CUSHMAN & WAKEFIELD

# CHINESE CAPITAL FLOWS

## WHERE TO FROM HERE?

FEBRUARY 2018

INSIGHTS INTO ACTION

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# CONTENTS

# EXECUTIVE SUMMARY

China is now Australia's largest export market and main source of imports, though the relationship is much deeper than the trade in goods and commodities alone.

Investment by Chinese entities into Australian commercial property has been significant at almost $23bn since 2010. From a sentiment perspective Australia is regularly pointed to as one of Chinese investors' most preferred destinations globally.

However, new trade agreements and policy updates have altered the investment landscape:

China-Australia Free Trade Agreement: Raising of investment review threshold in Australia before FIRB approval is required.

Belt and Road Initiative: China's massive multinational infrastructure investment plan, improving trade links and exporting production capacity around the world.

Updated Guidelines (Circular 74): Places real estate on the restricted list for outbound investment, therefore requiring investment approval from the Chinese government.

## Clearly these measures will have an impact, presenting both challenges and opportunities for commercial real estate in Australia:

#2 Australia will remain a key investment destination in 2018, with Chinese investors placing it second in global target markets for the third consecutive year

Lower investment volume and fewer investors in the market in the near term. However, this could present opportunities for capital partnering and local asset management services.

Change in strategy to real estate investment that aligns with the Belt and Road criteria. This is most likely to benefit the industrial sector, especially logistics, production space and R&D focused business parks. Development opportunities should also remain attractive.

Currently only 15 of the 200 Chinese companies on Forbes' top 2000 list are active in Australia. Over the longer term, demand for space from Chinese occupiers in the Australian market will increase as more companies "go global" and expand their occupational footprint.

# INTRODUCTION

China and Australia enjoy a strong relationship across trade, investment and population dynamics. Over recent years this relationship has increasingly spread to real estate.

Investment by China into Australian commercial property in particular has been significant at almost $23bn since 2010. Australia is regularly amongst the top destinations globally for Chinese outbound capital and placed third in 2016, behind the US and Hong Kong. However, in 2017 Chinese investment into Australian commercial real estate (CRE) markets slowed dramatically.

In this report, Cushman & Wakefield analyse Chinese investment into Australian real estate, review the new guidelines as well as existing trade agreements and development initiatives; and provide an assessment of the implications for commercial real estate in Australia into the future.

