Vision

In Hang Lung, we share a common vision and uphold the "We Do It Right" business philosophy to strive for excellence and achieve new heights for the Company.





BPR

Chairman's Letter to Shareholders

RESULTS AND DIVIDEND

Compared to the last financial year, revenue for the year ended December 31, 2016 advanced 46% to HK$13,059 million. Net profit attributable to shareholders increased 22% to HK$6,195 million. Earnings per share rose similarly to HK$1.38.

When excluding property revaluation loss and all related effects, the underlying net profit attributable to shareholders soared 45% to HK$6,341 million. Underlying earnings per share surged likewise to HK$1.41.

The Board recommends a final dividend of HK58 cents per share payable on May 18, 2017 to shareholders of record on May 5, 2017. If approved by shareholders, total dividends per share for the year ended December 31, 2016 will be HK75 cents.

BUSINESS REVIEW

The trading environment in the past year remained very difficult. As I will later describe, there are some signs of improvement but it is too early to be optimistic. We cannot confirm at this stage if such improvements in market conditions are sustainable. So for now, there is little good news to report, as far as the economy is concerned.

Given the headwinds, one may wonder why our results are not more unfavorable. Excluding for now the effect of the fall in RMB against our home currency, the Hong Kong Dollar, leasing revenue still grew by 5% for Hong Kong and 1% for the Mainland. Profits therefrom held their own.

As in recent years, our retail space rental was hardest hit. Beyond weak market conditions, there are factors negatively affecting our results. The basement of Plaza 66 in Shanghai was closed for renovation; it accounted for some 13% of the mall's total leasable space. Grand Gateway 66 in Shanghai also had some shops closed purely because upgrading work will begin in the first quarter of 2017. Consequently, rental margin fell one point in that city, originating exclusively from a 2% drop in Plaza 66 while that of Grand Gateway 66 was flat. Everywhere else, margins rose, especially at Forum 66 in Shenyang. Occupancy rates improved in four out of the six properties outside of Shanghai, with Forum 66 in Shenyang and Riverside 66 in Tianjin recording retreats. Total revenue edged up 1%, helped by the addition of Olympia 66 in Dalian. What is troubling is the pressure on rent reversions everywhere. As before, Forum 66 in Shenyang and Center 66 in Wuxi had the toughest time.

All this tells us that while management efforts were bearing some fruit, the market remains lethargic. Nevertheless, the positive performance of Shanghai may be a harbinger of better days ahead. That said, it is wise to remain cautious.

There are a few points worth pondering. First, the economy has been down since 2012. President Xi Jinping started the anti-corruption and anti-opulence campaigns soon after. The double effect was severe, especially for the luxury goods market, resulting in the consolidation of brands across the country. By now, I believe that the gifting of expensive items is all but history. Yet, years of weak sales of such products might have created some pent-up demand. With the economy still growing at 6% to 7% per annum in recent years, and with certain bright spots such as the very vibrant companies in technology and services, there must be a new crop of buyers for luxury goods. This may explain why our malls in Shanghai have performed so well.

As mentioned above, luxury brands have been consolidating. For example, whereas there might be four or five shops of a particular brand in a city in the past, there may now be only two. As long as you are one of the two, you will benefit even if total sales in the city shrink a little. Recent measures taken by some companies to equalize prices between China and the rest of the world have also brought some sales back onshore. All these explain why retail sales in our Shanghai malls, especially Plaza 66, have been quite strong.

On the broader economy, perhaps the pessimism of late can be somewhat moderated by the fact that commodity prices everywhere have firmed up. This may indicate that manufacturing, especially in China, may have bottomed out. Moreover, for the past few years Beijing has been encouraging or even forcing the reduction of excess capacity and inventory. The Belt and Road Initiative will help in this regard, although its impact is yet to be felt in force. All this can only be good for the Chinese economy.

A related point that worries some people is the reduction of international trade. Indeed, statistics do point to this fact. Whilst the economic slowdown in China and the lethargy in Europe and Japan have not helped, I believe the main reason for the decline is the domestication of trade in both China and the U.S., two of the world's three biggest trading areas (with the third and largest block being the European Union). The reasons behind the two countries on both sides of the Pacific are, however, very different.

