China's impact on Australian Real Estate

Key Points

- China has become enormously important to the Australian economy as its largest export destination, a rapid source of growth in inbound international tourism and migration, plus a strong source of foreign investment.
- The impact of China on Australian property has been both indirect through the impact on the broader economy and direct through capital flows and Chinese developers building Australian businesses.
- LaSalle's house view is that China's debt boom will undoubtedly cause turbulence in credit markets. However, only a full blown financial crisis would have a significant adverse impact on Australia and we see the likelihood of this outcome as low.
- The size of any impact would depend on the extent sentiment of global investors swings against Australia (with few remaining AAA alternatives) and how sustainable the domestic economic recovery in Australia proves to be.
- Uncertainty surrounding the Chinese economy is already driving strong capital flows into Australia and we expect this to continue over the medium-term.
- Longer-term, a recent free trade agreement (FTA) will likely further deepen the trade and capital flows between the two countries and Australia remains well positioned to capitalise on China's continued economic growth and expanding middle class.
- While occasional reversals in capital flows could prove disruptive to local property pricing at times, it is likely that the overall impact will be to boost property demand, particularly in the residential market. The hotel/resort market and the market for rural land are also likely to be impacted long-term.

The economic impact of China on Australia's economy

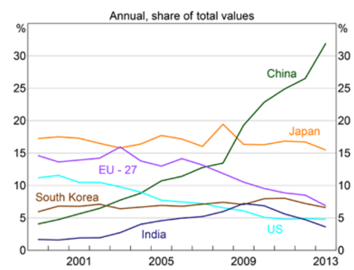
The Australian economy has quite remarkably experienced twenty one years of continuous expansion. The saying used to be that 'when the US sneezed, Australia would catch a cold', but certainly over recent years it has been the strength of the Chinese economy that has boosted Australia's economic prospects well beyond those of most other major developed economies, including the US. While Australia's fiscal stimulus following the global financial crisis (GFC) was swifter and more significant than most other developed economies, undoubtedly a greater boost came indirectly from the fiscal stimulus and building program instituted in China, which fuelled strong demand for Australian commodities and re-ignited the mining investment boom that was starting to gain momentum pre-GFC.

Some of the clear impacts of China on the Australian economy can be seen in the following areas:

Exports

China overtook Japan as Australia's largest export destination in 2008 and over that time has risen from less than 15% of Australia's total exports to over a third of Australian exports (Figure 1). Exports to other major trading partners have also increased over the period in volume terms, but this growth has been more than

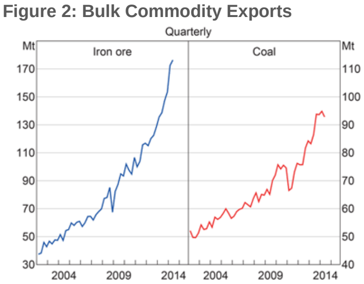
Figure 1: Australian Exports by Destination



Source: ABS, RBA

China is Australian's largest export market and now takes over a third of Australia's exports by value.

Figure 2: Bulk Commodity Exports



Source: ABS, RBA

Bulk exports, particularly iron ore and coal have driven the trend.

Table 1: Australian Tourism Expenditure
By Country of Origin

Market	Yr-End Jun 13 ($ m)	Yr-End Jun 14 ($ m)	% Change
China	**4,518**	**5,255**	**16%**
UK	3,144	3,548	13%
USA	2,467	2,641	7%
NZ	2,288	2,361	3%
Japan	1,460	1,355	-7%
Korea	1,225	1,107	-10%
Singapore	1,012	1,081	7%
Germany	917	1,023	11%
Malaysia	925	1,018	10%
Hong Kong	822	938	14%

Source: Tourism Research Australia

Chinese tourists spent over $5.2 billion in Australia last financial year, which is more than any other country and was up 16% y-o-y.

