なる市場サイクルに位置している。また、リーマン・ブラザーズのような海外投資家にとって日本での投資機会は東京に集中しているが、中国ではいくつかの大都市に分散している点を指摘した。

しかし、日中の不動産市場には重要な共通点もある。例えば、両国では債券などのフィックストインカム投資の機会が現在のところほとんどなく、両国とも貯蓄率が高い。加えて、両市場とも多額の不良債権を抱えている。 ヴォン・リパート氏はアーンスト アンド ヤングの資料を基に、不良債権総額は中国で 4 千億ドルを超え、日本では 6 千億ドル強にのぼると推測する。

ヴォン・リパート氏は、商業不動産取引総額において近い将来に中国は日本を追い越すと見ている。 例としては、ウォルマートやホリディ・インといった大手小売・ホテルチェーンによる今後数年間にわたる潜在的大型投資が挙られる。 もうひとつの相違点は政治情勢である。日本では誰が政権につこうとも状況は比較的落ち着いているが、中国では『昨日までの知識も明日には役に立たないかもしれない』、と氏は警告する。

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