RESULTS AND DIVIDEND

Compared to the last corresponding period, overall revenue decreased slightly by 1% to HK$5,237 million for the six months ended June 30, 2023. Our solid leasing performance was offset by the depreciation of the Renminbi (RMB), and no contributions were recognized from property sales. For our core business, rental revenue grew by 5% in Hong Kong Dollar terms to HK$5,237 million.

Underlying net profit attributable to shareholders remained flat at HK$2,225 million when excluding all the effects of property revaluation. Underlying earnings per share stayed at HK$0.49.

Net profit attributable to shareholders, after considering all the effects of property revaluation, increased by 23% to HK$2,394 million. Earnings per share rose correspondingly to HK$0.53.

The Board has declared an interim dividend of HK18 cents per share, payable on September 29, 2023 to shareholders of record on September 15, 2023.

BUSINESS REVIEW

Since we opened our first mall on the Mainland in Shanghai in 1999, our rental revenue therefrom has consistently increased in RMB terms, reaching new heights each year. Notably, even during the past three years of COVID-19, its growth has never stopped. The 1% drop in retail revenue in 2022 (over 2021) was more than compensated for by the rise in office rental. We broke the record again these past six months, as reflected in our first half-year results. We are working to continue this winning streak in the second half if the market cooperates. The chances are good.

Frankly, it is difficult for anyone to imagine a similar outcome in the commercial rental space in China. The achievement was a result of the combination of our market positioning and operational efforts. Because the present macro picture is so dire, investors are holding off from China, particularly in retail-related sectors like ours. As a consequence, our share price does not reflect what we consider to be a string of strong results, before, during, and now after the pandemic. But as I have long believed: always do the right thing and the market will eventually acknowledge our success. As our company motto says: **We Do It Right**, and more recently, **We Do It Well**.

When I last wrote to shareholders at the beginning of this year, China was just emerging from an odd series of unprecedented events. After abruptly reversing her almost three years of strict COVID-19 containment policies in early December, herd immunity was quickly achieved in about six weeks. Everyone expected that Beijing would come up with some strong economy-stimulating measures. They did, but the response may not be as they had hoped.

As I have explained before, the Chinese economy has at least four major challenges: the aftermath of COVID-19, consequences of dealing with Internet platform companies and private education institutions, bursting of the housing bubble, and deteriorating China-U.S. relations. Each contributed differently to — but all with financial and socio-psychological effects on — today's economic malaise, something which I will detail in the next section.

With this background, it is very challenging for property companies like us to grow tenant sales and rental revenue. The only sector that would have a chance is truly luxury retail. Even then, it may not be easy. As such, our performance can be considered quite satisfactory, breaking commercial rental records in each of the past 23 years, including the last three under the pandemic.

Given the unique circumstances of the recent public health threat, we should also compare our 2023 performance with that of 2019, which itself was a record high at that time. To eliminate the effect of currency translation, I will use RMB terms to elaborate, which is a better reflection of performance.

All our seven luxury malls made advancement in rental revenue for the six months under review when compared to the same period in 2022. The best performing property was Plaza 66 in Shanghai, which rose by 23%, followed by Olympia 66 in Dalian by 19%, Center 66 in Wuxi 16%, and Grand Gateway 66 in Shanghai 11%. Spring City 66 in Kunming came in at 9%, while Forum 66 in Shenyang recorded a 6% increase. Occupancy basically held steady, and tenant sales were very strong almost across the board.

When comparing rental revenue of the past six months to the first half of pre-COVID 2019, the growth was spectacular. (Spring City 66 in Kunming opened in August 2019 and Heartland 66 in Wuhan in March 2021, so the two cannot be counted.) Center 66 in Wuxi soared by 126%, Olympia 66 in Dalian 80%, and Plaza 66 and Grand Gateway 66, both in Shanghai, rose by 73% and 56%, respectively. In fact, occupancy increased everywhere except at Forum 66 in Shenyang. As before, Forum 66 remains the least successful of all our luxury facilities.

