RESULTS AND DIVIDEND

For the six months ended June 30, 2018, revenue decreased 19% to HK$5,150 million as fewer residential units were sold. With a larger amount of revaluation gain, net profit attributable to shareholders increased 22% to HK$4,689 million. Earnings per share rose similarly to HK$1.04.

When excluding the property revaluation gain and all related effects, the underlying net profit attributable to shareholders declined 24% to HK$2,319 million. Underlying earnings per share fell correspondingly to HK52 cents.

The Board has declared an interim dividend of HK17 cents per share payable on September 27, 2018 to shareholders of record on September 13, 2018.

BUSINESS REVIEW

During the six months under review, much has happened in both the external and internal environments. The former can be described as tumultuous and challenging, while much of the latter is pleasing and encouraging. I will begin with the latter.

Six months ago, I wrote extensively about the Company's viewpoint and process regarding succession. At that time, your Board, led by its Nomination and Remuneration Committee (NRC), was in fact undergoing a most critical task – finding a worthy successor to the retiring Chief Executive Officer (CEO) Mr. Philip Chen. It was a rigorous and in fact rather long process in which all Non-Executive Directors engaged.

Now I am happy to report that we have succeeded. Mr. Weber Lo joined us on May 16, 2018 at the age of 47 as CEO Designate. His appointment was a unanimous decision of the Board of both this Company and that of our majority shareholder, Hang Lung Group Limited. After two months of transition, he assumed the CEO post on July 16 on which day Philip retired.

Locally born and bred, Weber, like Philip, attended The University of Hong Kong. He began his career with Procter & Gamble and later joined Coca-Cola Company in Hong Kong and mainland China. For the past 18 years, he was with Citi, where he became head of its Hong Kong and Macau operations in 2013.

When Philip joined us in 2010, he did not have any experience in real estate companies but quickly learned. The industry is not technically complicated but it takes the right temperament with adequate experience to become good at it. Philip succeeded, and I believe so will Weber.

In the 1990's and 2000's, then Managing Director Mr. Nelson Yuen and I set the strategy for the Company which, upon repeated review, is still valid today. Philip led the building of our management team which should prove capable of executing the strategy. Now, Weber's task is to complete that building process and run with it. There is little doubt in my mind that he and the team will score successes in the years and decades to come. I am excited about our future.

The second encouraging event in the past six months was the successful purchase of a beautiful piece of land in Hangzhou. Just 48 minutes from Shanghai by high-speed train, it is the capital of Zhejiang Province which has one of the highest per capita incomes in China. We have been eyeing the city for about 15 years and have been working on this particular piece for about four. I fell in love with it the first time I laid eyes on it.

The official ranking in China regards four cities as first-tier: Beijing, Shanghai, Guangzhou, and Shenzhen. As a then top leader of Hangzhou said to us not long ago, his should not be called a tier-2 city. Rather, it should be reckoned as a tier-1.1 city. This perhaps is a bit of an exaggeration but frankly not much.

In the entire country, there are two cities which are most desirable for commercial properties – Shanghai and Beijing. The next three best are probably Guangzhou, Hangzhou, and Chengdu. An ideal portfolio should include a strong position in these five cities. We have a commanding presence in Shanghai, and now we have an excellent opportunity to also be a leader in Hangzhou.

To be sure, Shenzhen is also an extraordinary place with some good malls, but it is so close to Hong Kong that its residents can easily come and shop in my city. When the high-speed train service connecting Guangzhou, Shenzhen, and Hong Kong opens in a few short months from now, the entire journey will take only 48 minutes. From Hong Kong to Futian, a station in southern Shenzhen, it will take merely 14 minutes, and to Shenzhen North, 23. In the long term, Hong Kong and Shenzhen should be more economically integrated by virtue of the Greater Bay Area Initiative proposed by Beijing. It is to everyone's, and surely to Hong Kong's, benefit.

Consider the facts: whereas the per capita GDP of Zhejiang Province is almost US$14,000, the number for Hangzhou with a population of about 10 million is close to US$21,000. (These numbers were considerably higher four months ago when the RMB was stronger.) It has many good universities including one of the best in the country – Zhejiang University. The city is also universally recognized as one of the most beautiful in China.

Zhejiang is one of the most entrepreneurial provinces in the country, with many cities each boasting hundreds and thousands of successful small to medium businesses. Hangzhou is not the only one; others include Wenzhou, Taizhou, Huzhou, Shaoxing, Dongyang, Yiwu, and Jinhua, just to name a few. Many of their companies are top industry leaders not only in China but also, in some cases, the world. They are mostly privately held but an increasing number are listed publicly. Of significance is that when some of these have grown to a certain size, they move their headquarters to Hangzhou for a number of good reasons, such as ease of transportation, communication, and, most importantly, finding talent. I personally know many bosses of these companies; they can only be described as an impressive bunch.

Hangzhou is one of the top three technology cities in China, the other two being Beijing and Shenzhen. Everyone knows Alibaba and NetEase but there are hundreds of smaller companies. In the coming years, some of them may well become household names. The city is also known for its consumer products enterprises and transportation-related machinery operations. Suffice to say that the economy there is among the most vibrant.

