Penetrating Insights

Hang Lung established itself in mainland China in the 1990s and by the turn of the new millennium had already successfully expanded its market into China's second-tier cities with a portfolio of world-class commercial complexes. In 2015, with the opening of Olympia 66 in Dalian, and the phased completion of our core asset enhancement initiatives, Hang Lung is poised to advance further into a glorious era of insightful evolution and penetrating growth.

The HarbourSide, Hong Kong

Palace 66,
Shenyang

23-39 Blue Pool Road,
Hong Kong

Chairman's Letter to Shareholders

RESULTS AND DIVIDEND

Compared to the last financial year, turnover for the year ended December 31, 2014 advanced 81% to HK$17,606 million. Net profit attributable to shareholders rose 50% to HK$6,825 million. Earnings per share increased similarly to HK$5.04.

When excluding all the effects of revaluation gains, the underlying net profit after tax leaped 87% to HK$5,730 million. Underlying earnings per share likewise surged to HK$4.23.

The Board recommends a final dividend of HK62 cents per share, an increase of 1.6% from a year ago. If approved by shareholders, total dividend per share for the year ended December 31, 2014 will be HK81 cents, which is 1.3% higher than that in 2013.

BUSINESS REVIEW

Our major subsidiary Hang Lung Properties was able to almost sell out the remaining The HarbourSide units and part with 151 The Long Beach apartments. As a result, both turnover and profit for the year were very strong. Profit margins achieved in both projects were higher than that in all previous sales.

In the past I have, on this platform, explained the cause of runaway prices of Hong Kong housing since the mid-2000's, so I will not elaborate further here. Only with the incoming of the present government have serious actions been taken to moderate price growth. If it continues with its current land policy – and there is every reason to believe that it will – then sooner or later supply and demand will reach an equilibrium.

Ronnie C. Chan
Chairman

Since it would take a few years for land supply to catch up after more than a decade of very low supply, for the time being, we may see housing prices continue to rise. However, imagine what heights they would reach had the present government not taken any decisive actions in the past two years!

Demand for smaller units which are more affordable in terms of total sales price is particularly strong. This tells us that overall price levels are still high, and there is still plenty of pent-up demand. But increased supply will one day suppress price growth. No one, especially not the government, wants to see falling prices, but neither are runaway prices desirable, as we have witnessed in the second half of the 2000's. In fact, it has already created tremendous social problems which only a healthy residential market can help alleviate.

It is based on the belief that the government will continue to do the right thing (i.e. supply more land) that we have decided to sell down if not sell out our portfolio of completed apartments. Profit margins have already reached a rather high level and we should not risk missing the market. Nowadays the world is an uncertain place, and happenings elsewhere, whether by design or by accident, can change market sentiments very quickly. Realizing profit by monetizing inventory becomes a prudent thing to do. Conditions permitting, we will sell even more.

Hong Kong retail rental has slowed down. For the first time in well over a decade, the city's total retail sales in 2014 has fallen slightly from the year before. The role played by Mainland tourists cannot be denied. While the number of visitors continued to climb, they have spent less on luxury products. This must be related to the anti-corruption campaign on the Mainland which shows no sign of abating.

Of late there has been a troubling phenomenon in Hong Kong. There were incidents where mainland Chinese were publicly made to feel unwelcome. This is human nature and we have witnessed similar occurrences in Singapore. Such prejudice is frankly unwarranted. The only difference between the local residents and the visitors is that the former have achieved middle-class status earlier. Not respecting others simply degrades one's own self-respect.

Yet Hong Kong will do well to remember that every action will elicit a reaction. Many Mainlanders are already saying that visiting Hong Kong is no longer as pleasant an experience as before. We should be clear about who our "client" is. Mainland shoppers are frankly a major economic force which keeps our city basically fully employed. People should not be so foolish as to bite the hand that feeds them. Our economy is now highly dependent on the Mainland and its visitors.

Conversely, Mainland's need for Hong Kong is on the wane. One study shows that in 1997 at the time of the city's return to her Motherland, as much as 20% of the Mainland economy was in one way or another tied to Hong Kong. Now this number is less than 2%. For us to not recognize these changes is nothing less than foolish. Of course Beijing would much rather than not receive help from Hong Kong in the nation's continued economic development, but everything has a price. They have alternatives.