Table 2: Chinese Investment in Australia
By Industry, 2012/13

Industry	China ($m)*	% of Total
Agriculture, forestry and Fishing	328	14%
Finance & Insurance	23	1%
Manufacturing	957	15%
Mineral Exploration	8,273	19%
Real Estate	5,932	16%
Resource Processing	-	0%
Services	291	1%
Tourism	-	0%
Total	15,803	13%
Total Approvals (number)	**6,102**	**48%**

Source: Foreign Investment Review Board

Chinese investment in Australian real estate has increased significantly over recent years.

overshadowed by the growth in Chinese exports and all other major trading partner's shares of Australia's exports have declined in recent years. The growth in Australia's exports to China largely reflects the bulk commodity demand emanating from China's strong economic growth and construction-led investment boom. Australia's main two commodity exports have been iron ore, which have more than doubled in volume terms in the past five years, and coal, which has almost doubled (Figure 2).

Tourism

Australian tourism has been through a lean period over recent years, with the strong Australian dollar (AUD) dampening inbound international tourism and boosting outbound international travel (and in the process dampening domestic tourism). Despite this generally subdued environment, inbound Chinese tourism has been one area of strong growth over the past five years. This growth has seen China become the largest inbound international market for Australia by value, with Chinese visitors spending AUD 5.26 billion over the year to June 2014 (Table 1). With the weakening of the AUD in 2014, tourism from other countries has also improved in the latest 12 months. But, the Chinese market still dominates, as it has grown 16% off an already large base.

Foreign Investment

Chinese foreign investment in Australia, particularly in agriculture, resources and residential housing has gained some public attention over recent years. Total foreign investment is lumpy and can jump around due to particular large corporate or commercial real estate deals, but China has consistently been one of the larger sources of foreign investment into Australia over recent years (with the US the largest). Figures from the Foreign Investment Review Board (FIRB) suggest that in 2012/13, Chinese interests invested $15.8 billion into Australia, or 13% of all money invested. The proportion of investment in some sectors was high, such as mineral exploration (19%), real estate (15%), agriculture (14%) and manufacturing (15%). However, investment in many other sectors such as finance and insurance, services, tourism and mineral processing was low or zero.

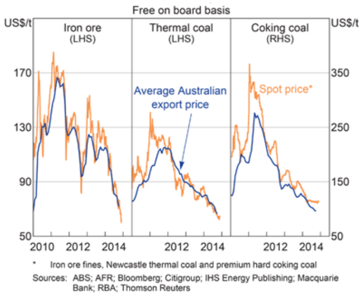
Comparing these results to 2008-09, both the level and share of Chinese investment is slightly lower now than it was four years earlier. Nevertheless, there have been some big changes in the composition on investment. What stands out is the number of approvals and particularly China's share of approvals by number (48%). This supports anecdotal evidence that Chinese investment is having a big impact on residential housing markets, particularly in Sydney and Melbourne. Evidence suggests that this activity has increased over the past 18 months and also that some of this impact has been indirect through Chinese-born Australian residents and not picked up in the FIRB numbers.

A parliamentary enquiry into overseas investment in the Australian residential market released in November 2014 concluded that current regulations that push investment into new rather than existing stock are an overall positive for the Australian market and dampen pricing over the medium-term by stimulating supply in the apartment market. However, the recommendations focused strongly on boosting enforcement of the FIRB regulations, noting they were easy to by-pass due to limited resources dedicated to policing the regulations.

How big is the risk of slowdown?

