# 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

For the year ended December 31, 2016, revenue leaped 43% to HK$13,648 million. Net profit attributable to shareholders increased 16% to HK$3,713 million. Earnings per share rose similarly to HK$2.73.

Excluding all the effects of property revaluation loss, the underlying net profit attributable to shareholders advanced 40% to HK$3,772 million. Underlying earnings per share increased likewise to HK$2.78.

The Board recommends a final dividend of HK61 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 would be HK80 cents.

## BUSINESS REVIEW

Any young person with an ambition to be successful in business should first ask himself or herself these two questions: where in this globalized world should I go, and to which line of business should I devote myself?

Imagine a young Chinese man in the post-World War II (WWII) period aspiring to amass a world-class fortune. Where was the best place to achieve this and in which industry? Fast-forward to today with the benefit of hindsight, the answer is rather obvious. Hong Kong must be one of the best cities, and real estate was among the best if not the best business.

It is instructive to ask a few more questions. The first is "Why Hong Kong and not elsewhere?" and the second is "Why real estate?" Let me start by addressing the first issue. For various reasons, certain countries are inappropriate for such a young person: lack of prospects for economic development, heightened local competition, visa problems, language and cultural barriers, and his own inadequate education, just to name a few. Those ethnic Chinese who succeeded in the U.S., Canada, Australia, Japan, Western Europe or Brazil are rare exceptions, but one could hardly compare their wealth to those in Hong Kong.

Outside of our home city, the bulk of those who became truly rich were mainly in Southeast Asia and Taiwan. However, each place had its own unique problems. In most ASEAN countries aside from Singapore, corruption was a serious issue. It was simply not worth acting against one's own conscience only to be tormented by sleepless nights. With the Chinese being an ethnic minority in many societies, anti-Chinese sentiments and even periodic uprisings were truly troubling.

Even if you had made it big as some did, weak societal institutions in those economies led to the destruction of several decades of accumulated wealth during the Asian Financial Crisis that began in 1997. Currency depreciation alone wiped out significant portions of it. Many of my business friends in Indonesia and Thailand, for example, found themselves left with only a fraction of their previous glory.

Singapore was a different story. While it did not have many of the problems of its neighbors mentioned above, the clean and competent government became so powerful that it left little room for big private enterprises to develop. Government-controlled businesses dominated the most lucrative sectors. As such it was much harder to accumulate wealth on a grand scale. For the society as a whole, this might not be a bad thing, but it would hardly be ideal for the young man with sizable ambitions as described above.

Personally I have considerable respect for Taiwan business leaders, especially those in technology-related manufacturing endeavors. To be successful, they had to keep abreast of the newest technology and possess excellent managerial skills. Just take a look at the bookstores in Taiwan's airports: there is an abundance of publications covering these topics. The same phenomenon is also observed nowadays in mainland Chinese airports, but not the one in Hong Kong!

However, Taiwan had serious difficulties of its own. Compared to Hong Kong or Singapore, it was far more corrupt, albeit in a rather subtle way. The grey economy, for example, was much larger as a percentage of the total economy. Equally troubling was the ubiquitous presence of local politicking over the past few decades which deeply affected commercial activities. The society was preoccupied by petty politics and so it became more divided. None of this was good for business. As a result, the economy has been stagnant for some time. The root cause was not economics but politics.

Fortunately, mainland China welcomes Taiwanese businessmen. Not far from Shanghai in the Suzhou region alone, it is said that there are well over one million Taiwanese people living and working there, mostly running their own businesses. To be sure, the Mainland has its own set of challenges, but at least unlike small Taiwan with a population of just over 23 million, the market is huge. In fact, if Taiwan were to play its political cards right vis-à-vis Beijing, the island could be much more thriving economically. But Taiwan is currently doing just the opposite and runs the risks of dying a not-too-slow economic death.

This brings me back to Hong Kong which has proven to be the best place for the ambitious young Chinese man after WWII to build a world-class fortune. Serious corruption subsided after the establishment of the Independent Commission Against Corruption (ICAC) in the early 1970's. (One should take note that ridding a society of corruption in general does not necessarily mean corruption has left the hearts of the players therein.) Thanks to the then colonial government, Hong Kong has one of the best social institutions in Asia, for example, its public administration, public finance, infrastructure, education and health care. Private property rights were respected and personal freedom, while not perfect, was very acceptable. There was no local politics to speak of, for the then British masters did not allow it.

Like many of our neighbors, post-WWII rebuilding presented all kinds of commercial opportunities. Moreover, Hong Kong had unique advantages which were related to politics. When mainland China was closed to the world after the Korean War, we benefited. Whenever China underwent periods of domestic political turmoil, which happened quite frequently from the 1950's through the 1980's, we gained economically because our Motherland needed us more then. Inbound immigration as a result of each political crisis saw an influx of both people and business opportunities. Likewise, when the Mainland opened up in earnest in the early 1980's, again Hong Kong was the first beneficiary. Certainly there are risks in doing business anywhere, but one could hardly script a more favorable scenario for the young man mentioned above!

