RESEARCH

CHINESE OUTBOUND
REAL ESTATE INVESTMENT:

NEW WAVES, NEW DESTINATIONS

KEY FINDINGS

- Despite domestic market uncertainties, Chinese real estate investment overseas has continued to grow strongly in 2015, riding on the strong appetite for overseas real estate from both major and smaller investors. This trend is also supported by the growing need for diversification from some of the more hotly contested property markets in China. While more developers among the country's top 20 have invested overseas in 2015 (increasing from 10 to 14), there has been only a limited increase in the number of top 20 insurers investing abroad (four in 2014 and six in 2015), even though they managed to clinch several mega-deals in 2015.
- Global gateway cities continue to attract the bulk of Chinese overseas real estate investment. The insurance giants, in particular, continue to splash out on trophy properties. In 2015 investment in the UK is on par with that of 2014, but strong growth in Australia continues unabated. There has also been significantly increased investment in US commercial real estate, making it the fastest growing mature market. Manhattan has absorbed the lion's share of this capital, with a fivefold increase year on year (YoY), dwarfing other primary cities. However, there has been a flurry of activity by small- to mid-cap investors in projects below US$50 million, especially in primary and secondary American cities.
- De-coupled from the uncertainties of China's domestic economy, Chinese outbound capital is set to grow. This is not just the result of the government's various capital liberalisation initiatives, such as the Qualified Domestic Institutional Investor (QDII) schemes, but also, perhaps more importantly, an outcome of China's long-term national strategy both to project its trade and investment prowess globally and to ensure financial stability.
- When compared with gateway cities, the yield spread in some leading regional centres has continued to improve over 2014, indicating the relative attractiveness of these cities for investors, especially small- to mid-cap ones. However, large investors will continue to favour gateway cities because of the availability of stock, capital value and rental growth. Gateway cities with a strong quality pipeline, relative stability, active occupier activity and sustained income growth will continue to benefit from the growing outflow of Chinese capital.

INTRODUCTION

In 2015, we have seen drastic RMB devaluation and stock market turmoil in China, as well as considerable debate on the health of China's economy. Inevitably, many in the field are keen to understand whether all this will have a fundamental impact on China's outbound investment.

Knight Frank's Chinese Outward Real Estate Investment: After the Initial Waves What's Next report, published in December 2014, identified a succession of Chinese investment waves hitting global real estate markets. Apart from the heavyweight financial institutions, developers and insurers who formed the first three waves of capital outflow, we identified a new "**Fourth Wave**" - a mixed group of investors consisting of lesser known small- to mid-cap companies and developers, private equity funds and individuals, who were increasingly active in those markets. With them joining the fray in the last two years, we have already seen all these waves beating on the shores of mature markets.

By shedding light on recent investment deals and activities of Chinese investors, this paper intends to answer **two key questions**. First, given the uncertainties in the Chinese market, going into 2016, will there be a tapering of investment from China? Second, what will bring investors to the market?

HAVE THE CHANGES IN THE CHINESE MARKET LED TO A RETREAT IN OUTBOUND CAPITAL?

Chinese property market showing signs of recovery

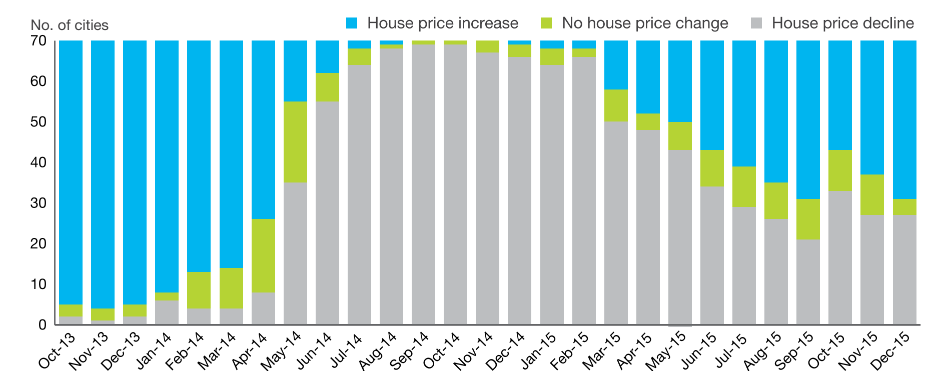
Throughout 2014, the price decline in the domestic housing market was one of the key drivers of the surge in Chinese outbound real estate investment. In 2015, however, there have been signs of a steady housing market recovery. The latest statistics indicate that among 70 cities surveyed, 39 recorded a house price increase. This is in sharp contrast with the picture at the end of 2014, when prices in cities across the country were declining (see Figure 1). Prices in the first-tier cities showed the strongest growth. For example, Beijing's house prices have grown 10.5% year on year in 2015, and Shenzhen's have grown 47%. Transaction volume also rebounded. This turnaround was largely thanks to monetary and financial easing, as well as the lifting of purchase restrictions by the government. With the Chinese economy experiencing the worst slow-down since 2008, the government is eager not to let a stagnant real estate market drag down consumption and the GDP.

Inventory, competition and uncertainty

Nationwide housing inventory levels, however, remain high and are increasing as over-construction in the past continues to add to the existing stock. The 406.8 million square metres in 2014 rose to 452.5 million square metres in 2015 according to official statistics. This has put pressure on the profit margins of many developers, in particular, many small- to mid-cap developers.

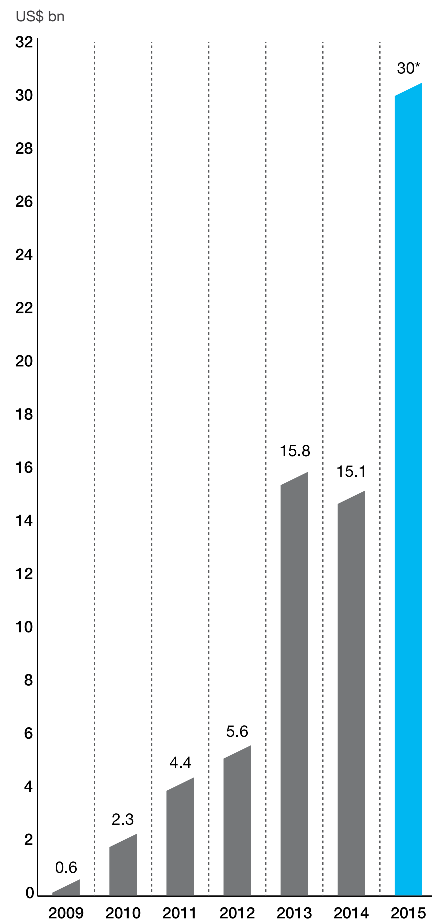
These smaller developers find it difficult to compete with the bigger players, such as Vanke and Wanda, in land auctions, especially in the first-tier cities, and in securing additional funding for development. They also find it hard to clear their accumulated inventory, the majority of which is in lower-tier cities, where local

FIGURE 1
More Chinese cities saw home prices increase



Source: National Bureau of Statistics, Knight Frank Research

FIGURE 2
Chinese outbound global real estate investment volume



Source: RCA, Knight Frank Research
***Note:** Preliminary data as at December 2015

purchasing power is not as strong as that in the first-tier cities. With cash flow a major problem, turning to overseas markets seems to be a viable option for these developers.

