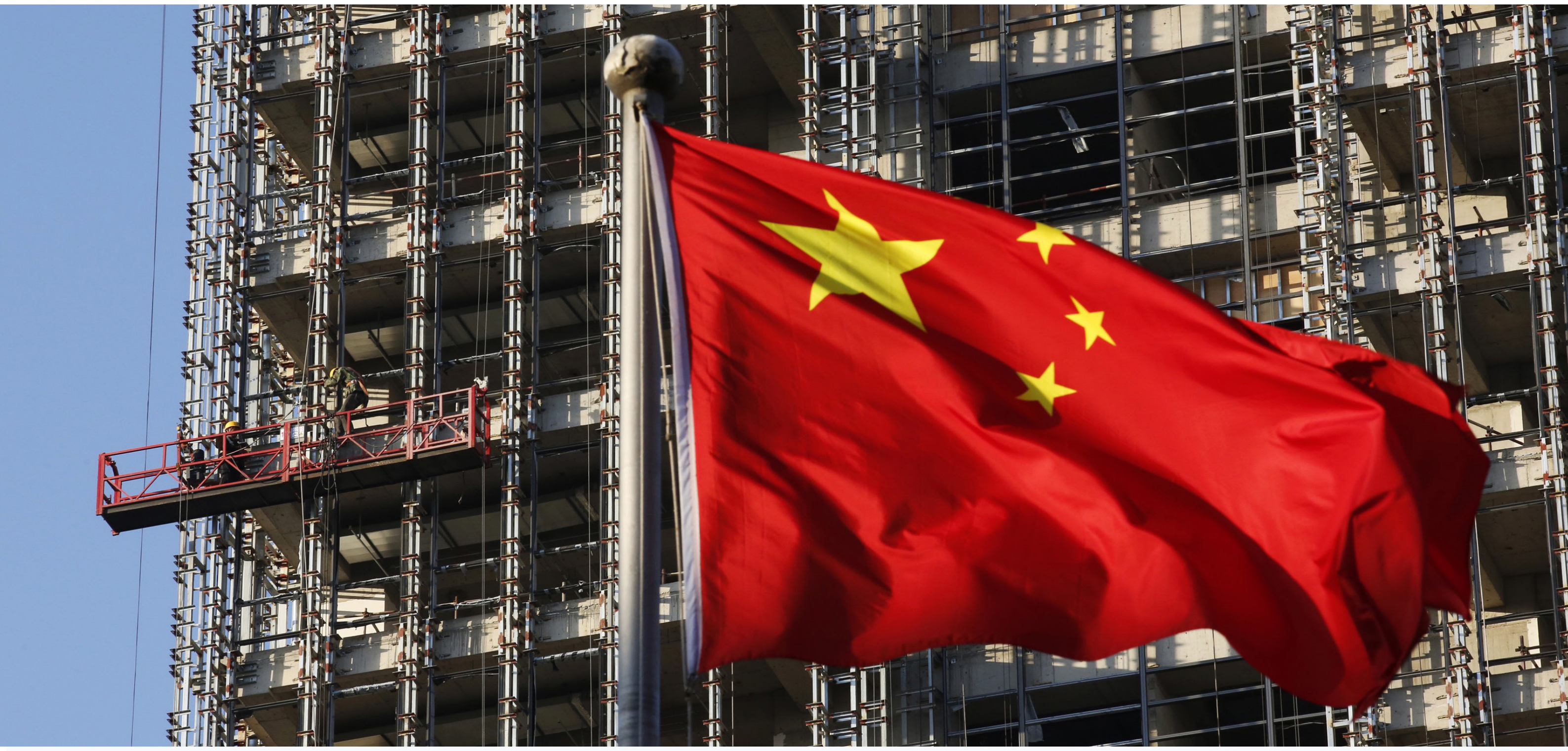

JANUARY 2017

Leashing the Red Dragon: Chinese Investment in Australian Real Estate

Highlights

- China is Australia's biggest foreign real estate investor, receiving approximately A$24.5bn worth of approvals for investment in Australian residential and commercial property in 2015 alone.

