RESEARCH

Knight Frank

CHINESE OUTBOUND
REAL ESTATE INVESTMENT

RIDING THE WAVES

OCTOBER 2018

KEY TAKEAWAYS

- The ramifications of last year's sweeping changes in Chinese policy on outbound real estate capital continue to linger. Even though Chinese outbound investment last year managed to stay on the growth path of the past three years, increasing 11.7% year on year (YoY), this was largely helped by a large logistics portfolio acquisition by China's sovereign wealth fund CIC. This year, however, has been a mixed market for Chinese investors.
- Capital outflow controls have had a detrimental impact on key markets, like the US and Australia, where volume dropped as much as 64% YoY last year. In contrast, the UK saw four times more Chinese investment than in the previous year. Hong Kong has also emerged as one of the top gateways for Chinese capital.
- In the next 12 months, Chinese capital outflow restrictions are likely to persist, bringing an end of the current cycle of bulk buying. However, the markets will continue to see the presence of experienced, mature Chinese investors, such as sovereign wealth funds and developers with offshore fundraising capability.
- The retreat of Chinese Mainland buyers in many gateway markets, such as central London, made way for significant purchases by Hong Kong investors. But they face competition from other Asian investors, such as Korean and Singaporean funds, each vying for market share. Trade disputes, Brexit negotiations, yield compression and interest rate hikes may also raise concerns.
- From the Chinese investment perspective, London and Hong Kong remain the key destinations to watch. The former's strength is in its long-term return prospects, while the latter's is in medium-term value appreciation. In contrast, investment activity in the US and Australia will continue to be subdued because of factors such as worsening bilateral relationships and increasing competition from other investors.

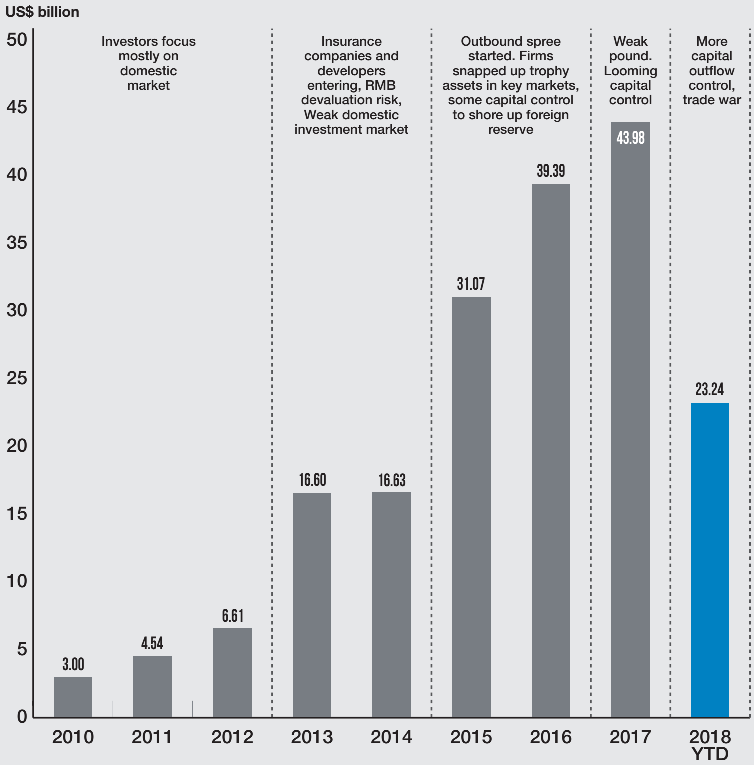
ONE KEY FACTOR

In the past 18 months, one factor – China's tight control over capital outflows – has overshadowed the world's key real estate markets. This outflow control has intensified since mid-2017, when real estate was classified as a "sensitive" sector, requiring official approval for every large transaction. Even before that, there was lingering concern in the market that the Chinese outbound bull run had drawn to a close.

Yet 2017 proved to be another good year for Chinese capital outflow. Chinese investors (including those based in Hong Kong with capital originating from the Mainland) invested nearly US$44 billion in global real estate markets, representing an 11.7% YoY increase (See Chart 1).

However, this was helped by one of the largest real estate deals of the year, China Investment Corporation's (CIC) US$14.56 billion purchase of the Logicor portfolio, which has logistics properties scattered across Europe. Without this mammoth deal, Chinese capital outflow in 2017 would actually have fallen 25.3% YoY.

