RESULTS AND DIVIDEND

For the six months ended June 30, 2016, revenue increased 37% to HK$6,311 million. Net profit attributable to shareholders grew 3% to HK$2,935 million, and earnings per share advanced similarly to HK65 cents.

Excluding property revaluation loss, related deferred taxes and non-controlling interests, underlying net profit attributable to shareholders rose 29% to HK$3,167 million. Underlying earnings per share went up by 27% to HK70 cents.

The Board has declared an interim dividend of HK17 cents per share payable on September 29, 2016 to shareholders of record on September 15, 2016. This is the same as the previous year.

BUSINESS REVIEW

Perhaps I should begin with a brief overview of a few global events. This is atypical of this letter but some of these events will sooner or later affect our business. The world has always been a turbulent place but previously most of the causes and consequences were local in nature. However, these happenings of late are truly of global significance.

I have foremost Brexit in mind. Is this the beginning of the end of the European Union (EU) as we know it? How will it affect global trade? At the minimum, the global financial map will be redrawn. This may in the short run benefit Asia, particularly Hong Kong and Singapore, the region's two premium international financial centers. In fact, one of the world's largest fund management companies has just opened its first bond-trading operation in our part of the world. Is this a harbinger of more to come? In the meantime, EU is embroiled in turmoil after the latest mass migration from the Middle East. What worries the business community is that for sure there will be more uncertainties ahead.

As well, terrorist threat in the Middle East and Europe has gone from bad to worse. Even America has not been spared, although the causes are quite different. Coupled with the rise of nationalism everywhere, it is possible that globalization, which has been thriving for decades, may be entering a phase of retreat: consider the "Buy American" campaign. Or as Donald Trump said in his speech officially accepting the Republican nomination for the U.S. presidency, it is Americanism, not globalism, that will be the country's credo. So far international travel and cross-border businesses have not suffered, but they may.

In such a highly uncertain global environment, China, which is our main market, may not be able to rely on the rest of the world as much as before. Fortunately, it has a huge domestic market and has amassed sufficient wealth and technology to survive in a less globalized world. If the uncertainties of late were to take place in the 1980's, 1990's or even the 2000's, China would have been affected more. To be sure, the country will continue to develop global connectivity as exemplified in the "One Belt, One Road" initiative. However, it seems certain that the domestic market will play a more significant role moving forward.

Looking ahead, the U.S. and China will remain the twin engines of the global economy. America still has by far the strongest and most advanced economy in the world. For the foreseeable future, no country can challenge its leadership position. That China has over four times the population and may surpass the U.S. in absolute GDP size cannot take away the fact that the American society and economy are the most innovative and the most resilient. Barring financial meltdowns like in 2008, the U.S. will remain the most significant player in the world.

The Chinese economy, on the other hand, is big in size due to its population and is vibrant in many areas. However, it has social and structural weaknesses which may render its economy, if not the entire society, vulnerable. Nevertheless, since all other major economies such as the EU and Japan are going nowhere, by default, China becomes the only other dynamic place aside from the U.S.

Provided that the two engines do not stall, global economic gravity will move further from the Atlantic to the Pacific. As a matter of fact, this shift has been ongoing for half a century, but it has never been as obvious as it is today. Headquartered in Hong Kong, a city that understands both nations and in many ways helps connect the two, Hang Lung is in a privileged position. With the Mainland being one of the fastest growing major economies and it having been the focus of our growth strategy since the mid-2000's, few companies are as well-positioned as we are.

Given the above description of the present world such as the likely retreat of globalization, China will have to quickly develop its internal market to compensate for the possible adversities in the international arena. There may be no one externally on whom the country can rely for further economic growth. It must look inward. This reluctant move is in contrast with the self-motivated retreat from the global marketplace on the part of the U.S. Whatever the case, speeding up private consumption seems inevitable for China. This area is exactly where your Company plays.

We are headquartered in the best city, focused on the most dynamic market and positioned in the right industry, so what more can one ask for? Short-term volatility and periodic market lulls are inevitable but your management, which has always kept a healthy long-term horizon, can look beyond them. Having very little net debt, we are well-positioned to weather the present downturn. We can foresee better days ahead.

But for now, the economic environment is not encouraging. The pathetic condition I described six months ago has only gotten worse. Perhaps more so than any other time in history, negative interest rates are seen everywhere. In almost all major economies, growth has proven evasive.