Whereas Beijing's anti-corruption efforts affect Hong Kong, their impact is felt much more keenly on the Mainland. Retail sales of some of our tenants cannot be spared. Yet the toll is perhaps felt more acutely by the department store business. When retail sales are strong, everyone gets a share sufficient to at least survive, while a few like us thrive. When sales are slow, department stores, as an inferior retail model, may feel the impact the most. This can be detrimental to the more feeble players.

A few years ago, many analysts asked me about the merits of malls versus department stores. I am obviously biased but nonetheless I shared my views. I believe that department stores as a major distributor of luxury goods are inherently inferior to shopping centers. With or without the present difficulties, they will lose market share, although I do not believe they will disappear altogether.

In the past year, it seems that more and more capital market practitioners are coming around to my view. I remember a few years ago a neighboring department store which was part of a rather strong chain simply closed soon after one of our malls opened.

We do not concern ourselves with constructing a massive amount of residential units for sale on the Mainland; rather, we only build high-end units that are part and parcel of our larger commercial complexes. Nevertheless, the former can affect our business. For example, many large housing projects have a retail element. Although they are community malls, which are different from our regional ones, they will nonetheless draw some footfall away.

The Mainland housing market is an extraordinarily complicated one. The reason I want to touch upon it briefly is that investors everywhere – and especially in the West – are concerned with it. Some analysts and institutional investors have long predicted that the bubble will burst. They think that it is one of the greatest threats to the Mainland economy that could potentially end its growth. As a result, many foreign investors have in recent years forsaken the China market. They are eagerly awaiting disaster.

I do not share this view. It is not that the dollar amount involved is not huge. It is just that the problem is much smaller and in any event more manageable than most think.

Take for example the so-called "ghost towns" where blocks and blocks of overbuilt units are lying empty. From a simple observation, some deduce that the residential market would soon crash. After all, if this took place in the West, surely the market would fall.

This conclusion misses several critical factors. First, in China, the purchasers of those units have, for the most part, very small mortgages outstanding. Many simply paid all cash up front. So when there is little or no debt, how can the market tumble?

Take for example a group of individuals who supposedly owns a lot of such empty buildings, such as the coal tycoons of Shanxi Province and Inner Mongolia. There are simply too few investment instruments domestically to absorb the huge wealth they have amassed. The stock market is at its infancy stage; the bond market is almost non-existent; the insurance and investment fund industry is underdeveloped; precious metal trading is restricted; and investing overseas is heavily regulated through foreign exchange control. The only place to park a large sum of money is to buy real estate, and sometimes to buy up entire residential blocks. Even if there is little chance for price appreciation, at least there is, at the end of the day, bricks and mortar with the land underneath it. In principle, the same applies to all Mainland people with money to invest.

All these conditions are absent in developed economies. Investment professionals using a Western paradigm to judge the odd Chinese market will most likely arrive at erroneous conclusions.

This is on the side of home purchasers. Housing providers have a different story but it leads to the same conclusion. Banks, mostly state-owned, have been reluctant to bankrupt the highly geared developers who are strapped for cash. As I have told Chinese friends in and outside of the government, the economic and social impact of putting such people under is rather low. There is hardly obsolescence in real estate and weak players can easily be taken over by stronger ones without creating unemployment. Alternatively, resolution trust-like structures can be set up to take over the bankrupt entity with its real assets. Once the market recovers, the trust can then orderly dispose of the properties. All these can be done in ways that would minimize the negative impact on societal sentiment and so contain contagion effects of bankruptcies.

The Peak Galleria,
Hong Kong

That said, by historical standards, Mainland developers today are not that highly geared. In the final 3-4 months of last year, pent-up demand pushed up transaction volume if not prices, so much so that the first three quarters of slow market notwithstanding, the industry ended the year with higher volumes and total sales turnover than 2013.

So looking at this landscape, I do not believe the property market will be in serious trouble. If I am correct, then many foreign experts will be sorely disappointed!

One other point deserves some attention. While home prices did not rise significantly in the market recovery of the last quarter, land auctions in first-tier cities, especially Beijing and Shanghai, have seen record prices. The same is not true elsewhere. This is a phenomenon which I have long observed and is similar to the story of New York City in the U.S. Properties in Manhattan have had for a long time the highest unit price among all American cities. Prices there tend to increase the most in bull markets and fall the least in bear markets. Moreover, the better the location, the more this is the case. The same will be true in Beijing and Shanghai. Like New York City, these are unique metropolises that stand out.