The recent RMB devaluation and stock market turbulence has also contributed to market uncertainty, which has led to investor wariness of further policy intervention. This underscores the need for diversification for Chinese investors, particularly overseas.

Outbound capital continues to flow

Against this background, there were some predictions of a retrenchment of Chinese outbound investment. Our latest statistics, however, point to the opposite. In the first 10 months of 2015, total volume of Chinese outbound real estate investment has already exceeded that of the entire previous year. By the end of 2015, the total Chinese outbound capital has reached nearly US$30 billion (See Figure 2), doubling that of 2014.

Investors, especially heavyweights with ample financial power, seem to be able to decouple from any negative impact that domestic policies and the economy might have. The explanation lies in the relatively small proportion of total capital that has been deployed overseas by these big players. Some estimates put it under 10% for developers and less than 5% for insurance companies. As a result, in 2015 we continued to see many mega-deals taking place around the world, with the majority in gateway cities (See Table 1).

A comparison with the same list of 2014, which featured a similar number of London deals but only two New York deals, revealed that in 2015 investors were focusing more on New York, while London stagnates. Investor interest in Australia, particularly Sydney, has not diminished as many had feared, even after the latest RMB devaluation and with demand for natural resources weakening. Australian prices, coupled with strong Chinese buying power and continued weakness in the Australian dollar, has continued to attract capital inflow.

It is worth noting that there were several mega-deals made by Chinese investors in Hong Kong in 2015 that would easily make the top 10 list in Table 1, edging out several deals at the bottom. As we discuss later in the report, Hong Kong has recently seen renewed interest from Chinese investors.

TABLE 1
2015 Top 10 overseas deals completed by Chinese insurers, institutions and developers (excluding Hong Kong)

Date	Purchaser	Property Name	Location	Property Type	Consideration (US$ million)
Feb	Anbang Insurance	Waldorf Astoria	New York	Hotel	1,950
Aug	Anbang Insurance	Heron Tower	London	Office	1,172
Jan	China Investment Corp (JV LaSalle Investment)	Meguro Gajoen	Tokyo	Office	1,170
Jul	Taiping Life Insurance	111 Murray Street	New York	Apartment	820
Jan	Greenland Group	Tebrau Bay Waterfront City	Malaysia	Dev Site	683
May	Bank of China	7 Bryant Park	New York	Office	600
Jan	Ping An Insurance	Tower Place	London	Office	506
Oct	China Life Insurance (JV Qatar Investment Authority)	99 Bishopsgate	London	Office	420
May	Anbang Insurance	Merrill Lynch Financial Center	New York	Office	414
Jul	Fosun International Ltd	Palazzo Broggi	Milan	Office	384

Source: RCA

WHO, WHAT & WHERE?

More developers enter the market, while insurers snap up trophy assets

In 2015 there was significantly more Chinese developers in the country's top-20 list investing overseas (increasing from 10 to 14), reflecting the need this group sees to diversify their investments amidst fierce domestic competition (See Table 2). In contrast, there has been only a limited increase in the number of top-20 insurers investing abroad (four in 2014 and six in 2015). Caution is key, as there has been hardly any movement in the bottom half of the list, most of whom are either financially less ambitious about expanding beyond their national borders or have adopted a wait-and-see attitude.

In dollar terms, however, 2015 has proved to be the most productive year for Chinese insurers, with more than US$4 billion spent buying overseas property, compared to about US$2 billion a year before. One of the most active investors, Anbang Insurance, completed the US$1.95 billion Waldorf Astoria hotel deal in February, the largest Chinese overseas investment deal in 2015. It then spent another US$414 million in May buying the Merrill Lynch Financial Center in Manhattan. In London, it just splashed out US$1.172 billion on the Heron Tower. Also, Ping An Insurance purchased the Tower Place in Central London.

More building deals, new directions and asset diversification

Amidst this onslaught, Chinese investors are also learning and adapting, leading to subtle changes of direction in their approaches. Some insurance companies, for example, are exploring development projects. Ping An Insurance and China Life JV formed a joint venture with US developer Tishman Speyer to invest in a mixed-use development project in Boston, and state-owned

TABLE 2
Outbound investment status of major Chinese developers and insurance companies

Developers

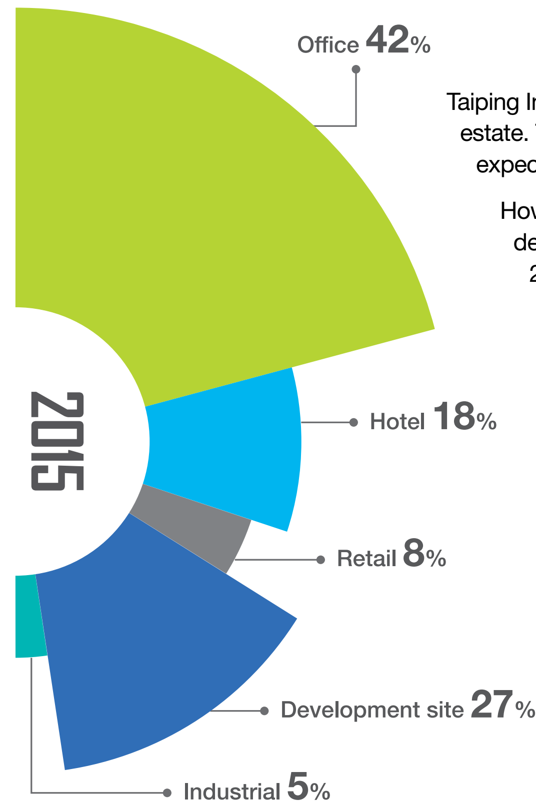
Rank	Developer	2014 Property sales (US$ billion)	Outbound investment status (2014)	Outbound investment status (2015)
1	Greenland Group	37.7	◆ green	◆ green
2	Vanke Group	33.7	◆ green	◆ green
3	Wanda Group	25.1	◆ green	◆ green
4	Poly Real Estate	21.4	◆ orange	◆ green
5	Evergrande Group	20.6	◆ orange	◆ green
6	Country Garden	20.2	◆ green	◆ green
7	China Overseas Land & Investment	17.6	◆ green	◆ green
8	Greentown China	12.4	◆ orange	◆ orange
9	Sunac China	11.2	◆ orange	◆ orange
10	Shimao Property	11.0	◆ green	◆ green
11	China Resources Land	11.0	◆ red	◆ red
12	R&F Properties	8.5	◆ green	◆ green
13	CFLD	8.0	◆ orange	◆ orange
14	China Merchants Property	8.0	◆ orange	◆ orange
15	Longfor Properties	7.7	◆ red	◆ red
16	Gemdale Corporation	7.7	◆ orange	◆ green
17	Agile Properties	6.9	◆ green	◆ green
18	Sino Ocean Land	6.3	◆ orange	◆ green
19	Beijing Capital Development	3.9	◆ green	◆ green
20	Future Holdings	3.8	◆ green	◆ green

