Fashion Walk,
Hong Kong

Olympia 66,
Dalian

Plaza 66, Shanghai

Insightful Vision

Upholding our business philosophy, We Do It Right, Hang Lung looks ahead in all of our areas of business. From market timing, location choice, architectural design, to daily operations and talent development, our pledge of excellence is to act with foresight to develop the Company into a highly admired national commercial developer in China.

CHAIRMAN'S LETTER TO SHAREHOLDERS

Ronnie C. Chan
Chairman

RESULTS AND DIVIDEND

Revenue for the year ended December 31, 2015 declined 46% to HK$9,528 million as fewer residential apartments were sold against a year ago. Coupled with a smaller amount of property revaluation gain recorded against the previous year, net profit attributable to shareholders fell 53% to HK$3,211 million. Correspondingly, earnings per share fell to HK$2.37.

When excluding revaluation gain and all related effects, underlying net profit attributable to shareholders decreased 53% to HK$2,700 million. Underlying earnings per share declined similarly to HK$1.99.

The Board recommends a final dividend of HK61 cents per share. If approved by shareholders, total dividends per share will be HK80 cents for the year ended December 31, 2015. Final dividend is payable on May 18, 2016 to shareholders of record on May 5, 2016.

BUSINESS REVIEW

It has been almost a quarter century since we bought our first piece of land on the Mainland. During this period, both international and domestic economies have undergone many ups and downs. The most severe situations were the Asian Financial Crisis of 1997 and the Global Great Recession of 2008. In both instances, serious effects lasted many years. Yet in terms of their impact on our business, there was never a situation as severe as what we face today.

Worse yet, the recovery will be slow. In my 2012 interim report to Hang Lung Properties (HLPL) shareholders, I already predicted this. Now 42 months later, not only is there no rebound, but our market may still be on the way down. Contrary to historical norms, the second half of 2015 was weaker than the first. I fear that the worst still lies ahead.

The 2008 global debacle was long in the making. Effects of the problematic policies in the U.S. being practiced since the 1990's have blown up in our face. Before that, hardly anyone noticed the ongoing troubles until the global financial system and with it the economy was on the brink of collapse. At that time China was among the very first major economies to have recognized the situation and promptly took action to avert disaster. Its retail market experienced a V-shaped fall and then recovery. In fact, the rebound was rather powerful, so much so that retailers and the related real estate industry hardly felt the pain.

This time it is China's turn. Problematic policies which once brought great prosperity for the short-term also came with tremendous challenges. Contrary to the stealthy nature of Western government missteps since the 1990's, China was repeatedly warned by economists – especially those in the West.

Frankly I could sympathize with Beijing on what they had done in order to ensure handsome growth at that time. However, the system was such that herd instinct was not checked, so many things went to the extreme. Just take a look at the existing capacity of many commodities from steel to cement, and from solar panels to apartments. On the part of Beijing leaders, there was perhaps a late recognition of impending troubles, an underestimation of their severity, and even an over self-confidence in their ability to manage the economy.

Beyond policies and policy executions, there are also structural or systemic issues that must be addressed. I for one do not subscribe to the view of many foreigners that China must adopt the Western model wholesale. To be sure, in the past 30 years or so, China has already learned tremendously from the West. However, should the RMB be fully convertible like the U.S. Dollar, the Euro or the Japanese Yen? I am not so sure. Or should the country give up all its State-Owned Enterprises (SOEs)? I doubt it.

Singapore's economy is dominated by SOEs; they just do not call them as such. Yet things have gone well in the country for over half a century. Her economy is still considered one of the strongest in the world. Ironically, the small island state is rated as the world's second freest economy next only to Hong Kong according to the Index of Economic Freedom published by the Washington, D.C.-based think tank The Heritage Foundation. Perhaps public relations are done better in Singapore than in China. Everyone knows the disadvantages of SOEs but few have written about their advantages. Given geo-political and geo-economic considerations, China, I believe, will keep their SOEs for the foreseeable future.

That said, China still needs a tremendous amount of structural reform. Consider taxation, social security, healthcare, education, and housing, etc., and the list goes on. Most of the needed changes are frankly at the operational level. One area close to our heart is real estate. Unless land sales are done differently, residential prices will be easily subjected to wild swings. Many such changes will inevitably infringe upon vested interests. Political courage and skill will be needed if reforms were to be introduced. The good thing is that conceptually most of these issues can be resolved or at least improved on as long as the political will is there.

