VISION

At Hang Lung, we are driven by a shared vision: to always strive for excellence and scale new heights.

Chairman's Letter to Shareholders

Ronnie C. Chan
Chairman

Results and Dividend

Revenue fell 14% to HK$11,774 million for the year ended December 31, 2017. Net profit attributable to shareholders advanced 43% to HK$5,314 million. Earnings per share rose similarly to HK$3.90.

When excluding all the effects of property revaluation gain, the underlying net profit attributable to shareholders decreased 12% to HK$3,314 million. Underlying earnings per share fell similarly to HK$2.43.

The Board recommends a final dividend of HK61 cents per share. If approved by shareholders, total dividends per share for the year ended December 31, 2017 will be HK80 cents. Final dividend is payable on May 16, 2018 to shareholders of record on May 3, 2018.

Business Review

Much has happened in the past year in Hong Kong and on mainland China, on both political and economic fronts as well as in our industry. Most of these developments should prove favorable for our business.

In Hong Kong, the new Chief Executive Mrs. Carrie Lam took office last July 1. She is expected to continue the land policy of her predecessor, Mr. C.Y. Leung. Namely, she will do her best to procure more land for residential development. We are moving closer to correcting the wrong policy of 2005–2010 when the then administration sold very little land. In the first six months of the government's fiscal year starting April 2017, the budgeted land supply for the entire year has already been met. However, 70% of the land was previously privately held. The government was only able to supply 30%.

Even if this rate cannot be maintained, the joint efforts of the public and private sectors should finally bear fruit. Once land supply is back to a more reasonable level, land prices should moderate, and this will one day slow down the rise of residential prices. When that day will arrive is hard to predict, but it should not be too long a wait.

Few if any major metropolitan areas in the world are like Hong Kong where about 75% of our landmass is covered by vegetation. Approximately 40% of our 1,111 sq. km. is designated as country parks. Only less than 25% of our land is developed. It is reasonable to take, say, 1% to 2% of green land for residential development. Yet there are irrational voices in society that reject this view. It is plain foolishness. Land shortage is at the root of much of our community's social ills. We must strike a balance between buildable land supply and maintenance of park land. No one can have a cake and eat it too.

Another way to create more supply is to reclaim land. Most of our citizens, including this one, are against further reclamation within Victoria Harbor. It is one of the most beautiful harbors in the world, and a key asset of Hong Kong as a world renowned city. However, in parts of Kowloon and especially on the east and west sides of the New Territories, much can be done without destroying our landscape. To be irrationally against all land reclamation, as some of our citizens have become, will only force land prices and eventually residential prices to climb.

Equally critical is that once the supply and demand of land is more or less balanced, the government should begin to build a land bank for future needs. The mistake made in the late 2000's of not preparing a land portfolio from which to draw upon should be avoided. When to sell the land is up to the government, but it must have something to sell when called upon, for it takes time to prepare land for sale. Moreover, if private developers see at some point that the government's inventory is running out, land and apartment prices may both go up sharply. We must preempt that.

That said, no one should expect Hong Kong's residential prices to be cheap in the foreseeable future. Our post-1997 political system has ensured a slower economic growth, as we have experienced in the past two decades. This should in general imply lower property prices. However, there are powerful countervailing forces at work. Chief among them is that many of our fellow citizens from the Mainland would like to own properties in the Hong Kong Special Administrative Region.

In the past three decades or so, wealth creation to the north of the border has been nothing less than spectacular. Usually in the post-war years, some economies can grow tremendously over a short period of time. Post-WWII Western Europe and Japan were two great examples. Reconstruction and development were matters of necessity. The speed of recovery was thus impressive but understandable.

Moreover, two factors made Western Europe and Japan's rise possible and fast. First, both were technologically advanced before the war, providing a good basis on which to rebuild. Second, after 1945, they were both helped by the U.S., which willingly provided capital and favorable policies.

