Chairman’s Letter to Shareholders

Results and Dividend

Compared to the last corresponding period, turnover increased 3% to HK$4,607 million. With a much smaller property revaluation gain, net profit attributable to shareholders fell by 12% to HK$2,841 million. Earnings per share dropped 13% to HK$0.63. When excluding all the effects of revaluation gain, the underlying net profit attributable to shareholders was down 1% to HK$2,448 million and the underlying earnings per share of HK$0.55 was the same as a year ago.

The Board has declared an interim dividend of HK17 cents per share payable on September 30, 2015 to shareholders of record on September 16, 2015.

Business Review

The trading environment was tough as expected. Mainland China’s overall economy was weak and retail growth especially for luxury goods has slowed further. Given this situation, we were performing as well as one could have expected.

For example, due partly to the completion of the expansion plans of six major brands at Plaza 66 in Shanghai where each of them has taken 57% to 480% more space, rental turnover compared to the same period of the previous year jumped 12%. At Grand Gateway 66, it increased by 6%. Our overall retail rental growth in Shanghai was 9% while occupancy stood at 99%. Rental reversions were on average up by almost 10%.

Because of the oversupply of new space in the immediate neighborhood, office rents collected at Plaza 66 fell by 7%. (The competitive landscape in Xujiahui District where Grand Gateway 66 is located has not been as severe. As a result, the office tower there, which is held by our parent Hang Lung Group, experienced a rental rise of 5%.) The blended growth rate for Plaza 66 was 3%. The total rents collected in Shanghai rose by 4% to HK$1,454 million. Rental margin remained high at 87% and gross rental return on unleveraged investment cost rose to 46%.
Shopping centers in second-tier cities encountered tougher conditions. Continuing on the path of recovery, Shenyang Palace 66 saw a rise in rental turnover. Jinan Parc 66 retreated slightly but Shenyang Forum 66 and Wuxi Center 66 fell. As predicted six months ago, occupancy held steady at Palace 66, rose nicely at Parc 66 but deteriorated at the other two facilities. The overall weak retail environment is putting downward pressure on rental reversions everywhere, especially at Forum 66 and Center 66. Tianjin Riverside 66 which has less than a full year of operation is performing acceptably with occupancy climbing steadily.

As long time readers of this letter know, almost from the beginning of our operations on the Mainland, we have always insisted on a solid base rent. We are willing to sacrifice part of the upside in the form of turnover rent. When the market rose sharply, we might have lost some additional revenue, but now when conditions have become tough, we are much more protected. Many of our competitors voluntarily or involuntarily required little or no base rent from tenants, especially from top luxury brands. They are all suffering today.

An important indication of the health of shopping centers is the retail sales of our tenants. Both within and beyond Shanghai, we saw a growth of 4%. In second-tier cities, Palace 66 rose by 10%; Parc 66 almost kept up with the same period of a year ago; Forum 66 fell by 5% while Center 66 jumped 15%. The last number, however, warrants some explanation. The two car showrooms – Ferrari and Maserati – accounted for almost a quarter of the total sales of the property. Excluding them, tenant sales were flat. Whatever the case, the fact that 93 luxury cars have been sold in merely a few months tells us that private wealth abounds in Wuxi.

Despite the sluggish economy, our two new office towers are leasing satisfactorily. 60% of the one in Wuxi Center 66, completed in the fourth quarter of 2014, is committed. At Shenyang Forum 66, almost one-third of the space is leased. By year-end I expect the numbers to be over 80% and 60% respectively. Besides achieving acceptable unit rents, attracting the best possible tenants is just as important. This we are striving to do.

Hong Kong investment properties performed satisfactorily. Overall rent collected was 7% higher than the same period of 2014, with retail rising at 6% and office 9%. Both asset types remained basically fully occupied. At over HK$1.7 billion, Hong Kong accounted for 45% of the Company’s total rents received. Mainland China brought in 55% or slightly over HK$2.1 billion.
We continued to sell down our inventory of completed apartments. This period we only parted with 26 units compared to 88 a year ago. Turnover was 17% less but operating profit was actually 4% higher due to a higher profit margin. For example, the nine condos at The HarbourSide achieved a margin of 82%. We also parted with many car parking spaces.