# AUSTRALIA CHINA RELATIONS

## Export Trade

**CHINA is #1 trade partner,** totaling **AUD$101bn** (year to Nov 2017)

Growth of **16% per annum** over past decade

## Foreign Direct Investment (FDI)

**AUSTRALIA is 2nd largest recipient** of FDI at **USD$103bn** (aggregate since 2005)

Real estate accounts for **20% of FDI** in 2014-17

## Population

**1.2m** identified as having **Chinese ancestry** in 2016 census

## Tourism

**2006**
**7 direct flight** routes and **1,425 flights**

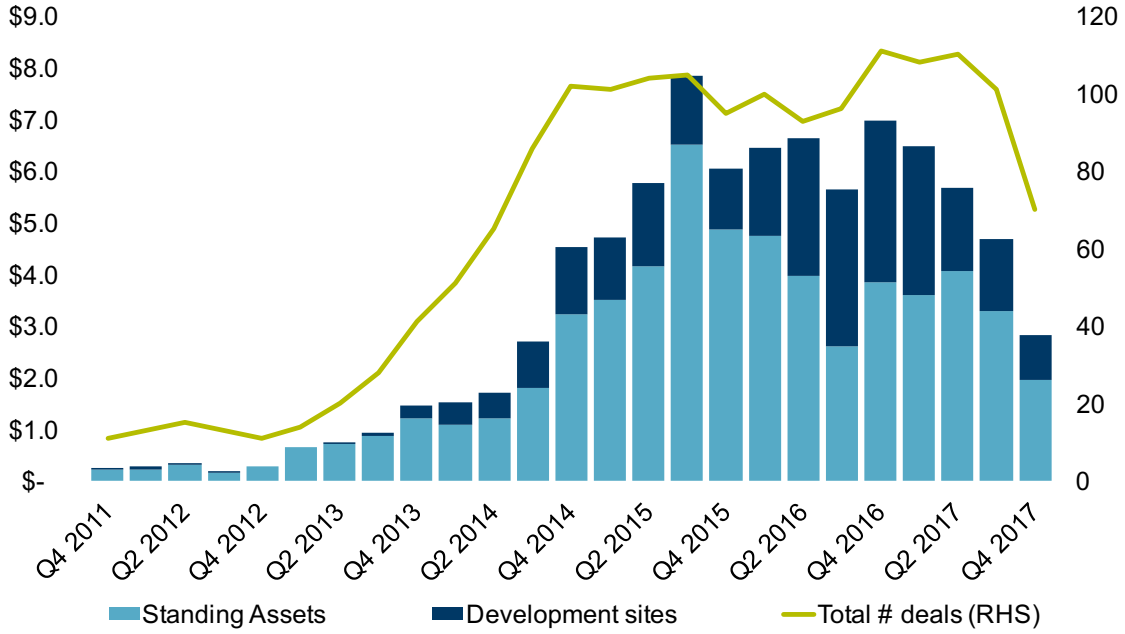
**2017**
**29 direct flight** routes and **7,400 flights**

**1.1m**
**Chinese visitors** in 2017 spending **AUD$7.6bn** in Australia

# CHINESE INVESTMENT INTO AUSTRALIAN COMMERCIAL REAL ESTATE

Since 2010, Chinese investment into Australian commercial real estate has totalled $22.8bn, comprising $15.9bn in standing assets and a further $6.9bn in residential development sites. While total investment reached a peak in 2015, coinciding with CIC's acquisition of the Investa Property portfolio, overall volume remained robust throughout 2016 (Figure 1).

**Figure 1: Rolling annual investment volume by deal type (AUDbn) and total number of deals**




*Source: Real Capital Analytics; Cushman & Wakefield*

## VOLUMES DECLINING AS DEAL ACTIVITY BECOMES MORE DIFFICULT

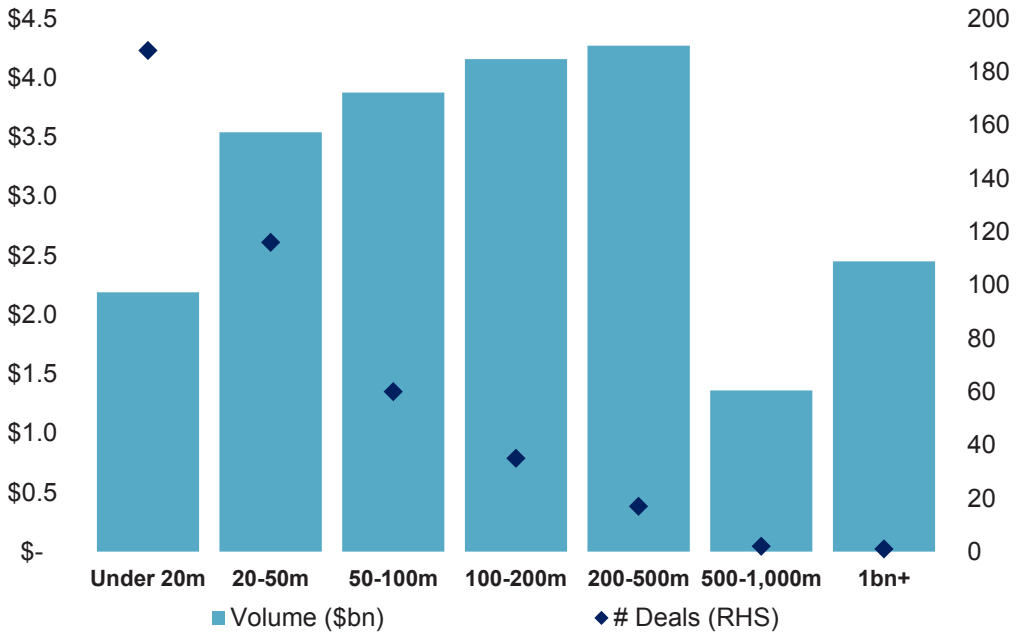
Investment in 2017 represents a departure from trend, which cannot be fully attributed to the Chinese Government's updated guidelines on outbound investment (see next section), though they no doubt have had an impact. In addition, risk of residential oversupply in some markets, tougher lending conditions (both in Australia and in China) and increased tariffs for foreign investors in residential real estate have all contributed to weakening sales of development sites. Investment in standing assets has also softened, though this is likely due to increased competition for assets from domestic and offshore investors, as well as a 30% decline in average deal size y-o-y.