Chinese global real estate investment* Chart 1



Source: RCA, Knight Frank Research
Note: Data as 31 July 2018
*Including office, retail, hotel, logistics, industrial, development sites and multi-family properties

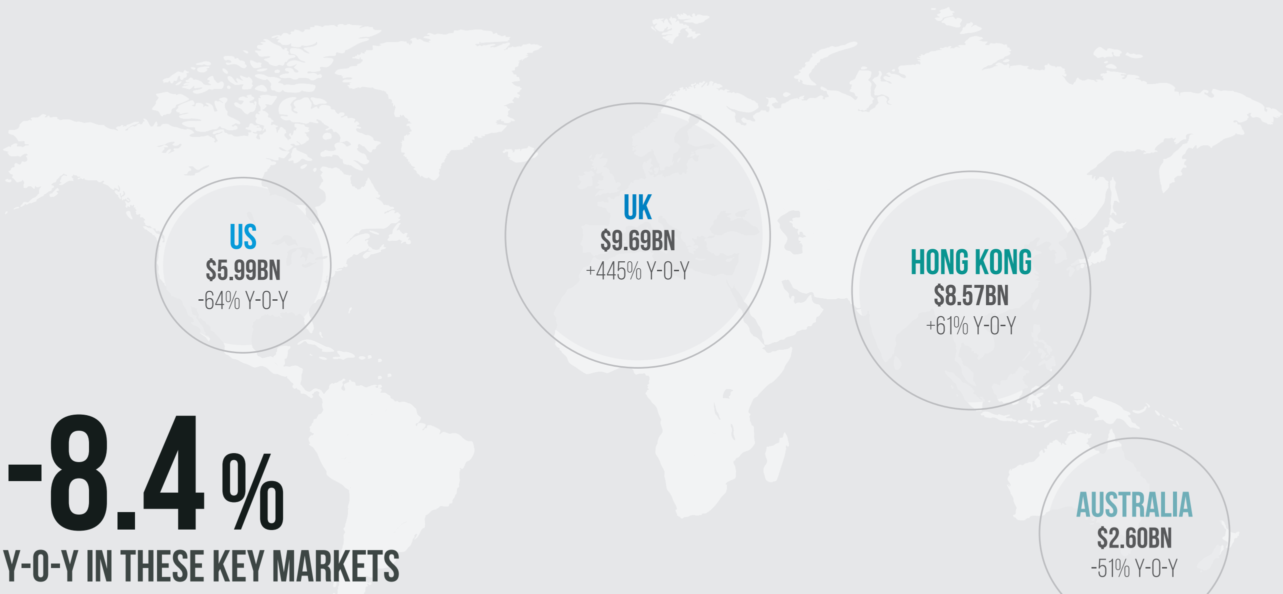
KEY MARKETS OVERVIEW

As in past years, Chinese capital focused mainly on the UK, the US, Australia and Hong Kong. In terms of value, the US$26.85 billion invested in these markets represented an 8.4% YoY drop (see Chart 2).

The volume drop in Chinese participation in the key markets was mainly because of the lack of large commercial transactions in the US and Australia last year, brought about by both Chinese and domestic policy factors.

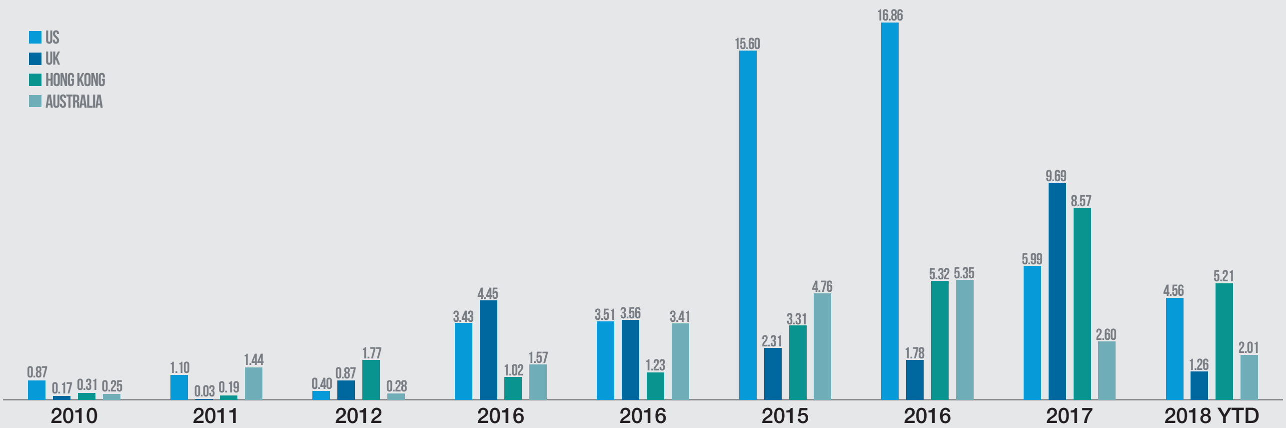
In contrast, both the UK and Hong Kong saw tremendous growth in Chinese investment during the year. The UK was at the top of the list, taking a staggering US$9.69 billion, while Hong Kong was not far behind at US$8.57 billion (see Chart 3). In many ways, these developments continue to have an impact on the market, as we move past the first half of 2018. So it is worth examining how individual markets have coped and will continue to cope with the policy upheaval.

Top Chinese capital destinations Chart 2



Source: RCA, Knight Frank Research
Note: 2017 figures

Chinese investment in key markets* (US$ billion) Chart 3



Source: RCA, Knight Frank Research **Note:** 2018 data as at 31 July *Include the UK, the US, Australia and Hong Kong SAR of China

US

How did policy restriction and trade war impact Chinese capital into the US?

