Vision

We share a common vision
and uphold the We Do It Right
business philosophy to strive
for excellence and achieve
new heights for the Company.


Westlake

Spring City 66, Kunming

Heartland 66, Wuhan

Chairman's Letter to Shareholders

Ronnie C. Chan
Chairman

Results and Dividend

For the year ended December 31, 2018, revenue decreased 15% to HK$10,015 million. Net profit attributable to shareholders fell slightly to HK$5,285 million. Earnings per share at HK$3.88 were almost the same as the year before.

When excluding the effects of property revaluation gain, the underlying net profit attributable to shareholders decreased 21% to HK$2,631 million. Underlying earnings per share fell similarly to HK$1.93.

The Board recommends a final dividend of HK61 cents per share payable on May 21, 2019 to shareholders of record on May 7, 2019. If approved by shareholders, total dividends per share for the year ended December 31, 2018 will be HK80 cents.

Business Review

Let me begin with an overview of our business in mainland China from three aspects — the industry, high-end retailers, and our operations. I will concentrate mainly on the sales of quality goods, such as those taking place in so-called four- or five-star malls. This is our main business.

China's Reform and Opening-up Policy began at the end of 1978. Ideological barriers were high but they were gradually overcome in the 1980's. There was a backlash in June 1989, from which it took a few years to recover. The then-paramount leader Mr. Deng Xiaoping paid a visit to the south of the country in early 1992 to revive the national experiment. Many reforms were subsequently made in the 1990's, which laid the foundation for an economic takeoff that began in earnest this century.

When I visited the Mainland in the 1980's, many daily necessities were still unavailable in stores. Quality products were almost non-existent. The 1990's saw considerable improvements, but the base was still quite low. However, societal wealth accumulation became noticeable. In response, smaller and invariably poor quality malls began to pop up, mostly in Guangzhou and Shanghai, and a few in Beijing. Many of them were developed by Hong Kong real estate companies but no one was willing to bet big.

We were the exception. Strategically we decided to go big in Shanghai in 1992. It is probably correct to say that Hang Lung pioneered both the sub-luxury malls, like Grand Gateway 66, and luxury malls, like Plaza 66, on the Mainland. Those pieces of land were purchased respectively in 1992 and 1993, and construction was completed in 1999 and 2000 respectively.

Quality retailing, then limited to the three cities mentioned, began to take off around the turn of the new millennium. The speed of advancement took many by surprise. Even in many tier-two cities, wealth creation became obvious. Bigger malls began to emerge everywhere in the country, although few were of high quality. Nevertheless, personal consumption became a more meaningful share of the domestic economic pie. Quality goods gradually became prevalent in many economically vibrant cities.

For the 12 years between 2000 and 2011, private consumption on average increased at almost 13% per year. It was an amazing period of growth. Even the global financial crisis of 2008 to 2012 hardly had any adverse effect. In the ensuing six years of 2012 to 2017, the average annual growth slowed to a still respectable 10.4%. However, luxury goods sales were much more affected. The anti-corruption campaign in the past few years was certainly a major factor. The increase in overseas sales of such items was another. This trend only began to turn around towards the end of 2017.

Now let me turn to the high-end retailers. Before 2000, one could hardly find them anywhere in mainland China. Top Western fashion houses, mostly European, began to take notice of the market potential in the late 1990's. When we opened Plaza 66 in Shanghai in 2000, many of them landed in this big country for the first time, and most local citizens were introduced to these fashion brands for the first time.

As the economy grew rapidly, these retailers began to make a lot of money. They projected that China would soon become their biggest market in the world, and they were correct. Consequently they expanded rapidly into many tier-two cities, so much so that some of them over-expanded, beyond what the local economy could sustain at the time. By 2013 at the latest, most if not all of these top brands froze further advancement. A good number had to cut back the number of stores in many cities. The head office grip was so tight that moving a shop from one location to a much better location at comparable rents was rejected. This condition lasted through the end of 2017 and the beginning of 2018. Sentiments now have definitely turned and they are all opening new stores again. Their sales growth in China has been brisk of late.