# DEALS BELOW $50M HIT THE SWEET SPOT

Although there is great diversity in the individual entities that actively invest in Australia, they broadly fall into two investor types – Private Investors or Real Estate Operating Companies / Developers, there is comparatively little investment by Chinese Unlisted Funds and Pension Funds.

As a result, there is a distinct sweet spot where most investment occurs which, contrary to public perception, is below $50m. Larger deals in excess of $200m do occur and are headline-grabbing, however since 2013, when total investment gathered momentum, only account for less than 4% of deals by number, though 37% by dollar value (Figure 2). Instead much more deal flow occurs in the sub-$50m range, accounting for 73% of deals, but only 25% of investment volume. The difference between these bookends comprises entities seeking CBD assets or significant (re)development sites in metropolitan and greenfield areas.

**Figure 2: Total Chinese investment (AUDbn) by deal size, 2013-2017**




*Source: Real Capital Analytics; Cushman & Wakefield*

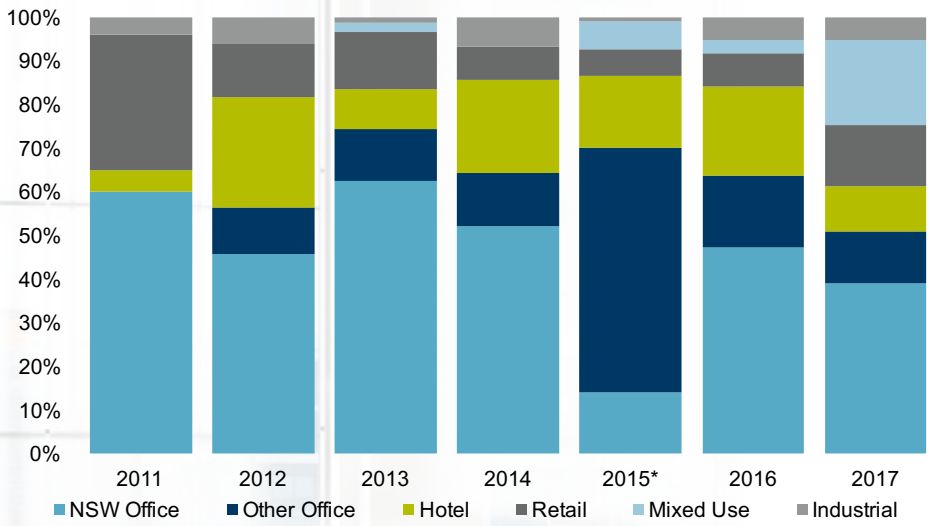
# NSW OFFICES ACCOUNT FOR ALMOST 50% OF INVESTMENT

Outside the development site market, Chinese investors have a sharp focus on the office market and offices in New South Wales in particular, which have averaged 48% and 45% of total investment by value respectively since 2011 (Figure 3).

In part this explains the recent decline in overall volume, with many of Sydney's largest transactions in 2017 undertaken by domestic entities. This has resulted in greater diversification, sectorally into retail / mixed use and geographically into metropolitan Sydney and Victoria (Map 1).

