

RESULTS AND DIVIDEND

Compared to the last corresponding period, revenue decreased 18% to HK\$4,204 million, which was due primarily to the lack of property sales. Net profit attributable to shareholders fell 25% to HK\$3,516 million. Earnings per share retreated similarly to HK78 cents.

Underlying net profit attributable to shareholders fell 4% to HK\$2,229 million when excluding property revaluation gain and all related effects. The corresponding earnings per share moderated similarly to HK50 cents.

The Board has declared an interim dividend of HK17 cents per share payable on September 26, 2019 to shareholders of record on September 13, 2019.

BUSINESS REVIEW

Six months ago I wrote about the dichotomy that exists between the troubled world around us and our Company's bright future. The irony continues: our core business is performing rather well and, in some cases, very well, yet the external environment has gone from bad to worse. Six months ago, we had one problem – the China-U.S. trade war. Now we have two – the added social turmoil in Hong Kong. This means that in both of our markets – mainland China and Hong Kong – there are causes for concern. Yet we seem to have defied gravity. Our Hong Kong business is steady; our Mainland operation has traded strongly, and is projected to continue to do so for at least a further two to three years.

To be sure, the social unrest of recent weeks on Hong Kong streets will impact many businesses sooner rather than later. Tourist arrivals are already negatively affected, which will translate into slower retail activities. For luxury products, sales may even retreat. Unlike our Mainland business, our retail tenants in Hong Kong mainly deal with local people's daily necessities. As such, we are expected to be less affected.

Like six months ago, I will begin with a review of our business before addressing the external environment in the next section on "Prospects."

After the initial success in the early 2000's in Shanghai with our two malls at Plaza 66 and Grand Gateway 66, in 2005 we embarked on the second phase of our Mainland strategy. Believing that luxury sales will sooner or later overflow from Shanghai and Beijing into many wealthy tier-two cities, we began to buy land in the latter in a deliberate and highly selective manner. We picked only what we believed to be economically vibrant cities, and in them, we focused only on large tracts of land that were centrally located for retail purposes. We were disciplined, even religious, about this approach. We designed and constructed buildings to the highest standards, and will hold these properties for a long period.

So far we have not seen any other company having the same strategy. We will pass up the best located piece of land if we do not deem the city to be attractive enough. A few years back, we worked on such a piece of land that was ultimately offered to us at a reasonable price. The local government ardently courted us, but we eventually turned it down because we decided at the time that there was a fair chance to buy in more prosperous cities. We did not want to be financially or psychologically burdened by an inferior plot in case a superior one comes along. The result was the Hangzhou Westlake 66 piece acquired last year. Unless a city is among the top one-third or even top quartile of all tier-two cities, we shy away. And in those cities that pass our stringent requirements, we still do not purchase unless we believe that the land being considered is among the best in the city – not merely the best that we can find in the city.

For this strategy to work, strict discipline and much patience are required. We will wait and are willing to pay more for the best piece in town. If not, we may be stuck with a substandard piece of land. Earlier I cited the land in Hangzhou. We first visited the city in the early 1990's but decided to go to Shanghai instead. In 2004, we began to look outside Shanghai in earnest and the city again appeared on our radar. From that time onward, we had plenty of opportunities to acquire, but waited until 2018 before we acted. We believe we now have a plot that has the potential to be the number one in the city for luxury retail and Grade A offices. In fact, we have a decent chance to create a commercial hub in the very center of this highly prosperous city. A downtown, if you will.

Those who have followed these writings in the past would know what I call the “real estate genetics” for luxury malls and high-rise offices. (I first wrote about it in the Chairman's Letter of 2013 Annual Report. Readers can find this piece and other previous letters on our website.) There are five “genes”, and location is the first of them.

Second, the land must be big enough.

Third, it must have a government-stipulated development brief that is conducive to building a world-class complex. A person who does not know what a true luxury mall looks like, let alone built one, will unlikely be able to recognize or negotiate the requisite development terms for a particular lot. I cannot emphasize enough its importance, for this can make or break a project. The last two “genes” are that a commercial complex must be designed right, and constructed well.

These five genes in high-end commercial real estate – location, size, development brief, design, and construction – are the key determinants for success. I call them “genetics” because once a project is “born” with them, rightly or wrongly they cannot be changed. Just as a short man can never play top-league basketball, a commercial complex with defective genetics cannot compete. In this business, hardware is more critical than software. When there is no competition, a development with defective genes may do fine, but once a project with the right genes appears, the inferior one will suffer, if not die.

For three reasons I deem it necessary to repeat this concept of high-end commercial real estate genetics. First, we have many new and potential shareholders who have never read what was written many years ago. Second, our experience in the past few years makes me even more convinced than ever that our approach is correct. Third, it is always safe to remind my colleagues, old and new, about this. Although not perfect, all of our Mainland projects nevertheless possess strong real estate genes. This was why our total rental income hardly suffered a down year in local currency terms during the bear market of 2012–2017, and when good days return, like now, we can outperform. Our prospects in the coming few years are quite encouraging.

Once I took a potential American investor to visit Plaza 66 in Shanghai. At that time the property was almost 15 years old, yet he thought that we had just opened it two or three years ago. Now that the complex has been in business for close to 20 years, we have spent over HK\$700 million for its upgrade. Anyone visiting it today may well think that it is brand new. This is possible because we designed the mall and office towers correctly in the 1990’s, and constructed them well. It remains the city’s most prestigious address.

Consider Center 66 in Wuxi, which opened in 2013. Recognizing in late 2011 that the bear market was approaching, we did our best to woo as many luxury brands as we could. We succeeded, but before some of them moved in, everyone realized how serious the downturn was. A few of the top brands who had committed to us later withdrew unilaterally. The mall became half-baked as the bear market lingered for four more years. When sentiments reversed in 2018, all those who had turned their backs on us have returned. Of course, we welcomed them with open arms.

The question is: why did they come back? Because no other mall in the city has the proper hardware, i.e., good genetics. We knew it all along and so did the brands. Today, there is no doubt in anyone's mind that Center 66 is the only five-star mall in Wuxi.

The same will be true for Parc 66 in Jinan and Olympia 66 in Dalian. Both properties were “born” in difficult times – 2011 and 2015, respectively – especially the latter. Consequently, the top brands already in other malls would not move over to us, for their headquarters froze all store movements. Now that the market has turned, it is just a matter of time for these two facilities to become their respective city's prominent luxury retail hub. We are convinced about this, because our properties were designed and built correctly. They have the right genes, while no one else in those cities has.

Compared to the last three malls mentioned above, Spring City 66 in Kunming is much more fortunate – it is being completed amid a strong recovering market. It will open its doors to shoppers next month, and the official inauguration will take place in mid-2020 when all the luxury brands have moved in. So far there is little competition in that city and so, like Plaza 66 in Shanghai, it will be born a “Home to Luxury”.

