CHAIRMAN’S LETTER TO SHAREHOLDERS

RESULTS AND DIVIDEND

Compared to the last corresponding period, revenue was slightly higher at HK$6,358 million. Net profit attributable to shareholders advanced 30% to HK$3,830 million. Earnings per share rose similarly to HK$85 cents.

When excluding property revaluation gain and all related effects, the underlying net profit attributable to shareholders decreased 4% to HK$3,040 million. Underlying earnings per share fell 3% to HK$68 cents.

The Board has declared an interim dividend of HK$17 cents per share payable on September 28, 2017 to shareholders of record on September 14, 2017.

BUSINESS REVIEW

A year ago, I suggested here that there were gentle signs of spring in the then chilly winter of the Chinese economy, particularly in the luxury retail sector. By January this year, I was more positive but did not want to commit myself yet. Now I believe that the ice has thawed. Luxury goods tenants at our Shanghai facilities have seen strong growth in sales. It is very possible that recovery, which usually begins in tier-one cities, will spill over to other cities. Some but not all brands are beginning to expand again.

Given the nature of lease contracts, rental income has not yet reflected sales growth. But it will.

What we went through in the past six years was like a “perfect storm.” It also differs in character from all previous downturns since the country’s market opening in late 1978. It lasted the longest. Also, many of the earlier economic troubles had strong political overtones. A case in point was the 1989 nationwide turmoil which sparked an economic slowdown.

The latest downfall was more economic in nature although it was partially caused by government policies. But even without the anti-corruption and anti-opulence campaign, the market would have fallen sooner or later. Years of loose monetary policies resulted in huge overcapacity in production and excess inventory of commodities and manufactured goods alike. All these factors will bring on a correction.

There is at least one more difference. In the past the government has invariably tried its best to revive the market, and was successful in almost all cases. This time, Beijing was much more light-handed. Apparently it did not see the necessity to overly intervene.
There were other reasons for the economic slowdown. Diminishing export growth was one. For that, the domestication of formerly international trade as described in my letter to shareholders six months ago was, I believe, a major cause.

A factor more specific to our industry was said to be the oversupply of shop space. For example, it was said that Shenyang, a city we entered early after Shanghai, has more retail floor area than Sydney and Melbourne combined. Fortunately, very few of the shopping centers in Shenyang are world-class, with two being ours — Forum 66 and Palace 66, one each in the luxury and sub-luxury goods sectors. A similar situation exists in all other cities where we operate.

On the other hand, top international fashion brands also over extended in the late 2000’s. At least they expanded too fast. Given the anti-corruption measures and subsequent market shrinkage, they were forced to quickly close down some of their shops. Let the market grow for a few more years and the previous larger portfolio may be just right, but not for now. I can imagine the psychological trauma that the senior management of those brands must have gone through, and can only wonder if they have fully recovered.

The concomitant occurrence of the above two phenomena — oversupply of space and over expansion of fashion shops — led to some unhealthy practices. As mall owners chased after a limited number of luxury brands, not only free rents but also large sums of cash for tenant improvement were offered or demanded. This was a treacherous situation for the landlord as the retailers had little at stake. They could pack up and leave anytime. What was surprising was the fact that some of the world’s top brands would open shops in terrible properties just because they were rent-free. When the market turned south, they simply returned the key and there was little that the property owner could do. In fact, the fashion houses themselves also suffered in terms of reputation. Their brand equity was invariably hurt.

In such market conditions, only the best world-class facilities like ours can be spared from these practices. Without being offered such outrageous terms, top brands still chose to open in our malls because they knew that they could sell more products.

Another aspect of the “perfect storm” had to do with offshore purchases of luxury products. Tax and price differentials between mainland China and the West can be great. The annual report of one of the world’s top fashion groups once stated that whereas almost a quarter of global sales were transacted with mainland Chinese, only 5% to 6% of total purchases were done within China, excluding Hong Kong. To exacerbate the problem, until the past two years the RMB was strong, which made buying overseas even more attractive.
In the past few years, e-commerce has grown tremendously, taking some market share away from physical stores. The phenomenon prompted some to pronounce the death of brick-and-mortar stores. While such predictions cannot be correct, neither should one ignore the impact of this new form of sales. Eventually a steady-state ratio between online and offline sales for each category of products in a particular market will be reached. Fortunately, for reasons explained in previous years, high-end malls like ours are definitely less affected.

