CHINA CROSSBORDER INVESTMENT

Professor David Yu, CFA, ISTAT Certified Aviation Appraiser, examines the drivers and policies affecting China crossborder aviation investments and financings.

In this ever changing world, there are constant changing policies and other drivers that affect crossborder investments from China and its impact on aviation investments. While some changes have more direct impact than others, these main drivers further analyzed are the ones to watch going forward.

One of the major themes has been the explosive growth of Chinese outbound deals over the past five years which saw outbound M&A volume rise 33% per annum from $49bn to $227 in 2016 according to McKinsey. While this growth has been more publicized, some other important facts might not be as acute. While Chinese companies were involved in ten of the largest deals worldwide in 2016, most deals were in the middle market with the median ~$30m deal size. While the absolute volume has increased, there is arguably further room for growth as this volume as a percent of GDP is smaller for Chinese companies (0.9%) than its counterparts in Europe (>2.0%) and US (1.3) in 2015.

While this trend has been the case up until this year, the latest figures as year to date third quarter 2017 show that the number of Chinese company M&A deals has decreased 14.8% to 572 compared the previous year while the overall value has decreased 38.9% to $97.7 billion according to PWC. These figures represent a decrease in the share of overall investment in Europe and the U.S. from 77% for calendar year 2016 to 50% for latest figures. It's noted that this decrease follows an almost 300% increase in the value of transactions to $214.9 billion for 2016.

There are many broad and sub themes behinds these impressive figures. One of the major China policy drivers is President XI Jinping's One Belt One Road ("OBOR") initiative which aims to link up the countries through land and sea along the old silk road through investment in infrastructure and increased trade. While this concept was first announced in 2013, the real traction kicked off in earnest in 2015 and was developed alongside with the founding

and backing of the Asian Infrastructure Investment Bank in 2013 and the Silk Road Fund in 2014. This focus on trade has driven a lot of crossborder and outbound investment to countries along the routes. This has amounted to $33 billion in 68 countries this year as of August compared with $31 billion in 2016 according to Thomson Reuters with $124 billion pledged at the May 2017 summit. In the aviation space, this has seen a surge of investment in airports, airlines, tourism activities and in aircraft leasing.

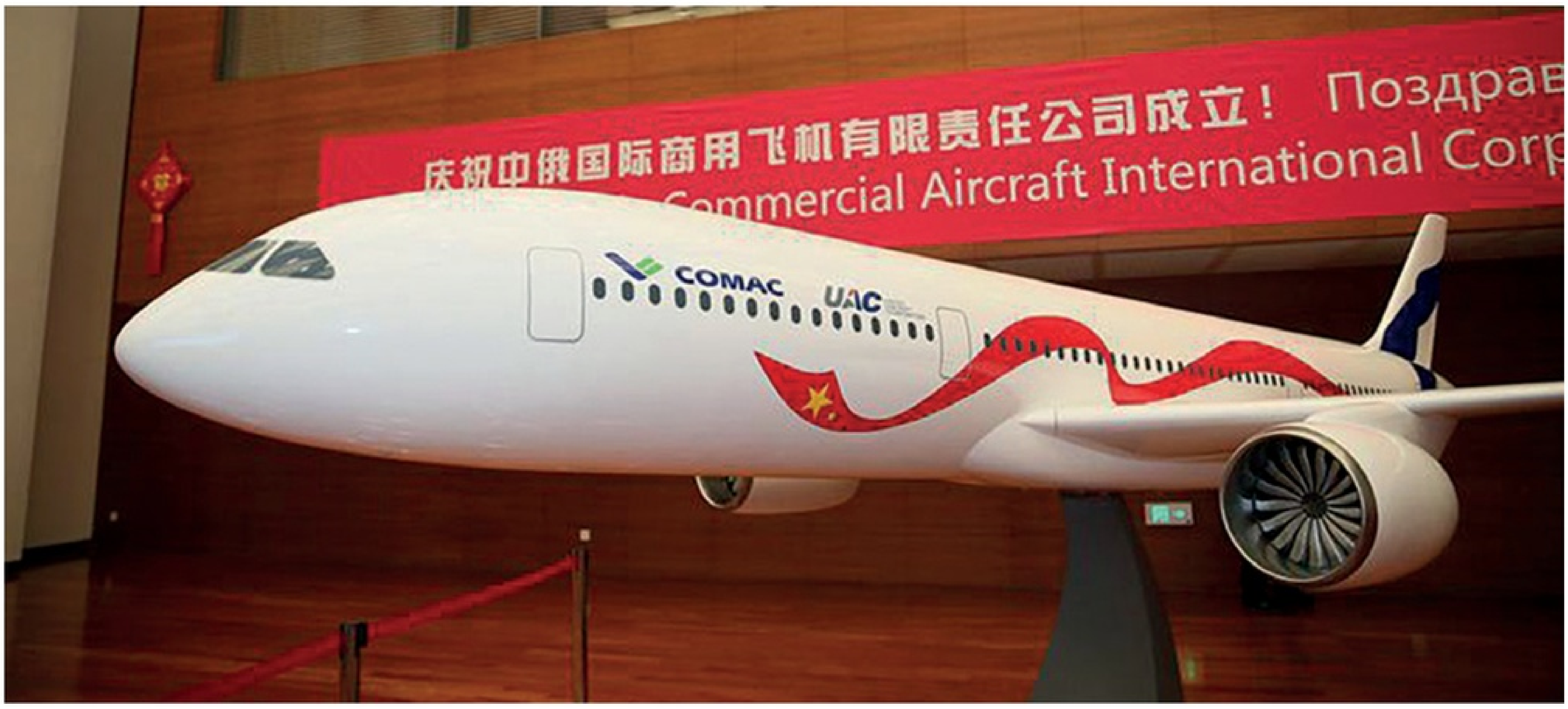
Another major theme and driver are the series of supply side reforms that have been implementing since 2015. All of these different components are the overarching policy directions which have large effects on aviation and crossborder investments. The main sub-categories include cutting excess industrial capacity, deflating the real estate inventory and bubble, corporate deleveraging, lowering corporate costs (taxes, fees, etc.) and Made in China 2025.