Unlike tier-one metropolises, which can each support multiple stores for a fashion name, most tier-two cities at present can only support one. Our real estate genetics ensure that we are the home to that one store. If a brand is already present elsewhere in the city, as long as our competitor lacks at least two of the five real estate genes, we have a good chance of luring the brand to our place.

What if there is a competitor that also has good genes? Then we had better be the first in the market. The experience of Forum 66 in Shenyang is a good reminder of what to avoid. Playing second fiddle to another strong player is not pleasant. We do not want to be in that position; that is where we want our competitors to be.

Good genetics have other benefits. For the first 15 some years, Grand Gateway 66 in Shanghai was a four-star mall. But because it was well-located, and was designed and built right, i.e., we had the correct hardware, eventually the top brands began to move in. Once the mall fully reopens later this year after undergoing its Asset Enhancement Initiative (AEI), it will be transformed into a five-star facility commanding commensurately higher rents. If faulty genetics were hardwired in the mall back in the 1990's when we first built it, such an upgrade could not have been successful.

So far, Riverside 66 in Tianjin and Palace 66 in Shenyang are solid sub-luxury shopping centers. However, both were designed and built to a specification that will allow them to migrate upward. For the time being, we are pleased with having four-star content (i.e., the tenants and products sold) in a five-star building. This may change one day.

In the case of Tianjin, the great majority of luxury brands were already in a huge facility that predated us. It is a mall with a department store attached. Our performance has been lackluster since inauguration, mainly due to the city's weak economic performance in recent years. The other place fared worse: the department store has long since closed down and, together with the mall, was sold recently. Given the differential in genetics, can we one day lure top names to Riverside 66? I think so, although it will take some time.

As for Palace 66, the district in which it is situated has been a two- to three-star location. With our arrival and that of three or four other sizable facilities, now the area is more like three- to four-star standard. It may take a decade or two to move up, if it moves up at all. This is fine since we already have a luxury mall – Forum 66 – in the same city. When we bought the land for Palace 66, we targeted the sub-luxury market, or four-star, if you will. We have achieved that, and the retail sales figures as well as rental revenue have increased strongly of late. In the past six months, they grew 29% and 23%, respectively, compared to the same period a year ago. The mall is doing what it was designed to do.

Another conviction we had in the mid-2000's has also worked out nicely in recent years. We believed then that, although the Grade A office market in tier-two cities will never be as vibrant or as profitable as that in Shanghai or Beijing, nevertheless some demand will exist. Before we built ours, there were no such quality skyscrapers in those metropolises. Once we are there, we can easily become the market leader. Top Mainland banks, insurance companies, and professional firms, as well as many foreign enterprises, will always choose to rent from us. This was a reasonable prospect then, and it is today a reality for us.

Investments in such office towers should yield a reasonable return, although they can never match that of luxury retail space. For us, the former is always part of a bigger complex that centers around the mall below. The two product types complement each other. White collar footfall will fuel retail sales, and the convenience of shopping will help attract better office tenants. The ecosystem thus created should make us competitive overall. This is not to mention that offices are a lot easier to manage, and their rent much steadier.

Our experiences at Forum 66 in Shenyang and Center 66 in Wuxi have proven that our idea of almost 15 years ago was sound. Seven of our 11 locations on the Mainland have this product type, and we are happy to do more.

Beyond retail and office space, five of the 11 complexes also have a residential element. Besides Grand Gateway 66 in Shanghai which was long completed, two are under development (Heartland 66 in Wuhan and Center 66 in Wuxi), and plans are being drawn up for a further two (Forum 66 in Shenyang and Spring City 66 in Kunming). We should begin to pre-sell those in Heartland 66 in 2021. It is likely that for a few years thereafter, we will have something to sell each year. How much profit therefrom is hard to predict at this point, but I do expect at least some from each of the projects. An added benefit for this product class is that cash inflow is much faster than that from investment properties. We welcome that.

As we open Conrad Shenyang at Forum 66 late next month, it is likely that at least three other complexes – Center 66 in Wuxi, Spring City 66 in Kunming, and Westlake 66 in Hangzhou – will also have a hotel element. They are not expected to be big money makers, but will mainly support the offices and the shopping centers.

All in all, we are pleased that the strategy we put in place in 2003–2004 is finally bearing tangible fruits. Believing that it will remain relevant in the coming decades, we will keep refining it as well as expanding it. Our properties outside Shanghai will increasingly contribute a higher percentage of total profit. I am convinced that what we have seen is merely the first fruit; the full harvest has yet to come, and when it does, it will continue for some time. Both rent and profit therefrom will grow.

Moreover, our Mainland strategy is quite resilient. During the very tough years of 2012–2017, our top and bottom lines from retail space, both inside and outside Shanghai, hardly had a down year. What brought about this resilience and what gives us the confidence now for a bright future, as long as the Chinese society remains calm? Why are we relatively sanguine in the face of a trade war between China and the U.S.? In the past, I presented on and off the many positive features of our strategy in a somewhat unique industry. Here I would like to present them in a more systematic fashion. It is not easy to find another business like investing in high-end commercial real estate for the long term.

This should not surprise long-term readers of this letter, but let me once again state in one sentence what our strategy is: TO DEVELOP IN ECONOMICALLY VIBRANT CHINESE CITIES, AND TO OWN AND MANAGE FOR LONG-TERM RENTAL WORLD-CLASS COMMERCIAL COMPLEXES, ANCHORED AROUND A LUXURY OR SUB-LUXURY MALL THAT IS THE NUMBER ONE IN ITS MARKET SEGMENT. The phrase “world-class” implies possessing all five real estate genes mentioned above. Namely, the location must be among the best in the city, the complex must be sizable, the development brief for the piece must be acceptable, and the design and construction are both good and reasonable.

With this in mind, we can consider the strategy that we have adopted from two perspectives: the external markets that we have chosen, and the business model that we have devised. I will move from the macro to the micro, that is, from the market to the company. They are first presented in an outline form, and then I will comment on each point. This is critical to the understanding of our Company.

A. Market Factors

1. The Chinese retail market is huge, and its future is relatively certain
2. The overall Chinese consumer spending is advancing much faster than her GDP
3. Our chosen market segment is rising particularly fast
4. Competition is light
5. Growth in our market niche should last for at least another 30 to 40 years

B. Business Model Factors

1. Our business model is unlikely replaceable by technology or other business models
2. We have long-dated hard assets with little obsolescence and flexible usage
3. We are only capital intensive, not labor, technology or regulation intensive, nor single commodity dependent
4. We enjoy quality recurrent income which is dependable and growing steadily
5. Our profitability is quite predictable
6. We can have relatively high investment returns
7. Considerable capital appreciation is possible but usually goes unnoticed
8. Our market position is defensible
9. Management is not dependent on any individual, but on a team within an ecosystem buttressed by corporate culture
10. Our business model is conceptually simple but extremely difficult to execute

Each of these 15 points needs some explanation. In the past, I have expounded on many, some at considerable length, but not on all of them. I refer readers to my previous Letters to Shareholders of this Company and those of our majority shareholder Hang Lung Group Limited. They can be found on our websites. As such, I will be somewhat succinct here.

