Point/counterpoint: China

What are the most compelling reasons for and against investing in China's property markets?

with Dr Jennifer Molloy

On the world stage, China cannot be ignored, but a plethora of options is available to institutional real estate investors, depending on their comfort level with investing in the country's property markets. Are they more bullish or bearish about doing so, and why?

As senior editor of *Institutional Real Estate Asia Pacific,* for this year's Special China Edition, I asked two China experts to provide their best arguments: one for jumping into Chinese real estate and one for taking a far-more cautious approach to China and its property markets. They were each given roughly 700 words to make their best cases.

Taking on the "bullish on China" perspective is **Collin Lau,** founder of Bei Capital Partners and former managing director, head of global real estate and head of European private equity, at China Investment Corp. And on the "bearish on China" side is **Jack Rodman,** a senior advisor of Crosswater Realty Advisors.

Collin Lau, Bei Capital Partners

Collin Lau: Bullish on China

Investing today requires a paradigm shift. As institutional investors, we need to think long term but, indeed, how many of us do really think of a "quarter" in the context of 25 years? Investment strategies have to be forward-thinking rather than regressive-looking.

Global asset allocations in real estate are usually regressively home biased, guided by broad-brush perception of where the developed nations are located. Developed nations are supposed to be wealthy, have better infrastructure, run with stable governments and consistent policies, and are open to attracting international talents with congruent societies and social values. Events that have unfolded in more recent times seem quite the opposite.

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Underestimated economic development

For a long time, China has been labelled as a developing country or emerging market and, therefore, any investment there will be accorded a significant risk premium. The end result is a significantly minimised, or trivial, allocation to it by most Western institutional investors. This has been further aggravated by a recent drop in foreign reserves and concerns of a perceived potential credit crisis in China if not reined in.

Such a paradigm ignores the fundamental bedrock of the Chinese model — substantial domestic savings, wealth, investments for the future, universal education and, increasingly, its citizens taking on global perspectives. For those who tend to focus on foreign-reserve movements, they have ignored that the consolidated government "balance sheet" of the People's Republic of China should take into account the state ownership of all freehold land — almost all of which is infrastructure — the balance sheets of all state-owned enterprises and aggregated assets, and ultimately the policy and channel influence on national savings and wealth.

An August 2016, Bloomberg News article also pointed out, "China's debt is largely locally funded and is backed by a huge hoard of domestic deposits. This makes any Asian financial crisis–style blow-up unlikely." Decades of wealth accumulation at the state and personal levels are not bubbles, but reflect productivity and hard work.

A lot of Western institutional investors have grossly missed the opportunities over the past decade: Those who invested US$1 in 2006 in Beijing grade A residence and office should have seen an average return of US$3 (before any currency effect) in 2016.

The issue of pricing

Yet, this poses another challenge: Is the price too high now to enter the Chinese real estate market? The answer is "yes" — we do see significant challenges, if an investor simply buys core real estate and counts on market beta. The top limiting factors are deferred taxes and competition from local capital.

The answer is a resounding "no", however, if there is a real value-add strategy evident that can capture the market alpha and be consistently applied through a platform that operates in excellence and comes with better deal flow. It also requires the team to have an exceptional understanding of how China's government and market interact.

With a powerful and financially-strong government, it is not easy to pick up distressed investments in China opportunistically, as the former tends to smoothen out the mini-cycle effectively and more expediently than many outside analysts comprehend.

Taking the plunge

Likely the better formula for institutional investors, therefore, is a long-term commitment to the second-largest economy in the world, backing portfolios and platforms that are value-add in nature, which are capable of constantly operating better, responding faster and are culturally sensitive to the systems in place.

We always have choices. The general rule of thumb for long-term strategic asset allocation should be proportionate to the size of the national economy or national wealth, especially for major economies. China has been an exception, and there continues to be a persistent denial the country deserves a fair share of global investment allocation, often veiled by many near-term perspectives, such as currency fluctuations or short-term price movement.

There should be no doubt about China's growing affluence and the depth of its real estate market, as well as the country's ability for technological, Internet and e-commerce innovation, particularly the ability to handle massive cargo and human flow with the latest built physical and social infrastructure. The train is of higher speed now, and I hope investors will not miss it for another decade.

