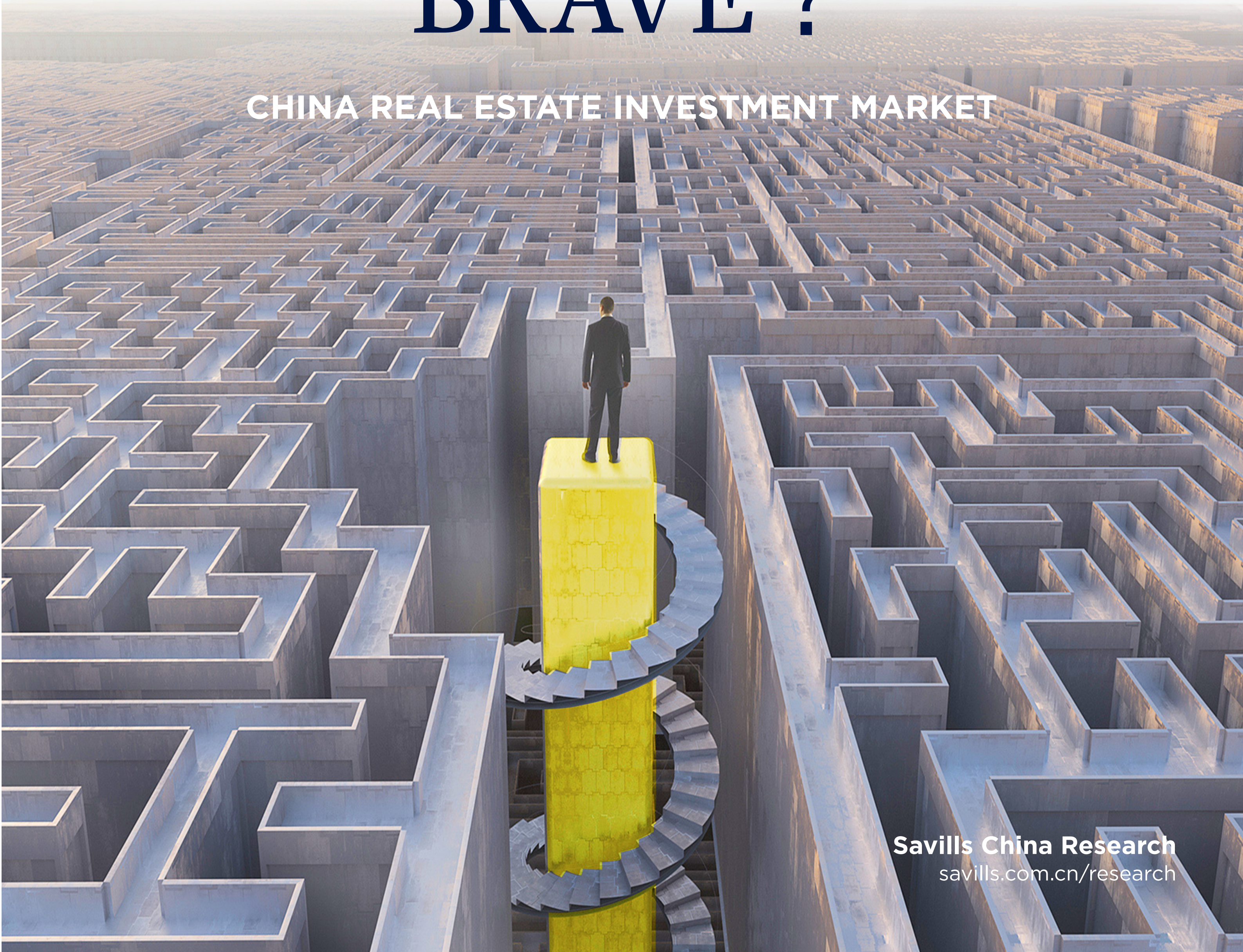
SPOTLIGHT | 2019

A CHANGING MARKET A TIME TO BE BRAVE ?

CHINA REAL ESTATE INVESTMENT MARKET



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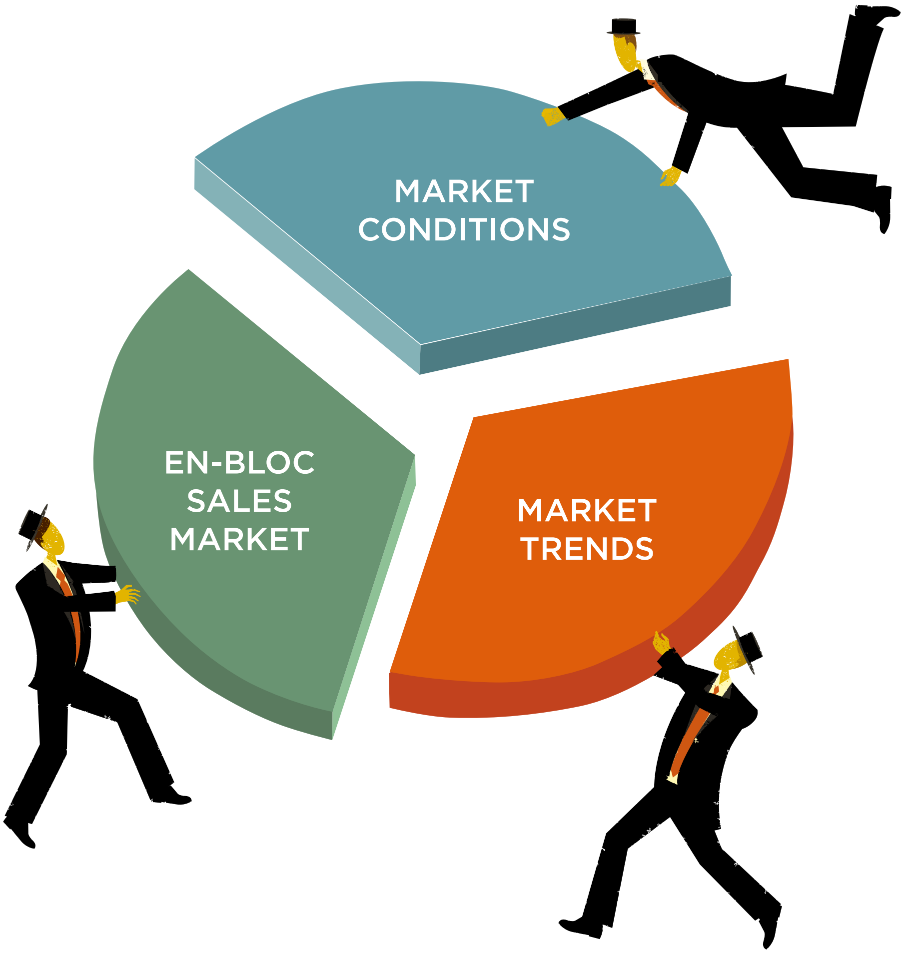


Welcome to our inaugural Savills China Investment Report.

In this report, we will look at the investment market by examining the country's financial environment and the performance of other key investment classes, review China-wide investment performance including platform investment and niche market investments and talk about some themes and featured topics in the market.

The activity and profile of investors in China's property market has changed significantly since the Chinese government imposed deleveraging policies from the end of 2016. Domestic buyers are facing big challenges in getting loans amidst rising financing costs, which is giving foreign investors a window of opportunity. While Tier-1 cities remain the most attractive investment destinations for most investors, some fast-growing Tier-2 cities, with their strong potential, are also appealing to investors. In addition, niche markets are getting more attention as they offer higher yields, greater growth potential and less competition.

We hope you find this publication on China's investment market an informative and insightful read. We look forward to your feedback.