It is superfluous to repeat how big the consumer market in China is. With a middle-class population estimated to be about 300 million and growing fast, it is, or soon will be, the world's single largest group of shoppers. Even in absolute dollar terms, the amount available for spending is among the highest on earth.

Today it seems that nothing is certain in the world anymore, and this includes the economy. Hardly any business anywhere can be spared from uncertainty. If anything is relatively sure, it is the continuous rise in China's consumer spending. Even the present trade war between the U.S. and China cannot stop it. In fact, it will help. As the country's exports slow down, Beijing must put in more effort to stimulate its domestic market. This is exactly what we have witnessed since Donald Trump moved into the White House.

This is why I have said in the past that our Company can be considered a retail-related company as much as a real estate concern. Providing physical space for retail transactions to take place is a critical step in the entire merchandising chain.

Since we are in the most hard assets intensive part of that chain, the number of malls we can own is of necessity limited. This is why we can hardly afford to have a failed mall, or even a weak one. We also must stay at the higher value-added end of the market spectrum. To put it in colloquial terms, we want our malls to be selling expensive goods with rich profit margins, so that our retailers are able to pay us higher rents. We certainly do not like to be at the other end: building big boxes that house the likes of hypermarkets where the profit margins are extremely thin. They can hardly pay a reasonable rent, let alone a high one.

Moreover, there are many people who know how to construct such unimaginative matchboxes. Their game is basically a financial one. But to build sophisticated malls that sell luxury products to discerning shoppers is another story. It is a complicated endeavor which requires a tremendous amount of knowledge and experience.

For the past 20 some years, several Mainland companies have tried but very few succeeded. The reasons are simple: they are unaware of the real estate genetics needed for such properties, not recognizing their significance, or incapable of abiding by them. Anyone who respects and adheres to the five genes in real estate genetics cannot help but win, as long as he or she is the first in the market. Frankly, most cities are eagerly waiting for the arrival of such quality malls.

The luxury and sub-luxury segments in the mall business in which we play are not a particularly big part in the overall Chinese consumer real estate market, but are particularly fast-growing. If the past 30 years saw a tremendous increase in the sheer quantity of goods consumed, the next 30 will see the improvement in the quality of products. The question today for most Chinese city dwellers is no longer whether or not you own, but what you own. Many will migrate from how much you own to how superior the things you own. The latter is related to our business.

Now we come to a point that is surprising to many: Competition is light (A4 in the Outline above). Careless analysts complain that China is overbuilt with shopping centers. Not exactly. Admittedly there is a glut of low-end or nondescript malls in many cities, but that is not what we build. As Mr. Deng Xiaoping, the architect of China's economic reform, once said: it is glorious for some to become wealthy first. We tailor our malls only to those who become wealthy first; we specialize in four- or five-star retail centers. How many cities in all of China have at least one luxury mall that is akin to those that we develop? I doubt if the number is larger than 20, and we are in nine of them.

Yet, there are 121 metropolises in China that have a population of over a million (the equivalent number in the U.S. is nine), 92 with over 3 million, 78 with over 5 million, and 13 with more than 10 million. The purchasing power in tier-one cities – Beijing, Shanghai, Guangzhou, and Shenzhen – is very strong indeed, and the best tier-two cities, like Hangzhou and Wuhan, are growing fast. We have been doing business in the Mainland for 28 years and are only in nine today. I estimate that given our present strategy, there are at least 20 more metropolises where we will consider developing.

On the supply side, from what I can tell, so far only a few companies have a track record of being capable of developing luxury malls like ours. Most of them, including ourselves, are from Hong Kong. Many of the other firms who build cheaper products are not a direct concern to us, for we play in different market segments.

The reality in the marketplace is, whereas there is an overbuilding of two- or three-star malls in certain tier-two cities, there is a dearth of high-end ones in most of them. This is not unlike the difference between a 50-square-meter apartment (which is larger than the median size dwelling in Hong Kong) and a 500-square-meter house. Both are residential, but the oversupply in one category can never meet or replace the demand for the other. The rationale is simple and obvious, yet one may be surprised by how many analysts have told me that they worry about the abundance of retail space in China somehow affecting our business. This is simply foolishness.

One final point on market factors: some researchers believe that, due to China's extraordinary population size and her relationship, geographic or otherwise, between various regions therein, the country's continuous growth and development should last three times that of smaller economies. But for the sake of conservatism, let us just treat China like everyone else.

In almost all Asian countries, after achieving certain wealth, their citizens begin to seek luxury fashion items like those sold in our malls. Japan was the first, and the Tokyo Olympic Games in 1964 was usually taken as a symbol of the country joining the ranks of developed nations. From around that time, the Japanese began to consume high-end goods. The market has remained strong for over 50 years, and so far there are no signs of waning. Many top brands today still single out Japan as a separate region, while the rest of Asia is combined as the other Asian region.

Hong Kong became affluent in the mid-1970's, so its luxury goods market has been growing for 40 some years. Similarly, such products have been selling well in Singapore, South Korea, and Thailand for over 30 years. The markets in all these places are still growing strongly.

The question at hand is: what about mainland China? Plaza 66 in Shanghai was one of the earliest luxury malls that sell expensive items in the entire country. It has been in business just shy of 20 years. It is thus reasonable to expect that under normal circumstances, the market still has at least 30 to 40 years to go, if not much longer. This should mean that our malls will be kept busy for many decades to come.

Now let me turn from market factors to those relating to our chosen business model, i.e., the 10 points under B in the Outline. First, good physical retail space will not be replaced by technology such as e-commerce. In previous years, I wrote at length about this so will only summarize here.

Everyone knows what a souk is – it is a marketplace common in the Middle East and North Africa. Some of them have existed for over a millennium, and are still with us today. They may have been modernized somewhat, but the concept is exactly the same today as they once were. Recently I revisited one in Istanbul which has been there for hundreds of years. Generations of new technology and related business models have not displaced the souks – mail order, catalog sales, telephone ordering, and now, the Internet. Instead, most of those once new sales channels have all but disappeared, but the souks are still with us. After all, human beings are social animals who need to and want to physically interact with each other. The souk of the old days was not just a place to buy and sell but also a place for social interactions. Today, the modern souk is called a mall.

In the past few years, the market has discovered that e-commerce and physical stores actually complement each other. For each product class in a particular market, sooner or later a dynamic equilibrium will be reached between the two channels of sales. Although e-commerce started in the West, it has grown a lot faster in China. The annual sales volume of Alibaba or even JD.com far exceeds that of their Western counterparts. The phenomenon is particularly acute in tier-three and tier-four Chinese cities where traditional distribution and sales channels are not as well-developed.