China, on her part, is still searching for a new economic impetus. Growth in private consumption continues to slow, and the luxury goods market remains particularly weak. No one knows when and how the anti-corruption campaign will end. Just as in the West, there is much uncertainty.

Given this highly unfavorable trading environment, many major retailers such as department stores have for the past two or three years recorded decreases in both top line and bottom line. It is not uncommon that of late the former has fallen by about 10% annually and the latter by over 50%. The slide has in fact gotten worse in the past year or so.

Compared to this, our tenants have performed better. Retail sales in four of our seven Mainland shopping centers have recorded growth compared to the same period a year ago. In the four advancing malls, increases ranged from 2% to 6% while the other three recorded a decrease of 5% to 7%. Taken as a whole and not counting Olympia 66 in Dalian which is less than a year old, total tenant retail sales were about the same as the year before. I suspect that our long-held strategy to concentrate in top central locations is a key reason for this out-performance.

Before turning to our overall result, a word should be said about currency translation. On the Mainland, we collect rents in RMB but as a Hong Kong-based company, we report numbers in Hong Kong dollars. Calculated on the basis of weighted average daily exchange rates, the six months under review saw a drop in RMB of about 6% from the same period a year ago. Comparing June 30 this year to last December 31, the fall was about 2%. In order to get a true picture of performance, I have excluded the effect of currency fluctuation in the reporting of Mainland rents here, although in the financial statements, all figures are reported in Hong Kong dollars.

A related issue is foreign exchange translation loss due to RMB devaluation. By far the bulk of the loss came from re-translation of our vast net assets on the Mainland. This relates to the value of the many completed complexes we own, which is not inconsequential. A lesser amount of the loss arose from the RMB that we hold as cash. In past years when RMB appreciated, there were huge translation gains. These translations, either gain or loss, went into our reserve account and were not reported on the profit-and-loss statements.

Rental revenue in Hong Kong and on the Mainland (in RMB terms) grew by 7% and 2% respectively. Since the RMB devalued 6% against the Hong Kong dollar, any increase on the Mainland less than this amount will result in a negative number in our home currency. In this case, reported rental revenue from the Mainland was minus 4%.

Compared to the same period last year, we sold over three times more Hong Kong completed apartments in monetary terms. As a result, overall revenue growth was 37%. Due to lower rents at the shopping centers of Forum 66 in Shenyang and Center 66 in Wuxi, the two properties suffered a revaluation loss while all other facilities scored a slight revaluation gain. Consequently, net profit attributable to shareholders as well as per share earnings only advanced by 3%. When the net revaluation loss, a non-cash item, was taken out, the underlying net profit attributable to shareholders rose 29%, and the underlying earnings per share advanced by 27%.

We sold 226 units of The Long Beach as well as the two remaining flats at Carmel-on-the-Hill. The sales brought in over HK$2.4 billion, resulting in an operating profit of almost HK$1.4 billion. Profit margin was 58%, which for these properties was quite good.

Hong Kong rental income was 7% higher than the same period a year ago; retail space was up 13% and offices, 4%. Occupancy stood at 99% and 92% respectively. The main reason for the strong performance in retail properties was that several facilities previously under renovation are now open. Hong Kong now accounts for 48% of total rents received; the Mainland 52%.

Overall Mainland rental rose by 2%. Due to RMB devaluation of 6% as mentioned before, the book in Hong Kong dollars showed a fall of 4%. If we exclude new properties – the office towers at Forum 66 and Olympia 66 in Dalian – organic growth was minus 2% in local currency terms or minus 8% when translated into our home currency.

Shopping centers had a particularly difficult time. Rents therefrom retreated 2%. If we exclude the newly opened Olympia 66, they fell by 4%. Office rents increased by 17% with reasonable organic growth.

The two shopping centers in Shanghai deserve special mention. Due to the Asset Enhancement Initiative (AEI) at Plaza 66, 13% of the space was taken out of operation. This was why we collected 7% less rent than the year before. On a like-for-like basis excluding the area under renovation, rents received were basically the same as last year. Although Grand Gateway 66 will not officially undertake AEI until later this year, a small portion of space was already affected. Consequently, occupancy fell two points to 96%. Nevertheless, we received 1% more rent than in the same period last year. This was due to higher rental reversions.

For the other five Mainland shopping centers, revenue in three of them either remained unchanged or increased. The two most challenging ones were Forum 66 and Center 66 whose revenue fell by a whopping 20%. Occupancy improved in Palace 66 but retreated in the other four.