The case of China has some similar characteristics but its climb was perhaps even more amazing. Like Western Europe and Japan, there was a powerful historical background. China began to wane in the mid-Qing Dynasty around 1800. Small foreign armies from Western Europe and the U.S. defeated the giant that previously appeared to be invincible. After the Qing Dynasty ended in 1911, China was embroiled in a civil war, followed by the Japanese invasion in 1931. Full-scale civil war broke out again as soon as victory over the Japanese was achieved in 1945. After the establishment of the People's Republic of China in 1949, the good days turned out to be short-lived. By the late 1950's, the country went into further decline, with many political campaigns culminating in the decade-long Cultural Revolution. In late 1978, Mr. Deng Xiaoping instituted the Reform and Opening-up policy which changed everything.

Rebuilding after a serious war requires little impetus, especially if the country was previously economically advanced. In the case of 1978 China, it had gotten used to weakness and poverty. Yet the will of one man, Mr. Deng, changed all that. He almost single-handedly made the lives of the biggest number of people better by the greatest margin and in the shortest time. No one in history has ever accomplished that and it is doubtful whether another person could emulate his achievement! This is why I believe that he will be remembered as one of the greatest men of the 20th century.

Fortunately, the external environment for the Reform and Opening-up policy was also auspicious. Less than seven years previously, U.S. President Richard Nixon visited China in 1972 thus opening up a relatively long period of rapprochement. Unlike Western Europe and Japan after WWII when the U.S. provided much free assistance, China had to earn every penny by itself. It took full advantage of the then cordial relationship with the U.S. and the West and quickly built up its manufacturing and export machinery, which today rank among the most powerful in the world. From that base, the country has gradually become a global leader in many technologies. Along the way, it has also amassed quite a fortune for its citizens.

From this description, I trust that most of my readers will agree with me that the rise of China is one of the most amazing feats of the 20th century. For us, as a business enterprise operating in this country, its population, economic size, as well as its speed of economic growth have presented us with tremendous opportunities.

Since the 1950's, many Hong Kong people have unspokenly looked down on our Mainland friends because they were poor. All this has gradually changed over the past decade or two, which is 20 some years after China's Reform and Opening-up. Since 1983, the Hong Kong dollar has been pegged at HK$7.8 to US$1. As the Mainland's economy has become stronger, so has its currency. When the exchange rate of the RMB against the U.S. dollar broke through 7.8 in early 2007, one Hong Kong dollar could no longer buy one RMB, and a psychological barrier has been smashed.

Another milestone was passed in 2009 when the total GDP of Shanghai surpassed that of Hong Kong. It is possible that once the 2017 statistics are out, the economy of Shenzhen will likely be shown to be bigger than ours. Guangzhou’s GDP is also expected to pass that of Hong Kong sometime next year. Due to their much larger populations — Shanghai at 24.2 million, Shenzhen almost 12 million and Guangzhou over 14 million versus Hong Kong’s 7.3 million — our GDP per capita at about US$43,500 is still considerably higher than theirs.

Naturally the average Hong Kong citizen does not look at these macro statistics. But to feel their impact, such numbers are unnecessary. Over the past 10 to 15 years, Mainlanders have increasingly come to buy products in our city. At the beginning, mostly daily necessities like toilet paper, diapers, and baby milk powder were carried back, often in sizable quantities. (Knowing how entrepreneurial the average Chinese is, it would not surprise anyone if some of these goods were brought home to be sold at higher prices.)

Then came the purchasers of luxury items such as those sold at our Plaza 66 in Shanghai or Forum 66 in Shenyang. The tax differential makes it a lot cheaper to frequent Hong Kong shops. It is not uncommon for some Mainlanders to visit our city at least once a month for that purpose. Whereas some Hong Kongers resented the shoppers of daily necessities, no one complained about those who buy luxury products. After all, most of us either do not or cannot afford such expensive goods anyway!

My personal moment came about a decade ago. One day my wife and I walked into a high-end fashion store not far from my former office. The saleslady scrutinized us from head to toe and began to speak to us in Mandarin. (In Hong Kong, we mostly speak Cantonese.) When we walked out, I told my wife that we should now be proud — finally someone thinks that we are wealthy!