On the other hand, there has been an overbuilding of retail space in the U.S. with a per capita square meter of over 2.2, whereas in Asia, the number is around 1.0, and in Europe, between 0.2 and 0.5. So in the past few years when e-commerce finally hit the American market big time, many shopping centers had to close down. Some analysts still believe that everything in the West is more advanced, and therefore think that this is the end of physical stores everywhere in the world. One even suggested that one should sell all the stocks of companies that own physical retail assets anywhere. What hubris and what ignorance!

The reality is that Chinese mall operators like us have had to live in the past two decades with powerful e-commerce companies like Alibaba and JD.com. In most product categories, an equilibrium has been reached for some years. In fact, many retailers who started their businesses selling on the Internet learned that they need to have a physical presence. Because of the lingering mistrust by the general public on many products sold electronically, having a physical store can help boost the brand's credibility. The result is that the unit price of its goods can be as much as 20% higher if it has prominent shops in well-located and widely respected malls.

Needless to say, such brands will not open too many physical stores. They only want to be where their brand value can be enhanced by the prestige of the address, and the association with respectable neighboring retailers within a mall. More often than not, Hang Lung's properties become their first choice. This is another reason, albeit a minor one, to always position our facilities as the number one in a particular market.

That said, obviously we are very respectful of e-commerce. It is a serious phenomenon that will change the way we live, if not just the way we shop. Some products are more vulnerable than others to the threats from this new sales channel. Fortunately, another decision we made as early as the 1990's has protected us well even in this regard. We decided long ago that we do not want to be in the low-end of the retail business. Luxury retail properties are far less affected by e-commerce.

To be fair, there was no e-commerce in the 1990's, so we could not have known about this added benefit. All we knew then was that the sellers of goods that command richer profit margins have a better ability to pay higher rent. Now everyone understands that in general, the higher the price point of an item, the less likely it is for people to buy it through the Internet. High-end fashion, exquisite jewelry, and expensive watches, for example, would hardly be sold on the Internet. Potential buyers may first study them electronically, but transactions are physically carried out after careful product inspection in tastefully crafted stores in luxury malls like ours.

Having established that our business model can hardly be upended by technological advances, a corollary is that there is little obsolescence in our malls as long as they are designed wisely and built adequately. They are also long-dated assets: once constructed, they will continue to produce income for decades to come (Point B2 on the Outline). Only regular maintenance and periodic freshen up are required.

The latter was exactly what we have done with our two Shanghai complexes. Approximately 17 to 18 years after inauguration, we spent a total of over HK\$1.5 billion to upgrade them. This included the employment of the latest technologies to both enhance revenue and reduce operating cost. In the case of the mall at Plaza 66, we saw two successful years of double-digit growth in rental revenue after its AEI. The “new” property should go on strongly for another two decades before it needs another new lease on life. The cost of such an AEI is minor compared to the building’s original cost.

One characteristic of our developments that is not of immediate value, but should nevertheless be mentioned, is that they are flexible. They are invariably built to the highest standards. If for whatever reason the high-end retail market for which these developments were originally built somehow diminishes, we can always adapt them for less prestigious purposes. A five-star mall can be converted into a two- or three-star one but not vice versa. Similarly, a mall design can be easily adjusted to fit a department store, but a structure built for a department store can never be used as a mall. Many in China have tried the latter and failed. All our properties have this versatility, although I do not foresee a time when this flexibility would be called upon.

Another beauty of our business model is that it is only capital intensive, a point to which I will return (Point B3 in the Outline). Other than this, it is not labor intensive, technology intensive or regulation intensive. Moreover, it is not beholden to any single commodity whose price may fluctuate greatly, like oil or gas. In this respect, if the airline business is one of the worst in the world (which I believe it is), ours must be among the best. I always believe in parsimony – all else being equal, the simpler the better and the fewer moving parts the better. There is less chance of things going wrong. I am happy to work in a business that is intensive in only one dimension, i.e., capital. Hang Lung can handle this and has handled it well.

There are many other virtues of our business model that are, one way or another, finance-related. They affect profitability (see B4 to B7 in the Outline). Apart from the periodic sales of expensive serviced apartments in certain projects of ours, we basically rely on quality recurrent income. Since we are invariably the best or among the best commercial complexes in a city, our tenants, both for the mall and for the offices (if the project has the latter), are among the most prestigious that can be had. For example, our office tenants read like the Who's Who of Chinese and international businesses. Their ability to pay rent even in tough economic environment is far better than the less solid renters. Such companies are also less likely to disappear overnight.

Since our revenue is rather dependable once the buildings are leased up, and since expenses are not difficult to estimate, profitability becomes quite predictable. Putting aside new projects where land acquisition done in our way can be sporadic, the steady-state condition of our Company should be transparent to anyone who cares to study us. With this as a base, one can make reasonable assumptions about the addition of new developments, and the future of our Company's profitability can be approximated.

Having completed eight complexes on the Mainland, and with three more on the way, we have a pretty good idea of the life cycle of large new projects in terms of profit growth from inception to steady-state, adjusting for the stage of the economic cycle as well as the local competitive landscape. Such "predictability" cannot be said for most other industries or businesses.

To add to all these favorable elements is perhaps the ultimate attraction: our business model is capable of producing reasonably high investment returns to those who respect the five real estate genes. We accomplished this in Shanghai, and are now emulating it elsewhere.

Ten years after completing the two Shanghai projects, we have achieved a blended unleveraged gross rental return on the original cost at slightly over 30%. The number is much higher for the retail space, but that for the offices is also very rewarding. By the time we did the AEI, it has reached over 45%. The cost of the AEI has brought it down by a few points, but approximately three years after the onset of AEI, the gross return has recovered its high watermark. Its 19 years in business included the six-year severe downturn of 2012–2017. It was certainly not a straight upward line; neither can we expect it in the coming decades.

When will the rental return stop growing and what is the limit? Due to the characteristics of the market, office yield can be capped. But for the mall, one can say the sky is the limit. Since our rental margin is at or close to 90%, net return is also very high. Moreover, this does not take into consideration the tremendous capital appreciation we already enjoy and will enjoy.

Obviously the same cannot be expected elsewhere. In Shanghai, we caught the opening of the entire country to quality goods in the early 2000's; outside Shanghai, we are only benefitting from the economic rise of the metropolitan area plus the surrounding region, which can include the entire province. In other words, the catchment area of Shanghai in the past was much bigger than that enjoyed by tier-two cities today.

There is another reason why our properties outside Shanghai will grow more slowly. Our six existing facilities all opened immediately before or during the six-year bear market of 2012–2017, where negative growth was the industry norm. For practical purposes, we might as well reset the clock to begin in 2018. Our next two complexes – Spring City 66 in Kunming and Heartland 66 in Wuhan – do not have this problem. They will open in the next 12 months in a bull market.