Across the entire investment portfolio, rental margin decreased by 2 points to 75%. Hong Kong held steady at 86% while the Mainland fell from 69% to 65%. This is mainly due to the margin retreat in the two Shanghai shopping centers by 0.85 point, and to a lesser extent the loss arising from the new Olympia 66 in Dalian. Perhaps surprising to many, margins rose in all of the other five complexes, including Forum 66 and Center 66. Both were helped by the addition of office space. But in the case of Forum 66, even the shopping center alone recorded a healthy rise. After a few years of operation, these properties saw a drop in the high initial costs associated with new facilities.

This is an encouraging phenomenon. Over time as rental rates increase, more will fall to the bottom line. When this happens, with the present cost control efforts in place, these projects will become even more profitable. But for now, we will have to wait until the market recovers.

Compared to a year ago, footfall in all our shopping centers improved except in Parc 66 in Jinan and Riverside 66 in Tianjin. The former, being our second busiest next only to Grand Gateway 66, saw a drop of almost 5%, and the latter, almost 3%. By far the best percentage increase in footfall took place in Center 66. This was followed by Forum 66 and Plaza 66. Thanks to the new office towers, the top two growths were from our most troubled malls. This is encouraging, but to translate this into higher retail sales and in time improved rent will require more efforts.

The two new office towers, one each in Forum 66 and Center 66, are leasing up gradually. In the former, committed space has increased from 44% six months ago to 52% now, with 49% being occupied. The number for Center 66 is 58% leased and occupied.

As previously reported, certain tenants, especially in Center 66 which are in the private financing business, had come under government scrutiny and some were even in financial difficulties. As such, we had to terminate some of those leases. In the past six months, the vacated space has been almost completely re-let. Encouragingly, the quality of tenants is much better and rents received have gone up nicely. In short, the two new office towers are becoming a meaningful source of income for the Company.

At Forum 66, we have signed a management contract with an international chain for a five-star hotel with over 300 rooms on the high zone of the existing office tower. We are also adding a ballroom on the ground floor. In the meantime, preparation for construction is being carried out. Hopefully these projects will be ready by the first half of 2019.

The second office tower at Center 66 is progressing. A cinema will be added to the podium to help drive traffic. The total size is about 55,000 square meters, which is much smaller than the first building of 89,000 square meters.

In mid-December, 2015, we had a soft opening at Olympia 66 in Dalian. The name comes from the huge park in front of our facility called Olympia Park. Six months ago, I wrote that its initial success would depend in part on “government actions or inactions.” Subsequent events have proven this forecast to be true. For example, through no fault of ours, we encountered much difficulty with the local fire services department. A serious fire elsewhere in the city had caused the government to suddenly tighten-up policy. Fortunately most difficulties have been resolved or are expected to be very soon.

To refresh the memory of our regular readers, in Phase 1, we will open 87% of this huge shopping center of 220,000 square meters. With clever design, shoppers should hardly notice the remaining 13% space that will be opened later as Phase 2. We expect over 70% of Phase 1 to be leased by early September with over 60% ready for business. Once the entire shopping center is fully leased, we expect a gross return of 4% to 5%, very tough trading environment notwithstanding.

Construction works at Spring City 66 in Kunming and Heartland 66 in Wuhan are proceeding as planned. The latter is somewhat behind schedule due to government intervention and inclement weather. We will try to catch up.

In the past year, there were several Mainland articles circulating on the Internet that said we had stopped construction in Kunming. Some of the rumors went even further to suggest that we were negotiating with the local government to return the land. There is not a shred of truth in these allegations.

There are two plausible explanations for such repeated articles. One is ignorance and the other, malicious attacks by our competitors. As we all know, many media concerns can easily be “bought” in mainland China.

Unlike certain local developers who boast of their ability to inaugurate a shopping center within 18 months of land acquisition, we devote more time to crafting an optimal design. This is a tedious yet critical process. As I have previously written, this is why those quickly slapped-together projects are of inferior quality and will not survive the test of time. A cookie cutter design may work for two- or three-star facilities, but we build four- and five-star ones where good design is of paramount importance. It is an iterative as well as a collaborative effort between the architect and the developer. Careful consideration must be given to balance aesthetics and functionality. I have yet to meet a single person who can bypass this process and produce a perfect or near perfect outcome.