A critical KPI for our business is obviously tenant sales. Compared to the same period in 2022, all our malls grew at double-digit rates except one. Our seven luxury properties on average did 42% more business, and our three sub-luxury ones rose by 36%. In Shanghai, the growth of 68% for Grand Gateway 66 and 62% for Plaza 66 were an anomaly due to a low base, as a result of the two-month citywide closedown last year. Olympia 66 in Dalian, Heartland 66 in Wuhan, and Center 66 in Wuxi all experienced growth rates between 24% and 26%. Forum 66 in Shenyang sold 16% more, and Spring City 66 in Kunming increased by 8%. All malls did better than in the six months immediately prior.

A more meaningful and interesting comparison is made with the same period in 2019 before the pandemic. On average, among our seven luxury properties, our tenants did more than triple the amount of business this year than in the first six months of 2019 — a rise of 217%. Center 66 in Wuxi made more than four times the sales. At Olympia 66 in Dalian, tenants sold 257% more; at Grand Gateway 66 in Shanghai, the increase reached 156%; and at Plaza 66, also in Shanghai, the gain was 136%. Even the shops at Forum 66 in Shenyang did 40% more business. The three sub-luxury properties did marginally better than in pre-COVID 2019. All of these encouraging results strongly underpin the rise in rents that our spaces command.

These figures show that, if done well, as we did, the pandemic did not hurt our business at all. At a time when public information demonstrated a clear trend of rising vacancies and lowering unit rents, our performance seemed to defy gravity. Actually, we do not. We are fortunate to be well-positioned in the right segment of the business — luxury fashion — and have executed this strategy reasonably well.

In recent years, our Mainland office portfolio has grown nicely. Being a steadier product less subjected to fluctuations like retail space, comparison with the same period in 2022 is more reasonable. Due to the weakening of the overall economy, the growth rate has moderated to 6% in local currency terms. When translated to our reporting currency, the Hong Kong Dollar, which appreciated 6.3% over the RMB, the total office rent received was 1% less. Minor weaknesses were identified in a few of our locations, but the two towers in Plaza 66 in Shanghai saw a pleasing rise in rents. More spectacular results in percentage growth came in the two newer skyscrapers, one at Spring City 66 in Kunming and one at Heartland 66 in Wuhan.

People began to travel after the pandemic, so our hotel business has improved significantly. But given its modest scale, it does not change the total picture much for us. There was also no sales activity on our residences at Heartland 66 in Wuhan.

In Hong Kong, both our tenant retail sales and rental revenue have improved from a year ago. These grew, respectively, by 22% and 6%. But when compared to the same period in 2019, i.e., pre-pandemic, they were still down by 7% and 16%, respectively.

Hong Kong office rents have edged up 1% compared to the same period last year. Rents from our residential and serviced apartments were down by 1%.

To summarize, on the Mainland we collected 13% more rents in RMB terms when compared to 2022. Revenue from retail space increased 13% — a 16% rise in luxury and a 3% retreat in sub-luxury. Office rents rose by 6% and hotels by 130%. Due to the devaluation of the currency, the growth rate was 6% in home currency terms. Together with a 4% rise in Hong Kong rents, the total rental revenue advanced by 5%. We did not sell any residential property in the past six months.

To give my readers a sense of our performance compared to 2019 before the pandemic, our Mainland portfolio delivered a growth rate of 66% in revenue in local currency. Retail rents rose by 69% — 93% for the luxury category, while sub-luxury malls retreated by 11%. We collected 40% more revenue from our offices. In Hong Kong, total rents remained 16% below the pre-COVID level — by the same magnitude for both retail and office, and 24% lower for residential and serviced apartments.

Leasing operating profit for the six months was up by 8% from a year ago, and its underlying net profit attributable to shareholders increased by 6% to HK$2,246 million. After a minor net revaluation gain, the net profit attributable to shareholders climbed 31% to HK$2,415 million. Compared to a year ago, the profit margin was up two points to 74% — three points on the Mainland to 70%, and one point in Hong Kong to 82%.

Mainland rental revenue now accounts for 68% of the total and Hong Kong 32%. The net debt-to-equity ratio moved up a little to 30.4%.

