China's Infrastructure REIT Market: From Slow Start To Big Bang?

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PRIMARY CONTACTS
Gloria Lu
Hong Kong
+ 852 2533 3596
gloria.lu
@spglobal.com

Laura Li
Hong Kong
852 2533 3583
Laura.li
@spglobal.com

SECONDARY CONTACTS
Richard Langberg
Hong Kong
+ 852 2533 3516
richard.langberg
@spglobal.com

Kendrew Fung
Location
+ 852 2533 3540
kendrew.fung
@spglobal.com

RESEARCH ASSITANTS
Rick Yoon
Hong Kong

Tiani Li
Hong Kong
Overview

- China’s pilot REIT program is aimed at controlling leverage in the infrastructure sector, creating space for new projects and growth.
- In our view, a dearth of underlying assets with high and stable operating cash flow could slow the start-up of this market.
- Nonetheless, we see potential for China’s infrastructure REITs to become a US$300 billion-US$735 billion market within a decade, driven by “new infrastructure” and e-commerce assets.

At long last, China is launching real estate investment trusts (REITs). The country is taking a decidedly different route, however. The pilot program explicitly excludes residential and commercial real estate properties, and is instead starting with infrastructure. S&P Global Ratings believes “new economy” infrastructure assets will eventually dominate the trusts. In the longer term, investors will likely be more interested in REITs backed by 5G and data centers, than roads and power plants.

Dozens of companies have begun preparing for launching publicly tradable REITs since the National Development and Reform Commission (NDRC) and the China Securities Regulatory Commission (CSRC) issued a joint circular on April 30, 2020 (“Circular 40”). We view the guidelines as rigorous, requiring the instruments to have high payouts, effective minimum yields of 4%, and tighter caps on leverage than global norms.

We anticipate Chinese REITs will be endowed with the ambitious task of controlling leverage in the infrastructure sector, thus clearing the deck for new investments. Through selling off operating assets and accompanying project debt, private and public infrastructure developers can reinvest proceeds into new projects to assist deleveraging and boost economic growth. The timing is not surprising, given infrastructure stimulus will be critical to stabilizing domestic demand and employment as China recovers from the COVID-19 shock.

Scaling up infrastructure trusts won’t be easy, given that cash-producing assets operating on market principles are still scarce in China. On top of that, asset owners with strong franchises, especially the state-owned infrastructure companies, may have limited incentive to spin off their assets. However, while China’s infrastructure REIT market will likely start slow, it has the potential to grow into one of world’s largest.

Big Infrastructure Goals, Limited Financing Options

China has long bet big on the benefits of ambitious infrastructure investment, a strategy that allowed for rapid catch-up development and productivity gains. However, since the 2008 global crisis in particular, these investments increasingly became a growth driver in themselves, and often outpaced GDP growth. Some estimate the value of China’s infrastructure assets at Chinese renminbi (RMB) 100 trillion-RMB150 trillion (US$15 trillion-US$22 trillion), a capital stock that was largely debt-fueled.

Central and local governments in China have developed a sizable portion of the country’s broad and high-quality infrastructure stock spanning traditional infrastructure (rail, road, power, etc.) to new infrastructure (information and communication technology). In the process, they piled up significant off-budget borrowings through their wholly owned corporate arms: local government financing vehicles (LGFVs). This financial overhang explains why in recent years, China has been
more focused on deleveraging and government debt management, as indicated by a sharp decline in infrastructure investment in 2018-2019 amid a crackdown on off-budget debt.

This deleveraging project has been derailed by COVID-19. China will once again need to rely on infrastructure stimulus to revive economic momentum in the wake of the pandemic. We expect overall infrastructure investment, including that in power generation, to reach about RMB19 trillion (US$2.8 trillion) in 2020, or roughly 18%-19% of GDP. This is up one to two percentage points compared with the five-year average through 2019.

**Evolving New Infrastructure Financing Models**

We see REITs as part of an evolving infrastructure financing framework aimed at relieving debt burdens for infrastructure developers. Switching to market-based frameworks should in turn influence the way projects are structured, with greater emphasis on internal cash generation and returns. Such a focus could direct more funds to "new economy" infrastructure versus traditional "public goods" that are often not sufficiently paid for by users.

