Global Economic Policy Lab

Falling Chinese Investment in Australian Commercial Real Estate

– an Opportunity for Other Investors?

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- Chinese investment in Australian commercial real estate has been declining since 2016-17.
- The souring bilateral trade and political relations between the two countries and internal policy changes in China have severely impacted investment size and direction.
- While COVID-19 affected the overall commercial property market (at least between March – October 2020), it does not explain the decline in Chinese investment in Australian commercial real estate.
- Falling Chinese investment and the impact of the pandemic on commercial property value open up an investment opportunity in the sector for other investors with high risk tolerance.

Section 1:
Trends in Chinese Capital Outflow to Australia

Since 2017, Chinese capital flows to Australia have witnessed a significant decline. Overall investment declined from USD 10 billion in 2017 to USD 6.2 billion in 2018, approximating a fall of almost 37.6 per cent (see Figure 1), despite an increase of 4.2 per cent in Chinese outward FDI globally. This is the sharpest decline of Chinese investment in Australia in the last decade. Investment further fell by 62 per cent in 2019, even before the advent of COVID-19. One transaction of A$1.5 billion alone accounted for 43.7 percent of the total Chinese investment in Australia. Within real estate, there were significant reductions in the capital outflow from China to Australia, especially since 2016 (see Figure 2).

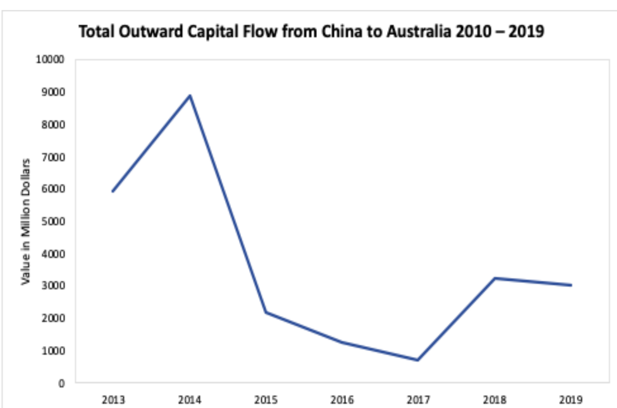

Figure 1: Total Outward Capital Flow from China to Australia 2010 – 2019| Source: OECD

Figure 2: Chinese Investments in Australian Real Estate by Investment Value (Million Dollars) |
Source: China Global Investment Tracker

Commercial Real Estate used to be the second most popular destination for Chinese investments in Australia after food and agribusiness. However, quantitative assessments show that this is no longer the case. Capital investment from China in Australian commercial property fell by 31 per cent between 2017-18, and by 51 per cent in 2019, totalling up to a loss of USD 1.5 billion pre-COVID. In contrast, regional investment flows gained momentum, with Hong Kong receiving 43.5 per cent of total capital outflows from China. Moreover, Chinese interests have shifted from commercial real estate to other more strategic Australian industries since 2017. While investments in renewable and non-renewable energy saw a growth in Chinese capital by 295 per cent and 217 per cent respectively, capital invested in commercial property fell drastically (see Figure 3). A shift towards smaller acquisitions was also recorded, with residential development taking 41 per cent of total investments in 2019. This reflects the new Chinese domestic mandates for investments in low risk and high-quality assets at well-located sites. The overall value of investments has declined by 22 per cent since 2016.

Commercial property investment approvals for Chinese investors by the Foreign Investment Review Board (FIRB) of Australia have also plummeted in the last four years, leading to significant losses. In November 2020, a group of Chinese investors withdrew their bid to invest A$80 million (US$58.5 million) in an office tower in Sydney, as the FIRB delayed approvals by eight months. Further, an evaluation of commercial real estate prices shows that at the height of Chinese investments in Australia (until 2016) commercial property prices were rising. However, prices began falling in mid-2017, following the decline in Chinese investments in commercial real estate. Prices picked up briefly in 2019 before another plunge owing to the pandemic in 2020. The trend has remained downwards since (see Figure 5).

