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Plaza 66, Shanghai

Grand Gateway 66, Shanghai

CHAIRMAN'S LETTER TO SHAREHOLDERS

Ronnie C. Chan
Chairman

Results and Dividend

For the year ended December 31, 2019, revenue decreased 6% to HK$8,852 million because we almost did not sell any Hong Kong residential units. Net profit attributable to shareholders declined 24% to HK$6,172 million. Earnings per share fell similarly to HK$1.37.

When excluding the effects of property revaluation gain, the underlying net profit attributable to shareholders rose 9% to HK$4,474 million. Correspondingly, the underlying earnings per share increased to HK$0.99.

The Board recommends a final dividend of HK59 cents per share payable on May 20, 2020 to shareholders of record on May 7, 2020. If approved by shareholders, total dividends per share for the year ended December 31, 2019 will be HK76 cents.

The one-cent increase in per share dividend bears some explanation. At year-end 2015, the Board saw it appropriate to send a clear signal to our shareholders that our market has been terribly weak and would likely remain so. The one-cent drop was altogether immaterial to our cash flow.

In fact, we began to feel a chill in the market as early as mid-2011. By late 2012, those who were perceptive knew that Winter was quietly arriving, and by 2013, the downturn became clear to all. In 2014 and 2015, the slowdown was so severe that no one was expecting a prompt recovery. No one knew when Spring would return, and neither did we. It was at that juncture that your Board felt the need to send a message to the market. We believed that it was the only responsible thing to do. It took another two years before recovery came.

Events subsequent to our deliberate dividend cut showed the disparity of views between investors and management. The latter is primarily concerned with the long-term health of the Company and acts responsibly towards all stakeholders, particularly our shareholders. Understandably, most investors on the other hand are predominantly occupied by short-term – and in some cases, very short-term – considerations, namely the return on investment which comprises share price performance and dividend.

It was amazing how the one-cent decrease annoyed so many shareholders. Perhaps it hurt them psychologically, since for at least 30 years prior, we only lowered the dividend twice, in 1988 and 1999, both times during serious regional or global financial and economic turmoil. Investors and analysts understood our rationale as well as its immateriality from a cash flow perspective, but they just did not like it. A good many of them told me so in my face. One often heard phrase was, "When will you give me back the one cent?!" We heeded them and are happy to oblige when we deem the timing auspicious.

Your Board believes that the time has come. The long bear market ended in late 2017 or early 2018. On the second anniversary of the recovery, we are quite confident of our near- to medium-term future. We fully recognize the uncertainties in our two markets – the social unrest in Hong Kong and the U.S.-China trade war involving the Mainland. Later in this letter, I will share my views on the former, just as in the last interim report where I presented my thoughts on the latter. Also six months ago, in my letter to the shareholders of our parent Hang Lung Group Limited (HLG), I wrote about the implications of a broader conflict between China and the U.S.

The conclusion was that consumer spending in mainland China, and luxury retail in particular, should continue to do well. In fact, the dispute between the world's two biggest economies may in fact help our business somewhat. Moreover, rent increases in our Mainland portfolio are expected to be strong such that it will more than compensate for any possible fall in Hong Kong rental.

Since Summer has arrived for our Mainland business, your Board believes that this is the time to raise the dividend. Nevertheless, we must balance any payout with future outlays. In the coming several years, our annual capital expenditure will not be inconsequential. We are very much in a growth phase as I reported before – we will have completed almost 380,000 square meters of mainly world-class commercial space each year for the seven years between 2019 and 2025. I challenge my readers to find another real estate concern in the world today which has this amount in its pipeline. There will be very few, if any. Consequently, prudence dictates that we should not be careless in spending our cash.

As to the longer-term dividend payout, our policy has always been to pay more as we make more, subject to the bounds of financial prudence. As much as possible, we have a tendency not to cut; rather, we prefer to see a stream of steady or rising dividend in absolute dollar terms.

Business Review

As the operating entity to our parent company HLG, I wrote six months ago at considerable length about the market factors and business model factors which made our business so attractive. Some of the points were explained in detail in previous years and I refer readers thereto. As is my practice, I usually devote this letter to strategic as well as operational issues that impact our business more directly. Because much of our future is in mainland China, I address economic and other developments relating thereto which may affect us. For the piece to HLG shareholders, I tend to step back a little and look at the broader global affairs that may have an effect on our enterprise. I may even at times wander ever so slightly into their philosophical underpinnings. Purely Hong Kong-related issues are also for the most part put there.

As my regular readers know, I take the two semi-annual letters most seriously. I see it as my duty to communicate to our shareholders (and potential shareholders) regularly, and at some length, the critical external events that may affect us. This is of course in addition to the basic company information that a chairman should report. Nevertheless, the nature of this platform is private, in the sense that it is only meant for a certain audience who is interested in our firm. Yet much of the world today has changed because of the Internet. As a Mainland Chinese shareholder recently said to me, few "private letters" are as widely read as mine. In fact, my two semi-annual reports have spread well beyond the investment community, particularly in mainland China. This is fine, for it will not change in the slightest my approach to crafting them.

Management has turned in another set of satisfactory results. This is set against an environment that is most troubling. China-U.S. relations are still on ice, the recent preliminary resolution in the trade dispute notwithstanding. Hong Kong's social unrest might have subsided on the surface, but a half-way acceptable solution is still nowhere to be found.

Consequently, like all other owners of Hong Kong commercial real estate, our rental revenue is somewhat affected. Thanks to the growth in the first half of 2019, we were able to eke out a 2% year-on-year rental growth for the 12 months. Fortunately, our Mainland business has risen strongly, which more than compensated for the market weakness at home. In local currency terms, we collected 12% more rents outside of Hong Kong – 8% for Shanghai and 19% elsewhere. Excluding the newly inaugurated properties, the Mainland portfolio grew 10%.

Plaza 66,
Shanghai

While our Mainland offices have only gently advanced, our shopping centers have commanded much higher rents. In Shanghai, Plaza 66 rose 14% and Grand Gateway 66, in spite of an ongoing Asset Enhancement Initiative (AEI) where the main building was only partially open, advanced by 6%. Not counting the newly inaugurated Spring City 66 in Kunming, four out of six malls outside Shanghai saw double-digit growth, with three gaining 20% or more – 20% for Palace 66 in Shenyang, 22% for Center 66 in Wuxi, and 28% for Olympia 66 in Dalian. The number for Parc 66 in Jinan stood at 10%. Even the two weaker properties of Forum 66 in Shenyang and Riverside 66 in Tianjin rose respectively 3% and 4%. In other words, every mall experienced rental increase.

The numbers for leasing operating profit were dramatic. Those for Hong Kong and Shanghai only advanced slightly because our facilities there were rather mature. But elsewhere on the Mainland, the improvement was staggering. This is a very good sign – it means that our operating efficiency was greatly enhanced, i.e. cost has stabilized or has fallen while top line has continued to grow at rates which are in themselves not inconsequential. Best of all, I expect more to come.

Consider this set of results: the worst performer (Riverside 66) advanced by a very respectable 13%. The next best, Parc 66, accelerated by 21%. The rest are in the stratosphere. In ascending order, they were Palace 66 at 56%, Center 66 at 59%, Forum 66 at 68%, and Olympia 66, with a whopping 81%.

These figures are not commensurate with the rise in revenue. They are characteristic of our business which I had previously described; namely, a few years after opening, cost increase will slow down if not flatten out while rent will continue to climb. This jaw, once opened, will only widen over time such that more and more of the top line will drop straight to the bottom. We had been expecting this but the bear market of 2012-2017 has delayed its arrival. Once Spring returned in early 2018, we knew that our mall business would soon return to the trend line, and in the second year of the recovery, it happened. Rental margin everywhere has improved.

Grand Gateway 66, Shanghai

In a mature market like Hong Kong, where our investment properties are older, rental margin has for years stayed at around 84% to 85%. The two malls in Shanghai are close to 20 years old and the numbers have always lingered around 90%. Even Grand Gateway 66, which is undergoing AEI, still achieved 85%. In time, it will return to Plaza 66 levels.

Outside Shanghai, three malls have risen to 45% or above: Palace 66 and Center 66, both at 45%, and Parc 66 at 56%. All other properties witnessed improvements, especially Olympia 66 whose Phase 2, accounting for some 13% of total space, was not open until recently. We gradually brought them to the market, resulting in higher occupancy which greatly lifted rental margin. In all our developments, I expect the favorable trend to continue. The same is true for the occupancy rate and average unit rent.