- For Chinese nationals there are two overarching factors that are encouraging outflows of capital. Firstly, the general sentiment in China that the Renminbi will continue to depreciate, which is creating an impetus to expatriate funds. Secondly, a deep-seated concern that the Chinese system is not transparent or fair and that political instability may at any time threaten the accumulated wealth of Chinese companies and individuals. Investing in Australian real estate is therefore considered a value-protecting strategy.

- For the next 12 to 18 months, Chinese investors will struggle as a result of new restrictions on capital outflows and the reluctance of the big four Australian banks to lend to foreigners.

- A reduction in off-the-plan real estate purchases by Chinese overseas investors is inevitable. Apartment prices in inner city Melbourne, Brisbane and Sydney as well as certain locations on the transport spines of Western Sydney, areas where Chinese buyers have a particular investment preference, will suffer declining purchase prices.

- Outside of the inner-city geographic areas, the expected reduction in Chinese demand will have little impact on property prices.

- The abrupt cessation of lending by Australia's big four banks to Chinese nationals has opened the market to non-bank lending institutions. These Australian funds and Chinese funded special purpose vehicles are profiting handsomely by charging up to 12% on the cost of funds and levying origination fees up to 5%. The big four banks will not be able to ignore the loss of market share and profits and are likely to recommence lending to foreign nationals in the next 18 to 24 months.

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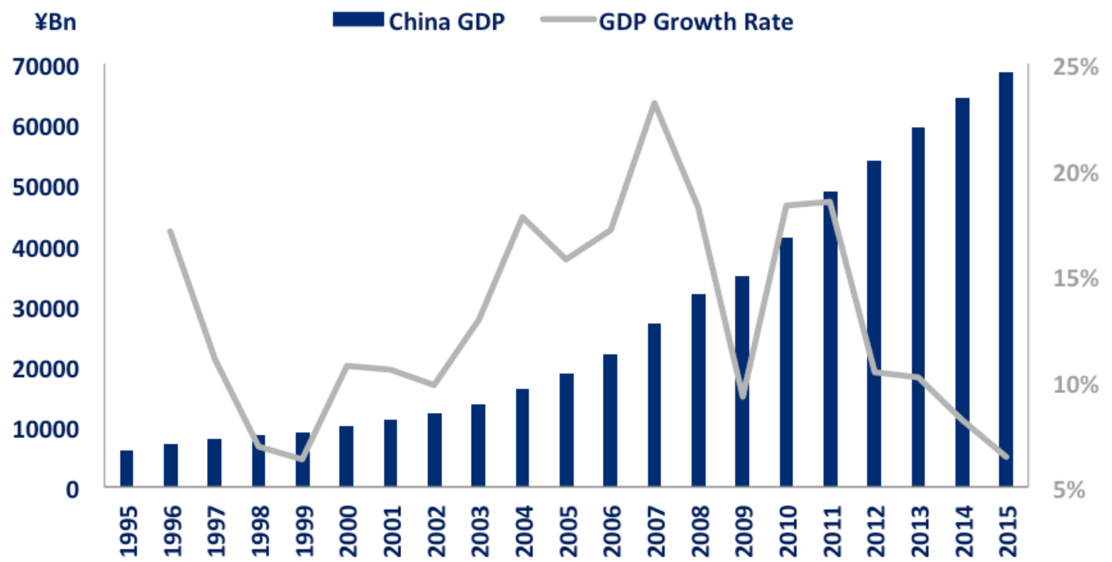
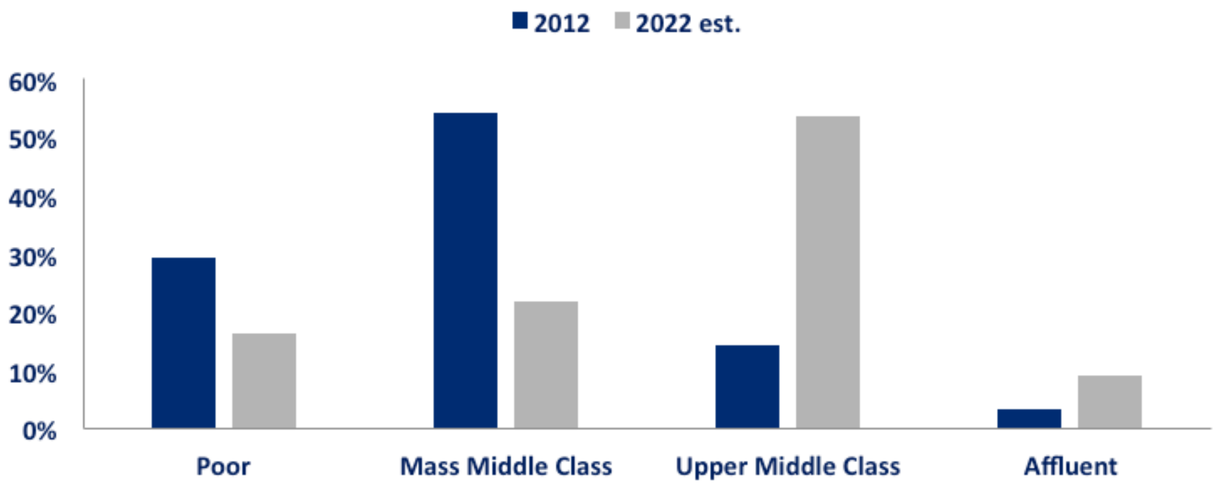
On average, China has experienced a whopping 12.93 percent per annum of GDP growth over the past 20 years. This has resulted in an elevenfold increase in real GDP over the same period (Figure 1).