REITs add to financial market developments aimed at reducing debt risk for local governments. For example, five years ago, China launched a market for local governments to issue municipal-like bonds rather than depend on off-balance LGFV-related debt. This both improved fiscal transparency and reined in overall spending. When the pandemic hit, the governments responded by significantly increasing the bond issuance as part of their stimulus packages. This however resulted in higher government debt this year.

Infrastructure trusts are also in line with other market-based and risk-sharing approaches that China has been exploring in recent years. Public-private partnerships (PPPs) were officially introduced in 2014, with mixed success. Most PPP projects still depend on government commitments to honor payments to investors. Only a very small portion of the total number of projects are self-sustaining based solely on user fees. These "user-pay" PPP projects are mostly transportation projects, and more specifically, toll roads.

2014 was also the year that saw a broadening of structured finance markets after earlier pilot programs, with steadier deal flows of asset-backed securities (ABS). Debt from infrastructure assets like toll roads and warehousing logistics have been packaged and offered as ABS transactions. However, these ABS are only placed to institutional investors and, in our view, are essentially debt-financing providing fixed returns to the senior tranche, and are redeemed by the originators when they come due. Nonetheless, these debt instruments fit into China's nascent REIT structure, so this backdrop should facilitate the country's roll-out of infrastructure REITs.

REITs provide an equity finance option for further infrastructure development in China. The asset owners can monetize their qualified assets by selling and listing them through REITs and reinvest proceeds into new projects. The spinoff will help originators to deleverage through recouping investments and deconsolidating liabilities. Meanwhile, improved balance sheets will enhance their financing capacities for new investment. This process would also revitalize the existing assets by unlocking their value, and turn illiquid infrastructure assets to liquid REITs, which can be publicly traded.

REIT rules will require issuers to have stand-alone profitability... Projects dependent on government guarantees won’t be eligible.
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**Which Projects Will Seed Growth Of China’s REIT Market?**

Authorities will likely cherry-pick a small number of pilot projects to test market appetite. Circular 40 outlines high standards for eligible assets as well as on the duties and responsibilities of operators and managers of the REITs, and all other intermediaries. The rigorous guidelines appear to be designed to ensure the success of the pilot program and boost market confidence toward this financial instrument; that said, they might prove too restrictive, in our view, dragging down market start-up potential.

Priority will go to target regions and sectors supporting national strategies. REIT assets should be located in six target regions assuming "national strategic importance" (see chart 2). State-level new areas, qualified development zones, and emerging industrial clusters supporting national strategies are specifically outlined as preferred areas as well.

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**Chart 1**

**China’s Massive Stock Of Infrastructure Built With Credit**

- **FAI**—Fixed asset investment. **Infra**—Infrastructure. **ex**—Excluding. **RMB**—Chinese renminbi. **Tril.**—Trillion. **YoY**—Year-on-year.

Source: National Bureau of Statistics, Wind, S&P Global Ratings. Copyright © 2020 by Standard & Poor’s Financial Services LLC. All rights reserved.
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Chart 2

Six Strategic Regions Will Get Priority In Infrastructure REIT Development

Table 1

Five Sectors Targeted For Infrastructure REITs

<table>
<thead>
<tr>
<th>Sector</th>
<th>Examples</th>
</tr>
</thead>
<tbody>
<tr>
<td>Warehousing &amp; logistics</td>
<td>Toll roads, railways, airports, ports</td>
</tr>
<tr>
<td>Transportation infrastructure</td>
<td>Sewage, garbage processing, solid and hazardous waste treatment</td>
</tr>
<tr>
<td>Environmental protection</td>
<td>Water, power, gas, and heat supply</td>
</tr>
<tr>
<td>Urban utilities</td>
<td>Data centers, artificial intelligence</td>
</tr>
<tr>
<td>New infrastructure</td>
<td>5G, cell towers, internet of things, broadband network, cable TV</td>
</tr>
<tr>
<td></td>
<td>Smart transportation, smart energy, and smart city projects.</td>
</tr>
</tbody>
</table>