As a result, fortunes of all sizes and in great numbers were created. Even the shocks in the 1980's and 1990's relating to the city's return to her Motherland did not seriously dampen the momentum. The only real setback was the devaluation of the currency in 1983.

Fortunately thereafter, it was pegged at HK$7.8 to the U.S. Dollar and has remained stable since. No wonder many Hong Kong people believe that ours is a particularly blessed city.

The next question is: what business should the young Chinese man from the Mainland engage in after WWII if not real estate? Trading could be an option, but earning very small margins on each transaction would not make it easy to accumulate a sizable fortune. Also the associated risk was not small. Only very few such operators made it really big.

Manufacturing could have been another good area, and this was the case throughout the 1950's, 1960's and 1970's. By the early 1980's, rising labor and land costs had rendered our city uncompetitive. For better or for worse, the economic opening of the Mainland beginning in 1979 gave manufacturers a new lease on life. Many of them moved the old machines to the Mainland with cheap land and factories and they continued to thrive for a while. But the lag in technology upgrades has prevented most of them from growing further, nor did they change their product lines to higher value items. As a result, most of our manufacturers have remained small and insignificant in the global scheme of things.

Like everywhere else, the service sector needs a big market to scale up. Until the 1990's when the Mainland economy opened in earnest, there was not the opportunity. Furthermore, branding is critical and very few of our businessmen did particularly well in this area.

Shipping was another good option at times but it was highly cyclical. It is also an industry that needs strong support from banks, which may not be readily available to most. At one point after WWII, some of the world's biggest ship owners came from our part of the world, including Hong Kong. The most successful ones eventually continued their wealth accumulation only after they got into the local real estate business.

Compared to other industries, ours has many attractions. Young Mainlanders coming to Hong Kong 50 to 60 years ago were probably only moderately educated. Real estate is not rocket science and any hard-working individual with a reasonable intellect can easily handle it. Lax regulations before the 1990's made entry to the industry relatively easy. The unit price is high but mortgages were usually available. The latter meant that one could do a lot more business than one's capital would otherwise allow. The former indicates that slight movements in price can make or lose a lot of money. The many who survived usually made a lot of money.

To be sure, real estate is a long-dated asset class and construction takes years to complete. This makes cyclicality unavoidable. But as long as one is not overly aggressive in one's finances, or is apt in navigating cycles by deleveraging ahead of market troughs, one will not only survive the cycles but will thrive because of them.

As I explained years ago, perpetual shortages of land in Hong Kong gave price movement a unique characteristic. Namely, each peak is higher than the last one, and each trough is usually higher than two peaks ago. So even if one buys at the top, as long as one makes it through the ensuing bottom, he or she will still make a lot of money. The same cannot be said for mature markets like the West.

History shows that many Hong Kong young people amassed world-class fortunes by doing exactly this. Hang Lung is one such business which has been relatively successful in this game. Once sufficient capital and experience are accumulated, a steady future should be assured. Very few big names failed even during the severe market turbulence of the 1980's relating to the Sino-British negotiation on the return of Hong Kong to her Motherland. Hang Lung went through a rough patch at that time, but like many others, we survived. In fact, we all went on to benefit from the ensuing long bull market. Even the Asian Financial Crisis of 1997-2002 and the Global Financial Crisis of 2008-2009 did not dislodge any of these bigger players. Instead, some of us took advantage of the down market and created serious shareholder value. By this time, this young man should be very rich.

Huge wealth notwithstanding, by now these companies are about 50 to 60 years old. An urgent issue facing them is management succession. Many of these founders are now gone or are very elderly. Some even have second generation leaders near retirement. So far most of them seem to have had a smooth transition. Fighting over family inheritance at such a time is perhaps inevitable in some cases but as long as company performance is not seriously affected, the public shareholders need not be overly concerned.

Instead, the competence of the next generation is the issue to watch. It would not be easy for the children of the founder to match their father's brilliance, and to have the third generation perform equally well is even more challenging. Probability seems to work against such family-managed companies, public or private.

Another troubling issue is that the external environment has changed a lot over the decades. The world goes in cycles; few industries remain "hot" indefinitely. Is Hong Kong real estate still the best industry to be in now and for the coming years? Have policy changes, which are inevitable, rendered the sector less attractive? Even if it is still attractive, has the competitive landscape changed so much such that the winners of the past will now have a much smaller chance of success? None of us should take answers to these questions for granted.