Figure 1. China's GDP and annual GDP growth rates from 1995 to 2015. Source: NBS China



China's exceptional growth has, unsurprisingly, spurred the rise of upper middle class and affluent families. According to McKinsey & Company, 63 percent of China's urban population will be considered upper middle class or affluent by 2022.[1] To understand the increase in purchasing power of the Chinese citizens, it should be noted that in 2012, just 17 percent of the urban population was considered upper middle class or affluent. Given the internal political risks in China, it is understandable that these households now seek to diversify their wealth and invest geographically.

Figure 2. Estimated growth of China's middle class inside urban households from 2012 to 2022. Source: McKinsey & Company

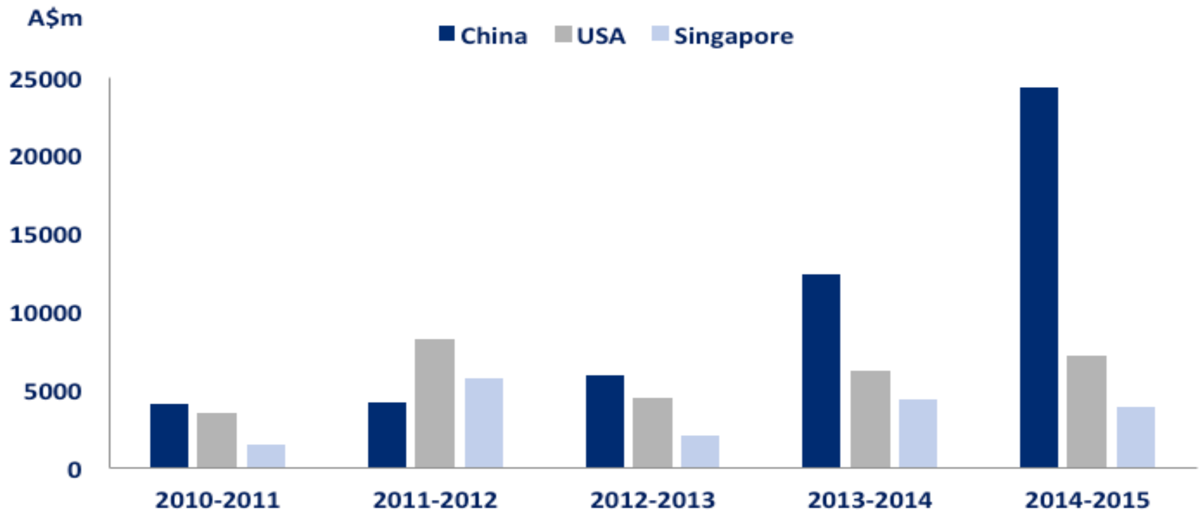


[1]Dominic Barton, Yougang Chen, and Amy Jin. "Mapping China's Middle Class." McKinsey & Company. N.p., June 2013. Web. 18 Jan. 2017.