Historically, Hangzhou is known for its rich culture. This may be the reason for as well as the result of its being one of only two cities south of the Yangtze River that had served as the national capital. Its citizens have always been highly educated, and many famous poets and artists, past and present, hail from there. Just look at how people dress today as one walks down its streets. It is obviously a wealthy and sophisticated metropolis.

Our piece of land measures just shy of 45,000 square meters, and with a plot ratio of 4.33, the buildable space is over 194,000 square meters. This excludes the basement area of 50,000 square meters, so in total we have 244,000 square meters. (This number does not include car parking space which may be another 200,000 square meters or so.) The retail mall will take up at least 104,000 square meters, with the rest being mid- and high-rise office towers. Land clearance has been accomplished by the municipal government so the plot has few complications.

Not only is Hangzhou an excellent retail city; its premium office leasing market is also very strong, especially in the downtown area. The present rents are about 10% below their equivalent in Shanghai. The height restriction for part of our land has recently been relaxed to 150 meters, thus allowing us to be the tallest in the neighborhood. We will command a view of the most famous lake in the country – the West Lake, or Xihu. Frankly, the office element is as much a reason for the plot's desirability as the anticipated world-class mall.

We paid RMB10.7 billion for the piece and the preliminary total project cost is about RMB16 billion. The per square meter land cost is approximately RMB55,000 excluding the basement, or just below RMB44,000 when including it. We will take possession of the land next February, and completion is projected to begin from 2024 in phases. Once leased up, we believe that an initial yield of 4%-5% can be achieved.

In line with our tradition, the land is among the best located in the city – Wulin Square at the very center of downtown. All the top retail space in the city surrounds this square; we are across the street from its southeastern corner. A subway station is just one block away, and will be linked to us by an underground passageway. The piece may well be the last sizable one in this prime district for some time to come. In fact, it is difficult to conceive finding anything better.

The land, however, is not without challenges. Street frontage could be longer, but there may be an opportunity in the not too distant future to improve that situation. Traffic patterns in the neighborhood will require careful planning. Our coming retail mall is not without competitors but, as I shall explain later, we should be able to prevail.

A very satisfactory outcome notwithstanding, the process that we went through in the past four years was rather tortuous. There were apparently a number of formidable suitors for this site. City officials were struggling to decide on the land usage and hence its development brief. Fortunately, the ultimate decision was a sensible one which we found acceptable. But before we finally won the bid, there were many occasions when victory looked highly uncertain.

I cannot emphasize enough the significance of a reasonable development brief for any piece of land. Even if it is best-located, a project cannot be world-class nor its profit maximized if the government imposes unwise or even unreasonable conditions on its development. Many times the problem is that the city wants more money and therefore sets the plot ratio too high. The developer must cram a lot of buildable space into a plot with limited footprint. If there happens to be a height restriction, the situation will be worse. The resulting development, no matter how experienced the developer and architect are, cannot be good.

I remember a piece of well-located land in an excellent commercial city on which we once worked. We identified the land and brought it to the attention of the city officials. They insisted on development briefs that would have preempted a world-class project. That blunted our interest and we eventually lost the land at the bidding. The winner did a reasonable job in developing it and the retail space, as we expected, is doing well. However, the office towers, from what we can tell, are struggling. Sadly, there is no way that the project can be considered world-class. It is not the fault of the developer; the city officials who sold the land must bear that responsibility.

This is another reason we like our piece in Hangzhou. Plot ratio is not too high, and the height limit has been relaxed. If street frontage can soon be lengthened, then I am confident that a truly world-class project can be built. Both aesthetics and profitability can be maximized.

Now let me turn to the more troublesome issues. They are all external to our business and are in the geo-economic and geopolitical spheres. Since such developments will inevitably impact our operations, it is necessary to share my views here. After all, some shareholders have repeatedly asked about it. The focus is China-U.S. relations but the real situation is far more serious than that.

China-U.S. relations have always been uncertain in the past many decades, but under U.S. President Donald Trump they have been brought to a new level of direct confrontation. The trade war is just the surface; there is much that is unspoken and graver. Even so, I believe that the relationship is manageable and will not spin out of control. As explained later, its effect on our operations will not be that serious. In fact, it may be beneficial.

Since this writing is not primarily on China-U.S. relations, I will only lay out my basic thinking without getting into lengthy explanations. I am merely informing our shareholders and potential shareholders of my analyses of the geopolitical and geo-economic environment in which our business operates. Some of my fellow directors of the Company may hold very different views. For whatever it is worth, here are some of my thoughts after having observed the world for 40-some years. I have also spoken at various international forums on this topic.

Over the past two decades, the U.S. increasingly sees China as a strategic threat in three dimensions: military, currency, and trade, in descending order of significance. Whereas Russia must be America's number one military threat in the near term, it will be less of a worry later on. The reason is simple: it takes economic development to generate money that is necessary for continuous technological advancement. It is technology that lays the foundation of weapons development and fuels military capabilities. China is economically significant, and apparently has the science and engineering to further develop her military in all domains, whether land, air, sea, space, or cyber.

This is why before the 2016 U.S. presidential election, then candidate Trump, like some others in the U.S., wanted to work with Russia to contain China. In the long haul, Russia was perceived as a lesser threat than China because of her weak and single industry economy.