JAMES MACDONALD

Head of Research, Savills China

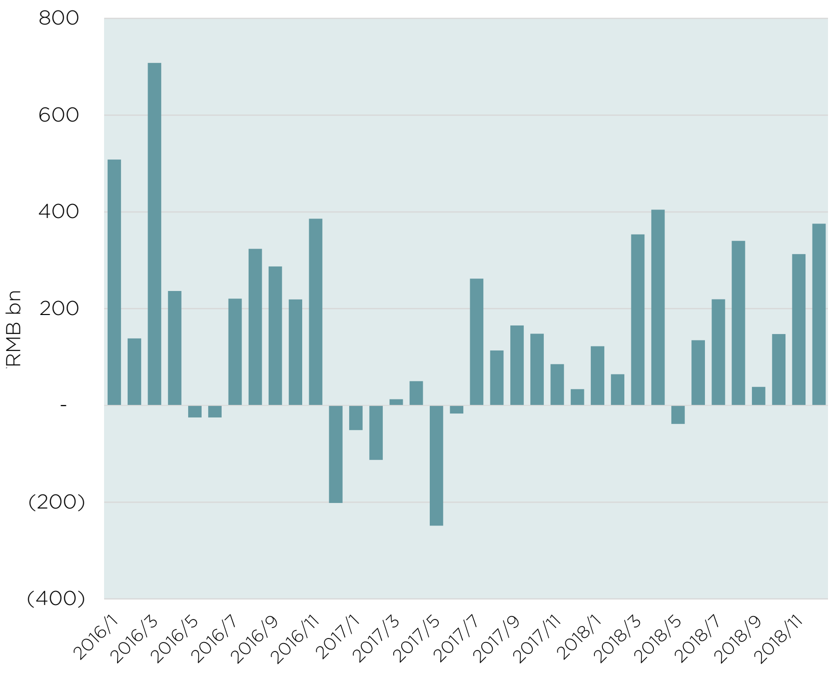
Credit Becoming Increasingly Scarce

The Chinese economy has seen increasing levels of corporate and personal debt since the Global Financial Crisis (GFC) of 2008. Years of highly leveraged, large investment projects stimulated the double-digit growth in China's GDP figure. From the end of 2016, however, the government started introducing a series of measures to deleverage the economy, including clamping down on the shadow-banking sector and raising the bar on onshore bond issuance. Private companies have been hit the hardest by the financial de-risking; in the first five months of 2018, 13 companies defaulted on about 20 bonds, worth a combined RMB14.8 bn. Both the number of defaults and their combined value were significantly higher than corresponding figures from the previous year. Since the second half of 2018, China has been relaxing its deleveraging effort—partially due to the pressure from the trade war with the U.S.—by taking measures such as cutting reserve requirement ratios for banks and increasing the issuance of onshore bonds. However, larger companies and SOEs are more likely to have access to this line of credit than smaller enterprises.

In the real estate world, developers—especially small-to-medium sized ones—are having difficulties accessing capital and are turning to more expensive sources of capital such as offshore debt and mezzanine loans. Overseas debt for listed Chinese developers reached RMB99.6 bn during the first four months of 2018, with the average cost gaining over 100 basis points to 6.98% from 2017, according to the China Index Academy. Additionally, developers are also struggling with slower sales volumes resulting from government housing-purchase restrictions and rising mortgage rates. To make matters worse, Zhongshan was the first city to ban pre-sales—a policy that is rumoured to be implemented across China in the future. Pre-sales are now the most important source of financing for developers, so if a ban on pre-sales were to be implemented retroactively, it would be disastrous for developers. Chinese developers have significant refinancing pressures to deal with as the sector faces a record US$23 bn maturity wall in Q1/2019 or as much as US$43 bn if bond investors demand early repayment of some notes.

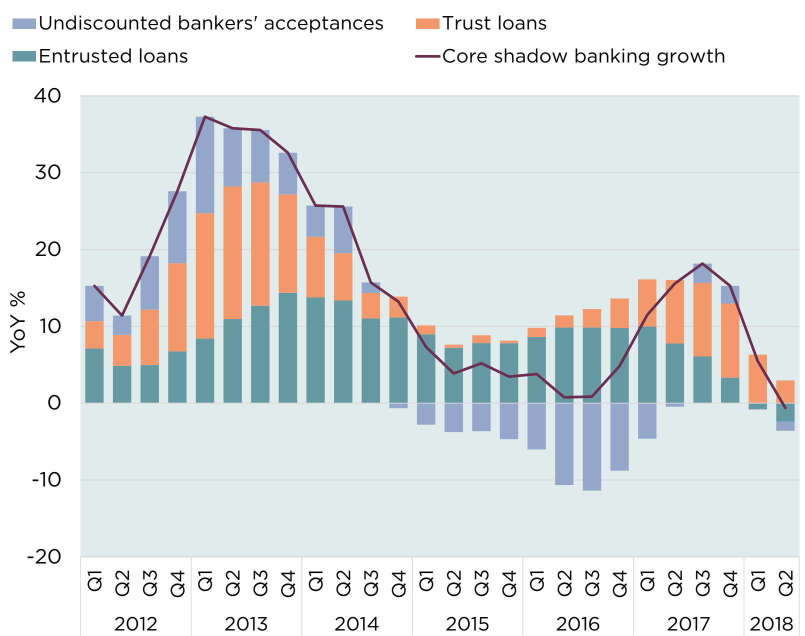
In 1H/2018, Chinese developers' ability to service their debt was at its weakest level in three years. Cash-to-short-debt levels at more than 80 publicly-traded real estate companies tracked by Bloomberg were 133% on average in the first half, the worst since the first six months of 2015 and down from 297% a year earlier. Almost a quarter of developers saw a ratio below 50% in 1H/2018.