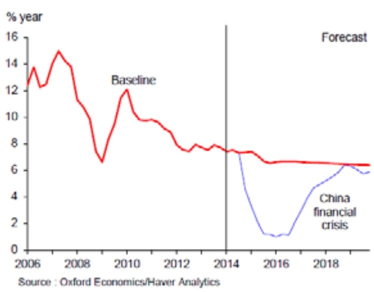
Slower recent Chinese economic growth and recent sharp falls in commodity prices (particularly iron ore, see Chart 3) and the AUD have put a sharper focus on the risks that

Figure 3: Bulk Commodity Prices



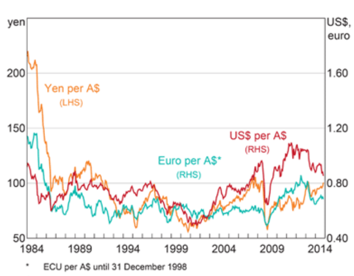
Recent price fall has been significant and raises the need for Australian domestic drivers to take up the slack.

Figure 4 Chinese GDP Outlook



While not the central forecast, a Chinese financial impact would have a large impact on both the local and Australian economies..

Figure 5: AUD Exchange Rates



A slow steady fall in the AUD will be good for Australia's economic re-balancing

larger than forecast Chinese economic slowdown would have on the Australian economy and property markets. It should be recognise that the pace of Australian resource exports to China was always going to slow at some point because China's post-GFC building boom could not be sustained forever and it was always intended that growth be shifted more towards consumption. The issue has always been whether this transition is slow and gradual, or if the imbalances of growth in the past cause a more rapid adjustment period. This would likely be triggered by a rapid decline in Chinese property prices, increased bad debts (many outside the regulated banking sector) and an ensuing financial crisis.

To date, China has been able to successfully tighten credit conditions and engineer a slowdown in property markets, with only isolated developer/investor bankruptcies and without tipping into financial crisis. Economic growth has slowed, perhaps slightly more than intended, but with plenty of reserve capital to tip into the financial sector and things seemingly stabilising, the risk appears to remain low. Oxford Economics rate the likelihood of Chinese financial crisis to be only around 10%. However, while the probability is low, the impact would be large and Oxford estimate that Chinese GDP would fall to below 2% in 2015 and 2016 in the event of a full blown financial crisis. This magnitude event would certainly have a large impact on Australian growth prospects and likely tip the economy into its first recession in nearly a quarter of a century.

Slower Chinese growth has certainly been a factor in recent declines in bulk commodity prices, most notably in iron ore. This has affected investor sentiment towards Australia to some degree and been a major factor driving a recent depreciation of the AUD (Chart 5). However, this depreciation is not an unwanted event and the Reserve Bank of Australia (RBA) has been arguing for some time that a lower AUD would help other sectors of the Australian economy and help balance out growth.

In the short-term, Australian commodity exports will not fall away sharply because rising export volumes (as more resource projects undertaken over recent years complete) and a lag between spot prices and contract prices mean recent price falls will take a while to reach their full impact. This lag buys more time for Australian domestic drivers to pick up. On this front there are still mixed signs– business sentiment remained positive through 2014, which is supported by an apparent stabilisation in the labour market and by increase leasing activity in office market in Sydney and Melbourne. While consumer sentiment remains fragile, housing construction activity has been stronger of the past 12 months and contributing to GDP growth. Stronger housing market activity, continued low interest rates and lower petrol prices should all support stronger consumption activity over the next 12 months (particularly if employment growth increases as expected).

A recent FTA will create some opportunities

Australia and China signed an FTA in November 2014 in the wake of the G20 meeting in Brisbane. The negotiation on the long-awaited FTA commenced almost a decade ago and the agreement is in its 18th iteration. Some of the key aspects of the agreement are as follows:

- Over time, as much as 95% of Australian exports will enter China without attracting a tariff;
- Tariffs on most Australian agricultural goods will be phased out over the next four to nine years;
- For mining, tariffs on alumina, zinc, nickel, copper, coking coal and uranium are to be eliminated, while tariffs on thermal coal will be removed in two years;

The recent FTA should provide a general economic boost to Australia, increase capital flows from China further and create some specific opportunities in the agricultural and service export sectors.