Why the change? The effects of the anti-corruption campaign mentioned earlier have long been felt. Gifting involving government officials is long gone. The market has shifted into a healthier one where demand mainly comes from end users. The slow growth of the past five to six years has created pent-up demand. Since the salary rise of the target customers, especially younger professionals, has never stopped, this clientele that bought less when market sentiments were weak has now returned, and with more money to spend.

Many top brands have told us that the average age of their shoppers in the world, including China, is getting younger. This means that they now have even more fans and potential fans. The fashion name owners are also expecting that Beijing's efforts to bring overseas sales domestic will soon bear fruit. All these factors are once again fueling the expansion plans of luxury brands.

How do we fit into this overall picture? Our strategy and timing could not have been better. Betting big in the 1990's to build two sizable malls in Shanghai — one each in the luxury space (Plaza 66) and sub-luxury space (Grand Gateway 66) — has paid off handsomely. Expanding into tier-two cities in the mid-2000's was a necessary step for the long-term growth of the Company. We have been the "Home to Luxury" in Shanghai since the 2000's, and were expecting the same in other cities in the 2010's.

GRAND GATEWAY 66, SHANGHAI

However, we were hurt by the bear market of 2012 to 2017. Those were the years when China's economic growth slowed, market sentiments for private consumption weakened, and the luxury retail sector was particularly hard hit. In hindsight, could we have escaped the onslaught? Hardly, but we could have minimized the pain if we had done a better job in one area.

As I wrote several times to shareholders, the rapid expansion of mall construction outside of Shanghai in the late 2000's had greatly strained our management. Our team build-up could not catch up with the pace of construction — between 2010 and 2015, we completed almost 2 million square meters of world-class commercial space (including associated car parks), much of it during the bear market. That was over four times what we have in Shanghai, and almost double the size of our combined investment property portfolio in Hong Kong and Shanghai that was built over some 35 years.

Now the picture is completely reversed. We have resolved most of our management issues, and the luxury and sub-luxury markets have fully recovered. Better days should await us.

Whilst management is not overly concerned with our share price, it is nevertheless worth commenting on it briefly. For about 30 years before we opened our two Shanghai complexes, we underperformed our peers. Beginning around 2002, we outperformed almost all property counters in Hong Kong for about a decade. Then in the past six to seven years of bear market as mentioned above, we again did not do well. So far this year, we have outperformed. We may be at an inflection point.

More significantly, our business may also be at an inflection point in several respects. First, except for the luxury home project on Blue Pool Road, we have all but sold out our developmental residential products in Hong Kong. (Only one unit of The Long Beach remains unsold.) Those pieces of land were purchased in the early 2000's, so the ultimate profit margins obtained therefrom were phenomenal. However, as my regular readers know, for about 15 years we have been concentrating our efforts on Mainland high-end commercial property development for long-term investment. Since 2004, we have undertaken eight sizable developments in seven cities. Upon completion, they will provide about 4.3 million square meters of world-class commercial space, of which about 43% have been completed and are generating profits.

We will continue to do development projects for sale in Hong Kong, but only with a targeted approach. As I shall report in the next section, at present we have two such projects for which land acquisition is almost complete. This seems natural since we already have the expertise; indeed, this Company started its existence doing just that. Such efforts will supplement our main business in rental properties and provide a faster cash flow. Nevertheless, our focus in the coming years will still be on high-end commercial properties for long-term hold.

The second inflection point relates to the market. As reported earlier, Mainland Chinese high-end private consumption grew briskly for almost 12 years between 2000 and 2011. This was followed by a long bear market of six years from 2012 to 2017. Now the sector is again rising strongly.

The third has to do with our management. Problems of the late 2000's and the first half of the 2010's have been all but resolved. Our team today is stronger than ever, although there is still room for improvement.