Social psychology also played a part in the “perfect storm.” When job creation and/or salary increases slow down, citizens are less confident about their prospects and will consume less. A periodic slowdown in residential price rises adds to this sentiment. The resulting negative wealth effect can be serious.

A point worth mentioning here is the effect that China’s economic slowdown has on the rest of the world. For decades it was said that when the U.S. economy sneezed, the rest of the world would catch a cold or, in some cases, pneumonia. Such is the nature of the beast called globalization. Now the same can be said of China. Commodity rich economies like Australia felt it the most, but few countries were spared. They are all praying for China’s recovery. What a far cry from only 20 years or even 10 years ago! Ancillary to this phenomenon is that after two to three decades of fast wealth accumulation, a rise in Chinese private consumption becomes inevitable and is certainly good for our business.

So what caused the market recovery of China? Here endogenous factors are much more significant than exogenous ones. It was the cleaning up of China’s own house that brought new shoots to the economy.

First, there was a passage of time to work down inventory. The government has forced the closure of excess production capacities, especially the weaker facilities. Lowering inventory and removing excess capacity are accompanied by general deleveraging and credit reallocation to productive investments. All these have very positive effects on the overall economy.

Internationally, the Belt and Road Initiative (BRI) proposed by President XI Jinping in 2013 is beginning to bear fruit, not only for China. Last year a former Prime Minister of Pakistan told me that some USD40 billion are being invested in his country from ports to roads and railways. The BRI is thus good for all. For a fuller explanation, I refer readers to my letter to shareholders of our parent company, Hang Lung Group Limited.

Second, external trade, both exports and imports, has improved. The strengthening of major trading economies and a weaker RMB certainly helped in the recovery of export growth rate.
Third, public investment, which has always been an economic engine, has once again done its magic. Westerners are correct to point out that no economy can rely forever on it to drive growth. But knowing the enormous size of a genuine need for infrastructure, the country is far from the point of saturation. The environment, for instance, is but one of the many areas that requires billions if not trillions of RMB of new investments to improve it.

Fourth, private consumption has continued to expand. The luxury goods sector, which is critical to us, in fact led the charge and yielded the highest percentage gain in terms of sales growth. Since salary rises have not abated, especially for the highly educated, five to six years of a slower economy did not dampen the increase in the number of city dwellers who are now candidates for high-priced products. Rising residential prices of late can only help to improve sentiment.

What seems sure is that the market for high-end goods has found its bottom after the removal of corruption-related purchases. What we are witnessing nowadays is a real demand in normal market conditions. While there will always be ups and downs, overall we may be seeing an upward trend which should last for many years to come. The rise today is a systemic as well as a cyclical one.

In terms of retail sector recovery, Hong Kong lags behind the Mainland by perhaps a year. Twelve months ago I wrote about slight indications of a turnaround in tier-one markets like Shanghai. Now we are observing the same in our home city. How sustainable and how strong it can be remains to be seen.

Amidst a weak local market in recent years, we have definitely outperformed, due mainly to asset enhancement initiatives undertaken before conditions worsened. We seemed to have defied gravity — we grew while others stagnated. Years of outperformance have however raised the rental to a high level, which in turn makes a continual strong increase more difficult to achieve. Consequently, our growth rate may in fact moderate. This is counterintuitive but rational.

Of significance is the “new normal” for Hong Kong retail business. Years ago, when Mainland tourists poured in, rents went through the roof. Due mainly to the foolishness of some of our citizens in making hostile gestures toward our compatriots from the North, an unpalatable impression has been formed in the minds of Mainland visitors and potential visitors. Yet they are getting wealthier by the day. People in the industry know that not only does China have the biggest number of outbound tourists, they are also among the highest per capita spenders when they travel. Sadly, Hong Kong for many of them is no longer their preferred destination for shopping.
When such rich consumers began to shop in other places such as Taipei, Tokyo or Seoul, our retailers could no longer afford the very high rents that they and their landlords were both accustomed to. Vacant retail spaces that were hardly seen before began to appear. Reality soon set in and everyone had to accept a new normal — a new level of rent that was lower than before. In some cases, the percentage drop was significant. Fortunately our Hong Kong rental portfolio has always been oriented toward local shoppers, and so was not hurt.

Set against this background, our performance of the past six months was acceptable. Rental income in both Hong Kong and the Mainland edged up 1% in local currencies. Due to the 5% depreciation in the RMB vis-à-vis our reporting currency, the Hong Kong Dollar, Mainland revenue fell 4% resulting in a retreat of 2% for the entire portfolio. The contribution split was 49% Hong Kong and 51% the Mainland. Overall rental margin improved slightly to 76% with Hong Kong at 86% and the Mainland at 65%.

