RESULTS AND DIVIDEND

Against the backdrop of the resurgence of COVID-19 in both mainland China and Hong Kong, revenue increased by 6% to HK$5,605 million for the six months ended June 30, 2022. Overall rental revenue remained stable at HK$5,289 million.

Net profit attributable to shareholders decreased by 5% to HK$1,439 million. Earnings per share dropped correspondingly to HK$1.06.

Underlying net profit attributable to shareholders rose by 7% to HK$1,600 million when all the effects of property revaluation are excluded. Underlying earnings per share increased similarly to HK$1.18.

The Board has declared an interim dividend of HK21 cents per share payable on September 29, 2022 to shareholders of record on September 15, 2022.

BUSINESS REVIEW

There are periods of time in history that are particularly critical and fraught with danger. Somehow, a few pivotal events, in quick succession of each other, changed the world forever. In modern times, this phenomenon occurs every few decades. I believe that we are at one such point. This time, China may not be at the epicenter, yet she cannot but be impacted. Almost all major businesses will be affected, including ours. It is time to be cautious.

In the past 30 years, the U.S. became increasingly worried about the rise of China, and about a decade ago, America's actions in this regard became more open. She began to throw all her weight behind efforts to slow down China's growth. Beijing was not a threat to the world; she was at best a threat to American supremacy. When Donald Trump assumed the U.S. presidency in 2017, things became ugly. President Joe Biden is merely continuing what the American body politics has talked itself into. Things have gone from bad to worse.

Then COVID-19 hit every corner of the world, beginning in early 2020. I do not recall a time in history when a pandemic could spread so far and so fast, largely thanks to technology-enabled globalization.

This was followed by the Ukraine War earlier this year. There have been plenty of wars in recent decades so it should not come as a surprise — remember Korea, Vietnam, Iran, Iraq, Afghanistan, Yemen, among others. What is particularly significant this time is the reactions of the West. That, much more than the war itself, will change the world for many years to come.

This is not the first time that the U.S. has, at will, frozen the assets of other countries or people. Not long ago, Afghanistan suffered that fate. But, primarily because of her energy resources, Russia is far more significant. If banks can be barred from transacting through SWIFT at any moment, will anyone, including U.S. allies, trust Washington, D.C. anymore? Such actions will likely change global capital flow in the coming decades.

The face of global energy politics will also not be the same. Russia is a major supplier of natural gas to Western Europe. From where will the latter now buy, and to whom will the former sell? These are huge changes which will alter economies and businesses. Being an integral and significant part of the global trading system, China, which is our primary market, will have to adjust, for better or worse.

When Donald Trump first became president, he might have wanted the U.S. to ally with Russia against China. Now President Biden has driven Moscow into the bosom of Beijing. All that took place within a few short years. Not only has China averted a historical enemy from the north; she has also gained a friend who increasingly needs her.

Global inflation, exacerbated by hikes in energy and food prices as a result of the Ukraine War, will have dire consequences in almost all nations. Famine in some regions will bring political instability and refugee migrations. Such will be the fate of certain poorer countries. Wealthier nations will also suffer, albeit in different ways. Raising interest rates to combat inflation will hit debt-ridden developed economies as it will less developed ones. What will happen to the U.S. and the U.S. dollar? These are troubling questions that will affect all of us.

Will China be spared? For better or worse, no. The long-term effects may in fact be positive, as a weakened and isolated Moscow will need Beijing more than ever. China will be able to buy much needed energy, food, and minerals more easily, for Russia is rich in all these commodities. The two economies are quite complementary to each other.

The one area to watch is obviously the Taiwan Strait. It seems that Washington, D.C. is keen to provoke Beijing into action so as to turn the world against China. This is similar to the position that the U.S. has taken against Russia during the Ukraine War to weaken her. So far, China is keeping her cool, but America's goading has definitely moved forward Beijing's schedule to take back the Island. Irrespective of the outcome, it will be complicated.

In the more immediate term, an issue of concern to Beijing and to our business is Mainland's economy. Recent government policies have left local and international companies unsure of the future. As is often the case with business people, when in doubt, wait it out. Consequently, no one is in a hurry to make investment decisions. Some of the same government actions have also pushed up unemployment. To make matters worse, Shanghai responded to the pandemic by imposing total lockdown, while several other cities experienced partial shutdowns. The combined effect of all these is a very hesitant economic future.

That said, I believe that Beijing is capable of stimulating the economy if she wants to. While the West is raising interest rates, China is moving in the opposite direction. Unlike many major countries elsewhere, China's national debt is relatively low. Moreover, exports are still faring well.

Yet, another worry relating to mainland China is her housing market. Since we are basically not in that sector, it is not our primary concern. Nevertheless, it is such a major part of the economy that its health will affect a lot of things.

As I have publicly stated repeatedly, China's housing industry is a crisis long in the making. The business model adopted by almost all private sector home developers was unsustainable. They seemed to only care about the size of their land bank and the top-line revenue. To accomplish that, and to beat their competitors in these measures, they overborrow. How could they not get into trouble?! What I cannot comprehend is why the Central Government did not take action sooner to rein it in.

Interestingly, the present problem is not industry-wide. It only affects private developers and not state-owned enterprises (SOEs). The latter are under the tight control of the government ministry in terms of their debt levels. Such restraints were absent in privately held home builders. So, when new government tightening policies were introduced, their balance sheets were severely strained. Many of them are now fighting for survival. Nowadays, land buyers are primarily SOEs.