The degrees of success of structural changes made to these social issues will determine if the economy can become sustainably strong. All honest businesses, including our core shopping mall operations, need a healthy economy to thrive. This is why we are concerned about the success of these structural reforms.

While a strong balance sheet helps to resolve most problems, sitting with lots of cash can also lure one into overconfidence and inaction. It can be a boon or bane. A few years ago China's finances were very strong. Now there is much debt in both the government and most corporations, SOEs or otherwise. This can make life difficult, but it can also drive the much-awaited improvements. Let us hope that it is the latter.

We do not have any idea when the economy and our industry will recover, nor do we believe that China will not rise again. It is probably easier today for Beijing to prevent disaster than to stimulate the economy. So the most likely scenario is that the country will muddle through. After all, Chinese culture enables its people to withstand a lot more uncertainty than the Europeans, just like the Europeans can bear more uncertainty than the Americans. Arguing who is better is meaningless here, for we have to live with the country in which we invest.

For businesses like us, what is critical is how well we are prepared for the worst. As was in the case of bear markets in the past quarter century, we are in great shape, financially and otherwise. Management of our subsidiary HLPL periodically conducts stress test scenarios of economic and market conditions which are far worse than today's. At our recent revisit of the subject, a favorable outcome was confirmed. The Company will be standing well even if horrific economic and market conditions were to happen at the same time and to persist.

There are several fundamental reasons for our confidence. First and foremost is that for all practical purposes, we have little debt. With no bank chasing after us, we can sit back and wait. Neither are we under strict obligations to complete all projects under construction. In the past two decades and more, we have always dutifully fulfilled our obligations toward local governments. When market conditions were difficult in 1998, 2008 and again in the past few years, we never slowed down construction. There were times when other developers ceased work and city officials entreated us not to follow suit. We always told them that we had no intention of slowing down. In this regard, the goodwill we have gained with municipal leaders is considerable, and we have thus built a favorable reputation in the country.

In July 2012, I wrote to HLPL shareholders that the economic downturn at that time would recover slowly. I later informed readers that although we were not rushing as before to complete projects, neither would we stop construction. The same position is true today. But if market conditions worsen substantially, we can certainly take more drastic measures. As always, we are constantly monitoring the situation.

Take the most extreme case where all construction must stop. We would continue to collect rents, albeit likely at a reduced amount, and just sit tight. We have sufficient resources to pay back all bank debts.

Addressing concerns over possible market volatilities, HLPL started in 2012 to issue bonds. They cost more than bank debts, but funding is more assured, and we can be less worried about loans being called at the first sign of trouble. So far almost 40% of all HLPL obligations are in such longer dated instruments. The average tenure remaining is six years. This further strengthens our financial position.

With this assurance in mind, we are as of today still moving forward with our building program. If the lethargic conditions were to continue for another two to three years – in which case the bear market would have lasted for six to seven years if we start counting in 2012 – and if we from now on do not cease or significantly slow down construction, then our malls in Kunming and Wuhan will be opening right around the time of economic recovery. Most likely, there will hardly be any other new developments inaugurating around that time, for the financially weaker players will likely have put on hold all earlier projects.

The same rationale goes for the construction of the second office tower in Wuxi Center 66. We will not blindly move ahead, but neither should we brainlessly cease work. Thoughtful and correct decisions in difficult times are much more important than those in happier days. Our boldness in 1999-2000 to buy land in Hong Kong baffled many at the time, but history has shown it to be wise. We are again hunting for land both on the Mainland and in Hong Kong, but we will only pay what we consider to be very reasonable prices. Let us face it: the market is unlikely to recover any time soon, and it is possible that one day cash will again be king. We have been in that situation before, and we like it.

Looking back at the past year, our performance given the dark picture was perhaps all we could have hoped for. Rental revenue has risen on the Mainland. Excluding the newer properties, the increases in Shanghai were not quite sufficient to cover decreases in other cities. Shenyang Forum 66 and Wuxi Center 66 were particularly challenging, while Shenyang Palace 66 and Jinan Parc 66 performed acceptably. New office leasing in Center 66 and Forum 66 was somewhat slow. The fact is that there has already been some attrition, which means that previously leased space could become vacant again as certain industries are particularly vulnerable to the weak economy.