Australia - An Investment Destination of Choice

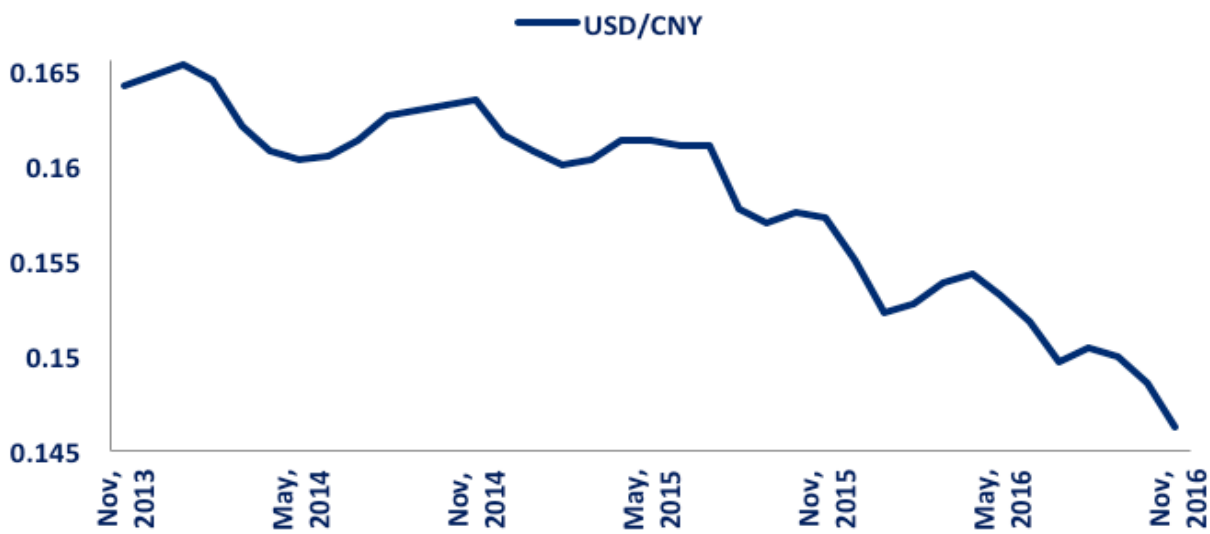
According to the Foreign Investment Review Board,[2] China is Australia's biggest foreign real estate investor, receiving approximately A$24.5bn worth of approvals for investment in Australian residential and commercial property in 2014-2015.

Figure 3. Real estate approvals (A$m) by country of investor. Source: FIRB Annual Reports



Australia has become a very attractive destination for foreign investors thanks to the country's due process and stable government. But for Chinese investors there are two overarching issues that are encouraging outflows of capital. Firstly, the continuing depreciation of the Renminbi has ignited concerns among Chinese businesses and nationals anxious to preserve the value of their domestic savings and assets. China's currency has depreciated more than 6 percent versus the US dollar over the last 12 months. This depreciation is a result of declining economic growth, looser monetary policy and the anxiety associated with domestic debt levels, particularly in the financial services sector. Investment in Australian real estate means offshore earnings in Aussie dollars. Such earnings represent a diversified revenue stream that will increasingly become more valuable should the Renminbi continue its downward trajectory.

Figure 4. Chinese Yuan devaluation against United States Dollar (Nov 2013 – Nov 2016)