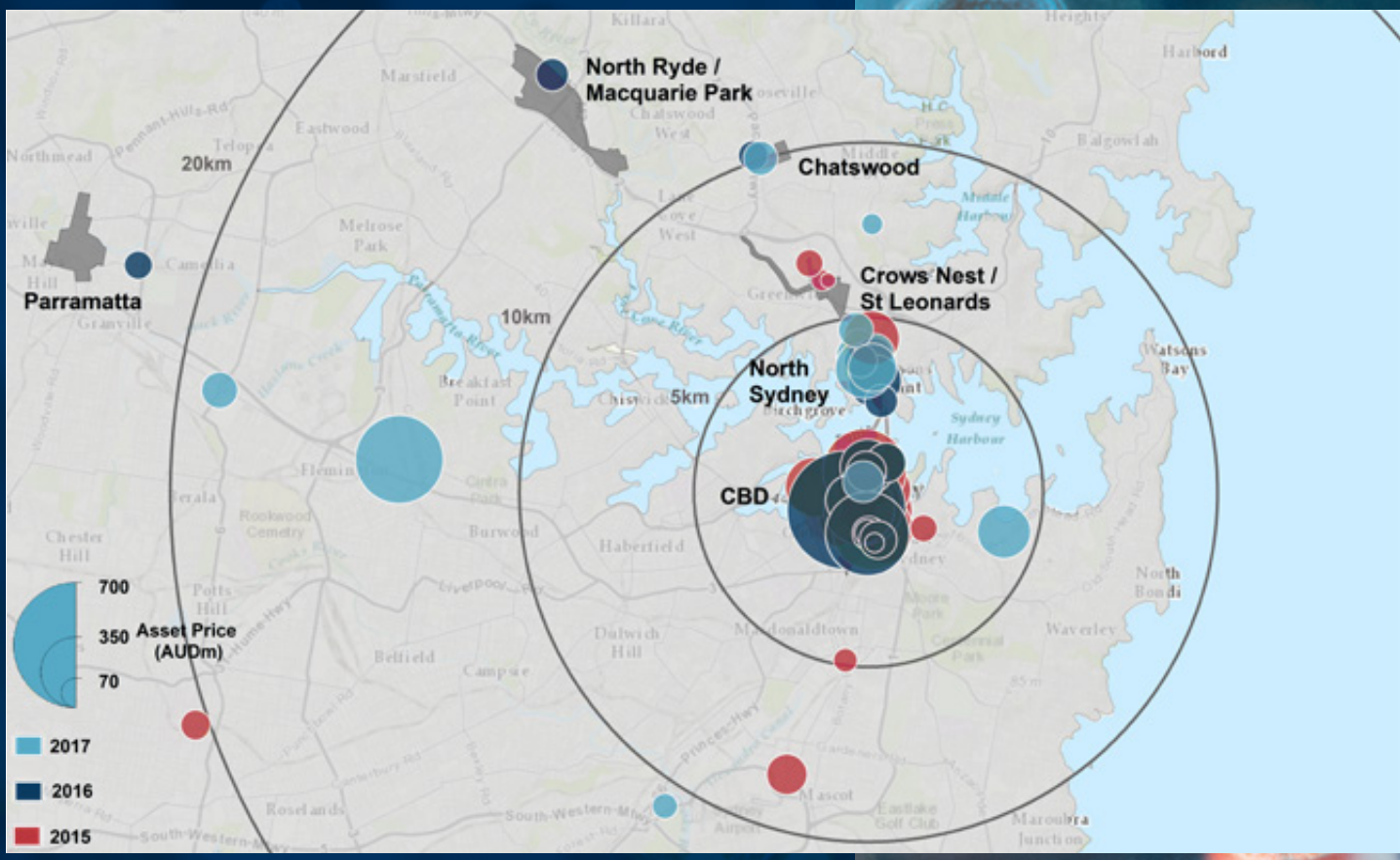
However, it is predominantly private investors, rather than institutional investors, that have made this transition and have targeted large format retail and neighbourhood centres. In contrast Real Estate Operating Companies / Developers, who have been the backbone of investment in dollar terms over the past seven years have maintained a stronger focus on offices, and as a result seen deal flow tighten.