Another way to see how strong the Mainland market is and our performance therein, is to look at the sequential growth in rental revenue. Let us examine four sets of year-on-year numbers: full year 2019 compared to that of 2018, the first half of 2019 to the first half of 2018, the second half of 2019 to the second half of 2018, and finally, the second half of 2019 to the first half of the same year. Whether in Shanghai or outside, all figures are in the positive territory. In fact, all four numbers for properties outside Shanghai achieved double-digit growth. They were respectively 19%, 14%, 24%, and 16%. For Shanghai, they were 8%, 4%, 12%, and 9%. The overall increases for all Mainland projects were respectively 12%, 7%, 16%, and 11%.

Key to our continued success is of course retail sales. Only when our tenants do more business can we expect higher rents from them. Here again, the numbers are quite encouraging. Excluding Grand Gateway 66, which is currently undergoing AEI, and the newly opened Spring City 66 in Kunming, our tenants everywhere else have done more business in 2019 than the year before. In four places, the rise was over 20% – Palace 66 achieved 20% more sales, Plaza 66 and Center 66 both came in at 21%, and Olympia 66, 29%.

An interesting observation on retail sales is that Plaza 66 in Shanghai is already within 10% of the total sales of all our Hong Kong retail tenants put together. Once Grand Gateway 66 is fully operational after the AEI and all the top fashion brands have moved in, its tenant sales will likely soon approach our Hong Kong number. Even more promising is that putting together all the Mainland malls outside Shanghai, the sales figure is already over 80% that of our home market.

Because the respective competitive landscape and purchasing power are different, unit rent varies greatly from city to city. This is why Hong Kong is far higher than all Mainland cities. Even if the former does not fall in the coming few years, an assumption which is questionable (a point to which I will return in the next section), it is almost inevitable that the gap will continue to narrow. This bodes well for our business, for we have been aggressively expanding on the Mainland.

Look at it in another way: what would have happened if we had not entered the Mainland market in the past? Over the years, we were cautious to not sell down too much of our Hong Kong investment portfolio for fear of uncertainties on the Mainland. However, recent local turmoil has shown that our home market can also be not that trustworthy. What is certain is that by being in both places, i.e. taking a diversified portfolio approach, we will not get caught in the most undesirable scenario, namely all eggs in one basket whose bottom has fallen out.

This year's financial account is particularly cumbersome. Several elements, some old and others new, can easily cloud the true picture of our performance. Only very careful analysts can adequately dissect it. Management has done its best to make it easier to understand, and we encourage all our readers to study this report. Here I will call your attention to a few key elements.

For almost two decades, we have focused on building up our Mainland commercial properties for long-term rental. As such, our present and future performance should primarily be measured by this part of the business. And since almost half of our rental revenue still comes from Hong Kong, how we fare in this regard is also significant for the near term. The rest, like property sales, should be considered as supplemental. It should be stripped out to see our underlying performance. Our main business is the main business.

Whereas smart professional analysts have long evaluated us this way, local newspaper reporting is another matter. Since property sales is to us secondary and is sporadic, lumping its results with our steady rental income will only cloud the picture. But because most of our fellow Hong Kong real estate companies rely primarily on property sales, this is how the media sees us. Over the decades, we have transformed from that model to an investment-led concern. Because periodically we still have some property sales activities, the press became confused. We understand the futility of expecting local journalists to grasp such nuances. Nevertheless, Management will do our best to make this clear to our readers when preparing externally oriented publications like this report.

Another longstanding issue is currency translation. It too can seriously distort a proper assessment of the state of our operations. With the Hong Kong Dollar being the home currency for reporting purposes, any RMB appreciation will overstate our profit, and any RMB depreciation, like in the past few years, will have the opposite effect. As such, the sensible way to assess our business is to view the results in its local currency, namely, to evaluate our Mainland rental operations in RMB terms. As we now receive over half of our rental revenue in that currency, your Board has long considered the possibility of reporting the company results in RMB. Nevertheless, so far we are not convinced that we should make such a change.

Somewhat new to this year's reporting are two issues. First is the change in accounting standards (HKAS 23). It started a year ago and is again explained elsewhere in this report. Simply put, further capitalization of interest payments has lowered the current interest expenses which boost net profit.

The second relates to the semi-annual revaluation of our investment assets. As many analysts who cover our Company know, for many years the cap rates used to value our properties were on the high side compared to our peers. This is especially true, considering the superior quality, and commensurate revenue-generating ability of our Mainland developments. This view has been repeatedly confirmed by the actual sales transactions of inferior buildings in our neighborhoods at much lower cap rates.

Our external valuer has thus decided to, across-the-board, lower the cap rates of our Mainland properties. This is especially true for the two Shanghai complexes which have performed superbly after their recent AEI. (Although Grand Gateway 66 is still undergoing upgrading refurbishment, the possibility of it following the good example of Plaza 66 seems compelling.)

To give a value or a single number as the worth of a complicated investment asset is as much an art as it is a science. Many subjective determinations are inevitably involved, although the methodology must be, and in our case is, rigorous and consistent. For example, the valuer's expectation of our future income stream is part of the equation. He or she may take into account the present U.S.-China trade war and its effects on rental growth. How about market factors, such as the oversupply in the asset class under consideration? How much competition is required to begin affecting our rent-bargaining ability? And by how much? These illustrate how subjective the resulting number is. Short of comparable sales activities, any valuation is nothing more than a guesstimate. And even with neighboring actual sales, how does one assess the difference in quality among buildings?

A case in point is the two investment properties that we and our parent company HLG respectively sold early last year. The realized prices were two to three times the book value, which by definition was less than six months old. (We revaluate the entire portfolio every six months.) A similar situation existed for all our rental properties sold in the past decade.

As such, the semi-annual valuation should be taken only as an indication. To predict the future is a fool's game, although at times necessary, like in our business. I understand and agree with the concept of reflecting a truer value of hard assets in the accounts, but anyone looking at such numbers must recognize the limitations of the methodology and of the valuer. For none of us is omniscient. Too many factors contribute to one final number, and many of those factors do not and cannot have a precise answer.

Spring City 66 in Kunming was inaugurated in late August 2019 so there is nothing to compare. Suffice to say that its initial performance is quite encouraging. Over 90% of the space has been leased or has rental contracts being finalized, and many of the world's most valued fashion brands are already committed. Some of them are still undergoing interior decoration and will only start to do business in the second quarter this year. The official mall opening ceremony will thus take place around the end of May. The mall will be indisputably the Home to Luxury for Kunming, the country's number one gateway to Southeast and South Asia. It is also interesting to note that one-third of the brands are debuts to the city if not to the country.

Spring City 66, Kunming

All our offices are performing steadily but not spectacularly. Relatively speaking, the skyscraper at Forum 66 in Shenyang performed the best in terms of improvement in operating profit. The second tower of Center 66 in Wuxi opened last August and is leasing satisfactorily.

Conrad Shenyang at Forum 66 commenced business on September 1, 2019. It already commands the highest room rate in the city and is fast becoming an attraction for the wealthy in Shenyang and its neighboring cities. And there are many such people!

Construction works in all of our Mainland developments are proceeding as planned. This includes our latest project, Westlake 66 in Hangzhou, where we eventually broke ground in September 2019. We were delayed by government procedures by five months. All preliminary construction works have commenced and we hope to catch up as much as possible. Kohn Pedersen Fox Associates based in New York City has been appointed as the design architect. We have worked with them before on many projects.

Due to the social unrest in Hong Kong, our economy has been seriously hurt. It will take some time to recover, and even after that, the level that can be achieved in some industries may be below that of the pre-trouble days.

In the next section, I will attempt to discuss Hong Kong's possible longer-term future. Suffice to say here that what has happened in the past seven months was nothing less than insanity. The violence was more atrocious than what took place in the major riots of the world in the past few decades. I refer to London, Paris, Barcelona, New York City, and the like. What foolishness! But liberal politics is often irrational. For an ideology, a religion, or a political system, some people would hawk their money or their future for very little. Yes, street violence hurts businesses but the pain is manageable for bigger enterprises like us. But for the tempestuous young people, their future may be ruined for life. The adults behind the scenes who instigate violence will have to bear a good part of the responsibility.