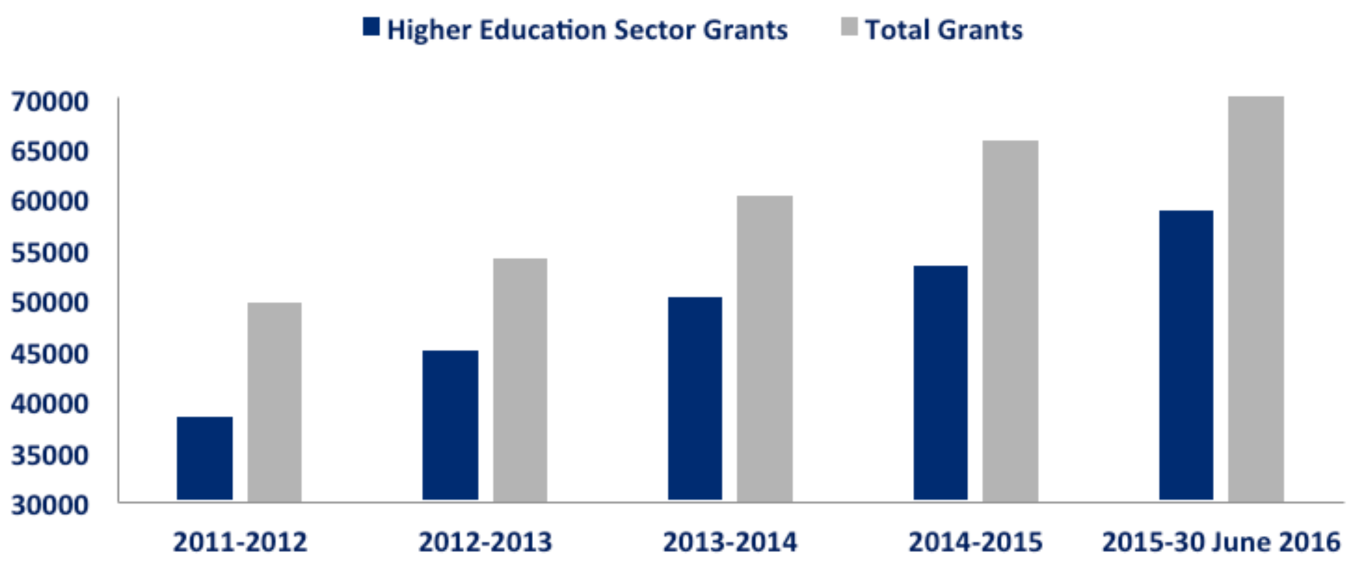
[2]Foreign Investment Review Board. "2014-2015 Annual Report – Foreign Investment Review Board." Firb.gov.au, n.d. Web. 05 Jan. 2017.

Secondly, China has a reputation for uneven enforcement and unequal treatment of its rules and laws. The uneven application of these rules, in terms of who the rules apply to and when those rules apply, contributes to a deep-seated concern that the system is not transparent or fair and that political instability, evident in relatively recent movements such as the Cultural Revolution and Great Leap Forward, remains a clear and present danger. Investing in Australian real estate is considered a value-protecting strategy which allows middle class Chinese nationals to safeguard their wealth from China's uncertain, politically influenced investment climate.

China's concept of land ownership is markedly different when contrasted against the concept of freehold title, which is a defining characteristic of Australian property. When a Chinese purchaser is "buying a home in China", they are effectively purchasing from the government a leasehold interest for a period of time, typically 70 years. Once this period expires, the property 'reverts' back to the government, unless the current holder of the lease is granted a renewed lease. This lack of perpetual ownership rights and the risk arising from the renewal of lease process create significant uncertainty. Unsurprisingly, middle class Chinese nationals find investing in Australian real estate very attractive as title vests in the purchaser in perpetuity.

Australia's education system is a significant drawcard for Chinese investors. Australia's well-ranked universities, as well as the potential graduate career opportunities, have made the country a very popular destination for international students. Chinese nationals now account for almost 30% of international student enrolment. In the last 5 years, there has been a 53% increase in the total number of student visa grants to Chinese nationals. New visa subclasses permitting Chinese pupils to apply for Australian student visas from the age of 6, along with guardian visas for parents to accompany their children, will further encourage Chinese student enrolment. According to Basis Point, an estimated 15 percent of foreign Chinese students buy property in Australia, with an average price of A$700,000. Trident Real Estate Capital expects the new visa subclasses, which considerably simplify the application process, will significantly boost Chinese interest in the Australian housing market in 2017.

Figure 5. The increase in the number of student visa grants for Chinese nationals over the past 5 years. Source: DIBP Study in Australia Statistics