Insurance companies

Rank	Insurance company	2014 Premium income (US$ billion)	Outbound investment status (2014)	Outbound investment status (2015)
1	China Life Insurance	58.2	◆ green	◆ green
2	PICC	51.9	◆ orange	◆ orange
3	Ping An Insurance	49.6	◆ green	◆ green
4	China Pacific Insurance	30.0	◆ orange	◆ orange
5	New China Life Insurance	17.2	◆ orange	◆ orange
6	China Taiping	12.3	◆ orange	◆ green
7	Taikang Life	10.6	◆ orange	◆ green
8	Anbang Insurance	9.1	◆ green	◆ green
9	Sunshine Insurance	6.1	◆ green	◆ green
10	Sino Life	5.7	◆ orange	◆ orange
11	China Post Life	3.4	◆ orange	◆ orange
12	CCB Life	2.5	◆ red	◆ red
13	Union Life	1.8	◆ orange	◆ orange
14	ABC Life	1.6	◆ red	◆ red
15	Aeon Life	1.3	◆ red	◆ red
16	Minsheng Life	1.2	◆ red	◆ red
17	Happy Life Insurance	1.2	◆ red	◆ red
18	Lian Life	0.8	◆ red	◆ red
19	Zhongrong Life	0.7	◆ red	◆ red
20	Guohua Life	0.6	◆ red	◆ red

◆ (green) Already made investment offshore ◆ (orange) Expressed interest to invest offshore ◆ (red) No public plan to invest offshore

Source: Knight Frank Research, public sources



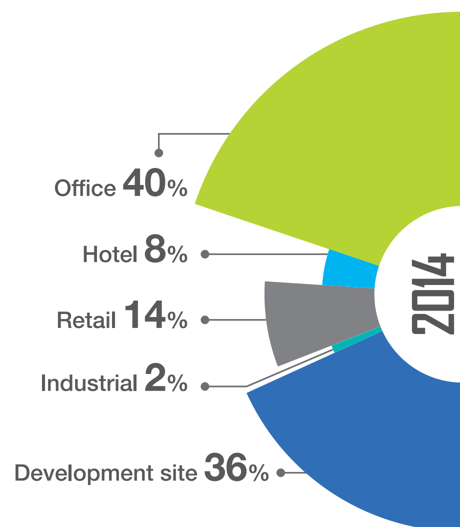


FIGURE 3
GLOBAL CHINESE OUTBOUND INVESTMENT BY SECTOR

Source: RCA, Knight Frank Research

Taiping Insurance set up an offshore subsidiary investment fund to invest in overseas real estate. Their first deal, a luxury condo project on 111 Murray Street in New York, was expected to cost US$820 million.

However in 2015, there was a general preference for building deals, even by the developers. Development deals took up 36% of the total outbound investment in 2014, but in 2015, this percentage fell to about 27% (see Figure 3). As residential development typically makes up more than 40% of total development deals, this shrinkage reflects the fact that many developers, while still looking for land for residential units, believe the preparation work and complexity of local laws and planning rules make acquiring existing prime buildings more attractive.

Chinese developer Beijing Capital Development Holdings, for example, invested US$98.8 million in Friary Court, an office building in London in December 2015. Dalian Wanda bought two office buildings in Sydney earlier in 2015, with the intention of transforming the site into a mixed-use project, costing US$1 billion overall. Greenland Group bought the Mercure Hotel in Sydney and will convert it to a residential apartment building.

Among building transactions, office investment remains the favourite for Chinese investors. It is largely unchanged proportionally compared to 2014. Meanwhile hotel deals also ballooned, propelled by a number of mega-deals in New York (the Waldorf Astoria) and Sydney (the Hilton) by insurance companies. Even if we exclude these mega-deals, investment in the hotel sector was still double that of 2014.

Chinese insurers in a buying frenzy of a different kind

During the course of 2015, some major Chinese insurance companies invested heavily in the country's large developers. In December, for example, Anbang Insurance purchased 20.5% of Sino Ocean Land for US$1 billion. Anbang eventually increased its ownership in Sino Ocean Land to 29.98%. At around the same time, Foresea Life Insurance increased its ownership of leading developer Vanke to 24.26% (see Figure 4). Many of these developers already had substantial overseas property investments.

There are three major reasons behind this flurry. First, insurance firms often lack experience in property development. For this reason they prefer to tap into the expertise of major developers who have already have significant development projects in countries like the US, UK and Australia.

Second, facing reduced availability of trophy assets and yield compression in the gateway cities of these countries, many Chinese insurers were finding it difficult to deploy capital in 2015. This partly explains why we did not see a substantial increase in the number of players in the market in 2015.

Third, given their often complicated approval processes, insurance companies are not as nimble as their developer counterparts, who can move quickly to adapt to changing market conditions. Also, many developers have already made substantial investments overseas, learning valuable lessons along the way. This makes them ideal targets for Chinese insurers.

Chinese firms in other sectors have also taken a stake in the country's developers. For example, China Communications Construction, a construction company, bought a 24% stake in Greentown China Holdings for US$771 million (HK$6.013 billion).

Sizable capital flows

The traditional gateway cities are still the preferred destinations for Chinese investment (see Figure 5). New York has become the top investment destination in 2015 having spent US$5.78 billion in the city, with a fivefold increase YoY. 2014's top destination, Sydney and Melbourne, is in second place in 2015, attracting a total of US$3.8 billion of Chinese investment. Interest in London has remained strong, but it fell to third place as the momentum of previous years absorbed many of the most prized properties available.

In 2015, Australia continued to see rapid growth in real estate investment from China, with Sydney and Melbourne the focus. Chinese developers have been particularly aggressive, with seven of the top ten players active in Australia, along with a drove of smaller developers.