Forum 66, Shenyang

For now, retail was the first to get hit. When shops and malls have to close to avoid destruction by the mob, everyone suffers. Mainland visitors who have been the key to our decade-long prosperity stopped coming. As landlords, we have to strike a balance between the sanctity of legal contracts and business relationships. Consequently, in the past three months, we had to give some rent relief on a case-by-case basis. Fortunately, most of our retail space is tailored to local people, and as such, they are less affected though few can be totally immune.

The Hong Kong office market has also felt the effect. Prices at lease renewal have become softer.

In the first half of 2019, Hong Kong rental grew by slightly over 3%. Street troubles began in June and our rents collected for the last six months were flat. Consequently, we were up 2% for the full year.

Under such circumstances, selling luxury dwellings like those on Blue Pool Road became difficult. This was why we were only able to sell one house. Unit price realized was comparable to those achieved the year before when we parted with three.

We sold some mature investment properties before the violence began. Our hope was to sell more but the market turned very quiet.

Our two Hong Kong development projects progressed as planned. We were successful in consolidating ownership last April at the former Amoycan Industrial Centre in Ngau Tau Kok. Demolition is proceeding and it will be redeveloped into residential units with a small commercial podium below. Total gross floor area will be slightly over 16,000 square meters. We hope to pre-sell in 2021 for 2023 completion.

Demolition work is completed at the Electric Road redevelopment project in North Point. We will construct one office block just shy of 10,000 square meters. Completion is expected in 2022.

For the calendar year just ended, RMB depreciated 4.3% against the Hong Kong Dollar. As a result, our reported income from the Mainland was that much lower in our home currency.

While our underlying business has performed strongly on the Mainland, for two reasons Net Profit Attributable to Shareholders was down 24%. First, we sold a lot less development properties in Hong Kong. Second, revaluation gain attributable to shareholders was not as high as in 2018. Taking out the second factor, net profit was up 9%. Ignoring as well the first factor for the moment, our overall property leasing business jumped 29% in its bottom line. This is rather pleasing.

Prospects

The near-term prospects, say for the next two years, may differ greatly between our two markets – mainland China and Hong Kong. While the local social turmoil will likely have a lasting effect on retail and related businesses, as I will elaborate later, our Mainland operations should continue to thrive. Inasmuch as we do not like to see our home market suffer, the dynamics of our portfolio will render its effects on our overall profitability somewhat insignificant.

Let me paint a somewhat harsh scenario where Hong Kong rents would fall by 5% per annum for the next two years. This would translate to a drop in annual company-wide rental revenue of about 2.3%. To counter this, it would take an additional increase of 4.4% in our Mainland portfolio to fully make up the loss. It is however quite possible that in this period, our Mainland portfolio would annually raise its rents by well over 10%, perhaps in the high teen numbers. (Last year it was 12%.) This would still leave us with a reasonable growth in overall rental revenue.

The fact of the matter is: our reliance on Hong Kong has diminished considerably over the past decade. Our organic growth rate north of the boundary is so much faster, and we have so many new properties soon to be completed and become income-producing. The significance of our Hong Kong business can only lessen further over time.

In the past seven months, we have seen severe violence on our streets. For our city, one has to go back to the riots in 1967 to find something remotely like what we see today. I was here back then, just about to enter university. At that time, the turmoil was more contained; this time it was much more pervasive. The police then was merciless and crushed the rioters quickly. This time the police was most restrained, so those on the streets were greatly emboldened. How could a young man pour gasoline onto a stranger and then set him on fire! There were other similar atrocities. Equally serious was the fact that many otherwise sensible citizens would condone such senseless crimes.

For now, hopefully we have seen the worst on the streets. The effects of the turmoil on our bottom line are so far manageable. But what about this year and the next if violence resumes?

These days, a question commonly asked by investors is: how long will the Hong Kong economy be down? The correct answer is, of course, that no one knows. Nevertheless, as executives we are often forced to make assumptions that form the basis upon which business plans are crafted. That said, it is possible that the external environment may be so confusing that no reasonable estimation can be made. To me, now is one of those times. One can only compare it to certain somewhat similar historic events which will hopefully shed some light.

Six months ago, I reminded my readers how bad it was at the time of the Asian Financial Crisis which began on July 2, 1997. Our Hong Kong rents went down and it took us almost 11 years, until 2008, to return to the pre-crisis levels. Will it be as bad this time? I do not know and do not want to guess. However, several observations can be made which may provide some perspective.

During the Asian Financial Crisis of 1997 to 2002, the problem was primarily one of economics, although it was exacerbated by political uncertainties surrounding Hong Kong's then recent return to her Motherland. In August 1998, 13 to 14 months after the financial crisis broke, a herd of six international financiers – three investment banks and three hedge funds, all of whom were personally known to me – thought that they could take advantage of the Hong Kong-U.S. dollar peg. By breaking it, they would make a windfall, knowing well that the process would destroy our economy along with the livelihoods of many citizens.

Their entry point was the stock market which was much smaller than the currency pool and therefore more maneuverable. By breaking the stock market during the severe regional financial crisis, it would create social horrors that would likely snap the currency peg. Having already shorted the Hong Kong Dollar, they would stand to reap huge profits. Fortunate for our city, the then Chief Executive (CE) Mr. Tung Chee-Hwa with the support of Beijing took resolute actions to fight the attackers and won. If not, our economy would have been thrown into utter confusion which would have taken perhaps a decade to recover from.

Although what the attackers did might not have been illegal, it was definitely morally indefensible. They would not blink an eye for destroying the livelihoods of innocent people just for selfish monetary gains. Such an act was immoral, and those engaging in it must also be immoral, for they concocted and executed the scheme. Because Hong Kong's financial system was healthy and strong, and we happened to have good leadership, the city was spared. Thailand and Indonesia were not as fortunate. As one who has lived through that period, I witnessed the trauma experienced not only by those economies in general but specifically by their myriads of citizens, especially the poor. For many, their whole lives were destroyed; others struggled for many years just to get back on their feet. It was capitalism at its worst.

In the year of the attack (1998), Hong Kong's economy contracted by almost 6%. It took almost three years for its GDP to return to 1997 levels. With the exception of the inevitable rebound which came in 2000, the economy grew very slowly until 2004. We had five lethargic years – 1998, 1999, 2001, 2002, and 2003. GDP growth of those five years was a meagre 0.4% per annum.

Even though Hang Lung was financially strong then as it is now, it still took a decade for our Hong Kong rental to return to its pre-crisis levels. Fortunately our then new-found revenue from Shanghai soon kicked in (in 2000) which helped blunt the fall. Many other companies were not as lucky as we were. Multiply this sad story thousands of times over, and one can understand why it took Hong Kong's overall economy so long to get back on its feet.

The recession then was externally instigated, but this time it is altogether self-inflicted. Twenty-some years ago it was primarily a financial problem; now we are confronting a political crisis which is dragging our economy down. Recovery may take time, but pure economic problems usually have a solution. The present situation, being political in nature, may take longer to resolve. In fact it is a conundrum – no one, probably including Beijing, has any idea how to resolve it. Few can agree on the causes, let alone the solutions. From day one I had publicly stated that this problem cannot be solved without Beijing's involvement. But their solution, if there is one, might help the situation or hurt it. Good intentions do not always translate into desirable outcomes. We will have to see.

Such is the political beast where reactions to an action are often far more difficult to foresee than those in the economic sphere. Politics and economics are both social sciences, but the driver or the currency in economics is a lot simpler. While money is not the only measure of an economy, it is definitely the dominant one. On the other hand, motivations in politics are far more complicated and are often unspoken or unspeakable. That said, politics can also surprise us in the opposite direction. Sometimes intransigent knots can suddenly be untied, but I will not count on it this time.

Leaving aside the political roots of the present trouble, one can easily make certain economic observations and come up with reasonable predictions. An obvious one is that retail and its related businesses such as restaurants, hotels, and certain services like amusement parks, beauty parlors, medical clinics, etc. will be the first to suffer. Some of these will affect our operations.

Last year I befriended a relatively wealthy couple in Hainan Island. They used to spend a weekend in Hong Kong each month. Staying at five-star hotels, they sampled different cuisines and took their young son to Hong Kong Disneyland or Ocean Park (another amusement outfit); she went shopping while he surfed on the Internet and paid her bills. The entire family every so often visits a drug store for medicine, a doctor's office for vaccinations, and, as needed, sees a dentist. They are familiar with our streets and probably know more local eateries than I do. Upon hearing about their monthly excursions, I, as a Hong Kong citizen, thanked them. Whether or not they shop at our malls or frequent our tenants' restaurants is secondary. They are holding up our economy.