Net Financing Of Onshore Corporate Bonds，2016 - 2018



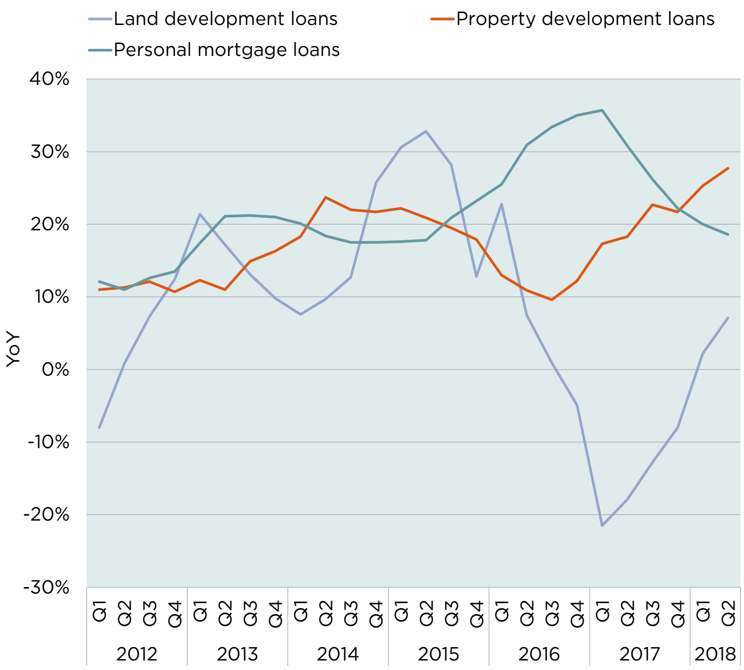
Source PBOC, Savills Research

Shadow Banking Crackdown, 2012–Q2/2018



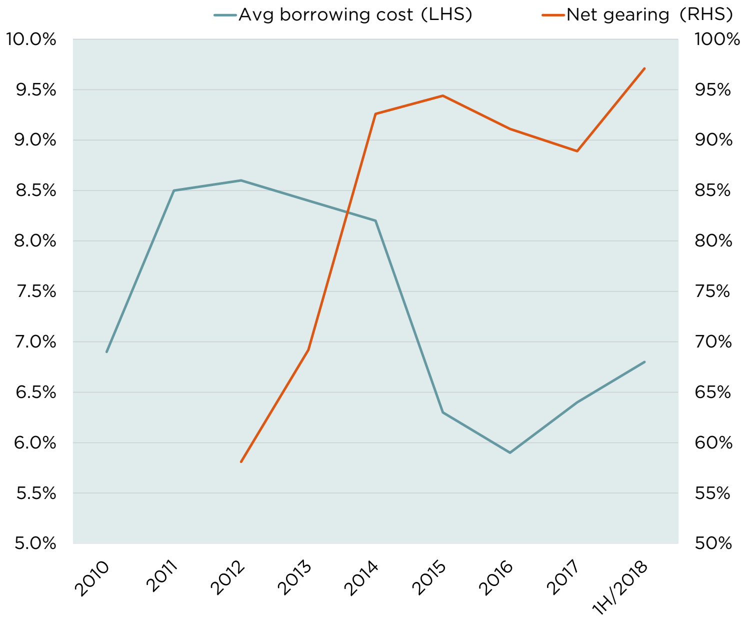
Source Moody's Investors Service, PBOC, Savills Research

Loans To Real Estate Sector Growth Rate, 2012–Q2/2018



Source PBOC, Moody's Investors Service, Savills Research

China Property Developer Average Borrowing Cost And Net Gearing, 2010 - 1H/2018



Source Citi Bank, Savills Research

Bright Spot

China's pension funds have significant potential. From 2012, when China's National Council for Social Security Fund (NCSSF) began to oversee local pension funds for Guangdong province, to July 2018, when NCSSF took over RMB130 bn of local pension funds in Shanghai and Sichuan, 14 local governments have contracted NCSSF to oversee RMB585 bn, of which the Council itself had invested RMB371.6 bn by the end of the June 2018. The government will continue to encourage more regions to put pension funds into investments and will strengthen risk management to secure long-term and stable investment returns. Pension funds are a major source for stable core assets in mature markets such as the US, Singapore and Canada. As pension fund investments are increasingly regulated, and more supportive policies are released, we expect China's pension funds to play a bigger role in China's commercial real estate market.

Insurance capital also has plenty of room to increase allocation to real estate. Insurance companies have pulled in enormous amounts of cash after a round of deregulation in 2015 that paved the way for the proliferation of universal insurance policies. Insurers held RMB17.6 tn in assets as of 1H/2018. Chinese regulations allow up to 30% of total assets to be invested in real estate and 15% into overseas investments, however only a very small amount of insurance money is currently deployed in real estate. During "Ping An Open Day", Dexian Chen, Chief Investment Officer of Ping An Group, mentioned that Ping An Insurance plans to raise its future real estate allocation from the current 2% to 10%. As with pension funds, insurance money will have a big impact on the core market if its full potential is released.

REITs are on the horizon. In 2018, the China Securities Regulatory Commission and the country's housing ministry released documents to encourage the securitisation of rental projects. Though most of China's current security products are debt in nature, collaterised by assets without any true sale of equity, many people are speculating that publicly traded REITs are on the horizon. A Peking University report estimated that if legal and tax barriers were removed, China's REIT market could surpass US REITs in terms of market size, creating an important exit for investors.

Is The NPL Market Becoming More Appealing?

China has supported a fairly loose credit environment since the Global Financial Crisis (GFC) in 2008 in an attempt to shore up and stabilise economic growth rates. This has led to a steady growth in debt levels as a percentage of GDP in the non-financial sector. According to the Bank of International Settlements (BIS), non-financial corporate debt to GDP grew from 96.3% in Q1/2009 to 164.1% in Q1/2018.

While China's outstanding loans within the domestic banking sectors totalled RMB120 trillion by the end of 2017, up by 12% YoY, China's economy is faced with slower growth as its economy matures. The GDP growth rate has fallen from 14.2% since 2007 to 6.8% in 1H/2018. Additionally, greater oversight and controls in the offshore and onshore corporate bond market and a slowdown in residential sales have created extra issues for developers in rolling over debt.

In this environment, China's non-performing loan (NPL) market has grown quickly. According to a PwC report, outstanding bad loans from commercial banks amounted to around RMB2 trillion by 1H/2018, up from RMB646 billion in Q1/2014. Additionally, "special mention loans", part of which can be classified as NPL under international standards, are both significant and expanding. Fitch estimated that the real total amount of NPLs could be RMB19 trillion.

Chinese commercial banks are under a lot of pressure from the government to better manage and process their NPLs and clean their balance sheets. In early 2017, the China Bank Regulatory Commission (CBRC) issued a set of new rules aimed at controlling a broad range of risks in the financial system, including requiring banks to strengthen credit risk management (including NPLs) and widen channels, and accelerate NPL disposal. China's NPL market has experienced big changes in the past six months as Asset Management Companies (AMCs) have been more active in buying and selling and the market has seen more portfolio deals with higher IRR. In general, the unleveraged IRR of China's NPL portfolio could reach 12%-15% and increase to 17%-22% with 50%-60% leverage according to PwC.

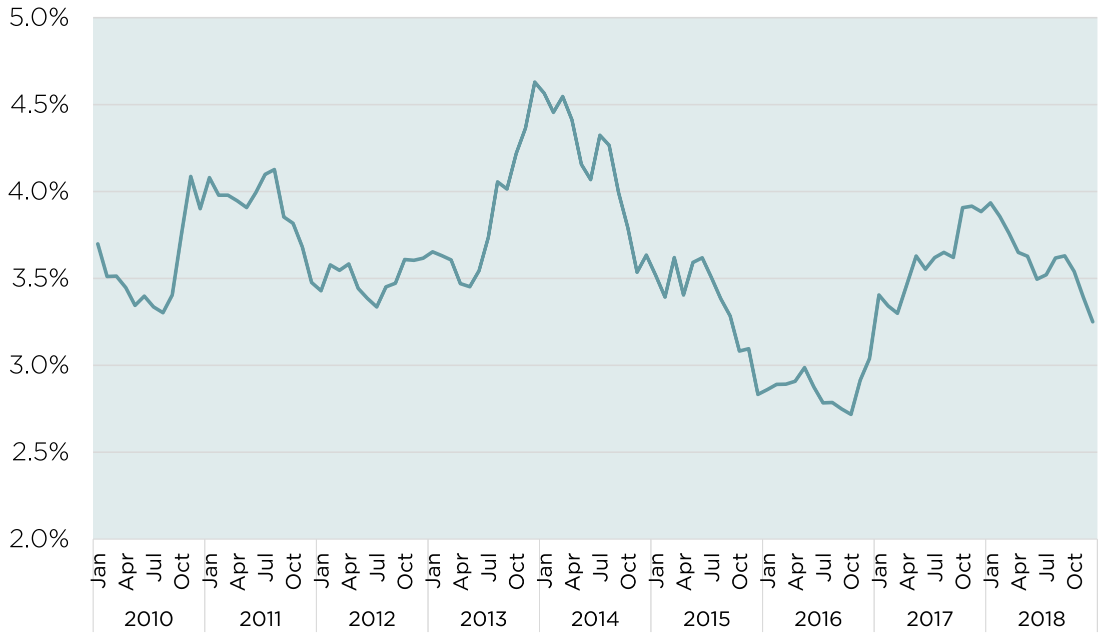
The growing China NPL market is becoming increasingly appealing for international investors. Investors active in the market include Goldman Sachs, Blackstone, Bain Capital, Lone Star, PAG, ShoreVest Capital, Oaktree Capital and KKR. Most of the time, buying NPLs in China is about real estate. The typical deal size of a China NPL portfolio for foreign investors is around US$100 mn, a significant increase from two years ago. International NPL investors are looking for bigger and bigger portfolios because smaller ones come with a lot more competition from domestic investors.

