RESULTS AND DIVIDEND

This is the first interim report since we changed our fiscal year end from June 30 to calendar year end. Because of the fast changing environment, this time I have written a somewhat lengthier piece than usual at mid-year.

For the six months ended June 30, 2012, turnover grew 60% to HK$4,234 million compared to the same period of last year. Net profit attributable to shareholders rose 55% to HK$3,678 million; earnings per share also advanced by 55% to HK$0.82. When excluding the effect of revaluation gains, the underlying net profit attributable to shareholders increased by 72% to HK$2,520 million and the underlying earnings per share by 70% to HK$0.56.

The Board has declared an interim dividend of HK17 cents per share payable on September 13, 2012 to shareholders of record on August 31, 2012.

STRATEGIC INITIATIVES

In the past year, the European sovereign debt crisis has deepened and has spread; economic recovery in America is at best uncertain. All these are affecting the Chinese economy. Residential sales on the Mainland have not been strong, and many property developers are saddled with inventory and some with red ink as well. Contrary to the wish of many city governments, Beijing is for the time being not relaxing its tightened policies.

Some say that the situation today is not as severe as the crisis of 2008/09. True indeed, for the fall is not as sharp, but I fear that the recovery will also be not as quick. In fact I believe that the challenges we face today are more difficult to handle. Governments everywhere knew then what needed to be done -- inject huge amounts of liquidity. Now no one seems to have a clue. The world may well have entered a prolonged phase of systemic slowdown that will last for years. In the post World War II era, economic growth was taken as a given; now the world must change its mindset and get used to a new paradigm -- the norm of a flat economy.
At Hang Lung, the new macro-economic reality is forcing us to rethink our tactics. As long as China can keep a relatively peaceful domestic environment, its economy should perform better than those of the West and in fact most economies in the world. Enough wealth has been amassed in the past decades; given a relatively strong government which is pro-growth, domestic consumption will gradually be built up to alleviate the burden on export and public investments as engines for growth. Challenges nevertheless abound.

On the one hand, we are fortunate to be in commercial real estate which should perform acceptably. Urbanization and personal consumption are the main stories of the economy. This means that probably there is no need for strategic redirection for your Company; only tactical adjustments are called for. On the other hand, none of us should underestimate recent changes in society. Caution must be exercised.

Because local governments have not been able to sell land of late, their coffers are becoming tight. Stories of financial difficulties are plentiful and the urgency to sell land in almost every city makes the stories all the more credible. Our own experience bears out this fact -- some city officials are now much more willing to negotiate.

Although cash-rich, we are for the most part not biting. Only if a choice plot like our piece in Kunming is available on very attractive terms will we buy; anything less will have to wait. We should not waste money on anything other than the best, for why should we?! It is a buyers’ market. After all, land may become cheaper tomorrow.

Nevertheless, a time will come when we will buy. Financially we are very strong and will as before take advantage of market misery.

In bull markets like that of the past two decades, one can make money merely by riding on the surging waves. That was the case of almost all Mainland commercial property developers. We never settled for that. As previously written, we relied much more on our know-how, experience and hard work to create value which resulted in our past outstanding performance. In today’s new environment, such expertise is even more critical. Cycles will always be with us; it is just a matter of whether one can survive the trough to enjoy the next upsurge, and for those who survive, how big will the win be. In the past two decades, compared to the market we did superbly and may outperform even more. After all, the present competitive landscape may become more favorable to us than that in the recent past.
Let me illustrate. As I wrote six months ago, we witnessed a slowdown in consumption. For the first time in more than a decade, the luxury sector was more severely affected than other sectors. (For example, that was not the case in 2008/09.) As a result, rental increase in Shanghai Plaza 66 moderated. However, that in Grand Gateway 66 continued in double digits because we were now able to attract the world’s top brands like Gucci, Bottega Veneta and Tiffany as our tenants there. The upgrading of a so-called four-star facility to a five-star one should yield higher sales rent and thus maintain the growth momentum.

Shareholders who have read my previous letters know that there are two sets of success factors in our business. The first may be coined project genetics which relates to location and design. The second, call it project operation, has to do with all activities thereafter from construction to leasing to property management. We strive to be among the best in both factors, for only so will we be able to remain competitive in the long run and perform satisfactorily under different market conditions.

Let me begin with the first -- genetics. Once finalized, it cannot be changed; in other words, location and design remain immutable. But unlike genetics in biology which is predetermined by parentage, a developer can choose a project’s genetic material. It is thus surprising why so little attention is paid to it by most players. But we are religious about it -- we never want any of our developments to be “born” inferior to its competitors. While I like to think that our team is among the best in project operation, we do not and should not consider ourselves so much better that we can overcome genetics. This was why in the 1990’s we were meticulous in choosing our sites and designing our buildings in Shanghai and why we today still insist on the same everywhere else.

While project genetics is determined once and for all at the beginning phase of a product’s life, the second success factor of project operation is an ongoing effort. Management must always be vigilant because slippage, albeit usually gradual, can easily occur. Hence this is a far more tiring activity than choosing a location and designing a building.