All told, Company-wide turnover and operating profit both increased by 3%. Because revaluation gain was much lower than the year before, net profit attributable to shareholders fell by 12%. Taking out the non-cash item of revaluation yielded an underlying net profit attributable to shareholders of minus 1%. The number was so small that underlying earnings per share remained the same at HK$0.55.

As I have told shareholders before, we will spend HK$1.3 billion to enhance and upgrade our two Shanghai properties. They are over 15 years old and we want to make sure that they will continue to be leaders in their respective markets. Works at Plaza 66 have started already and that for Grand Gateway 66 will begin in the second half of 2016. Only after mall-opening hours will workers enter, and they will reinstate the premises before the new business day arrives. It will take longer to complete the renovation but tenants and shoppers will be least affected.

Two developments in the past few months were of particular significance to our Company. One was specific to our business while the other was of a more general nature. The former was the price cutting by luxury brands in China including Hong Kong. The latter related to the plunge in the Chinese stock market.

According to the global consulting firm McKinsey, China now accounts for some 20% of the annual global luxury goods market of some US$30 billion. Moreover, the rate of growth in China is astonishing. This has caused almost all major brands to flock to the country. In fact, more often than not they have to adjust their global strategy to tailor to this market. Together with the introduction of technology such as e-Commerce, and the fast-changing – and some say, upgrading of – tastes and preferences of Chinese consumers, we have an industry which is rapidly evolving.
Although high fashion only takes up 6% of our mall space, they generate some 17% of retail rents. Shopping centers in turn are responsible for about 80% of all our rents received on the Mainland. Beyond just numbers, our reputation in the country is built on luxury goods sales which help drive other types of tenants. As such, developments in this sector are of particular concern to us.

For many years, the same luxury products in China on average have been sold at about 20% higher than in Europe. As a result, over 60% of the purchases made by the Chinese took place outside of the Mainland. It also bred a kind of arbitrage of buying overseas and selling on the Mainland. A main reason, although not the only one, for the price differential is the high import duty levied by the Beijing government. Three years ago I asked a relevant senior official why the government still kept the high taxes when they were losing money over people buying overseas. I was told in no uncertain terms that when it was politically expedient, such import duties would be adjusted downward. So far it has not happened.

Your management was certainly expecting such an adjustment. It should benefit us as a certain percentage of overseas sales will surely return to China where we have some of the best malls. If only a quarter of the present 60% overseas transactions were brought back onshore, the domestic market would grow by about 40%. Recent announcement of the lowering of taxes for certain consumer products also gave us hope.

To our surprise, in March this year a top global luxury brand started to cut prices in China on a permanent basis, i.e. it was not a seasonal sales campaign. Before long a good number of other big names followed suit. The idea is ostensibly to equalize prices with other parts of the world so as to stamp out the undesirable consequences of a significant price differential.

Our preference is to have the government cut the import duty because it will impact all luxury products instead of only a few brands which have chosen to lower prices. In fact, I was concerned that such brand decisions may preclude government action. But whatever the case, as long as the consumer pays less, some overseas sales will likely return. This should be good news to us and to the industry in China.
Then there was a piece of not so encouraging news – the sharp fall in Chinese stock prices in recent days and weeks. When the Beijing government began late last year to flood the economy with liquidity and direct it to the stock markets of Shanghai and Shenzhen, we knew that it would sooner or later bring trouble. We in the rest of East Asia have seen all too many market crashes. Recall 1973, 1987, 1997, 2000 and 2008. While the immediate cause of each might differ, it was always preceded by euphoria and inevitably ended in almost free fall. They were scary and anyone who has experienced them will not easily forget. Yet inside Mainland China, investors have not seen it, and it takes firsthand experience to know what it is like.