Despite interest in the NPL market from a number of investors, many challenges remain. The biggest challenges include a general lack of sophistication and maturity in the market, unrealistic pricing expectations, and a lack of transparency and liquidity where assets are becoming available. Additionally, because of the unique structure of Chinese banks, the procedure for acquiring NPLs could involve prolonged legal battles in local courtrooms. At the same time, investors are also facing competition from new, alternative channels of NPL disposal, such as the 14 separate issuances of NPL ABSs in 2016.

Bonds

China's ten-year bond yield has been on a downward trend since the end of 2017. However, in the long run, China bonds look attractive from a total return perspective as well as a macro standpoint as they can also provide investors with exposure to the world's second-largest economy. China has been opening up its bond market over the last several years—notably with its inclusion, starting from April 2019, in the Bloomberg Barclays Global Aggregate Bond Index—which has led to a marked increase in foreign holdings of local bonds. As Beijing pulls down the barriers, foreign holdings in Chinese bonds are expected to increase in the future.

Ten-Year China Treasury Bond Spot Yield, 2010–2018



Source CEIC, Savills Research

Stocks

Chinese stocks took a hit in 2018 partly due to the uncertainties over Beijing's trade relations with the U.S. Both the SSE Composite Index and the SZSE Component Index have lost one-quarter of their value from previous highs in the same year. Though the financial reports of many listed developers looked fairly promising, with rising revenue and profits, the stock price of most of them dropped significantly in 2018. For example, the stock prices of Vanke and Greenland have decreased by around 20% and around 10% year-on-year (YoY), respectively, from the end of 2017. The reason for the difference between financial performance and stock price is that stock prices usually reflect the outlook for the company and the industry as a whole despite what the balance sheet says. In the long run, many people are expecting a rally as A shares were included in the MSCI Emerging Markets Index and as the government has been taking supportive steps such as IPO reform, asset management reform and the issuance of China depository receipts.

How China Stacks Up Against The Rest Of Asia

Key Asian Cities En-Bloc Transaction Volume and Ranking

2016	2017	2018	CITIES	TRANSACTION VOLUME (RMB mn)	YoY CHANGE
3	1	1	Hong Kong	187,531	20%
5	5	2	Seoul	132,601	60%
1	2	3	Tokyo	107,091	-17%
4	4	4	Sydney	85,536	-2%
2	3	5	Shanghai	72,048	-31%
7	6	6	Singapore	55,215	-14%
8	7	7	Melbourne	46,526	-9%
6	8	8	Beijing	39,769	18%
10	10	9	Brisbane	27,767	-17%
9	11	10	Osaka	18,984	-39%
17	19	11	Taipei	17,565	115%
20	16	12	Auckland	12,239	-23%
31	14	13	Guangzhou	11,001	-20%
19	9	14	Yokohama	10,938	-67%
15	18	15	Perth	10,807	23%
13	54	16	Mumbai	9,304	568%
51	26	17	Bangkok	7,865	72%
14	29	18	Fukuoka	6,928	39%
24	30	19	Tianjin	6,211	68%
18	22	20	Chongqing	5,509	-6%
27	28	21	Adelaide	5,112	-10%
30	21	22	Saitama	3,953	-37%
46	—	23	Dalian	3.670	0%
32	53	24	Xi'an	2,871	98%
21	25	25	Nagoya	2,550	-51%

Source RCA, Savills Research

Asia Pacific's real estate markets faced rising headwinds in 2018—the impending trade war, rising interest rates and tighter access to credit. Transaction volume in Asia Pacific in 2018 reached RMB1,108 bn, down by 6% YoY according to RCA. Hong Kong, Seoul, Tokyo, and Sydney recorded the highest sales volume in 2018. Mumbai, India—the fastest expanding market among Asian cities—witnessed the biggest YoY growth in sales volume among key Asian cities. Boosted by a few big deals, Taipei and a couple of Chinese mainland cities including Xi'an and Tianjin also saw strong growth in transaction volume, supporting the regional total. Meanwhile, Shanghai and Singapore showed downward movements.

Each Asian city has its own unique geographical, cultural, economic and social characteristics. For example, investing in Hong Kong and Singapore is mainly a bet on their continuing growth in financial services. Hong Kong is a conduit for China's relatively closed capital market and Singapore is the historical banking hub for Southeast Asia. Tokyo maintains a strong business concentration as a large number of major domestic and international companies reside there. India's economy is expected to grow at a fast pace backed by its growing IT industry and a raft of legislative changes designed to further open its market. India is expected to launch its first REIT IPO in 2019, which has huge potential as it offers an exit for private equity investors.

EMERGING MARKETS

- High capital value growth
- Strong economic growth
- Volatile market with inflation risk
- Currency fluctuation

Examples: **India, Philippines, Indonesia**

CORE MARKETS

- Positive yield spread
- High liquidity
- High transparency
- Good governance
- Secure market
- Stable currency risk

Examples: **Japan, Hong Kong, Australia, Singapore, South Korea**

Is China a core market or an emerging market?

There were positives for both core markets and emerging markets in the investment climate of 2018. China still has a negative yield spread and comparatively low liquidity and transparency. Capital values there have reached significantly high levels, so there is no foreseeable sharp capital value increase expected in the next couple of years. In addition, China is striving for a stable and more sustainable GDP growth. For investors, however, China is still a market in which they want to allocate capital, so as not to miss the growth of this huge economy.

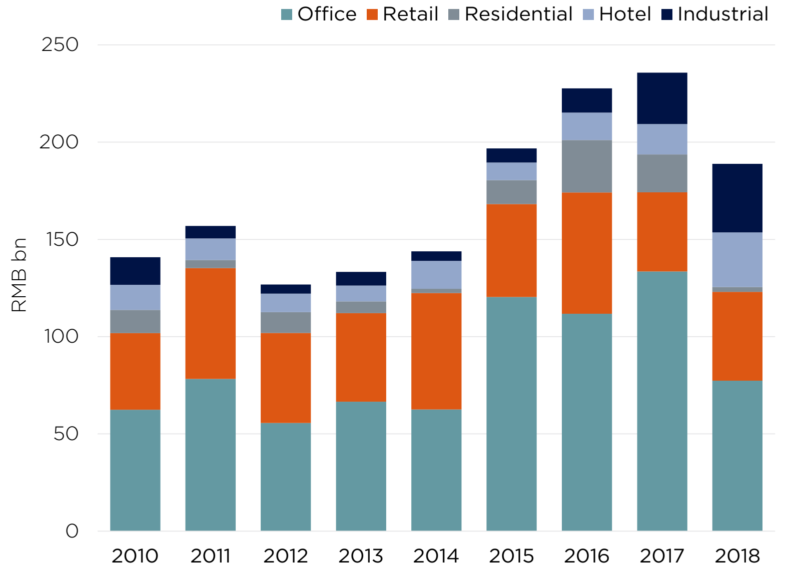
EN-BLOC SALES MARKET

Overall, the China commercial real estate investment market was slow in 2018. Total consideration for income-producing properties that were worth more than RMB100 million was RMB189bn, down by 20% YoY. Office remains a popular asset class given its high liquidity and transparency while the most active markets for investments remain in Tier-1 cities and fast-growing Tier-2 cities such as Chongqing, Hangzhou, Wuhan, Chengdu and Xi'an. The volume of retail investments remained stable with most of the big deals focused on Tier-1 cities.