No wonder the past 15 to 20 years were a golden era for Hong Kong retailers. Without outside help, our organic growth would simply be too slow. Our natural population increase was among the lowest in the developed world. Wholesale wealth creation seemed a thing of the past; our citizens are not keen to find or develop new industries. As a result, a domestically generated rise in retail can only be lackluster.

The primary reason for strong retail sales in the past two decades was the huge amount of Mainland visitors. They bought everything, from daily necessities to expensive and not-so-expensive jewelry, and high-end and not-so-high-end fashion and cosmetics. Some people in Hong Kong and elsewhere have the erroneous impression that the Mainlanders are poor. Far from it! Those who visit our city for sure have money to spend. While not all can afford or like to stay at five-star hotels, many of them help fill our mid-range and low-end facilities. In the process, jobs are created for our residents.

Now all these are gone. Rioters were not just targeting the local government; they wanted nothing to do with the Central Government of China. If they had stopped there, the negative impact on our economy would still not be detrimental. But they were against Mainlanders as well, the very visitors who were trying to shuffle dollar bills into our pockets.

Another anecdote will help drive home the point. About two weeks ago, a small Mainland organization comprising top high-tech entrepreneurs visited Hong Kong. They spent three days at an expensive hotel and invited me to address them on a Sunday. The evening before, they planned to dine at a fancy restaurant some 200 meters away. That afternoon, two women staffers wanted to determine if a bus was necessary. Dutifully they walked over to the restaurant to check out the route. While on the streets, their spoken Putonghua must have betrayed them. A "Black Coat" (the infamous rioters) heard them speak Putonghua and not the Hong Kong's local dialect Cantonese. He harassed the two young women in a very unbecoming way. Terrified, they ran back to their hotel and rented minibuses. This was by no means an isolated incident. Will my friends hold meetings again in Hong Kong? I doubt it.

Since Mainlanders are apparently no longer welcomed by our residents, why should they come?! With money in the pockets, they can spend it anywhere. Many other cities will warmly welcome them. One must recognize the fact that the extraordinary growth of our economy in the past two decades was intricately related to the Mainland and to the visitors therefrom. By scaring them away, we are forcing their dollars to go elsewhere.

It is important that we understand the severity of the problem. For the past many years, the Mainland accounted for 75% to 80% of all visitor arrivals. As is true elsewhere in the world, their average per capita spending is among the highest in the world. They outspend the Japanese, the Germans, the Americans, etc. Given the quantity and quality of this group, their absence will greatly hurt our economy.

The impact is felt immediately as we have experienced in the past months. From shops and restaurants, the listlessness rippled outward. Retail as well as office rents have softened; commercial real estate transactions have disappeared. Price and transaction volume of mass residential have both moderated. The 50-plus percent of our population who own homes will not be happy. As the negative-wealth effect sets in, people spend less. The economy spirals down.

It will not be easy to keep the rents up in Hong Kong for the coming year. As always, we are realistic about rent renewals, and will sacrifice some price for a higher occupancy. It is better to lose in one dimension and not in both. Vacancy is usually the worst scenario.

What about the long-term future of Hong Kong? After all, Hang Lung has always been a long-haul player. The short answer is: I am genuinely worried. In fact, since Hong Kong's return to her Motherland in 1997, I have never been this concerned. If this city were to lose its greatness, it would not be economically instigated. Instead, it would be caused by social and in particular political developments that could hurt us. This is now being played out in front of our eyes.

If the nature of our problem was primarily economic, we might lose time but would sooner or later get back on our feet. Recovery might be even faster today because the Central Government is now financially strong and can pull us up. But since our present problem is political in nature and is self-inflicted, it will be much more difficult to resolve.

As I have publicly stated in the past, a root problem of Hong Kong and its governance is that the local people have very different social genes than those of the Mainlanders. The former for the most part escaped to Hong Kong either around 1949, during the political campaigns of the late 1950's, the Great Famine of the early 1960's, the 10-year Cultural Revolution (1967 to 1977), or in the aftermath of the student movement of June 1989. As a result, they have an inherent mistrust for and a deep-rooted fear of Beijing.

Once those Chinese moved to Hong Kong, in whichever time period, they were subtly stripped of their sense of nationhood. Given their attitude towards Beijing, this was not too difficult. Neither were they allowed to meddle in politics. This gave rise to a population which has three strong characteristics: a deep suspicion of Beijing, a lack of national identity, and political naivety. This is the exact opposite of our compatriots north of the boundary. They grew up in an environment where politics is paramount; are for the most part ardent patriots; and almost all of them support the government.

To be sure, the Mainland has improved tremendously in almost all aspects of society over the past 40 years. Chief among them is her economic progress. Yet the memory of the first 30 years of troubled history since 1949 has been indelibly etched into the psyche or social genes of the Hong Kong people. Moreover, the social norms of the two sides differ greatly. Instead of trying to understand their compatriots from the north, Hong Kong people simply look down on them.

Underestimating the depth of such feelings will make overseeing Hong Kong impossible. Does Beijing understand this? I have my doubts, yet this is at the root of today's difficulties.

To make things worse, while this is the general attitude of most Hong Kong people towards the Mainland, like every other society, there is always a small group of radicals. To them, Beijing is the root of all evils. Their stated or unspoken objective is to cut all ties between Hong Kong and her Motherland, unless they can change Beijing to their liking. Since the latter is hardly possible, this group at heart craves for Hong Kong independence, although they dare not say it, or are too smart to admit it.

Several months ago, certain influential individuals from the capital visited Hong Kong. They were befuddled as to why some of our citizens want independence. I told them that such people at heart do not really want independence. Their goal is not so much to change Hong Kong's political system as to change that of the country's. If they were to succeed in the latter, would they still want Hong Kong independence? Not at all! This clearly shows that what those extremists ultimately want is not to overthrow Hong Kong but Beijing. Given that, how can the Central Government not treat our problem with the utmost care!

In today's toxic relationship between the U.S. and China, such zealots easily become a pawn in the much bigger chessboard of geopolitics. There are always foreign governments who are all too happy to take advantage of Hong Kong's turmoil to cause Beijing pain, if not harm.

During Hong Kong's 2014 Occupy Central or Umbrella Movement, the organizational capacity of the dissenters was tremendous. Whereas there are many local people who can devise and operate complex projects and structures, riot-related expertise has not been seen in this city. As such, it was almost certain that there were foreign coaches and supporters.

Compared to merely six years ago, this time the riot organizers have brought the game to a much higher level. A knowledgeable person told me that the tactics used and technologies employed were among the most sophisticated in the world. It defies belief that the locals were not trained by the best in the world. Many observers arrived at the same conclusion as to its source. At the least, it is a fact that an intermediate step of that help came through Taiwan. Riot leaders have publicly admitted that.

If the present trouble had taken place at a time when the China-U.S. relationship was warm and cordial, the situation could not have developed to such an extent. Not only are the local radicals a pawn; the whole of Hong Kong has become the same!

What was the role of the local government in the present turmoil? It provided the spark, the now defunct extradition amendment bill, as well as much fuel through its incompetence and total lack of leadership. It is amazing to witness what it has done and what it has failed to do. All these have helped to unleash the deep-seated mistrust of many for, and the bitterness of a few towards, Beijing.

Then, there are structural flaws in the design of the One Country, Two Systems construct that have increasingly added much strain between Hong Kong people and the Central Government. For example, our CE and all the major officials are appointed by Beijing as prescribed by the Basic Law. Since China is a unitary state like most countries in the world, all powers in Hong Kong are devolved from the Central Government. Yet under the Basic Law Hong Kong has been promised a high degree of autonomy, but not full autonomy. How high is high? And some are obviously pushing for full autonomy. This makes the relationship between the two sides very delicate and tricky. No one here or in Beijing, in fact anywhere in the world, has any experience handling this.

If one is objective and fair-minded, he or she would have to agree that Beijing has basically honored its commitment. The practice of the first many years since Hong Kong's return to China was "no governance is good governance." By July 1, 1997, most Mainland officials then responsible for Hong Kong affairs retired or were re-posted. Rules were put in place that made government officials on the Mainland traveling to the Hong Kong Special Administrative Region (HKSAR) extremely difficult. Permission for each trip must be obtained from the top. Beijing's trust in Hong Kong people governing Hong Kong was almost absolute.