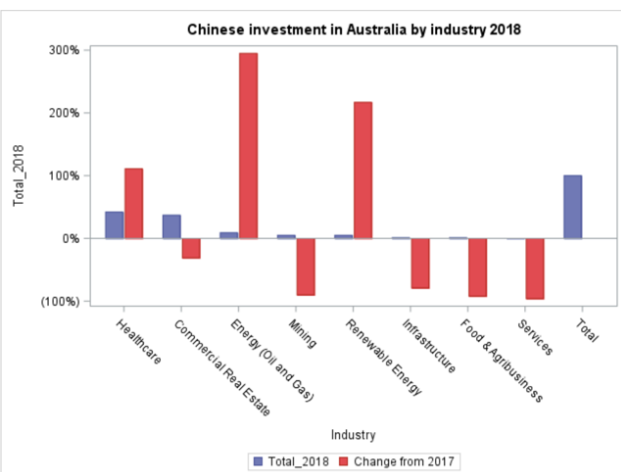

Figure 3: Chinese Investments in Australia by Industry (Change) 2018 | Source: KPMG/Sydney University Database

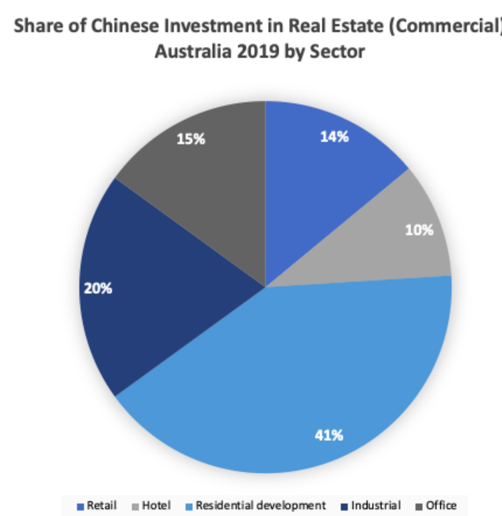

Figure 4: Share of Chinese Investments in Commercial Real Estate by Sector 2019| Source: KPMG/Sydney University Database

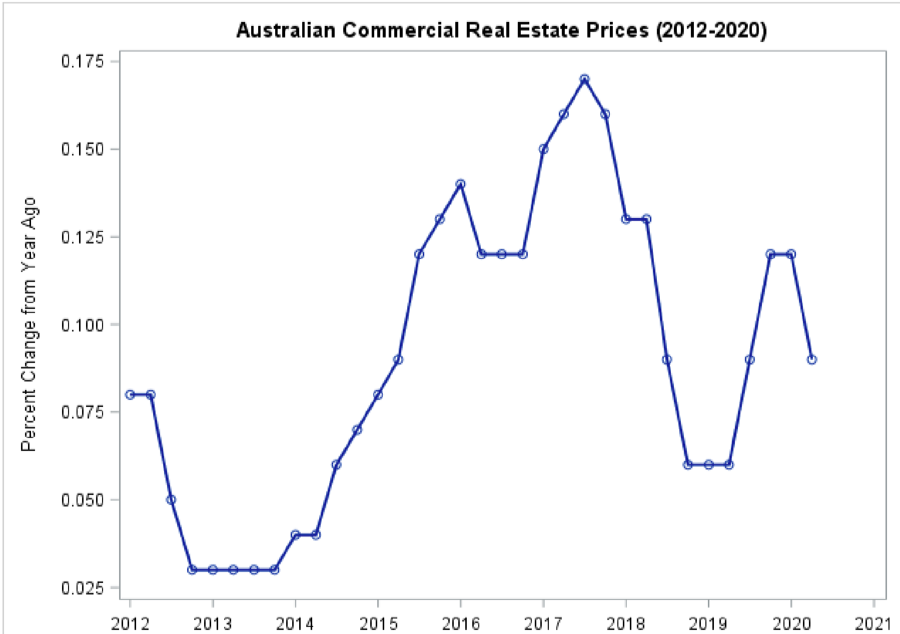

Figure 5: Australian Commercial Real Estate Prices (2012-2020) | Source: FRED Economic Data

Section 2:
Qualitative Assessment

Chinese businesses have invested more than $100bn in Australia since 2008, leading to a strategic two-way trade between both nations and a boom in investments and economic growth in the recipient country. However, an ongoing surge in diplomatic and trade tensions between the two states, along with internal investment policy changes in China have dampened Chinese investments in Australian commercial real estate in recent years.

Internal Investment Policy Changes

A major slide in Chinese capital in Australia is observable since 2018. A series of communist government mandates and internal economic reforms in China in 2018 dictated where and how much capital could leave the country. This had an adverse effect the following year, bringing 70 per cent deal value sizes down to below AUD 50 million, with more investments in smaller acquisitions. Until 2018, Australia had continued to attract relatively high investments into commercial real estate, with total investment reaching 37 percent. While the investment in 2018 was 31 percent down from 2017, the drop was in line with a wider global trend towards lower Chinese outbound investment in other key markets such as the US and UK during that year. This was because China's government limited both developers and individuals from getting money out of the country to ensure overseas investments were not speculative, and therefore consistent with the country's socio-economic development goals. An investment prospectus was prepared, highlighting the sectors where investment was encouraged, restricted and prohibited. The

Belt & Road Initiative (BRI) fell under the encouraged investments, while those in real estate, hotels, cinemas, entertainment and sports clubs were restricted, explaining the decline in Chinese investments in Australia. However, Chinese attitudes towards Australia remained positive through 2018, as perceptions surrounding the political environment improved, despite tensions over the Australian Government's ban on Huawei participating in the 5G mobile rollout.