PROSPECTS

It is very difficult, if not impossible, for an ordinary citizen like me to know when China's anti-corruption campaign will let up. But regardless of timing, the luxury goods market in which we play will sooner or later find its "new normal". We should be psychologically prepared as the new level may be lower than the heyday of pre-2013. What is certain, however, is that the market will resume its growth from there.

The rise of the middle-class in the past two decades has been nothing less than phenomenal, and this trend will continue for decades to come. This is due partly to urbanization which can only march forward briskly. Last year alone, over 18 million people from the countryside moved to the cities. According to one study, China had a middle-class population of 230 million people in 2012 and it is expected to grow to 630 million by 2022. Literally hundreds of millions of people are moving up the economic ladder. As they progress, their tastes and requirements will mature. Most city dwellers, who already account for over 54% of the nation's 1.37 billion citizens, will sooner or later become customers of our malls like that of Shanghai Grand Gateway 66. A smaller percentage will rise to the level of the likes of Plaza 66. When the consumer base is so huge, even a small portion of it in each of our cities is a significant number.

In Hong Kong, rental increase may approximate that of the year just reviewed or be slightly better. I do not expect particularly exciting or difficult news from the market. Since we have, in the past two years, begun to upgrade many of our properties, improvement in rents therefrom can be reasonably expected.

As long as Hong Kong's residential market holds up, we will sell more completed apartments. The omen is good, although we do not know yet how much we can do. We will continue to time the market and maximize profit margins.

In the past several months, there have been many personnel changes on the Board. Our Non-Executive Vice Chairman Mr S.S. Yin and Independent Non-Executive Director Dr H.K. Cheng have both indicated that they will not stand for re-election at the coming Hang Lung Group Annual General Meeting (AGM) on April 29. Personally and on behalf of the Board, I would like to thank them for their long years of service.

Mr Yin, or S.S. as he is known to friends, joined Hang Lung Development, the predecessor of Hang Lung Group, as Executive Director in 1971. Upon the death of our founder in 1986, then Managing Director Mr Thomas T.T. Chen took over the chairmanship and S.S. was promoted to Managing Director. S.S. retired in 1992 and became Non-Executive Vice Chairman until now.

Trained as a banker, S.S., together with Mr Nelson Yuen who later succeeded him as Managing Director, shepherded the Company through the difficult period of the mid-1980's and restored its financial health. He will be remembered for his many contributions to the Company.

Dr H.K. Cheng joined as Non-Executive Director in 1993. He is among the most distinguished structural engineers of his time, not only in Hong Kong but also internationally. Later in his career, he became active in civic affairs, having served in different capacities including member of the Legislative Council. He has chaired many government-appointed advisory bodies and educational institutions. At Hang Lung, he has ably headed various Committees of the Board.

I am pleased to announce that your Board has elected two equally distinguished leaders – barrister Mr Martin Liao and Professor Lap-Chee Tsui. They serve as Independent Non-Executive Directors of the Group until the coming AGM when they will stand for election by shareholders. We are still searching for additional qualified individuals to serve as Non-Executive Directors.

Mr Liao is a top barrister in Hong Kong. He is one of the members of the Legislative Council representing the business community and has considerable knowledge of the Mainland.

Professor Tsui is the immediate past president of the University of Hong Kong. A renowned biological scientist, he is engaged in many education and not-for-profit entities in Hong Kong and on the Mainland.

Recently the Directors have devised the term and age limits as principles to guide future operations of the Board. This should strengthen our corporate governance further. We endeavor to devise the most appropriate board structure that befits our Company and our industry while recognizing that there is no single perfect model.

Fashion Walk,
Hong Kong

For example, it is absolutely essential that Non-Executive Directors remain "independent" of management so that they can adequately protect the interests of all shareholders. In this regard, I believe our existing standard is high.

To illustrate, our Nomination and Remuneration Committee (NRC) comprises only Independent Non-Executive Directors. They exercise absolute power to determine the salaries and bonuses of all Executive Directors including the Chairman. This has been our practice since we formed the NRC in the early 2000's. It is highly doubtful that other companies in our sector practice that.