Source: S&P Global Ratings.
Table 2

**Tough Terms And Limited Targets**
A summary of key terms based on infrastructure REIT guidelines

1. **Underlying Assets:**
   - (a). Asset location and sectors: Preference given to six target regions, and five target sectors.
   - (b). Legality: Completed projects in compliance with all rules and polices.
   - (c). Ownership: Full ownership of REITs in underlying assets free from liens and other legal encumbrances.
   - (d). Operating period: At least three years of consistent and stable cash flow and reasonable returns. Market-based returns, with no reliance on non-recurring income such as third-party subsidies.

2. **REITs:**
   - (a). Distribution: Annual payout ratio of no less than 90%.
   - (b). Cash dividend yield: No less than 4%.
   - (c). Originator's shareholding: No less than 20%. Mandatory holding period of five years for portion within 20%; and three years for portion beyond 20%.
   - (d). Leverage: Total assets cannot exceed 140% of REIT’s net assets, usage of debt limited to operation, maintenance & overhaul, and project acquisitions. Acquisition borrowings cannot exceed 20% of REITs net assets.
   - (e). Fund/asset management: Managers must have three years of operating track record, with corporate governance assessed as fair. Majority of senior managers must have no less than five years' experience in infrastructure projects operation.

3. **Tax break:** Not applicable at this stage.


We believe a large number of infrastructure projects will not qualify for the program, given the restrictive guidelines. In particular, the underlying assets are unlikely to be able to generate sufficient operating cash flows to meet the minimum cash dividend yields of no less than 4%. Many existing projects were developed to meet the government’s role in meeting social and political goals. Profitability was not a consideration.
China's REITs Will Have Complicated Structures

We also expect China's new infrastructure REIT market will have additional complexities compared with global norms. These complexities may drag on returns, which could in turn slow lift-off in the market.

**China is not enacting a new law for the debut of REITs.** Instead, REIT investors (including both retail and institutional) will publicly subscribe to units offered as a closed-end infrastructure fund. The offering, management, and operation of the infrastructure funds will be governed by the prevailing regulations on public funds as well as the rules on the infrastructure REITs as set out in Circular 40 (and any other supplemental rules). Notably, public funds can only invest in tradable securities such as stocks, bonds, and other permitted financial instruments rather than directly holding underlying assets. Hence, Chinese REITs have to be structured in a way to address the restrictions under the existing regime.

**REITs will typically adopt a transaction structure of "public fund plus ABS."** The infrastructure fund will apply 80% or more of proceeds to subscribe to the securities, which will be asset-backed securities (ABS). That is, the ABS will act as a conduit for passing through the cash flows from the underlying assets to the fund. In practice, one more layer—a private equity (PE) fund—between the ABS and the project company is likely. The PE fund would be set up to acquire all the shares of the project company, and make shareholder loans to enhance the equity return via leverage (see chart 4).

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Multiple managers could elevate fees, making it harder for underlying assets to meet the yield requirement.
Rules cover both asset management and operators. Under China’s guidelines, the originators should subscribe to at least a 20% stake in the infrastructure fund for at least five years. This design was put in place, we believe, to facilitate interest alignment. In addition, the fund may entrust originators to manage the assets for generating stable cash flows because of their experience and expertise. Hence, originators will earn service fees for providing the asset operation and management.

Complicated transaction structure may lead to cash leakage and dilute the returns to REIT investors. Cash leakage may be caused by service fees paid to the transaction managers, as well as the tax ramifications associated with asset sales or transaction features. There is no tax break/incentive for the REIT transactions, originators, or investors in the current Chinese REIT guidelines.