In China, domestic consumption has been growing at a healthy rate for many years. Southern China, for example, where the supply chain is the biggest and the most advanced, used to produce goods mostly for international consumption. Now it is increasingly domestically focused. The rise in Chinese household income has made this possible.

On the other hand, the U.S. has in recent years, and certainly well before Donald Trump was elected president, advocated "Buy American". The likes of Walmart must have been under pressure to sell goods in the U.S. that are exclusively produced within the country. My manufacturing friends in Hong Kong and Southern China have been forced to relocate plants to the U.S. if they want to continue selling in that market. Even leather goods makers have to buy materials from the U.S., although the tanning industry which is highly polluting has long left America for the likes of Taiwan and Spain.

In this sense, what the new president insists upon, at least in rhetoric, is nothing new. In fact, many local leaders from the Southern States, where labor laws are more conducive to manufacturers and where they have plenty of empty factories, have been visiting my part of the world a lot. They want Chinese companies to relocate to their cities at very favorable terms indeed. So, trans-Pacific trade has turned into American domestic trade. In other words, global trade has not decreased; it is just that some international trade has gone domestic.

It is interesting to observe that the rationale for this domestication of trade phenomenon differs in the two countries. In the case of China, it is driven by the rise of domestic consumption, whereas in the U.S., it is outright protectionism. Almost 20 years ago, the West lectured China on the need for globalization as the latter sought to enter the World Trade Organization. Today, the tables have turned. It is developing countries like China and even India who are advocates of free trade and globalization.

Looking a few years ahead, it is very likely that the U.S. will once again become the world's largest manufacturing center, as it was in the 1950's and 1960's. After all, few countries in the world are as naturally endowed as America for that role. She has all the factors for production – natural resources, cheap energy, land, capital, technology and managerial talent. The only item she lacks is cheap labor. But now with robots, 3D printing, and other technological advances, labor is fast becoming less important if not insignificant.

Jobless or non-job-creating economic growth is a new and serious societal problem. As one study conducted in the U.S. shows, almost 90% of job loss in America is due to technology; only a small percentage is due to displacement by other countries. Do politicians know these facts? I assume so, but the truth can never stand in the face of political expediency. Such is the world we live in today. The only difference between one country and another is that one tells a few big lies every now and then, while others repeatedly tell many small ones.

Many people today are worried about the China-U.S. relationship going haywire under the new U.S. president which will somehow disrupt businesses like ours. I am, however, relatively sanguine about it. To put it simply and figuratively, 20 years ago China was like the size of a youth standing 1.6 meters tall while the U.S. stood at 2.3 meters. The giant could have easily dispensed with the other. For example, there was nothing Beijing could do in 1996 when Washington, D.C. dispatched two aircraft carriers just outside of Taiwan. Then, 10 years ago, China had grown into a man of 1.85 meters in height. America, still at 2.3 meters, could still have knocked China down with relative ease if he had wanted to. What Beijing could do was still rather limited.

Another 10 years have passed, and now China is 2.1 meters tall and still growing. Would the 2.3-meter man pick on the 2.1-meter man? Hardly. It would be a painful exercise for all parties. President Trump may, out of inexperience, say foolishly provocative words, but he will soon learn that any action on his part will elicit a reaction. What Mr. Trump does understand is pain, as well as America's self- and best-interests. So whereas his first year in the White House may be troublesome to other nations, being an intelligent man he will surely learn, and learn quickly he will. As long as China does not overreact – and she has matured a lot in this regard – the future of China-U.S. relations should be fine. After all, unlike his predecessor who has pursued an ill-conceived policy of "Pivot to Asia", Mr. Trump will soon discover that problems elsewhere in the world such as the Middle East are far more troublesome and dangerous.

If my analysis is correct, then we should count ourselves fortunate to be doing business in East Asia, particularly in the relatively stable and biggest developing country in the world, China. Economic growth in this country will remain among the highest in the world. The combination of size and speed is unseen in human history and should be advantageous to our business.

In the longer term, international economic realities are more likely to affect our business and so we must be cognizant of them, but in the immediate term, we do not need to be overly anxious. Whether products are manufactured here or there is of less significance to our shoppers; it is quality and price that matter most to them.