In the hotel sector, R&F Properties concluded the purchase of a portfolio of 74 hotels from Dalian Wanda for RMB18.9 bn in early 2018. Outside of that deal, total consideration for hotel assets was down by 42% YoY. The market still saw interest in hotel properties with conversion potential, but this strategy is proving problematic as supply is limited. Based on hotel design, land permits and market demand, hotels are usually converted into for-leasing apartments or offices. For example, Beijing has concluded a number of hotel deals in which the hotels transacted are being converted to offices. As the new supply of office space in centralised areas is very limited in Beijing, underperforming hotels located in core areas are well-received by the market once converted into offices. But with hotel fundamentals improving—due to increased Average Daily Rates (ADRs) and supply growth backed by rising disposable income and expanding tourism needs—some investors are starting to look at the hotel market and investing and operating hotels.

In the industrial sector, a consortium led by China Vanke, Hillhouse Capital Management and Hopu Investment Management concluded the buyout of Global Logistics Properties Ltd (GLP) for RMB19.9 bn in 2018. Without that acquisition, however, the volume of industrial deals saw a decrease of around 40% YoY; the decrease was also driven by limited supply rather than lack of demand. With strong fundamentals, investors are still actively searching for industrial properties because of their rental growth potential and comparatively high yields.

Transaction Volumes By Asset Type, 2010-2018



Source RCA, Savills Research

Key Transactions (Excludes Portfolio Investment) In 2018

NAME	CITY	ASSET TYPE	DATE	PRICE (RMB MN)	BUYER
Harbor 55	Shanghai	Mixed-use	2018-Q4	20,500	CapitaLand
Pacific Century Place	Beijing	Mixed-use	2018-Q4	10,500	Beijing Yuanjing Mingde Management & Consulting Co
Mapletree Business City	Shanghai	Mixed-use	2018-Q4	11,000	Blackstone
Rock Square	Guangzhou	Retail	2018-Q1	3,341	CapitaLand
Ocean Tower	Shanghai	Office	2018-Q4	3,000	Gaw Capital, Quadreal Property
Beijing Jingtong Roosevelt Plaza	Beijing	Retail	2018-Q4	2,560	Link REIT
Fangheng Fashion Center	Beijing	Office	2018-Q4	2,229	Byte Dance (Toutiao)
Clifford Group Building	Guangzhou	Office	2018-Q1	1,487	Clifford Group China
Dalian Xiwang Tower	Dalian	Office	2018-Q1	1,182	China Life
Flourish Center Tower A	Xi'an	Mixed-use	2018-Q1	1,010	China Life

Source RCA, Savills Research

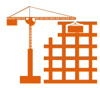
Buyer Analysis

PE Fund

Foreign funds which used to be outbid by domestic investors are expected to fill the funding gap in China in 2019.

Institutional Buyer

Long-term institutional investors place value on stable cash flow and capital value growth in China.



Developer

Big developers are having more advantages in acquisitions given their financing abilities.

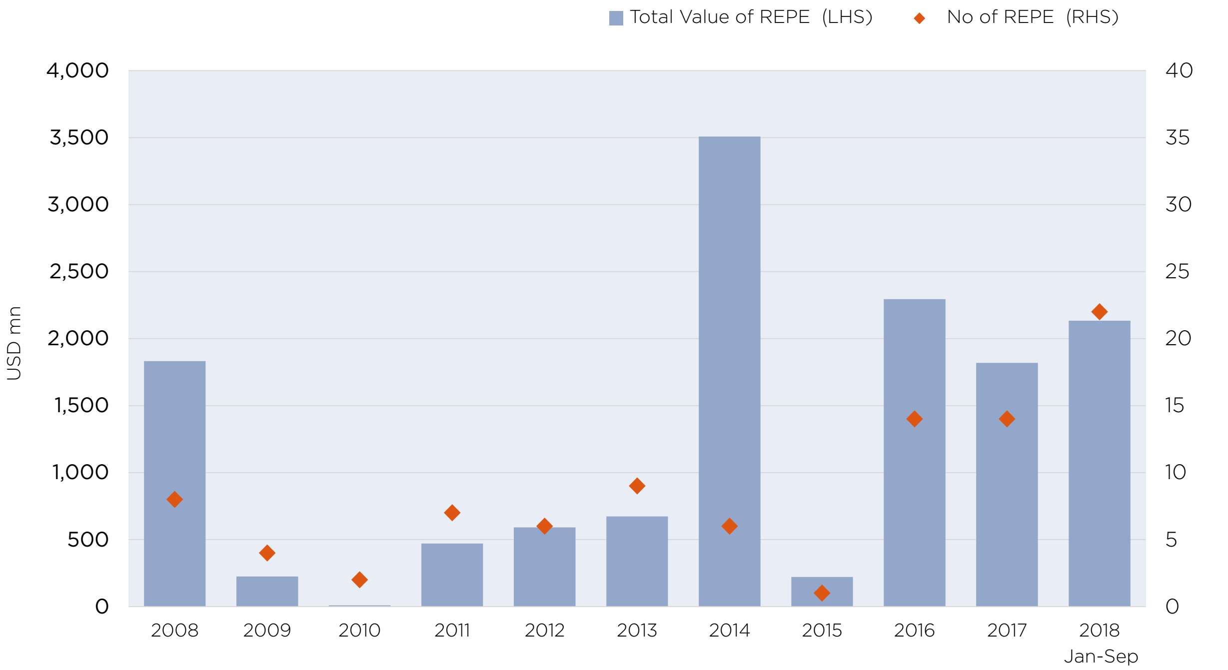
Corporation

Demand for self-use remains strong.

China has maintained a fairly loose credit environment since the GFC in 2008 in an attempt to shore up and stabilise economic growth rates. Until the end of 2016, Chinese developers and local PE funds had access to plentiful sources of capital at comparatively low costs, and therefore were the major buyers of commercial real estate in China. They tended to make short-term investments that relied on high leverage. However, such a strategy is getting harder to execute under the tightened credit environment. By September 2018, China Real Estate PE funds had increased 17% from 2017 full year to a total value of US$2.1 bn. However, the size of the China Real Estate PE funds shrank sharply in 2018 causing average fund size to go down by around a quarter YoY.

On the other hand, foreign funds, which used to be outbid by domestic investors, are expected to fill the funding gap in China. In the next 12-18 months, international private equity funds should become more active in the market, potentially in the form of JVs with local developers or SOEs. According to a PERE 2018 report, there are nine China-based international PE funds in the market with a total size of US$3.83 bn.