Here, several related points are worth mentioning. They all affect the return calculations.

First, the rental margin of Plaza 66 in Shanghai today stands at 90%. This figure converts the gross rental return to a net rental yield, which is still amazingly high. Although we probably can further improve the margin somewhat, it may not be wise to do so. Maintaining the facility in tip-top condition for our tenants and shoppers is much more important than shaving a point or two in rental margin. Grand Gateway 66 can achieve a similar figure, but is for now in a temporarily lull due to its AEI.

Outside Shanghai, various market and regulatory dynamics will render it unlikely for us to achieve such high margins. But can we reach 70%-75%? I think so. Compared to most other businesses, this number is already very attractive. Needless to say, the earlier we get there, the more profitable a project will be.

A second point is that the rental return figures above are on an unleveraged basis. I can hardly believe that any commercial real estate concern, no matter how small, would use no debt, let alone one of our size. Indeed, for over a decade beginning in the mid-2000's, Hang Lung was basically debt-free. It was a unique situation which is not easily replicable. Before the Asian Financial Crisis of 1997–2002, we prepared ourselves well for it, and afterwards wisely bought land in Hong Kong in the absence of competition. We also timed our sales well to maximize profit. Consequently, we were cash-rich. We began to buy land outside Shanghai in 2005, which coincided with the beginning of a period of zero debt for more than a decade. About three years ago we started to have some debt, although our gearing today is still rather low by the industry standard. Even with moderate leverage, our investment return can rise further.

A third point is that the rental return figures are calculated based on the original cost. The land price however is not all paid on day one, and the total cost including construction is usually expended over six to seven years, starting with the first land payment until soon after the opening of the building.

By now, my readers may agree with me that our business can generate attractive returns. At steady-state, each development is like an annuity where income usually grows over time. The rate of increase should more or less reflect the rise of consumer spending in the country. After two to three decades of double-digit growth, today the Chinese still spend 8%-9% more each year. Unlike in developed economies where private consumption accounts for over 60% of GDP, this number in China is only in the low to mid-40's. There is much room to grow, and so our “annuity” will become even more valuable over time.

Finally, there are two financial gains that are not captured by the rental return numbers. First, although not the mainstay of our strategy, for those developments that have serviced apartments, the sales of these units will bring extra profit and faster cash flow. In the order of their time to market, the four complexes in this category are Heartland 66 in Wuhan, Center 66 in Wuxi, Forum 66 in Shenyang, and Spring City 66 in Kunming. All these units are for sale and are projected to be profitable. The only exception is Grand Gateway 66 in Shanghai with two residential towers and one block of serviced apartments. There is no present plan to sell them.

Another somewhat hidden financial gain is capital appreciation, which is also my next point in the Outline (B7). Seldom has any analyst focused on this. The fact is that, compared to our competitors, our land cost is cheap and our developments command the highest unit rent in their respective markets. Our properties are considered the most prestigious in their respective city with a bright future. Yet the cap rates used to reevaluate our assets semi-annually are among the highest in the industry. The fact of the matter is: give me a 2% cap rate and I will not sell our commercial properties, yet some inferior buildings in our neighborhood are transacting at not much more than that level.

Many investors probably do not pay much attention to revaluation gain, or deem it unimportant. What should be pointed out is that such asset appreciation is as much the fruits of our labor as it is windfalls from a rising market. When evaluating the worth of this Company, such factors should be taken into consideration.

Point B8 says that once a luxury mall achieves market leadership, that position is quite defensible. There are at least two reasons why a high-end retail facility must be the number one in its market. First, as I have written in years past, the investment return for the market leader usually far exceeds that of the runner-up. Tier-one metropolises can afford multiple stores, as can some tier-two ones such as Wuhan, Hangzhou, and possibly Shenyang. In other places, prestigious brands will congregate in one best mall. They do not want to be the odd one out – stuck somewhere alone in an inferior property.

There is, however, another reason to be number one. Once a top luxury mall has achieved the top spot in the market, it is very difficult for others to dislodge it. In other words, its preeminence is relatively easy to defend. Of course, this assumes that such a facility has good genes. If it does not but has gained market prominence merely because it was the first in the market, or because all competitors are also weak genetically, then its position is still vulnerable. When someone like us with strong genes comes along, the former leader can be displaced. We have seen this in Palace 66 in Shenyang, Center 66 in Wuxi, and Spring City 66 in Kunming. We are also beginning to witness it in several of our other developments.

The penultimate point (B9 in the Outline) relates to management. What makes our business model work is not because of any single leader, nor is it dependent on any individual. It is teamwork within a particular ecosystem that entails a certain corporate culture. Before the mid-2010's, our Chief Executive Officer was Mr. Nelson Yuen, now an Independent Non-Executive Director of the Company. He and I together conceived this model in the 2000's and gradually developed it. His successor Mr. Philip Chen, now a Non-Executive Director, quickly recognized its virtues and fully embraced it. We refined the model and built the organizational infrastructure that brought us to where we are today. A year ago, Mr. Weber Lo, our present Chief Executive Officer, took over. Just like Philip before him, he understood the model's value and is now executing it. Like Nelson, Philip or Weber, any intelligent person with good general management experience and a controlled ego can do the job. Before joining Hang Lung, Nelson was an accountant, Philip was the head of two airlines, and Weber came from a consumer products background followed by banking. All of them are good leaders of this Company, past or present.

The second half of the 2000's and the first few years of the 2010's was the time when this business model began to take shape. A number of our then senior colleagues could not adapt to the new organizational changes. For example, some could not get used to the teamwork that was required of them and left. Because our Company was then a darling among local real estate counters on the stock exchange – we outperformed almost everyone between 2002 and 2012 – our former senior staff became desirable commodities in the job market. Companies in Hong Kong and the Mainland quickly snapped them up. They thought that our former colleagues could replicate for them our business model. On the one hand, we were gratified that they were apparently being held in high regard by our competitors. On the other hand, we gradually observed that none of them was able to replicate our success.

This brings me to the last point in the Outline (B10) – conceptually, this business model is very simple, but in practice, it is extraordinarily difficult to execute. I like its simplicity – what is so challenging to develop, own, and manage large and high-end commercial complexes? It seems a lot easier than many manufacturing operations. If so, simple economic principles would dictate that there must be many competitors, especially in light of the relatively high investment returns and other attractive characteristics. Why then are there only so very few that are successful in this fast-growing niche market?

As mentioned above, this model works only under a particular mindset or mental ecosystem that is supported by a certain culture. One must be able to consistently focus on the long term. While recognizing the need to report semi-annual profits as a public company and pay dividends, management must avoid making critical decisions that may produce immediate results at the expense of our long-term prospects. We respect every shareholder, but we are not here to please every one of them. We particularly like those who share our long-term horizon in doing business.