Let us assume for a moment that Hong Kong real estate is still a good business to be in. One should nevertheless recognize that there are now many new market participants who may disrupt the industry.

To be sure, having new entrants is nothing new, and there will always be changes in the dominant players. Until the late 1970's, for example, British firms dominated Hong Kong's commercial landscape. Thereafter, the colonial master, out of enlightened self-interest, decided that Chinese businessmen should be allowed to play in the big league. They began to allow former "second-class citizens" to buy up major British-run enterprises.

From then on, there were two main forces in the local business scene: a few remaining large British concerns and a rising cadre of big Hong Kong Chinese enterprises. The latter group was almost exclusively rooted in real estate, and the high land price policy of the then government, which was partially politically motivated, made them very wealthy indeed. In fact, some of these Chinese-run companies grew so much that they surpassed in size of all but the largest British entities.

Under the flawlessly executed policy of the colonial government, and with the help of some luck, an amazing run-up in real estate prices occurred right before 1997. One of the highest transacted unit prices took place on June 30 that year, the last day of the British rule.

One wondered how prices could be sustained thereafter under Chinese rule. Well, they did, the onslaught of the Asian Financial Crisis on July 2, 1997, notwithstanding. Prices rose until the end of that year by which time we sold a considerable number of commercial buildings at a great profit. Hong Kong went through the greatest political change and yet that young man continued to thrive.

Prices peaked around December 1997 and January 1998 and then started to fall under the weight of the Asian Financial Crisis. When it was about to end in 2002, Hong Kong, like much of East Asia, was hit by SARS. One would expect the young man's fortune to end, but it did not. In fact, the greatest price hike was just beginning.

Thanks to the misguided policies of the then HKSAR government, prices resumed their climb in 2004. With the exception of the brief hiatus during the Global Financial Crisis of 2008, shortage of land supply had kept prices up. They peaked on September 13, 2015, the day Hang Lung celebrated its 55th Anniversary. 2016 saw a correction which no doubt was the result of the present government's efforts to supply land.

But as I had previously explained, what the present government is confronted with is the lack of available buildable land to sell. The previous administration did nothing to prepare a land bank, so residential prices went up again in the fourth quarter of 2016 and soon reached new heights. This was when we began to part with our remaining inventory. It is likely that, with the exception of the luxury semi-detached houses on Blue Pool Road, we may sell out all completed apartments this year.

Since the beginning of the rise of Chinese family-run firms in the late 1970's and early 1980's, over 35 years have passed. Both economically and politically, much has happened locally and beyond. The most significant development for Hong Kong and even to the world was the rise of mainland China. Its effects could be felt everywhere, for decades of double-digit economic growth for over one billion people could not but affect every corner of the earth. Could Hong Kong real estate be exempted from this, for better or for worse?

There is no reason why Hong Kong cannot continue to thrive. Sadly, like Taiwan, politics has become poisonous after 1997. We have been seriously paring down our own economic growth potential, and may continue to do so. But even then, we should still perform acceptably compared to much of the rest of the world. After all, as long as the Mainland, with a population of 1.38 billion, remains socially stable and economically healthy, what is Hong Kong with 7.3 million people! We are still useful to our Motherland, although our value has greatly diminished since 1997. It is true that 20 years ago some 20% of the Mainland economy was one way or another related to Hong Kong, but today the number is less than 2%. That said, from Beijing's perspective, it is much better to have the help of Hong Kong, which is administered under the "One Country Two Systems" construct. So for practical and other reasons, Hong Kong will be well taken care of.

Nevertheless, it behooves our citizens to sober-mindedly recognize the reality: as a small territory and an entrepôt, our city's economic raison d'être or, if one wants to be more pragmatic, our utility is always to serve our bigger neighbors. It was once the U.S. and Europe, but now we are almost exclusively beholden to the Mainland. Size, geography and history dictate that.

Just as Hong Kong's overall situation has fundamentally changed, there are also two potential game changers in our industry. The first relates to land supply and the second to the new players from the Mainland. I have touched upon them earlier but will here expound further.

For right or wrong reasons, Hong Kong has for decades suffered from a serious shortage of land supply. For the first time, the present HKSAR administration is doing something to change this. While it takes time to right the wrongs since buildable land takes time to prepare, the policy reversal is unmistakable. Unless subsequent administrations unnecessarily alter that, one day, sooner rather than later, a supply-demand equilibrium will be achieved. Thereafter, Economics 101 tells us that housing prices will soon moderate. This will become an important legacy of the present administration.

Like most other businesses, real estate should yield reasonable but not exorbitant profit. Due to reasons explained above, our industry has for decades been an exception. In the long run, it must and will revert to the mean. Favorable conditions cannot last forever. The heyday of Hong Kong real estate will soon return to normal. The past 30 to 40 years were frankly an anomaly.

