

## RESULTS AND DIVIDEND

For the six months ended June 30, 2013, we sold much fewer residential units than the last corresponding period. As a result, turnover slipped 22% to HK\$3,305 million and net profit attributable to shareholders 23% to HK\$2,828 million. Earnings per share fell 23% to HK\$0.63. Excluding effects of revaluation gains, the underlying net profit attributable to shareholders and the underlying earnings per share both went down by 23% to HK\$1,933 million and HK\$0.43 respectively.

The Board has declared an interim dividend of HK17 cents per share payable on September 26, 2013 to shareholders of record on September 12, 2013. This is the same amount as in mid-year 2012.

## OPERATIONS REVIEW

For both Hong Kong sales and Mainland China rental markets, winter has descended upon us. There is as yet no indication when spring will arrive. What we do know however is that it will sooner or later return. Much should be done in the interim to prepare ourselves for the next round of good times. That we shall do as I shall explain later.

As our shareholders know, since 2001 we have concentrated our efforts in Mainland China, and have hardly purchased land in Hong Kong. Due to the lack of land supply which was a direct consequence of the Hong Kong government's then policies, residential prices could only move up. As a result, we have taken our time to sell completed apartments. We would go for profit rather than quantity of sales.

In each six-month period since mid 2008, we had only twice sold flats in mass quantities — in the second half of 2009 and in early 2012. Profit margins kept rising which should not be a surprise. That notwithstanding, a year ago I wrote that prices had risen to such levels that we would be happy to sell all flats on hand. Unfortunately the prevailing global economic conditions coupled with the inauguration of the new administration in Hong Kong have made selling more difficult. Nevertheless we are not overly concerned given the quality of our portfolio. Almost all remaining units have harbor view which is highly desirable anywhere especially in Hong Kong where population density is high and the harbor beautiful. Such assets tend to hold up their value much better than most in the market.

In the past six months, we parted with very few apartments. That was the main reason why total turnover and profit fell. Another is that in 2012 we sold quite a few long-held Hong Kong investment assets on a one-off basis.

Leasing turnover and profit both grew in Hong Kong and on the Mainland. Total rents rose by 9% and so did profit. Mainland now accounts for 53% of top line and 51% of bottom line, and Hong Kong 47% and 49% respectively.

Excluding the effect of the sales of Hong Kong investment properties a year ago so as to compare like with like, rents in our home city advanced by over 11%. The increase was sufficient to offset the loss of rent from disposed buildings, leaving us with an overall revenue increase of 2%. Retail space recorded a 14% rental rise and for offices, 11%. Residential and other rents were flat. Occupancy rates improved by three points to 98% for commercial and by one point to 96% for office.

18 months ago, I wrote about slowing retail sales on the Mainland when some market participants were still optimistic. Now everyone is bearish. I remain cautious, but nevertheless am pleased to report that with the exception of one special case, all of our properties recorded rising rents.

In Shanghai, both Plaza 66 and Grand Gateway 66 saw revenue grown by 7%. In Plaza 66, shopping center rent rose by 8% and for offices, 7%. Occupancy was about 96% for the entire complex. For Grand Gateway 66 where your Company only owns the mall which was fully leased, turnover increased by 7%. Rental margin everywhere held steady.

Compared to a year ago, retail sales advanced by 3% at Plaza 66 and 5% for Grand Gateway 66. Occupancy cost to our tenants did not change much. Turnover rent contribution fell especially for the luxury mall. Fortunately, unlike many shopping center owners, our lease terms are well-covered with a solid base rent. We always insist on this arrangement, and our relatively stronger bargaining power with tenants has enabled us to do that.

Jinan Parc 66 remained a happy story. We collected 6% more rent, and operating profit advanced by 15%. Rental margin improved four points to 57%. Retail sales grew by 6% although occupancy rate fell to 92%. The slippage occurred because after two years of operations, changeover of tenants became inevitable, be it voluntary or involuntary.

Let me now turn to the two shopping centers in Shenyang. The luxury one Forum 66 has only been opened for a little over nine months and is performing acceptably. For the period under review, retail sales have already surpassed those of the four-star Palace 66. It is fully leased, and rental margin at 61% is higher than that of the older Jinan Parc 66. The reason is that Forum 66 has mostly top fashion brands which pay higher unit rent. Nevertheless, as in any new facility, challenges abound especially as we enter a slower retail sales growth period which is particularly severe for high-end products. The first office tower being built next door has turned part of the mall's surroundings into a construction site. This too is not ideal and will last for some time.