Plaza 66 in Shanghai was the star performer. Revenues rose 23% while retail sales went up 29%. These numbers underlined the strong recovery of the luxury retail sector just as I had previously reported. The fact that its renovation works were recently completed contributed further to the strong performance.

Grand Gateway 66 in the same city has just commenced a major HK$800 million plus refurbishment program. They are expected to be completed in late 2019. So far 19% of retail space has been removed from the market, and the total at its height will reach 31%. On a like-for-like basis, rents went up 9% in the past six months and retail sales rose 7%. The 7% drop in the reported revenue was due solely to the asset enhancement initiative now in force.

Outside of Shanghai, retail sales increased everywhere. This was true on a year-on-year basis as well as when compared to the half year immediately before. These are good signs even though rental revenue in some properties fell due to lingering downward rent reversion pressure. Occupancy rate improved in almost all projects. Occupancy cost everywhere has come down slightly or has remained the same.

As reported previously, Parc 66 in Jinan is now a successful shopping center. Riverside 66 in Tianjin is also performing quite well and improving. Management efforts have borne fruit, and I am hopeful that we will very soon see an increase in both top and bottom lines.
In the past we had two concerns: Forum 66 in Shenyang and Center 66 in Wuxi. Now just one concern remains. The latter’s difficulties are not only basically resolved; it is already on an upward trajectory and should do well. The completion of the second office tower in late 2019 should further help. Forum 66 will need more work and I am confident of its eventual turnaround. Olympia 66 in Dalian, being new, has much room for improvement, but progress is being made.

Our offices in Shanghai are performing acceptably. The two new towers, one each at Forum 66 in Shenyang and Center 66 in Wuxi, are doing quite satisfactorily. We should be able to reach full or near-full occupancy by year end, or at the latest, by early next year. We have let some weaker tenants go, only to replace them with much stronger ones. Now we can boast some of the biggest commercial names in the West and in China. Offices now account for approximately 22% of our total rents received on the Mainland.

When we first entered the Mainland market, this asset class was meant to be supplemental to our main business of shopping centers. In some ways this is still true. Nevertheless, our appetite for offices has grown such that we can even look upon it as a stand-alone business. We certainly do not mind doing more of it. Besides land price, the criteria for new projects are the same as those for malls — choose only the best cities and best locations.

Taking advantage of the continued strong residential market in Hong Kong, we further sold down our inventory at an excellent profit. Compared to the same period a year ago, we parted with fewer units (198 versus 228) but pocketed 5% more in revenue and 18% more in operating profit. Profit margins improved from 58% to 65%. We have sold the last unit at The HarbourSide, thus closing what may be our longest voluntary sales campaign spanning 14 years. The project might also have broken another record — it is perhaps the single most — or at least one of the most — profitable real estate projects in Hong Kong.

A slight revaluation loss on the Mainland was compensated by gains in Hong Kong. Profit attributable to shareholders rose 30%, and earnings per share increased similarly. Because of lower interest income and capitalization of interest expenses, underlying net profit attributable to shareholders and underlying earnings per share decreased by 4% and 3%, respectively.

Construction progress everywhere is acceptable, with minor delays. As I will report later, 2019 will be an extraordinary year for us. On average, a project will be completed every other month.
PROSPECTS

In my letter to shareholders in the Annual Report for the financial year ended June 2011, I stated that beginning in 2012, the Company might well enter a golden era. This was based on the assumption that there would be no major disruptions in the market, which unfortunately did not turn out to be the case in the past six years. However, as management has of late critically reviewed our strategy which we always do periodically, we remained convinced as ever that our future especially on the Mainland should be bright for decades to come. As I have periodically written, private consumption will be a major driver of the economy and we are well positioned to take advantage of the opportunities arisen therefrom.

This means that whereas inevitable periodic economic downturns may hold off our schedule, as they have in the past six years, they cannot and will not fundamentally alter our course. Frankly, the recent bear market was not what concerned our management the most. After all we have been basically debt-free throughout this period. Our main task was not to counter the effects of market weakness. Rather, it was to build a world-class management team on the Mainland worthy of our strategy and our commercial properties, which stand among the best in the country. We need to get our software right, just as we had in the past decades got our hard assets right. In other words, our main focus of the past few years was not so much to be defensive, to survive the market lull at the time. Instead, it was offensive, to prepare ourselves for the tremendous opportunities that lie ahead.