The US market attracted US$5.99 billion worth of Chinese investment in 2017, a decrease of over 60% YoY, making it not only the first drop in recent years, but also the worst performer among key markets. This was largely due to Chinese capital outflow restrictions, which were aimed at some of the mega deals in the past, which had accelerated the depletion of the country's foreign exchange reserves. As an earlier Newmark Knight Frank report pointed out, this was also partly because of the market uncertainty arising right after the Trump administration took office.

The policy impact has been felt in all major investment centres in the country, with Chinese deal volume dropping nearly two-thirds in New York City and roughly 60% in other locations (see Chart 4). The insurance giants and sovereign wealth funds that purchased major hotel portfolios and prime office towers in previous years all but retreated from acquisitions. In fact, in New York City last year there was only one major office deal over the US$150 million mark completed – a tower at 245 Park Avenue. In 2016, in contrast, there were eight such transactions.

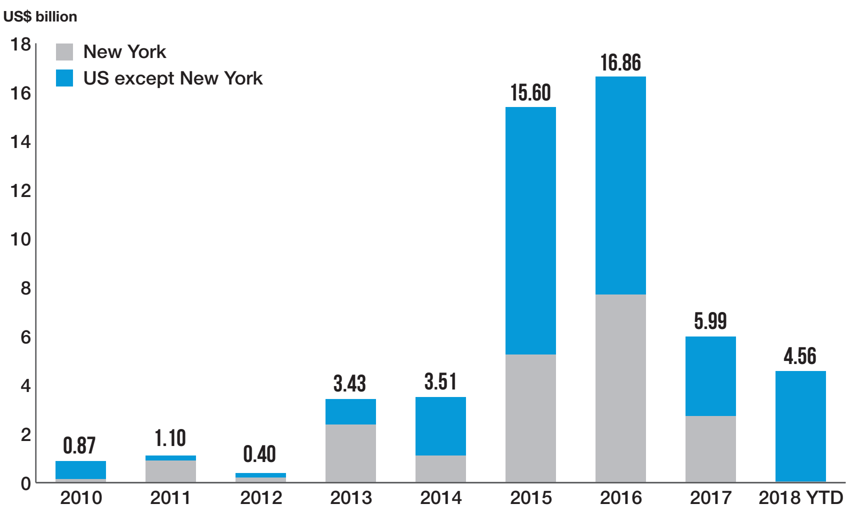
2018 saw a worsening of the bilateral trade relationship between China and the US, with the US vowing to place extra scrutiny on both Chinese companies and their investments in the US. While this is not aimed specifically at real estate, the pushback followed some hotel purchases offered a glimpse of the difficulty facing Chinese investors penetrating the US market, in addition to the existing taxation and regulatory hurdles. Some businesses have therefore shifted their attention elsewhere. For example, Xinyuan Real Estate, a Chinese developer that had been active in the New York City market for years, recently branched out into the UK market. It is unclear, however, whether this will become a trend.

Ironically, the volume of Chinese investment in the US so far this year is on track to match last year's (See Chart 4). However, this was generated almost entirely from the buyout of the GLP logistics portfolio by a Chinese consortium consisting of PE firms Hopu and Hillhouse Capital, the Bank of China and Vanke. In fact, the deal was struck before the current outflow restrictions kicked in. Without that deal, this year's transaction volume would have dropped to a dismal level, even lower than that in the years before the Chinese outbound drive started.

Now that the Sino-US trade war is escalating, the US market is inevitably viewed as difficult territory even though the trade dispute has limited direct bearing on the property market. As a result, there is currently not enough incentive for Chinese companies, especially state-owned or state-financed ones, to initiate a major investment in the US in the short term.

Meanwhile, even as Chinese activities slowed down, overall international investment into the US has increased 22% YoY in the first half of this year. Apart from Canadian and European buyers, Asian investors such as Singapore's GIC and Mapletree have also made significant acquisitions in the past 12 months. So it is not hard to see from the Chinese perspective that, policy and trade issues aside, the US still offers great opportunities in the long run. Administrative measures such as the recent tax law changes should also benefit commercial real estate.

Chinese investment in the US Chart 4



Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

AUSTRALIA

What are the impacts of changing policy and market environment on Chinese investment?

Chinese investors spent US$2.60 billion in Australia in 2017, a drop of over 50% YoY after three years of double-digit growth. As in the US, Chinese capital outflow controls had a detrimental effect on market transactions. Perhaps this is also a reflection of how crowded the local markets have become. The participation of investors from Korea, Singapore, Europe and the US, as well as domestic investors, has intensified competition for Chinese investors.

As investors have focused mainly on the office markets in Sydney and Melbourne, supply in these two major business centres has remained tight, resulting in a decrease in vacancy rates and rising rents. Yields and office leasing incentives are also contracting, thanks to the competitive environment.