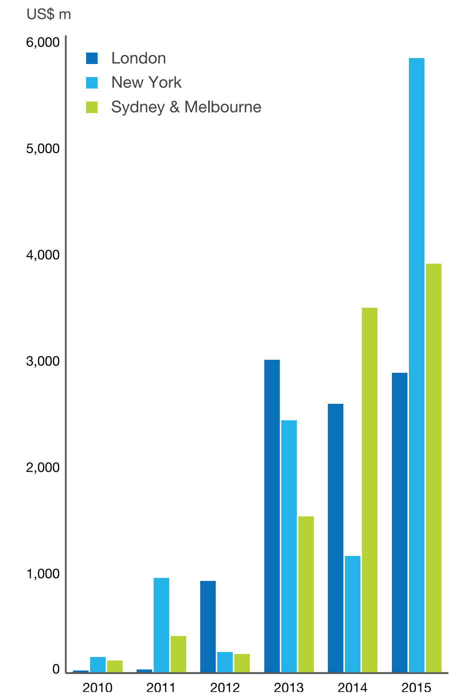
The China-Australia Free Trade

FIGURE 4
Insurance companies' investment in shares of developers with overseas reach

	China Life Insurance*	Ping An Insurance*	New China Life Insurance	Anbang Insurance*	Sino Life Insurance	Foresea Life Insurance	Hexie Health Insurance
China Vanke*				7.01%		24.26%	
Greenland Group*		20.14%					
Country Garden*		9.91%					
Sino Ocean Land*	29.99%			29.98%			
China Jinmao			9.5%				
Gemdale Corporation*				14.6%	27.63%		
Financial Street Holdings				13.35%			15.88%
Landsea Group*		9.9%					

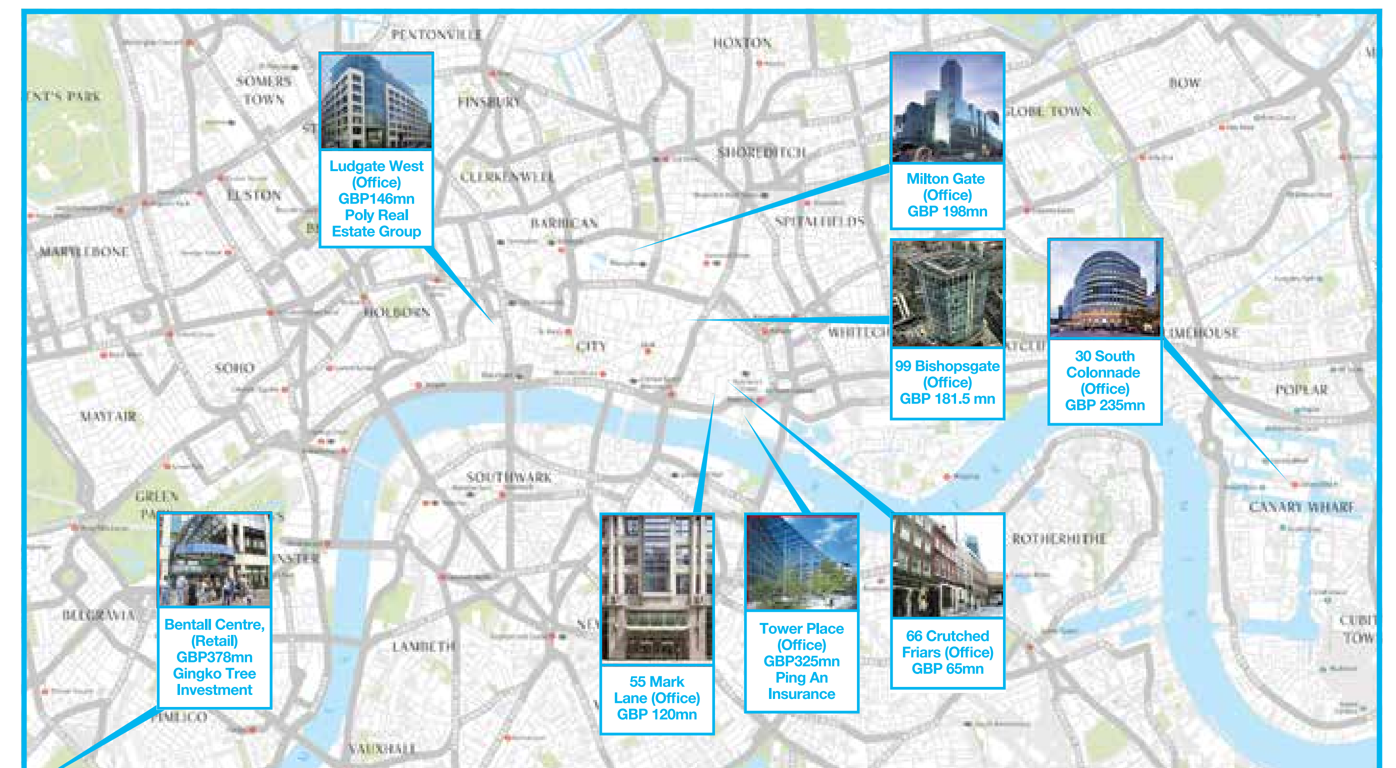
Source: Knight Frank Research, Public sources **Note:** Foresea Life insurance together with Shenzhen Jushenghua *The firm has also invested in overseas property markets