Rise in Political Conflicts Between the Two States

In 2019, the commercial real estate sector was the second largest recipient of Chinese investments, despite an annual decline of 51 percent. The reasons for this decline have been attributed to many factors like the shift of Chinese state-owned enterprises (SOEs) investments towards BRI projects and Latin America from developed markets, along with the tightening of Chinese ODI regulations. Moreover, Chinese perceptions of Australia soured in 2019 as Australia imposed stricter investment regulations and media narratives on both sides worsened. Further in 2020, Beijing vowed trade reprisals after Canberra called for an international inquiry into the source of the COVID-19. This was followed by the introduction of scrutiny measures in March in Australia, driven by worries that the coronavirus pandemic would make some essential industries vulnerable to takeover bids. Tightening of the scrutiny of foreign investments in Australia led to longer processing times of investment applications which dissuaded incoming Chinese investments. Australia also unveiled a stricter national security test for foreign investments, which was the biggest shake-up of the country’s rules in the last four decades. The proposed rules gave the government broader authority to reject deals based on national security grounds. This was viewed as a direct retaliation to China’s restrictions on Australian imports.

Section 3:
Has COVID Further Impacted Chinese Investments in Australian Commercial Property?

Since the pandemic significantly affected the global economy, it is vital to review the overall commercial real estate performance in order to analyze whether COVID-19 has negatively impacted Chinese investments in Australia. "Completed construction work” is an important indicator of the performance of the Commercial Real Estate market and can partially reflect foreign investment demands in the Australian commercial property. The total construction work initiated in Australia decreased by only 1.4% in 2020, as compared to 2019, when the non-residential construction was down by 4.5%. Figure 6 displays Australia's quarterly commercial property index from 2018 to 2020, for three sectors - offices, retail, and industry. The trend for each sector appears to be relatively stable before the first quarter of 2020. However, when COVID-19 emerged in the early 2020, there was a sharp decline across all commercial properties. By quarter four, both office and retail properties indices remained low, with the exclusion of industrial property, which rebooted and reached a higher index than pre-pandemic times. Thus, it can be concluded that COVID-19 did significantly impact Australian commercial real estate investments, with properties like office and retail buildings affected the most.