Now let me review a little history for my readers. It can be instructive for the future. Our strategy is not altogether unique; many others also develop, manage, and own commercial real estate in mainland China. But examining beneath the surface reveals that perhaps we are somewhat different from most, if not all, of our counterparts.

For example, our projects are invariably centered on a retail mall, usually with a top luxury market positioning. We are more willing to invest in the long term, as evidenced by our insistence on the choice of location, our design and construction, and the Asset Enhancement Initiative (AEI) we execute. During the bear market years from 2012 to 2017, we began a total upgrade of our two flagship Shanghai properties, and we spent a total of over RMB1.5 billion on these two AEIs. Our malls are often strongly supported by our offices. These skyscrapers are of the highest quality in the country, which is reflected in their high occupancy and rents.

Is ours an acceptable strategy? The proof of the pudding is in the eating. Consider the following historical numbers: for the past 23 years since we opened our first mall in December 1999 and up to 2022, our commercial rental portfolio has never suffered a down year. All this was set against rather turbulent times.

While 2000 to 2010 were relatively peaceful years, a prolonged bear market began in the second half of 2011 and was greatly exacerbated by the government's anti-corruption and anti-decadence policies implemented from 2012. Luxury retail was the hardest hit. It was not until early 2018 that the market began to recover.

In those six to seven difficult years, five malls and two office towers were slated to open. Barely two good years passed, and in early 2020 we were confronted with the COVID-19 pandemic, which lasted three years. Between the second half of 2019 and 2021, we inaugurated two sizable shopping centers and three office towers. So almost half of the past 23 years were troubled times.

What sustained the 23-year winning streak was not primarily the addition of new space, for it takes one or two three-year lease cycles for properties to mature after opening. The key is to ensure organic growth. This is amply demonstrated in the successes of all our luxury malls, with one exception.

Due to last year's total closure for two months and partial shuttering for the rest of the year, our two malls in Shanghai naturally recorded a drop in rents — less than 1% for Grand Gateway 66 and 10% for Plaza 66. Before that, there was not a down year for our retail rents except when we closed part of the facilities for the AEIs, as mentioned above. A similar situation occurred in our luxury properties outside Shanghai.

During the last two of the six- to seven-year bear market (2016 and 2017), Center 66 in Wuxi, then not yet in the luxury category, recorded a fall in rents. By 2018, it began to metamorphose into a top-end center. Revenue has jumped every year since. During the four fast-growing years from 2018 to 2021, it achieved an average annual increase rate of almost 28%. Remarkably, even the abnormality of 2022 was unable to stop the rise. Rents rose 7% that year.

Olympia 66 in Dalian followed a similar path and transformed itself even faster into the luxury category. With the exception of the first year of the pandemic in 2020, which brought tremendous business disruptions, the rise in rents was spectacular. For the last two years, it averaged 30% annual growth. This increase may continue for a few more years.

Spring City 66 in Kunming and Heartland 66 in Wuhan were born shortly before and during the pandemic. Their rates of rental rise have shown a healthy upward trajectory. Barring a major market setback, the two malls should continue to grow nicely.

Office rents fluctuate a lot less than their retail cousins, resulting in less frequent rent reductions. Even during the pandemic, our revenue hardly fell. Again, in the past 23 years and apart from AEI purposes, there were only two down years. In both cases, the magnitude was minimal — never exceeding low single digits.

At our two skyscrapers at Plaza 66 in Shanghai, the three years of AEI saw an average annual fall of 3% in rent. This was because we deliberately chose not to renew certain leases. That aside, there was hardly a down year in the project's long history. (A similar condition was observed in Grand Gateway 66 Office Tower, owned by our parent company, Hang Lung Group). Forum 66 in Shenyang saw only a 2% annual decline during two of the three pandemic years, but none before that. The two buildings at Center 66 in Wuxi, taken as a whole, have consistently seen rent increase since their inauguration.