Some of these sub-themes are aimed at realigning the domestic economy and transforming it from the old to new while making the sources of growth to more sustainable. This would include cutting excess older industrial capacity and encouraging more clean energy projects. This goes hand in hand with overall deleveraging and control of the growth of the credit exposure in China as well as deflating the real estate bubble and excess inventory especially outside of top tier cities. This desire includes slowing down the credit growth due to normal and shadow banking activities and thus far focused on larger private companies and smaller banks and now moved on to local municipal and provincial state owned enterprises ("SOE"). Credit growth has intensified since 2008-2009 global financial crisis and infrastructure spending and borrowing has been a key method to drive economic growth by local governments but lately such initiatives have shut down projects such as new subways in farther out regions, etc. due to the concern for the amount of additional debt. These policies however do not dampen the growth of airports and related aviation infrastructure especially in more western and more underdeveloped regions in China which have continued to see steady growth. China plans to build 74 new airports by 2020 and 136 by 2025 with the largest currently under construction in Beijing and Chengdu each handling over 90 million passengers annually. This also doesn't include the general aviation airports which currently stand at 310 with the goal of reaching 500 by 2020.

The lowering of corporate costs has not been as big point of emphasis. It has so far focused on reducing fees and bureaucracy rather than major tax cuts while trying to stimulate the economy through encouragement of "mass entrepreneurship" by Premier LI Keqiang. This has especially been true of the test regions of policies such as the free trade zones such as the Tianjin Dongjiang Free Trade Port zone ("DFTP") and Shanghai FTZ which are the homes of the most active jurisdictions for aircraft leasing in China.

The Made in China 2025 initiative is also part of the overall supply side reforms that has its roots in 2013 which focuses on the upgrade of the Chinese industry similar to the "Industry 4.0" initiative by Germany. This initiative increases the competiveness of industry and encourages investments in high technology sectors and has recently been given a renewed push. In the aviation world, this would be focused on new bio-fuels, clean technologies implemented for airlines, aircraft and airports. This theme is sometimes combined with the OBOR initiative. This is the case of domestic made COMAC C919 and ARJ21 and aircraft leasing which both are being rolled out under both initiatives.

As result of these initiatives and the desire for more offshore assets due to the exchange rate, the perceived difference in regional investment returns, these have driven up crossborder investments in aviation and tourism with Wanda and HNA Group, among others have been among the most acquisitive groups. These high profiled deals have caused the CBRC to review the credit exposures for "systematic risk" to these four outbound groups including the aforementioned and Anbang and Fosun. In addition,



the government has stepped up scrutiny of both the convertibility of RMB to other liquid currencies and the transfer of funds to offshore locations. The aim has been to slow down and dampen the more frivolous offshore investments that is outside the scope of the main business competencies and refocus on more core policy driven investments have still have government backing. These actions also helps support the RMB exchange rate and total foreign reserves which have steadily grown from the 1980s to its all time high of $4.0 trillion reached in June 2014 but have since receded to its recent low of $3.0 trillion in January 2017 to the current levels of $3.1 trillion in December 2017.

Recently, there have been more policies relating to the opening up of the domestic economy by foreign capital including publications of a national unified negative list of industries for inbound investments which was previously more locally administered policies as well as a pledge for the opening up of investments in the financial institution space along with asset management companies. This provides more stability for foreign investors especially in aircraft leasing and airlines and also prevents retroactive unraveling of deals due to unanticipated policies. This has seen more foreign lessors establish local on-shore subsidiaries in China to attract more local customers.

These newer policies go hand in hand with the opening of the Hong Kong jurisdiction as a base for foreign and Chinese capital investing in aircraft leasing. This special designation under the most recent local revenue laws were passed to coincide with the visit of President XI to Hong Kong in July 2017 to mark 20th anniversary of the handover which aims to make the jurisdiction more competitive compared to Irish and Singapore as a home for aircraft assets. Many of these themes were reiterated with the election of the new government from the just concluded 19th National Party Congress in October.

Another change that has affected these policies is the sources of the funding in aviation and aircraft leasing. Newer entrants provide both equity and debt capital have emerged such as large private, regional and SOE conglomerates, insurance companies and more creative on-shore ABS like financing structures. These innovations will continue to drive along with the changing dynamics of the industry.

In addition, the trend towards creation of new dedicated equity funds and the resurgence of sidecars and joint ventures has been a significant portion of growth especially involving Chinese companies. Sidecars are a form of joint venture which involves a capital source in joint venture along with a more established aircraft leasing company which creates benefits for both parties. (See my other articles for a more detailed discussion on the topic) These new funds include committed and announced from JVs constitute more than $26 billion in the aviation space since 2008. The latest example is Standard Chartered with their SDH Wings International Leasing Limited JV with Sichuan Development Holding and separately their establishment of an on-shore China leasing platform in Tianjin DFTP.

While some of these policies and drivers can seem a bit contradictory at times, what is certain is the encouragement of technologies and growth platforms that enhance of the sources of GDP growth and composition, especially as China continues to emerge as a leading driving force in global integrated economy. Aviation including airports, leasing, technology and tourism are much still favored industries that are promoted not only because of the policy considerations but also the strong underlying stability and economics. There will be continued challenges as these policies and drivers evolve to changing global economy and industry which bodes well for more opportunities for nimble and creative players.

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