But our "delight" may be short-lived. In many of the high-end restaurants in our city, Mandarin-speaking customers (i.e. likely coming from the Mainland) outnumber Cantonese-speaking ones (i.e. locals.) Moreover, like other Hong Kongers, my wife and I only order dishes that we like, but our visitors from the north seem to prefer only the most expensive choices on the menu. Who do you think will receive better service from the waiters?! Our place as "second-class citizens" notwithstanding, we are nevertheless happy. For why should we not! Our compatriots have been poor for so long that I, as an ethnic Chinese, am just pleased that they now enjoy a much better living standard.

The most expensive item that Mainlanders buy in Hong Kong is, however, neither jewelry nor costly clothes. Many like to own a residence here. Just as many of the wealthy people in this city bought homes in London, New York, or Tokyo, our Mainland friends with their ever-increasing personal wealth are now venturing beyond their shores. Their first choice is usually Hong Kong. The superrich usually lead the way in buying luxury apartments or even houses. Then other well-to-do's will follow suit and purchase near-luxury units. With tens of millions of middle-class people wanting to buy properties in Hong Kong, how can our residential prices fall in the long term?

Indeed, the economic rise of China has changed the world. To be sure, the place that it first affects is the Mainland and secondarily Hong Kong, which is now reunited with her Motherland. Whereas the per capita income on the Mainland is approaching US$9,000, the number in tier-one and certain tier-two cities is far higher. It was not that long ago when those city dwellers were only buying daily necessities. Today many of them are voracious purchasers of expensive items. It is not uncommon for lines to form in front of shops such as Chanel and Louis Vuitton at our Plaza 66. It can be a daily occurrence and can last for much of the business day. Tier-two cities are also experiencing a rise in personal consumption, although not to the same extent.

Chairman's Letter to Shareholders

With technological advances in the society and qualitative improvements in the economy, China's GDP will continue to rise. It is highly unlikely that the middle-income trap prevalent in Latin America will be experienced in China. While all developing economies have certain common problems, China exhibits significant differences from the likes of Argentina or Brazil. Short on natural resources except human capital and rare earth metals, China is nevertheless strong in education and technology, resulting in the rise of productivity. In the coming decade or two, it may surpass all of the Latin American countries in terms of GDP per capita. A key driver of China's economy will be personal consumption.

This is the basic reason why we believe that our strategy will work very well in the years and decades to come. Every year, tens of millions of people are lifted out of poverty, while many others are brought into the ranks of the middle class. Already China is estimated to have some 300 million of them by international standards. This is almost the size of the entire U.S. population. Of these, many will become purchasers of quality or even luxury products. These are our target customers. The speed at which this group grows is staggering. Indeed the qualitative improvement of the products Chinese companies make and its consumers buy in the coming decade will be one of the biggest economic stories of the country.

Let me turn now to the more recent past. Retail sales in mainland China have recovered well, especially in the high-end sector. There are many reasons for this and here are a few key ones. First, the market has been weak for about five years. The hardest hit was in the luxury goods sector which was important to us. Anti-corruption and anti-opulence campaigns of President Xi Jinping have taken their toll. His actions were absolutely necessary for the long-term health of the economy and the country, but it was a short-term pain for us. On balance, we were very pleased that Beijing took these resolute actions.

Needless to say, not all previous purchasers of luxury goods were corrupt officials. The fast formation and rising prosperity of an affluent class were and still are the main reasons for the robust sales of such products. Years of a weak market must have created pent-up demand. Since the salaries of professionals have never ceased to rise sharply, and many local businesses, big or small, have continued to make money, the cadre of wealthy shoppers must have expanded considerably during the past few years. The combination of these two forces — pent-up demand and the enlargement of potential customers — has contributed to today's remarkable climb in luxury goods sales as witnessed in some of our shopping malls.

There are other more technical reasons for the recovery. For many years, the prices for the same luxury items on the Mainland were much higher than in Europe or in the U.S. High import duty was one main factor. Brand owners also charged more in China since they could get away with it. This began to change in 2015 when Chanel led the charge to equalize prices. China is still more expensive than most other places but the differential has shrunk to such an extent that traveling overseas to shop is no longer as lucrative. The fact that terrorists have been increasingly active in Western Europe over the past few years has also discouraged some Chinese to travel and shop abroad.