Taking the entire office portfolio together over the span of 22 years (our first skyscraper in Plaza 66 was inaugurated in 2001), there were only two years of fallen rents of about 3.5% each. (The same holds true when the Grand Gateway 66 Office Tower from Hang Lung Group is added.) Spring City 66 in Kunming and Heartland 66 in Wuhan each have one office building, and their rents have been steadily rising. They are, however, quite new — opened in 2019 and 2020, respectively.

The total office rent now approaches that of our second most profitable mall, Grand Gateway 66 in Shanghai, in terms of total revenue. It accounts for almost 20% of our Mainland business and is no longer inconsequential.

Inasmuch as we were able to grow our luxury retail rental business over many years with limited volatility, the addition of a steady office portfolio did help to keep the revenue increase momentum. For example, in the particularly difficult year of 2022, under strict rules fighting COVID-19, Shanghai was the hardest hit, yet our total Mainland rents did not fall. This was because of strong office performance as well as the rapid rental growth in luxury malls elsewhere in the country.

I am not sure if there were other commercial property owners as fortunate. If there were, the number would probably not be large. In that sense, we are quite unique. Over the years, we have had our share of mistakes, but have also done many things well. Apparently, the latter strongly outweighs the former.

There is a more immediate market development that I should review with our shareholders. In the past few years, I have opined that when the pandemic subsides and international travel resumes, the sales leakage of luxury goods to overseas should not be serious. That assessment was based on the prevailing conditions then. At that time, there was a considerable convergence of domestic and international prices, which was not the case for many years. When the price of the same item was much higher at home, Chinese customers would, of course, be tempted to shop overseas. This phenomenon was further affected by the movement of the RMB vis-à-vis foreign currencies of countries or economies (including Hong Kong) of intended purchases. It also depends on the actions of Chinese customs officers at the ports of entry. If there was a period of relaxation in customs regulation, smart Chinese citizens will notice and begin buying overseas, as long as a sufficient price differential exists.

In this regard, it is interesting to observe that when a top European fashion house announced their results last week, it stated publicly that they would raise prices in Japan, in order to reduce the big price gap between Japan and China. One reason is that the Yen has been very weak of late. I will not be surprised if other major brands take similar steps. This is good news for us.

It is always helpful to have external validations of our own experiences and observations. This is why we always compare our results with those of major fashion companies. The announcement last week made by several top fashion houses have confirmed that China, which invariably is their most significant market, is still growing strongly.

Moreover, comparing their growth rates in China with that in our stores tends to indicate that their shops in our malls are more productive. This does not surprise us for we strive to be the best in the business. It leaves us in good stead with the management of those brands, which are important to our future. The issue is how to maintain that outperformance. My team and I will certainly do our best.

Please allow me a final observation for this review. As I have long written on this platform, mass retail, even in what I call four-star malls, is not where we want to be. Such shops have too low a profit margin to pay high rents. They are also much more vulnerable to online shopping. And since the expertise required to build such facilities and manage the business is much lower than luxury ones, many developers can build and own the former. On all counts, the opposite is true of what we strive for and excel in doing.

The latest pandemic has confirmed all that. The lack of people movement in the past three years has accelerated the migration to online shopping. COVID-19 was a boon to e-commerce and a bane to physical retail rental. The only sector that has been spared is the truly five-star malls. Our experiences have borne out that fact. Today, there is a general negativity towards retail space owners. Rightly so, for there are not many malls that are genuinely top-end like ours. The differential in performance between our seven luxury facilities and the three sub-luxury ones speaks to the same. I do not see any possibility of a reversal in the near future.

PROSPECTS

In the last section, I have listed the major causes of weakness in China's economy. There are primarily four.

The first is the cost of fighting the pandemic the way China did. There were direct costs to contain the virus as well as indirect costs, such as diverting limited resources from productive economic activities. The financial consequences were dire. Equally serious was the disappointment of the Chinese populace. The abrupt reversal of her containment policy had baffled many, although, as I had stated six months ago, it was totally explainable. Either way, when people are uncertain about the future, they tend to reduce consumption. They feel the need to save up for rainy days ahead. With the pandemic essentially gone for only six months, society needs time to adjust.