I am hopeful that the worst for Palace 66 is almost over. Road works surrounding our site are still ongoing, but with the 12<sup>th</sup> National Games opening in Shenyang on August 31, they are expected to be completed soon.

As reported before, we have undertaken rather extensive tenant remixing which led to a repositioning of the mall. Such a process inevitably resulted in lowering the occupancy to 87% and a temporary slip in rental income. By year-end, it should return to 92% or higher. Because less rent was collected, margin retreated to 23% but I expect it to soon rise again. An encouraging sign is that notwithstanding all the difficulties, total retail sales actually grew.

Our overall leasing performance seemed to have beaten market expectation. Profit for the period under review was above most if not all market forecasts. Let me offer a few plausible explanations, none of which should be new to my faithful readers.

First, just as I have written in the past, retail malls are not exactly fungible assets. Location, size, design as well as customer service all combine to make a very few of them highly successful and the rest also-runs or living deads. Frankly the majority of Mainland properties belong to the latter categories. This approximates what I once described the winner-takes-all phenomenon. A corollary to the above is that in adverse market conditions like today, stronger players will weather them better.

Secondly, the superior shopping centers have far more bargaining power with desirable tenants. The level of rent paid — base or sales related — is not the primary concern of shop owners. The crux is the sales thus generated. This is why even though top brands may receive cash upfront for decoration and more from owners of poor properties, they usually choose to pay rent at superior facilities. The former more often than not do not perform well; the latter usually do. In fact, luxury names who care for their brand equity mostly refuse to play the get-cash-to-move-in game. And for those who do, the “rent-free” stores are for nothing more than marketing.

Where will that leave the property owners?! They have no one to blame except themselves for putting inferior buildings in wrong spots. As I have explained before, location, size and design are basic “genetic” elements of a mall which cannot be changed once built. Developers who do not respect them are almost destined to failure even before they open the doors for business.

Thirdly, quality design and construction, supported by reasonable facility management, will yield better than average rental margins. Newer properties will inevitably have lower margins, but experienced developers cum managers should outperform others in the long run. Most analysts probably did not expect our Mainland portfolio with many newly opened malls to have achieved a rental margin of 79%. The average for that market is perhaps 66-67%. So for every dollar of rent received, we are able to pocket 12-13 cents more in profit. That differential is significant indeed.

To complete the picture, together with a two-point improvement in rental margin at 86% in Hong Kong, the blended ratio for all our properties was 82%.

During a bear market, much can and should be done. Here I will only mention that one of them is to buy land when sellers need cash. That was exactly what we did in February. We have for years been searching in Wuhan which is an excellent city for retail sales. The piece we purchased is in the city's best shopping district, and site clearance is basically complete.

Plot size and buildable space are both slightly larger than the Kunming piece but land cost is cheaper. We paid RMB3.3 billion for the 8.26 hectares and will build 4.9 million square feet upon it excluding car parks. Total space including car parks should be around 7 million square feet. By comparison, Kunming cost us RMB3.5 billion for 5.6 hectares of land with buildable area of respectively 4.6 million and 6.5 million square feet without and with car parks. Both projects will have a shopping center, an office tower, as well as some serviced apartments which can be sold. Overall, we are quite pleased with this acquisition.

## PROSPECTS

In the whole of the 2000's, the Hong Kong government being by far the city's biggest land owner hardly sold any land. Before 2002, it was understandable because of the Asian Financial Crisis which struck on July 2, 1997. That was the day after Hong Kong's return to her Motherland. After the economy has gradually recovered, the city was hit in 2003 by SARS. But by 2004 and latest 2005, there was no excuse not to sell land. This was beyond incompetence.

The consequence to us was significant. Residential prices kept rising and that was why we were in no hurry to sell the completed apartments built on land bought in 1999 and 2000. Successive sales resulted in ever rising profit margins.

A similar situation existed with our investment properties. With an ever growing number of Chinese tourists, Hong Kong's overall retail sales kept climbing. Heightened economic activities on the Mainland spilt over to our city which increased the need for offices, not the least of which was from the financial services industry. Yet there was almost no new supply of land for commercial developments. All that have kept rents rising.

Anyone who has the best interest of our economy — and not just any single industry — in mind would not like to see this situation continue, for it will lead to price bubbles which will sooner or later burst. The economic consequences will be dire. But to correct the situation is easier said than done. There is little land that can be sold by the government not only now but also in the near future because the previous administration has not built a land bank. Now it is being done but it will take time.