Moreover, in China, all schemes must be approved by the municipal government. All it takes is one official, with or without adequate expertise, to disrupt the timetable. Building regulations are also becoming more complicated, or even impractical if not unreasonable. As such, the design process is a complicated tripartite endeavor between the developer, the architect and the government. Since we uphold the highest design standards, a certain passage of time is inevitable.

While waiting for this to work its course, a process which will take many months even if there is no serious hiccup, we will to the extent possible carry out soil testing and the like. However, if there are complications like those in Kunming, we will just have to exercise patience while pressing forward as best as we can.

It is thus conceivable that the construction site may be temporarily hoarded up, such that even if there are minor works being carried out inside, outsiders will hardly notice. So for journalists who are used to projects of inferior design that are slapped together quickly, they see only what they want to see and may think we have stopped work. With design being one of the four key elements of “real estate genetics” as I have previously written in detail – the other three being location, size and shape of the plot, and construction – we do not take shortcuts. In the long run, it is simply not worthwhile.

If the falsely-reported articles were from a poorly informed journalist, then we are not as concerned. After all, there are many of them. Worse is the strong suspicion that the whole saga may be orchestrated by a competitor. There are reasonable grounds for this suspicion.

For one, these articles go to the extent of accusing your Company of negotiating with the city to return the land. Since this is simply untrue, government officials could not have confirmed the story. The author then further surmised that Hang Lung was running out of money or was otherwise very negative about market conditions. A simple search on the Internet will show your Company is in excellent financial health, if not the strongest in the industry. One can also easily locate this letter to shareholders from the same source and see that I was never that pessimistic about the market. In fact I have previously stated that when the market is down and other developers have stopped or slowed down construction, it affords us the best opportunity to become the first to enter the market. Our strong financial position enables us to do that.

The reality is that ever since Hang Lung entered the Mainland in 1992, we have never stopped or even slowed down construction due to lack of funds or pessimism. We may well be the only developer in Hong Kong or the Mainland that can unreservedly make this claim.

So why did the journalist not check these sources before he or she embellished the article as if stating a fact? We smell maliciousness.

In the past year or two when we speak to institutional investors in the West as we regularly do, we have received strong signals that perhaps someone has been speaking negatively about us. Some investors may, out of a good heart, advise us not to be overly bothered, as it may prove that we are truly a market leader; otherwise why have we become the target of negative attacks? However, such a terrible practice on the part of our competitors, if true, is not healthy for the development of the Chinese equity market. In our opinion, every participant therein should uphold the highest standards of integrity.

In Hong Kong as well as in any other major stock markets around the world, there is an unspoken rule that we do not bad-mouth our competitors. In fact we try to avoid commenting on other companies in the same industry. Hang Lung certainly abides by this. Unfortunately this civility is most likely not practiced by some in mainland China, not even by those so-called large and reputable firms. For those who know anything about the local culture, sadly this is perhaps not unexpected.

At Hang Lung, not only do we practice good governance, but when pressed or when the situation calls for it, we will also speak up in favor of better standards for the industry. In doing so, we may in some small ways contribute to the healthy development of the capital market and our industry.

For example, a few years ago, certain professionals in Hong Kong called for the shortening of reporting deadlines for results announcements. At that time, Hong Kong was the most relaxed of all major stock markets in the world. In the ensuing public discussion, Hang Lung was the only major real estate company agreeing with the better rules. We have long practiced it and have always announced company results within one month of period end.

Arguments employed by our competitors then were frankly absurd. They wanted to keep longer reporting deadlines so that major shareholders cum management can legally, albeit unfairly, trade in their own shares in the stock market. Partly due to sound arguments which we put forth then, I am happy to report that at least a few of those who previously disagreed with us are now reporting much earlier than they had previously done. We practice more than good governance; when appropriate, we promote it.

My sincere hope is that mainland Chinese companies, which for the most part are new to the stock market and to the international arena of institutional investors, will practice civility.

Back to your Company: although we finally incurred a net debt, it remains at an insignificant level. Net debt to equity ratio stood at 2.1%, which is very low by any standard.

PROSPECTS

For the next six to even 12 months, it is not easy to envisage a scenario where the global economy will substantially or even perceptibly improve. The same is true for China including Hong Kong. There is little good news on the horizon; instead, uncertainties abound everywhere. The only government that can do a lot about its own economy is China. Yet I do not foresee Beijing being able to come up with a remedy soon. A panacea may not exist.

