The past six months have been unpredictably unpredictable, even by the stretched standards that have been set over the past three years. Investors will first note that this period has been trying on our share price, especially in Q2. Operationally, it has also been challenging: it was at the same time a live stress-test, a test of our planning and budgeting abilities, an operational obstacle course, and mentally fatiguing. What we would have previously considered black swan events almost seemed commonplace.

Despite the long succession of external headwinds and uncertainty in 1H22, we have delivered a strong and resilient set of results. Top line rentals are up, although retail sales are down. There are many reasons for our good performance despite the duress of the times, but I want to highlight two that I feel are most important: the first is our resolute focus with important aspects of diversity — commercial real estate coupled with geographic and product diversity, and the second is our great people and robust processes.

FOCUS WITH DIVERSITY

Geographic Diversity

In the dozen years since we opened Palace 66 in Shenyang — our first development outside of Shanghai — we have strengthened and consolidated our position in each of our markets. Our portfolio now consists of 10 centers in eight cities, of which eight centers are outside of Shanghai.

This meant that when Shanghai went into its 60+ day lockdown earlier this year, we were supported by our other centers to make up for the lost rent. In previous years, our non-Shanghai portfolio was only a fraction of our Shanghai income, and so analysts and shareholders often ignored them, even as they grew in number and sales. Each non-Shanghai center was simply too small to move the consolidated needle.

However, over the past year or so, this has dramatically changed. Coinciding with roughly two lease terms since the clamp-down on corruption and opulence in 2012 (the start of a long, cold "winter"), we have seen a mass migration of luxury brands into most of our non-Shanghai malls. To illustrate the impact of this using retail sales, just one mall today — Wuxi Center 66 — sells more than all other non-Shanghai malls did, combined, at this point five years ago (1H17). That represents a CAGR of almost 40% over five years. Even more dramatically, Olympia 66 in Dalian has nearly tripled its retail sales in just 18 months.

The combined incremental sales growth across Wuxi Center 66, Dalian Olympia 66, Kunming Spring City 66, and Wuhan Heartland 66 were able to more than offset our loss of two months in Shanghai. This would have been unimaginable to many of our shareholders just two or three years ago, but it has actually been our intent since day one, when we crafted this strategy to expand outside of Shanghai.

It is as if a 17-year-long proof-of-concept has finally been validated. This concept began with the investment in our first plot outside Shanghai, Riverside 66 in Tianjin in 2005, was tested by the challenging operating environment in the decade after our first opening in Shenyang in 2010, and is finally turning the corner with the broad adoption of luxury brands across our portfolio, which started about 18 months ago. The challenges of the past six months have been the first test of our current iteration, and I think our results prove themselves.

Product Diversity

I would be remiss not to highlight our growing office portfolio, which now accounts for ~20% of our mainland China income, thanks to the addition of 168,000 sqm at Kunming Spring City 66 in 2020, and 152,000 sqm at Wuhan Heartland 66 in 2021. These two Grade A towers are now respectively 80% and over 60% leased, and feature our higher-margin “modular office” product which caters to tenants who do not want to deal with the administrative and financial hassle of office design and capex.

In addition to our modular offices, we have HANGOUT in Wuxi, a flexible office space (analogous to co-working) which has also contributed nicely to our office margins in the city. Having run HANGOUT for several years, it has proven itself as a concept, and we are at work to roll it out in some of our other office towers across the country.

As our Chair has pointed out in his previous letters to shareholders, and as we have discussed in our media, investor, and analyst briefings, our unique strategy of building true international Grade A office towers in second tier Chinese cities has several key value drivers. We are usually the only true international Grade A office tower(s) in each city, thanks to our understanding of the market, experience, and design. The higher cost of construction for an international Grade A product is also a deterrent to competitors, who almost always construct to sell, rather than to operate themselves. As you would expect, a developer will design and build a product for sale differently from one that they intend to keep.

As a result, as the market grows to appreciate the differentiation of our product, we end up almost "cornering the market". There are simply no comparable towers in cities such as Wuxi, Wuhan, Kunming, or Shenyang. As such, our higher-than-most construction cost that had previously been considered a handicap, is now yielding a competitive advantage.