Your Company is fortunate that under our now retired Managing Director Nelson Yuen, we have set the course for achieving the first factor, and now under his successor Philip Chen, we are well on our way to strengthening the second. While religiously adhering to the former, it is the latter that will ensure continued success.
Back in Hong Kong, we have in the past six months made some strategic moves. As I wrote two years ago and again twice since, we will one day sell mature investment properties which are low yielding with slow rental growth. Such older non-core assets are not in the best of districts (like Central, Causeway Bay or Mongkok) and are stand-alone buildings where we do not have properties nearby. With little upside, they should be traded into higher yielding and faster growing Mainland developments. We have not done so earlier for good reasons: besides waiting for better prices, we wanted to make sure that we could grow rents on the Mainland. After completing Shenyang Palace 66 and Jinan Parc 66, and with Shenyang Forum 66 leasing very well ahead of the September opening, we are now confident of a relatively fast top and bottom line increase. As such we started to sell older Hong Kong properties.

To be sure, the buildings being sold are not the best located, class A type, which we will not part with in the foreseeable future. But if the older structures can fetch a capitalization rate of around 5%, then they should exit our portfolio. As shareholders know, the targeted initial yield of our newly opened Mainland developments is at least 4-5%, which is expected to be followed by a period of relatively fast rental increase. Comparing the two sets of numbers and taking into consideration growth potential, the decision to sell becomes obvious.

As always, we will find an auspicious time to exit and frankly, the current market condition is quite acceptable. We are in no hurry to complete the task, but neither will we intentionally hold back unless we think that we can sell at a higher price by waiting a bit. Of late we have encountered quite a number of legitimate purchasers. Certain private investors may be able to do something meaningful with some of the buildings which we being a publicly listed company should not attempt. Our risk appetite is different and we have better use of our management time, something we guard carefully.

Two transactions were completed so far and they brought in a profit of HK$220 million. They only represent a small portion of the portfolio that can be sold. Provided that the market holds up, more sales may materialize before the end of the year. As indicated previously, realized prices should be considerably higher than the June 30, 2012 book value thus resulting in good profit.
OPERATIONS REVIEW

As mentioned earlier, retail rental increase in Shanghai has slowed especially in the luxury mall Plaza 66. It stood at a mere 2%. Nevertheless, three major fashion brands which underwent extensive shop enlargement have now reopened. That should bode well in an otherwise difficult market. Our ability to attract the world’s top brands to the four-star shopping center of Grand Gateway 66 has been key to maintaining higher rental growth of 13%. Blended rate for the two malls was 8% while office rose by 5%. Overall, Shanghai rents advanced by 7%. Rental margin has reached 87% and all spaces are basically full.

The road works surrounding Shenyang Palace 66 were finally completed. We are in the process of altering the tenant mix to tailor to a younger crowd. The changeover is causing a slightly lower occupancy rate of 90% but unit rent is on the rise. Rental margin has improved from a negligible level a year ago to 30% now.

Jinan Parc 66 has exceeded expectations on several fronts. First year gross rental return on cost is projected to be 7.9%. Rental margin has improved to 53% and rising, and the facility is basically fully occupied.

Investment properties in Hong Kong have performed acceptably. Rental income increased by 4%. If we exclude the effect of the discontinuation of Queensway Plaza, The Wesley and the two latest properties sold, then rents actually rose by 7%. On that basis, retail rents grew by 8% and those for offices, 4%. Occupancy stood at 95% and rental margin nudged up a point to 84%.

Our entire portfolio saw a 12% rise in rents with Hong Kong recording 4% and the Mainland 22%. Overall rental margin was 82%, two points above that of the same period a year ago. Rental split between Hong Kong and the Mainland is now dead even.

Besides the sales of mature investment properties, another activity which caught some attention was the parting of 108 flats of The Long Beach. We detected a window of opportunity in May and acted decisively. If not for the misfortune of running into a huge drop in the stock market around those few days, we could have transacted more. Nevertheless, there will be other chances.

This was the first time we sold units at that development since 2007. Average price achieved is over 50% higher -- almost HK$10,600 per square foot versus less than HK$6,950 five years ago. We are quite pleased with the present prices and will be happy to sell more once there is the opportunity.
We also let go of nine units at The HarbourSide. One penthouse went for HK$55,000 per square foot which might be a Hong Kong record for multi-story apartments. Not counting that one, the other harbor-facing flats went for an average of over HK$34,000 per square foot, while those overlooking the garden fetched on average approximately HK$20,000 per square foot. Both are much higher than previous transactions. When there are further perceived opportunities, we will continue to sell.

On June 18, 2012, we raised US$500 million through a 10-year bond issue under the Medium Term Note Program put in place last year. Effective yield is quite acceptable and is among the lowest of Hong Kong developers, a slight premium due to first issuance from an unrated company notwithstanding. The entire amount was used to repay short-term bank loans. Together with a similar issuance a few months earlier, we have now collected through this channel about HK$5.2 billion.