So to the latest trouble, I have the following comments. First, every developing economy and its stock market will sooner or later undergo such a roller coaster ride. Even the U.S. experienced it in 1929. Every East Asian market which is somewhat mature has gone through it. For example, today few global investors pay attention to Taiwanese stocks. But in the mid to late 1980’s, it was a wild market. One should not be surprised that Mainland China today should undergo similarly huge ups and downs. Indeed it would be abnormal if it does not. It is just the normal process of market maturation.

Some may take exception to the way and the extent that Beijing has strived to prop up the market. That too should not surprise anyone. History tends to show that every government will do its best to come to the rescue if it is within its power to do so. The Chinese may have more tools to use and so they have used them.

While such huge equity market swings will inevitably hurt the local economy to some extent, in most historical cases the latter recovers. So will the Chinese economy. After all, the Beijing government not only has various means to rescue the market; it also has many to stimulate growth. While it is difficult to predict how much longer Beijing will be able to keep that privilege as its economy continues to deregulate, for now, it will do its best to revive it.

If the latest “experiment” of directing massive amounts of private capital into the stock market was meant to stimulate the economy, it has backfired. No doubt a collateral benefit of this disaster is that officials have learned what not to do. This should help them do a better job next time.
There is another reason why the market fall may not damage the real economy as much as in other places. Namely, the correlation between the Chinese stock market and the underlying economy may be weaker than that of the West. A big part of the Chinese capital market is associated with huge state-owned enterprises which are monopolies or oligopolies in their respective industries. Many of them are financially strong and their ability to make money has little to do with the conditions of the stock market.

Furthermore, compared to a year ago or to the beginning of 2015, the Chinese stock market index today is still considerably higher. Nevertheless those individuals who have lost money of late in the stock market will inevitably consume less.

Perhaps a greater worry for the economy is the weakness of the housing market. Real estate is one way or another related to some 20% of the overall economy. In the past when everyone was building feverishly, the economy was buoyed by it. Now the reverse is true. I have touched upon this worry in the past, and its effects are now increasingly felt. This explains why loan demand all over the country is weak. With diminished economic activities, job creation is also curtailed. These are worrying signs.

This must be why the government is doing all it can to stimulate the economy. Old tricks such as monetary easing will not work so well anymore. There is already an oversupply of many basic materials and manufacturing capacity.

On the demand side, China’s biggest export market – Europe – is not growing. The U.S. economy is faring better but this market as far as China is concerned has three issues. First, after years of fast salary growth in China, the cost differential between China and the U.S. has narrowed. Secondly, with technological advances such as robotics and 3D printing and the availability of cheap energy from shale gas, America may soon once again become a manufacturing powerhouse as in the 1950’s and 1960’s. Her need for the import of a myriad of goods may lessen. Thirdly, protectionism is rearing its ugly head: consider the slogan "Buy America!"

Aside from export, consumption is the second engine for the economy. Partly due to the negative wealth effect of stagnating home prices, the citizenry has become more cautious in spending money. The increase of public investments remains the only time-honored method, but this too has its limits. New initiatives must be crafted but these will not be easy.
The two attempts in this regard are to encourage entrepreneurship among younger people, and the introduction of the new Silk Road concept called “One Belt, One Road” or as some say, “OBOR.” It is doubtful if either will bring sufficient short term benefits to jump-start the economy.

Whereas the stock market trouble of late may not in itself be that serious, it is the more fundamental difficulties which are worrisome. It is not easy to see what the new economic engine will be. This is why I do not see a quick uplift in our shopping center business.

The Hong Kong retail segment has been performing acceptably although it could have been better. Some locals have reacted to Mainland visitors buying up daily necessities here. Unfortunate incidents of unwelcoming gestures have left many of our compatriots cautious about visiting Hong Kong. Doubtless this has hurt our retail sales. So much so that in certain districts, many street front shops which have previously commanded high rents are now empty. While the phenomenon affects us little, it cannot be good for Hong Kong as a whole.