While there will always be a housing market given continuous urbanization, the relative share of the market may have changed considerably by the time the dust settles. Whereas in the past, SOEs only had roughly 30% of the country's housing market, they may, one day soon, account for more like 70%. The final form will depend on what further policies will be enacted.

The only residential units we have to sell on the Mainland are luxury serviced apartments. They are invariably a part of a much larger commercial development with a mall and high-rise office towers for rental. Nevertheless, today's poor market sentiment does affect the sales of our serviced apartments. Our first project with a residential element for sale is in Heartland 66 in Wuhan. It will not be ready for occupancy until the second half of 2023. As such, we still have time to wait for market recovery.

In Hong Kong, the fifth wave of the pandemic struck soon after the beginning of the year. Government measures dealing with it continued to render our economy isolated. We cannot travel freely either to the Mainland or the rest of the world. So far, we are stuck. This cannot be good for business, including our property rental operations.

Set against this background, I believe that our set of results for the past six months is rather satisfactory. Rental revenue on the Mainland rose 2% from a year ago, while in Hong Kong, it fell 4%. Together, total rent collected was on par with the year before. Our home market now accounts for 32% of rental income, while the Mainland garners 68%. Rental margin retreated one point on the Mainland to 68% and two points in Hong Kong to 81%.

The sale of a luxury house on Blue Pool Road in Hong Kong contributed to the growth in total revenue of 6%.

PROSPECTS

From the description above, this is not an easy environment to do business in. Both internationally and within China, there are simply too many uncertainties. As such, Management believes that it is time to be very cautious. As longtime followers of our group activities know, historically, we had taken advantage of bear markets — we invariably bought when others did not have the guts or the money. In the past three decades, it was a fun game which had made a lot of profit for our shareholders. Remember 1994, 2000-2001 in Hong Kong, and 2005-2007, again 2013 on the Mainland. But this time it is different. As I have said at a Mainland real estate conference, the present environment is unlike any that I have seen. This bear is not those bears of the past.

We have always been conservative in our finances, and this is not the time to change this policy. If anything, we must be even more careful, especially with capital investments. Unless something very attractive comes along, we will wait before making new commitments. Major capital projects that can be postponed should be postponed.

As long as we do that, we should be in a comfortable position. We are lowly geared and have multiple sources of further financing lined up. That said, we do not expect to draw upon them beyond what is the normal course of business. We only have one new large-scale commercial complex under construction, that of Westlake 66 in Hangzhou, that requires significant capital spending. The project is scheduled for completion in phases from 2024 onwards. Most other projects can be put on hold if necessary. So far, we have not made that decision.

Moreover, we have already completed our two big Asset Enhancement Initiative (AEI) efforts at Plaza 66 and Grand Gateway 66 in Shanghai. As such, our older properties are in tip-top shape while the others are much newer. There is no urgent need for further major improvement projects. Finally, our business model is also rather defensive — we rely on rental income and our tenants are among the most solid business names in China and internationally. It is highly unlikely that our revenue will disappear overnight. The same cannot be said of real estate companies relying exclusively or predominantly on property sales.

What about the long-term prospects for our primary business of high-end commercial property leasing? I believe that they are, in fact, quite good. Frankly, there are not many industries that are as attractive as ours. Here are my reasons.

In the longer run, China should still be a relatively stable place to invest. As long as China-U.S. relations do not deteriorate into military conflict, such as over the Taiwan Strait, the huge Chinese domestic market will continue to be attractive. Average economic growth for the coming few years may settle at 4% to 5% per annum, but it will still be much higher than most, if not all, other major regions of the world. Personal consumption will be an increasingly important economic driver, and I will not be surprised if luxury spending grows slightly faster than regular spending. Neither do I, for now, foresee adverse industry-specific government measures in our sector. If so, then we are in a sweet spot of a relatively strong economy.

As I have written in previous years, there are industry-specific characteristics that make the core of our business — luxury retail rental — particularly attractive. The amount of experience and knowledge required to be successful are considerable and are not easily acquired. Consequently, there are not many companies in mainland China that have successfully built and operated luxury malls. The number of such players is probably not much more than half a dozen in the entire country. Needless to say, we are one of them.

In each city, there is rarely room for more than a few such malls. Of those, the top one or two always collect much of the sales dollars and hence rent dollars as well. As long as you are the top one or two, it is not easy for newcomers to dislodge you. In all but one of our luxury retail markets, we have achieved this to varying degrees. It is highly likely that in the coming years, these favorable positions of ours will be further strengthened. Once Westlake 66 in Hangzhou opens in two to three years, we expect to occupy a similarly pleasing spot.

Given the above, at present we do not see the need to change our long-held strategy. What needs constant tweaking, however, are operational and tactical issues, such as when and where to buy land; how much we are willing to pay for each plot; what product to build; what market position we want to occupy, etc. These are issues which we constantly have to tackle anyway, and we are improving as we go.

For the rest of this year, Management is cautious. Nevertheless, we hold out hope that, given no further deterioration in the pandemic situation, our results for the rest of this year may be slightly better than the half year just reviewed.

A year and a half ago, I asked Mr. Adriel Chan to start penning a *Vice Chair's Notes* alongside this writing. I encourage my readers to read that piece as well. It complements this letter.

Ronnie C. Chan
Chair
Hong Kong, July 28, 2022