So for now, all the government can do is to control demand. Draconian measures such as double stamp duty have been introduced and the market went dead. Unless the government let off the brake which is improbable, prices will have to wait until land supply catches up before they will move again. This is for the long term health of the real estate sector which is very important to the overall economy.

As such, it is unlikely that we will be able to part with our completed apartments in meaningful lots in the near future. Looking back, unless we were willing to lower prices considerably, we would not be able to sell more in the past 2-3 years. We were also hit at least twice by misfortune during our sales campaigns — the stock market fell seriously on one occasion, and the government launched austere curbing measures on another.

None of the market conditions described above will in the foreseeable future affect rents of commercial properties. However, market sentiment has caused almost all sales transactions of such assets to cease. As such, it was fortuitous that we had let go of a lot of our fringe buildings to highly pleasing profits. Today, such good prices could not have been fetched.

On the Mainland, retail sales have slowed considerably. Factors affecting them are rather complex. Compared to Hong Kong, not only is the domestic market on the Mainland far bigger and more complicated, internal politics as well as international economics also play a greater role. I can analyze extensively here, but what is critical to the long term health of our business is not that complicated. The prime question to ask is: Will China's domestic consumption rise in the long term? The answer is a resounding yes. This is important so that dependence on public investments (such as infrastructure projects) and on exports may be gradually reduced. There is no choice.

Indeed private consumption has been rising considerably even in the face of recent economic slowdown. It is just that public investments have increased so fast of late that private consumption as a percentage of the economy seems to have not grown or even contracted. But the consensus inside and outside of Beijing is that domestic consumption must rise. Consumer spending presently stands at around 34-35% of China's GDP. If it were to catch up only halfway to that of America's 70%, it would have grown 50% from today's level. In the process, the economic pie will continue to expand at 6-8% per annum. Such is the potential of our market.

This is why your management is not overly worried by today's bear market. Instead, we will take advantage of it and will focus our efforts in at least four broad areas.

First, we will redouble efforts to ensure smooth construction of the remaining Mainland projects. At present, we are erecting over 30 million square feet of world class commercial space costing close to HK\$90 billion. It will realistically take at least 10-12 years to complete. Nevertheless, it will be front-end loaded in the sense that we are moving full-steam ahead subject only to market conditions. Moreover, the more complicated and highest value added retail elements will be ready first, leaving some of the offices to be built as demand arises. We will also speed up the construction of residential units which are mostly for sale. This means that the next few years will be particularly critical.

Secondly, we will continue to strengthen our management team both in terms of quantity and quality. As our shareholders know, for the past six to seven years we have been adding a lot of staff but the number of new projects kept growing. Our resolve is to build a top-flight workforce to realize our dream of owning and managing some of the world's most outstanding and profitable commercial complexes.

Thirdly, it is important that we shore up our corporate culture, a topic which I have addressed in my previous letters to shareholders. It is not sufficient to merely have the best people; we must build a culture conducive to always doing the right thing. This is captured in the tagline which we have adopted last year — We Do It Right!

What we have today is not only a slowdown in the property sector but also a lull in our share price. After outperforming our peers for much of the 2000's, our stock has been drifting along with other real estate counters. The investment public knows well that our parent entity has of late been buying our scripts. We believe that this is beneficial — both in the short and long term — to shareholders of our Company.

For the past six to seven years, we have been basically debt free. Sales of completed Hong Kong apartments and of matured investment assets have kept us from net borrowing until last month. As of today, gearing ratio is however only about 0.3%. Even in the absence of further sales of Hong Kong properties, an assumption which is perhaps unrealistic, we have sufficient financing on hand to pay for all anticipated outgoings including capital expenditure (mostly construction payments) for the coming few years.

Given the above, we can comfortably buy one to two reasonably sized plots of land in the coming year or two. However, we are in no hurry to act unless we find a very attractive opportunity. Even if it does not come, we have plenty of work to keep our team very busy.

For the rest of 2013, it is doubtful if we will be able to sell apartments in mass quantities. Leasing activities in both Hong Kong and the Mainland should approximate the period just reviewed.

However, bottom line numbers do not tell the full story. With the weakening of Mainland retail sales especially in the luxury sector, certain measures of our performance may suffer slightly before conditions begin to improve. Your management is well prepared for the coming challenges.

We welcome Mr. Norman Chan who recently joined us as Director — Leasing and Sales. Like his predecessor who has retired from us, he will be in charge of all our leasing activities. Norman is very experienced in property management and has worked for many years on the Mainland.

**Ronnie C. Chan**

*Chairman of the Board of Directors*

Hong Kong, July 31, 2013