Noteable Chinese investments include Dahua Group's purchase of an office development site in Melbourne for US$144 million and the purchase of Sydney offices by Shanghai Shenglong Investment Group and Maville Group. There were only two deals over the US$150 million mark, both residential sites bought by Country Garden. This is a far cry from the situation in previous years such as 2015, when a sovereign wealth fund and other SOE giants splashed out on trophy assets.

Strain in the bilateral relationship is also partly to blame for the slowdown in large Chinese acquisitions. At the governmental level, there is now a call for Chinese activities to be more closely monitored. However, this is part of the learning curve that both countries have to adapt to as they move their relationship forward.

Nevertheless, there is a positive outlook for Chinese developers who seek long-term growth in Australia. The country has experienced a significant population boom in recent years; its growth is among the fastest of OECD countries. The majority of this growth is from immigration, mainly from Asian countries, like China. Therefore, from the developers' point of view, the influx of a young student population from China will help ensure steady demand for housing in the long run. This will sustain solid interest in residential development sites, even though the capital outflow controls will take a toll on fund sources for both developers and individual buyers.

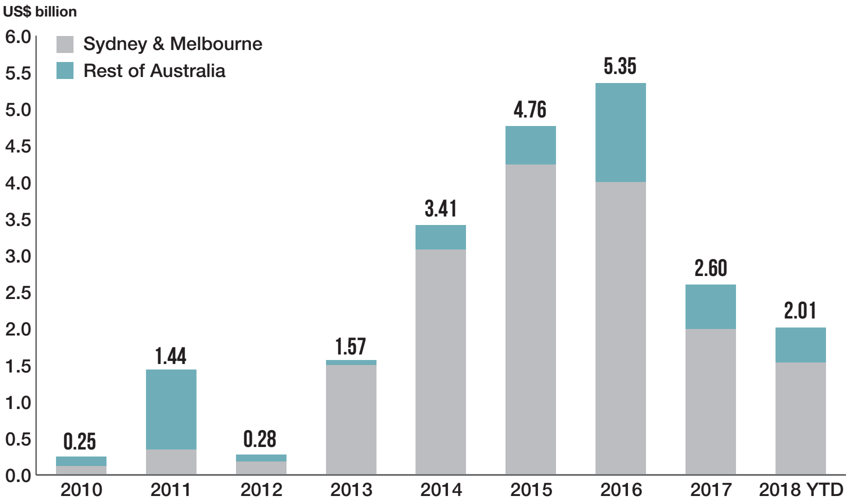
At first glance, Chinese investment so far in 2018 seems to be off to a good start, with volume approaching last year's level (Chart 5). This was boosted by Yuhu's purchase of Wanda's sites and buildings in the Gold Coast and Sydney. However, these transactions were in effect assets changing hands between Chinese investors. In the office markets of Sydney and Melbourne, the substantial drop in investment volume from Chinese Mainland has resulted in a visible shrinkage of their market share amongst foreign investors in the past two years. This has opened the door for Hong Kong and Singapore investors to take up a larger share of this market (Table 1).

Changes in market share of cross-border investment in Sydney and Melbourne offices Table 1

	Chinese Mainland	Hong Kong	Singapore
2016	32%	4%	14%
2017	24%	22%	28%
2018 YTD	22%	25%	11%

Source: RCA, Knight Frank Research

Chinese investment in Australia Chart 5



Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

UK

The Brexit vote and the pound devaluation helped boosting Chinese investment.

After a steady decline in volume from 2014 to 2016, the Brexit vote and the subsequent devaluation of the pound led to a major rebound in 2017, as Chinese investors seized the opportunity to acquire prime commercial property in the country.

As a result, Chinese investment in the UK in 2017 leapt fourfold YoY to US$9.69 billion. CIC's Logicor acquisition alone made up US$4.97 billion of this. The remainder, which is mostly in London, amounted to US$4.72 billion (Chart 6).

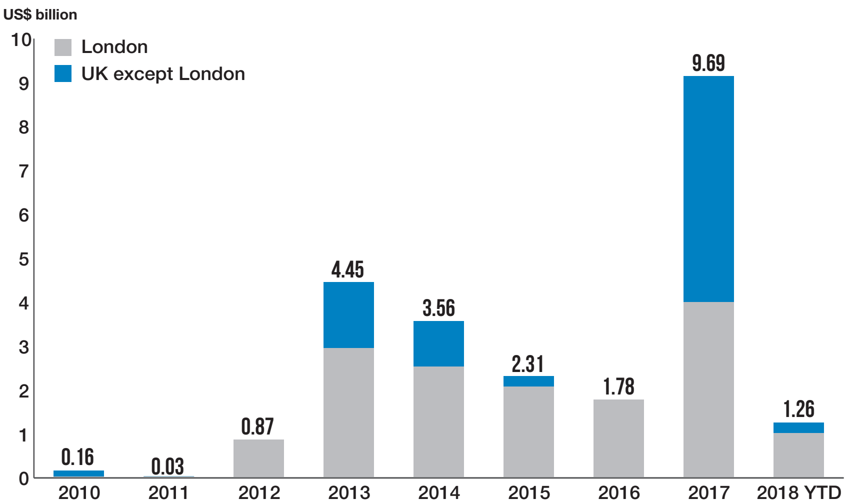
The majority of these investments were in Central London offices, such as CC Land's purchase of the 48-storey Leadenhall Building, "the Cheesegrater". Many of the office transactions were carried out by Chinese Mainland entities listed in Hong Kong. In fact, Mainland and Hong Kong buyers made up 39% of central London office deals by foreign buyers last year.