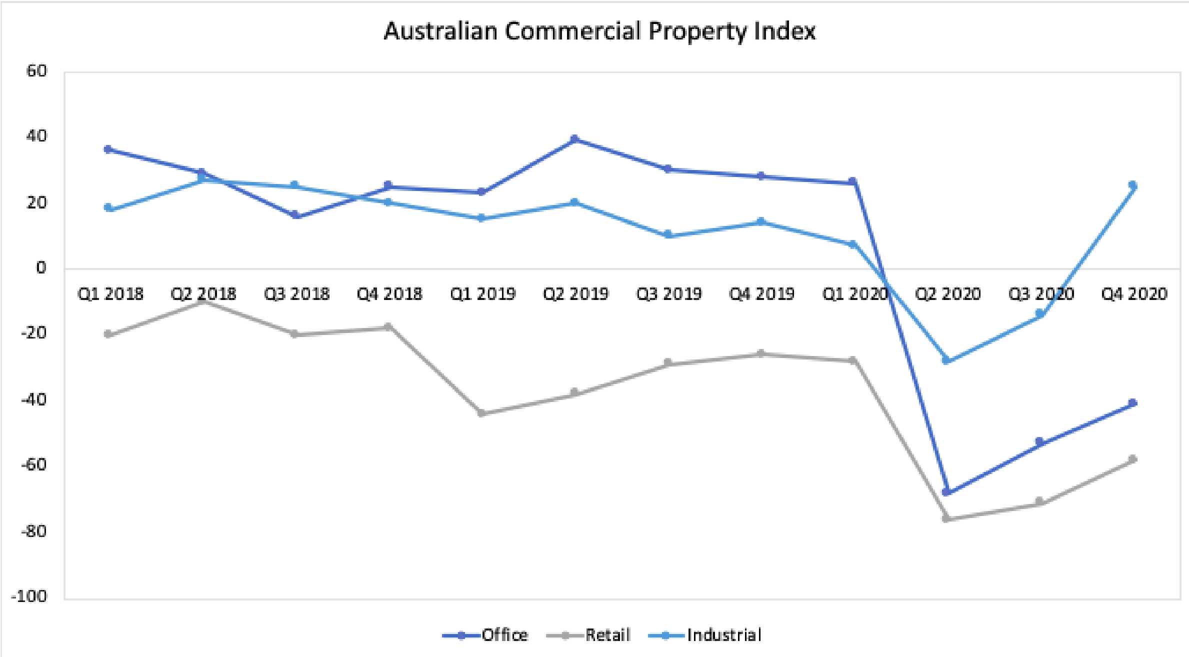

Figure 6: Quarterly Australian Commercial Property Index (2018-2020) |
Source: NAB Commercial Property Surveys (2018-2020)

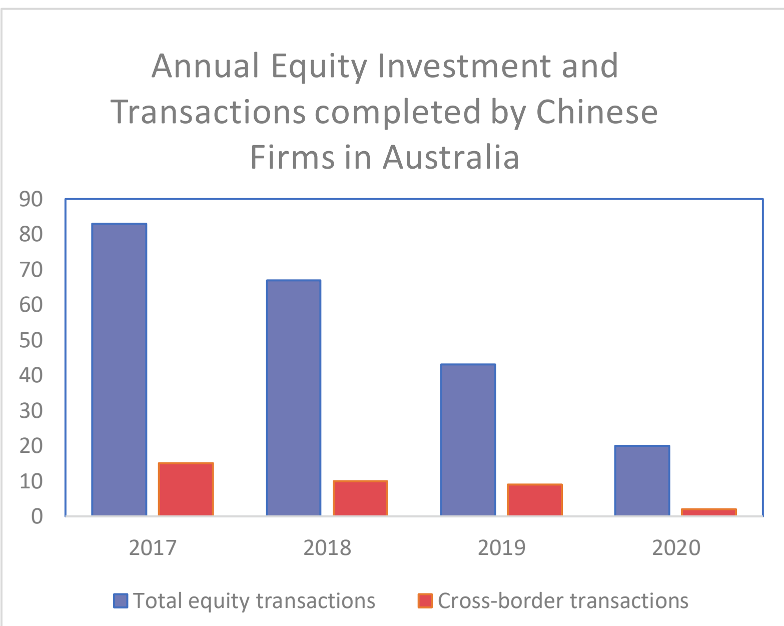

Figure 7: Annual Equity Investment and Transactions completed by Chinese Firms in Australia 2017 – 2020. | Source: CHIIA

Chinese investments in 2020 have continued to shrink, and this can be attributed partly to the pandemic related declines in the overall FDI received by Australia. However, the decline in Chinese investments is not as severe as the fall in investments from other foreign sources. According to the CBRE, Australia received close to 15 billion USD from the capital market in the first three quarters of 2020, which was a drop by 46 per cent compared to capital received in the same period in 2019. Further, the domestic share accounted for 60 per cent of the total investment in 2020.

Although China fell in the top three foreign offshore investment sources, capital from China accounted for only 800 million AU$, a decline by 55 per cent compared to previous years. Moreover, according to CHIIA, the total number of commercial projects by Chinese companies were only 20 in 2020, as compared to 87 in 2017. However, Chinese cross-border transactions in education, mining, financial and insurance sectors were more heavily impacted by the pandemic, than the commercial property and rental sectors

(Figure 7). This can be because Chinese investment in commercial property is mainly internal or through the third-party agencies in Australia, so the fall is far less than that in other sectors.

Section 4:
What Does the Future of Commercial RE Look Like for Investors?