**Figure 3: Chinese investment by sector, 2011-2017**




**Investa portfolio coded as national and not by specific markets*
*Source: Real Capital Analytics; Cushman & Wakefield*

Map 1: Chinese investment in greater Sydney 2015-17




*Source: Real Capital Analytics; Cushman & Wakefield*

# RECENT POLICY DEVELOPMENTS

Since late 2015 there have been three key policy developments that affect Chinese investment into Australian real estate:

## CHAFTA

The China Australia Free Trade Agreement (CHAFTA) came into force in December 2015. The overarching aim of the agreement was to provide greater access for Australian exporters into the Chinese market. At the same time measures were enacted that allow a greater flow of goods and capital into Australia including raising the threshold at which Chinese investment in non-sensitive sectors, including real estate, is considered by the Foreign Investment Review Board (FIRB) from $252m to $1.094bn. This effectively puts China on the same footing as the US, Japan and South Korea for private entities, though Chinese State-Owned Enterprises (SOEs) still require FIRB approval.

> *Under CHAFTA the threshold for Foreign Investment Review board (FIRB) approval was raised from $252m to $1.094bn*

# BELT AND ROAD INITIATIVE

The Belt and Road Initiative (BRI) was officially launched in 2013. It is a modernisation of the old Silk Road, comprising two components: (i) The land-based Silk Road Economic Belt; and (ii) The 21st Century Maritime Silk Road (Map 2).

Belt and Road is primarily an infrastructure development program linking China to Europe through Eurasia (the Belt) as well as linking China via South East Asia and Northern Africa to the Mediterranean (the Road). Longer term the overland belt is expected to comprise a network of new rail connections, while the maritime element expects a massive program of port developments.

While Australia is not on the indicated route, the Chinese Government has made it clear that Belt and Road is open to all countries, and has suggested on two occasions that the development of North Australia could be a potential project for such investment.

Currently 68 countries have signed a memorandum of understanding (MOU) with China, seeking to be part of the Belt and Road program. As yet, Australia is not one of the signatories, though New Zealand is a participant.

### Map 2: Belt and Road Initiative


*Source: Mercator Institute for China Studies*

# UPDATED GUIDELINES ON INVESTMENT OVERSEAS (CIRCULAR 74)

The most recent announcement was in August 2017, when the Chinese Government released their updated guidelines to promote foreign investment that was more aligned with the BRI. Within these guidelines, outbound foreign investment is classified into one of three categories. Real estate falls within the "restricted" list, rather than "encouraged" or "prohibited" and therefore requires Government verification and approval review.

# IMPLICATIONS FOR COMMERCIAL REAL ESTATE

CHAFTA is designed to make Australian investment into China easier and more efficient, while also relaxing review thresholds for incoming investment, resulting in the growth of Chinese investment activity since its ratification. However, the two Chinese policy announcements are likely to have a much bigger influence on investment from China into Australia going forward, influencing both scale and strategy.

## LOWER INVESTMENT IN THE NEAR TERM

With real estate now placed on the restricted list there will be greater scrutiny of transactions, suggesting deal activity will slow. Recent survey research by Cushman & Wakefield on outbound Chinese investment has shown that 50% of respondents have been significantly impacted by the latest guidelines. However, the remaining 50% felt limited or no impact. Therefore, while deal activity may slow it is not expected to dry up completely; not least as Australia remained the second most favoured destination for outbound investment for the third consecutive year. However, given local conditions, development site sales are likely to remain problematic for now, while it is likely to become more challenging for Chinese investors to secure Government approval to purchase trophy assets, hotels and retail centres.

