RESULTS AND DIVIDEND

For the six months ended June 30, 2023, overall revenue fell marginally by 1% to HK$5,525 million. The improved leasing performance was affected by the depreciation of the Renminbi (RMB) and lower contributions from property sales. Rental revenue increased by 4% to HK$5,523 million.

When excluding all the effects of property revaluation, underlying net profit attributable to shareholders decreased by 3% to HK$1,560 million. Underlying earnings per share decreased similarly to HK$1.15.

Net profit attributable to shareholders, after including all the effects of property revaluation, increased by 17% to HK$1,682 million. Earnings per share rose correspondingly to HK$1.24.

The Board has declared an interim dividend of HK21 cents per share, payable on September 29, 2023, to shareholders of record on September 15, 2023.

BUSINESS REVIEW

In 1960, my late father, Mr. T.H. Chan, founded Hang Lung. Its subsequent progress mimicked the overall growth of the city, the region, and indeed the world. The economic boom in much of East Asia, including Japan and the Four Asian Tigers of South Korea, Taiwan, Singapore, and Hong Kong, was nothing short of spectacular. Within Hong Kong, history showed that real estate was a particularly lucrative industry. It was truly an opportunity of a lifetime.

There were multiple factors that contributed to this phenomenon. The post-World War II (WWII) era saw the fast rise of economies in much of the then so-called free world. Hong Kong was part of it and benefited greatly. Immigrants are known to be hard-working and entrepreneurial, and our city has plenty of them. Given a globalizing world and a somewhat laissez-faire local government, Hong Kong and real estate thrived.

In the first 30-some years after WWII, China was closed to much of the world. Hong Kong became one of the very few windows in and out of the country. We thrived as a result. After China opened up right before the 1980's, our city's role expanded, and more economic opportunities came our way. We must have been among the top beneficiaries of the country's Reform and Opening-Up Policy. Together with the high land price policies of the then colonial master that limited land supply, helped by Beijing during the Sino-British negotiations on Hong Kong's 1997 return to her motherland, our real estate prices became one of the most expensive in the world. The lack of quantity, in terms of total number of residential units and commercial space square footage, was more than offset by the super high unit prices. Some developers were able to take better advantage of the opportunities than others, but even the also-rans did well.

Hang Lung was certainly a beneficiary. While 30 or so years ago, we began to turn our attention to top-end commercial properties on the Mainland, it was the financial resources, industry expertise, and reputation garnered in Hong Kong that laid the foundation for our subsequent successes up north. Although the property market of our home city is no longer where our future lies, our headquarters is still here, and about 30% of our recurrent rental income is derived from this market. None of that should cloud our assessment of this city.

For several reasons, I believe that Hong Kong is undergoing a systemic change. For decades, we were an integral part of an increasingly globalized world whose economy grew almost incessantly. Amid America's fight with China, this city has become the first collateral damage. The global economy will become bifurcated to a significant extent. The global market that we once served so well to everyone's benefit has shrunk and will continue to shrink. Commercial activities are already slowing. The flow of sensitive or strategic products, however defined, no longer passes through us. People flow and capital flow are clearly being curbed by the U.S. All this can only worsen in the coming months and years.

This does not mean that Hong Kong's economy will disappear altogether, but it does mean the city must adjust and adapt quickly to stay relevant. The process is bound to be challenging and painful. Failure to recognize or deny the need for change will be detrimental.

There are further reasons why the real estate sector in our city would weaken. The riots of 2019 have chased away many locals as well as expatriates. More left because of the way we handled the three-year pandemic. All that means is diminished demand. Ironically, those who opposed the government, which led to the violence of 2019, kept property prices high. By indiscriminately fighting anything the government did after the city's return to her motherland, such as selling more land, they prolonged the decade-long bull market, which kept residential prices extremely high. In so doing, these opposers shoveled money into the pockets of local developers, whom they also disliked.