The U.S. must also be concerned that international trade and investments are increasingly denominated in RMB, thus potentially eroding the international reserve currency status of the U.S. dollar. This will force America to be fiscally more responsible. Frankly, this is not a bad outcome, for no country should or can live beyond her means forever. Whatever the case, the RMB is far from that position. About a decade ago, I publicly asked the 1999 Nobel Laureate in Economics and "father of the euro" Professor Robert Mundell, "How long will it take?" His answer: not in a hundred years! But that does not mean that today the U.S. will not want to keep the advancement of the RMB in check.

Trade is the least significant threat compared to the other two above, and is more short-term oriented.

The question for the U.S. is how best to influence Chinese behavior with the hope that China will do what is best for American interests while advancing her own goals. As a friend or foe? I believe it is the former, but the powers in Washington, D.C. apparently think otherwise. Increasingly, Beijing is viewed as a threat if not yet an enemy. Incident after incident around the world have shown that America has been working hard to contain China.

At the root of the problem is America's miscalculation of China's long-term intentions. This is doubly sad because, even today, China still wants to work with the U.S. as a friend. In fact, I have always held the view that China will be very happy to play second fiddle to the U.S. So why turn this friend into a foe?! All China wants is to better the livelihood of her 1.4 billion people and to become a respected member of the global community. Can the opposition of a foreign country, no matter how powerful she may be, stop the wishes of 1.4 billion people? Hardly!

So how will China react to this belligerent neighbor across the Pacific amidst a shrinking world? She will do her utmost to work with the U.S., keep the peace as much as possible, and not let the U.S. derail her own economic progress. After all, like governments elsewhere, the legitimacy of the Beijing regime depends on its ability to deliver improved livelihood to its citizens.

With this in mind, it is not difficult to predict how the trade war initiated by President Trump may evolve. After all, trade is a rather rational issue where the currency is literally dollars and numbers. History tells us that in such disputes where both parties are relatively strong, everyone will lose out. It will be painful for all. In today's situation, China may get hurt more, but neither can the U.S. go unscathed.

On the tariffs side, frankly there is much room for China to give. Understandably, the country takes trade very seriously. However, more than once since Trump became president, mutually agreed deals negotiated by at least cabinet-level officials on both sides were turned down by President Trump. For domestic political considerations such as the upcoming mid-term elections and thereafter his own re-election, he does not want a deal now. No wonder China feels betrayed and, for a while, refuses to further engage.

This notwithstanding, the two sides will have to come together sooner rather than later. China now understands that unless President Trump is himself party to a discussion, there cannot be a real agreement. Some would say that even a personal promise from the president may still mean nothing, for he often changes his mind and goes back on his words. Who can blame those who hold this view?! Nevertheless, since China potentially has more to lose, she will be more willing to concede.

Then there are the non-tariff barriers and other bundled terms and conditions. In the latter category, it is unclear what the currency is: it is not just dollars and numbers. No doubt China will do her utmost to gain as much here as she may yield on tariff and non-tariff barriers. At the end, God knows who will be ahead – each will get something and give up something. Such is the reality of negotiations between nations. One thing however seems probable: China will let President Trump claim victory on tariff concessions, while winning something valuable elsewhere in return. China can do that because she has less pressure from her domestic constituents. Beijing is freer to negotiate what it considers to be in the best interests of China. In a more democratic state like the U.S., national interests are often sacrificed or ignored purely because of domestic politics.

Here is a question worth pondering: since none of the U.S. presidents who negotiated previous trade agreements were traitors, nor did they run a charity to benefit their counterparts, those agreements must have been the best deals that could have been obtained at the time. After all, no sovereign state handles her international trade altruistically; few if any issue in cross-border relations are not self-serving. Even the Marshall Plan for the benefit of Western Europe after World War II was necessary to help the U.S. contain the then Soviet Union.

Given that, what then does President Trump mean when he says that other countries like China are taking advantage of the U.S.? Or could it be that he is being ideological and keeps deceiving himself? If times have changed and new agreements are necessary, then why not simply renegotiate? Why tear up previous frameworks such as the North American Free Trade Agreement or NAFTA?

In light of the above, I have two serious worries. The first is of immediate concern. The U.S. is not picking only on China for a trade dispute; Mexico, Canada, the European Union, Japan, and even countries like Rwanda are all targets. It is doubtful if President Trump knows when to stop. If he does not, the world would run the risk of having certain critical supply chains disrupted. This may then spook the capital markets, which may in turn bring about economic disasters. This reminds me of the late 1920's, when global trade was severely curtailed, also caused by the U.S., that eventually led to the Great Depression. This could be serious.

My second worry is that the U.S. is once again isolating herself. This cannot be good for the world. To be sure, President Trump did not invent the process; America always has that tendency. But doubtless he is accelerating the movement by leaps and bounds. As a country founded in isolationism – remember the Monroe Doctrine of the early 19th century; American exceptionalism even present today; the Roosevelt Corollary of the early 20th century; refusing to join the League of Nations after World War I; recently pulling out of several international bodies under the United Nations; for decades even to this day being in arrears on its United Nations dues – she is merely returning to her old habits. In her young age of 242 years, only about 30% of the time – the 70-some years since World War II – was the country guided by internationalism.

With the American economy accounting for about 24% of global GDP, will its multinational corporations cede the 76% to someone else such as China? Obviously not. As such, the country will have to find a way to be commercially engaged with the world while politically retreating therefrom. No one knows how this can be done. After all, the world today is an interconnected place, economically or otherwise.