## ESTABLISHED INVESTORS TO REMAIN ACTIVE PURCHASERS

Given the higher level of scrutiny around real estate investment, less diversity is expected in the range of investors. Investment will be more restricted to those that have real estate as a core function of their business, rather than large conglomerates diversifying into different sectors. Furthermore the current environment is also likely to favour larger investors that have access to offshore capital, either through offshore banks or by recycling assets. Notwithstanding three recent high-profile asset sales in Australia, driven by other reasons, a large scale sell-off by Chinese investors in Australia is unlikely. At the other end of the spectrum, Chinese private investors are expected to remain active which is reinforced by the fact there was little drop off in activity from this group in 2017.

> *Australia remained the second most favoured destination for outbound investment for the third consecutive year*

## OPPORTUNITIES FOR CAPITAL PARTNERING

The tighter investment environment may create opportunities for domestic investors and lenders, not least as it will dampen potential offshore competition for assets. However, more positively it could provide opportunities for capital partnering as Chinese investors seek to allocate a lower volume of funds offshore. There are then subsequent asset and funds management opportunities for local investors to boost total returns.

## ADOPTION OF BELT AND ROAD PRINCIPALS IN REAL ESTATE INVESTMENT

While the updated guidelines aim to control the flow of outbound capital, a clear preference remains for allowing investment that follows the principles of the BRI. Rather, the focus of the new guidelines is to curb "irrational" investment. The guidelines go on to state that logistics and hi-tech manufacturing may be favoured under Belt and Road.

To date, Chinese investment in the industrial sector in Australia has been extremely limited at just 4% ($608m) of total CRE investment since 2012, though CIC partnered with Goodman and CPPIB in 2011 to purchase the $1.1bn ING industrial portfolio. This is similar to the global trend for Chinese outbound investment which has averaged less than 10% into industrial assets. However, the massive purchase of Logicor's European portfolio by CIC in 2017 for €12.25bn (AU$18.75bn) highlights the increase in focus on this sector. Clearly this is one area that has the potential to grow in the near term given the focus on Belt and Road.

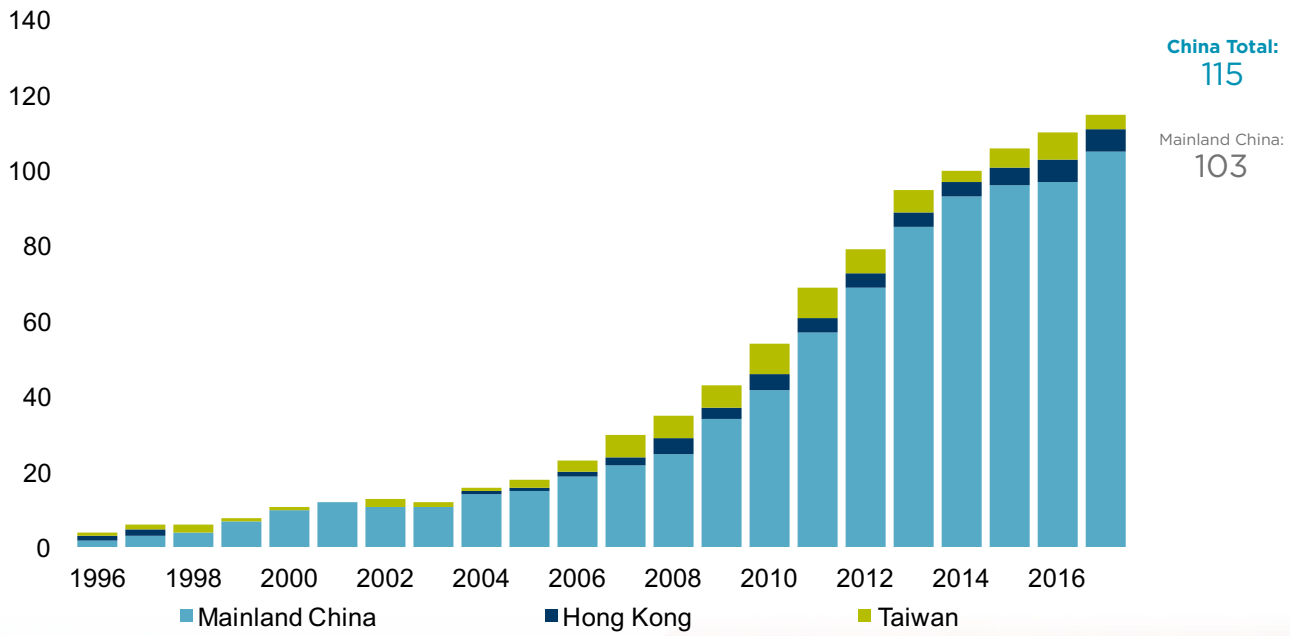
Although it is noted that Australia has not signed the MOU, the ratification of CHAFTA – just one of 14 such agreements globally – is a clear indication of the strength of relationship between the two countries, as is the high level of FDI into the country. In light of this, Chinese investment into Australian commercial real estate is likely to expand beyond the office sector and residential development to include logistics, manufacturing and business park space. It is noted that this is a significant departure from recent trends and therefore potential investors are likely to need robust advice on how to enter and navigate the market.