Such sentiments against Mainlanders are unnecessary and improper although we are not unique. Singapore has witnessed the same. Some of the issues are supply-demand related that can be easily resolved. Taking infant milk powder as an example: why not go to the best supplier in the world and purchase in huge quantities? Then set up outlet stores close to the border between Hong Kong and the Mainland. Quantity buying will bring down prices for all and we will retain shoppers from the other side. Animosity towards such visitors will thus be alleviated and at the same time, Mainlanders’ sentiments towards our city will not deteriorate. They will keep coming and while here, will use our many other services. This will keep our job market healthy and our overall economy more sound than otherwise.

As we all know, Mainland tourists anywhere in the world are among the highest spenders, both in absolute terms and on a per capita basis. To turn them away is to turn money away. Hong Kong has always been an open commercial city and to turn away legitimate business is foreign to us.

Hong Kong people will do well to remember that we have competition. With our dollar pegged to the American dollar, and with almost all major currencies depreciated of late against the greenback, many of our neighbors appear very attractive to Mainland tourists. Our Tsim Sha Tsui (TST) district used to be a popular destination spot; now the new TST to them is Tokyo, Seoul and Taipei. And once a bad reputation of our city is formed on the Mainland, it will be difficult to reverse.
To look down on our compatriots is equally irrational. Very few of our local population are truly native to Hong Kong. A little over a century ago, this city was not much more than a fishing village. Even by the end of World War II, our population was quite small. Most of us or our parents originally came from the Mainland. As such, the difference between the mistreated tourists and recent immigrants and the mistreating locals is only the time they arrived at this city.

Statistics have already reflected the downturn. Growth in inbound Mainland tourists has slowed, and even consumer spending is slightly down. Hong Kong must as soon as possible take steps to reverse the slide. Our democratic and so strait-jacketed political process are also stalling the much needed infrastructural development such as the third runway at our airport. The Hong Kong-Zhuhai-Macao Bridge when built should help our economy, but that too is mired in wasteful political infighting.

All the above are cautioning us that we should not be overly optimistic about Hong Kong’s retail business in the next year or two. Market expansion will be limited. As such, we will have to gain market share if we want to grow. In this regard, our recent Asset Enhancement Initiatives should help. There is still considerable potential in our portfolio for upgrading. This we will do.

PROSPECTS

Given the slower retail markets in both Mainland China and Hong Kong, we are bracing ourselves for a long winter. I would be happy to be proven wrong, but it seems prudent at this stage to be cautious. We do not see many encouraging signs in the economy nor our industry.

Consider the fact that within six months of our opening Tianjin Riverside 66 last Fall, at least six sizable retail outlets in the City had closed down! We do not for a moment think that we are the cause of their troubles. We are not that powerful, being among the best in the market notwithstanding. While recognizing that there will be less competition going forward, we are not particularly pleased with this development, for it tells us that the market is lethargic and there is no end in sight.
Coincidentally all six closed-down retail facilities in Tianjin were department stores. It was not that long ago when institutional investors asked us which model – traditional department stores versus shopping centers – was superior. I thought the answer was obvious but one could have easily accused me for being biased. Now most people are as convinced as I am. This however does not mean that all malls are spared from trouble; rather, it merely says that the weaker model will be the first to be hurt. (That said, some department stores will survive.) If consumer confidence remains low, the inferior malls will also go. This is already happening.

Fortunately not only do we have some of the best properties in the market, we are also financially very strong. For the past nine years and to this day, we basically have zero net debt. As such, it is difficult to think of an exogenous factor that can kill us. The same cannot be said for most of our competitors.

Observing for some years the glut of inferior retail space in Chinese cities, I have long pondered over how the industry will evolve. Now the answers are unveiling before us at considerable speed.

The simplest form is to close down, or at least to mothball the property. Many are doing just that. To figure out an alternative use will tax one’s ingenuity. One possibility is to turn them into old folks’ activity centers. Given an ageing society, there will be considerable demand for such facilities. However, how to make money therefrom is another issue. Retail rental is among the highest yielding for any space, which means that most other usage, if not all, will bring inferior returns.