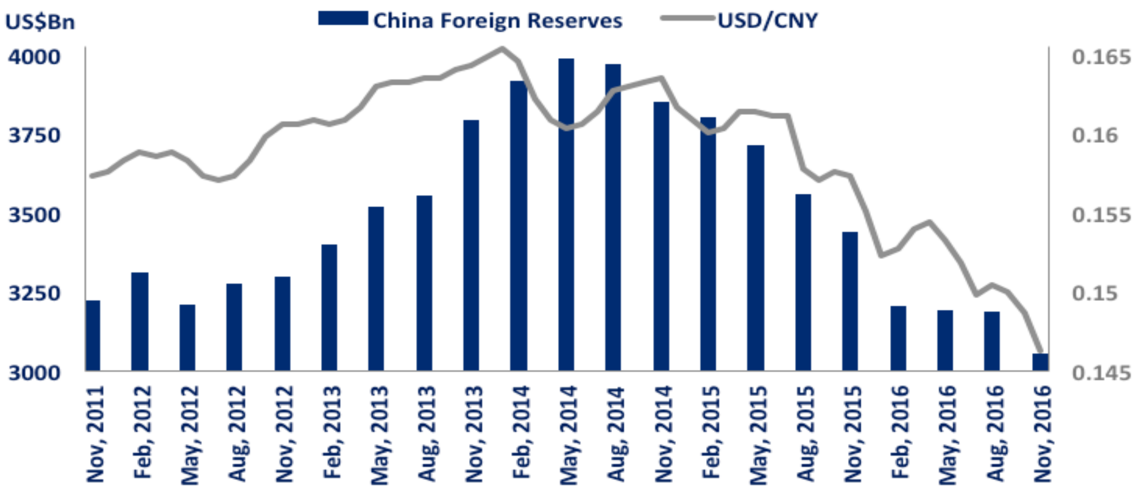


Recent Investment Hurdles

Capital Outflows

Recently, in order to combat the continuing depreciation of the Renminbi, the State Administration of Foreign Exchange has imposed stricter capital outflow restrictions and strengthened punishment for illegal money outflows. China now requires citizens converting yuan into foreign currencies to populate new online forms to provide detailed information on how they plan to use purchased foreign exchange funds. Approved uses of funds are restricted to non-investment uses including tourism, schooling, business travel, and medical care. As a result, nationals have resorted to unconventional methods to overcome the restrictions, managing to move over US$760bn overseas in the first eleven months of 2016.[3]

Figure 6. China's foreign reserves (US$Bn) and the devaluation of the Yuan. Source: The People's Bank of China



One method involves the 'pooling' of foreign exchange quotas. People combine the capital outflow allowances – US$50,000/person/year – of their extended network of family members and friends, raising enough money for the initial deposit required for an off-the-plan apartment.

Currency exchange stores in Hong Kong and Macau are also helping the Chinese subvert capital controls. After opening a Hong Kong / Macau bank account, Chinese nationals visit a currency-exchange shop, where they are provided a mainland China bank account number. Afterwards, these individuals transfer a certain sum from their own mainland bank account to the account number received, and the equivalent in the desired foreign currency is transferred to the Hong Kong / Macau account, from which the money can be easily sent to Australia.

The Chinese shadow banking system is another adjuvant for sending money overseas. After receiving a payment in yuan from a client, an 'underground bank' emits a cheque worth the equivalent sum in the desired foreign currency, drawn from a Hong Kong bank account. The cheque can be then cashed abroad.

In response to the above methods, Chinese authorities have strengthened the current capital outflow restriction measures. These include imposing a daily limit of 100,000 yuan (A$20,000) on cash withdraws with Chinese cards from foreign ATMs, intensifying the scrutiny on the underground channels (Hong Kong and Macau), requiring Chinese nationals to pledge not to use their US$50,000 capital outflow allowance for offshore property purchases and hindering the "pooling" of family and friends' allowances, and stopping further transfers to a foreign account if it received more than $US200,000 in the previous 90 days.[4]

[3]News, Bloomberg. "China Considers Options to Back Yuan, Curb Outflows." Bloomberg.com. Bloomberg, 03 Jan. 2017. Web. 05 Jan. 2017.
[4]Grigg, A. and Murray, L "China Tightens Controls on Moving Money Overseas." Financial Review. N.p., 20 Jan. 2016. Web. 05 Jan. 2017.

Such stringent new measures implemented by the authorities are encouraging Chinese nationals to exploit legal loopholes. One such scheme involves individuals that have ownership in both the Chinese and Australian subsidiaries of a multinational entity arranging the transfer of money. Chinese individuals are required to make a payment in yuan to the mainland bank account of the Chinese subsidiary, which is reimbursed from the Australian subsidiary in Australian dollars to the Australian bank account of the client as an offset loan.