# INCREASING DEMAND FOR SPACE FROM CHINESE OCCUPIERS

Over the past decade, the rapid growth experienced by China's largest companies has propelled them up the global rankings, such as Fortune 500. In 2007 there were less than 40 Mainland Chinese companies in the Fortune 500 list, as of 2017 this had risen to 103 (Figure 4). Similarly there are now 200 Chinese companies on the Forbes 2,000 list. The common theme though is that there is relatively little presence of these companies in Australia – only 15 out of the 200 on Forbes' list are active in Australia.

> *In 2007 there were less than 40 Mainland Chinese companies in the Fortune 500 list, as of 2017 this had risen to 103*

### Figure 4: Growth in Chinese Fortune 500 companies, 1996-2017




> *Only 15 out of the 200 on Forbes' list are active in Australia*

However, it should be remembered that the small footprint of Chinese companies in Australia is not necessarily surprising as many are still in the early stages of global expansion and are mainly targeting high growth markets.

To date the most visible activity in Australia has been through mergers and acquisitions, such as China Communications Construction Company's (CCCC) acquisition of John Holland, which has little impact on the demand for business premises. Notwithstanding this, there has been evidence of organic growth of Chinese companies driving space demand including ICBC and China Construction occupying premises in Brisbane, Melbourne, Perth and Sydney.

More widely, there has already been an appreciable increase in demand for space from Chinese companies in core markets across North America and EMEA. While it is impossible to quantify the amount of space Chinese companies are likely to absorb into the future, as they continue to expand both within Asia-Pacific and globally, acting on the Belt and Road Initiative, Australia is increasingly expected to become a target market across a range of sectors building on the two countries' longstanding economic ties.

# CONCLUSION

Chinese investors have been a visible part of the Australian commercial real estate investment landscape, however with recent local market and regulatory changes, both in Australia and China, deal flow declined in 2017. As a result, the strategies of Chinese investors are likely to change, presenting opportunities for both Chinese and local companies alike.

Deal activity is expected to be weaker in the near term and be restricted to Mainland Chinese entities with real estate as a core business function, presenting opportunities for local capital partnering. Longer-term opportunities exist in the industrial sector and occupier markets as Chinese companies further embrace the Belt and Road Initiative.

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However, the 45,000 employees in more than 70 countries aren't complacent or content, instead strive for new and better ways to do things. Rather than conforming to convention, they challenge it, combining the entrepreneurial spirit of small business with the expertise of a century in a global marketplace. Cushman & Wakefield anticipate market changes and are first to capitalise, ensuring clients can **be what's next.**

Cushman & Wakefield see things differently and take a fresh approach across a range of property services including agency leasing, asset services, capital markets, facility services, global occupier services, investment and asset management, project and development services, tenant representation, and valuation and advisory.
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