If our retail portfolio growth outpaces our office growth, which is a reasonable assumption, the office contribution to our top line will likely normalize a few percentage points lower than today's ~20%. Unfortunately, since offices are generally a lower-yielding asset class, it will pull down our overall rental yield. That being said, offices bring value in the diversity that they add to our otherwise retail-heavy portfolio, and I expect it to continue to be a strong pillar to our leasing income.

Lastly, we have our serviced apartments and hotels. The residential market in mainland China has been through a particularly tumultuous period. Sales are dramatically down, and almost all the local players are in dire straits. Many are facing an existential moment. In this environment, it is easy to be blindly bearish; however, I think there is reason for Hang Lung to have hope. As a developer, we are in a completely separate class, and do not face the financial pressures that local developers face. We will comfortably and happily complete our current pipeline of apartments for sale, so our current full-speed construction is taking place against a backdrop of record-low land sales and record-slow apartment construction. Thus, projecting two to three years out, I see a market with very limited apartment supply. Yet for us, that will be a time when our projects are coming to market. Even if the market has not fully recovered by then, we will still be selling at a time when consumers have less choice.

Admittedly, the outlook for hotels is more hazy. While the domestic tourism market has inevitably grown, not all of our cities are leisure hot spots, and international travel will probably be more difficult than it was, pre-COVID, for the foreseeable future. That being said, our hotels will all be among the best properties in very vibrant cities, so I would expect them to outperform their peers in each city.

GREAT PEOPLE, STRONG PROCESSES (AND GOOD GOVERNANCE)

I regularly say — both externally and internally — that one of the top KPIs by which I measure my own performance is "people". (The KPI that I mention in the same breath is "culture", with which "people" sits in a tight binary orbit.)

Over the past five years, Hang Lung's executive team has seen significant change. Firstly, with the Hang Lung Boards' blessing, I brought in Weber Lo to join us as CEO, succeeding Philip Chen, who retired due to health reasons, and who still sits on our board today. In the years since Weber joined, several of our top managers reached retirement, among them the CFO (now Kenneth Chiu), our Executive Director and head of leasing (now Derek Pang and Mikael Jaeraas), and our head of corporate communications (now Maggie Ma and Joyce Kwock). In each case, we filled these roles with strong, mostly internal candidates, all of whom are a decade, or more, younger than their predecessors.

The fact that internal candidates took most of these senior roles reflects our significantly strengthened management bench. (In our previous round of senior hires, most were external.) In the cases where we have hired externally, we have attracted top talent, which speaks to the quality of our operations, our culture, and our reputation in the market.

Weber's ability to quickly identify, attract, and promote talent has already shown results, in the form of a senior management team which I believe is now stronger than at any previous time. This was partly made possible by the thoughtful and intentionally-paced churn of our senior management team since 2010.

I intend to continue this trend, which I see as part of the path to creating a more meaningful and rewarding workplace. I also expect our level of diversity to increase, and the average age to decrease.

People are often appreciated as the most important asset of a company. Due to the relative simplicity of our industry, and other aspects of our environment, *processes* often go under-appreciated.

However, it is no coincidence that both our current- and immediate-past CEO came from organizations with extremely strong processes and systems. (Weber came from banking, and Philip came from airlines.) Hang Lung is committed to building robust processes that ensure stability and resilience, and that are appropriate for our business and context. In the past 10 years, we have reviewed all levels of our processes, systems, and structure; each time, we have not shied away from making difficult, even fundamental, changes. As I write this, we are in the midst of an extensive exercise to further digitize, upgrade, and streamline ourselves, which will bring both financial and non-financial returns.

Looking at scenarios for the combined systemic threats that we face — climate change, reverberations from the war in Ukraine, COVID-19, etc., in almost all outcomes, a key requirement is for Hang Lung to be very resilient. I am thus thankful that we embarked on this long journey of self-improvement over a decade ago, and that we have made significant progress which is tangible today.

Hang Lung's great people and robust processes, coupled with strong governance and sound financials, are the foundations that will hold us through what I predict will be a period of further change and uncertainty.

Adriel Chan
Vice Chair
Hong Kong, July 28, 2022