The more senior a person becomes in this Company, the more patience is required of him or her. At the operational level, of course our staff must meet short-term deadlines. For example, we cannot let construction drag on for it costs money – higher interest payments and delayed rental inflow. A project staff of managerial grade must also be able to deliver timely results. But this is different at the senior level. For example, a senior person must not make design decisions that will quickly render our buildings obsolete, or choose construction materials that are not durable or not easily maintained in the long run.

Then at the top level, our executives must be prepared to wait, not just for months, but at times for years. For example, I first visited Hangzhou for business in the early 1990's. After choosing Shanghai instead, we stopped looking at Hangzhou until 2004. For the ensuing 14 years, we studied most of the better land pieces and rejected all until last year. We finally found a plot that possesses the five real estate genes. During almost the entire 14-year wait, we were cash-rich. With money on hand, it became even more difficult not to buy, but we resisted the temptation.

What if our waiting was in vain, namely no suitable land surfaces? My answer is: at least we would not be stuck with substandard land. China is big and there will always be opportunities, if not in one city, then in another.

Having a long-term outlook also implies the necessity of persistence. For example, it does take us longer to finalize a design scheme. No one is smart enough to quickly come up with an optimal solution that takes nearly all things, including those that may happen many years down the road, into account. It is an iterative process where each edition improves upon the last one. There are always issues that have not been considered before, so persistence is required to find them and keep improving on them. When to stop? When the marginal utility becomes smaller than the marginal input.

We do not build to sell, for once sold, the building with all its present and future defects will be someone else's worry. We build to hold for the long term. This means we have to live with the problems we have created for ourselves for not being careful and thorough in the design phase. For our strategy to work well, everyone on the team must be long-term minded and quality conscious.

Teamwork, as mentioned earlier, is also required. When architects and engineers design something, the user must also be brought in from the beginning. The leasing team, who will have to live with the building for decades to come, must have valuable input. The perspectives of the user can often be diametrically opposite to those of the planner.

Because of the long cycle in real estate which usually lasts six to eight years, waiting becomes inevitable. Only then can one always do the right thing at the right point in the cycle. The history of our industry, in both the East and the West, teaches us the same thing: investors must learn to wait to be successful. Those who do not will sooner or later get caught by the bear market. Cash flow problems will follow and bankruptcy is highly probable.

In order to wait, discipline is also required. These two are severe tests for a developer (or investor). Without them, one can never adhere to the five real estate genes. Waiting can be frustrating, but one must learn to sit on his or her itchy hands. It is easy to pay lip service to these cardinal principles of the industry but lip service means little. A friendly competitor once announced publicly that he would adopt the Hang Lung model. I could have told you the outcome that day.

Obviously we do not have the only winning model. We have one – and a very good one at that – which no one has been able to replicate successfully, and we know why. The past 27 years (counting from the time we bought land in Shanghai for Grand Gateway 66 in December 1992) have shown us that this model works and should continue to do so. We are far from perfect; we are still learning every day.

That said, no business model is free of problems. Neither is ours. It has a serious flaw which also serves as a huge barrier to entry. It requires a massive amount of capital, most of which upfront. Anyone who does not already possess a solid financial base should not even begin. And of those with a strategy similar to ours – building large commercial complexes for long-term hold – and which have been successful, all have strong financial wherewithal before venturing into this business.

In our case, our Hong Kong development projects brought in a lot of cash in the 2000's, which launched us onto this path. Our initial rental success in Shanghai in the early part of that decade provided confidence as well as cash flow for dividend payments. This enabled us to use the Hong Kong development profit to venture outside Shanghai. The rest is history.

An interesting and meaningful point here is that such a strategy is particularly suited to business groups controlled by a family, even when the company is publicly traded on a stock exchange. This is indeed the case with all our successful competitors. In each case, the company is in the hands of a family, and the Mainland entity is an SOE (State-Owned Enterprise) where the government plays that role. Although all of us are publicly listed, the security of having a controlling shareholder enables management to look at the long term.

Not only is this business heavy upfront in capital deployment, payback also comes slowly. Each development usually takes slightly over a decade from land acquisition to maturity. Adding new projects will continue to consume capital and push back the date of achieving full harvest. It takes time for an income stream to build up, but once steady-state is achieved (assuming that there are no more new projects, which is unrealistic in China), it is very consistent.

After having observed the Asian stock markets for decades, and having been a participant therein, I think I know the pitfalls of family-controlled entities. The Hong Kong Stock Exchange has many such companies. In spite of the rather stringent regulations, including stock exchange rules, a few of them may have mistreated minority shareholders. These activities should be minimized. However, let us not throw out the baby with the bath water. This genre of publicly listed entities has definite advantages and unique strengths. Whether run by family members directly, or by professional managers with the oversight of the controlling shareholder, management is basically free from the possibility of being replaced. This enables the top executives to take a real long-term view and create something meaningful for society. Hang Lung is one in this category.

What if Hang Lung were not controlled by a family, and what if I were just a hired gun? I took over the chairmanship in 1991 after the Company had underperformed for two decades. It was not until 2001 or 2002 that we began to outperform, and the winning streak ended in 2012. Would the investment public have given me 10 years to turn the Company around if I did not represent the controlling shareholder? I doubt it.

Of the major local real estate firms, we were among the earlier ones to invest in the Mainland beginning in 1992. Our strategy was unique then: we acquired land much larger than that of our fellow Hong Kong developers at that point. It was a big bet, and we bought two huge pieces in the same city, Shanghai. Signs of success did not begin to surface until approximately 2001 or 2002, a full decade since we began. Would shareholders have waited that long, or would they have kicked me out? Perhaps the latter, but I will never know.

Then, before the Asian Financial Crisis which began in 1997, Hang Lung did in Hong Kong the exact opposite of the prevailing beliefs of that time. Everyone was rushing to expand their land banks. Instead, we sold investment properties and hoarded cash. We raised it in every way we knew how. That took place before our Shanghai venture had any signs of success. Again, what did the investors think?

As noted earlier, our shares performed superbly between 2002 and 2012 relative to our competitors. But when Beijing's anti-corruption campaign began, the market turned south and so did our stocks. We had a cold winter for six years. Our scrip only recovered when 2019 approached. During those few years, we had to fix many internal issues caused mainly by rapid expansion. Without a controlling family, shareholders might have pushed management to take short-term measures purely for the sake of the share price, but would have diminished the long-term prospects of the Company. We might not have the opportunity to reap the benefits as we are now beginning to do. I might even have been fired!

Now let me turn to the performance of the immediate past. We turned in a set of satisfactory results for the first six months of this year. The most encouraging aspect is that the prospects of the Company are rather favorable. Signs that are pointing in that direction are now clearly seen.

Plaza 66 in Shanghai continued to trade well after its AEI. In RMB terms, retail sales increased 15%, and mall rental income 11%. These were accomplished following two years of strong growth, which established a high base. Since Grand Gateway 66 is undergoing an extensive upgrade, I will exclude it from the following discussion. Suffice it to say here that once its AEI is completed, I expect the same pleasing results as that experienced in Plaza 66.