Mainland Chinese developers have also been snapping up development sites. For example, R&F Properties partnered C C Land to acquire Nine Elms Square, a prime London residential site in the middle of last year. This deal entails two Hong Kong-listed Mainland developers taking over a project from another Chinese developer.

Without any mega deals of last year's scale, Mainland Chinese investment in the UK this year seems to have retreated somewhat (Chart 6), but is still on par with 2016's level. One factor is that key segments of the UK market, such as Central London offices, have now attracted Hong Kong and other Asian investors to fill the space left by the Mainland Chinese investors, as illustrated in some recent cases. For example, Hong Kong's CK Assets splashed out US$1.326 billion to purchase the UBS headquarters in the City.

What we are witnessing is a shuffling of market positions amongst various players at the transactions level. At the macro level, despite uncertainty related to Brexit, investors are still drawn to the market stability and depth that the UK, and London in particular, offers.

Chinese investment in the UK Chart 6



Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

HONG KONG

How did Hong Kong become one of the top destinations for Mainland capital?

Capital controls in the Mainland have strengthened Hong Kong's position as both a gateway and a key market of the Mainland. Hong Kong attracted the second-largest Mainland investment in 2017, amounting to a record US$8.57 billion, up 61% YoY (see Chart 7). The city witnessed a rush to invest in development sites, with Mainland firms constituting around 56% of total site investment. For example, in 2017, a residential site in Ap Lei Chau was bought by a Mainland joint venture led by KWG and Logan Property for US$2.172 billion, by far the largest deal in the territory in 2017. That deal, together with several other large residential development site transactions, dominated the Hong Kong market, where only a handful of building transactions were concluded during the year.

To many investors, Hong Kong is viewed as a unique market, often constituting part of their Greater China investment strategy. Yet it offers international access and fundraising possibilities that other Chinese cities lack, which explains why despite the high prices and lack of centrally located office properties for investment, money has still been pouring into both buildings and sites, pushing up volume this year so far to 60% of last year's total (see Chart 7).

In Hong Kong we have also witnessed the "deckchair reshuffle" seen elsewhere. For example, some large development sites acquired by Mainland investors last year were sold to Hong Kong developers this year.

This year, only one development site was sold to Mainland developers, a very different picture from 2017 when eight out of the top 10 Mainland purchases were development sites. Most of this year's transactions involved offices, many of them smaller strata title purchases.

This could be a reflection of the reality that capital outflow controls on firms in the Mainland have been extended to their subsidiaries in Hong Kong. As a result, we are now seeing more partnerships being forged between Mainland firms based in Hong Kong and Hong Kong local investors, as in the examples of recent Link REIT shopping mall sale and the sale of a large stake in The Center.

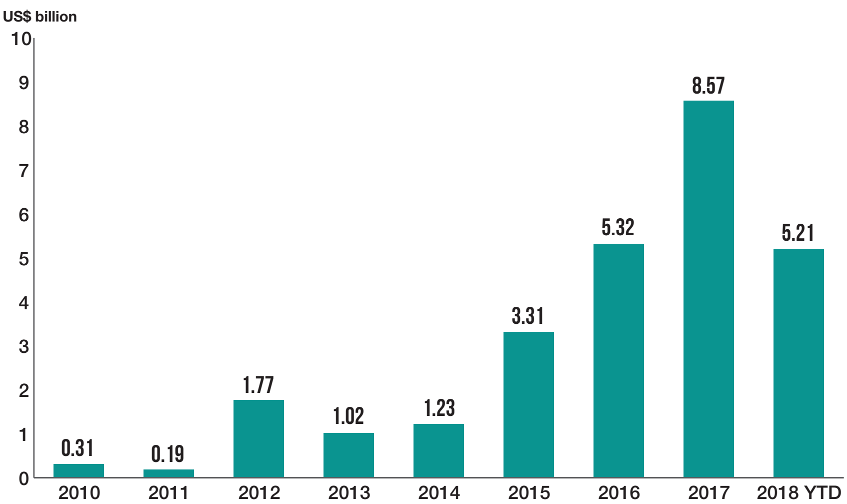
MAINLAND OR HONG KONG?

In recent years, Hong Kong has seen a significant amount of capital raised by subsidiaries of Chinese Mainland conglomerates, as well as by Mainland firms listed in the local stock market. This fund-raising drive was behind many large acquisitions of commercial buildings and residential development sites in gateway cities such as London, New York and Hong Kong.

Despite this geographic shift, these investors are still susceptible to Mainland's policy influences, in addition to strategic financial backing, unlike "traditional" Hong Kong investors. That is why we still classify them under the "Chinese Mainland" category.