A few daring souls are buying up failed shopping centers. Perhaps the new owners will be able to come up with better usage. But if all they do is to keep the space for retail, then I question their chances of success. The main reason for mall failure is not the software but the hardware, i.e. what I call “real estate genetics” – location, size, design and construction. These are factors which can never be changed once a facility is constructed. It is like a short man not being able to play professional basketball or a tall man doing gymnastics. A switch to a better coach will not help, for it is the genetics that counts the most.
I believe that finding other reasonable functions for the space is a safer route to take. One company is turning well located malls into office space for entrepreneurs on a daily rental. After all, top Chinese leaders are calling young people to innovate and to start new businesses. So apparently there is some market for it but will it fill up a mall or many malls? Hardly! Moreover, simple calculation if not common sense will tell us that the return from such a conversion can in no way come close to that of a well-run shopping center, especially one in the luxury sector. Such is the price for not respecting “genetics.”

There are yet other strategies. One high-profile player who formerly claimed to be in the luxury mall space has publicly announced that besides closing down some weaker facilities, all remaining properties will go downward on the value chain. They will now tailor to the masses. Like many others, they have finally discovered that to build and manage top-end shopping centers is a high-expertise endeavor, something that I have repeatedly advocated on this platform.

I believe the conversion game has just begun. As long as the economy remains sluggish and consumer spending feeble, the speed of conversion can only pick up, for the oversupply situation in many cities is serious. It may take a few years for those markets to reach a supply-demand equilibrium. My suspicion is that once the sentiment turns for the better, this market cleansing mechanism will stop. People will begin to build again. Like everywhere else, one should not underestimate the follies of human nature.

What then shall Hang Lung do? First, stay the course. Several institutional investors have recently asked if we would consider lowering the price point of products sold in our malls. I find their suggestion incredulous. Since there will always be a market for luxury goods, we should not move downward on the value chain. At or near the top-end of the market, there are very few players, for few know how to develop and manage four- or five-star malls. We already have several properties well entrenched in that space with a limited number of competitors. If we move down, we will dilute our uniqueness and run into much more competition even though the market is bigger. The segment where we play today is much easier to defend than the next level below.

Secondly, whereas we have no intention to slow down construction, neither will we break our neck to get ahead as we once did. We expect the market lull to be with us for some time so there is no hurry.
Thirdly, we will take advantage of the present slow market to upgrade our existing portfolio. Our Asset Enhancement Initiatives have started a while ago in Hong Kong with much success. We have done a lot of work in Mong Kok and Causeway Bay, and will do more. The enhancement of Plaza 66 has also started, while that for Grand Gateway 66 will follow in 2016. Payback period will be about 4 years for both Shanghai properties.

There will come a time when land prices on the Mainland become attractive. This is the fourth area to which we will pay attention. But for now, we will not rush into acquisitions, for we do not see how the economy can recover quickly.

The fifth item is critical and we will do our best to complete – the building out our management team, especially at the senior level. Six months ago I have written extensively on the subject. Progress is being made but there is always room for improvement.

Finally and concurrent with augmenting the team is the strengthening of corporate culture. This is yet another topic to which I have previously devoted considerable attention.

At times of adversity, the strong players will become even stronger, and the weak ones, as we have seen earlier, will sooner or later fail. Given the assets we possess both tangible and intangible, Hang Lung will be one of the very few big winners. As in most industries in market economies, success will over time concentrate in the hands of a few.

Dalian will officially open in early December under a most difficult environment. With a gross floor area of about 220,000 square meters, to fill it up intelligently will be a challenge for anyone. Average unit rental rate is expected to be slightly below that of Tianjin.

We will inaugurate the mall in two phases, with the first accounting for 87% of all available space. At the opening we shall expect 80% occupancy of phase one or 70% of the entire mall. When we approach 90% full for phase one, we should have achieved the targeted 4-5% initial gross yield. Once fully occupied, there is a good chance that we will be at the 5-6% range. Given the enormity of the property size and the tough market environment, this is a rather satisfactory outcome.