Compared to the same period a year ago, all Mainland retail properties outside Shanghai advanced in retail sales and rental revenue. For tenant sales, the following malls saw their numbers jumped: Palace 66 in Shenyang, Olympia 66 in Dalian, and Center 66 in Wuxi rose 29%, 27%, and 25%, respectively. Rental increases for the three properties were 23%, 30%, and 26%, respectively. Parc 66 in Jinan, which has always performed steadily, advanced 11% and 12% on these two measures. Even the two weaker complexes, Forum 66 in Shenyang and Riverside 66 in Tianjin, recorded positive growth of 2%-3% each. Rental margin and occupancy everywhere improved, except at Riverside 66 which is undergoing a major tenant remixing.

All our offices on the Mainland performed satisfactorily. The two latest towers, one each at Forum 66 in Shenyang and Center 66 in Wuxi, achieved about 90% occupancy. Unit rents remain steady.

All the numbers above are in local RMB terms. Its value however fell 6% against our reporting currency, the Hong Kong Dollar, in the six-month period under review. So whereas our Mainland total rental rose 7% – 4% in Shanghai and 14% outside – in Hong Kong Dollar terms, it only advanced by 1%.

It is worthy to note the fact that rental growth outside Shanghai is now faster than that in Shanghai. When Grand Gateway 66 reopens fully next year, the situation may change. If Plaza 66 after its AEI is any indication, then a double-digit growth may last for at least two to three years. Whatever the case, I will not be surprised if in the next, say, five years, organic percentage growth outside Shanghai will be stronger than that in Shanghai. Coupled with new space opening – the second office tower of Center 66 in Wuxi next month, the mall and office of Spring City 66 in Kunming in the next month or two, and of Heartland 66 in Wuhan early next year – the rents arising from outside Shanghai will become more significant.

There were no surprises in Hong Kong: rents increased 3%. Together with the rise in Mainland leasing revenue (which was greatly affected by the devaluation of the RMB), overall rental growth was 2%.

We only sold one house at Blue Pool Road, but completion will not occur until the second half of the year. We also parted with 100 car parking spaces in Hong Kong. The transaction will not close until later, so no profit is recognized in this reporting period. The sale is in line with our policy to recycle our assets – selling older mature properties and deploying the cash in higher potential ones, be they in Hong Kong or on the Mainland.

Interest expenses would have been not much less than the year before. However, due to a change in accounting rules, it has all but disappeared. Gross revaluation gain was about a billion dollars less than the prior year.

The combined effect of the above is that net profit attributable to shareholders was 25% lower than last year at HK\$3,516 million. The lack of development profit and the modest revaluation gain were the primary reasons. When the latter is taken out, the underlying number is down 4% to HK\$2,229 million. The underlying net profit attributable to shareholders from property leasing alone was up 25%.

PROSPECTS

The China-U.S. trade dispute continues with no end in sight. As I have said from the beginning, the day there will be a deal is the day when U.S. President Trump needs one. Apparently he has not gotten to that point.

To a careful observer of the process, one cannot help but come to the conclusion that it is somewhat of a farce. With the press hanging on to every tweet of President Trump, he is pulling strings at whim, while blaming the Chinese every step of the way. One day he would announce that the two sides are close to a deal, only to say a few days later that the Chinese have pulled away. A month or two later, he would repeat the game while dragging the global stock markets with his antics. Frankly, he is fooling everyone – the Chinese, the U.S. public, the world, the media, and the stock market.

On May 8, the famed columnist Martin Wolf wrote in the Financial Times that the American offer on the table then was nothing less than an unequal treaty à la those of the 19th century imposed on China by the Western powers. There was no way that Beijing could have accepted it, and Washington, D.C. knew it. Another renowned European journalist friend told me recently that Steve Bannon, although out of office, admitted that fact to him. This meant Washington, D.C. had no intention at this stage to conclude a deal. Trump was merely using the process to gain political points at home for his upcoming re-election, while his cronies like Bannon got what they wanted – to give Beijing hell in order to contain China.

Is China that desperate for a deal, such that she does not mind being played in the international arena? Will history not show this to be a kind of humiliation, not unlike the unequal treaties of years past? Given that, it is possible that Beijing will wake up one day and harden her position. If the U.S. continues to overplay her hand, China may even walk away. Trump, I assume, understands that. Since he too sooner or later needs a deal for his re-election, the earlier Beijing is willing to walk away, the sooner we may see a deal.

Will the ultimate treaty be substantially better than what the U.S. is getting before? I have my doubts. Perhaps marginally better, just like the fact that the latest trade agreements with Canada and Mexico were not much better for the U.S. than the original NAFTA. Trump gained political kudos, and a few other trading partners elsewhere in the world lost some, while the three parties involved (the U.S., Canada, and Mexico) reshuffled slightly their relative positions to each other. What the U.S. really gained was a strengthened image as a bully; what she lost was the reputation as a credible partner.

For China, I have long stated that Beijing is quite willing to trade something away. This way Trump can claim victory in front of the media. Will China be able to withstand the pain? No problem, but let us not forget that there are real costs to the Americans as well. Their consumers may be the first to be hit, but the pain will not stop there. U.S. companies, and therefore the economy, will also suffer. There are usually no winners in trade wars, but there may be one this time – Trump, apparently.

I wrote six months ago that the Chinese are much more prepared for the worst. The U.S. was not so at that time, and neither is she today. The huge increase in subsidies to American farmers is just the beginning. Other short-term measures to ease the pain may well create much more serious long-term problems.

The bottom line is that China will speed up the diversification of her markets as well as her technology sources away from the U.S. She will also upgrade her industries faster. These moves are actually advantageous to the country's long-term competitiveness, and exactly what America does not like to see. The U.S., on the other hand, will isolate herself more from the global market. Her credibility and moral leadership in the world will be greatly eroded further. This is the price of Trump's personal victory. To me, this is sad!

How will this affect our business? On balance, not bad. What I wrote before will soon come to pass. Beijing has redoubled her efforts to stimulate domestic spending. In April, private consumption dipped a little, but by June, it has rebounded strongly. We will see what the coming months will hold.

But one thing is certain: luxury products are at present selling well. Our own experience is substantiated by pronouncements as well as sales figures of the world's top fashion companies. China now accounts for some 30% to 40% of their global sales. Whereas I am sure that this market, like those of most other products, is cyclical, the impetus is for now on the rise. I will not be surprised if in the next five to 10 years or longer, the overall trend continues to go up. This will be good news for us.

Here, we will all do well to remember one thing. There is a fundamental difference between a small- or medium-sized country and a very big one. Whereas smaller ones need to sell to or service others overseas in order to survive, large economies can be far more self-sufficient because of their huge domestic markets. Just like the U.S., China is one such. Internal economic dynamics can keep the country going for some time even in the absence of external involvement. The only commodity that China absolutely needs from the rest of the world is energy.