That said, there should still be reasonably good opportunities. By nature our industry is a cyclical one and those who time the cycles well will still make good profit. Moreover, Hong Kong's return to the Motherland brings unexpected dividends. There are now so many wealthy – indeed many super wealthy – Mainlanders who want to buy residential as well as commercial properties in our city. They will keep our sector's spirits high. Periodic changes in Hong Kong and Mainland policies to encourage or limit such purchases seem inevitable, but it is still good to know that there are perhaps hundreds of thousands, if not more, of our compatriots just north of the border who would like to own our real estate.

One more historical note: before 1997, successful businessmen were admired by the Hong Kong society. Like in many other places around the world, there is now an increasing anti-rich sentiment. Whatever the cause is in a sense irrelevant, for societal affairs always move in cycles. Human nature dictates that. But how should we view these property moguls?

First, the market environment in which they accumulated their initial wealth was a very open one. Anyone could have joined the game. Almost all of the successful company founders began as poor men. It was through hard work and wits that they climbed the economic ladder. As such, the first generation developers are still worthy of our respect. As a famous local stock market investor cum journalist once said, his greatest regret in life was not having entered the property business wholeheartedly. Nothing prevented him; it was his own decision. He too accumulated some wealth, but only at a fraction of his real estate friends'.

Some may accuse those friends of corruption and undue influence on the government. There was considerable truth to this, but I can hardly think of one emerging economy anywhere in the world where that was not the case. At a certain stage of economic development, corruption is inevitable. As explained earlier, Hong Kong is fortunate to have the ICAC since the early 1970's, which has to a good extent cleaned up the problem. Given human nature, total eradication is impossible but compared to almost everywhere else in the world, Hong Kong is among the least corrupt.

Here I may add that the situation has further improved since 1997. A case in point is the recent high-profile imprisonment of some of the most senior government officials as well as top businessmen. It was almost unimaginable before then.

The proper way to assess these real estate titans is in my opinion twofold. The first is whether they have forsaken their former corrupt ways and practices. Many have, but not everyone. This is inevitable. In this regard, I am proud to be the chairman of your Company, Hang Lung. I can safely say that while the Company may not be the most successful in dollar terms, we are from our early days one of the most ethical.

The other way to evaluate them is on how much they give back to society. Monetary donation is necessary but not sufficient. The rich must behave in a way that engenders respect from society. Words and actions are important but good deeds must come from the heart. As Chairman Mao once said, the eyes of the citizens are sharp. They will not be fooled – at least not for long.

The other potential game changer relates to the competitive landscape. Because of extremely high unit price – in fact among the highest in the world – it is difficult and indeed inadvisable for outsiders to enter our real estate market. Over the decades, many foreigners have tried but few seriously succeeded. Major players today are basically the same group 30 to 40 years ago. However, there may be new players on the horizon.

Over the past 30 years, many state-owned enterprises have become behemoths by world standards. Some of them have simply outgrown their own industry or their home market China. While a few are already significant in the world, such as banks, more are aspiring to spread their wings.

The first place many of them would go to is Hong Kong. After all, it is part of the same country yet different, thanks to the "One Country Two Systems" construct. And since some of them are already in the real estate business on the Mainland, and given the open nature of the Hong Kong market, they can easily become our competitors. So besides some Mainland developers who are entering our game, we are also seeing many whose main business is something else. Before they arrive at our doors, we have no idea who they are or if they have an interest in our market.

As I have in years past written extensively, many Mainland developers have grown extremely large in recent decades. The size of their debt is often matched by that of their market cap. Now in Hong Kong, they are confronted with a new environment which, while very small compared to their home market in terms of number of units – several of which build multiples of the total annual supply of new apartments in Hong Kong – has one of the world's highest unit prices. Having a big business back home may have caused them to think that our "small" market is easy or otherwise insignificant to them. The high prices they are willing to pay for land are astonishing.

They reminded me of the prices local developers paid in the irrationally exuberant days of 1994-1997, right before the crash brought on by the Asian Financial Crisis. Hang Lung stopped buying land in early 1994 and was ridiculed while other local players continued to drive up prices. They all learned a painful lesson when the market fell precipitously in December 1997 and January 1998. This time around, all the locals stayed away from the market. We all simply watch the Mainlanders play. They probably think we are foolish just like how others saw Hang Lung before 1997. Only time will tell.

The bottom line does not seem to be the main consideration of these newcomers. Perhaps they have other reasons to participate in our market. One less sinister view is that today money is cheap, but even so, the land price they are willing to pay seems to go beyond the cost of money. Even if they do not need to pay interest, it is difficult to imagine how they can turn a profit. They must know something that we do not.