There is, however, one factor which seems to directly affect luxury goods sales. Statistics of recent years show that whenever the RMB is strong, these products sell less well in China, while a weaker RMB correlates to stronger domestic sales. The reason is obvious: a strong RMB makes the same products cheaper overseas and vice versa. This may be yet another reason for the strong performance of Plaza 66 in Shanghai. Sooner or later, the effect should spill over to second-tier cities.

On the subject of RMB, many of our shareholders and potential shareholders have often asked when the currency will be fully convertible on a capital account basis. Needless to say, we do not know the answer. The prevailing belief of not long ago was that it will come in the not-too-distant future. More recently, however, the sentiment might have changed. In a world which is increasingly uncertain whether economically or otherwise, the risks associated with total relaxation seem higher today.

After all, of all the mid-income countries of Southeast Asia during the Asian Financial Crisis of 1997-2002, only Malaysia was spared from external shocks. This was because the country, at that time, had insisted on not totally opening up its capital market. As such, one can sympathize with Beijing leaders for being cautious.

A more fundamental question is this: why should there be only one way of conducting one's financial affairs? Since the big bang of the capital market in the mid-1980's, the world has not only seen the Asian Financial Crisis mentioned above, but worse yet, the Global Financial Crisis of 2008. Its effects have lasted to this time – just look at the European banks today. Just as the West has apparently changed its mind on trade liberalization, perhaps it should also be open-minded about not insisting on further financial liberalization. Otherwise, a catastrophe may strike again, and the ensuing overreaction may then cause the West to reverse its views on financial liberalization. After all, a crisis caused by the collapse of financial institutions is far more sudden and dangerous than trade protectionism. The amount of dollars involved in a few short days can be many times that of annual global trade.

In this light, it is possible that the policies adopted by China today may prove to be more sensible than those of the West, especially the United States. Only time will tell. From the perspective of business folk like us, we want stability and hopefully some certainty. China's present position on its currency is fine with us. It provides both certainty and stability.

Back to the more immediate business issues facing the Company. The RMB continued to slide in the past year. Comparing 2016 year-end to 2015 year-end, it fell 5.7% in Hong Kong, the so-called offshore RMB rate (CNH), and 6.3% on the Mainland, or onshore RMB rate (CNY). Calculation of translational losses for our hard assets on the Mainland used the CNY rate; for our RMB cash held in Hong Kong, the CNH rate was employed. During the year, we sold down our RMB cash holdings, totaling RMB3 billion.

As explained six months ago, rents collected on the Mainland are reported here in RMB terms. Only by doing so can the real performance of a property be known. But when they appear on our consolidated accounts, they are translated into our base currency, the Hong Kong Dollar.

For several years, all we had on the Mainland outside of Shanghai was retail space. But beginning in the last quarter of 2014, we have a meaningful portfolio of grade-A offices. It will only grow over time. They represent a more stable source of income. This asset class is much easier to manage than shopping centers, and unlike malls which take time to mature, offices do not share this problem. However, they usually do not offer the rental upside that malls can deliver.

Offices now account for 23% of our Mainland rents and 27% of our operating profit. The two respective numbers for malls are 77% and 73%.

While our leasing operations held their own under very difficult market conditions, sales of our Hong Kong completed residential units did well. We successfully avoided the market lull of early to mid-2016 and sold at higher prices at the end of the year and into 2017. In fact, the Centa-City Leading Index was close to an all-time high this month.

The overall performance of Palace 66 is satisfactory

We parted with a total of 441 units at favorable prices. The average profit margin achieved was over 60%. Total revenue was HK$5.3 billion and operating profit was HK$3.2 billion. Worth mentioning is the sale of the first two units of the semi-detached houses on Blue Pool Road. If sold at or above the latest realized prices, the remaining 16 houses on Blue Pool Road will garner considerable cash flow as well as profit. At the time of writing, we have 87 units at The Long Beach and one luxury apartment at The HarbourSide remaining unsold.

The economy in Northeast China remained particularly difficult. But knowing China, the Central Government will not allow such a strategically important part of the country to remain weak for long. Balancing growth between different regions of the country has been a necessary and long-standing practice.