In fact, the U.S. and China are the world's only two continental economies. They are so big that they can accommodate almost all industries – upstream and downstream, heavy and light manufacturing, primary, secondary, and tertiary industries, and high-tech, mid-tech and low-tech. (Because of high salaries, low-tech manufacturing has disappeared in the U.S., but it may return one day given robotics.) This notwithstanding, I am quite sure that China will for decades become even more engaged in the global economy as a major player. My worry is that the U.S. will increasingly move in the opposite direction. More so than any other country, including China, the U.S. has the ability to isolate itself and still survive. For example, it now pumps more oil and gas everyday than Saudi Arabia! America's withdrawal cannot be good for the world – nor herself.

Now to a sad development that was not present when I last wrote to you six months ago. At that time, Hong Kong was relatively calm. In the past month and a half, the city has erupted into a tumultuous place. It was the result of unwise policies made locally and not initiated by Beijing, which has since basically kept quiet. But the trouble on the streets today are not just directed at the local government but also at the central government in Beijing.

Such social disturbances cannot but negatively affect business. Visitor arrivals will definitely slow down as we have observed during the Occupy Central movement of 2014. Retail will be hurt. If trouble persists, then confidence among the international business community will be affected. Whether or not there will be any long-term effect will depend on how the situation resolves itself. But for now, no one can predict how this will pan out.

The local residential market will no doubt slow down. We will see if prices will fall alongside with volume. More likely than not, they will. Nevertheless, as long as Hong Kong gets back on its feet after the trouble is over – and over it will be, most probably with the help of Beijing – our residential market should be fine in the long run. There is real demand locally and from the Mainland.

The present disturbances will force Beijing to change its tack regarding Hong Kong. From “no governance is good governance” of 1997 to whatever it is tomorrow, one thing is certain. Beijing has been too lax about enforcing the Basic Law in the past 22 years. If the present turmoil forces all parties to embrace the Basic Law, this may not be a bad outcome. In this eventuality, Hong Kong’s residential market and indeed the entire economy may well gain a second wind.

But for now, turbulence will be with us. We are fortunate to have sold out all our development projects, except for the 11 semi-detached houses on Blue Pool Road, one duplex in The Long Beach, and some car parks. We still hold out hope to sell these luxury units at good prices, but if we have to wait a bit, it is not the end of the world. The timing is beyond us anyway.

As for our Hong Kong investment properties, we will do our best to maintain the growth rate of the past two years at about 3% per annum. If social unrest persists, it may prove to be difficult. Nevertheless, we should still be able to produce some growth in the second half of this year. After all, in the very tough years of 2013–2016 when local retail properties all over Hong Kong suffered severely, we never had a down year.

How bad can this get? During the Asian Financial Crisis of 1997–2002, we had four consecutive years of negative growth followed by two more that went sideways. Then it took another almost five years to return to the total rent levels of 1998. It was a terrible journey of 10 to 11 lost years. The bear market was doubtless exacerbated by the dot-com bubble of 2000 and the SARS epidemic of 2003, but those effects were short-lived. For us, fortunately, our Shanghai properties began to contribute in 2000, which blunted the fall.

What will be the effects of the present trouble? I do not yet know. The nature of the problem this time is different; it is political rather than economic. My guess is that it will take more time to recover.

On the Mainland, I believe that the coming few years should be auspicious for us. In Shanghai, organic growth in Plaza 66 should continue, although a post-AEI jump in rent has already created a much higher base. To slow down a little is inevitable one day. Fortunately, Grand Gateway 66 will see its AEI completed in the coming year. The North Building reopened recently and is enjoying a double-digit growth. This may last for a while. The same should happen when the South Building, which is the main part of the mall, is ready. Tenant upgrading is impressive, which should translate to considerably higher rents. It is now a five-star mall.

Outside Shanghai, organic growth is proving exciting. Three of our six malls have seen an increase in retail sales and rental revenue of 23%-30%. I believe that there is still much more room for further advancement. Four of the six properties are at the threshold of a growth phase which should last many years. When things begin to slow, say, in the second half of the 2020's, AEI will be needed as we have done in Shanghai. The rejuvenation will hopefully launch these facilities onto a new upward trajectory, like what is happening now with our two Shanghai properties.

Impetus for growth outside Shanghai will also come from the new space that we will complete between 2019 and 2025. By way of comparison, in the seven years between 2010 and 2016, both years inclusive, we built over 1,900,000 square meters in total, or on average more than 271,000 square meters per year. (Stripping out the car park, we still completed about 1,100,000 square meters in all, or some 156,000 square meters annually.)

However, between 2019 and 2025, also a seven-year span, we expect to deliver 2,660,000 square meters in total, or almost 380,000 square meters per year. This is some 40% more than the earlier seven-year period! No wonder many investors agree with me that Hang Lung is truly a growth stock! It is doubtful if many – or any – real estate concern anywhere in the world has this magnitude of a pipeline.

Equally significant is the fact that the experience of the next seven years should be far better than the previous period. First, our management team today is much stronger than before. Back then, staffing needs was a real problem, but it is no longer the case today. Second, last time we were heading into a prolonged and severe downturn from 2012 to 2017. Today, the luxury goods market is thriving. It started last year and will hopefully continue for a few more to come.

Beyond rental income-producing properties, we also have over 400,000 square meters of high-end residential units in four of our Mainland cities. They will be ready for sale in the coming few years. How much profit can be derived therefrom cannot be determined with any certainty at present, since Chinese home prices can fluctuate greatly, depending partly on the government policies at the time. One thing however is sure: the successful sales of these serviced apartments will be beneficial to our mall business next door.

By now, I trust that my readers are as excited as I am about Hang Lung for the coming few years. Barring unseen circumstances, our future should be bright.

There is one more question that needs to be answered: will we buy more land in the next few years? Yes, we are looking, our not insubstantial land bank notwithstanding. The industry is healthy and growing, so of course we should expand. The fact of the matter is, we have never stopped searching in the past 15 years. As always, we will only act when we find something that has the five real estate genes. This cardinal principle must not be compromised.

Nevertheless, recognizing the turbulent geopolitical and geo-economic situations around us, and the impact that they may have on China, we should not overextend ourselves financially. As always, we will adhere to fiscal conservatism as stringently as we will to real estate genetics. These two are the cornerstones of our business.

With this in mind, we will nevertheless not hesitate to strike when the stars are aligned. Given how strict we are in land acquisition, we cannot afford to let too many good opportunities go to waste, for they do not come along too often. Once missed, they may likely never return, and those cities may be forever lost to us. As such, prudence is required to know when to act and when not to. Our track record of the past almost three decades on mainland China stands us in good stead for the future.

Ronnie C. Chan

Chairman

Hong Kong, July 30, 2019