One possibility is that they bring with them a large group of potential Mainland purchasers of the completed apartments. This tactic has been used by Chinese developers building overseas like in Malaysia and Australia. Whether they can repeat the feat in Hong Kong is yet to be seen. Skeptical as one may be, we will take a wait-and-see attitude.

So the question for local developers is: “What do we do next?” One obvious answer is to wait for the market to fall. It will take a few years for the land acquirers of today to feel the pain at the time of apartment sales. Will this mean that these Mainlanders will in the interim continue to bid up prices? None of us can know at this time. Although unlikely, the possibility always remains that Beijing will notice this phenomenon, which will be perceived as not good for Hong Kong, and discourage such land purchases. Barring that, it is possible for land prices to continue to rise further.

But as we all know, there is no necessary relationship between land and housing prices. Factors behind land prices can be rather detached from those of residential units. A crash in the former does not automatically lead to a fall in the latter. The nexus can be only psychological. If so, then there may come a time when land price will again become attractive to local players. The only problem is that no one knows for sure when that day will arrive.

The assumption is that when the bottom falls out, pain will cost the present land purchasers to learn. They may or may not. Sometimes it takes more than one market cycle for participants to learn the lesson. Moreover, there will be many other Mainland business groups who may join the game at that time. Hong Kong’s property market has always been an extremely open one. Capital can freely come and go. As long as Beijing does not limit its exit on their end, we welcome them. That, however, may fundamentally change our market. There will be almost an unlimited number of possible new players.

This is not necessarily bad for Hong Kong in the long run. An increased number of participants should mean that high land price will remain and the government’s coffers will stay full. If so, it is conceivable that our personal and/or corporate tax rates may fall further. After all, for competitive reasons, the trend around the world seems to point to the lowering of taxes. Rising revenue will also lighten the government’s burden for ever-increasing social services. The Basic Law governing Hong Kong stipulates that the special administrative region remains a low tax regime. Higher revenue from the sale of expensive land will help in this regard.

What will happen to those high land price purchasers? We should not care for we are a free market. What concerns us is the future of local developers like us. For reasons given above, the lucrative days of Hong Kong real estate development may be coming to a close. Experiences of the past has not prepared us well for other industries.

Moreover, Hong Kong developers, and indeed our businessmen in general, are usually short-sighted. Our post-WWII history described earlier has created a special breed of entrepreneurs. For decades before 1997, we lived on borrowed time in a borrowed place. Uncertainties surrounding the city's return to her Motherland had made these entrepreneurs want to make money fast and get out of town if necessary. This is epitomized by one of our biggest property magnates who never owned a building except the company's head office. People like him only buy land, build and sell. There was a deep suspicion about the future of our city after 1997. Although 20 years have passed and Hong Kong has continued to thrive, this short-term mindset cannot be easily changed.

Where shall that young man go now and in what business shall he engage in? 50 to 60 years later, the same two questions will come back to haunt him and his offspring.

With plenty of money on hand, he can go anywhere. Most likely he and his children, like many wealthy families before them, can turn themselves into passive investors. Use money to make more money. This is certainly legitimate. The only problem is the future of his now publicly listed real estate company. Will he be able to convince his investors that he can still make as much money in Hong Kong properties as he did in past decades? Continued success in the business is questionable.

Since China has economically grown so much in recent decades, an obvious answer to the two questions above is to enter the Mainland real estate market. But as I had written a few years ago, the best days of their residential market may be over. We have seen the rise of many big players in the past 20 to 30 years, some of which are now entering our market. If Mainland opportunities abound, why bother to come to our much smaller market? Moreover, what makes Hong Kong developers capable of competing with so many local giants on the Mainland?

The only alternative then is commercial properties, especially high-end shopping centers. Of all the traditional real estate product types, the most fungible is industrial buildings, including warehouses. Whether one occupies this one or that one usually matters little. Next in line in terms of decreasing fungibility is residential properties and then offices. The least fungible is retail space, especially in high-end properties. A one-block separation in location, or being on the opposite side of the street albeit on the same block, may make or break a mall.

The exact order exists in terms of the expertise required to develop these facilities – it is easiest to build an industrial building, while a luxury mall requires the most know-how and experience. The ease of management of the various types of properties follows the same pattern. For all these reasons, I believe the best business for Hong Kong developers to enter the Mainland market is high-end retail space. After all, there is little expertise on this on the Mainland.

Some say there is a glut of shopping centers on the Mainland. If one were to superficially and indiscriminately look at data, one may come to this conclusion. However, observe carefully and one will quickly discover that in each city, the top one or two luxury malls account for the lion's share of sales dollars for high-end goods. As a result, their rent is much higher than the rest. The key is to become one of these two in any particular city. This, in a nutshell, has been our strategy since 1992.