In light of the HK$27 billion anticipated construction costs to be expensed in the coming four years (unless we slow the process due to possible adverse market conditions) as well as possible land acquisitions, Management deems it prudent to take in some longer-term money. Our capacity to raise more is considerable. Due to concerns over the global financial system, we will not issue bonds shorter than ten years.

A year ago I wrote about Management’s belief that soon Hong Kong companies like us will be allowed to wire RMB into the Mainland even for real estate projects. It seems to be happening now although some local governments will need time to work out details to accept funds. Our decision in the past two years to buy RMB in Hong Kong has proven correct.

Last month we tendered for a piece of land in Hong Kong, our first attempt in a long time. It took some people by surprise but the rationale was simple. With a new Chief Executive for the Hong Kong SAR government, how developers would react to his land policies was unclear. In case most did not participate or were cautious, perhaps we could luck out and pick up a site inexpensively. It was not meant to be and so be it.

As I have publicly stated many times, we are not pessimistic about Hong Kong’s residential market; it is just that there are too many players who are willing to take more risks than we are. So unless there is a repeat of a big bear market like 1999-2000 when we bought a lot in the absence of competition, our chance of succeeding now is slim. Let others make the profit and also take the risks. In our opinion, the risk-reward ratio is in general better on the Mainland. There is also the possibility that our proven ability to generate returns there has an impact on that ratio.
PROSPECTS

By now shareholders may get the impression that we have been building a war chest. My fear a year ago of not being able to buy land is temporarily gone. We have been successful in selling completed apartments as well as mature rental properties in Hong Kong. At the latest balance sheet date, we had HK$29 billion of cash and bank deposits. Together with committed undrawn banking facilities amounting to HK$4 billion and the HK$18 billion remaining limit of the Medium Term Note Program (for issuing bonds), we have ample financial resources at our disposal.

On the other hand, a period of chilling economic conditions has descended upon us -- even in China. That should be very favorable to us -- “Bear Hugger” as we are called -- for we tend to shine when most of our competitors are in trouble. However, when to buy is a really tough decision especially as we deem the present economic malaise a systemic one. It is global in nature and may last longer than most think. All we can do is to observe, analyze, and be patient. In due course we will strike, but I am not sure if it will be within this year. It will take an excellent piece at an attractive price to lure us to act.

As long as market conditions allow, we will sell Hong Kong properties -- both completed apartments and mature investment properties -- as in the six months under review. Most analysts tend to underestimate the profit margin we can achieve in both categories. Perhaps they did not heed my reiterations that the book value of our investment portfolio is rather conservative.

Whatever the case, we will build out our many Mainland commercial developments. For the completed complexes, we will continue to maximize near-term profitability without sacrificing their long-term health. As more of our well located and superbly designed malls open, our relationship with key tenants can only deepen. A brand that is in any of our facilities should be a candidate for most if not all of our other facilities. All these should help us grow our rents on the Mainland.

Having gone through the initial difficulties experienced at Shenyang Palace 66, many of which are externalities beyond our control (e.g. road works done by the city government surrounding our site), we have turned the corner and are on the way to build a successful mall. On the other hand, Jinan Parc 66 was from day one a success. At the opening in August 2011, I gave everyone the good news that initial gross yield would exceed our threshold of 4-5% by quite a margin such as 6%. By year end we were confident enough to revise the number to 7%. Now with less than a month to its first anniversary, we are projecting 7.9%. For a first year result, this is the best that we have had. Management is hopeful that the growth in rent and the improvement in operating margin will also be promising.
Now comes Shenyang Forum 66. Contracted rents indicate a return even better than that of Parc 66. This is truly rewarding! Nevertheless, the office tower, of which the low zone should open in the second half of next year, will not attract such a high yield. On a blended basis, the mall and the office together should still produce a return that is far better than our threshold.

While Shanghai rents may still come under pressure, our Hong Kong investment portfolio is expected to hold steady. For both cities, results of the second half of the year should approximate those of the first six months.

Recently we launched an advertising campaign in Hong Kong and mainland China which aims to build our brand. The tagline has received rave reviews. Obviously biased, I think that it is superb -- it captures the core values of our Company as I have repeatedly written on this platform.

In Chinese, the tagline is even more expressive than the English version which is “We Do It Right!”. Coined in eight simple characters, the Chinese rendition “只選好的 只做對的” encompasses the following ideas: “We only choose what is good, and always do what is right!” The meaning embedded herein is rich indeed. For example, we only choose the best sites to buy, the best designs to adopt, the best people to hire. Similarly, being “right” entails so much, such as being ethical, caring for our staff, respecting the environment.

Obviously we are far from being perfect, but the tagline does set forth our aspirations and is to some extent a depiction of what we are. The message is not just for outsiders; it is equally a principle to guide Management as well as each and every staff. With that, I have confidence that we will continue to create sustainable and relatively high risk-adjusted returns to our shareholders.

Ronnie C. Chan  
Chairman of the Board of Directors  
Hong Kong, July 31, 2012