Industry Insights:

Finding the Right Partner — and Hoping for the Best

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Introduction

Most people who have been following, even casually, the development of the senior living industry in China know that significant demographic pressures, resulting primarily (but there are several other causes as well) from the one-child policy enacted in the late 1970s, increased longevity and China's extraordinarily rapid rate of urbanization, have given rise to much discussion and policy-making in China about how to deal with the social and economic issues presented by China's large and increasing aging population. The central government has announced its broad policy goals that 90% of the elderly should be cared for in their homes, 7% in community service centers, and 3% in senior living institutions. This newsletter will focus on the 3% allocation portion of that formula, although parts of what we discuss will apply as well to opportunities in the home health care and community service center sectors.

The Need for Senior Housing

While China has some 40,000 or more "senior homes" (akin to nursing homes in the U.S.) providing beds for over 4 million elderly citizens, these facilities are widely regarded as substandard, where children place their parents only when they are unable or unwilling to care for them – essentially, warehouses where the elderly go to die, providing little, if any, services or amenities to enhance their quality of life. The need for housing alternatives that provide a far more dignified and enjoyable way of life for seniors is obvious and compelling – both to replace many, or most, of these existing, outmoded and unacceptable facilities and to increase the overall number of beds for China's growing elderly population.

The Industry Response

In order to spur the development of privately owned and operated senior living facilities, since this product type is very new in China –

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"nascent" is the word often used to describe the industry, governments at all levels, developers and investors have been eager to import expertise and resources from abroad, primarily from the U.S., where the industry is quite mature, to cooperate in designing and operating senior living facilities. The form that this cooperation typically takes is a collaboration of some sort between the domestic developer and the U.S. operator, whereby the developer provides local support in obtaining land use rights, permits, approvals, licenses and financing for the project, and the U.S. operator provides know-how in planning, developing and operating the project, training staff and developing operating procedures, among other tasks. This collaboration can take a few different forms, from establishing a joint venture, with each party contributing know-how, relationships, and the like, and perhaps some amount of capital, to consulting and management agreements, where the operator provides design, development and/or management services to the project for a fee. How the collaboration is structured will depend in large measure on the goals and objectives of the parties. For ease of expression, we will refer to these arrangements collectively as "partnerships," and to the parties as "partners."

What Makes for a Good Partnership?

With this as background, this paper will examine what constitutes a "good" partnership, meaning one that will endure the long and potentially difficult process of developing and operating a successful senior living project, and provide satisfactory returns to the parties over the short and longer term; and guidelines for how to achieve these results. There are no guarantees, of course, that even if "all the boxes are checked," the resulting partnership will, in fact, endure or ultimately be successful. We have seen examples of partnerships that failed, despite displaying each of the characteristics that would suggest a successful partnership; but what follows are points to be taken into consideration that will perhaps increase the chances of positive outcomes.

Points to Consider in Entering Into a Partnership

- **Know your partner (generally)**. There are many aspects to this. It begins with the basics of choosing a partner in any industry: reputation in the community, to confirm that the potential partner is generally well-regarded and known for good, ethical conduct; background checks, to confirm that the partner has not been the subject of investigations for corruption, etc.; and financial capability and stability. With listed companies, this is an easier inquiry than with privately-held companies, where information is much harder, or virtually impossible, to obtain. Assistance and advice from sources with networks of local contacts, such as a trusted attorney, could be quite helpful in getting reliable answers to these inquiries.

- **Know your partner (more specifically)**. This inquiry then ordinarily moves on to the question of the partner's experience in the industry that the intended partnership will engage in. Because the senior housing industry in China is such a recent phenomenon, this is a hard task, as there are very few, if any, potential partners out there with more than a two or three years of actual experience in the industry. Some companies, particularly certain insurance companies, have spent years studying the industry, but their and others' operational experience is extremely limited at this point in time.

- **Drill deeper**. Unless you are fortunate enough to find a potential partner with significant experience in the industry, and one that passes the general inquiries above, the next step would be to engage in further investigation and some in-depth discussions with the potential partner; the goal being to determine how good a "fit" there would be between the partner and you. Suggested topics might include:

   - Is the potential partner involved in the real estate industry in China? (If the potential partner has not been involved in real estate, then in our view, that would greatly increase the level of inquiry required to convince yourself that this would be a good partner.)