Finance Hurdles and Alternative Financing Solutions

In June 2016, the big four banks ceased to consider foreign home loan applications for applicants who did not have an existing Australian income. This action was partly as a result of the difficulty in assessing the creditworthiness and income sources of overseas buyers and partly as a result of Australian banks tightening their lending standards for non-residents in response to the RBA's Financial Stability Review April 2016 and APRA's capital requirements.

This behavior by the big four banks has opened the market to non-bank lending institutions, as Chinese nationals seek alternative financing options. Trident Real Estate is aware of three separate financing options for Chinese investors[5]:

ALTERNATIVE FINANCING OPTIONS

Non-Bank institutions lending to foreign Chinese investors

Option	1	2	3
Source	• Australian	• Singaporean	• Australian/Chinese
Documentation	• Low	• High	• Medium
Interest Rate	• 8-12%	• 4-5%	• 8-10%
Origination	• 2-3%	• 4-5%	• 2-3%
Loan-to-Value Ratio	• At most 70%	• 70%	• At most 75%

The first option is offered by Australian funds that have been set up for the purpose of servicing Chinese foreign nationals. These funds generally require clients to provide only their passport and the property title to secure the loan. Two examples of such funds are Prime Capital and Development Finance Partners, the latter lending up to A$5m only for Sydney, Melbourne and Brisbane purchases.

The second option is financed through Singaporean capital which is quasi-government related. It requires documentation similar to the big four banks including payment slips, employment letters and independent valuations, inter alia, however, this option will only extend to properties that are located within 10kms from Sydney and Melbourne's CBDs.

The third option is through online Australian groups structured as special purpose vehicles funded with Chinese capital. The required documentation for this avenue of funding is moderate with no geographic restrictions.

The abovementioned funds, offering differing avenues of finance for offshore buyers, prefer to keep a low profile and are difficult for Chinese investors to identify for three main reasons. Firstly, to protect the identity of their clients from the Chinese Authorities. Secondly, to avoid the additional regulatory burden from regulatory authorities. Lastly, to prevent an uncontrolled increase in the number of clients, which would cause a sharp rise in administrative costs.

Please contact Trident Real Estate Capital for a referral should you be interested in alternative finance.

[5] Johnson, CT. "Residential Mortgage Financing Options for Offshore Buyers." Development Finance Partners. HR Assured, 29 Nov. 2016. Web. 05 Jan. 2017.

Introduction of New Taxes on Foreign Purchasers

The introduction of stamp duty surcharges on property purchases made by foreigners (NSW: 4%, VIC: 7%), and of land tax surcharges (NSW: 0.75%, VIC: 1.5% from 1 January 2017), at first glance, may be argued to reduce the attractiveness of Sydney and Melbourne's property markets. However, it should be noted that other cities, popular among Chinese investors, have for some time levied stamp duty surcharges on foreigners: Singapore – 15% (2013), Hong Kong – 30% (2016), Vancouver – 15% (2016). When compared to other international destinations of foreign capital, the Australian property market remains competitive and attractive. Trident Real Estate Capital does not expect foreign demand for Australian real estate to be discouraged as a result of the recent introduction of stamp duty and land tax.

Settlement Risk

For the next 12 to 18 months, Chinese investors will struggle as a result of the stricter capital outflow restrictions and the availability of finance. These barriers will impact all sectors that depend on Chinese investment, including real estate.

Trident Real Estate Capital believes that developers should be aware of the heightened settlement risk arising from selling off-the-plan units to Chinese buyers and may consider some of the following appropriate measures to mitigate any potential cash flow concerns:

1. Extending settlement periods. Settlement risk may arise as a result of very short notice periods provided to off the plan purchasers to complete a contract for sale. It is customary for a purchaser to be required to complete within 14 days following the registration of a strata plan or the service of an occupation certificate. Securing finance may take up to 2 months for Chinese buyers. A solution may be to extend the settlement period to allow the Chinese purchaser to put into place the necessary arrangements to raise the finance required.