Jack Rodman: Bearish on China

In the Year of the Rooster, investors are already dealing with their fair share of policy uncertainty. In the United States, the Trump administration's economic nationalism on trade and immigration issues, coupled with its seeming willingness to question long-standing allegiances and international relations norms, has ruffled the feathers of allies and foes, alike. Meanwhile, China is dealing with its own set of issues, both economic and strategic. Investors with exposure to these issues have enough to worry about, such as China's ongoing debt sustainability questions, and the potential for increased curtailment of capital flows from both China and the United States.

Rising debt

In China, nationalistic pride will trump Trump's words, as China's economy continues to struggle to find sustainable footing amid rapidly-rising debts. Chinese GDP growth in 2016 was the lowest in 25 years. Its US$10 trillion economy has amassed more than US$30 trillion in debt, bringing the ratio of debt-to-GDP north of 300 percent. Meanwhile, domestic capital continues to vote with its feet. Despite China's "travel ban" on domestic currency seeking asylum (and a better economic life) in the West, 2016 saw more than US$1 trillion take to the lifeboats in search of a safe haven beyond Chinese shores. Chinese capital outflows found familiar destinations, driving up real estate values in gateway cities, including London, New York City, San Francisco, Sydney, Toronto and Vancouver.

China's oft-cited "life vest" of foreign exchange reserves has fallen from more than US$4 trillion to less than US$3 trillion. Halting the decline through market measures is no simple task; if China hikes rates in an attempt to retain domestic capital and attract foreign capital, it risks setting off a crunch in the domestic economy and its banking sector, which is saddled with nonperforming loans.

Capital flight

If China eases monetary policy to keep economic growth churning along, however, domestic capital will continue to flee. Faced with this dilemma, the central bank and State Administration of Foreign Exchange have turned to capital controls — rolling out a new wave of restrictions on capital flows, including the acquisitions of foreign companies and assets by Chinese corporates. Investments of more than US$10 billion, and mergers and acquisitions of greater than US$1 billion, are now subject to oversight and approval.

In January, the State-owned Assets Supervision and Administration Commission enacted interim measures, introducing a "negative list of outbound investment projects by central enterprises", which prohibits outbound investment in certain categories and requires enterprises complete a regulatory examination before making a decision to invest. Adding to China's outbound-investment woes, the Committee on Foreign Investment in the United States, or CFIUS, could act further to restrict Chinese investment ambitions, as the US Congress links foreign investment to national security and employment issues — something the Trump administration appears to be making a high priority.

Jack Rodman, Crosswater Realty Advisors

Taken together, these measures will act as a headwind to asset markets and geographies that have been the beneficiaries of Chinese outbound investment. The Rhodium Group estimates Chinese institutional investors poured as much as US$16.9 billion into 37 real estate deals in the United States last year.

So if the prospects for Chinese outbound investment look bleak, throwing into question the marginal source of investment in gateway city real estate markets, how do the prospects appear for investment in China?

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Plummeting return on debt

Although some of China's debt issues are addressed above, perhaps the most alarming issue is the plummeting return on debt. China requires US$4 of debt to create US$1 of GDP growth. One result of this is the growing nonperforming-loan problem on Chinese banks' balance sheets — an issue Chinese officials continue to understate. According to Fitch Ratings, NPLs could be as much as 15 percent to 21 percent of China's total loan pool. By comparison, Chinese official data listed the rate of NPLs at commercial banks at only 1.8 percent. Any significant capital shortfall could trigger the need

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for a banking system recapitalisation, which would result in a sharp increase in government debt-to-GDP levels and exert further downward pressure on the Chinese currency and increase capital outflows.

China, master of the off-balance-sheet manoeuver, can obfuscate these concerns through various measures — corporate-to-corporate lending, wealth-management products, investment receivables, and so on — but someone ultimately will be left holding the bill. History repeatedly has shown rapid credit growth in condensed periods — such as the type China has experienced since 2009 — contributes to sloppy credit practices.

Be cautious

The fact foreign capital continues to avoid this market seems to indicate foreign investors are not buying the official Chinese story that bad debts have been sufficiently disclosed and adequately provisioned.

Until China takes its medicine, it will continue to contend with economic uncertainty, asset market volatility and questions surrounding its exchange rate. Trump's posturing and the potential for a row over the US dollar/Chinese yuan exchange rate — or worse, a trade war between China and the United States — only stoke the bonfire of uncertainty. Investors would do well to assess their holdings in China, and in outside markets affected by Chinese investment, and be prepared for a world in which US-Sino relations devolve into a tit for tat. ❖