On the other hand, whenever Hong Kong needs or wants anything such as economic assistance, Beijing almost always obliges. For example, during the Asian Financial Crisis, our financial system was given much needed backing. During and after the SARS outbreak of 2003, again certain Mainland policies were changed and new ones instituted to help Hong Kong. Without allowing millions of citizens north of the boundary to annually travel here and spend money, would our economy have been so strong in the past two decades? No way!

Put yourself in Beijing's position: what did they receive in return from Hong Kong? Chiefly the pride of a unified country that had for centuries been divided by Western powers. Ironically, many in Hong Kong do not share that sentiment. As mentioned earlier, they have no national identity whatsoever.

Other advantages are usually beneficial to both the Mainland and Hong Kong. For example, our Stock Exchange provides Mainland corporations a platform to tap international capital. However, consider the many high-paying jobs it creates for this city, and the economic benefits it produces. Frankly, without us, these companies could still go to Singapore, London, or elsewhere for funding, although Hong Kong is more convenient. But without the Mainland corporations, our financial services sector would have shrunk by a lot! Much of the market capitalization of our Stock Exchange and its daily transactions are nowadays related to Mainland entities. In other words, they can do without us but we can hardly do without them.

As I wrote six months ago, Beijing was way too relaxed in overseeing Hong Kong after 1997. When certain aspects of the Basic Law were not strictly adhered to, they turned a blind eye, trusting that our citizens would know what they were doing. What the national leaders did not know in the past 22 years was how to be tough. Sadly, this was perceived by the Beijing detractors as weakness – and it was! – and they began to agitate for change, often in contravention of the Basic Law. Time and again, Beijing backed off, which further emboldened the opponents. On July 1, 2003, within the hour the then Chinese Premier Mr. Wen Jiabao left our city after a celebration, five hundred thousand marched on the streets against the HKSAR government's plan to enact the national security law. Hong Kong has the constitutional obligation to legislate under the Basic Law, and by not doing so, frankly the existing security law left over from the British, which is draconian, still applies today.

Since 1997, the leaders of the opposition took every opportunity to defy the Hong Kong government, treating it as a proxy for Beijing. They do not care if their actions hurt our residents as long as they themselves benefit politically. Should Beijing tighten a little and return to a more proper interpretation and implementation of the Basic Law? They should, but will they? Or can they?

Before 1997, local residents under the British were not allowed to engage in politics. If not careful, imprisonment without trial or deportation would be your fate. A son of one of my late father's business friends was presented with that choice. The young man had to flee Hong Kong for decades until after 1997. Telephones of a number of our leading citizens were previously daily tapped to check for subversive activities. All that is unimaginable after 1997.

Consequently, before 1997, Hong Kong was almost exclusively a commercial city. With the exception of some selective industries and services that were reserved exclusively for the British, the rest of the economy was free play. Telecom, power generation, airlines, etc. were off-limits to the local Chinese until not long before 1997. On the service side, the medical and legal professions, among others, were open only to those trained in the British system. Luckily, the remaining commercial and professional fields were still big enough for the locals to play in.

Furthermore, the huge uncertainty relating to 1997 had for decades given the locals an urgent sense of living on borrowed time in a borrowed place. Make money fast so one can buy a foreign passport, in case! As a result, Hong Kong was an economically propelled city, driven especially by short-term financial gains. Few other places are like that.

Given this background, Hong Kong has produced many successful businessmen. For the same reason, the disallowance to touch politics also led to a dearth of skillful politicians, especially those who could maneuver in election politics of Hong Kong after 1997. Former civil servants may be capable administrators, but politicians they are not. This is not to mention that under the British, they were not key decision makers. The colonial masters did that; the local officers only executed. This is why we are suffering from a lack of political leadership and high level decision makers.

Some may ask: why then are there apparently capable political operatives in the opposition? When the government makes a decision, it has to live with it and be answerable to society. Consequently, it has to be very careful. Not so for the anti-government crowd. It is always easy to criticize, especially when one does not have to bear the responsibility for one's words or actions. Their job is easy: whatever the government proposes, they automatically object. They oppose for the sake of opposing; and there is no room for compromise. This is not constructive and is often to the detriment of society. But what do they care? The louder they shout, the more headlines they receive from the press, which is useful in election politics. Innate in all of us is a dislike for authority, so beat up on the government and people will like it. At times, it has become a spectacle just like in the West.

Moreover, many of the opposers can be verbally abusive and attitudinally vicious. To mitigate their attacks, many officials simply choose to do nothing, then there would be nothing to be attacked upon. As a result, the government becomes ineffective. Who is to blame? Perhaps both sides, but primarily the anti-government people. The same phenomenon is seen in foreign democratic societies, although it is probably worse in Hong Kong because the chances of the opposition coming to power are extremely low. This makes them even more irresponsible.

Yet such politicians can easily appeal to Western democratic countries. For purely political purposes, the latter would support our opposition. Rights-and-wrongs are thrown out the window, for there is no room for such in international politics. The self-righteous West can become the most unrighteous. Just witness how they supported our rioters of late. The sins of the local criminal acts on the streets are also on the heads of those Western politicians.

Let me come back to the less extreme. Take the case of land supply in Hong Kong, something that is related to our business. Our first, third, and the present and fourth CEs all have sound land policies. None of them could execute because of the opposition. Mr. Tung Chee-Hwa, our first CE, proposed in 1997 the building of 85,000 residential units per year. It was shot down by his opponents purely because it was the government who proposed it. Yes, our second CE, who deliberately sold no land, together with a few greedy developers who convinced him not to sell, must also be held responsible, but it was the anti-government politicians who must bear the main blame.

Here are a few facts. Some 41% of Hong Kong's land mass is designated as country parks; only less than 25% of our territory is built-up. Residential usage only accounts for about 7% of the total. So why not take

1% to 2% of the country parks and turn it into residential land? It could not be done because of the opposition. They have no intention to solve the problem; they are there to create more. Problems validate their existence.

There are also social chasms between Hong Kong people and the Mainlanders living here. One is economic and the other is political, and both have contributed to the unsatisfactory situation of today.

As I have previously written, for decades our average citizen have despised the Mainlanders because the latter were poor. But within a short period of time, many from the north are now much more affluent than we are. This is certainly true for many of those who moved here for work or just to live. Our expensive restaurants are packed with Putonghua speakers. In the past, they inhabited middle-class districts like North Point and Kwun Tong; now they live in the Mid-Levels or Island South as well. We used to find them shopping only in the likes of Mongkok; now they move about in Central District, often better dressed than the locals. This has created a psychological imbalance among some Hongkongers. Those whom we – certainly not I! – once looked down upon are now somehow above us. The migration from despise to jealousy is too fast and too much for many.

If the locals somehow feel inferior in economics, they also harbor a huge sense of superiority in social culture. They believe that our social and political values are better. To be sure, the Mainland has a very different value system, one which many of our people do not like. Whether or not such a view and attitude is justifiable is another matter. Like in everywhere else, most of our citizens do not read history or study global affairs. They may be biased or even ignorant, but this does not change the reality.

To illustrate how big the gap is in Hong Kong between the people from the two sides, let me describe a phenomenon which I have long observed but is seldom publicly discussed. Perhaps due to my total fluency and lack of accent in both Cantonese and Putonghua, which is rare, and given my interest in people from around the world including those from the Mainland, I can move between the two groups with complete ease.

Many of my Mainland-born friends, having lived and worked in our city for two or three decades, are totally incapable of integrating into their adopted community. Many of them are graduates of Ivy League or similar universities, speak fluent English, and hold very senior positions in multinational organizations. Others are highly successful entrepreneurs whose net worth is the envy of 99% of local residents. At work, they are usually the bosses or at least the peers of Hong Kong-born professionals. They are a self-confident bunch. Yet, apart from work, these new Hongkongers have very little social interaction with the old Hongkongers. Language is perhaps the biggest barrier, and secondarily, it is social culture. Although most of our younger generation nowadays can speak Putonghua, usually quite awkwardly, the chance of Mainlanders speaking Cantonese half as decent is close to zero. If the elites from both groups cannot integrate, it is almost impossible to expect this in other social strata.