   - In what capacity? Developer, owner, investor, property management?

   - State-owned enterprise (SOE), publicly listed, privately held?

   - What type of real estate? Residential, commercial, mixed use? How many projects and of what size has the partner developed? What experience does the partner have in managing properties?

  The senior living business is a service business that utilizes real estate in its operations, much like a hotel, but with a far higher level of services due to the needs of residents. Although it is not a real estate business, if a potential partner has some meaningful experience in the real estate industry, that would engender some confidence that the partner at least knows what real estate is about in China, which, in actuality, is a significant factor in why you want to have a local partner in the first place. And, for a real estate company, particularly one that focuses on residential, to want to branch out into senior living is not irrational, given the efforts of the government to slow residential development. The question would be, is the company really serious about getting into the senior living business – being the "service business" it is – or is it using senior living as a tool to get the local government to grant land use rights, which are not as easily available as they previously were?

- **Drill deeper still**. So, if after conducting the investigations above, a potential partnership still seems promising, the next steps involve a lot of face time with the partner. This is a very important part of the process, as it would help determine if your partner's and your interests are "aligned." Parts of this determination are somewhat objective, and other parts are almost purely subjective.

   - The objective factors are concerned with the partner's organization. If the partner is not a real estate company *per se* – for example, an SOE, a conglomerate, an insurance company (many of which are forging ahead with senior living developments, for various reasons, some specific to the insurance industry), or an investor, does the partner have real estate experience and preferably, a division or section within the company dedicated to real estate development? It would be interesting to know how many people are in the division, what their experience levels are and where that division sits

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A practicing attorney for over thirty years, the primary focus of Mr. Christian's practice has been representing institutional investors and developers in commercial real estate transactions across the U.S. and in Asia. A specialty of his practice since 2000 has been the senior housing industry in the U.S., and since 2009, the senior housing industry in China. He lived and worked in Hong Kong from October 2008 to December 2011, where he co-headed the Asia real estate group of a global law firm. He was appointed a fellow at the Harvard Kennedy School in Cambridge, Massachusetts upon his return to the U.S. at the end of 2011.

in the organizational structure. What level of autonomy does it have? How powerful are its leaders in the organization? Some of this may be very hard to ascertain, but it's worth asking the questions.

- Is there a dedicated senior housing team within (or without) the real estate team? How big is the team, and what are its members' levels of experience? Here, the answers may be more along the lines of the team members' learned knowledge of the industry rather than hands-on experience, due to the newness of the industry; but it will at least provide a gauge to how easy or hard it may be to work with the team and how much time would need to be spent on educating its members, not to mention disagreements arising out of their unfamiliarity with the product type. "Build it and they will come," which seems to have been the mantra of the real estate industry in China in earlier times, is highly unlikely to apply to senior living projects, in our view. Openness to commissioning market and feasibility studies for its projects would be a good indicator of the partner's understanding of the complexity of the product type and of its willingness to take the steps necessary to develop a project that has a good chance of success.

- The more subjective factors are qualitative in nature, but nonetheless merit a lot of discussion between the potential partners. The opening topic might be the strategic visions of the partners for the business: what does each partner hope to accomplish, short-term and over the long term? For example, if the domestic partner is a developer, is it looking to senior housing as a means to an end, such as facilitating the grant of land use rights or using the label "senior housing" as a marketing tool to sell luxury residential units in the same development? Or is there a serious commitment to the senior housing business, which as noted above, is quintessentially a service business?

  This discussion can be broken down into more quantitative topics, such as what are each partner's time horizon and return expectations. Experience in the U.S. shows that senior living investments have a fairly long time horizon over which to maximize returns – in the order of seven years or so. In contrast, developers in China have been accustomed to selling residential units often in the early stages of construction; so they might be expected to start with the mindset that returns should come early in the cycle. Forming a partnership between partners coming from such different places is not easy. It will require many hours of discussion and mutual understanding to gain some confidence that both sides are signed onto the program. The expected level of returns from senior living may also be a point of divergence between the partners, stemming in part from the notion that senior living is a service business, not a real estate play. Returns can vary greatly, depending upon capital structure, operating efficiencies, staffing levels, etc.; but if carefully conceived and executed, the overall return on senior living properties can be quite attractive. It is very important that each partner signs off on *pro formas* based upon reasonable assumptions.