Term limits are meant to ensure independence. However, a properly functioning board must satisfy several criteria of which independence is just one. For example, the knowledge and experience of longer serving directors gained over the years are invaluable; newer directors without such background cannot easily acquire the same level of sophistication and insight. Moreover, in some circumstances, the board can actually be the constant while the company is undergoing management change. This is important, just as the independence of directors is important. Do we have to choose one over the other or can we have both? I would like to have both, or at least have much independence and some experience.

Problems arise when ideological people recognize one virtue and not the other. Physical science and mathematics are exact, and morality should be absolute. But like other disciplines of social science, management and corporate governance are neither exact nor absolute. They are an art as much as a science. Finding the right balance is the key to sustainable success.

Modern corporations as we know them are creations of the West, and so is corporate governance. They are very useful institutions, and all business leaders will do well to learn about them. We have strived to do just that. Yet no model of board structure or governance practice can claim perfection, and all of us should try to constantly improve in both areas. Moreover, a model may have its strengths and also its weaknesses. It may work well in one place but not in another. There are also significant differences from industry to industry.

Take for example quarterly reporting which some religiously advocate. Reporting to shareholders in a timely fashion is of course good, but it also breeds short-termism. In places where management owns few shares, the problem is particularly serious. Manipulation of quarterly results and even share prices becomes common practice. This is indeed one of the weaknesses of the prevailing Western model.

In much of Asia, the presence of a controlling shareholder or shareholding family, while having its own challenges, can avoid this. The issue is not whether there is such a shareholder but rather how good the regulatory regime is to minimize irregularities. Although not perfect, Hong Kong's capital market does quite well in this regard. In some areas, we are far more stringent than even the New York Stock Exchange. The recent IPO of Alibaba illustrates this well: Hong Kong will not accept unequal values to shares while New York does. We paid a huge price for it – Alibaba decided against listing in Hong Kong.

Another example is whether the board is given the authority to quickly issue certain amount of shares when necessary. Some ideological people with less practical experience in running a business would oppose this. We of course recognize the possible problems that such an authority may create – the major shareholder diluting minority shareholders' interest, which is not right. No one can dispute the fact that in our long history, we have never done this. Yet I still oppose the limiting of that authority because it neglects market realities.

In a fast-moving and volatile market environment like Asian real estate, opportunities can suddenly present themselves and can disappear equally quickly. Management must have the liberty to raise funds quickly, overnight at times, to take advantage of them. Raising equity by share placement can be the most appropriate means to achieve this. Setting limits on how much can be done is obviously needed, but to take away this ability is an overregulation that stifles market activities. We must recognize that overregulation can at times be as problematic as underregulation. A balance must be struck.

At the end, nothing can replace management integrity. This is where we strive to excel. In this regard, I like to think we stand out in our market and in our industry.

I want to take this opportunity to thank all of our shareholders for their trust in us, especially those who have stayed with us for a long time. Appreciation also goes to my many colleagues who have together worked diligently to make Hang Lung a great company.

Ronnie C. Chan
Chairman
Hong Kong, January 26, 2015

ADDENDUM TO CHAIRMAN'S LETTER TO SHAREHOLDERS

To Our Shareholders

Subsequent to our latest Board meeting on January 26 which was also the date of my last letter to shareholders, we have had two very competent individuals joining your Board.

A qualified accountant from the United States and Canada, Mr George K. Chang has for the past 30 some years engaged in the accounting profession as well as in the management of companies and in investment. For over two decades, he has been associated with Morningside Asia which invests in the region including mainland China. Morningside is the investment arm of my family. George is a Non-Executive Director of the Company.

Given the imminent retirement of two senior directors, Mr S.S. Yin and Dr H.K. Cheng, the Board is short on long-serving Non-Executive Directors. Professor Pak Wai Liu, an Independent Non-Executive Director of Hang Lung Properties Limited (HLP), has agreed to join our Board with the understanding that when his term at HLP is expected up in 2016, he will not seek re-election. As records show, since 1997, we have not appointed Non-Executive Directors who serve on both Boards. This practice will continue.

I am confident that the new appointments will greatly strengthen the Company.

Ronnie C. Chan
Chairman
Hong Kong, March 11, 2015