Even in the short run, and ahead of expected government actions such as beneficial policies, to think that the retail market there must be intrinsically weak is perhaps not correct. All things being equal, of course we like a vibrant local economy. But consider the experience of Palace 66 in Shenyang. After resolving teething issues within three years of opening, it is now thriving. In fact, all key performance indices have been improving. In the past year, tenant retail sales increased 12%; rental revenue was up 4%; rental margin although still low, improved 5 points; occupancy rose 3 points to 93%; average unit rent held steady; and rental reversion advanced 4%. Footfall is also satisfactory after doubling in the past few years.

All this tells us that as long as a shopping center is well-positioned in the right market niche, it can still be very profitable, slow market conditions notwithstanding. Forum 66 in the same city is in a different market segment with very different dynamics. Nevertheless, management is confident that given our persistent efforts and luxury market recovery, rental results will be equally pleasing.

One other factor will help Forum 66 in Shenyang: we have signed on the world-renowned Conrad Hotel to transform the top 19 floors of the existing office tower into a 5-star hotel with 315 keys. It is expected to open in 2019.

Mainland China accounted for 52% of all rents received; Hong Kong was 48%. In terms of operating profit, the split was 44% and 56% respectively.

Six months ago I sounded a word of caution on our Hong Kong rental portfolio. The second half of the year was indeed less pleasing than the first. Retail sales stagnated; rental revenue for the full year only rose 5% as opposed to 7% for the first six months. I explained the causes when making the prediction last July, and will not belabor the point.

So far our retail rents have held up well, growing at 9% for the year. Offices, however, only advanced 2% and our residential and serviced apartments retreated 8%. Operating profit for malls, offices and serviced apartments were respectively up 11%, up 3%, and down 12%.

PROSPECTS

Latest official statistics show that the Chinese economy is relatively healthy. While continuing to slow which was predicted by all, the absolute growth rate by any standard is still impressive. After all, the base is no longer small at about US$11 trillion, which is far and away the second largest economy in the world. A diminishing speed of growth is to be expected as the economy becomes more sophisticated and akin to those of advanced nations. Nevertheless, at the expected GDP growth rate of 6.7%, the newly added economic quantum is bigger than the entire economy of Switzerland. Or if you will, at this rate China will in two years “create” an economy bigger than that of Spain, or in four years, “produce” a Great Britain.

At this time of global economic slowdown, China still needs fixed asset investments to keep the economy going. Last year, infrastructure projects alone increased by 17.4%. For the longer term, however, the more sustainable source of growth must be from private consumption.

Retail sales last year advanced by about 10% to almost US$5 trillion. In total size, this is comparable to that of the United States. Since China has over four times the population, each Chinese consumer on average only spends 20% to 25% of what an American consumer spends. Recognizing, however, that the wealth differential between city dwellers and rural folk in China is still huge, an average Chinese living in major cities perhaps buys as much as 40% of what a typical American does.

Look at it another way: whereas some 68% of the U.S. economy is in private consumption, the number for China is more like 37%. The room for more retail spending in China is obviously humongous. If China, over the next 10 to 20 years, eliminates half of that differential vis-à-vis the U.S., this factor alone will increase personal spending by over 40%. But even without such a "catch up", growing at today's rate of 9% to 10% per annum will be a scene to behold. Once again, this is why I believe that we are in an excellent business.

Some people worry about the impact of e-commerce. In previous years I have written much on this subject. Indeed, online sales have been growing by leaps and bounds in China. Last year it rose 26.2% and now it accounts for over 15% of total retail sales in the country. This is a mind-boggling number which equates to some US$750 billion. However, there must be an equilibrium ratio for each market at which online versus offline sales will more or less settle. For example, due partly to inadequate distribution networks, online sales in rural areas and in third- and fourth-tier cities take up a much higher percentage of total retail sales. As such, the ratio will differ for different types of cities.

Moreover, the share of personal services in the total mix of retail spending is still very low in China compared to advanced economies. This percentage can only grow. Many of these services cannot be transacted online. Consider dental and many other medical-related services, or wedding feasts, tourism, and participative sports. The list is virtually endless.

Then there is the phenomenon of many companies previously selling products exclusively online but now setting up physical stores. The famous Chinese handset manufacturer Xiaomi is a case in point. Last year its president told me that they have plans to open many physical shops. One result: there is now a Xiaomi store in Riverside 66 in Tianjin, just as there is an Apple store in the same mall. In fact, Apple now has a presence in four of our six facilities outside of Shanghai. As long as our mall is among the best in a city, such brands will sooner or later come our way. This is certainly our case everywhere.