Now that the opposers are no longer making waves, the government can finally release more land into the market. Occurring at a time when the economy is weakened for the reasons given above, both land and residential prices are coming under pressure. As the supply of land increases, housing prices will moderate. In fact, this has already begun. I expect it to be a systemic and not just a cyclical change. In the long run, this will make Hong Kong more competitive. The timing, however, is challenging. The sustaining fall in prices may add frost to our economic chill.

For decades in Hong Kong, there have been two truisms that are historically infallible but no longer. The first is that when the Mainland is in trouble, we benefit, and when it thrives, we thrive even more. Given the U.S. is now denying the existence of the One-Country-Two-Systems construct, this city will suffer when the Mainland suffers. The second is that you can never go wrong buying real estate; time will always bail you out. Hong Kong people must change their mindset when the external environment changes.

In this, we can count ourselves fortunate. Having diversified into Mainland commercial properties about 30 years ago, we are not that affected by these Hong Kong realities. As I have explained in previous editions of this *Letter to Shareholders*, I believe that, present weaknesses notwithstanding, the Mainland economy should perform acceptably in the coming years as long as society remains relatively peaceful.

Over the past four decades since the Chinese economy opened up, enormous wealth has been accumulated in society, along with much expertise and experience in both the domestic and international markets. These cover much of the value chain upstream and downstream with a sufficient breadth of industries, all supported by reasonably good tertiary education institutions. As such, the economy should be able to sustain itself for a very long time.

That said, like any other economic system, there will be cycles, just as human nature has fluctuations. Each time the causes may differ somewhat, but ups and downs are unavoidable. As I explained six months ago in my *Letter to Shareholders* of Hang Lung Properties, our major subsidiary, China is currently in a rather difficult position. This is a combination of the cost of fighting COVID-19 the way China did, the reining in of Internet platform companies and private education institutions, the bursting of the residential bubble, and the consequences of a full-scale American attack just short of kinetic conflicts. The presence of these four factors at the same time is what makes the current economic challenge particularly daunting.

All these factors are, for various reasons, new to Beijing leaders. Together, the first three affected the desire of individual citizens to spend, and businesses to invest. It will take time to remedy the situation. But perhaps the most concerning is the fourth and last factor, for it is at its root a political issue. One misstep may seriously affect the country's future for decades to come. Frankly, there is limited room to maneuver, so extreme caution must be exercised. For many decades, the truly perilous challenges were often domestic in nature. This time, they are domestic and international all at once.

Given this background, uncertainties in both the overall economy and our industry are exceptionally high. There is no excuse to ignore the many risks, almost all of which are beyond our control. As such, this is not a time for expansive business adventurism. Rather, it is a time for great caution.

All three domestic factors mentioned above took place during the past three years of COVID-19. This makes our luxury retail industry and our performance all the more intriguing. While general consumption was weak, high-end spending never stopped growing. The results of top European fashion houses bear out this point, which is in line with our own experiences. In fact, taking a longer-term view reveals something rather amazing.

We collected our first rental dollar from the Mainland during the last three days of 1999 with the inauguration of our mall at Grand Gateway 66 in Shanghai. From that time until now, in local currency terms, we have never had a down year with our commercial property rental business in mainland China. Luxury retail underwent a six- to seven-year bear market between late 2011 and 2018. In fact, in July 2011, I already wrote about the chill in the market that was felt at our two Shanghai malls. At that time, we only had one property elsewhere on the Mainland — the sub-luxury shopping center Palace 66 in Shenyang which opened in 2010. (Parc 66 in Jinan started doing business in August 2011.) Even during the three pandemic years, we managed to grow our rents consistently year after year. Between 2000 (when we had full-year results on our first property) and 2022, we increased our rental revenue by more than 42 times. That is a compound annual growth rate of 18%.

It would not be easy indeed to find another business where revenue can increase continually for 23 years. Granted, we did have new properties added to the portfolio from time to time, but the organic growth of our projects was rather consistent.