- Service exporters are big winners, getting preferential access in a number of sectors. Australian business will gain access to Chinese private hospitals and nursing homes, tourism operators will be able to purchases restaurants and hotels, while Australian insurance companies will get access to the third-party insurance market;
- The threshold for FIRB review of investment by a private Chinese company will be lifted from $A248 million to $A1.087 billion. Chinese state-owned enterprises still need FIRB approval for all investments.
- The Australian government has agreed to a case-by-case application process for Chinese investors to bring Chinese workers for Australian projects.

What does it all mean for Australian property markets?

A Chinese financial crisis would have large economic ripple effects on the Australian economy and on property markets, but we believe this to be a "high impact/low probability" situation. If such an event were to occur, the impact on capital flows and values is also not entirely clear. In the immediate aftermath of a Chinese financial crisis, Chinese investors are likely to look for safe haven to place money and Australian assets could potentially increase in demand. However, eventual deleveraging could result in existing Australian assets being sold off to repatriate capital back to China. The impact of these fire-sales on asset prices would depend on the strength of Australian domestic property demand and the extent to which such an event affects local sentiment.

In the absence of such an event, the outlook for the Australian economy is still solid, with stronger domestic economic growth expected to improve prospects for property leasing demand in all sectors. Sentiment toward commodity markets and the prospect of rising interest rates in other major developed countries[1] could well cause further depreciation of the AUD, but this is likely to be a growth-positive outcome by assisting export-competing industries. Capital markets are likely to remain very strong, due to comparatively attractive asset pricing in Australia, and property yields have the scope for further compression over the next few years.

Regardless of what happens in the short to medium-term, a financial crisis would be cyclical and China (along with the rest of emerging Asia) will have a further big impact on Australian property markets longer-term. The indirect impact on the Australian economy through resource demand will return – the amount of people globally moving from low-income to middle class lifestyles over the next few decades will be unprecedented and will result in unprecedented resource demand. The nature of demand will change – particularly energy demand as dirty fossil fuels like coal subside in favour of cleaner fuels – but few places in the world have as many different resource reserves as Australia and such a small domestic market to service. This surge in the size of the middle class globally will also put great pressure on global food supplies and demand for services (including tourism and educational services). Australia's opportunity to capitalise on this is further enhanced by the recent FTA.

The impact of Chinese and other Asian investment has already been discernable in the residential property market, particularly in Sydney. While risk of a short-term reversal of capital flow is present (as discussed above), the longer-term impact on demand is likely to be strong. Being a particularly sparsely populated continent Australia is likely to face greater external global pressure to receive greater migrant intake in the coming decades.

Table 3: Australian International Students
By Country, 2013

Industry	Number	% of Total
China	150,116	28.5%
India	49,265	9.3%
Republic of Korea	27,580	5.2%
Vietnam	26,015	4.9%
Thailand	21,762	4.1%
Other Nationalities	252,194	47.9%
Total	526,932	100%

Source: Foreign Investment Review Boar

[1] A narrowing of interest rate spreads between Australia and other major countries would reduce the ability of investors to do 'carry trades' (borrow at lower interest rates elsewhere and get higher return in Australia) and just the anticipation of these gaps narrowing is enough to cause a depreciation.

Aside from opportunities in the residential sector, some smaller niche sectors are likely to benefit from the impact from China, inclduding tourism, student housing and rural land.

In our view this will also be tempting for future governments to counteract a shrinking natural tax base as the population ages. As such, greater migration potential than most other developed nations will good for Australian housing construction prospects long-term. China is already the fastest growing component of Australian migration, and the second largest source after New Zealand. This trend not only will have an impact on the volume of construction, but also further impact the mix of product as European and North American migration falls and Asian migration dominates.

From a supply perspective, Chinese developers (and developers from other Asian countries, particularly Singapore) have recently been active in acquiring sites and commencing major apartment developments across the Eastern seaboard of Australia. The recent parliamentary enquiry into foreign investment in the Australian residential market concluded that this stimulus to apartment supply will eventually outweigh the impact of strong offshore demand and dampen Australian dwelling prices. Many of the sites purchased by offshore developers are also currently occupied by office uses and so the eventual conversion or demolition of these premises will ultimately have the impact of removing some stock from Australia's major office markets.