A less obvious, more gradual, but equally serious corollary to the recent U.S. actions and her increasing isolation is the gradual erosion of America's moral standing as the world's sole hegemon. On final analysis, it was the U.S. during World War II which saved Europe from Nazi Germany and Asia from imperial Japan, and, some may add, during the Cold War saved the world from the then Soviet Union. These lay at the core of America's moral leadership. Many decades have since passed and unless properly maintained, that leadership will naturally fade. Sadly we are witnessing it. As it gradually sets in, the world will become a more chaotic place. Again, this phenomenon did not begin with President Trump but surely he greatly exacerbates it.

As a beneficiary of the existing international systems, from the United Nations to the Bretton Woods Institutions – their creation led by the U.S. after World War II – China will in the foreseeable future remain one of their strongest supporters. She will be joined by the European Union, India, Japan, and much of the rest of the world. The world has changed a lot since 1945, so certain adjustments to the system are inevitable. The U.S. should neither resist reasonable changes nor abandon the system altogether. It is, however, doing the former and increasingly, many believe, also the latter.

As the U.S. voluntarily retreats from multilateral organizations, there is no one on the horizon that can fill the leadership role. China certainly does not have the intention or the ability. What then will a post U.S.-led world look like? To arrive at the correct answer is not easy but also urgently necessary.

What seems certain is that whether China likes it or not, reality will force her to come forward more in most, if not all, global affairs. This is inevitable, for when a sizable country grows powerful economically, her political influence will increase. To protect her ever increasing global trade and investments, Beijing has little choice but to expand her military.

For example, China's dependence on imported energy is growing by the day. What if a Chinese oil tanker on the way home from the Strait of Hormuz in the Persian Gulf (or Arabian Gulf) runs into Somali pirates? Who will the Chinese "Captain Phillips"– remember the American movie by this name – call? The 5th Fleet or the 7th Fleet of the United States, which treats China as an enemy? Like everyone else's, Chinese trade routes must be somehow protected.

Whatever the ramifications of the U.S.-initiated trade war, I find her rationale problematic. First, it is very mercantilist. Second, increasing tariffs is tantamount to raising taxes for American consumers and the American companies involved. While President Trump is lowering taxes elsewhere in the U.S., why is he increasing it through tariffs? Third, there are some 68,000 American companies in China that supposedly make as much as US$260 billion of profit annually. A good portion of the U.S. tariffs levied on China actually affects those entities! So who will be hurt?

Fourth, the overall American economy is much more sophisticated than that of China. Many of its high technologies are superior to not only those of China but also of much of the world. The U.S. trade deficit with China can easily be wiped out by selling high-tech products and natural gas. Until recently, Washington, D.C. did not even want to export the energy source that is a totally undifferentiated commodity. So who is to blame for the trade deficit with China?

Fifth, China is today the world's first or second largest trading nation along with the U.S. It is not like a small country which has no wherewithal to retaliate with. In fact, strong reactions commensurate with U.S. trade actions are inevitable. The result is that both sides will be hurt. After all, with the exception of certain advanced technologies, all else that China imports from the U.S. has alternative sources. Look at the subsidies that Washington, D.C. now has to pay to her farmers. I also doubt if there are enough cold storage warehouses in the U.S. for the unsold pork!

Finally, along with many other currencies both of advanced economies like the European Union, Japan and Singapore, and of developing ones like fellow BRICS countries (Brazil, Russia, India and South Africa), the RMB has fallen like a rock in the past few months. This partially offsets the effects of higher American tariffs. In fact, a lower RMB benefits China's exports to many other parts of the world. In RMB terms, the profit decrease in selling to the U.S. maybe compensated by exporting more elsewhere. At the end, China may come out ahead. After all, the U.S. accounts for only 18% of China's total exports.

Even if my arguments above are only partially correct, the U.S.-instigated trade war with China is ill-conceived. It will not be viewed favorably by history. Does President Trump care? All his predecessors, as far as I can tell, did. Perhaps this is the root of the troubles caused by this administration. Some breaks from history are at times necessary, but the quantity and manner we see today are truly mind-boggling.

What will be the likely outcome of the present U.S.-China trade war, and how will it affect our business? I believe that the trade dispute, while serious, should be manageable. But as long as it persists, China's economic growth will slow down. To tackle this eventuality, Beijing will counter by encouraging private consumption and executing more public investments. Actions such as the recent lowering of import duties for goods including luxury items are clear measures which will benefit our retail malls.

Hong Kong as an entrepôt will suffer even less than the Mainland. In fact, whereas formerly many Chinese companies that went public chose to list in stock exchanges in America, increasingly they will come to Hong Kong. Companies everywhere including many in China are now wary about the U.S. as a place to do business. The American market, especially its financial market, is perceived as being overregulated. The higher likelihood of political interference further scares foreigners. Hong Kong is for the most part free of these concerns. This will help cushion the undesirable effects of collateral damages from the U.S.-China trade war.

Let me now turn to our performance of the past six months. The set of results was basically in line with what I had predicted when I last wrote to you.

Hong Kong's residential prices continued to climb. With the exception of a breather a year ago from summer to early fall, the rise has been relentless for the past two years. Our government is still struggling to find more land. Various measures have been introduced to moderate prices but they are of limited value. Only more supply will be able to correct the problem.