For example, our two malls in Shanghai have only experienced down years attributable to two incidents in the 23 years for Grand Gateway 66 and the 22 years for Plaza 66 (which opened in 2001). Because the entire city was shut down for two months last year with periodic business suspensions for the rest of the year, rents received could not have risen compared to 2021. The only other time the two shopping centers had a fall in revenue was during the initial stages of their respective Asset Enhancement Initiative (AEI) when we voluntarily closed parts of the properties. This history strongly indicates that, left to market forces alone, the two properties are capable of sustaining persistent rental rises.

Rents collected from Grand Gateway 66 in Shanghai increased 9.4 times from its opening until 2021 (thus excluding the abnormal 2022). This translated to a compound annual growth rate of more than 11%. In the case of Plaza 66 in Shanghai, counting from the full-year results of 2002 to 2021, revenue rose over 20 times, giving a compound annual growth rate of over 17%.

Luxury malls outside Shanghai also performed well. Center 66 in Wuxi opened in 2013 during the long bear market, so we were forced to take in only sub-luxury brands as tenants. Once some normalcy returned, we immediately transformed it into a top-end property with high-fashion stores. In the five years since then, rents rose 1.8 times, representing a compound annual growth rate of about 23%.

Olympia 66 in Dalian, inaugurated in 2016, followed a similar trajectory as Center 66 in Wuxi. Its upward migration from a sub-luxury mall began around 2019. Its only down year was in 2020 at the onset of the pandemic. Over the six years of full-year operations, revenue rose 1.6 times, yielding a compound annual growth rate of 17%.

What must be said here is that, for both Center 66 in Wuxi and Olympia 66 in Dalian, the rental rise is still very fast. In other words, these properties are still in their maturation stages. Barring external disasters, I expect them to continue generating considerable growth rates for several more years.

Spring City 66 in Kunming and Heartland 66 in Wuhan are still very young, having opened for business in 2019 and 2021, respectively. Both have seen rising rents, and this momentum should continue.

As I have explained in previous years, sub-luxury malls are a less desirable asset class to own and manage. The competition dynamics are very different from their fancier cousins. In an economy where e-commerce is super strong and prevailing, such businesses are easily replaced by online shopping.

Office rental is another area where we excel. We collected our first office rent dollar from the Mainland in 2001. It was the first tower at Plaza 66 in Shanghai. In the subsequent 21 years, only twice have we seen a dip in rents — in 2010 and 2017. We now have eight skyscrapers — two each at Plaza 66 in Shanghai and Center 66 in Wuxi, and one each at Grand Gateway 66 in Shanghai, Forum 66 in Shenyang, Spring City 66 in Kunming, and Heartland 66 in Wuhan. Together, these account for 21% of our total Mainland rental revenue. In Shanghai, the fall in rents is mostly related to AEIs. For the entire portfolio, whether the annual drop in rents are AEI-related or not, the magnitude is mild, usually less than 4%.

Given this history, it is perhaps not surprising that we did well in the six months under review. In the first few months of the year, everyone (including ourselves) was expecting a quick market recovery. That happened but did not last. Momentum began to slow down, at the latest in mid-May. Nevertheless, compared to the year before, tenant sales remain strong. The same is true for our revenue growth. It is quite possible that these conditions will hold for the rest of the year, in which case our full-year results will continue the tradition of the previous 23 years — an uninterrupted rise in Mainland rental revenue in local currency terms.

In RMB terms, Mainland rental revenue of the past six months increased by 12%. Due to a 6.3% currency devaluation vis-à-vis our home currency, the Hong Kong Dollar, we only reported a 5% rise. What is encouraging is the improvements in rental margins. Our retail portfolio has advanced by three points to 72% — by two points to 76% for our luxury malls, and by five points to 44% for the sub-luxury kind. The rental margin for our Mainland offices remained unchanged at 69%. In comparison, our Hong Kong retail space saw a rise of two points to 84%, while offices stayed the same at 83%.

Occupancy remained basically stable, while the average unit rents and rental reversions rose across all properties except a few sub-luxury ones. Rental reversions at our luxury malls outside Shanghai were particularly strong. The fact that turnover rents for such facilities, as a percentage of total rents, remains at a historically high level tends to indicate that rent rises at the next lease renewal seems assured. This is confirmed by the fact that, compared to the past, occupancy costs are at a relatively low level.