Moreover, before 2014, the RMB was basically strengthening which encouraged buying overseas. Between 2015 and 2016, the RMB changed its course. That was also the time when the domestic market for luxury goods was lethargic. In fact, the weak RMB made buying foreign products anywhere more expensive. Since early 2017, the RMB has been strengthening again. Will shoppers pick up the old habit to buy overseas? Some may, but not most of them. Price equalization in recent years has taken a lot of incentives away.

Because of all these factors, I expect the retail sector to perform well in the coming years. Nevertheless, it will take time for the higher sales by our tenants to be reflected as higher rents for us. This is because our lease contracts are usually signed for a period of three to five years. I expect that in 12 to 18 months' time, the positive effects will flow through to our revenue and profit.

Chairman’s Letter to Shareholders

The Hong Kong retail market began to recover after a lull of two to three years. Compared to the same period in the previous year, the growth rate in the second half of 2017 was much faster than the first half. Of late the number of Mainland visitors increased again. This must be an important reason for the rise in retail sales and rents.

The above analyses of the various markets where we operate explain our set of results: Mainland rental income held steady while that in Hong Kong rose slightly.

For Hong Kong property sales, we sold the last unit of The HarbourSide in early 2017 and parted with almost all apartments at The Long Beach. The profit margin kept rising as we sold down our inventory. We will let go of the Blue Pool Road semi-detached houses whenever purchasers appear with offers acceptable to us. The process is not fast but steady.

Prospects

The 19th National Congress of the Communist Party of China held last October removed uncertainties from the market. Going forward, the picture will be even clearer in March when the National People's Congress convenes and a new government lineup is announced. Nevertheless, sufficient clarity is already in place. As long as social stability can be maintained, the economy should continue to progress. An annual GDP growth of 6% to 7% can be expected in the next few years. It will not surprise me if it maintains at above 6.5% for the next year or two.

This is good news for us. Together with a more favorable environment, as reported earlier for retail businesses especially in the high-end sector, I do see better days ahead. All these factors will coincide with what I wrote six months ago, that from 2019 to 2020, we will open many new facilities and complete extensive upgrade works at others — Spring City 66 in Kunming, the second office tower of Center 66 in Wuxi, The Peak Galleria in Hong Kong, a Conrad Hotel in Forum 66 in Shenyang, Grand Gateway 66 in Shanghai, and Heartland 66 in Wuhan.

Given the above, and together with the organic growth of existing properties, our rental revenue should increase nicely during the next decade, and profit therefrom should grow even faster. Whereas we have encountered strong headwinds in the past seven years, we may enjoy some tailwinds in the coming few years.

Chairman's Letter to Shareholders

It is useful to add one more point to the understanding of our recent past which should help us understand our future. I first told the media in late 2011 that we detected a little chill in the Mainland economy and in our industry. Several months later, I wrote likewise to our shareholders. However, many people in the market were unaware of this for another year or two. This is why when we opened our first four malls outside of Shanghai — one each annually beginning 2010, namely Palace 66 in Shenyang, Parc 66 in Jinan, Forum 66 in Shenyang, and Center 66 in Wuxi, we were able to obtain good rental income. If those leases were negotiated in 2013 or after, rents therefrom would have been much lower.

Call it luck or whatever, we were able to enjoy reasonably good rents for a while. However, soon after we opened the malls, our tenants encountered a serious market downdraft. With the rents they had to pay, it became difficult for them to perform as they had hoped. We began to hear cries for lower rents. These were contrary to legal contracts but nonetheless a cruel commercial reality. Without making concessions, we would have faced a serious risk of premature departures by some tenants.

From 2013 onward, when the earlier leases were due for renewal, downward rent adjustment in many cases became inevitable. Even with certain cautious reductions, vacancy rates still rose. We did not have a monopoly of this plight, for every landlord experienced likewise. Our difficulties might have seemed more severe, because our good name and excellent track record had enabled us to negotiate higher rents than most before 2013.