Coinciding with the public health challenge were the government policies to rein in Internet platform companies and private education entities. As I have previously written, the rationale for such policies is certainly justifiable, but the execution and timing were problematic. Worse was perhaps the erroneous impression of sudden policy changes. Guessing what officials will do next generates much anxiety, especially in a top-down society like China. Businesspeople were at a loss to respond, not knowing what may be thrown their way next. This is perceived to be a high-risk period, and the rational and safest thing to do is to do nothing. This loss of confidence is a key driver of the present economic malaise.

A third factor troubling the economy is the bursting of the housing bubble. To be sure, it has been long in the making. Every economic model practiced by major countries in the world comprises two elements: market forces and government policies. What matters is the proportion of these two, which can vary over time. In general, the U.S. economy is more market-oriented, while the European ones are slightly less so. In the case of China, the market is more guided by the visible hand. When that hand does well, the economy can strongly rise; but if mistakes occur, the economy suffers. However, officials are also capable of making corrective actions, as we have witnessed before in China.

In the case of the Chinese housing market, government policies and actions are paramount. A crucial factor that led to today's market condition is that, over the past 30 years or so, developers were basically prevented from going bankrupt. As a result, a moral hazard exists — market participants can be reckless and do not have to bear the consequences. That is, until now. The crisis has become so grave that its financial weight is crushing everyone. In the past, I had written on the technical aspects of the unsustainable nature of that business model, so I will not belabor here. Suffice it to say that being a big part of the overall economy and a socially sensitive sector, the industry's troubles will become a problem for the economy and society. Worse yet, there is no easy solution now that the bubble has burst.

The last of the four challenges is the effects of worsening China-U.S. relations. It started at least 30 years ago with the fall of the Berlin Wall, which negated the raison d'être of the Nixon-era rapprochement. Over time, it has gotten progressively worse, although most people did not feel it until recently. The wild years of Trump cemented the bad relationship and galvanized almost the whole of the U.S. to oppose China. A bipartisan consensus was formed. But the worst may be the Biden administration, which heightened the attack on the grounds of national security and made turning back extremely difficult.

Beyond bilateral trade, which is fundamentally a matter of rational calculation, now the issue is one of politics and emotion, which can be illogical. Facts no longer matter, and common sense can be easily put aside. Being the most powerful nation that humankind has ever seen, the U.S. is forcing everyone to choose sides. The only thing that can hold her back is her self-interest, such as protecting her vital economic needs to preserve the international dominance of the U.S. Dollar. Even so, at times, America would seem to forsake even that for smaller short-term gains. It is madness, and such is the world we live in today.

In the name of protecting these "national interests", the U.S. is hitting China with all she has. High on the agenda is the competition in technology. Following therefrom is the limiting of people flow and capital flow. From what I can tell, this is just the start. More restrictions will come, and these will further bifurcate the world. It will lead to differences in standards from the critical to the mundane. The practical ramifications of all that will be profound and ubiquitous.

Trade flow will change, and so will people flow and capital flow. Dealing with multiple standards and systems will be hugely inflationary. In the short term, it may spur a construction boom from the physical to the digital domains, but the resulting rise in raw material prices and labor costs will fuel inflation. There will be no winners in this game. Frankly, it is the biggest spectacle of our time when the number one power (the U.S.) wants desperately to suppress the number two (China), and the latter has no choice but to fight back. All gloves are off!

The deterioration of this critical international relationship is the fourth drag on the Chinese economy. If the first three were of her own making, this one has been thrown at her whether the ancient country likes it or not. In the end, perhaps the most troubling aspect for Beijing is the timing. Each of these four problems alone is already a handful. Each of them has a financial aspect as well as social and psychological ones. For the four to occur at the same time is truly unfortunate. This will tax the wisdom of her leaders as well as the cohesiveness of her society.

To be sure, there cannot be a winner in this contest of the century. It is much more complicated and dangerous than the last Cold War when the U.S. and U.S.S.R. hardly had any commercial nexus. This time, the U.S. and China are deeply economically intertwined. 60 to 70 years ago, the conflict was, for the most part, hidden from the general public. This time, everyone cannot but feel it everyday.