Admittedly, the boundary between Mainland and Hong Kong funds has blurred in recent years, as Mainland-Hong Kong cooperation has deepened. The consortium formed by Goldman Sachs, Gaw Capital and Great Wall that successfully acquired Link REIT's retail portfolio in Hong Kong is a good example of this. This has inevitably presented a challenge to market observers attempting to distinguish the various sources of funds.

Mainland investment in Hong Kong Chart 7



Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

WHAT'S NEXT?

CONSEQUENCES OF CHINESE CAPITAL **OUTFLOW CONTROLS**

We have already seen signs of tighter and wider controls emerging. For example, in a directive issued at the beginning of the year, the National Development and Reform Commission (NDRC) expanded the coverage of a stringent approval process from firms on the Chinese Mainland to the Mainland firms operating out of Hong Kong, reaffirming its stance against firms investing outside of their core business and classifying real estate as a "sensitive" sector.

Although the market should not over-read the latest policy movements, a seasoned market watcher will recognise the top-down approach the Chinese corporate system operates under. The prevailing view is to contain and correct the over-expansion in the past. So unless this view changes because of a major event like a geopolitical shift, the investment in real estate by heavyweights, such as insurance giants and conglomerates, will remain subdued. The market will continue to see previously avid purchasers offloading their assets as their financial situation worsens. Outbound controls may also lead investors to look more for domestic opportunities.

Nevertheless, the market this year has seen some owner-occupation purchases and purchases with funds raised overseas. Some developers with offshore experience and mandates are still actively looking for opportunities.

In the long run, Chinese investors will develop more sophisticated global strategies so that they can easily re-focus to capture growth opportunities in a wider spectrum of the market. However, the top-down, policy-driven behaviour we have observed will take much longer to evolve.

HONG KONG CAPITAL AS A KEY **INVESTMENT DRIVER**

Since Chinese Mainland offshore activities have been curtailed, Hong Kong investors are actively stepping into the space they left open. For example, in February, Nan Fung invested in a mixed-use property in London for US$430 million. In May, a consortium led by the Hong Kong's Sino Land and Singapore's Far East group beat off competition from Chinese Mainland developers to clinch a development site in Singapore for US$915 million. Recently we witnessed one of the biggest office acquisitions in the City of London, when CK Assets bought the UBS headquarters for US$1.326 billion. Earlier in the year, CK Assets also entered the multi-housing market in Singapore. So far, of all the investments from Hong Kong, the city's "traditional" investors took the lion's share (see Chart 8).

No other market illustrates Chinese Mainland's retrenchment and Hong Kong's advancement better than the office market. In almost all gateway cities, the Mainland share in office investment has been shrinking since 2017 (Chart 9). In contrast, Hong Kong investors are quickly taking up a greater share in cities such as London, Sydney and Melbourne.

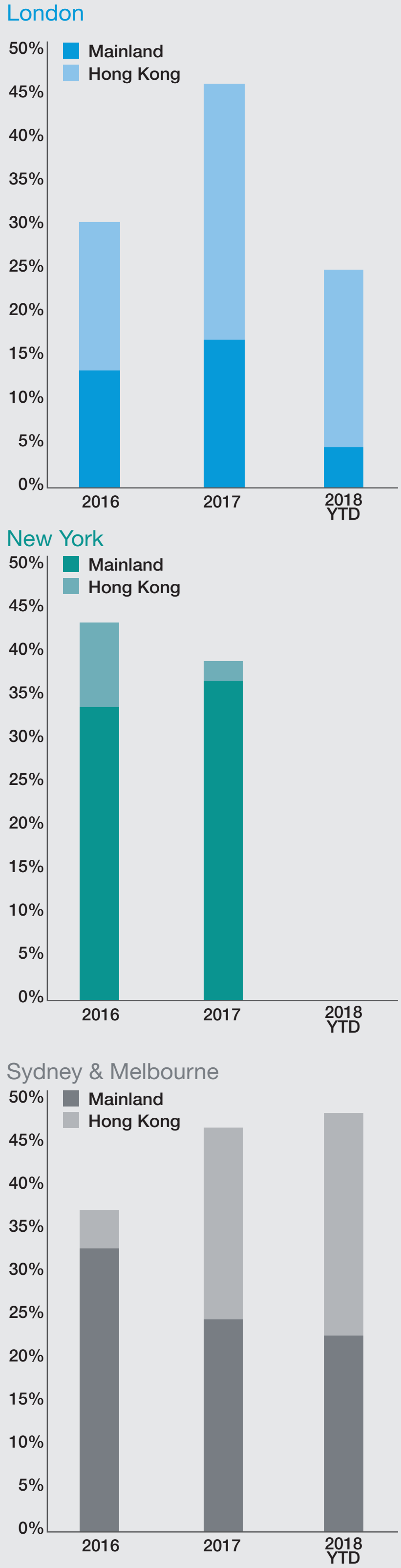
That said, from Hong Kong investors' point of view, the market is now overshadowed by the Sino-US trade war, the Brexit negotiation process and the interest rate increases led by the US Federal Reserve. Yield compression in gateways like London and Sydney could also present an issue for some investors looking for higher-yielding core deals.