Chart 4
Typical Chinese REITs Will Likely Be Complex

**PE**—Private equity. Source: S&P Global Ratings, Beijing Capital Co. Ltd. Copyright © 2020 by Standard & Poor’s Financial Services LLC. All rights reserved.
We believe the pilot REITs program itself is more of an experiment and will shortlist high quality projects in the target regions and sectors. Hence, the overall size will be relatively small; our rough estimate is US$5 billion-US$10 billion in the pilot stage. However, the experience and lessons will help authorities and the market to better understand REITs, and pave the way to scale up the infrastructure REITs market in China in the mid to longer term. After Circular 40 and supplemental rules were published earlier this year, a number of companies from target sectors either announced, or told the media, that they were interested in participating in the pilot scheme (see table 3). Among a few others, Beijing Capital Co. Ltd. has already launched a proposed offering (see sidebar).

Table 3

Prospective Infrastructure REITs Pilot Projects

<table>
<thead>
<tr>
<th>Originator</th>
<th>Underlying Assets</th>
<th>Location</th>
<th>Information Source</th>
</tr>
</thead>
<tbody>
<tr>
<td>Beijing Capital Co. Ltd.</td>
<td>Sewage treatment</td>
<td>Shenzhen, Hefei</td>
<td></td>
</tr>
<tr>
<td>Bohai Water Industry Co. Ltd.</td>
<td>Sewage treatment</td>
<td>Tianjin</td>
<td></td>
</tr>
<tr>
<td>Anshun Water Supply Co.</td>
<td>Water supply</td>
<td>Guizhou</td>
<td></td>
</tr>
<tr>
<td>Zhejiang Expressway Co. Ltd.</td>
<td>Toll roads</td>
<td>Zhejiang</td>
<td></td>
</tr>
<tr>
<td>Zhongguancun Development Group Co., Ltd.</td>
<td>Industrial park</td>
<td>Beijing</td>
<td></td>
</tr>
<tr>
<td>Shenzhen Metro Group Co. Ltd.</td>
<td>Subway</td>
<td>Shenzhen</td>
<td></td>
</tr>
<tr>
<td>China Vanke Co. Ltd.</td>
<td>Warehousing logistics</td>
<td>Nation-wide</td>
<td></td>
</tr>
<tr>
<td>Hainan Development Holdings Co. Ltd.</td>
<td>Power generation</td>
<td>Hainan</td>
<td></td>
</tr>
<tr>
<td>Wuhan East Lake High Technology Group Co. Ltd.</td>
<td>Warehousing logistics</td>
<td>Hubei</td>
<td></td>
</tr>
<tr>
<td>Yuexiu Transport Infrastructure Ltd.</td>
<td>Toll roads</td>
<td>Hubei and Guangxi</td>
<td></td>
</tr>
<tr>
<td>Shanghai Zhangjiang Hi-Tech Park Development Co. Ltd.</td>
<td>Industrial park</td>
<td>Shanghai</td>
<td></td>
</tr>
<tr>
<td>Suzhou Industrial Park State-Owned Assets Holding Development Co. Ltd.</td>
<td>Industrial park</td>
<td>Suzhou</td>
<td></td>
</tr>
<tr>
<td>Shanghai Lingang Economic Development (Group) Co. Ltd.</td>
<td>Industrial park</td>
<td>Shanghai</td>
<td></td>
</tr>
<tr>
<td>China State Railway Group Co. Ltd.</td>
<td>Railway</td>
<td>Hubei</td>
<td></td>
</tr>
<tr>
<td>China State Railway Group Co. Ltd.</td>
<td>Railway</td>
<td>Hainan</td>
<td></td>
</tr>
<tr>
<td>China State Railway Group Co. Ltd.</td>
<td>Railway</td>
<td>Guangdong</td>
<td></td>
</tr>
</tbody>
</table>

Beijing Capital Co. Ltd.: The Prototype Of A REIT Structure?

On Aug. 28, 2020, Shanghai-listed Beijing Capital Co. Ltd. (the originator) became the first Chinese company to disclose some details of its infrastructure REIT proposal. The application is still under consideration, but has obtained the blessing of the Beijing municipal government, the ultimate controlling shareholder of the originator.

**Underlying assets:** Two wholly owned sewage treatment projects operated by their respective project companies, each contracted on a concession basis with local governments.