In the past six months, Hong Kong retail sales continued to rise, and to a lesser extent, our rental revenue as well. Our office rents also advanced a bit but are rather anemic.

It is interesting to compare the performance of various product types to that of the pre-COVID-19 days, namely, the first six months of 2019.

For our luxury malls, tenant sales have in all cases but one more than doubled. Two properties recorded 2.5 to 3 times more business transacted. Two other facilities saw sales more than doubled. As a result, we collected much more rent. The story is very different for our sub-luxury shopping centers. Although tenant sales have recovered, rental revenue is only about 90% of the pre-pandemic days. Hong Kong retail exhibited a similar pattern but is even slightly weaker.

In terms of leasing revenue, the Mainland now accounts for 68% of the total, and Hong Kong is 32%. The former contributed 65% to the operating profit, while Hong Kong produced 35%. Compared to years past, the operational efficiency of Mainland properties is catching up.

Unlike the previous year, we had a much lower contribution from property sales in the first half of this year. As a result, the underlying net profit attributable to shareholders was down by 3%. Looking at property leasing only, the number went up by 2% to HK$1,571 million. After a minor net revaluation gain this year versus a moderate net revaluation loss in 2022, the net profit attributable to shareholders rose by 17% to HK$1,682 million. The net leasing profit attributable to shareholders rose by 23% to HK$1,693 million.

PROSPECTS

There is no denying that the Mainland economy is undergoing serious challenges. The combination of the four factors mentioned in the last section and occurring at the same time makes them particularly difficult to address. Since China's opening-up some 45 years ago, there have been many extremely tough situations. From 1989 to 1991, the entire opening-up was almost scuttled. The cause was domestic politics and ideology that led to economic malaise. This time, it is primarily economic but exacerbated by international politics. The latter is a new phenomenon that we have not seen before — an external political attack that has severe economic consequences.

Without the foreign element, the purely domestic problems would take time to resolve, if they can be resolved. Now, with the added exogenous factor, economic recovery would be even more challenging. The orientation of economic development will have to change. Recognizing this a few years ago, Beijing has, for example, redirected the formerly externally driven economy to one emphasizing domestic circulation, such as household consumption.

Hong Kong has its own challenges, as I have written previously. Our economy will not disappear, but it will suffer if the Mainland economy suffers — and suffer it will. The real estate sector in particular is undergoing structural changes. It is now a different game. Land supply will be increased and the days of exorbitant profits will be gone. The only bright spot may be the high-end residential market, for many affluent Chinese north of the border desire to move here.

We have not been active in the mass residential market for over 20 years. Many money-making opportunities were perhaps lost, but we can now count ourselves fortunate. At least we are not stuck with highly priced land and buildings.

While I was giving a speech on the Mainland in 2021, someone from the audience asked: when would Hang Lung take advantage of the bear market to buy land, since we were known to do exactly that in previous decades? My answer: today's bear is a different kind of bear! This is not a cyclical downturn but a structural or systemic change. Now is the time to preserve cash, not expand the business.

Are there some bright spots in this otherwise grim picture? One is the luxury sector on the Mainland. Sales have been strong, although the momentum has weakened of late. At the same time, overseas sales by Chinese shoppers have increased, as noticed by top fashion houses. Some of the latter have publicly announced that they are taking measures to equalize prices. For example, the weak Japanese Yen has attracted many Chinese shoppers to Japan, a phenomenon that is now being addressed. All that means that total purchasing power from the Mainland is still strong. It is just a matter of where these shoppers choose to spend their money. Any repatriation of sales should be beneficial to our business.

Can such luxury consumption growth continue? Yes, as long as China's overall economy remains steady. I suspect it will, but only time can tell. Looking at 5 to 10 years down the road, the country should be able to transform her economy in accordance with the new realities. In that case, her luxury retail should remain sustainable.