Retail performance in mainland China has recovered further, although the pace was not brisk. That for luxury goods was more encouraging. Many top brands are beginning to expand again, which can only be beneficial to us.

Our home city's recovery in retail spending continued. In fact, it has picked up speed. After a few years of stagnation, the total number of visitor arrivals, especially from the Mainland, has risen nicely. City-wide retail sales in percentage terms grew even faster than before.

Our total rental revenue grew 7% in Hong Kong dollar terms – 11% on the Mainland and 3% in Hong Kong. The Mainland now accounts for 53% of total rental revenue; the figure for Hong Kong is 47%.

In Hong Kong, our office rents rose 3% and residential and serviced apartments 5%. Our retail centers saw rents advanced between 2% and 8%. These numbers should indicate a higher than 3% rise for the Hong Kong portfolio. The apparent discrepancy is due to the asset enhancement program at The Peak Galleria, where 60% of leasable area was taken out of the market. All other properties remained basically full. Rental margin, average unit rent, as well as tenant retail sales were all healthy.

The Mainland figure of 11% growth warrants some explanation. During the six-month period under review, the RMB on average rose almost 9%. This means that in local currency terms, we only advanced 2%. However, one should bear in mind that Grand Gateway 66 in Shanghai was undergoing a massive renovation. A total of 32% of lettable space was taken out of the market but, on a like-for-like basis, retail rent received still went up 1% in the local currency. On the same basis and again in RMB terms, rents collected from the Mainland rose 5% and not the reported 2%.

Looking at our Mainland retail rental revenue mall by mall, it rose or held steady everywhere except at Forum 66 in Shenyang. Occupancy rates advanced or remained about the same on a comparable basis in all our properties, including Forum 66 where it went up from 77% to 87%. Even that for Olympia 66 in Dalian achieved 86% of all available space, thus giving us the confidence to start leasing phase two which accounts for 12% of the total mall area.

With a few exceptions, the average daily footfall jumped by double digits including that for Forum 66 and Olympia 66. Grand Gateway 66 was obviously an exception due to the major renovation. Our two malls along a pedestrian street – Palace 66 in Shenyang and Riverside 66 in Tianjin – saw a slight fall. These two cases bear some discussion.

When we opened Palace 66 in 2010, there were already three very large retail centers with numerous street-front shops along the pedestrian street called Zhongjie. (In Chinese it means Center Street and was one of the first, if not the very first, pedestrian shopping streets in the country. It is also considered one of the best.) Right after our opening, the city began to dig underground along the road and turned the space into many shops. Longtime readers of this letter will remember that the resulting disruption to pedestrian flow, together with our own internal challenges at the time, were the causes of our then severe difficulties.

By 2014, we had resolved all these problems, both external and internal. The numbers have improved and we have since done well. We began to take shoppers from our neighbors. In fact, we have been so successful that two of the malls mentioned above started to falter. One of them that was previously the market leader and the oldest on the pedestrian street is now being closed. Two new facilities abutting Palace 66 opened after us, and the first one that was relatively well-designed has long closed down. The other one, like the underground shops, is struggling. Only one odd-shaped but sizable property on the opposite end of the pedestrian street is still performing acceptably.

In other words, we have made ourselves the leader of that traditional shopping district. Are we happy? Yes and no. We are pleased with our success but now we begin to worry that, in the absence of reasonable competitors, the entire pedestrian street may suffer. We are working with the district government on how to breathe new life into the neighborhood.

The situation in Riverside 66 in Tianjin is somewhat different. There may be some interesting opportunities to remake the pedestrian street in order to benefit our mall. We are exploring these with the local government.

We are quickly selling down our Hong Kong development portfolio. Sales of three semi-detached houses on Blue Pool Road and five apartments of The Long Beach were recognized, as were some car parking spaces. Now we only have 12 houses and five apartments unsold in these two developments. Four of the five apartments have actually found buyers, but under the new accounting rules, their profit recognition will be pushed to the coming months.

Due solely to the lack of Hong Kong residential projects to sell, overall revenue and profit fell. Compared to the first half of 2017, top line retreated 19% to HK$5,150 million and net profit attributable to shareholders increased 22% to HK$4,689 million. Earnings per share rose to HK$1.04. Taking out revaluation gain and related items of HK$2,370 million, the underlying net profit attributable to shareholders was HK$2,319 million and underlying earnings per share was HK52 cents, a fall of 24% for both numbers.

PROSPECTS

In a macro environment as troublesome as today, it takes conviction to voice optimism about one's business. This I will do. Longtime readers of this letter would know that I always shoot straight. We were perhaps the first among Hong Kong property companies to point out back in the summer of 2011 the chill in the Mainland economy. Soon after, I wrote about the arrival of "winter", and last year the return of "spring". I am never one to shy away from taking a position, sometimes a strong one, when I believe that it is warranted.

The same is true about my views regarding the Company. I have probably been as forthright as anyone in this town in informing our shareholders of the difficulties experienced, and even mistakes made, by management. I see this as my responsibility.

So I am here today to express my optimism about the future of the Company. Otherwise, I would not be honest. What my readers do with the information is, of course, up to them. My job is to convey the management's assessment of the external and internal environments. We are of course aware of our share price movements, but my team's main task is to manage the business and not the ups and downs of the scrip.