1. **Shenzhen project:** Three sewage-treatment plants operating on build-operate-transfer (BOT) projects. Total treatment capacity of 375,000 tons/day.
2. **Hefei project:** Includes (a) Phase I, II, and III, operating on transfer-operate-transfer (TOT) basis; (b) Phase IV is a BOT project, which just completed construction and has not commenced operations yet. Total treatment capacity is 300,000 tons/day. This is a PPP project.

**Transaction structure:** A four-layer structure composed of “Fund + ABS + PE + project company” with cash flows paid as indicated by the diagram above (chart 4). Beijing Capital will be responsible for asset operations and receive service fees from the project companies.

**Size:** Likely RMB1.83 billion in total (as estimated by the company), to be listed as a publicly offered closed-end infrastructure fund.

**Investors:** The originator will subscribe to at least 20% of the offered shares and hold them for at least 60 months following the listing. The shares cannot be pledged during the holding period.

**Duration:** This matches the concession period.

**Cash distribution:** No less than 90% of the distributable amount of both projects, payable at least once a year.

**Fund investment:** At least 80% of proceeds to subscribe to all the ABS issued under the same transaction, and the rest to be invested into the treasuries, and/or AAA-category bonds on the domestic market.

**Use of proceeds:** Upgrading operating projects, financing new projects, and debt repayment.

**Red tape:** This deal cannot go forward without consent of local government authorities to transfer the concession agreement to the REIT. This could hold up the agreement if consent is not awarded on a timely basis.

**Operating fundamentals:** Like most sewage treatment projects in China, revenue is primarily derived from sewage treatment fees paid by local authorities—which are ultimately collected from water users. We view counterparty risk as low in this transaction because both the Shenzhen and Hefei governments have good fiscal power. Usually, the concession agreements may specify (1) a guaranteed payment by the government on the sewage volume below a preset threshold; and (2) the adjustment of treatment fees, as a result of the operating cost increase or facility upgrade etc. The concession agreement together with ongoing urbanization and household income growth in China will ensure the ramp-up of treatment volume to meet or exceed the design level, and generate reasonably good operating cash flows.
**Other Hurdles Include Supply Restraints And Lack Of Tax Benefits**

High bars and tough requirements are not the only hurdles. Other factors exist that could hinder the expansion of infrastructure REITs in China.

**PPP projects won’t provide much of a pipeline.** Theoretically, REITs could provide a good exit for the private investors of PPP. As of end-2019, however, merely 6%-7% of the nationwide 9,440 projects are purely user-pay, accounting for 9%-10% of the country’s accumulated PPP investments of RMB14.4 trillion. Hence, the door to the REITs market is effectively closed for about 90% of PPP projects, because they partly or fully rely on government payments. In addition, it could be time-consuming to get the consent of all PPP stakeholders for restructuring the asset for the REIT listing.

**Chart 5**

**Transportation Projects Make Up Most 'User-Pay' PPP Projects**

PPP projects in the six target regions. Percentage per investment amount.
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**Transportation infrastructure is tightly regulated in pricing** because the social goal of affordability of tolls generally overrides the profitability. Operation and revenues are susceptible to political interference without proper compensation. For example, all toll roads in China were required to suspend toll collection for 79 days earlier this year during the COVID-19 outbreak to support economic recovery and anti-epidemic measures.

Toll roads are likely on the shortlist of qualified REIT assets owing to their generally steady cash flows. However, the asset quality of toll roads varies across different regions. Listed toll roads tend to be mature, and enjoy strong traffic volume and cash flows (see chart 6.) Some unlisted toll roads in the economically advanced eastern coastal provinces also have decent cash flows because of their location. However, the vast majority of Chinese toll roads are operated at much lower toll revenue per kilometer than those of listed ones, indicating their low returns on investment.
In addition, most transportation infrastructure is state-owned and the incentives to sell the projects to a REIT are not as strong. Large infrastructure projects are usually developed by state companies owned by provincial or central governments. They tend to have good market access (especially bank loans) and favorable funding costs. Given their relative financial flexibility, they may have less incentive to spin off assets to REITs.