What we do see is that growth in public investments and private consumption are both slowing down. Export figures are also not encouraging. All these trends seem to signify that winter is not yet over. In fact it is hard to foresee anything that will warm up the economy. The only "hot spot" is residential real estate where land prices in some cities keep rising, but this is hardly good news.

In Hong Kong, the situation is no better. Tourism is down, and so is retail. Given the weakness in Mainland exports, our trade and logistics sectors cannot be encouraging. With China's overall lethargy and the uncertainties in Europe and the U.S., our financial market will not grow much in the near future. Even residential real estate is not strong. In other words, there is no bright spot on the horizon.

If all these are correct, then the markets in which we play may for the rest of the year see more or less a repeat of the past six months. In fact, they may weaken further before they can get better. Given this scenario, we would be fortunate if we can maintain the same performance as in the half-year under review.

So what can management do to maintain growth, or at least contain a further slide? First, our two new office towers on the Mainland will give new impetus in the coming year or two. The newly opened Olympia 66 in Dalian should provide top line increase. Net profit from these three sources is however not expected to be big, especially from the new retail space.

Nevertheless, this will tide us over until the second half of 2018 when Spring City 66 in Kunming opens, barring no further delay. It is possible that the shopping center, office, and possibly even the serviced apartments will be ready around the same time. A year or so beyond that, we should see the inauguration of Heartland 66 in Wuhan. The opening of the office tower there will soon follow.

In other words, in the coming four years, we will have a pipeline of new space being steadily added to the portfolio. If the Chinese economy recovers within this time frame, then these newly completed properties should bring much growth for the Company.

For our older retail facilities on the Mainland, we will adopt a defensive mode. A lot of AEI is being carried out which should prepare us well for the next bull market. Here I have in mind our two complexes in Shanghai. For the newer properties, they will improve but with some difficulty as the economy faces headwinds. Nevertheless, the success of Palace 66 and Parc 66 tells us that after teething problems are resolved, better days lie ahead.

For two reasons our Hong Kong rental business may not see serious improvements. In fact it will not be easy to maintain the high single-digit top line growth of the past few years. First, the economy is weaker today and may yet slide a little more. Second, advances brought upon by recent AEI will produce a higher base moving forward. Growth rate will thus become more difficult to sustain.

The one area which should bring higher profit is the sale of the 446 flats remaining at The Long Beach, the last two units at The HarbourSide, and the 18 luxury duplexes on Blue Pool Road. Our willingness to part with them will depend on our read on the market conditions.

Looking further down the road, I am quite sanguine about the Mainland economy. The chances of something seriously bad happening are limited. Private consumption will gradually take over as the main engine of economic growth. Beijing leaders may have little choice but to encourage this since overseas markets will unlikely be vibrant. More efforts must be directed internally. Nevertheless, the domestic market will need further reform to spur growth. The bad thing about reform is that it is never easy; the good thing is that the upside can be substantial.

Consider this: at least 1% of China's total population is expected to move from the rural areas to the cities each year. In about a decade, city dwellers will increase by some 150-200 million people. The latter population figure is bigger than all but five countries in the world. In time, the consumption they generate will be impressive. This is in addition to the inevitable rise in consumption of the existing 750 million or so city folks.

Since retail space rental is our main business, we are well-positioned to grow further. While cautious about the short-term outlook, I am optimistic about our long-term future.

One thing we may yet do is to buy more land on the Mainland. We do not know if the time has come, but whatever the case, we will be very selective. In fact, of late we have turned down certain attractive offers. Unless a plot satisfies most if not all of our criteria, we will not jump. But even with these rather stringent conditions, I will not be too surprised if we score a success in the coming year or two. In this regard, we would love to see the market go further south!

Six months ago I reported that your Company has been the recipient of many international and local awards. In just the first six months of this year, we have garnered 33 more. The area that received the most accolades was sustainability, followed by human resources development, marketing, and investor relations. Not surprisingly, we were also recognized for design and architecture (Center 66 in Wuxi) and crisis management.

On this last point of crisis management, it is with great sadness that I report on a recent incident in Hong Kong. A mini-storage facility operated by a tenant in one of our industrial buildings caught fire on June 21, 2016. The blaze raged continuously for 108 hours and claimed the lives of two heroic firefighters from the Hong Kong Fire Services Department. We salute them and their colleagues and we are doing our utmost to offer assistance to the two surviving families. We are also working with our tenants to ensure that the same will not happen again in the future.

Ronnie C. Chan
Chairman
Hong Kong, July 28, 2016