Needless to say, there are serious challenges. But barring geopolitical and geo-economic catastrophes whose possibility remains, as well as persistent domestic turmoil which is rather unlikely, our future should be bright. The strategy which we laid out for ourselves in 2004 is being played out. Previously we expected fruition in the early 2010's – we opened our first mall outside of Shanghai in 2010 – but this was postponed due to the "perfect storm" (see my letter six months ago to shareholders of Hang Lung Group, our majority owner) which lasted until late last year. Now better days should lie ahead.

The six difficult years gave us the opportunity to work out our internal kinks. We corrected the inadequacies in management and solved the problems in the newly opened properties. We also had time to learn about each of the markets in which we opened new centers. Now the way forward is much clearer than before.

Let me begin with some statistics. Until 2010, we did not have any property outside of Shanghai and Hong Kong. Our total rental portfolio at the time was about 1.09 million square meters of which Shanghai accounted for 0.44 million square meters, or 40% of the total. Today we own over 2.9 million square meters, of which about 2.27 million square meters are on the Mainland. Our Hong Kong and Shanghai portfolios did not change much; the increase of 1.81 million square meters is located in our six other developments in five Mainland cities.

In the past eight years, on average we completed almost 0.23 million square meters of space annually. This is roughly equivalent to finishing one Empire State Building in New York City each year for eight straight years! Few if any other company can boast such a record. Every one of our projects is nothing less than world-class, the likes of which are seldom seen in mainland Chinese cities.

Moreover, in the next two years or so, we expect to complete at least another 0.72 million square meters of space. More will follow in the two to three years thereafter. In other words, the pace of completion will speed up. This will bring us close to 2024 when phase one of our Hangzhou project should open.

Our goal is obviously not just to construct commercial space but to financially profit therefrom. Having operated on the Mainland outside of Shanghai for about eight years, notwithstanding six of which being bear markets, we are now more confident than ever in our forthcoming success. Let me present what to us is a compelling reason by summarizing our experiences so far. I will first focus on shopping centers and later turn to offices.

We have completed eight shopping centers in six cities on the Mainland. They can be grouped into three categories. The first is where we truly enjoy a first-mover advantage. The second is where we were not the first in the city but the first in top quality malls. The third is where another good retail facility preceded our entry.

Of the eight properties we have completed, only one had the benefit of being the first-mover. When Plaza 66 opened in Shanghai in 2000, there were no luxury malls in the entire city. We built the right product and managed it well. Since then, a number of quality facilities have opened, but we still enjoy a market leadership position. With Shanghai being a top commercial city in fast-growing China, everyone there makes money, although some more than others. In terms of the number of top global brands, average unit rent, and sales efficiency, we are the best.

All but one (namely Forum 66 in Shenyang) of the other seven malls fall into category two – when we opened our shopping center, there were already one or more sizable competitors in the city or in the same district. Because the rival malls were of a lower quality, our world-class properties were able to displace them and became the dominant market player. Four of our six shopping centers in this category have already achieved that position; the other two are on their way.

Consider Grand Gateway 66 in Shanghai. When we opened in 1999, there were already four rather large retail properties, all surrounding the same circle with us. Together, we form the shopping center of the affluent Xujiahui District. We were the fifth major player to enter the market. Competition was severe, and some existing facilities tried to block our entry using tactics that would be considered unacceptable in many other parts of the world. But because of our superior design, adequate size, and at least equally good location and management, we were able to become number one in that commercial hub in about six years. Today our unit rent is by far the highest.

The same story can be found in Palace 66 in Shenyang as explained earlier. Both average unit rent and sales efficiency are much higher than those of its competitors. It took us four to five years to achieve leadership position.

Parc 66 today occupies the same position in Jinan. There were several major players in the city when we opened in 2011, and many more have since joined the fray. But within about four years, we have established ourselves as the most prestigious mall in the city. Average unit rent is about twice that of all competitors. Due to the retrenchment of luxury brands in the past six years, we have yet to upgrade ourselves from a four-star facility to a five-star one. However, this should only be a matter of time, now that the top global brand names are once again expanding. As long as they remain in the city, we will almost invariably be their number one choice.

Center 66 is already considered the best shopping center in Wuxi. When we recruited tenants ahead of the 2013 opening, many world-class fashion names signed up. Because the market turned nasty right before our inauguration, those who opened shops could not achieve their forecasted sales, and a few who had not yet opened simply reneged. Tenants, like elsewhere, demanded rent reduction and our revenue fell. But when the market warmed up last year, which took place after the opening of our first office tower as part of the same complex, momentum began to pick up. More top brands have recently signed up and others are negotiating. Almost all of them are moving in from neighboring facilities.

During the difficult years, some of our neighboring property owners used unsavory tactics to keep their luxury goods tenants. Headquarters of fashion companies, mostly based in Europe, also froze their location changes then. Now that the market has turned, there is no reason to stay at inferior facilities. Moreover, they do not want to be a late-mover for fear that the best locations within our Center 66 may be taken by their competitors. A similar situation can be observed in our properties in some other cities. The ascendancy of Center 66 to its leadership position took three to four years. If not for the recent bear market, we would have achieved it much sooner.

The average time it took for the above four malls to become market leader was four to five years, or about two lease terms. For our other properties, which all opened within the past four years, the length of time will depend on the local competitive landscape, but it is just a matter of time. Once leadership position is achieved, rents should rise considerably. By the second lease term, initial opening expenses should taper off, leading to higher rental margin. The result of all this is of course improved profitability and investment return.