Apple Store unveiled at Riverside 66 in March 2016

Looking at the year ahead of us, it is doubtful if market conditions will improve significantly. There are positive factors as well as negative ones. As discussed above, there is the possibility that the Chinese economy may have reached a new normal. To put it another way, perhaps it has fallen to a level which will be sustainable in the coming few years. In the absence of game-changing events, it may not break out of a GDP growth of, say, between 6% to 7%. The consumption part of the economic pie will grow at a few points above that and will therefore play an increasingly significant role. This is good for us.

On the other side of the ledger is that 2017 is the last year of the 5-year term of the present government. A new team will come in where four or five of the present seven-member Standing Committee of the Politburo will likely retire. Only the present president and premier are of an age that ensures their eligibility to remain. Uncertainties arising herefrom may slow down government decision making and hence economic activity.

Looking beyond China's borders, uncertainties are even greater, perhaps much greater. Six months ago I wrote about Brexit; now the path to disengagement and what Europe will look like afterwards are no clearer. This year we will also see elections in several major European countries like Germany and France.

Then, the fact that Donald Trump is the 45th president of the United States creates considerable uncertainty for the world. The country has never seen such a controversial and divisive figure in the White House. There was hardly ever a Commander-in-chief with less experience in any branch of government or even public service. Could any former U.S. president have a more antagonistic personality and management style? What mistakes will he make? Will he be able to remain long in the job? How will major governments around the world react to his policies or to his tweets?

There are simply too many unanswered or unanswerable questions. It is difficult to foresee a scenario where Mr. Trump would not seriously disrupt the status quo, including that of China-U.S. relations. As explained earlier, although I am not overly concerned about this relationship in the medium term, the coming year will be full of potential troubles. The world will be happy if we can get through 2017 without any major, globally significant problem.

There are also challenges within our Company that will make this year difficult. Here are two which are unique to this time.

On the Mainland, the refurbishment of Grand Gateway 66 in Shanghai will begin just as we are finishing up the same at Plaza 66. Considerable space will be taken off the market which

The retail sales performance of Plaza 66 stays strong will hurt rental income. In the case of Plaza 66, fortunately, our strong performance relating to luxury brands has partially shielded us from the effects of the renovation. In the coming case of Grand Gateway 66, which does not have the same share in the luxury market, the effect may be greater. The fact that almost 30% of total space – as opposed to 13% at Plaza 66 last year – will be temporarily taken out of commission does not help. But for the long-term health of these two important properties, we have no choice but to proceed. The short-term pain should bring us many years of continued outperformance vis-à-vis the market. Our timing was also propitious to do upgrade at a market lull so as to minimize rental loss.

The other concern is that the Hong Kong rental market is not expected to pick up this year. Benefits of the recent Asset Enhancement Initiatives have come through well in the past two to three years. Particularly in retail space, rental increase has been strong. However, this has created a new baseline which is much higher than before. Growth rates of around 10% per annum will be hard to sustain. Low- to mid-single-digit rises may be the new normal until something major happens, and what that might be is difficult to foresee.

For Mainland cities outside of Shanghai, I expect continued improvement, although the process may be slow and circuitous. In the longer term, however, there is no reason why we should not be very successful. The properties we have built are of world-class quality and are all well-located. Once we resolve the initial bugs and market conditions begin to recover, the potential of these well-built complexes will be realized.

On a closing note, I am happy to report that Mr. Adriel Chan has joined the main Board as an Executive Director. Concurrently he has also begun to serve on the Board of our majority shareholder, Hang Lung Group. After several years working in Shanghai for the world-renowned accounting firm and our own auditor KPMG, as well as for the international banking group HSBC, he joined Hang Lung in 2010 in the same city. In 2012 he relocated to our headquarters in Hong Kong. With an education background in international relations and an EMBA, he has experience in most of the key departments in the Company. Sensible, possessing sound business judgment and excellent interpersonal skills, I fully expect Mr. Chan to contribute greatly to the continued success of the Company in the decades to come.

Ronnie C. Chan
Chairman
Hong Kong, January 26, 2017