Qualified assets should be free from liens and other legal encumbrances. In China, it is very common for developers to pledge future cash flows on projects to banks for securing long-term project loans. Hence, the originators need the banks’ consent to release the pledge and accept prepayment to meet the leverage cap on REITs through the listing proceeds.

REITs have to manage their financial leverage at low levels. Total assets of the infrastructure fund cannot exceed 140% of net assets, implying the ratio of total liabilities to total assets (gearing ratio) should be no more than 28.6%. Such a gearing cap is among the most stringent in the global REITs market. The idea is to protect investors and keep REITs from diluting cash flows available for distribution, however the stringent gearing cap could limit growth potential through acquisitions. External borrowings can be used for maintenance, operating expenses, and new acquisitions, but are subject to the gearing cap and borrowings for asset acquisition should not exceed 20% of net assets.

Valuations depreciate over time for REITs with concession assets, such as franchised toll roads and urban utilities. The concession agreements authorize operations under specified periods in the range of 20-30 years, varying by asset type and region. Such operating rights are classified as intangible instead of fixed assets for originators. All these may differentiate assets and influence the pricing and potential trading liquidity of REITs over time.

Most importantly, lack of tax breaks may reduce the appeal of China’s REITs. In most markets, tax benefits are probably the most important motivation for launching and investing in REITs. The underlying assets of REITs use have reduced income tax or full exemptions. Thus, the benefits can pass to investors for higher returns, even if they do not enjoy direct tax holidays from investing in these assets.
REITs. China has not yet tackled the tax issue, and the complicated "fund plus ABS" structure will involve multiple layers of asset transactions and return distributions, potentially leading to extra tax expenses for originators and other operating expenses of intermediaries.

We expect regulators will eventually introduce measures to address the tax ramifications of Chinese REITs as the market is further scaled up. Some local governments are moving fast and contemplating various incentives for local entities participating in the REITs program, such as lowering their corporate income taxes; and others may follow suit.

**Over Time, China's REIT Market Could Rival The U.S. Market**

While China's infrastructure REIT market will likely start slowly, the long-term potential is enormous. Given the sheer size of China's infrastructure market, even if just 1% of such assets were securitized and structured as trusts, that implies a RMB1 trillion-RMB1.5 trillion market.

We see particularly high growth potential for "new infrastructure" associated with technology, innovation, and digital economies. These niches are more market-oriented and have relatively high returns, as well as large capital needs. This view is also supported by the experience in other markets. Investors in the U.S. have gravitated to trusts backed by data centers and cellular towers, while warehousing logistics are popular in Singapore. Traditional transport, and the fast-growing environmental infrastructure market in China, will also provide pipeline assets for REITs, in our view. In January 2020, Beijing-Shanghai High-Speed Railway Co. Ltd. launched an initial public offering (IPO) in Shanghai, raising equity funds for the most profitable high-speed railway in China.

Based on our assessment on the motivation for issuing REITs, and the quality needed to meet investor demand and China's guidelines, chart 7 illustrates what the infrastructure trust market might look like over the next 10 years.

**Chart 7**

*Asset Quality And Motivation Will Drive China's REIT Market*

Bubble size represents potential scope of REIT market in the next 10 years

For each of the five target sectors, we rank their REIT market potential over the next 10 years primarily based on our forward looking view on asset size and quality, growth potential, and motivation for REIT financing. Asset quality includes our estimate of return on capital, EBITDA margin, and operating cash flow. Motivation is based on our assessment of a sector's average leverage and capital-spending needs, and financing costs, etc. Source: S&P Global Ratings.

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The following factors underpin our view of future market trends:

**Urban utilities and environmental services have more private capital than transportation assets.** Concession agreements with local governments protect the monopolistic position of the operators in the service areas. In addition, ongoing urbanization and growth potential partly moderate the evolving regulation risk, and underpin their largely stable cash flows. Urban utility markets are segmented and a mix of both state-owned and private operators.