There is no denying that the combination of a very weak market and the need to strengthen our management team presented a serious challenge. As our CEO Philip Chen, a former airline executive, said, to change airplane engines in mid-air was an uncomfortable exercise! Nevertheless, I am happy to report that the external environment has finally turned around, and is expected to continue in that direction in the foreseeable future. More significantly, the team that we have today is very different from the one we had before the downturn that hit in 2011. To be sure, the task of team building is not yet complete but we have already made much progress.

When we last placed shares in November 2010, the market was at its peak. Within a year, the Chinese economy began to falter. The overall stock market fell and so did our scripts. The latter has been weak ever since. I suspect that the feebleness of recent years was partly due to the market not being convinced that we could repeat the success of Shanghai in other Mainland cities. Frankly I can see why.
The situation is now substantially different. The market has recovered and our efforts have borne fruit. Not counting the brand new Olympia 66 in Dalian, all but one, Forum 66 in Shenyang, have successfully passed the initial stage of teething problems common to all new commercial complexes. The industry norm tells us that four to five years after opening are usually required to stabilize a new facility, and we are basically on schedule. For example, Center 66 in Wuxi opened in 2013 and Riverside 66 in Tianjin in 2014. Both are now doing well and are expected to do even better in the coming years.

To put things in context, although the past few years saw a lethargic market for our Mainland business, we nevertheless have approximately doubled our rental revenue therefrom since 2010. Looking into the coming five to seven years, it is likely that barring unforeseen circumstances, these numbers should double once again. The following three factors point to this outcome: continued market recovery and advancement, further improvement and organic growth of our existing portfolio, and addition of new properties.

Unlike the period between 2010 and 2016 when new developments arrived gradually — we inaugurated six malls, one per year except in 2015, and one office tower in each of 2014 and 2015 — a good portion of our coming new space will be completed in 2019, followed by gradual additions thereafter. Between the fourth quarter of 2018 and late 2019, we expect to open the malls Spring City 66 in Kunming and Heartland 66 in Wuhan. Their respective office skyscrapers should follow approximately one year later which may in turn be followed by their residential towers.

Also anticipated in 2019 is the completion of the 315-key Conrad Hotel in Forum 66 in Shenyang. Although this hotel is not expected to be a key profit driver, its presence should complement the office tower and retail space. The second office tower of Center 66 in Wuxi will follow soon thereafter. Later in the same year, the refurbishment of Grand Gateway 66 in Shanghai should be concluded. (Around the same time, the remodeling of The Peak Galleria shopping center in Hong Kong will be completed.)

If the decision to construct the second office tower of Forum 66 soon becomes positive, the space may be ready for the market by as early as 2020. The same is true for the high-rise residential units in Forum 66, Center 66, Spring City 66, and Heartland 66. All the apartments will be for sale.
With these developments in the pipeline, a meaningful increase in rental revenue from the Mainland in the coming, say, five years should be forthcoming. Thereafter, considerable organic growth in rent can reasonably be expected. This is why our management believes that whereas periodic market lulls may somewhat delay the arrival of the golden era as I have previously written, they cannot forestall its dawning. Our future is bright indeed.

For now, we will continue to watch the ice thaw. Barring black swan events, China’s private consumption market should grow further in the coming years. This is especially true in the luxury goods sector. Balmy winds will be expected in tier-two cities as they have been experienced in places like Shanghai.

Bucking the market trend in the past few years, a much higher base has been established in our Hong Kong retail rentals. Consequently, our rate of growth may moderate, as we have begun to witness in the past six months. Nevertheless, some increase in rent can still be anticipated.

There is a possibility that we will soon completely sell out The Long Beach. A certain number of houses at 23-39 Blue Pool Road may also find buyers. Profits therefrom should be rather satisfactory. As to the replenishment of the land bank, I remain hopeful that we can score success in the coming year or two but only with commercial plots on the Mainland.

Hang Lung began as a pure real estate developer in 1960. It quickly amassed wealth in a few short years and became perhaps the largest Chinese-run concern of its kind. Around 1970, it began to acquire rental properties in the Mongkok District of Kowloon and soon expanded into the Causeway Bay District on Hong Kong Island, two regions where we still maintain a strong presence today.

We may have been the first Chinese company to conscientiously engage in the rental business in the post-World War II era. While such capital deployment made us miss the huge surge in residential prices in the 1970’s and 1980’s, it also protected us from sharp periodic market falls. In hindsight, we entered the rental property business too early, a point I have made in recent years.