While the impact on housing is already evident, the impact on many other sectors of the property market is still to come. Our view is that the direct impact on commercial (office, retail and industrial) property of Chinese investors and developers is likely to be more limited in the medium-term because domestic players already dominate the relatively small market and it is hard to enter for external parties. There could be more significant impacts in smaller non-core property sectors where Chinese end demand is likely to have a bigger impact on market dynamics and barriers to entry are lower. In particular:

- **Tourism** – growth in Chinese international visitors is likely to continue to grow at a strong rate as Australia is currently only has a very low market share. Also, as wealth grows the market will grow. Strong Chinese migration adds immensely to the growth of tourism as well, as it adds to the 'visiting, friends and relatives' travel category. This is a strong opportunity for Chinese hotel and resort operators to develop product that suits and can be marketed back into their home country;
- **Student accommodation** – Australia is popular study destination for Chinese and student numbers have been growing strongly the past few years, in spite of the strong AUD making it a comparatively expensive study market. A somewhat lower AUD over time should improve the affordability side and boost the attractiveness of the market further. Australia has a relatively undeveloped student housing market, with most students accommodated on campus or in the private rental market.
- Institutionally owned student accommodation is an emerging asset class in Australia, but relatively low yielding one which has constrained its growth. Nevertheless, with strong end-demand more groups are starting to find business models that work in the student housing space.
- **Rural land** – agriculture in Australia has had relatively challenging times over the past decade, with drought affecting production and the GFC denting demand. Both production conditions and land values have increased in recent times, but the Asian growth story makes the long-term demand picture appear very strong. As Asian wealth grows, diets are evolving and shifting more towards Western diets. Longer-term this creates enormous potential for Australian industries like the beef industry, the wine industry and many

other agricultural products traditionally produced for a small domestic market. Foreign investment in agricultural land is always more politically charged than many other sectors, prospects for Australian agricultural land appear on a long-term upswing.

Conclusions

- Twenty two years of continuous economic growth runs the risk of investors putting too much faith in the idea that the Australian economy is bullet proof.
- While this run could well continue, the domestic economy remains very vulnerable to external shocks at present, and particularly any significant further slowdown in China.
- While a full blown Chinese credit crunch is not our central forecasts, concerned investors can position themselves defensively for such an outcome by limiting exposure to vulnerable sectors, for example inner urban residential development on the Eastern seaboard and offices in the resource-heavy markets (Perth and Brisbane).
- However, in the short to medium-term, the risk of such an outcome is likely to push more money into Australia real estate cause further upward pricing pressure on all assets.
- To protect themselves further, investors should now become much more discerning about paying too much for core Australian real estate as the capital markets enters the latter parts of the cycle. In particular, this includes Sydney and Melbourne CBD office assets, trophy regional and CBD retail assets in all major metropolitan areas and prime industrial assets across the Eastern seaboard.
- Value-add investments with a shorter investment timeframe certainly appear to offer much cushion against wider macroeconomic uncertainty, leading LaSalle to favour strategies in all sectors where active management can add value.
- Prime assets in some metropolitan office markets now appear attractive, with a relatively wide yield premium to CBD investments, moderate supply pipelines and expected improvement in demand over the next 12 months.
- Some new residential developments will certainly still make sense in 2015, particularly in Sydney and Brisbane. However, supply competition has increased sharply over the past 12 months and investors will have to be considerably more discerning about local market demand and supply conditions before commencing new projects in 2015.
- Longer-term, we think China will continue to have a very large direct and indirect impact on the Australian economy and real estate markets. While this will provide a broad boost to residential markets generally, we believe the best opportunites to capitalise longer-term may be in niche sectors where this impact could be very large, such as tourism, student accommodation and rural land.

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