**Sewage and waste treatment operators will be interested in REITs.** Some companies have undertaken aggressive debt-fueled expansions in recent years, weakening their balance sheets. They are adjusting business strategies to be more asset-light by divesting some capacity while generating cash flows from operations and maintenance (O&M) income. REITs could be a strategic fit for these companies, which aim for lower leverage while holding on to operation of these assets and earning fees from underlying asset management.

**China's booming e-commerce underscores the robust demand for warehousing logistics,** especially for high-standard warehouses with superior location and well-developed transportation networks. Benefiting from a surge in online shopping and delivery services during COVID-19, the sector's stronger growth prospects and long-term rental income support stable and recurring cash flows to the operators. Nevertheless, warehousing logistics tend to have low entry barriers and cyclical operating trends. They also depend on professional management to provide differentiated services, set pricing strategy, and maintain strong technological capabilities.

"**New infrastructure** will deepen digitalization of China's economy and society." While still only a small share of total infrastructure spending, this portion is definitely set to rise. New infrastructure covers seven categories, part of which relates to transportation infrastructure such as high-speed rail and subways. According to estimates by CCID Consulting, a think tank, new infrastructure in China through 2025 will attract direct investment of RMB9.31 trillion, of which the emerging 5G and internet data centers (IDC) combined will account for over 40%. In August 2018, China Tower Corp Ltd., the world’s largest tower operator, listed in Hong Kong, and the company continues to invest in upgrades to tower infrastructure as the country builds a 5G mobile network.

IDC -- the commercial real estate that houses the servers for internet communications -- also has long-term growth prospects. Rental income is the main source of revenue for vendors, which provide cabinets to corporate customers. The internal rate of return for this business can be as high as 10%-20%, and the cash inflow is relatively stable and visible. That said, IDC in China is also facing the challenges of a fragmented market, less mature projects, lack of land ownership, and demanding operating conditions.

Private capital will increasingly finance urban utilities and services, in our view.

Data and telecoms infrastructure is a strong potential asset base as REITs grow.
A US$735 Billion Market In A Decade?

A thriving REIT market in China ultimately depends on whether this new financial product can provide risk-adjusted returns to meet investor needs. Despite risks on capital gains and losses, REITs tend to be liquid and tradable financial products, and their dividends offer relatively stable and high cash distributions. In the U.S., long-term total returns of the REITs sector are well-above the average returns of equity and bonds, and the capital gains of cellular tower and IDC REITs even outweigh the dividend yields.

In China, we expect mainstream REIT investors to be institutional, in addition to the originators, which will retain at least 20% of offerings. Long-term investors such as pension funds and insurance companies will also likely be interested in this product for its yield and duration. Retail investors can invest up to 24% of total offerings. Global investors can also tap this virgin market through existing quota systems, bringing in perspectives such as their focus on environmental, social and governance issues.

China's 10-year treasuries lately offer yields of 3.0%-3.2%, so a minimum of 4% cash yield seems a low REIT premium based on differentials in mature markets. However, a 4% dividend payout is higher than most listed stocks in China and largely on par with major infrastructure stocks.

We believe China is more interested in the long-term development of this market than an exuberant start. The lessons and experience from the pilot program will be followed by more targeted and supportive policies for REITs development. This will likely include regulatory overhauls to allow tax benefits and other incentives.

Given China’s massive stock of infrastructure assets, booming e-commerce, and ambitious plan for new infrastructure, this market has potential to reach substantial size after start-up issues are resolved. By our rough estimates, infrastructure REITs could scale up to RMB2 trillion-RM5 trillion (US$300 billion-US$735 billion) over the next 10 years. This is a leap forward from the US$5 billion-US$10 billion we project in the pilot program.
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Chart 9
The U.S. Is The Largest Infrastructure REIT Market*
However China has potential to catch up

*China size is based on our projections over next five to 10 years; other markets sizes are based on market capitalization of REITs that are in line with the definition of China infrastructure REITs as of end-August 2020. Market cap portion—Infrastructure REITs as % of total REITs.
Source: Capital IQ, S&P Global Ratings.

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