The key to success in this sector as I had previously written is what I called the real estate genetics for luxury retail facilities, namely location, size, design and construction. Embrace them and one will have a good chance of success; ignore them then failure is almost unavoidable.

For the past 25 years, Hang Lung was fortunate to have decided upon and adhered to this strategy. There may be other equally or even better ways forward, but we have yet to discover one. Every Hong Kong property company of our genre must search for its own course forward. For better or for worse, our path for now is set. We believe that our strategy when adequately executed will lead to continued shareholder value creation.

A legitimate question here is: did we miss out on the opportunities to build residential units in Hong Kong after 2004 when the city recovered from SARS? To some extent yes, for we have concentrated our efforts in building up our commercial portfolio on the Mainland. However, Hong Kong land prices during that period were not cheap. Their return was acceptable but not great, and the risks involved were deemed by us as not that attractive.

Another possibility was to enter the Mainland residential market as some Hong Kong developers did. The risk-reward profile there was perhaps even less favorable than that in Hong Kong. We were also worried about corruption. Moreover, to compete against the many local big boys seemed heroic which bordered on foolhardiness.

Similar to the 1980's and 1990's in Hong Kong, unless a land bidder is prepared to project housing prices that are much higher than that of the time of land purchase, he will not win. All too often, government land auctions produced successively higher historic records. If you lose, you are sad; but if you win, you really begin to worry. As a Mainland developer once said to me, if he does not buy at crazily high prices, he will die immediately, because he has no more raw material; but if he buys now, he may probably die later. The choice then was clear: jump in with both feet but with eyes closed!

On the other hand, our Mainland strategy should be executed as early as possible. Once the best commercial land in a city is acquired by others, we will almost never see it again. We may even be forced to relinquish that city. For this reason, early market entry is critical. As such, we do not regret having spent our efforts since 2004 on the Mainland.

Before concluding this section, let me briefly summarize our performance of the past years. Taking advantage of rising Hong Kong residential prices in the last quarter of 2016, we sold a lot of our completed apartments with excellent profits. We even began to part with the luxury semi-detached houses on Blue Pool Road. Prices are quite satisfactory.

Our rental properties in Hong Kong did acceptably, advancing 5% in the top-line. In the Mainland portfolio, revenue grew 2% in local currency terms. But due to a 6.1% devaluation of the RMB, we recorded a drop of 4%. There was a revaluation loss on the Mainland which was partially offset by gains in Hong Kong. Like in 2015, we saw a serious retranslation loss due to the falling RMB.

All told, underlying net profit attributable to shareholders rose by 40% and so did underlying earnings per share. After revaluation loss, profit attributable to shareholders was up 16% and earnings per share, 15%.

## PROSPECTS

What remains to be done and done well is the execution of our chosen strategy. This was why in the past several years we have devoted much time to reorganizing our management. We are now a hugely different entity than before. Your management is convinced that if our strategy is properly executed, it will have relatively low risk but potentially rather high return.

In our first 30 years (1960-1990), a solid foundation was laid. In the next 25 years (1991-2015), we redirected and firmly established the Company in the Mainland market. It will take the third generation leaders to adequately execute the strategy and reap the financial benefits. Under the direct supervision of the Board, especially the few long-serving independent non-executive directors, our succession plan is proceeding well. It is an ongoing effort and so there is not yet a definite end date. Nevertheless, the key elements are being put in place.

Hang Lung is over 56 years old and we have had only four managing directors – the first being Mr. Thomas T.T. Chen who assisted our founder and first Chairman Mr. T.H. Chan. Upon the death of the latter in 1986, Mr. Chen became Chairman; then Executive Director Mr. S.S. Yin was made Managing Director. I took over the chairmanship in January 1991 and Mr. Yin soon became Vice Chairman. Then Finance Director Mr. Nelson Yuen was promoted to Managing Director until his retirement in 2010. Thereupon Mr. Philip Chen joined the group succeeding Mr. Yuen.

History has shown that our leadership in the Company has been very stable. Retirements were mainly due to age or health reasons. Philip has proven to be a pivotal figure in the Company's history – he has led the effort to greatly enlarge and strengthen our management team. The need came from the fact that in the past few years, we have completed the construction of 1.8 million square meters of world-class commercial space on the Mainland. Since we hold all such properties long-term, the property management team becomes critical to ongoing success.

Let the numbers speak. Since 2010, our headcount has almost doubled. Rental revenue from the Mainland grew from some HK$2.5 billion to over HK$4.4 billion. In Hong Kong, the numbers are respectively HK$2.9 billion and HK$3.9 billion. This means for the Group, we have grown our total recurring income from about HK$5.4 billion to over HK$8.3 billion in seven years. Profit therefrom has also advanced strongly.