- **The devil is always in the details**. After the partners are reasonably satisfied that they share common goals and objectives for the partnership, the process of putting the deal together must be completed. Issues such as capital requirements and contributions, ownership, management, major decisions, distributions, dispute resolution, duration and many more must be agreed upon. In some ways, how these issues are negotiated may provide insights into whether the partners' interests are truly aligned. For example, if one partner insists on being able to call for a sale of the project after three years, that will tell you something about whether the partners share a mutual goal of building a long-term senior living business.

Deal Structure and Documentation. At this stage, the parties should be highly encouraged to engage legal counsel with deep knowledge of the industry to advise on how the relationship should be structured, taking into account all that was learned in the process of due diligence. Should the parties form a joint venture, enter into a consulting/management agreement or consider a hybrid of these structures? Should the foreign entity enter the China market employing an offshore/onshore structure? What is the most tax efficient way to structure the transaction? What foreign exchange issues are involved and what is the preferred way to minimize any FX impact? Should the foreign partner form a joint venture with the Chinese partner, or establish a wholly foreign owned enterprise (WFOE)? These are just a few of the questions that will need to be addressed, and many others will arise in the course of negotiating the transaction. Experienced counsel can provide valuable advice on these questions, as well as, of course, assist in negotiating and drafting the necessary documents. Bringing in counsel early in the transaction will save the parties a great deal of time and expense, as an experienced attorney can provide valuable guidance along the way, avoiding wasted efforts.

Some Deal Breakers. We have seen several cases in which even though every "box" has been checked in the due diligence and negotiation process, a deal still ends up in failure. Often times, it is essentially caused by lack of alignment of interest between partners; sometimes, however, disagreement on certain issues lead to a broken deal, issues which could have been found and addressed in the first place, instead of finding out later in the process, after substantial time and effort have been invested. Through our experience in recent years, there are several points that we advise each side of a partnership to give serious consideration to in the process of negotiation – or, better still at an earlier stage of the process:

- Deciding on majority shareholder and voting right in a joint venture. There is no perfect formula for allocation of shares and voting rights in a partnership—most often, it's an art of balancing and compromising. For those foreign investors who want more decision-making rights in a joint venture, for example, to address their concern over protection of intellectual property, the corporate structure needs to be decided sooner rather than later.
- Whether the land title and licensing of a senior care project are without any legal barrier. Issues arising due to the lack of initial legal study on land title, planning or licensing requirements could lead a marathon negotiation to an abrupt end—for example, the target land or property was never intended by the local government to be used for senior housing at all, and both parties had mistakenly convinced themselves that these barriers can be overcome by "Guanxi".
- Fee model and operational liability. When discussions have

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Being a legal professional that has involved in the development of real estate and senior housing for years, Michael can serve for varied investors in the field, providing sound service on the full spectrum of issues in project development which can arising during the site selecting, acquisition, feasibility studying, construction, financing, pre-opening preparation, post-opening operation and disposal of senior care or hospital facilities.

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progressed to a more detailed stage, these concerns often pop up, particularly in an operation management deal. Disagreement could arise from the fact that the foreign brand could be putting its reputation on the line in a project for as long as 20 years, but its Chinese partner wants to take an aggressive, and possibly illegal, fee approach in order to satisfy its financial needs, which could bring about unsustainability and operational risks, if, for example, the Chinese partner wants to divert entrance fees or substantial deposits to the development of another project without putting in place enough reserves for the project that generates the revenue.

- Absence of exit strategies. There has been a lot of discussion over how Chinese partners are concerned about "face" and are reluctant to talk about "break-up" causes and remedies with foreign partners at the negotiation table. While the absence of exit pathways might not directly lead to a break-up, the fact that there is no exit clause in a partnership agreement could be ominous signal, indicating both parties, or at least one partner, haven't thought through the deal very well but just want to close a deal as soon as possible.