It is at this juncture that Mr. Weber Lo joined us last year as our new CEO. In early years, under the leadership of Mr. Nelson Yuen, we decided on a strategy, bought the land, as well as started the construction. When Nelson retired in 2010, Mr. Philip Chen took over, built the team, and set up the necessary systems. Last July, Weber succeeded Philip. His main task is to perfect the systems and realize the profits. I do not see why this cannot be accomplished.

It is worth mentioning that the leadership of the Company has always been quite young. When Mr. T.H. Chan founded Hang Lung in 1960, he was barely 40. I took over the chairmanship in 1991 at around the same age. Nelson was also at this age when he began to run the Company with me two years later. Philip was 54 in 2010 when he joined us, and Weber was 47 last year. Today, much of the management burden rests with Weber and our Executive Director Adriel Chan who is 36. They make a superb team which should be able to steward the Company for the next few decades.

Finally, in terms of business performance, the Company is also poised to advance significantly. All AEI (Asset Enhancement Initiatives) in Shanghai will be completed in a few months. In the next two years, we will have completed more world-class commercial space on the Mainland than at any comparable period in our history — a total of approximately 1.1 million square meters of luxury malls and office skyscrapers. To continue an analogy that I have used before, this is like bringing more than two Empire State Buildings of New York City to the market each year for two consecutive years.

The average quality of our tenants is also on the rise. Our office tenants are already among the highest caliber in each of the cities we operate. This was what we envisioned in the mid-2000's when we decided to build office towers in tier-two cities. In provincial capitals like Shenyang, and certain wealthy municipalities like Wuxi, there will always be a certain amount of demand for top-class Grade-A offices. As long as we build the best quality space in prime locations, we can always lease them at reasonable prices. Our experiences so far have borne out this fact, and we expect the same to happen soon in Spring City 66 in Kunming and Heartland 66 in Wuhan.

Mall tenant quality can always be upgraded, unless it is like Plaza 66 in Shanghai which already houses the world's top fashion brands, making it a true "Home to Luxury". Such names command rich profit margins which will enable them to pay higher rents. Particularly pleasing at this time is not just that we are signing over 30 such leases; rather, these fashion houses will enter many of our malls other than Plaza 66 — one-third of them will be in Grand Gateway 66 and two-thirds will be outside of Shanghai. They are convinced that, not just in Plaza 66, we have the best possible properties where they can sell their expensive products, and with which they would like to be associated. They will help transform Grand Gateway 66 into another "Home to Luxury" in Shanghai. Our other shopping centers that will benefit include Forum 66, Olympia 66, Center 66, Spring City 66, and Heartland 66.

All these inflection points are beneficial to our business, especially our rental operations on the Mainland. Some of these positive effects have already been seen in our results, but the full impact will only be felt starting next year, when Grand Gateway 66 fully reopens after the completion of its AEI, Spring City 66 inaugurates at the end of this year, and many luxury stores open in these and other malls of ours.

This said, the results of the past year have been satisfactory. They were in line with what I have predicted six months, even 12 months, ago. This was true of our investment properties in Hong Kong and on the Mainland. Since we have all but sold out our Hong Kong residential development projects, top and bottom lines both retreated.

This brings up the question of what should be a reasonable and sensible way to assess our Company and its performance. For well over a decade, we have told shareholders that moving forward, we will increasingly become an investment property-led enterprise. Development projects for sale will be done only under either one of the two conditions — in Hong Kong, opportunistically, and on the Mainland, as part of a bigger complex with primarily retail and office space. Given that, one should treat the development process as being separate from our rental operations. The former is by nature volatile, while the latter is steady. Only by doing so will we be comparing like with like.

PLAZA 66, SHANGHAI

Prospects

On the geopolitical front, there is a dark cloud looming on the horizon. China-U.S. relations are also reaching an inflection point, and the future can be troubling. I have written about this at some length in both my July 2018 and January 2019 letters to shareholders of Hang Lung Properties, our majority-owned operating and listed entity. I encourage you to read them. You can access them through our website (www.hanglung.com/en-US/media-center/publications/chairmans-letter-to-shareholders). I will only very briefly summarize them here.