In the coming few years, I expect rental turnover to rise further. It will come mainly from two sources, both of which will take place on the Mainland – organic growth through rising rents and lowering expenses, and the addition of new commercial facilities. Whereas the program for the latter is quite set, barring new projects, how much organic growth we can see will depend to a good extent on the recovery of the Chinese economy generally and its retail sales specifically. The performance of the luxury sector will be of particular significance to us.

Six months ago I voiced some optimism especially as it relates to the luxury goods sector. Today I am slightly more positive about the future. Recovery will not be abrupt but hopefully it will be sustainable.

Our shareholders may be concerned over the geopolitical and geoeconomic conditions of the world and their impacts on China. I refer you to my letter also of today to shareholders of our subsidiary Hang Lung Properties. There I devoted considerable time to analyzing the situation. Briefly put, I am not unduly worried about U.S.-China relations, arguably the world's most important bilateral relationship. If correct, then there will be a relatively peaceful environment for China's economy to develop further. In fact, all things point to an increased consumption in China which is good for our business.

To prepare ourselves for the future and with management succession in mind, your Board has invited Mr. Adriel Chan, age 34, to become an Executive Director, the position I held before becoming Chairman 26 years ago. Raised in Hong Kong until high school graduation, Adriel received his tertiary education at the University of Southern California. After working briefly in New York City for a not-for-profit organization and pursuing Chinese language studies at Peking University in Beijing, he joined KPMG, the auditing and consulting firm, in Shanghai. Later he worked for HSBC, also in Shanghai, before joining Hang Lung there in 2010. In 2012, he was transferred to the Hong Kong headquarters and has been working under Philip since. Adriel holds an EMBA from the Kellogg School of Management at Northwestern University in the U.S. and the Hong Kong University of Science and Technology.

In his undergraduate days, Adriel had already shown an interest in business. The 12 working years thereafter should have prepared him well for a career in the commercial world. He is capable of strategic thinking as well as operational management. Common sense, good judgment and excellent interpersonal skills are his hallmarks.

Ideally, Adriel should only be the first among a few more new executive directors. Nevertheless, your Board should always be comprised of a majority of non-executive directors, especially independent non-executive directors. It is my firm belief that the British board structure is in general superior to that of the United States. The model we have followed and will continue to follow is one which is basically British but with certain elements borrowed from the United States. Let me explain in a simplified form.

In a typical American publicly listed company, the chairman of the board of directors is an executive and is usually also the chief executive officer (CEO). The chief financial officer may or may not serve on the board. As such, a board of 15 members will likely have 13 or 14 non-executive directors, or they call "outside directors". If the one or two executive members want to cheat the board, it is relatively easy. A case in point is Enron which I knew well.

In a British board, again say of 15 members, it is most likely comprised of 9 to 10 non-executives and 5 or 6 executives. The opportunity for the former and larger cohort to interact with senior executives is far more than the American model. After all, legally speaking, both groups have equal per-person rights – one director one vote on the board. They are, in this sense, colleagues or equals. This facilitates the gaining of broader knowledge of the company on the parts of the non-executives, hence they can do a better job overseeing and strategizing for the firm.

Equally significant is the fact that it is far more difficult for the 5 or 6 executives to collude and cheat the non-executives. The tragedy of the likes of Enron is less likely to happen. Given this, the British model has superior aspects which can help avoid some of the serious ills of the American structure.

Unlike in the U.S., the board chairman of a British firm is usually a non-executive. How much time the person spends on company affairs differs from case to case. To my knowledge, it usually ranges between two to four full days per week. Whatever the case, the smooth working relationship between the non-executive chair and the CEO becomes critical. If amiss, the business will suffer. This differs from the U.S. model where the same person more often than not assumes both positions. Perhaps the American psyche is less adept at sharing power.

It is worth mentioning that from my experience, decisions of a British board are made primarily by the non-executives. The reason is simple: proposals brought to the full board come mostly from the management, so in most cases, the executives have all agreed beforehand. What is left to be done is for the outside directors to decide for or against the proposal.

There is yet a hybrid form of board governance which is perhaps more fitting to many Asian companies, where there is a majority or otherwise dominant shareholder such as the founder's family. Until not too long ago, some British companies such as HSBC practiced that. Namely, it is the British model described above except that the chair is also an executive. This is exactly what we follow.

On many occasions, I have written or otherwise spoken up regarding the viability if not the advantages of publicly listed companies that have a dominant shareholder. As long as the external regulatory environment is rigorous in construct and in enforcement like in Hong Kong, the presence of such a shareholder can be highly desirable. The family can and usually will take a long term view of the business, thus creating sustainable shareholder value. Many enlightened institutional investors in the West have of late become very concerned over the short-termism of companies and of institutional investors.