I should mention that at the opening, the upper floors and the basement will be basically full but not the first two levels. The latter are the easiest to fill for everyone wants to be there. However, we are unwilling to lease such premium space to just anybody. Once occupied, it will take time and effort to relocate them later when we need to make room for what may prove to be more appropriate names. For now top brands are not opening new stores and so we will take our time to find the brands we want.
After Dalian, the next mall to open should be Kunming. In recent years, building regulations have become increasingly unwieldy. This is perhaps understandable as the fast-rising market over the past two decades has left many holes in the system. As such, one can consider this latest development as an improvement. However, to address one problem often creates difficulties if not impossibilities in other areas. For example, new fire regulations have rendered efficient and indeed reasonable design unattainable. Such issues are usually resolvable at the end but the process is invariably tedious and painful. We have experienced similar situations before but they seem endless. So besides the fact that we bought the land almost two and a half years after that of Dalian, increasingly stringent building codes will also mean that Kunming will not open until 2018.

We welcome this respite. Since 2010, we have inaugurated one world-class shopping center per year. Opening six huge facilities in six years is by any standard phenomenal. No wonder the expansion of our management team could hardly keep up. We were indeed fortunate that no major mishaps have taken place.

Whereas adding new space will invariably raise the top line from day one, it will not contribute to profit immediately since it takes time for a shopping center to mature. In fact it will average down the rental margin. Not adding completed projects for a while will have the opposite effect. Ironing out the bugs in the newer facilities should raise both the unit and the total rent. Overall rental margin should improve and more of the top line will flow through to profit. This is ultimately the main purpose for any business.

As before, we will constantly review market conditions to determine when to construct the remaining office towers and apartment blocks in Forum 66 and Center 66.

Returning to the more immediate term, the overall consumer market is for now still weak. The threat of negative reversion in second-tier cities is real and serious. Your management will have to pull out all the stops to prevent the situation from getting out of hand. Moreover, enhancement of our two Shanghai properties will present some challenges although I do not expect the impact to be significant.

There are however some anticipated happy news. Although Hong Kong’s consumption is weak, we should fare better than the overall market. Asset Enhancement Initiatives being executed of late are beginning to bear fruit. For example, the next enhancement to be completed should be the podium at Hang Lung Centre where our headquarters was located before 1993. H&M will open one of their global flagship stores there towards the end of this year.
All told, I expect our total rents received to grow nicely. The less predictable part of our business is Hong Kong property sales. It is difficult to tell at this stage how many more completed apartments at The Long Beach we will sell for the rest of the year. Such number will impact our bottom line. Most likely the full-year sales figure will be less than that of last year when we sold many units at The HarbourSide. Nevertheless, the chances are good that we will be able to maintain the high profit margin at The Long Beach as in the recent past.

It saddens me to announce the death of our long-serving director Ms. Laura Chen. After a valiant fight of almost a decade, she succumbed to cancer on May 18, 2015. She began her career as a banker and eventually became an investor. Her philanthropic work stood out as bold and effective in helping to eradicate certain diseases in China. She will be sorely missed.

On a happier note, it gives me great pleasure to welcome Ms. Anita Fung as our new independent non-executive director. Anita left HSBC earlier this year. She was its CEO Hong Kong where the operation in 2014 accounted for over a third of the Group’s total profit. Anita was Group General Manager of HSBC Holdings plc since 2008 and was in charge of the Global Banking and Markets business of Asia Pacific. She is widely recognized as one of the most seasoned experts in treasury capital markets. I can hardly think of a more appropriate person to provide this expertise on our Board.

Finally, I am pleased to inform shareholders that the Company has continued to garner many prestigious awards especially in design, sustainability and corporate governance. A full list will be presented at year-end.

Ronnie C. Chan  
*Chairman of the Board of Directors*  
Hong Kong, July 30, 2015