The present trade dispute is in the total scheme of things but a proxy for a much longer term and more serious technological race. Increasingly perceiving in the past two decades that China is fast-rising and so must threaten her hegemony, the U.S. is now engaged in an all-out tech war with China because technology determines military might. To accomplish this, Washington, D.C. is using all that is within her power to contain China. While it is intellectually intriguing to elevate the competition to the level of culture, civilization, ideology, or political systems, at the heart it is a perceived threat to American hegemony.

How did we get to this point? It traces back to the fall of the Soviet Union in 1991. Believing thereafter that in almost every respect, the Western systems of market economy and democracy are superior (and in many ways they are), Washington, D.C. cannot accept that the Chinese model of state-guided and participated economy with limited democracy can at times be superior. Yet the facts are now staring in her face. For example, instead of competing with China to develop faster 5G communications, the U.S. is falling behind and so she tries to contain China by all means, even resorting to very unsavory methods. The gloves are off.

Objectively studying the situation, it is not difficult to come to the conclusion that China will be able to bear the consequences of a trade war without overly serious trouble. One should not forget that Beijing can also retaliate in trade and other areas, which will make it equally unpleasant for the U.S. At the end, no one will win, and some reasonable solutions can be derived.

But where will the great tech war end? What will the world look like afterwards? In a highly undesirable scenario, there will be two tech systems and two tech standards used in different parts of the world. Politically and economically, there will be two spheres of influence. All countries will have to choose sides — either the U.S. or China. Relationships between countries will have to be readjusted. With all this unnecessary friction, trade flows and even supply chains will be disrupted. They will have to be reestablished in patterns that we cannot predict today. It will be a totally different world from what we have known since World War II.

What about the Chinese economy which is of paramount interest to us? While the global economy will no doubt slow down, Beijing will try its best to stimulate its domestic economy for job creation and social stability. Any existing policy can be quickly reversed. For example, whereas citizens have for years been discouraged from buying homes, especially second homes, recently many of these rules have been relaxed to cater to macro-economic needs. Some possible negative consequences may arise that must be addressed, and Beijing will do so later.

It seems certain that the Central Government will do its best to stimulate domestic consumption. After all, individual (and corporate) saving levels are huge. The humongous pool of low-yielding or even idle money must be unleashed for more productive use. Just as home building and home purchases will greatly stimulate the economy, so will private consumption increase. This should be excellent news for us.

Nevertheless, the tech war may bring colossal unforeseen consequences which should keep us vigilant. These can be far more significant than those of the trade dispute. We have seen the latter before and can make predictions based on many similar historic incidents. The former is hardly known to mankind. No one has ever witnessed the speed, magnitude, and pervasiveness of technological developments as seen today. Francis Fukuyama's book *The End of History and the Last Man*, published in 1992, was premature if not outright misguided. However, the technology race of today may well bring about the end of history. It is an uncomfortable thought. Much more analytical work needs to be done before any of us can have a better handle on this novel but troubling development.

This is why, while being quite pleased with our business and its short- to medium-term prospects, we are also taking defensive measures. This is one reason why we have decided to soon build out our not inconsequential Mainland land bank of high-end serviced apartments. These are located in Heartland 66 in Wuhan, Center 66 in Wuxi, Forum 66 in Shenyang, and Spring City 66 in Kunming. I expect a healthy cash flow as well as profits therefrom.

In Hong Kong, we are pleased to have sold out almost all residential units, especially since prices are correcting. We only have 12 semi-detached houses at Blue Pool Road and one apartment at The Long Beach remaining. Our timing is again quite good.

We will part with some of our mature Hong Kong investment properties. In the past, we periodically sold some at prices far above their book value. I will not be surprised if history will repeat itself.

We have been and will remain cautious regarding our expansion plans. We will only take on investment property projects that have a clear strategic value and at the right price. The Hangzhou land purchased last May was such an example. We are now working on certain other similar projects, but I do not expect fruition to come any time soon.