Meanwhile, like their Hong Kong counterparts, other Asian investors are gearing up to fill the space left open by Mainland Chinese investors. For example, in March, the two biggest South Korea securities companies, Mirae Asset Daewoo and NH Investment and Securities, bought Cannon Bridge House in London for US$341 million. The Korean investors took time to evaluate their target projects carefully before buying. The diminished competition from Chinese investors has provided them with a window of opportunity to carve out a slice of the market. Singaporean investors have also been active in acquiring prime commercial properties, such as central London offices.

Hong Kong investors active globally Chart 8

Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

Chart 9
Share of Chinese Mainland and Hong Kong capital in cross-border office investment in gateway cities



Source: RCA, Knight Frank Research
Note: 2018 data as at 31 July

HONG KONG AND LONDON WILL CONTINUE **TO PERFORM**

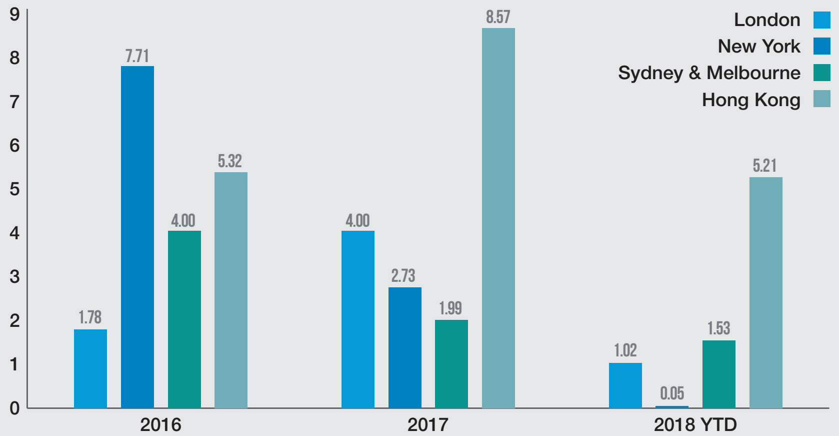
HONG KONG

Mainland investment in Hong Kong in the first seven months of this year reached 60% of last year's total (see Chart 10). This was boosted by Mainland funds' stake in the acquisition of a shopping mall portfolio and part of the purchase of The Center, a major office tower in Hong Kong's Central district. There have also been a slew of transactions for smaller development sites and offices this year.

Interestingly, in Hong Kong's residential land market, there has been higher participation but a lower success rate of Mainland developers in government land auctions (Chart 11). For example, of 17 government land auctions last year, Mainland developers bid on 12 and won five of them. This year however, they took part in eight of the 10 auctions, but won only one. Therefore, Mainland developers remain committed to Hong Kong's land market, despite their weakened financial power, as this is their core business permitted under the current policies. One of the pull factors is the tremendous price growth in Hong Kong's housing market, prompted by constant undersupply and strong buyers' appetite.

At the policy and infrastructure level, the integration of Hong Kong into the Greater Bay Area in the Pearl River Delta is well underway. In the next 18 months, the completion of major transportation projects and the entrance of Mainland firms, from tech giants and co-working space providers to retailers, will help boost the city's commercial investment and leasing markets.

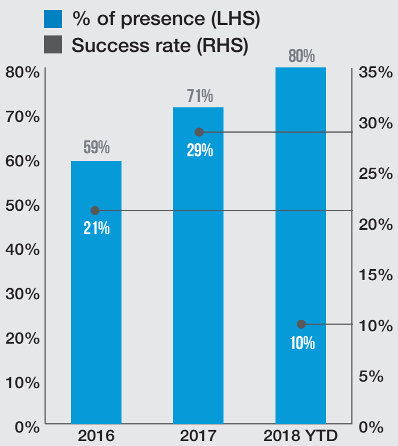
Chinese investment in gateway cities Chart 10



Source: RCA, Knight Frank Research

Chart 11

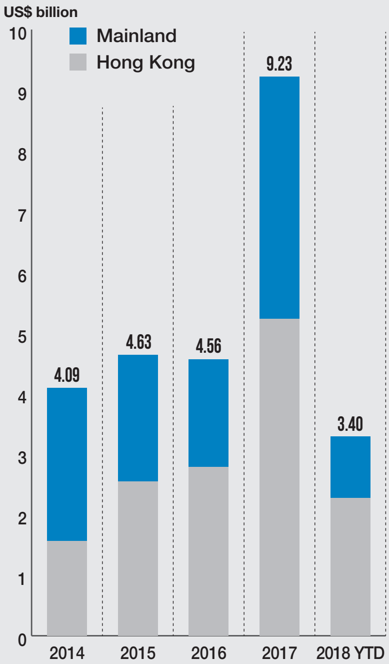
Mainland bidders in government land auctions in Hong Kong