FIGURE 5
Chinese real estate investment in gateway cities



Source: RCA, Knight Frank Research
Note: Preliminary data as at December 2015

MAP 1
Chinese purchases in London – key transactions in 2015



Source: Knight Frank Capital Markets

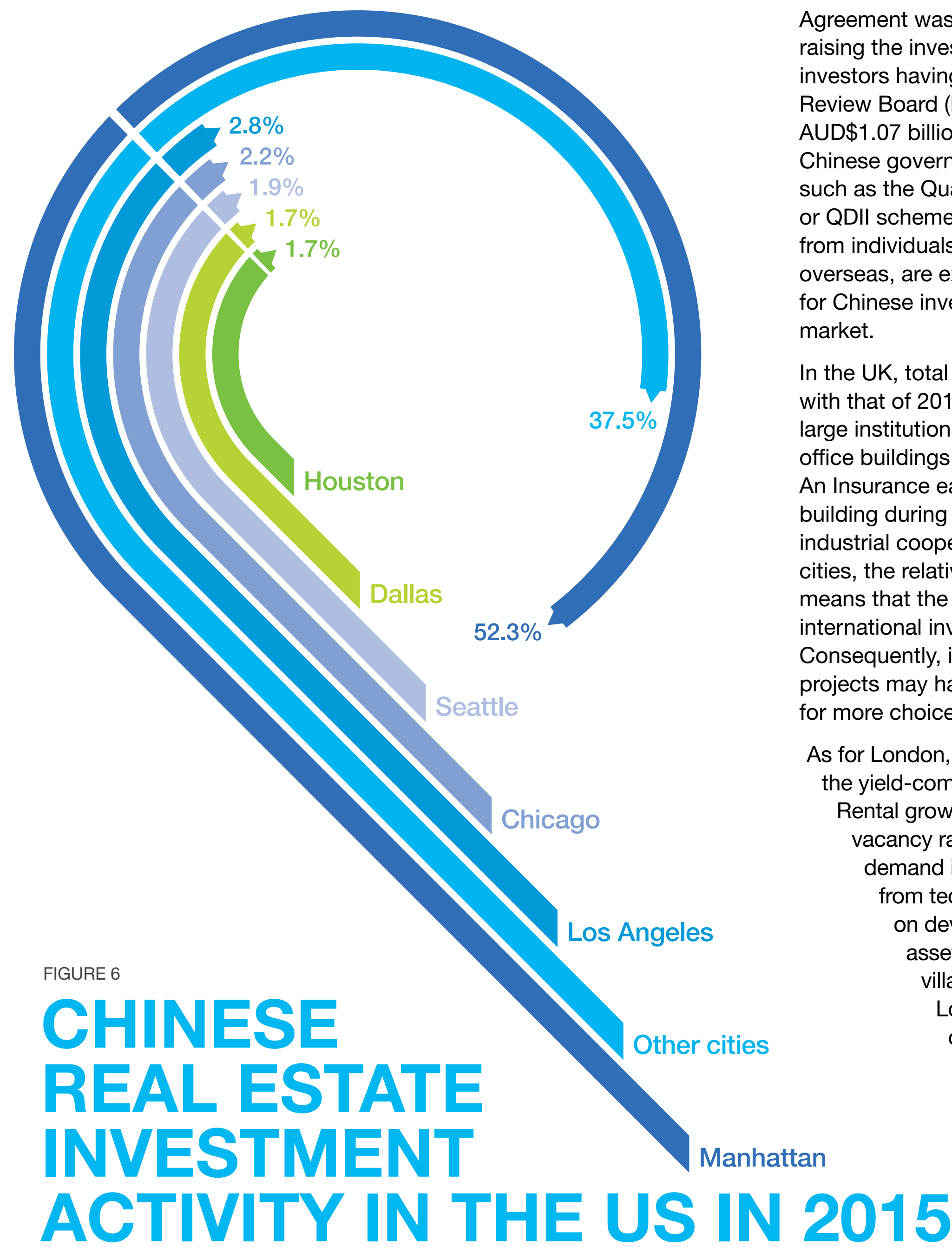


FIGURE 6

CHINESE REAL ESTATE INVESTMENT ACTIVITY IN THE US IN 2015

Agreement was officially signed in June 2015, raising the investment threshold for Chinese investors having to go to the Foreign Investment Review Board (FIRB) from AUD$248 million to AUD$1.07 billion. Warm bilateral relations and Chinese governmental policy encouragement, such as the Qualified Domestic Individual Investor or QDII schemes, which allow more funds from individuals and institutions to be invested overseas, are expected to provide greater access for Chinese investment in the Australian property market.

In the UK, total investment volume is on par with that of 2014, with most transactions by large institutional investors, focusing on prime office buildings in London. China Life and Ping An Insurance each acquired a London office building during the year. While Sino-British industrial cooperation may favour some regional cities, the relatively small size of these cities means that the volume of quality stock that an international investor would want to buy is limited. Consequently, investors for small to medium-sized projects may have to look to other mature markets for more choice (see Map 1).

As for London, our view is that we are at the end of the yield-compression stage of the office cycle. Rental growth prospects are strong with the vacancy rate at a 14-year low. There is robust demand in the leasing market, especially from tech firms. Buyer interest is focused on development sites and short income assets, particularly in London's tech villages. Although relatively expensive, London delivers consistently good, demand-driven rental growth, making it attractive for investors in the coming 12 months.

In the US, the majority of the Chinese capital flows were into hotel and office properties in the New York borough of Manhattan,

TABLE 3

Major deals completed by Chinese institutions in Hong Kong in 2015

Date	Purchaser	Property Name	Property Type	Consideration (US$ million)
Nov	Evergrand Group	MassMutual Tower	Office	1,612.8
Sep	Shimao Property	New Kowloon Inland Lot No. 6542	Dev Site (Residential)	905.8
Nov	China Life Insurance	One HarbourGate (West Wing)	Office	755.1
Sep	China Poly Group	Tuen Mun Town Lot No. 542 Castle Peak Road	Dev Site (Residential)	223.2
May	CITIC Pacific	Sha Tin Town Lot No. 605	Dev Site (Residential)	189.5
Sep	Centralcon Group	11 Au Pui Wan Street	Dev Site (Mixed)	144.5
Dec	Chinalco Overseas Holdings Limited	Far East Finance Centre	Office	48.0

Source: RCA

accounting for 52.3% of the total investment in the country (Figure 6). In terms of sector allocation of building deals, the hotel sector, boosted by the US$1.95 billion Waldorf Astoria hotel deal, made up 36% of the total activity in the country, followed by office (22%) and industrial (17%). The drop in proportion of office deals obscures the fact that there is actually a 60% increase of transaction volume in the sector in 2015 (from US$1 billion in 2014 to US$1.6 billion in 2015). The 12-fold increase in industrial transaction was propelled by China Life Insurance's US$1 billion injection into Global Logistics Properties' portfolio.

It is interesting to see that in large transactions above US$250 million, New York still attracts the lion's share of capital inflow. In 2015 Chinese investors were the second-largest buyers of Manhattan commercial properties, accounting for more than 20% of total cross-border investment in the city borough so far.

This capital influx can be attributed to heightened activity by Chinese groups, in contrast to the previous focus on London. Limited supply in Manhattan also drives faster capital value appreciation. High-value Manhattan properties are attracting big Chinese buyers who have the interest and ability to deploy large sums in a small number of transactions.

There have still been very significant investments in 2015 in a range of primary and secondary markets, such as Los Angeles, San Francisco, Chicago and Boston. In Boston for example, China Life and Ping An co-invested in Tishman Speyer's Pier4 Waterfront Project. In fact, there have been over 100 investment acquisitions below US$50 million by Chinese investors across the US (see feature: "The 'Fourth Wave' investors continue to seek opportunities"). The choices available in these primary and secondary cities may prove to be ideal for many small- to mid-cap investors.

On the policy front, the Obama administration's latest move to remove legislative restrictions on foreign pension funds investing in US properties and REITs will certainly raise interest among Chinese pension funds, though they do not yet have government permission to invest abroad. The potential is vast, given the estimated US$540 billion of investable capital they currently hold. The legislative change does to some extent help to enhance the US market's attractiveness. Therefore, we argue that any encouragement on the political front will strengthen the US position as the prime investment market for the Chinese.