Riverside 66 in Tianjin opened in 2014, and Olympia 66 in Dalian in 2016. Both began their lives in the depths of a bear market. In the case of the former, there is so far no clear leader in four- or five-star malls in the city. What we do know is that certain former dominant players which opened before we did are struggling today. While we are working to improve the pedestrian street where we are located, we may be quietly gaining on our competitors.

Several luxury brands have told us that Olympia 66, with some 220,000 square meters, is by far the best mall in Dalian. Elsewhere in the city, there is a longstanding facility housing most of the top fashion names. According to our knowledge, its investment return was supposedly superb perhaps until the recent bear market. In our opinion, their design is far from ideal and this gives us hope. There is another district in the city with several sizable retail outlets. Because none is properly designed or built, the entire area is going downhill.

Then came Olympia 66. Given our superior design and size, there is little doubt in my mind that in the next few years, many world-class luxury brands will make us their local home. Like Parc 66 in Jinan which is also sizable, the layout of the property allows part of the mall to house five-star brands, and another part four-star ones.

Our next two malls to open within the coming two years – Spring City 66 in Kunming and Heartland 66 in Wuhan – should also fall into this category. Namely, although not the first player in their respective city, they are by far the best in quality compared to anything else. As a result, I fully expect them to in time become the top retail center in their markets. Competition is less in Kunming, so Spring City 66 should achieve this status almost from day one. Heartland 66 will have to fight harder to earn that place. Whatever the case, both metropolises are excellent retail markets. The competitive landscape of our latest Hangzhou piece should, once completed, be somewhere between that of Spring City 66 and Heartland 66.

Forum 66 in Shenyang is the only mall in category three. Because of a worthy first-mover in the city, our property is struggling. Our plight was to a large extent self-inflicted. We could have opened ahead of the competitor but we were unaware of the seriousness of the situation. By building the office tower long after the retail center opened, management of the latter was more challenging. And as I previously reported, we also had some personnel issues before and after its opening. Fortunately, many of these problems have now been resolved.

All told, we have no one to blame but ourselves for the trouble. It will serve as a strong reminder of what not to do. Nevertheless, there are enough positive aspects of the project that will bode well for the mall to remain a very strong player in the city in the long run. For example, mall design improvements are being implemented, the first office tower has been completed and successfully opened, the inauguration of the Conrad Hotel will take place next year, and the subway connection to our facility has been completed. Improvements, while slow, are continuing. Also beneficial to the mall will be the eventual completion of the second and possibly third office tower, as well as several serviced apartment blocks. Indeed, our location is probably the best in the city and the land price we paid was by far the lowest.

Consider the fact that when Forum 66 first opened in 2012, there were already two sizable retail facilities in the neighborhood, one of which being the market leader. The other has since our opening been basically marginalized. So for now, we are number two in the market. We will certainly fight to narrow the gap. After all, I love challenges; they invigorate me and my team.

Looking ahead, we will continue to look for attractive opportunities to expand our portfolio. It will be hard to find vibrant metropolises where we will be the first-mover. Those opportunities have all but disappeared perhaps two decades ago. We will most likely enter markets considered to be category two as mentioned above – there will already be other players, but they are not that strong.

Reviewing our history as presented above, what lessons can we draw, and what will the future hold for us? What are the critical factors that we must have in order to remain among the most competitive? The conclusion seems clear enough. Real estate genetics mentioned in my 2014 year-end letter is the answer. The four elements are location, size and developmental conditions, design, and construction, with the first three as absolute necessities. (Beyond these, management quality is, of course, vital. However, since it is prudent to assume that others also have decent management, this is not a relative competitive advantage.) If the existing players in the city do not have these “genetics” hardwired into their properties, then it is almost game over for them once a newcomer with the four elements appear.

As mentioned, this was exactly the way how many of our malls – Grand Gateway 66, Palace 66, Parc 66, Center 66, and more to come – gained their leadership positions in their respective cities. Each has at least as good a location as its competitors; each is big enough to be a force in the market place; each has a design that is superior to all earlier entrants; and each is at least as well constructed as others. When we add reasonable management to it, success is within reach for all our new projects, as long as our competitors lack certain or all of the four genetic elements.

How long it will take for a property to gain prominence will depend on the magnitude of the advantage we have over our competitors. Moreover, once we win on that basis, it is not easy for others to displace us. Even if someone with all four elements joins the game later, we will already have a head start.

This explains why it takes us so long to buy land, and why it takes us longer than most companies to convert land into buildings. To buy land is easy; to buy the right piece of land is very difficult. Some analysts recently reminded everyone that the last time we bought land before the Hangzhou piece was in 2013. True indeed, but no one in this business can afford to buy wrong. A good location is usually recognizable by most, but few have the discipline to only buy the best. Also, few developers have the experience to negotiate the right developmental conditions for a particular plot.

Likewise, to properly design a four- or five-star mall requires much experience. From what I have observed, so far few Mainland developers have that knowledge; a number of longtime Hong Kong players like us can usually do a better job. Yet we are still learning. This is why I have publicly stated that anyone who can churn out a shopping center from land possession in 18 months is a novice. So are those who think that hiring a good or famous architect will get the job done. Such people do not know what they are doing; all they have is at best money and dreams of grandeur. There is plenty of money in the system, but ambition, if not matched by caution, calculation, and expertise, can only end in disappointment.