Source: Lands Department, HKSAR and Knight Frank Research

Chart 12

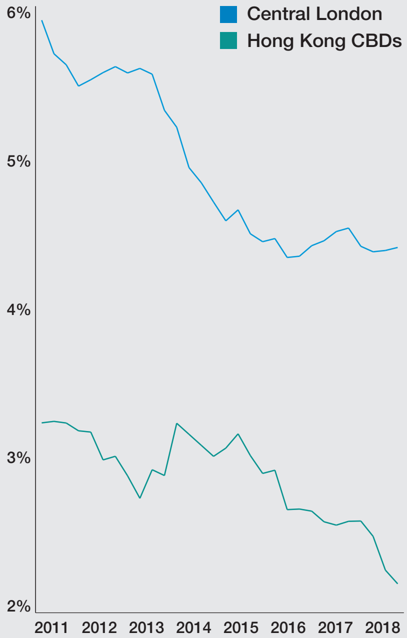
Hong Kong and Mainland investment in London



Source: RCA, Knight Frank Research
Note: Provisional figures as at 4 October 2018.

Chart 14

Prime office cap rates: London vs. Hong Kong



Source: RCA, Knight Frank Research
Note: As at Q2 2018

LONDON

Despite tapering deal flows from Mainland players, interest from the Greater China region is still keen, as can be seen from the year-to-date results. Without the likes of the CIC deal last year, it is still proportionally on par with previous years (see Chart 12).

In fact, investment from Hong Kong and Mainland Chinese investors in central London offices totalled £2.488 billion (US$3.23 billion) in the first half of the year. This accounted for 43% of overall foreign investment in central London offices, as well as 36% of total investment (both domestic and foreign) in central London offices for the period.

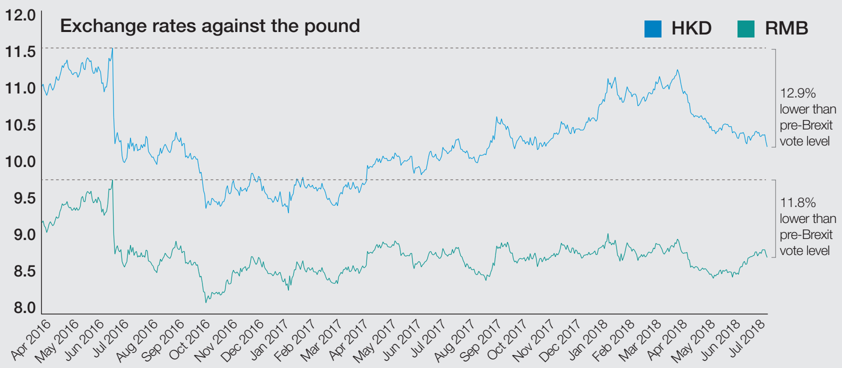
One example of these large transactions was the acquisition of an office project at 40 Leadenhall Street for US$439 million by a consortium of Hong Kong-listed CSI Properties and CC Land, a Hong Kong-listed Mainland firm. Another more recent case was CK Asset's US$1.326 billion purchase of the UBS headquarters in the City.

On balance, London offers the same strong property market fundamentals that other gateway cities offer, such as market stability and depth, as well as the language advantage. For Greater China investors, exchange rate arbitrage over the pre-Brexit period still exists even though the RMB has weakened somewhat recently (see Chart 13).

But for investors who seek long-term yield growth, the British capital does offer a comparative advantage (see Chart 14). Asset holders in Hong Kong, where capital value has reached new heights but yields are historically low, in many cases below 2%, now have the option of investing in London, where long-term yield growth is stronger. Recently, Hong Kong's Kwok family and Irish developer Barrymore paid over £50 million for two residential sites in Canary Wharf. Gaw Capital also invested over £36 million for two office buildings there.

Exchange rate advantages

Chart 13



Source: RCA, Knight Frank Research **Note:** Data as at 18 July 2018

CONCLUSION

As a result of China's capital outflow restrictions, the current cycle, which saw the disruptive buying spree by Mainland Chinese investors in the past five years, is drawing to a close. As some investors sought to exit the field, the market has returned to a sense of normality from the perspective of many long-term players, typically sovereign wealth funds with long-term national mandates, investors, and developers with offshore fund-raising capability, whose core business is real estate.

While capital controls persist, Chinese investors will remain cautious. This could have an impact on short-term transaction volume. But in the long run, they cannot ignore the many opportunities presented in the gateway real estate markets.

As the Sino-US trade dispute rages on, its ramifications will spread beyond trade to the general investment environment in gateway cities. So in the short run, New York's loss is London's and Hong Kong's gain.

Meanwhile, investors from outside Chinese Mainland, in particular from Hong Kong, are picking up deal flows, as we saw in their recent acquisitions in London, as well as in Sydney and Melbourne. Other Asian investors, such as Singaporeans, are also stepping up their activity. This has resulted in healthier competition and has helped reduce the risk of policy-induced market disruption. This actually bodes well for mature Chinese investors who seek long-term return for their investment.

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