SPRING CITY 66, KUNMING

Recognizing the comprehensive quality of all Hang Lung malls, top luxury brands are signing up in our properties

Whereas we are cautiously optimistic about the Mainland, we maintain a positive outlook on the future of Hong Kong, both its economy and its property market. Consider the following.

As the Mainland economy and society develop further, the gap between the Motherland and Hong Kong in many respects will narrow. It has been happening for decades and will continue for many more years to come. This is both boon and bane to Hong Kong, but mostly boon. For example, the Central Government is now determined to turn Shanghai into an international financial center for RMB-denominated products. As the Yuan (i.e. RMB) plays a more significant role in the global economy, which is inevitable in the long run, there should be a financial center on the Mainland for this. Why should Beijing cede all business to offshore RMB centers like Hong Kong, London, or Singapore? As long as Hong Kong people do not behave foolishly as they have done occasionally since 1997, our city should still be the most significant non-RMB as well as offshore RMB center for China for some time to come.

The right of passage to Hong Kong for Mainland citizens is expected to tend toward relaxation, although progress may be slow. As the two sides economically equalize and harmonize further, this condition should persist and even be enhanced. In time, money flow should also become freer. Imagine the increased demand for our residential units!

Even our commercial properties will benefit. Historically, purchasers of Hong Kong offices and retail space have been our citizens or local real estate companies like us. In more recent years, investment funds, both local and international, have joined the game. Most of them have a shorter term horizon. Long-term institutional money has always been lacking, but now it is lurking across the border. Think of the needs of the Mainland insurance companies and retirement funds — quality long-term assets to match their liabilities. They can buy in many Mainland cities, but few other than Beijing and Shanghai have commercial buildings as prestigious and as safe as investment assets as Hong Kong. The smallest of these three markets is Hong Kong, yet for various reasons, it may be the most desirable one.

Given all of the above, how can Hong Kong's real estate market — indeed the overall economy — be anything but good!

For domestic political reasons since 1997, Hong Kong has not achieved our potential. If we had been shrewder, we might have become a far more significant financial center of a fast developing economy which has now become the world's second largest. For example, the headquarters of some of the pan-regional development banks established in the past 15 years could have been located here. Think of the associated economic benefits that they can generate. In the overzealous desire of some to prove ourselves different from the Mainland, we are harming our own economic potential.

Nevertheless, given our unique location and history, Hong Kong will remain a vibrant city. Although no longer growing as fast as before, nor as fast as we should have been, we are still in an envious position. As long as mainland China needs us, or as long as we present ourselves desirable to the country, we will continue to do well.

In many ways, we are one of the safest economies in the world. Under the "One Country, Two Systems" construct, we can have the political, economic, and military support from the Motherland as and when required. If, as expected, the Mainland economy continues to develop well, we will continue to benefit. But if geopolitics across the Pacific turns ugly, Beijing may need Hong Kong more. I cannot say that our position is foolproof, but all things considered, we are still the envy of many.

The world has always been a turbulent place. It was particularly so in the first half of the 20th century, to be followed by seven decades of relative peace. I fear that now the world is entering into yet another unstable period. No one knows how serious it will be or how long it will last. In this sea of instability, China may in fact be a haven of relative tranquility. If so, then private consumption will rise and our business will benefit therefrom. Looking around the world, I consider myself fortunate to be engaged in our business on the Mainland.

In the more immediate term, I see gradual growth in our business for the rest of this year. The Hong Kong rental market performance should be similar to that of 2018. On the Mainland, it is quite possible that all our investment properties will do better than last year. The leap in the top line will begin next year, and the trend may last for several years. With a lag of say one to three years, the rental net profit should rise.

Our 2019 results will obviously depend on how many houses at Blue Pool Road we sell. This outcome is not possible to predict. What is quite sure is our main rental business should do satisfactorily.

Barring unforeseeable circumstances, the next few years should be very good for our business and, I trust, for our shareholders as well.

Ronnie C. Chan
Chairman
Hong Kong, January 30, 2019