The Mainlanders in this city are invariably low profile as minorities everywhere are. They like many aspects of Hong Kong, such as low taxation and less interference from the government, but they always have a choice to return to the Mainland. In contrast, most Hong Kong people have nowhere to go. True or not, they feel that the arrival of their compatriots from the north somehow infringes upon them.

All this is like dry wood stoking a fire. The radical minority took full advantage of them, and for now, assert themselves as if they were the majority. They tapped effectively into the anti-Beijing sentiment. The extradition amendment bill introduced by the Hong Kong (and not Beijing) government provided the spark. The incompetence of local officials in handling the fallout greatly fanned the flame. Our city was thus set ablaze.

What worries me this time more than ever was not just its magnitude nor its duration. It is the presence of several phenomena that I have never seen before, at least not to this extent.

First, in the past, it was mostly the young people who were easily enticed to take to the streets. This time, many older folks joined them. This showed how widespread the discontent was.

Second, the riots of late were much more violent than before, possibly as a result of well-organized radicalization. Basic humanity was gone; animalistic instincts were unleashed. I recall an old professor in Beijing who once told me that during the Cultural Revolution of the late 1960's, a perfectly nice young female student could overnight turn into a devil and mercilessly bludgeoned her fellow students and teachers. In principle, this was what we have witnessed in Hong Kong over the past few months. The Cultural Revolution has resurrected itself, and it is here. Who could have imagined that! This tells us that we all share a common human nature that has a very dark side to it.

Third, the anti-Beijing sentiment has never been so widespread, intense, and open. The radicals who hate Beijing have succeeded in turning many of our citizens against the Central Government in a public way.

Fortunately, Beijing has not reacted, and certainly not overreacted. If they had responded harshly, or had treated Hong Kong people as opponents, then the rift would have deepened and might never heal. By keeping silent – amazingly silent – there is still some hope. It is like a feud between two parties. If both sides act childishly, it is game over. But if one party behaves like an adult, then there is hope. Such is our situation today.

Fourth, Hong Kong's reputation as a city with the rule of law is being threatened. So far, very few of the law-breakers – their actions surely qualify them as criminals – have been brought to justice. It was surprising how the majority, namely people who previously were most sensible, have condoned extreme violence. If the criminals were not brought to justice, what would this make of our legal system? In the end, I expect that at least those who have committed hideous crimes must be punished.

Here is something ironic: as we all know, there cannot be democracy unless there is first the rule of law, for the law is the foundation of democracy. Today, many of those demonstrating on the streets are calling for democracy. Whether or not they understand it is another matter. To them, it is the only way to check Beijing. Yet many of the same people were the ones who blatantly broke the law. They did not violate mere petty regulations but committed outright criminal acts. So before they can receive what they want, they have already destroyed its foundation. If one day such law-breakers have their way, will they suddenly become law-abiding? Hardly!

The apparent lack of legal accountability so far has already emboldened some in the society to take up public actions of many sorts, the causes of which are often not legitimate or reasonable. Such actions will further divide society. They will also make our economy less efficient.

Fifth, over the past two decades, Hong Kong has increasingly become a political city. The economy is wantonly sacrificed for political goals. For purely political purposes, roadblocks to commercial activities are erected for honorably sounding but erroneous and sometimes ridiculous causes. Gradually the economy is unknowingly left to die and there is nothing to rejuvenate it. No one is interested in business because they are too occupied by politics. History from around the world tells us that within two or three decades, the economy will become listless. By way of a reminder, 1997 was over 22 years ago.

This brings to mind Taiwan. Since practicing election politics, the economy has gone nowhere. The island is living off its past business success. There is a deep divide in the society between those who seek independence from Beijing and those who want to maintain the status quo. In Hong Kong, it is between the pro-Beijing and the anti-Beijing camps. As political scientists tell us, one-man-one-vote type of democracy does not work when there is a deep ideological, religious, or racial fissure in the community. Such was the case in Taiwan and is now also the case in Hong Kong. Taiwan's downfall is becoming ours.

My sixth and final point is that Hong Kong, through its vocal minority, has alienated Chinese citizens on the Mainland. The negative impression will likely last for many years to come. Apart from necessary visits such as for business, most of them will stay away. The good days of yesteryear are gone and there is nothing on the horizon that can replace them as far as our economy is concerned. Hong Kong has managed to kill the goose that laid the golden egg.

For now, the economic impact of the recent turmoil will also be immediate. The rates of GDP increase this year and the next will inevitably slow down, if not contract. A good number of our citizens will lose their jobs, and everyone will suffer. If not for the latest trouble, chances are good that more and more Mainland well-to-do's will purchase homes in Hong Kong. Now they will think twice.

Two more important aspects of our society bear mentioning. I recently stated in an interview that two of Hong Kong's strongest economic drivers were financial services and our universities. I am hopeful that for lack of better alternatives, we will be able to retain our status as Asia's premier international financial center. Mainland companies have been the biggest user of this service, and we must do all we can to retain them. A Singaporean with some capability in this area would be unpatriotic if he does not try to attract such corporates to his shores. Why not, for it is fair play.

While any disruption to the financial services industry will immediately impact the economy, the waning of our universities and their influence on society is of a longer-term nature. Top-rung tertiary educational institutions help improve the quality of our people and of our economy long into the future. The converse is also true.

Twenty to thirty years ago, Hong Kong universities were known to pay relatively high salaries. Our University Grants Committee (UGC) makes research money available to professors. Consequently, many top academicians from around the world flocked here. For ethnic Chinese from the Mainland or Taiwan, there is the added benefit of being close to home. It is easy to visit their elders from Hong Kong. This was one of the keys how our institutions became so good. In the latest ranking of a reputable organization, three of our eight universities were among the world's best 50, with a fourth ranking number 52 and one more within the top 100. No other city in the world can boast of such numbers! This in turn drew to our shores excellent Mainland and foreign students both at undergraduate and graduate levels.

Sadly, the turmoil of late will inevitably change all this. Our biggest group of non-Hong Kong-born professors is no doubt from the Mainland. Many of them have received advanced degrees from the likes of Harvard, MIT, Stanford, Cambridge, and Oxford. A good number were already tenured in highly regarded institutions before moving here. With the horrific experiences of the past few months and the toxic social environment against them, it is doubtful if many of them will remain in Hong Kong for long. Those considering job offers here will unlikely come.

Furthermore, in the past decade or two, university salaries on the Mainland, especially for the very capable, have caught up with our own. Research dollars in many fields are more abundant than can be found here. Consequently, in recent years we have increasingly seen such talents choose Mainland institutions over ours. Now we have made our own chance of attracting or keeping them much more difficult. Only the less capable who have few alternatives elsewhere will come or remain. This trend can only continue to our detriment. When this happens, talented students everywhere will also not make us their top choice for study. Our universities run the risk of spiraling downwards.

The above is a summary of recent history which is necessary to understand today's predicament. It shows that the unrest will have immediate as well as far-reaching negative impacts on our society. The changes they bring are systemic and not just cyclical. Unless appropriate drastic measures – if indeed they exist – are taken, our future will not be bright.

In June 1995, a journalist acquaintance of mine, the late Mr. Louis Kraar, wrote in *Fortune* magazine a lengthy article entitled "The Death of Hong Kong." It was published ahead of our return to the Motherland. Many British and all China-haters were delighted, Hong Kong people were aghast, and Beijing was upset. I decided to do something about it and flew to the U.S. twice to meet with the author. My efforts were never publicized before and were known only to some of my friends.

Needless to say, I presented to Louis the other side of the story. He learned something new, but it was not easy to admit mistakes. After many hours of exchange, he said that he would discuss with his editor and promised to publish another article with the newly acquired knowledge. I flew back to Hong Kong with some hope of partial success.

When his second piece came out in September 1996 – 15 months after the first – I was disappointed. Not only were my points watered down; half of the article was about me. Indeed the piece was framed as an interview. Louis had purposely missed the mark. I flew back to the U.S. East Coast and spent a few more hours with him. This time he asked me to write something myself. By the time my article came out in January 1997, the damage was done. It was not until July 2007, a full 10 years after Hong Kong's return, or 12 years after the first piece was published, did the magazine admit its mistake – Hong Kong did not die.

Given this history, I suppose I am in some position to comment on today's affairs in this city. Hong Kong still will not die, but we risk losing the shine of being the Pearl of the Orient. Our future is now in the balance.