Number And Total Value Of China Real Estate PE, 2008–Sep. 2018



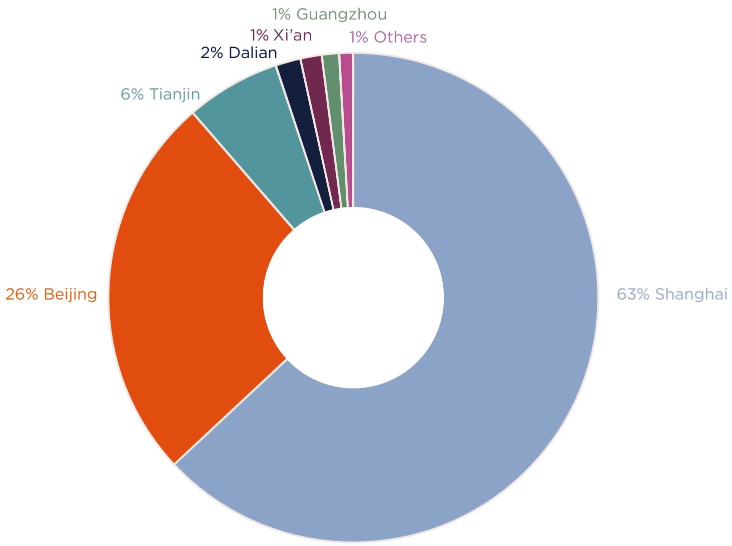
Source CEIC, ChinaVenture, Savills Research

Insurance companies remain a consistent buyer of core assets that provide long-term stable cash flows with limited risk. In addition to core assets, insurance companies also acquired headquarter buildings, senior-housing assets and development projects via trust funds. Insurance money is behind many eye-catching deals such as China Life's purchase of Century Link with ARA Fund Management for RMB20 bn. In 2018, new regulations were released to allow domestic insurance capital into the leasing market. In principle, insurance capital is encouraged to invest in stable properties for long-term holdings, and is prohibited from profiting from residential or risky investment projects. According to RCA data, in the last five years insurance companies targeted stable office assets in Tier-1 cities with an average deal size of over RMB1 bn. Active insurance companies include China Life Insurance, Shanghai Life Insurance, Huaxia Life Insurance and Ping An Insurance.

Other institutional investors with sufficient capital stock—including pension funds and sovereign wealth funds—are also expected to be more active in the current market with a focus on core assets that have limited risk and an investment horizon of five-to-ten years. Such long-term investors place value on stable cash flow and capital value growth in China in the comparatively long run, so they are more willing to put in more CapEx to extract the most out of the assets.

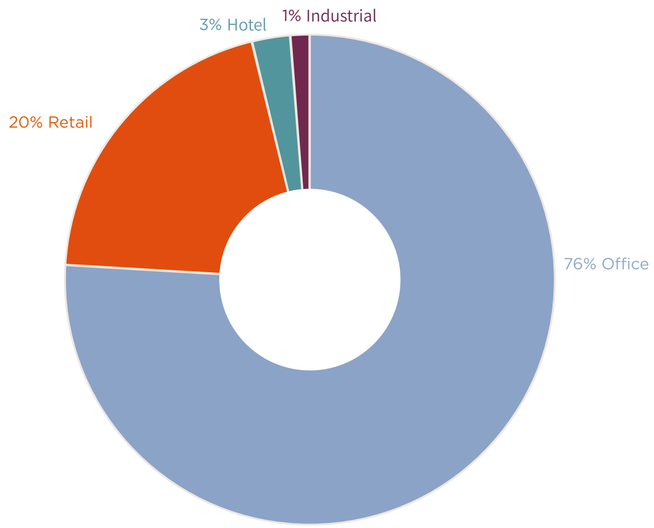
Lastly, corporations are also buying office properties for self-use. These corporations' core businesses are usually unrelated to the real estate industry. Based on the type of company, they sometimes require naming rights and locations associated with their industry cluster. Technology companies that are developing rapidly in China tend to purchase real estate when they reach a certain scale—such as post-IPO. In addition, SOEs are big buyers of core assets for self-use in Beijing, and most of those deals are conducted through connections with no brokers.

Insurance Buyer Purchases Breakdown By Key Cities, 2016–2018



Source RCA, Savills Research

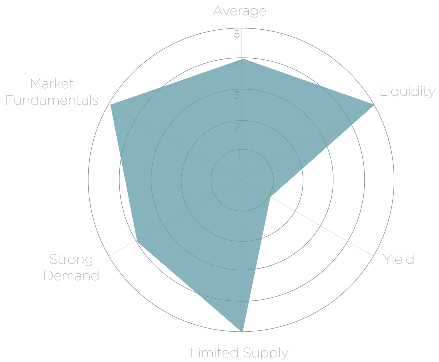
Insurance Buyer Purchases Breakdown By Asset Types, 2016–2018



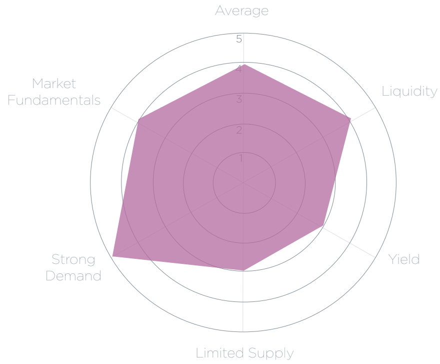
Source RCA, Savills Research

Investment Strategy

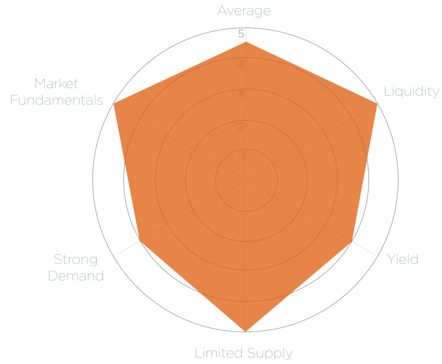
Investment strategies change over time, and investors often choose a strategy based on their risk profile.



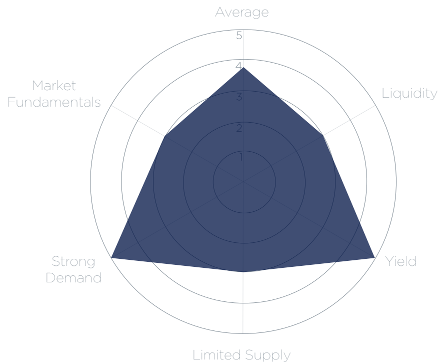
Premium Grade A Offices In Tier-1 Cities



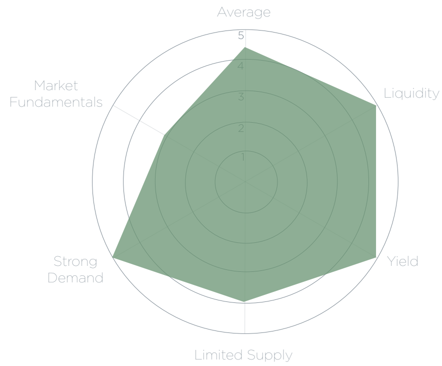
Grade A Offices In Emerging Decentralised Areas