2. Offering vendor loans. Vendor finance typically involves the vendor receiving a small deposit from the purchaser on exchange and then the rest of the purchase price is agreed to be paid at some later date. This sort of finance may be structured in a number of ways including a long term mortgage backed loan, or in the form of a bridge loan which provides finance until the purchaser secures a mortgage from a bank or even a lease option arrangement. Meriton's finance arm offers vendor finance for an interest rate that varies between 5%-7%, for a maximum two year period with a loan to value ratio of 90% of the purchase price on a 2 year fixed interest only loan, with no valuations, no mortgage insurance requirements, and no early payout penalty fees. Meriton's financial service arm makes its apartments very attractive for international buyers.

3. Loan covenants. Ordinarily, developers seeking construction finance are restricted by loan covenants which cap foreign domiciled purchasers (net of GST and selling costs) to 15% of the bank funded debt. In addition, banks may also cap foreign ownership in new developments to 20% of the apartment stock. Such measures are introduced by banking institutions to reduce a developer's overall reliance on foreign capital to secure domestic finance.

4. Regulatory changes. The Government intends to make amendments under the investment framework, allowing developers to sell to foreign purchasers off-the-plan dwellings that have returned to the market as a result of a failed settlement. These dwellings, instead of being considered 'established' after settlement failure, will keep their status as 'new dwellings' for the purposes of foreign investment rules. While these regulatory amendments are welcome, they do little to address the underlying reasons that are resulting in foreign nationals failing to settle.

Impact on Australia

Trident Real Estate Capital believes that in 2017 a reduction in off-the-plan real estate purchases by Chinese overseas investors is inevitable, unless alternative financing options become more readily available and/or the Renminbi significantly appreciates, allowing China to relax its capital outflow restrictions.

The anticipated reduction in Chinese demand will impact apartment prices in inner city Melbourne, Brisbane and Sydney as well as certain locations on the transport spines of Western Sydney, areas where Chinese buyers have a particular investment preference. These locations are further made vulnerable as a result of the surge of high rise construction activity in these areas. Property research firm CoreLogic notes that around 230,000 apartments are due to be completed across all Australian capital cities by 2018. In addition, the practice of buying off-the-plan increases the risk of price declines should a large volume of apartments return to the market in the event that the original purchasers fail to settle.

Outside of the inner-city geographic areas, the Chinese have relatively little influence. Trident Real Estate believes that any reduction in Chinese demand will have little impact on these outer suburb property prices. In fact, FIRB's approval figures for all non-residents applying to purchase residential property provide strong evidence that the Chinese only account for a small part of the acquisitions in the Australian residential property sector.

Figure 7. Chinese approvals compared to total real estate approvals for non-residents. Source: FIRB Annual Reports

According to the RBA, Australian-owned banks engage in some lending to foreign households to purchase Australian property, but the amounts are small relative to their mortgage books. Nevertheless, the RBA has noted if Chinese demand was to decline significantly in 2017, such a decline may weigh on domestic property prices and so lead to losses on the Australia banking system's broader property-related exposures.[6]

Trident Real Estate Capital does not believe that Australia is at risk of a significant decline in Chinese real estate investment. China's stricter capital outflow restrictions and the reluctance of the big four Australian banks to lend to foreigners are all factors that would typically materially reduce Chinese demand for Australian real estate. Yet these factors must be tempered against (1) the continuing depreciation of the Renminbi, adding impetus to the desire to expatriate funds, (2) a deep-seated concern that the Chinese system is not transparent or fair and that political instability may at any time threaten the accumulated wealth of Chinese companies and individuals, and (3) the growing tension between China and the US fueled by President Donald Trump, which may refocus Chinese funds, initially earmarked for US property investments, to friendlier English speaking countries such as Australia.

[6]Reserve Bank of Australia. "Financial Stability Review – April 2016 Box B: Chinese Demand for Australian Property." Reserve Bank of Australia. N.p., Apr. 2016. Web. 08 Jan. 2017.

Chinese authorities must be conscious that if they continue to implement policies that restrict capital outflows, especially in areas that may affect common households, such behaviour will contribute to the deep-seated public concern that the government is not being transparent or fair and may paradoxically prompt more outflows through channels that are difficult to effectively regulate.

Our Team

Trident Real Estate Capital is a real estate investment and advisory firm which is active in the Australian commercial and residential property market. We draw upon 30 years of real estate market experience and utilise an advanced suite of property data and analytical tools to provide client tailored specialist real estate advice including market assessments and forecasts, due diligence and location analysis to a variety of corporate, investor and institutional clients.

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