Meanwhile closer to home, Hong Kong has seen a new flurry of Chinese investment both in development sites and in office buildings (see Table 3). Despite low yields and high entry cost the Chinese institutions are keen to establish their presence in the city be it residential or offices for owner occupation as regional headquarters. Being an international financial centre with independent judiciary and financial system, Hong Kong is increasingly used as the first stop for Chinese outbound capital. With the development of financial cooperation between China mainland and Hong Kong, such as the Shanghai-Hong Kong Stock Connect programme and of Hong Kong as a Renminbi off-shore clearing centre, we expect to see heightened interest from north of the border in 2016.

The outbound frenzy has even indirectly caused renewed interest in key domestic gateways such as Beijing and Shanghai. On one hand, some major asset holders riding on the outbound wave are offloading some of their assets in order to re-deploy capital elsewhere, on the other hand, some local and foreign investors waiting in the wings are now ready to take advantage of the market low and a sudden increase in the available stock. Investment powerhouses such as the Blackstone Group are actively scouting buying opportunities amidst slow growth and market uncertainty. This has created an active market amidst the country's economic slowdown. (See feature "Shanghai Shines through Mist" on the next page)

The **"FOURTH WAVE"** investors continue to seek opportunities

In 2015 we continued to see the so-called "Fourth Wave" of Chinese investors (a new, mixed group following the first three waves of Chinese institutional investors, developers and insurers) venture offshore. Private UHNWI players, developers and industrialists in this wave have been making quite a stir in a quest for overseas properties. Unlike earlier investments made by Chinese institutions that focused on trophy assets, these new investors dominate small- to mid-cap investment in both primary and secondary locations in mature markets, especially in the US. For example:

Kuafu Properties, a New-York based developer backed by a Chinese private fund, acquired four US properties within one year of entering the market, spending over US$500 million.

Landsea Group, a small specialised developer, teamed up with Miami-based homebuilder Lennar to develop a condominium tower in New York.

Xinyuan Real Estate, a developer focusing on China's Tier II cities, acquired two residential projects in Brooklyn, New York.

Shanghai Yudu Group, a company engaged in construction and property development, acquired the Marriott LAX Airport Hotel in Los Angeles for US$156 million.

Grand China Fund, which specialises in investing in residential developments in major Chinese cities, teamed up with local partners Gaia RE Holdings and Menora Mivtachim to invest in residential projects in several US cities.

Wanxiang Group, an auto parts manufacturer, has invested in more than 60 US properties since 2010, including office, retail, industrial, hotel and development sites. The company recently formed a partnership with Geolo Capital, a private equity firm controlled by Hyatt heir John Pritzker, to invest up to US$1 billion in hotels.

Macrolink Group, an international trader engaged mining, chemicals, and financial investment, formed a joint venture with the Black Stone Resort in South Korea to build hotel and retail complexes on Cheju Island. The group has also acquired several plots in the Iskandar Development Region in Malaysia, where it plans to develop tourism-related projects.

Nanshan Group, a private-owned Chinese conglomerate, acquired the Pullman hotel at Sydney Airport for US$61 million.

Yuhu Group, an investment company focusing in real estate, acquired an office building in North Sydney with a consideration of US$46 million.

Shanghai Shines through Mist

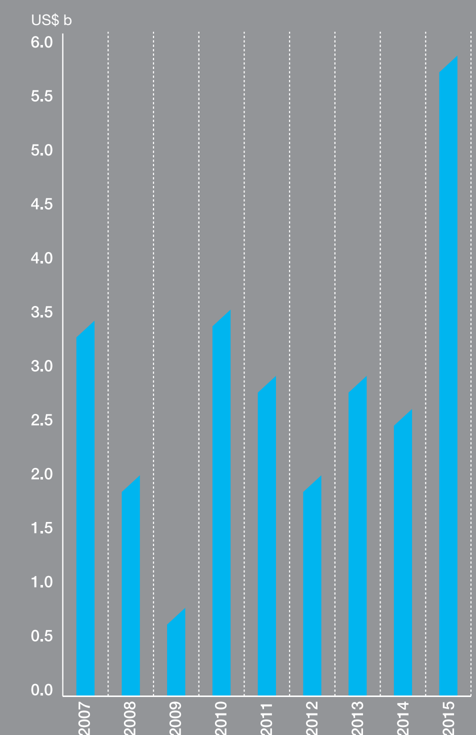
Given the increasingly difficult market environment, FDI in property in China has been declining in the past three years. To many China-focused funds, however, the importance of this market cannot be ignored, even with rising uncertainty and dropping yields. This is especially true in the first-tier cities, where there is less risk, higher liquidity and more stability than in their second-tier counterparts. In the past, however, the high prices and stiff local competition in cities like Shanghai drove away many international investors.

In 2015, bucking the trend, investment in Shanghai rebounded strongly, recovering to almost double the level of 2013 (see Figure 7 and Table 4). There is good reason for this change. For many investors in this market, long-term value gain is more important than yield. Therefore, when an economic slow-down drives down the valuation of many quality office buildings, they attract both developers and funds, many of whom struggled to deploy capital in the past year.

But why Shanghai? Among the four first-tier cities, Shanghai is perhaps the most open, international and business friendly. It enjoys a good business-government relationship, a relatively transparent operating environment, and perhaps most importantly, a large collection of quality commercial stock that is spread out not in just one CBD, such as Lujiazui, but in several other CBDs, such as Hongqiao, all of which boast good infrastructure and have attracted a cluster of local and foreign corporations who have or are planning to set up HQs for their China operations.

Just as with gateway cities such as London, Sydney and New York, a sufficient supply of quality office buildings and a stable policy environment will bring Shanghai to the forefront in attracting inbound investment in China.

FIGURE 7
Inbound property investment for Shanghai



Source: RCA **Note:** Excluding development site deals

TABLE 4
Top 10 Shanghai inbound investment deals in 2015

Date	Investor	Property Name	Property Type	Consideration (US$ million)
Aug	The Link REIT	Corporate Ave 1 & 2	Office	1,031
Dec	Lee Kum Kee JV China Vanke	Corporate Avenue 3	Office	891
Sep	ARA Asset Management Group	Platinum Tower	Office	448
Aug	Yuexiu REIT	Hongjia Tower	Office	423
Dec	ARA Asset Management Group	BEA Finance Tower	Office	422
Aug	Blackstone	L'Avenue	Office	403
Aug	PAG JV Goldman Sachs	Ciro's Plaza	Office	330
Jun	Mapletree Commercial Trust	Sandhill Plaza	Office	303
Jan	AVIC Joy Holdings (HK) Ltd	Shanghai Intl Shipping Service Center (Bldg 17)	Office	252
Oct	Carlyle Group	Manpo International Plaza	Office	233

Source: RCA **Note:** Excluding development site deals. Preliminary data as at December 2015.

WHAT WILL BRING INVESTORS TO THE MARKET?

