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Views

Q&A: Thomas Delatour, Century Bridge Capital

Century Bridge Targets Growing Chinese Middle Class

Thomas Delatour

Thomas Delatour, ceo of **Century Bridge Capital**, believes that the news of a real estate bubble in China is greatly exaggerated, particularly in the middle-market cities that the firm is targeting. The private equity fund, which has dual headquarters in Beijing and Dallas, was formed in 2006 on the notion that investment in middle-class homes in Tier II and III cities in China would dovetail with the country's growing middle class and provide attractive risk-adjusted returns for its private equity investors.

There are more than 40 cities in China with a population of at least five million people. The company invests via a roughly $170 million private equity fund that is backed by 11 institutional investors. To date, the fund has delivered six developments in China and is about 80% invested. Going forward, the company would like to diversify its investor base. About 60% of its investors are European institutional investors.

Delatour and his colleague **Jeff Tucker**, chief operating officer, sat down with *REFI*'s **Elizabeth Blosfield** and **Danielle Balbi** earlier this month in New York to talk about supply-demand fundamentals, why investments geared toward the middle class in China are a different beast than luxury developments in a market like Shanghai and how finishing a unit in China is the same as—and different from the U.S. Hint: it's not all about stainless steel and granite.

***REFI*: There is a lot of talk in the mainstream media about a real estate bubble in China. But this hasn't been Century Bridge's experience.**

TD: No, it has not. There isn't really a real estate bubble in China. Larger cities, like Shanghai, have a lot of luxury housing but this isn't representative of the country's actual situation. The key in China, and this would be for any industry including residential real estate, is the growth of the middle class. That's the real story. What interested us when we first came to China in 2006 and is still consistent today is the tremendous pent-up demand for affordable middle class housing.

The Tier II and Tier III cities where we invest exclude Shanghai, Beijing, Shenzen and Guangzhou and are a group of 40 to 50 cities with populations of approximately five to 12 million. From 2005 to the present household income in those markets has been growing faster than housing prices.

When you look at research, no matter the source, there are tens of millions of Chinese households that can afford middle class housing who still live in government issued housing. Over ten million units are sold a year and there is still pent up demand of tens of millions. On average, there is 5 to 7 % growth in the market every year, but there is still lots of fluctuation. In terms of pricing, one year, the market in a particular city can go up 20%, but then drop 10% the next year.

REFI: What are the potential downsides of investing in a market like China?

TD: It's actually less risky than what we see in developed countries, because the Chinese government encourages and supports middle class housing growth. Our investments are low-leverage investments and there is significant equity, but our investors still see an acceptable return.

REFI: How is investing in China different than the U.S.?

TD: China's real estate market structure is significantly different from the market in the United States because of the different forms of ownership. In the U.S., we are accustomed to fee simple, which is essentially total ownership of a property. By contrast, in China, some branch of the government owns the land, whether it be the city or province and leases the land on a long term basis, typically 70 years, to individuals or companies, where the lease payment is a single payment made at the beginning of the lease.

REFI: What about cultural issues?

TD: When you go to another country, being bilingual isn't enough. It's about being bicultural. In building our team in China Century Bridge has sought out and hired people who know the culture and the market in China, but have work experience and education in the West.

REFI: We've heard that it can be difficult to navigate the bureaucracy. Are bureaucrats always bureaucrats, regardless of borders?

TD: Yes. And with every different country and region there are different rules. In China although technically the rules may differ, the processes are actually very similar to those in the U.S. and Europe. We've gone full cycle on investments and never had any issues. The only problems we know of are when people try to cut corners and circumvent the established rules and the processes.

If you're doing a product type the government wants, such as providing more supply of middle class housing in Tier II and Tier III, then the whole process of coming in is just an administrative process.

REFI: How does the building process in China compare to what we see in the U.S.?

TD: What we consider middle class housing in the United States is different than middle class housing in China. In the U.S., a middle class home is typically a single-family home of anywhere from 1,500 to 2,000 square feet. In China, middle class housing is seen in high-rise apartment buildings—anywhere from more than 20 to 34 stories, ranging from 600 to 970 square feet. And those are two- to three-bedroom homes, so the rooms are very small.

Structurally, the foundations are poured in-place concrete, which is unusual in the U.S. for high-rise buildings. There is also no finish-out, meaning that electrical and plumbing to the unit is provided, but there are no sinks or toilets, cabinetry or appliances or partitions. The floors and exterior walls of the unit are just concrete. The finish-out is an entirely separate industry in itself in China, where individual home owners typically go online and choose whatever floor or cabinetry and other finishes are to their liking, and then choose a contractor to complete the interior of the unit.

REFI: Do you feel that global perceptions about China and the current economic situation affect investor decisions?

TD: In a global world economy there is always some degree of political unrest and economic cyclicality. There are always wars, always market fluctuations. Turmoil is a constant. However, capital markets have been steadier in recent years. And since China's best interest is to grow the middle class and grow their economy, anyone whose investments and strategies are in line with those objectives has no reason to worry about the viability of China.

REFI: Who are the buyers?

TD: The residential buyers in China are primarily owner occupants who use low to minimum leverage when buying. Few individuals in China have the opportunity to invest, and if they do it is in residential real estate. Most of them are savers as well. The maximum mortgage is 70% of the purchase price with a minimum of 30% down. One-third pay in cash. One-third put down a large down payment.

Most people say that when it comes to real estate it's location, location, location. For [us], it's partner, partner, partner. Century Bridge works in joint ventures with Chinese development partners. We are both very hands-on and learn from each other. The developer has a construction manager on site and so does Century Bridge.

There are more than 50,000 developers in China. As foreign investors, we have to be very selective in choosing Chinese development partners who are qualified, who are willing to work with foreign capital investors, especially institutional investors. We have to follow certain rules and we have to be able to enforce our own disciplines. Based on our strategy of developing middle class housing in Tier II and Tier III cities, the key to success is selecting partners who understand and are capable of meeting our criteria.