Compare the wealthy Chinese to those in Japan, South Korea, Hong Kong, Singapore, and Thailand. About 40 to 60 years after their respective economies took off, one still finds these citizens buying high-end fashion brands at home and abroad. Besides Putonghua being spoken in such stores in Paris, London, Milan, or New York City, Japanese, Korean, and Thai are regularly heard. Our Plaza 66 in Shanghai may well be the first luxury mall in mainland China, and it is merely 22 years old. Top fashion houses will be selling to desirous and wealthy Chinese customers for many decades ahead.

Besides Asia's propensity for branded products, China also has a huge population. As long as her economy is relatively healthy, there will always be new generations of younger shoppers in the coming decades. The Chinese customers of luxury goods are probably among the youngest; they are certainly much younger than those in the U.S. and Europe. In China, they start to buy in their late 20's and are expected to continue for, say, four to five decades. As such, the total number of customers accumulates over time. It means that, at present, this sector is only tapping into a small number of potential purchasers.

Although unlikely this year, there will come a time when we will be tempted to buy land again. It is hard to predict the timing, but my team never stops looking. Hopefully, we will not miss the next bargain. After all, we have a fairly good track record of buying right. Needless to say, for us, buying right is never just buying on the cheap because of timing. It is to successfully acquire plots of land that are well located and with reasonable developmental briefs by the local government.

For now, China will have to first address her various economic challenges. Together with serious conflicts in China-U.S. relations, exports can only be weak. Having printed a lot of money in recent years also makes public investments less likely to be a growth engine. Such investments work better when the economic pie is small. Now, as the world's second largest economy, it will take a lot more input to produce the same percentage output. If it is any encouragement at all, there are few places around the globe that have healthy growth.

That leaves household consumption as the only reliable source of impetus. But at present, consumer confidence is weak, and it will take time to recover. For now, luxury spending is one of the few areas that are still growing. Because of troubled geopolitics, Chinese people are traveling less overseas, especially to the West. This will affect the global tourism scene. For the same reason, domestic tourism is booming — all tourist spots are packed, and hotels are doing well. But even then, per capita spending is not on par with pre-pandemic levels. There are exceptions, such as our Conrad Hotel in Shenyang, which is doing superbly. However, it may not be representative of the overall industry.

Another issue of the economy is the lack of business confidence. Unless they have more clarity over where government policies are heading, it is unlikely that businesspeople will reinvest. For the most part, they are a cautious group, especially now.

Whatever the case, in the long run, China will have to rely much more heavily on personal consumption as an economic driver. In developed countries in the West or the East, its share in GDP is usually between 50% and 70%. For example, the U.S. is at 68% and most Western European countries have a percentage figure in the 50s. India, a huge developing economy like China, stands at 63%. Yet this number for China is about 38%. There is much room for growth.

Hong Kong's difficulties pale in comparison to those of mainland China. This city is slowly recovering from the pandemic. A prompt and lively rise is not expected, but hopefully, it will be steady. Retail sales are already improving somewhat, and a slow rise in shop rents can be expected.

Office rents reflect overall commercial activity, especially those of the financial sector and related professional services. Anticipating further attacks from the U.S. on those fields, recovery will be slow. The speed will be further impeded by the amount of imminent supply of Grade A office space in downtown areas in the coming few years. Secondary locations may fare less well in terms of occupancies and rent rises.

At issue is the lack of clarity on what may boost Hong Kong's economy. While tourism is improving, per capita spending remains wimpish. Given lackluster international trade, due to feeble economies overseas and fierce political currents, the logistics sectors will not be robust. Consequently, it is doubtful that personal consumption will be strong. Together with structural changes in the housing market mentioned earlier, it is now hard to be overly optimistic about the future.

Given such an economic outlook, it may surprise some that Hang Lung may yet have our best year ever in terms of reaching new heights for total rental revenue. The chances are fairly good. We performed well in the first half of the year and will likely continue to do fine in the second half, although the rate of growth has slowed. For 2024, however, I do not have much visibility. Hopefully, by the time I write to you again in late January next year, some clouds may have lifted.

Ronnie C. Chan
Chair
Hong Kong, July 31, 2023