Are regional centres and second-tier cities still attractive?

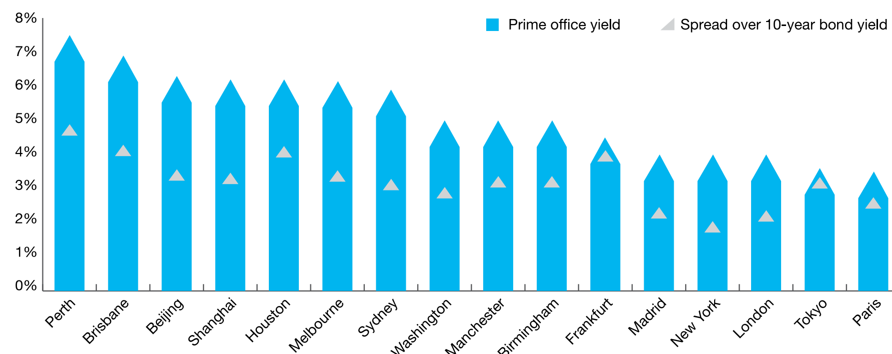
In 2015 a few regional centres and major second-tier cities continue to offer higher yield spread than the gateway cities (see Figure 8). Does this make them attractive investment destinations for the next wave of Chinese investment? We presented this hypothesis in 2014 when yield compression in gateway cities like London supported the emergence of opportunities in a few regional centres and second-tier cities.

The geographical distribution of Chinese investment in the US may provide some indication of where most investors are likely to focus their attention. Large institutional investors, like sovereign funds, banks, developers and insurance companies, tend favour big-ticket projects, which only major gateway cities can provide. Gateway cities are also where quality tenants and buyers with sufficient financial means can be found. The "Fourth Wave" investors, in contrast, are after quality stock available in other primary and secondary locations, especially in the US and Australia.

Meanwhile Chinese investors are also active in many locations away from the traditional gateway cities. For example, the Greenland Group partnered with a local developer to acquire a development site in Malaysia for US$682.6 million in January 2015. This was already Greenland's second investment in the country, following its US$180 million site deal in Johor Bahru in April 2014. Chinese investment in Japan was also significant in 2015 although it mainly attributed to the US$1.2 billion Meguro Gajoen mega-deal by China Investment Corporation (CIC). There is also a growing interest in countries such as India.

Outside of the mature markets, Chinese investment is primarily focused on development sites instead of completed assets, given the lack of high quality commercial stock in these locations. As a result, the investors are usually developers looking for diversification from the highly competitive domestic property market.

FIGURE 8
Prime office yield spread



Source: Knight Frank Research, Trading Economics

Occupier markets and the availability of future supply

We argue that yield spread is not the only factor considered by Chinese investors. One of the reasons investment grew faster in New York than in London in 2015 is likely that New York has a much greater volume of quality stock available. Another reason is that the past buying frenzy in London has strained the supply pipeline.

Over the next four years, however, we see a significant supply of office space coming on line in the London market. This should alleviate the current lack of quality office space available for investment in the city. And in New York, Sydney and Melbourne, some two million sq ft of office space will be added in each of the next four years, creating a depth of market unseen in the past (Figure 9). However since this substantial pipeline is still relatively small in proportion to the respective total stock of these cities, it can be easily absorbed by future demand.

We argue that capital flow from China, coupled with improving trade relations and economic activity, also results in occupier demand from Chinese financial services, banking and industrial institutions, which prefer Grade-A office space. Total occupancy of Chinese firms in New York has risen 70% YoY to 853,000 sq ft, following a trend that is already well established in financial hubs like Hong Kong, London and Sydney. This bodes well for rental growth and value appreciation of prime office buildings.

How Should the Market Read into Government Incentives Against the Backdrop of China's Long-Term Outbound Investment Strategy?

The past five years has seen the Chinese government delivering a slew of directives and policies aimed at channelling domestic investment abroad. From the easing of overseas investment restrictions for large corporations such as insurance companies, to programmes encouraging individual outbound investors such as the QDII programmes, all these are part of the government's long term strategy to project financial power as well as to secure a more steady income source for the country (see feature: "The 13th Five Year Plan and Outbound Investment").

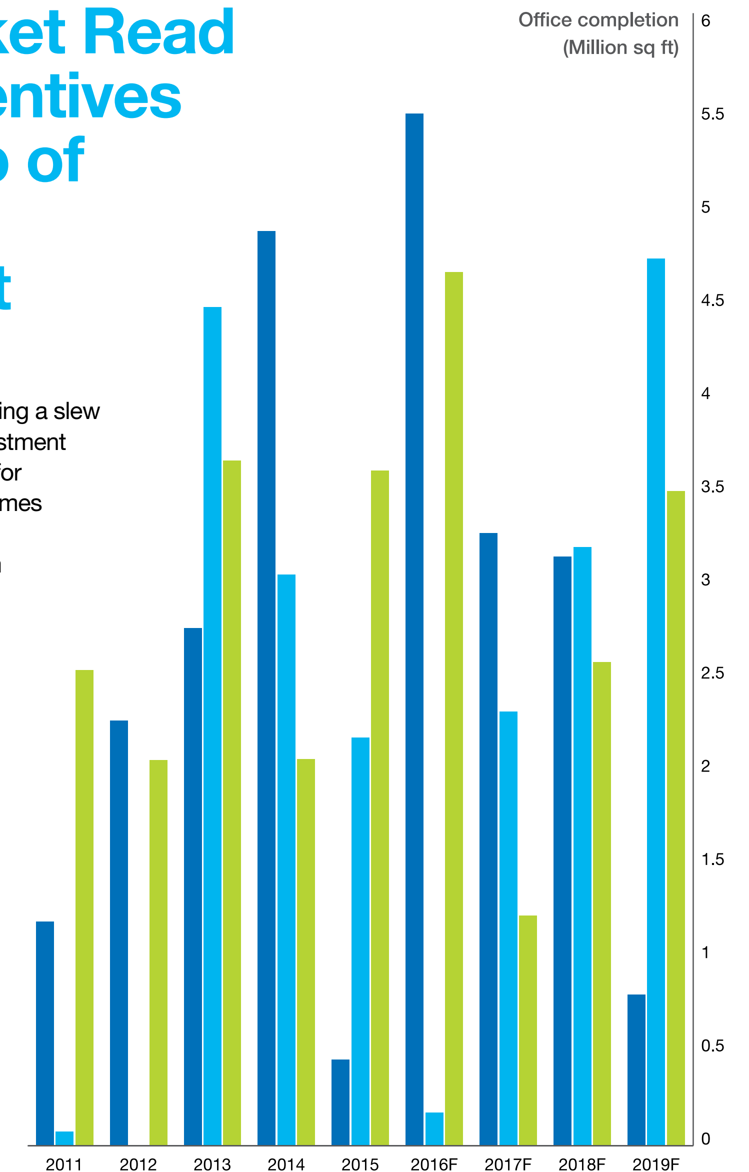
We agree that drilling into the clauses and text would no doubt help understand the details of Chinese government policies. Nevertheless it is important for market players outside China to know that these policies, bewildering as they are, are part of the grander schemes such as the "Belt and Road" initiative and the Asian Infrastructure Investment Bank which China championed. Operating in a planned economy, Chinese firms bigger or small all have a certain element of government support behind them. Therefore their outward expansion should be regarded as much a reflection on the nation's call as a result of their business strategies. With this in mind the market should have confidence in the sustainability of Chinese outbound capital.