China will be the first to suffer, but she will not endure alone. Hardly a nation on earth would be spared, although a few may, of course, opportunistically gain. In the end, another big loser besides China could very well be the U.S. China today is not without the means to retaliate, and America like everyone else has her own Achilles' heel, such as her currency. It is truly a lose-lose endeavor.

Our primary interest is China, where our business is based. My assessment is that it may take a few years for Beijing to successfully restart the economic engine. Some in the West mistakenly think that the Chinese leaders are no longer interested in the economy. This cannot be further from the truth. It is not a matter of intention; it is a matter of feasibility. Time is needed, I believe, to get out of the present doldrums.

To a commercial enterprise like ours, the set of environments is simply too uncertain and risky. The risk-reward ratio makes one uncomfortable. This is why in recent editions of my half-yearly letter, I have repeatedly called for caution. It is better to be safe than sorry.

We will, in the coming financial period, focus on improving our operational efficiencies and resilience. As always, we strive to be the best in class, for the best in our business, all things else being equal, will make disproportionately more money given the same capital. After all, there are still many improvements to be made.

We will also build out our projects, chief among them being Westlake 66 in Hangzhou. The mall and two office towers are slated to be completed by the end of 2024. The three remaining mid-rise office buildings, as well as the hotel, should be finished a year later. The world-renowned hospitality group Mandarin Oriental has been engaged, which will further enhance the luxury positioning of the entire project.

So far, we only have one hotel operating on the Mainland — the Conrad at Forum 66 in Shenyang. Business has improved significantly after the pandemic. Several hotels are being planned. In the order of expected completion, they are: Grand Hyatt Kunming, which forms a part of Spring City 66 (2024 opening); a Curio Collection by Hilton at Center 66 in Wuxi (also 2024); and the Mandarin Oriental at Westlake 66 in Hangzhou (2025). A fourth is in the offing which is yet to be announced.

We also have four residential developments for sale in the coming years. They are Heartland Residences in Wuhan, Center Residences in Wuxi, Grand Hyatt Residences in Kunming, and thereafter Forum Residences in Shenyang. All except the last are targeted to be completed in phases in or before 2025. Given this sizable portfolio of projects to be completed, our team will be kept busy. Whether we buy more land would depend on how the political and economic situations evolve over time.

Let me conclude by bringing us back to the more immediate developments. We started this year quite strongly after the relaxation of pandemic and social distancing rules. There was some optimism, and our results of the first few months tended to justify it. But by mid-May, we began to notice some slowdown. We were still growing nicely, but the rate was somewhat moderated.

When examining the domestic economy from various angles, it is not easy to conclude that this will turn around strongly anytime soon. One of the few sectors that remains relatively resilient is luxury goods. I will not be surprised if, for the rest of the year, we manage to maintain some growth. This seems to be in line with the forecasts of top fashion brands. If I am correct, this year will still reach new heights for our Company. Beyond that, the horizon is not clear enough for me to venture a forecast. But through operation efficiency improvements and prudent financial management, we should be able to handle whatever may befall us.

In Hong Kong, retail sales have improved and should gradually be followed by rent increases. However, progress is not expected to be fast. Office rental will remain weak for two key reasons. First, the overall economy, especially our financial service industry, is expected to be sluggish. It is likely that the U.S. will craft further policies directed at us. If so, the sector may yet become a target. Second, the supply of office space in the pipeline is plentiful. As such, one should not have unrealistic expectations of substantial rent increases.

A final word on corporate governance: I would like to think that, over the years, we have kept one of the highest standards on multiple fronts when compared to others in our industry. We are among the most transparent with shareholders and the investment public. That said, we have much room to improve such as diversity. Management has made conscientious efforts to promote a more balanced workforce, as evidenced by our recent and highly successful “Future Women Leaders Program”. Nevertheless, board diversity is an area that needs enhancement. Much work has been carried out in this area and I hope to have good news to report soon.

Ronnie C. Chan
Chair
Hong Kong, July 31, 2023