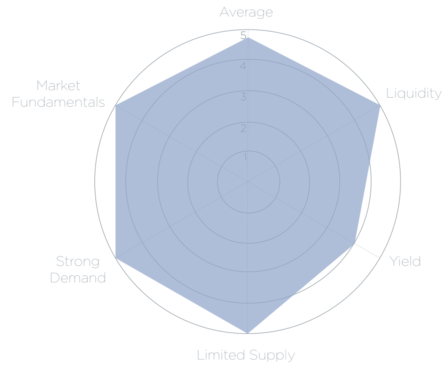
City Centre Retail Projects



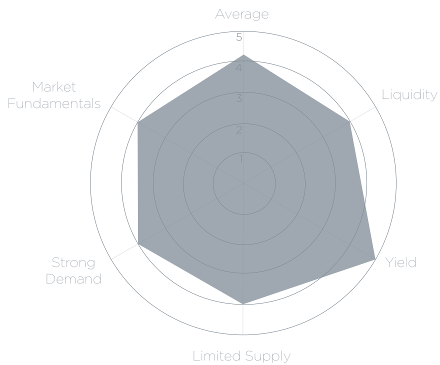
Underperforming Retail Properties



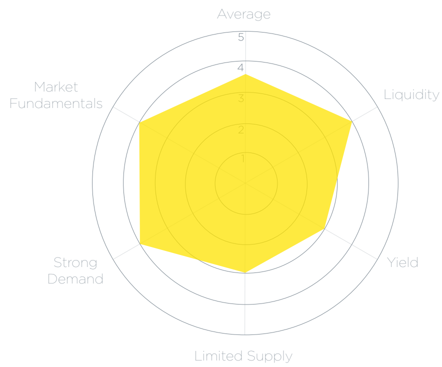
Project Conversion



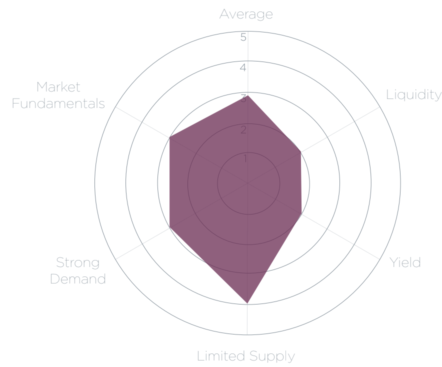
Logistics



NPL



For-leasing Apartments



Healthcare Facilities

Liquidity	The number represents the liquidity of the asset type.	5 means that the asset type has the highest liquidity and can be turned around quickly in the market.	1 means that the asset type has very low liquidity in the market.
Yield	The number represents the yield level of the asset type.	5 means that the asset type offers the highest yield with the most risk.	1 means that the asset type has limited risk but also has very low return.
Limited Supply	The number represents the short- to medium-term supply amount, and oversupply tends to hurt the capital value of the asset.	5 means that the asset type has limited future supply, thus the value is less likely to be affected by this factor.	1 means that the asset type could include a large amount of foreseeable future supply, and therefore the price of the asset might be negatively affected.
Strong Demand	The number represents demand from investors.	5 means that the asset type is highly desired by investors.	1 means that there is limited interest from investors for the asset type.
Positive Market Fundamentals	The number represents the comprehensive market fundamentals of the asset type including rental performance and occupancy rate.	5 means that the asset type shows strong leasing performance with a high rental level and low vacancy rate.	1 means that the asset type does not lease well and thus offers low rent and a lot of vacant space.

Core

Tier-1 cities premium Grade A offices and city-centre retail projects

The Tier-1 city Grade A office market continues to be the only asset class that has adequate liquidity, transparency and underlying support to attract core money. While a number of these markets are likely to face oversupply over the next 12-24 months—which is likely to inflate vacancy rates, suppress rents and limit capital value growth—they continue to represent the safest store of capital for long-term investors.

Premium retail centres also attract many investors though investment opportunities are scarcer, good asset managers are hard to come by, and the sector is still prone to competition from online operators.

Core-Plus

Decentralised Grade A office properties, underperforming retail assets and logistics facilities

With more limited upside potential for value-added assets in city centre locations, core plus investors are shifting towards decentralised locations and seeking assets with rental reversion or lease-up risk to achieve higher returns. These assets tend to be located in business parks or office clusters with relatively good accessibility.

Additionally, there are a handful of investors with retail management experience who are seeking opportunities to reposition underperforming retail assets, of which there are many in China.

Investment-level logistics facilities are mainly under the control of several big players in the market and are highly sought after by capital thanks to their growing rent as well as increasing demand, which is driven by the booming e-commerce sector.

Opportunistic

Project conversions and non-performing loans

Opportunistic investors are likely to focus on converting older, underperforming assets into higher and better-used assets. Recent examples include a number of hotel and retail assets that have been converted into office space—often but not always leased and operated by co-working spaces—and for-lease apartments. These conversions are likely to continue in the fairly long term with demand from co-working spaces and the for-lease sector showing no signs of slowing down.

The NPL market is growing larger as the government requires banks to clear up their balance sheets and companies face increasing repayment pressure. Foreign investors are currently looking for opportunities to invest in large NPL portfolios.

List Of Key Platform Purchases Categorised By Platform Sector, 2014-2018

Logistics | Co-working | For-leasing

2018

- JD.com invested in China Logistics Property; US$114.7 mn for a 9.9% stake
- JD.com invested in ESR; US$306 mn
- Vanke acquired Swire cold chain logistics unit; RMB2 bn
- Cainiao Network invested in Yiliu
- WeWork invested in Naked Hub; approximately US$400 mn
- Sino-Ocean Capital and Huarong Rongde Asset Management invested in Nashwork; US$78 mn
- GIC set up JV with Nova ; RMB4.3 bn

2017

- Vanke acquired GLP; US$11.6 bn
- GAW Capital invested in Harbour Apartments
- IDG Capital Partners invested in Beijing-based co-working start-up Kr Space; US$15 mn
- City Development Ltd (CDL) invested in Distrii; US$10.5 mn for 24% stake

2016

- Jin Jiang Hotel invested in WeWork; US$260 mn
- Gaw Capital invested in Naked Hub; US$33 mn

2015

- Warburg Pincus invested in Mofang Apartment; US$140 mn

2014

- Temasek and RRJ Capital invested in Yupei; US$250 mn

Platform Purchases

Besides single asset and portfolio purchases, investors are increasingly interested in investing in platforms—especially when they are trying to tap into a new sector or enter a new market. Platform purchases not only give investors key assets but also provide an experienced operation and management team.

Platform purchases can be either a full buyout or partial equity injection. Recently, an increasing number of developers and investors have been trying to expand their business scope, and are turning to platform purchases as a less-risky approach to getting involved and testing the market. For example, Vanke has been expanding its position as a real estate developer that mainly focuses on residential and office developments to a well-rounded player that also covers other sectors like retail, logistics and hotels. Vanke achieved this transition through platform purchases: SCPG from Blackstone, cold chain from Swire, a JV partnership with Banyan Tree Holdings, and the acquisition of GLP. Meanwhile, in sectors new to the China market, such as student and senior housing, we have seen Chinese investors buying overseas platforms, and we expect to see them bring that expertise back to China when the time is right.

Niche Market Investment

Fierce competition in traditional asset classes and weakening fundamentals have convinced a number of investors to turn to alternative asset classes for opportunities. With limited investment grade stock currently available, niche market investments typically focus on equity injections into asset managers and operational platforms. Hot sectors at the moment are logistics assets, the for-leasing residential market, the healthcare sector and data centres.

Logistics
High yields but limited supply

Logistics was the most transacted niche market so far thanks to the boom in China's e-commerce sector and high levels of institutional-grade logistics property stocks. The market is dominated by a handful of players who are responsible for most investment cases. A few years ago, the way to invest in logistics was to acquire land in the land auction market and build, but now with a limited supply of logistics-designated land, most investors are buying second-hand assets.

Big players are transitioning from warehouse landlords to logistics solution providers. As the logistics market matures, yields will continue to compress, but not as much as in the past couple of years. To improve returns and control cost, owners are also enhancing assets through technology. In addition, the scarcity of land supply also drives owners to create more multi-story products. The most active markets for industrial investment are satellite cities of Tier-1 cities, such as Suzhou, Dongguang and Jiaxing, and other Tier-2 and Tier-3 transportation hubs.

Healthcare
Profit model needed

China's healthcare market is expected to grow at an unprecedented CAGR of around 12% and reach US$1 trillion by 2020—in 2011 the sector was valued at US$357 bn—according to a McKinsey report. With individual wealth increasing and public awareness of elderly care facilities changing, the healthcare sector will see a huge increase in demand. Currently, we see market exploration from a number of investors, most of whom are developers diversifying their business scope. As elderly care facilities require heavy capital input, and only selling services will generate negative yields, the biggest challenge in the elderly care market is that investors are struggling to find the right profit model.