As I have written several times in the past few years, to be sure we had certain internal management issues that needed to be addressed. These began in the late 2000's when we were building malls in earnest. The shortage of professional manpower affecting the construction team soon spread to the leasing team. With so many huge projects being erected at the same time, the expansion of our management team simply could not keep pace.

It is true that the shortage of managerial staff made the teething problems common to all newly-opened properties more painful. However, it did not explain all the difficulties. Consider the fact that our two Shanghai properties which did not have serious management issues also experienced the same winter with concomitant weak results. If the market conditions then had been as strong as in the 2000's or today, all sins would have been forgiven. This was why I considered the market in the past few years a "perfect storm."

Chairman’s Letter to Shareholders

All that is now water under the bridge. We are pleased that many of our managerial problems have been solved, or are at least being solved. Equally pleasing is the fact that the macro environment has changed for the better.

The period between 2010 and 2016 could be considered as the first phase of our venturing outside of Shanghai, with many hundreds of thousands of square meters added to our rental portfolio. After a brief hiatus, 2019, 2020 and beyond can be considered as phase two. I believe that our experience in the two periods will be very different. The first was extraordinarily difficult; the next should be a lot more agreeable. Every factor affecting our business, whether endogenous or exogenous, seems to be much more favorable today.

In the more immediate term, rental income from both Hong Kong and the Mainland is expected to rise gently. From 2019 onward, revenue growth should pick up, with rental profit following soon thereafter.

It is safe to assume that we will sell out The Long Beach in the coming months. After all, we only have a few apartments remaining. With luck, we should also be able to part with more houses at Blue Pool Road. Thereafter, we will become, for the time being, a pure property rental company, until high-end luxury condos at some of our Mainland developments — Forum 66 in Shenyang, Center 66 (Phase Two) in Wuxi, Spring City 66 in Kunming, and Heartland 66 in Wuhan — are ready for sale.

Long-term observers of this Company know that whenever the share price of our publicly listed major subsidiary, Hang Lung Properties Limited (HLPL), is down, we buy the scripts. Inasmuch as we are one of the most transparent entities on the Hong Kong Stock Exchange, no one knows the intrinsic value of these shares as well as this management does. We consider it an excellent opportunity to acquire more at today's price. HLPL (together with this Company) underperformed before 2002. Thereafter, it became a market darling until 2011. I cannot predict how hot our shares will become in the coming few years, but management does believe that sooner rather than later, our intrinsic value will be recognized anew by the market. I await the arrival of that day.

Before 2001, my letters to the shareholders of this Company were much more substantial than those for HLPL. Around that time, we clarified the respective functions of the two entities, where HLPL became the operating arm, and all new real estate projects were put into it. As such, beginning around 2002, my reports for HLPL became much longer. Moreover, before 2011, when we changed our fiscal year-end from June 30 to December 31, my letter at the time of annual results was much more substantial than the interim one. So much so that I feared that many people would only read the end-of-year report of HLPL, and overlook the year-end letter of this Company and the mid-year one of both entities.

Chairman's Letter to Shareholders

Believing that for good governance, the chairman of a public company should communicate more often and in a more timely fashion with shareholders, I began in 2012 to even out the length of the interim and the final reports. After all, the year-end one for HLPL had become too long for me to write and for shareholders to digest. To ensure that our shareholders are aware of the change, I informed them about it in my 2014 interim report of HLPL. In fact, there were a few occasions when the mid-year piece was longer than the year-end one.

Over the past decade or so, I have also gradually enriched the content of this report. Whereas, in general, the letter to HLPL shareholders concentrated more on operational matters and market analyses, I tried to cover macro issues here as well as my views on the Hong Kong residential sector. Nevertheless, it is impossible to cover everything in both reports each year, so I may from time to time refer my readers to the letter to HLPL shareholders. Furthermore, I always cover one or two specific topics of interest to shareholders in each report. It is unlikely that I will return to the same subject each year or half yearly. As such, I may from time to time refer my readers to a previous letter of either company. All such reports can be found in our company website.

A case in point: this year I covered top management succession and board composition, among other issues, in my letter to HLPL shareholders. I encourage you to read it.

Ronnie C. Chan
Chairman
Hong Kong, January 30, 2018