Developing Class A offices requires less expertise than world-class malls. This is one reason why the former usually yields a lower return. Nevertheless, they are complementary to the retail space beneath, and the effect can be considerable for they bring quality footfall. Shenyang and Wuxi, for example, are not easy markets, but our offices in both cities have done well. They enhance the performance of the malls. Initial gross yield of around 4% is achievable for an office tower, but it will not grow as fast nor by as much as a well-run mall. Neither will they take up as much management attention. All things considered, we like to do more offices especially if they form part of a shopping complex. This is the case with our three newest projects – Spring City 66 in Kunming, Heartland 66 in Wuhan, and the latest purchase in Hangzhou. They are not unlike our earlier ones, Grand Gateway 66, Forum 66, and Center 66.

In time, serviced apartments for sale will likewise be accretive to the shopping center beneath or immediately adjacent. Conversely, by developing high-end commercial space first, we add value to the surrounding neighborhood. Constructing residences for sale is one way to capture some of that value for ourselves. Selling will also bring faster cash inflow. Again, like Grand Gateway 66, Forum 66, and Center 66, our two recent projects under construction, Spring City 66 and Heartland 66, both have quite a bit of this product type.

There is no doubt that private consumption is becoming more important on the Mainland. Last December, the Chinese government lowered import duty on many categories of products. Even certain luxury items have been included. Together with the rising demand for high-end fashion, many top brands are again opening new stores. This is a reversal of their policy of the past five to six years.

This is a welcoming development for us. Once Grand Gateway 66 in Shanghai has completed its major refurbishment in mid-2019, it will be a very different place than before. It will look much more like Plaza 66 in the same city. A year from now, I also expect Center 66 in Wuxi to become the city's first truly luxury mall. In the same time frame, when Spring City 66 in Kunming opens its door to customers, this biggest city in southwestern China will boast its first top-end shopping center. There will be many world-class fashion brands, some of which entering the capital of Yunnan Province for the first time.

Thereafter, I will not be surprised if Parc 66 in Jinan and Olympia 66 in Dalian will progress in the same direction. When each of these properties welcomes such tenants, unit rent should rise. Top names in turn will attract sub-luxury brands, and together they will raise the total rents collected.

My best estimate for our retail rental in the coming six to 12 months is as follows: Plaza 66, Parc 66, Center 66, and Olympia 66 should continue to perform well. Palace 66 and Riverside 66 will make less progress by comparison. Forum 66 will still be struggling although, like the first half of this year, further improvements will be made.

Like in the recent past, 32% of Grand Gateway 66 will be undergoing upgrading. Works in the coming months will affect the very core of the mall. This means that total rents received will inevitably be affected, but we will soon have a very different place that will command higher unit rents.

The offices in Shanghai are expected to hold steady. The other two towers, one each in Shenyang and Wuxi, may well be fully leased by year-end, or at least very close to that. The quality of tenants should continue to improve.

Before leaving the Mainland market, I should mention that in the past three months or so, the RMB has depreciated by over 8% against the U.S. dollar. (This followed a rise in currency of similar magnitude when comparing the first half of 2018 to the same period of 2017.) If the present trend remains unchanged, or if the currency is stabilized at today's level of about RMB6.8 to US$1, the effects on us will be at least twofold. Since our home currency the Hong Kong dollar is pegged to the U.S. dollar, a weaker RMB will translate into lower reported earnings, if all else remains constant.

A second consequence is that fewer Chinese will go overseas to buy luxury items. This effect will be similar to the lowering of import tariffs. There are reasons to believe that much of the sales overseas have yet to become domestic, but as long as present trends persist, common sense dictates that they sooner or later will. Whatever the case, almost all currencies fluctuate and increasingly the RMB as well. For now, we can only wait and see how the RMB will move for the rest of the year.

The picture for commercial rental performance in Hong Kong in the coming six months is expected to remain similar to that of the first half of the year. Our portfolio will likely grow again at low single digits.

By now, I trust that my readers will agree with me that the Company's future should be bright. Completing new space is of course exciting, for it will grow the top line. However, what invigorates me the most is the organic growth of our Mainland properties outside of Shanghai. It should deliver improved bottom line. As you have just read, much operational progress has been made, and there is more to come. Its effects are only beginning to be felt, for fixed lease terms have so far held back its manifestation. But in the next one to two years, the situation should become clearer. It will be very rewarding when our labors in the past few years finally translate into higher profits. In time, this should be reflected in our share price.

After eight years with Hang Lung and 41 years as a business executive, Mr. Philip Chen retired on July 16. He has kindly agreed to serve for a year as my advisor and has since become a Non-Executive Director of the Company. In the past I have written several times on the critical contributions he has made. I will not repeat them here except to mention that he has also ably served as a mentor to our youngest Executive Director, Mr. Adriel Chan. One can hardly find a better teacher than Philip. I count him as a great fortune for the Company in general and for the young man in particular. His efforts will have very long-term effects on Hang Lung.

For that and for his many extraordinary accomplishments, I thank him most sincerely. I wish Philip the best of health and look forward to his advice and contributions in his new capacities.

Ronnie C. Chan
Chiarman
Hong Kong, July 30, 2018