The 13th Five Year Plan and Outbound Investment

At the time of this paper's release, the Chinese government is on the verge of rolling out its 13th Five Year Plan (FYP), an economic roadmap for the five years from 2016 to 2020. Prior to its release, Knight Frank invited a small group of industry experts for a discussion on the likely impact of any changes in foreign-investment policies.

On the outbound trend, the participants generally hoped that the relevant clauses in the 13th FYP would include specific measures to streamline and facilitate outbound investment, including improved financing facilities and enhanced fund-channelling programs, such as the QDII scheme.

The experts agreed that the significance of these policies depended on follow-up laws and regulations that are fully clarified and enforced.



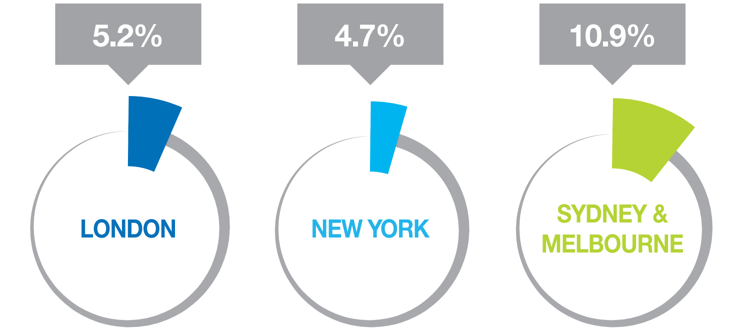


Figure 9

OFFICE SPACE COMING ON LINE IN GATEWAY CITIES (2016-19) & ITS RELATIVE SIZE TO TOTAL STOCK

Source: Knight Frank Research, NGKF

CONCLUSION

Now we can return to the two questions asked at the beginning: **Will there be a tapering of Chinese investment? And what market factors attract investors in the short- to mid-term?**

The answer to the first question is "unlikely". The growth of Chinese outbound investment in 2015 was strong despite the ups and downs of the domestic economy, in contrast to some predictions. Even with country's efforts to boost domestic consumption, especially in the housing market, we are not seeing a drastic retreat but dramatic increase of Chinese capital globally. In fact, policy-induced market uncertainties continue to plague market sentiment in China, accentuating the need for investment diversification.

As for the second question, the answer, as argued previously may lie in the availability of quality stock. However, it is equally important that gateway countries capitalise on the bilateral relationship improvements. For Australia, some positive macro-economic developments come at the right time, when Sino-Australian relations are at their warmest in history. A relatively cheaper Australian dollar and ample investment opportunities will ensure the continuation of current property investment growth.

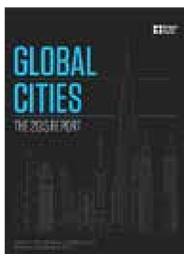
The recent visit by President Xi Jinping to the UK and the trade deals that followed are likely to confirm the UK's prominent position in China's future investment map. This will help sustain commercial and financial interest in both investment and occupier markets in London.

In the US, despite this being a presidential election year, and with ongoing political and trade friction, the sheer size of the US market and volume potential will be a major draw to Chinese investors going forward. While the larger deals still favour New York, the latest data indicates that major regional cities will provide opportunities for many small- to mid-cap investors.

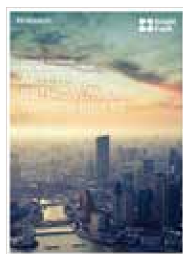
Going forward, as Chinese capital outflow increases with policy support, as well as China's trade and financial initiatives, capital outflow will become increasingly sustainable. This means ample opportunities for gateway markets, as well as key regional hubs.

Knight Frank Research provides strategic advice, consultancy services and forecasting to a wide range of clients worldwide, including developers and investors, as well as financial and corporate institutions. All recognise the need for the provision of expert independent advice, customised to their specific needs.

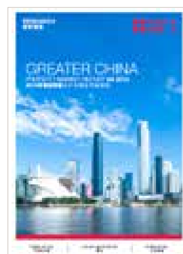
RECENT MARKET-LEADING RESEARCH PUBLICATIONS



Global Cities The 2015 Report



Chinese Outbound Report 2014



Greater China Quarterly Q4 2015

Prime Cities Forecast Report 2016

Knight Frank Research Reports are available at
KnightFrank.com/Research

CAPITAL MARKETS

Paul Hart
Executive Director, Greater China
+852 2846 9537
paul.hart@hk.knightfrank.com

Tommy Zhang
Associate Director, Beijing
+86 10 6113 8039
tommy.zhang@cn.knightfrank.com

RESEARCH & CONSULTANCY

David Ji
Director, Head of Research & Consultancy, Greater China
+852 2846 9552
david.ji@hk.knightfrank.com

Regina Yang
Director, Head of Research & Consultancy, Shanghai
+86 21 6302 1728
regina.yang@cn.knightfrank.com

Vincent Li
Assistant Manager, Research & Consultancy, Beijing
+86 10 6113 8017
vincentx.li@cn.knightfrank.com

Ocean Ruan
Manager, Research & Valuation, Guangzhou
+86 20 3839 6408
ocean.ruan@cn.knightfrank.com

Sam Lau
Senior Analyst, Research & Consultancy, Greater China
+852 2846 4876
sam.lau@hk.knightfrank.com

© Knight Frank 2016
Knight Frank Petty Limited. This document and the material contained in it is general information only and is subject to change without notice. All images are for illustration only. No representations or warranties of any nature whatsoever are given, intended or implied. Knight Frank will not be liable for negligence, or for any direct or indirect consequential losses or damages arising from the use of this information. You should satisfy yourself about the completeness or accuracy of any information or materials.
This document and the material contained in it is the property of Knight Frank and is given to you on the understanding that such material and the ideas, concepts and proposals expressed in it are the intellectual property of Knight Frank and protected by copyright. It is understood that you may not use this material or any part of it for any reason other than the evaluation of the document unless we have entered into a further agreement for its use. This document is provided to you in confidence on the understanding it is not disclosed to anyone other than to your employees who need to evaluate it.