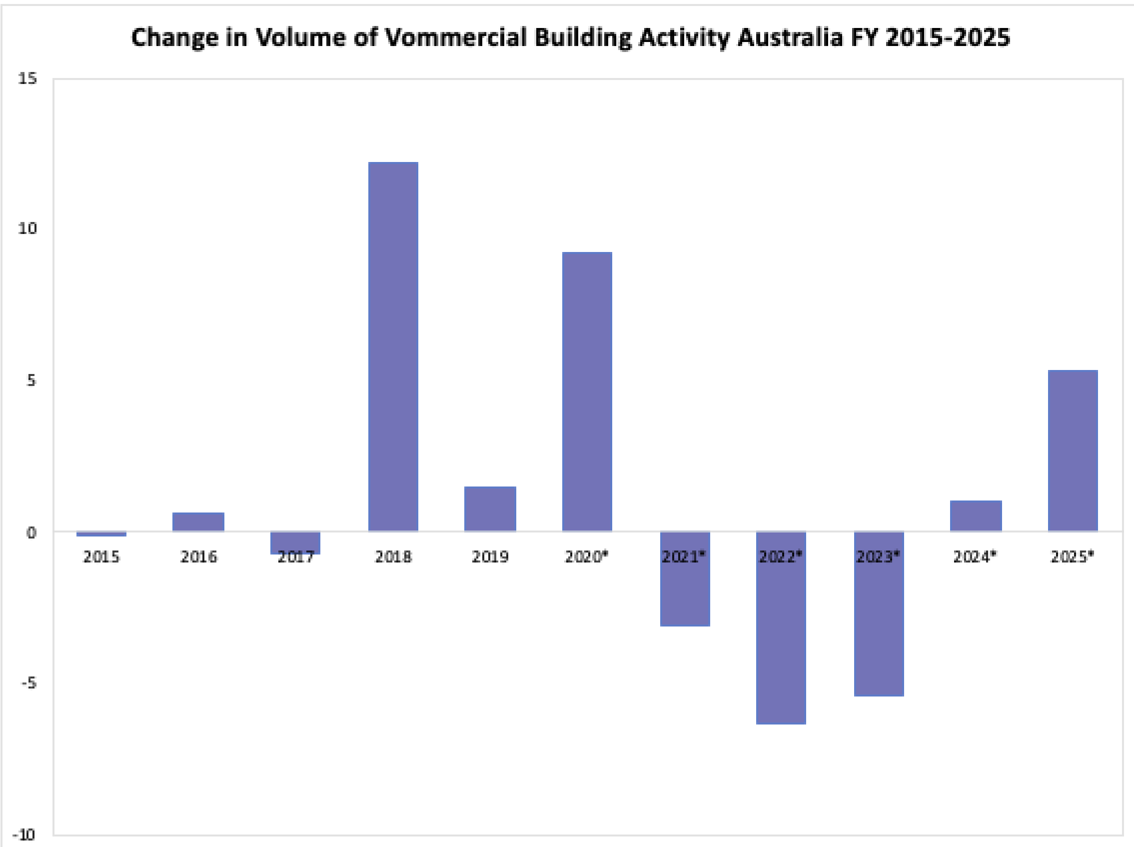

Figure 8: Pre-COVID Predictions for Change in Volume of Commercial Building Activity in Australia FY 2015-2025|
Source: Master Builders Australia

Pre-pandemic predictions for commercial building activity in Australia had suggested a decline, as the share of Australian e-commerce market was expected to increase (see Figure 8). COVID-19 exacerbated negative sentiments for an already declining industry. As lockdowns forced firms to shift to remote work, the demand for office spaces slumped, and corporate, retail and industrial property vacancies soared (from 9.2% to 11.1% in quarters 2-3 of 2020). This also resulted in a shift of investments within commercial real estate from mainstream properties (offices, retail complexes and hotels) to alternative spaces (data centres, medical offices and student housing) in suburban areas. Still, investor interests in Australian commercial real estate have remained strong. As Chinese investments began declining in the sector, American and British investors moved in quickly to fill in the gaps. In fact, even in 2020, foreign investments in commercial real estate were soaring in Australia. A survey by commercial agency JLL concluded that given strong economic growth in the last 30 years and low volatility in returns, half of the foreign investors who responded were looking at investing in Australian commercial property in 2021.

While predictions were not as positive in 2019, it is evident that COVID-19 has opened new windows of opportunity for risk tolerant investors. With currently elevated levels of vacancies in office and retail spaces, several owners of commercial property are eager to liquidate even at discounted prices. As commercial rents remain low, commercial property looks less attractive and even unviable. This is a good time to leverage the low rates and take a risk, when only few others are willing to do so. While work and retail during 2021 may remain mostly remote, there has been evidence to prove that at least 3 in 4 workers want to move back to working in offices. Further, even if work from home continues for the next few years, vacant commercial property can be repurposed as multi-use spaces. It is likely that such repurposing will sustain post-pandemic. Australian investors are already exploiting this opportunity. A case in point is the sale of a $648 million logistics property portfolio in Sydney that was owned by Aldi, a German supermarket giant, in June 2020. For investors with a strong aptitude for risk, falling Chinese investments courtesy of the political tensions between China and Australia and the impact of the pandemic on commercial property value may prove to be the perfect investment opportunity.