Conclusion

This has been a general overview of our thoughts about a process that might lead to a "good" partnership, but following the process will by no means ensure that result. What must be remembered is that the senior living industry in China is still quite young, and all participants are still feeling their way. Expectations and perceptions may, and probably will, change over time; but spending the time and effort to go through the process – painstakingly – will help ensure that the base of a good working relationship has been established, which will go a long way in allowing the partners to resolve the challenges they meet as they move forward. ■

CareExpo Shanghai • China

A Message from the Chairman…

Care Expo China: trade show ROI done right!

When I first came to China in 2010 looking to establish my US based senior care business, China it was truly the Wild West...no road signs, no how-to books, no marketing platform…nothing really. But today, five years into the modern era of senior care here in China, there is a lot you can triangulate and learn from: Many Western companies have set up branch offices here and most of them are doing well. China is passing helpful legislation on a monthly basis to enable foreign companies a leg up on the business, quite a few journalists write helpful blogs on the industry and there is at least one book about China senior living. But more importantly, there is a trade show and conference which has customized its platform to fit your needs and provide you with access to local companies and opportunities that might otherwise take you years to realize....welcome to Care Expo!

I helped start Care Expo four years ago because I saw a true need for a trade show that was more than just booths and speeches. Today, I have crafted Care Expo into the largest, pure play B2B, multinational aged-care trade show and conference in China. It's an event that you should not miss and one which you can depend on for measurable trade show ROI.

Let me explain just how different and effective we are:

Care Expo has multiple conference programs each with a carefully tailored educational agenda that enables experts to present their skills in numerous senior care disciplines. The 2015 Care Expo program will showcase the following conferences:

1) Main Summit - The centerpiece of Care Expo's conference program. The Day 1 portion of the Summit will showcase a series of industry keynotes which set the stage for Day 2's multi-track exploration into the rapidly developing world of senior care in China.

2) ADI Masterclass – World renowned London-based NGO, Alzheimer's Disease International, will co-host a one day presentation entitled "Practical approaches to understanding Alzheimer's Disease in a China context." Published experts in Neuroscience, professors and care-givers, both Chinese and Western, will gather to offer the best in class ideas for advancing policy and practices for Alzheimer's treatment in China.

3) IAGG Symposium – Global senior care educator, International Association of Gerontology and Geriatrics, is co-hosting a one day, deep-dive educational seminar for local care givers taught by leading experts in the field of aged-care.

Care Expo has also developed a series of auxiliary programs to assist locals and foreigners in their mandate to connect and do business in China. These are:

1) GoodMatch program – GoodMatch is the next evolution in matchmaking where we create fully customized meetings in our private VIP Lounge based on targeted customer profiles you provide us with…all you need to do is make the deals happen.

2) CareExpo TV – Your interview and your company commercial will run on a continuous loop via large LED

screen TV's placed throughout the Expo floor during the event and on our website until March 1, 2016.

3) CareExpo StudyTour – Care Expo operates a series of educational trips throughout the year. Immediately after Care Expo in November 2015, we will offer a 3-day/2 night tour of senior care facilities and geriatric hospitals in the greater Yangtze River delta area. This tour will put you in direct contact with Chinese owner/operators.

Care Expo is in its 4th year of providing a platform for companies like yours to explore the market, learn from insiders, market your services and products and engage with locals who are serious about doing business with you. Our visitors and delegates consist of precisely the people you want to meet: local senior care facility developers, procurement officials from local health care organizations and c-level executives from insurance companies, hospitals and associations.

In sum, if you or your company is 1) presently entering the senior care market in China and looking to get-smart-fast 2) already in China and looking for dependably real opportunities to pitch business or 3) not sure if the China opportunity is for you but want to explore and collect facts before you fully commit, then in all three instances, you should be attending Care Expo.

Come take a booth, present your skills at our educational conferences, let your infomercial do the marketing on Care Expo TV or participate in a GoodMatch session and engage carefully selected locals in partnering discussions. Then, after the event venture out to inspect local senior communities in the StudyTour program. You'll be pleasantly surprised with our customer-centric, innovative approach to the trade show business: I know...because I built it for businesses like yours.

My name is Bromme H. Cole and I own Care Expo. I am happy to answer any questions you may have. Contact me on Bromme.Cole(at)CareExpoChina.com

See you in Shanghai this November 17/18 at Care Expo!!