Whatever the merits and demerits, we survived. As a decision totally independent of this history, we focused on the rental and not the development business soon after we entered the Mainland market in late 1992. We however continued to do development projects in Hong Kong in the 1990’s and especially in the early 2000’s. The Asian Financial Crisis of 1997–2002 afforded us a great opportunity to buy developable land on the cheap. We have taken full advantage of the market and have finally almost sold out all units for a great profit.
Given the high Hong Kong land prices in recent years, we believe that the risk-adjusted return on Mainland commercial projects for lease is more favorable than that on Hong Kong residential developments. Consequently, in the past decade and more, we concentrated on building our rental portfolio north of the border. Ancillary to some of these projects are luxury apartments for sale, but their profit contributions relative to our total business are not expected to be too big. That said, there is always a possibility that we will one day do more of these.

The likelihood of our purchasing significant quantities of Hong Kong residential land for development does not appear to be great at this time. All too many bidders, especially new entrants from the Mainland, have pushed up unit prices. But if there ever is another opportunity akin to that of 2000, we will be happy to seize it. After all, we are not pessimistic about Hong Kong’s property industry.

As reported before, we would like to expand our Mainland rental portfolio by buying more land. Given our long-held strategy, these acquisitions are critical to the subsequent performance of the projects. As such, we have always been very careful. In the 12 to 13 years from 2005 till today, we have made nine acquisitions. (Phase I and II of Center 66 in Wuxi were separately purchased.) Going forward, we will become even more selective in our choice of land. If on average one piece of land is bought every two years, I will be pleased.

Given this landscape, and as we sell down our Hong Kong residential inventory, we will increasingly become a rental business-led company. For the many reasons given in the past, we believe that this is a good strategy today. This is especially true since the risks in Hong Kong residential development projects are too high, given exorbitant land prices. On the other hand, neither are similar activities on the Mainland attractive, due to the relatively low unit price in tier-two cities, and the competition and market saturation in some tier-one cities. This is not to mention the frequent periodic changes in government policies, and high taxes.

This is why some Mainland developers are entering the Hong Kong market, for they have increasingly found it difficult to grow revenue, let alone profit back home. Some are going even further afield, to places such as Southeast Asia, Australia and the United States. For those of us who have done real estate business in such places in past decades, we know how treacherous they can be. Yet I sympathize with our Mainland friends. If their home markets still had plenty of opportunities, they would not venture out. If so, then why should we as a Hong Kong-based company do residential projects on the Mainland, except in niche markets like we have been doing?
This strategic direction of ours will have a bearing on our dividend policy. In the past year or two, some institutional investors have been speaking of the merits of higher dividends. To be sure, small local investors have always demanded that. We listened to them carefully but only to a certain extent. We are keenly aware of the fact that at times they do not share the same objectives as ours. Representing primarily the long-term interests of our shareholders, we manage our business and not our short-term share price. This is why we like long-term investors with whom we have total parallel interests.

Our long-held and publicly stated dividend policy is to strive for a steady stream of payments. As we earn more, we will pay out more. Our strategy to maximize profit from each Hong Kong residential development means that we will only sell when prices are high. As a result, profit therefrom may fluctuate greatly from year to year. In some years, it may be substantial, but in others very little or even none. If the dividend payout is directly linked with such profit, then the absolute level of dividend may fluctuate wildly. This is why we do not adopt a fixed payout ratio. Instead, we should primarily look at rental income to determine the level of dividend. Nevertheless, the probability of considerable sales profit for a particular year can influence the Board’s decision on how much to pay out.

My readers may be surprised to learn that in 13 of the last 16 years between 2001 and 2016, we basically paid out more than our leasing profits. In the other three years, on average 90% of such profits were passed onto shareholders. The Board was able to make such decisions based on two considerations: we knew that rents would rise quickly in the coming years, and there was considerable impending development profit.

As reported earlier, our Mainland rental portfolio will greatly enlarge from 2019 onwards. Topline growth will sooner or later lead to a profit increase, thus enabling us to pay more dividends. However, we will likely have a hiatus in property sales profit once the remaining completed Hong Kong residential units are sold out in the coming few years. With this in mind, we cannot for now be too aggressive in dividend payout.

I do not expect too many surprises in the 2017 full year results, especially on the rental front. The final number will obviously be affected by how many Hong Kong residential units will be sold.

Ronnie C. Chan
Chairman
Hong Kong, July 27, 2017