For-leasing
Significant support from the government

As China's leadership pushes for the development of the for-leasing market in China's major cities, both foreign and domestic investors, including some of the country's largest developers, are actively working to establish operating platforms. Different operators are adopting different business models. On the capital side, the two models are asset-light and asset-heavy. Generally speaking, developers usually adopt an asset-heavy strategy, and lead leasing demand to their idle properties. However, asset-heavy strategies require large capital injection upfront, challenging companies, which leads to the growth of many new financing products such as Quasi-REITs, Commercial Mortgage-Backed Securities (CMBS), and Asset-Backed Securities (ABS). Investors with limited capital usually opt for an asset-light strategy with the intent of seizing market share in a short time. However, such a strategy requires a property to have a fast turnover rate and investors with a low tolerance for vacancy. Investors such as Nova are moving from an asset-light strategy to an asset-heavy strategy in this sector.

On the other side, while the market is expanding quickly, many problems exist. There are concerns about the flood of for-leasing apartment products vs. actual demand for them. Other problems include investors' lack of management expertise and lack of regulations. As the for-leasing apartment market grows, the government is expected to issue more guidelines to regulate the market to improve quality control.

Data Centres
Still highly restricted

Though data centres in China have been heavily restricted and dominated by local SOEs, some investors are still willing to consider them, usually in partnership with a professional operator. The continuing growth of online platforms such as Baidu, Alibaba and Ctrip, along with online gaming, has significantly raised demand for data storage. In June 2017, China ratified new cybersecurity laws mandating that foreign firms operating within China's borders must store sensitive data on domestic servers. To comply with the new regulations, Apple is building its first China-based data centre in Guizhou, China. In addition, data centres' specialist nature is now seen as an asset because it protects against competition.

Invest in properties that future talents want to work in

Employees are looking at other factors outside of salary and benefits when it comes to choosing a job. It is not all about money—flexibility, the environment, society, culture and challenges are all important considerations. The talent war of the future will no longer be between companies, but between cities, and even different office buildings within cities. Following the millennial generation, Generation Z (Gen Z)—defined as people born between the mid-1990s to the early 2000s—will be the generation that takes up space in the work places of the future. Gen Z, forecast to reach 2.56 billion people by 2020, is often described as one of the most tech-savvy and entrepreneurial of recent generations.

Valuing privacy

While millennials desire open workspaces, Gen Z values privacy and enjoys order and predictability in the workplace. Since Gen Z people appear to place a lot of value on boundaries and personal space, a workplace that will work best should include more options for both collaborative workspaces and quieter private workspaces, according to a survey conducted by office design company Peldon Rose. Members of Gen Z would also prefer office workspace that is easy to understand and use.

Digital natives

Gen Z has grown up with constant access to technology. Within the workplace, Gen Z members will expect, and often require, access to technology solutions and devices to get their work done, but will see technology as more of a tool than a full solution.

Well-designed workplaces of the future should foster collaboration, connection, and community. Companies of the future will move to offices that can fit their employees and that can bring the best out of employees' potential. Meanwhile, it will be important for investors to keep in mind the characteristics of this new generation and its workplace needs, in order to make smart investment decisions. Investors need to choose the right city and community, and create an appropriate environment to attract the right companies and employees of the new economy.

How does the sharing economy concept affect real estate investment?

Shared transportation expands the investment zone

By the end of 2017, there were about 16 million bikes running on China's streets to transport about 130 million registered users. Free-floating bike-sharing offers an alternative to often-insufficient public transport systems, crowded streets and traffic jams. It also provides people with the method to cover the last mile from subway or bus stops to their final destination. According to a Tencent Penguin Intelligence survey from Dec 2016, 62.9 percent of customers use shared bikes on the last mile. The increasing connectivity resulting from the sharing economy can expand the radar for appealing investment opportunities, and raise the capital value of properties further from the radius of the metro stop to within cycling distance.

Co-working business increases efficiency but can create potential risks

Besides shared bikes, shared workspaces could have a bigger and more direct impact. Co-working spaces create a community that share common functional areas as well as resources. Co-working spaces also allow more flexibility for tenants when they expand or downsize. They could improve the efficiency of a building by utilising "dead space" such as vacant meeting rooms, but co-working also presents risks to landlords because operators usually lease a large amount of space over a long term. Currently, the co-working market is booming, and is being chased by a large amount of capital. However, when the market cools, co-working operators might be faced with limited cash flows and may terminate contracts, vacating office space at a time when demand is weak, resulting in massive vacancies. Therefore, some landlords are limiting their exposure to co-working spaces to below 10% or relying upon the recognition and credibility of their co-working operators (a sometimes misplaced faith). Co-working is also evolving to serve as a secondary landlord, or in some cases, a management company or asset manager for the building.

Outbound investment

Curbed outbound investment

The government, concerned about the pace and nature of outbound investment, has placed a number of restrictions on the practice in recent years. China outbound investment for income-producing assets in the first nine months of 2018 decreased by 37% compared to the same period in 2017.

China's outbound investment—which started with development opportunities sometimes with local JV partners and often focused on residential assets—morphed in the mid-2010s to aggressive acquisitions of trophy assets—sometimes by companies whose core business was neither real estate development nor investment. Often the companies making the investments were highly indebted and purchasing at above market prices, not knowing enough about local laws, taxes and market practices, and investing in the hope that values would continue to rise.

While outbound investments are likely to continue in the coming years and could or should surpass previous levels, the targets for investment are likely to be dramatically different.

One Belt One Road/Belt & Road Initiative

One of China's signature foreign policy initiatives, often called the modern Silk Road, the OBOR, or BRI, as it has come to be known, is an ambitious program of investment in infrastructure between China and Europe via the Middle East and Africa.

The belt (northern section) is the "Silk Road Economic Belt", connecting China overland with Europe, Africa and the Middle East with railways, highways and fibre-optic cables. The road (southern section) is the "21st-Century Maritime Silk Road", an initiative aimed at investing and fostering collaboration in Southeast Asia, Oceania, and North Africa.

Not all of the investment is new. Many schemes had already been under negotiation for a number of years before China announced the OBOR, but the scope of the BRI continues to grow. There is no definitive figure for how much the BRI encompasses, with estimates ranging from US$1trn to US$8trn.

The initiative has proved controversial with many of the details of the agreements shrouded in secrecy. The majority of the deals mainly engage Chinese contractors and are reported to create few jobs for locals while the host countries often become indebted given the scale of some of the infrastructure projects with respect to their local economies.

Supporters point out that Asia is in dire need of more investment, and a recent report by the Asian Development Bank estimates that Asia needs US$26 trillion of investment in 2016-2030 to maintain today's growth rates and adapt to climate change.

Market Outlook

- 2019 is likely to be filled with uncertainty and change, whether it be geopolitics, financing conditions or new disruptive PropTech.
- Tighter credit, a slower economy, and ample supply are likely to result in a price correction in some markets and asset classes, with sellers more motivated to sell in order to capitalise on current valuations, generate cash flow, pay down debt or reposition themselves in the market. This will likely lead to more buying opportunities at valuations that investors have not seen in a while. In particular, international investors, who have been priced out of the market in the past, are seizing the opportunity to deploy funds as domestic peers find it more difficult to raise capital.
- As we reach the zenith of the property cycle, investors continue to move up the risk curve to secure desired returns with value-added, conversion and niche market investments playing a more significant role in future investment strategies. Outsized returns can no longer be accrued by purely taking the China growth-vs-risk strategy, but have to be achieved through creating value through actively working assets and financial structures.
- While China risks may still be akin to emerging markets, returns are looking ever more core in nature.

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