The Asian way, which is usually a board with a controlling shareholder – not that Asians have a monopoly on it – can in fact effectively take care of the problem. A major shareholder can hardly be introduced where it does not exist, but if a company already has a major shareholder, it is advisable to not force it to change. The West does not have a monopoly on good governance, and neither does Asia on bad governance. Just make sure that external regulations are appropriately rigorous.

In companies with a major family shareholder, it is understandable why a member of the clan should want to serve as the board chair. After all, the family has the most to gain or lose. It is useful if this person has had executive experience in the company so that he or she can be a more effective chair.

In this top post, this person will likely focus on strategy and board communications, leaving the day-to-day management of the company to the CEO. Either one or both of them can be the public face. Whereas the day-to-day operational decisions are left to the CEO, on critical issues, which do not require board approval, the two will jointly decide, with the chair having the final vote.

For this to work smoothly, the top two executives must respect one another. It is very important for the chair to be self-enlightened and leave plenty of room for the CEO to manage the company. Otherwise, why pay for an expensive CEO if the chair has no intention to cede considerable power? And which competent CEO will agree to the job when he or she has the responsibility but not the authority? The company might as well collapse the two positions into one.

At Hang Lung, we have satisfactorily practiced this model for half a century. I see little reason to change. The West, especially the Americans, have a tendency to advocate one-size-fits-all. What is good for me must also be good for you. It is ironic that a country like the U.S. which leads the world in diversity to have so little respect for – or ability to respect – differences including cultural ones. At the same time, many Western systems are increasingly showing serious weaknesses.

The investment community should allow experimentation as long as they meet the basic standards of good governance, such as the protection of minority shareholders, and transparency. The fact that over the past decades, your Company has repeatedly been chosen by the investment community as the best in corporate governance for our sector, is perhaps a testament that our model works well.

Before concluding, let me return to the more immediate concerns of all shareholders – our market. Although improving, the mainland Chinese economy is not yet completely out of the woods. Personal consumption may improve further in the coming months, and if so, we will all be happy. But irrespective of the external environment, I expect our retail properties outside of Shanghai to continue to improve in terms of operational efficiency. Doubtless this will one day translate to higher rents.

Our two Shanghai malls may have a divergence of performance. The luxurious one, Plaza 66, should continue to trade well, while Grand Gateway 66 may slow down a little due entirely to the Asset Enhancement Initiatives that is just starting. Almost 30% of the space will be taken out of service, and no rent increase in the remaining space will be able to compensate for the temporary loss of revenue. This is nevertheless necessary for the long-haul and we will do our best to minimize the negative impact.

Our offices outside of Shanghai should continue to fill up nicely at acceptable rents. This will help the malls beneath as it brings additional footfall.

Our construction team will remain very busy. Spring City 66 in Kunming and Heartland 66 in Wuhan are both at the stage of superstructure erection. We have experienced some delays in both cities and we will do our best to catch up as much as possible.

The second office tower at Center 66 in Wuxi as well as the hotel conversion on the top of the office skyscraper at Forum 66 in Shenyang will proceed as planned. We are also in discussion with the Wuxi government on the transfer of the land next to our existing site. That plot was purchased soon after the one on which now stands Center 66.

Our effort to add to our Mainland land bank will continue. It is always difficult to predict when success will strike, but we are hopeful. As always, we will concentrate our search on economically strong tier-two cities.

Hong Kong's economy will move along with little excitement except that land prices are highly bidded up by Mainland companies. This has effectively dashed our hope for land acquisition in the foreseeable future.

I do not yet see rousing retail sales returning to our home city. Maintaining rental growth rates of the recent past is all we can hope for. Frankly it will be challenging.

With luck we will sell a few more of the semi-detached houses on Blue Pool Road. As the market knows, we will only part with them when the price is deemed attractive. As to the rest of our portfolio, it is likely that it will be sold out this year. Profit is again expected to be satisfactory.

Whether total profit will surpass that of last year will depend on the amount of properties sold. Units at The Long Beach sold last December but with Agreements for Sale and Purchase signed this January will only be recorded in the present period.

In the long run, we will have to rely on rental income for our bottom line increase. While our Hong Kong portfolio provides stability, the Mainland is where growth will come from. It will take time but the future is bright. I am excited about this prospect.

A postscript: this semi-annual letter is traditionally meant for shareholders and potential shareholders. However, it is also for our staff, particularly this year's writing. It is important that they know our history and the market in which we are a part. Properly reading history is the only way to predict the future. It is also my hope that while reviewing the happy – and at times not so happy – path that the Company has trodden, we will be reminded of the values and corporate culture that we must hold dear in order to continue to thrive. Ours is a company which, behind all our hard and soft assets, has a soul which animates all.

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