What can Beijing do? Frankly I do not know. Conceptually there are three possibilities: remain soft or feeble, play tough, or a combination of the two, preferably gentle on the outside but firm on the inside. They have tried being soft without much success. The mess we are in today is a direct result of it. Being tough will only exacerbate the situation. This is not the time. With the opposition determined to make martyrs of a few among themselves, Beijing may not like to oblige unless it decides to dismantle the entire One Country, Two Systems construct. I seriously doubt if Beijing would do that.

So the only alternative is a hybrid solution, but it is extraordinarily difficult to execute. If put in China's position, I doubt the U.S. or almost anyone else could manage it satisfactorily. If anyone could do it, it would be the British. History has shown that they know best how to exploit human weaknesses to their own advantage. This was how some 200,000 British, of which only about 10% were officers and soldiers, successfully ruled over a 300 million-strong India for 200 years. This was also how they navigated in Hong Kong since 1841 when the rest of China went through turmoil after turmoil throughout that time.

One key reason for the success of the British was their employment of hypocrisy to perfection. To be sure, every person and every nation is hypocritical. Anyone who says that he or she is not is either lying or self-deceived. Yet the Americans will tell you that they are the exception. They really believe it – how self-deceiving! When the British are told that they are hypocritical, they will neither deny nor admit it. They will merely look at you with an ever so faint a grin. They have perfected the art. By not denying it, they are actually the most honest.

What about the Chinese? It is not in Beijing's temperament. They are culturally incapable of using it to their own advantage, not least of which is the present Beijing government. Will they be able to do it in Hong Kong? We will see, and I certainly wish them success.

Naturally my prognostication for Hong Kong may be erroneous. If I am wrong, it will not be the first time, nor will it be the last. But if my general direction is correct, then what does it mean for our economy? Growth will be slow for many years to come. There will always be a brief catch up after the initial fall, but the rate will likely moderate again.

What about our business? The answer is obvious: our reliance on the Mainland portfolio will heighten. Hong Kong will not disappear, and neither will our properties here. We will continue to collect decent rent, but increases will be slow for the coming few years. This is expected of both our retail and office rental.

Fortunately we do not have luxury malls in Hong Kong like we do on the Mainland. Those here will likely suffer the most as the Mainland wealthy stop coming to shop. After all, recent Beijing policies have considerably equalized the prices of high-end fashion items between the Mainland and cities elsewhere, including Hong Kong. Many of the top brands used to do 5% to 10% of their global business in this city, much of it selling to Mainland Chinese visitors. This percentage cannot but fall, and likely drastically. Much of this lost business will be domesticated, which can only benefit malls like ours in Shanghai and elsewhere.

This is the perfect juncture to turn to a much more pleasant subject: the prospects of our Mainland properties. Let me begin with the weaker segment which is the offices.

Going around the big cities in China, one cannot help but notice the huge number of empty offices everywhere. Very few of them were designed correctly or constructed well. Outside tier-one cities, there are hardly any that are of world-class standard. Many are not even in reasonable locations. As I have explained before, those developers blatantly ignored the "real estate genetics" for high-end commercial projects. There is almost no chance that those office blocks will succeed. Many will remain empty or half empty for a long time, if not forever.

Center 66, Wuxi

On the other hand, our office towers everywhere embrace these cardinal genetic factors and so have done well. Nevertheless, oversupply provides tenants with choices, which will dampen rental rise. Being the best in class, for us to maintain full or near full occupancy should not be a problem, but the investment return can never be compared to that of malls. This we have known from day one.

Take the case of Center 66 in Wuxi. While our first tower hovers at 90% occupancy, the second, which opened last August, is already 25% leased. In time, it will be filled. Besides providing a reasonable return, its function is to support the mall below. Offices bring quality footfall, for the two product classes complement each other.

Nevertheless, such a phenomenon prompts us to be cautious when we evaluate new projects. Our Westlake 66 in Hangzhou should be an exception. With the city almost being tier-one, there are many fully let office buildings, but very few are Grade A or in the traditional city center where we are located. We should be able to create a true "downtown."

The problem all over mainland China is caused as much by the government as by the developers. I have come across all too many projects where the city stipulates many office blocks atop or adjacent to the mall. Their motivation is obvious: the higher the plot ratio, the more money the government receives with land sales. This is a clear violation of the third of my five-point genetics – unreasonable development briefs to which the land purchaser must adhere. Many problems will flow from it.

First, the local economy simply cannot absorb so much office space. It is an outright disrespect for supply and demand, the most basic market economic principle. Second, it is a huge misallocation of resources and is environmentally unsound. I have seen high-rise office buildings constructed, left empty for years, even decades, and eventually had to be torn down. While standing, it could not be leased or sold at any price and is an eyesore.

Third, no quality projects can be erected given such governmental stipulations. Mankind has never seen such a scale of city-building like China in the past 30 years, but why is there so little truly outstanding architecture? At the initial stage, one can rightly blame the lack of finances. Any office was better than no office when the economy began to move up. After all, the Chinese at that time had never seen decent quality buildings. But even in the past 10 to 15 years, we still saw pitifully little. The local business community simply did not think about it. Even many overseas developers did not believe in it. Thank goodness that we did. But as a fast developing country, the lack of good architecture was definitely a great opportunity lost.

In the past 15 years, we were twice confronted with this decision: we found land that we liked but the governmental brief was most unreasonable, so should we buy or not?! It was a real heart-wrenching time. Eventually we decided to be conservative in our bidding and ended up losing both plots. Did I regret it? Strongly at the time, but not half as much today. Some competent developers bought the land and did their best to make their projects work. It was not easy for them, if not impossible, because there are birth defects, i.e. genetic defects.

History has shown that given such conditions, no world-class development could be erected. Moreover, the financial return could be seriously curbed – constructing more may actually mean less return for the developer. The rich rental income from the mall must carry an unreasonably high cost – the land element allocated to the empty offices as well as their construction expenses. In such a situation, no one wins – the developer or owner cannot maximize profit, the tenants do not enjoy a pleasant environment, the citizens are forced to live with empty and poorly maintained skyscrapers. As for the government, while obtaining cash upfront from land sales, it will be unable to collect more from ongoing taxes. Very regretful for all!

Fortunately, we are not stuck with any such projects. The experience makes us more careful when evaluating new opportunities. So far, we are quite happy with what we already have. We will continue to do our best to maximize the long-term profit therefrom.

In the coming year, I expect our Mainland malls to continue to perform well. For Plaza 66 in Shanghai, I cannot guarantee double-digit rental growth for the fourth straight year after the AEI, but believe that our chances are good. Grand Gateway 66 will fully reopen by the third quarter, and tenant sales and rents should both soar. It will not surprise me if like Plaza 66 in the same city, it will see a few years of double-digit rise.

Outside Shanghai, I anticipate improvements across the board. Parc 66 in Jinan has been an excellent workhorse in the sense that it is big and its revenue has been steadily growing for many years. The mall was completed in 2011 and is now due for minor refurbishment and indeed some upgrading. The goal is to bring in more luxury brands that can pay higher

Palace 66, Shenyang

Parc 66, Jinan

rents. Plans are already in place, the execution of which will inevitably bring minor disruptions to business. It is necessary if we want to achieve even better unit rent soon.

In Shenyang, Palace 66 has in recent years occupied a market niche that is producing steady increases in rent at a respectable rate. The pleasing performance is the result of our fine-tuning of the tenant mix. It is now closer to optimal than before. That said, market condition changes continually, so we must move with the times. Only then will we be able to sustain the stream of rising rent; but so far so good.

Forum 66 also in Shenyang is improving slowly. Plans are being drawn up to build out Phase 2, which comprises residential towers as well as a shopping center that will be integrated with the existing one. It will enlarge our retail space by about 50%. It should make the combined mall much more competitive. The residential units will be sold.

Olympia 66 in Dalian should continue to trade very well. I can compare it to Palace 66 in Shenyang (in the same province of Liaoning) and Center 66 in Wuxi. What took place there will now likely take place here.

Palace 66 was our first development to open outside Shanghai in 2010. The first few years were really tough and the bear market which began in 2011/2012 did not help. After much efforts by Management, by around 2014, I told shareholders that Palace 66 had turned around and might become a star. It did.

Center 66 opened in 2013 in the depths of a market trough. But by around 2016, which was still a year or two before the bear market ended, I pronounced that the property would one day become a darling of the group. Soon enough, it became our second "Home to Luxury" (the first being Plaza 66 in Shanghai) and has since been on the rise.

2019 performance numbers as reported earlier tell the story. For Palace 66 and Center 66, rental growth was respectively 20% and 22%; operating profit rose 56% and 59%; rental margin has for both projects increased to 45%; and tenant sales were up 20% and 21% respectively. The next few years should still be very promising for both properties.

Now I anticipate that Olympia 66 should be the next development to experience a similar breakthrough. The reasons are the following: its increase in tenant sales was the strongest of all our Mainland malls at 29% last year. Rental revenue climbed 28% in 2019, and operating results rose by 81%, making it our best performing property in terms of improvement. Organic growth is expected to continue. Phase 2, accounting for 13% of total space, is now being released into the market. Tenant mix is moving upmarket, resulting in higher unit rent. Some top brands have already moved in, and many more are expected in the coming years.

Olympia 66, Dalian

Riverside 66 in Tianjin will continue to improve slowly. As many businesspeople in the city know, the local economy has been a disappointment. No mall operator is doing particularly well because of that. In such an environment, our performance, while lackluster, is considered acceptable. The market does not seem to be growing that fast, although economic statistics may indicate otherwise. If true, why are all the shopping centers throughout the city struggling? In any event, we are trying different things with the aim to bring improvement to tenant sales, followed by increase in rents. Hopefully we can grow at around 10% or more, up from the present low- to mid-single-digit.

Spring City 66 in Kunming should be a success from day one. Located in the capital of Yunnan Province, which is the country's gateway to Southeast Asia, there is so far nothing in the city that comes close to our quality and size. We will likely draw customers not only from Kunming but also from the entire region. The fact that so many of the world's biggest fashion names are in our mall is a confirmation that our decision to enter the market nine years ago was the correct one.

The 66-story office tower of almost 170,000 square meters was opened at the same time as the mall. They are beautiful together! I expect that our experience in Forum 66 (in Shenyang) and Center 66 (in Wuxi) will be duplicated here; namely, the skyscraper will gradually fill up. Most of the tenants will be either multinational companies or major Chinese corporates. At 350 meters, it is so far the tallest building in Kunming and in the province.

The rest of the project comprises apartments and a hotel. Grand Hyatt will be the hotel operator, and it will open in 2023. Pre-sale of the residential portion is targeted to begin in 2022.

Both the mall and the office tower in Heartland 66 in Wuhan are targeted to open in the third quarter this year. Retail leasing is quite strong and we are negotiating with more top fashion brands. We are also beginning to sign rental agreements with office tenants. I am hopeful that the project will be as successful as Spring City 66 in Kunming when it opens. The omens are also favorable for long-term success.

Westlake 66, Hangzhou

Westlake 66 in Hangzhou is still targeting 2024 for the opening of Phase 1, with the rest to open in the following year.

Starting next year, we will begin to pre-sell Mainland residential units. In the order of completion, they will be Heartland 66 in Wuhan, Center 66 in Wuxi, Spring City 66 in Kunming, and finally, Forum 66 in Shenyang.

In Hong Kong, for now the turmoil on the streets has somewhat died down. If it does not flare up again, then this year's retail environment should be better than the second half of 2019. In fact, there is usually a period of sales rebound after a slow down which is caused by exogenous factors, i.e. not due to organic market factors. This is the best scenario that we can hope for. A worse case would be the return of social unrest. We cannot preclude this possibility. As such, there is no way to tell at this stage how our rental business will fare in the year ahead. The same goes for the possible sales of more luxury houses on Blue Pool Road.

Some three weeks ago, a new coronavirus was discovered in Wuhan where Heartland 66 is located. Having gone through SARS, which in fact had heavily hit one of our Hong Kong residential buildings in 2003, we are very sensitive. Let us hope that it will not spread. But if it does, then our business on the Mainland will inevitably suffer. We will watch the situation closely.

This year our parent company HLG celebrates its 60th anniversary. In my letter to shareholders there, I have briefly analyzed our industry in Hong Kong during that period as well as look back on our own history. Suffice to say here that I believe that better days are ahead of us. Barring unforeseen circumstances, the next few years should be quite rewarding, thanks to our Mainland business.

Ronnie C. Chan
Chairman
Hong Kong, January 21, 2020

Addendum to Chairman's Letter to Shareholders

Our last Board meeting was held on January 21, which was also the date of my year-end letter to shareholders. I mentioned in my Hang Lung Properties (HLP) letter the new coronavirus disease or COVID-19 which has already been spreading in Wuhan. At that time, people did not fully recognize its seriousness. However, only a few days later, in fact right before Chinese New Year (January 25), China and indeed the world woke up to the severity of the epidemic. Since then, a lot of bad news has been reported, not just from the epicenter but also beyond. Doubtless, it will negatively impact our business, hence this Addendum.

My plan was to write this Addendum as late as possible, right before we have to go to print, with the hope that more information will be forthcoming. Unfortunately, there is still no end in sight to the problem. Perhaps the only good news is that some experts believe that the spread of the epidemic may be peaking. Whatever the case, being for long years associated with the field of public health, I have of late been in touch with many top experts from around the world and do my part to help, especially in the two places where we operate our business – mainland China and Hong Kong.

Wuhan, where Heartland 66 is being built, has for a while now been sealed off from the outside world. Most transport links between mainland China and other countries have also been cut, and that includes Hong Kong as a Special Administrative Region. Retail everywhere in China has fallen. A mall is considered lucky if footfall does not drop by 80% or more. Luxury sales on the Mainland tumbled in the past month. On January 25, we announced to our Mainland retail tenants an across-the-board cut of 50% base rent for three weeks. But the situation is still very fluid. We will work with our tenants to alleviate the potential impacts on both sides.

As mentioned in my HLP letter, since the fourth quarter of last year, in Hong Kong we had to give some rent relief on a case-by-case basis. This was due to retail slowdown brought on by the social unrest. Just as that trouble appeared to have moderated, we found ourselves hit with the novel coronavirus outbreak. The only positive outcome of the latter is that it would make large-scale street riots less likely. However, the impact of the invisible virus on retail is expected to be greater, although more short-lived, than the visible social turmoil.

In my letter to HLP shareholders, I presented a "somewhat harsh scenario where Hong Kong rents would fall by 5% per annum for the next two years." This was based on the assumption of prolonged social turmoil. If the epidemic is over by April, then I am hopeful that our Hong Kong rents for 2020 would not drop by that much, although it is not beyond the realms of possibility. As before, we will negotiate as needed with each tenant regarding rents. Past experiences here and elsewhere show that there should be a rebound once a public health threat is over. The negative effect also will not extend to a second year.

When the 2020 budget was formulated late last year, we were projecting a very good year on the Mainland. The performance in January was indeed strong until the last week of the month. Since no one knows when and how the epidemic will end, it is impossible, at this stage, to project full year results. It is possible that the anticipated rental growth in the high teen numbers may be halved or even more.

Construction projects everywhere will slow down, especially in Wuhan. At the media and analyst conferences right after announcing profit (on January 21), I commented that we needed to watch out if construction workers would return to Wuhan to work after Chinese New Year. Since then, Beijing has extended the holiday season for the entire country to February 16. Construction everywhere, however, has yet to resume work until the government gives its permission. In some cities like Wuxi and Tianjin, all malls (and other places where people congregate) were ordered to close. Only today will Center 66 in Wuxi reopen. We are currently applying for Riverside 66 in Tianjin to do business again.

Our hope is that, instead of the third quarter, Heartland 66 in Wuhan can still open before the end of the year. The Asset Enhancement Initiative (AEI) at Grand Gateway 66 in Shanghai may also be slightly delayed, as will other projects under construction, like our residential developments. As well, we will need to see how luxury brands will react after the COVID-19 epidemic is over. We hope that negotiations on new leases will not be too much affected.

I am gratified to report that under the capable leadership of our CEO, Mr. Weber Lo, the morale of our colleagues everywhere is high. Of our 200 or so staff in Wuhan, a little over two dozen are Hong Kong citizens. The leader in fact volunteered to stay there with his team. I salute all of them! Needless to say, we at the head office are in constant contact with them, and will do our utmost to support them.

Whilst the epidemic, which has brought with it tragic loss of life and a profound impact on business, is deeply regretful, nevertheless history tells us that the market will recover once it is over. We firmly believe that this short-term setback will not affect our longer-term prospects. Our future is still bright.

Ronnie C. Chan
Chairman
Hong Kong, February 21, 2020