Dalian Olympia 66 had its soft opening last December. The initial response was acceptable. One problem however is that municipal regulations can be capricious, making the lives of our tenants difficult. These are problems that can be resolved but they will take time. The official opening is expected in May.

Hong Kong rental rose mainly on the back of our asset enhancement initiatives. The market itself is weak and such condition will likely persist. Maintaining the same level of growth will not be easy.

Because we sold a lot fewer completed apartments in 2015, total profit for the Group fell. Revaluation gain was also meager.

PROSPECTS

For 2016, there is little doubt in my mind that top line rental revenue will grow in both mainland China and Hong Kong. However, we will have to monitor carefully tenant retail sales. Frankly I am not too optimistic, our best efforts notwithstanding. Sooner or later pressure will be put on rents. The fact that in 2015, our Mainland tenants actually had less retail sales during the seasonally more favorable second half of the year was a worrying sign. We will have to work very hard to keep the bottom line growing.

Your management however is not only pre-occupied with short-term performance. We are equally devoted to the long-term health and prosperity of the Company. The present market lull will one day go away, but what kind of condition will we be in at that time? Since we are not financially pressed, we are not in an emergency mode. Instead, we are spending considerable time and resources on long-term issues.

Much attention has been paid to e-commerce and its impact on shopping centers. I once devoted much of my letter to shareholders on this topic, and I refer readers to my 2013 HLPL annual letter which is available on our website. The points raised at that time are still valid today.

On that occasion, I also introduced a program we called EST or Experience, Service and Technology, i.e. the use of technology to provide services which enrich the shoppers' experience. To learn what others have done in this regard, a few years ago we sent our staff to visit certain major mall operators in the U.S. and Australia. Different companies were apparently trying different things, but we saw nothing that was earth-shattering. Meanwhile, we have been developing our own EST program and have achieved certain results.

We believe a quiet revolution may be taking place in retailing. To begin with, omni-channel retailing will be with us for a long time. So far the two main ways to consummate retailing sales are through physical stores and the Internet, i.e. e-commerce. For the latter, how fulfillment is carried out is just operational detail that can change over time. What is important is the transactional mode. Some 50 years ago we had catalog sales through mail order or phone order; now it is online sales. Mobile devices have made the latter possible and indeed convenient. Consequently, the Internet's impact on physical stores will be greater than their older cousins. But just as mail or phone orders did not replace physical stores, neither will online sales.

This, however, is only one side of the story. Just as technology like e-commerce can take business away from physical stores, it can also enhance in-store sales by altering shoppers' behavior in malls. The effect should be very beneficial to our business. In the coming few years, combining big data and mobile devices can greatly enrich the retail experience.

For example, technology is in place today to perform the following: when a guest drives her car – I used "her" because some 70% of our customers are female – into our car park, a lighted message can welcome her. We can advise her to park in a particular zone because data collected on her previous visits showed repeated purchases at a certain store closest to that zone. We can further tell her exactly how many spaces are available around there and the parking space number of each spot. Her cell phone can even direct her to those spaces.

Once inside the mall proper, the electronic concierge in our website can provide her with essential mall information. For instance, what and where the new stores are, new products that may be of interest (since we have her previous purchase records and so buying habits), what are on sale, which restaurants are highly rated, what is on the menu and if seats are available, and so forth. I will let my readers use their imaginations for providing more of such technology-enabled services. Write to me if you have a great idea; my personal email is at the end of this letter. We will add yours to our idea bank, some of which may be developed for implementation.

As one can easily see, such new shopping experiences are fun and efficient. They should drive up footfall and increase retail sales to our tenants. All this should result in higher rent to us.

This is the reason why in recent days we have become increasingly cognizant of our business not only having a B2B model – we as a business rent space to shop owners which are business concerns. We must add a B2C element to our operation where we interact more directly with shoppers. To be sure, we have always done that, but we will take it to a higher level. We market directly to our customers for our tenants and with our tenants.

As a result, we will work closer than ever with brands and shop owners to gather information that will be good for tenants and landlords alike. I find this prospect exciting. You may refer to my latest letter to HLPL shareholders for a related discussion.

Since EST entails applications of technology and not creation of technology, it is not that difficult to implement. It is not particularly expensive especially for a company of our size. We only need a team of younger program developers who are tech-savvy and in tune with the consumer market.

Nevertheless, one point worth mentioning is that there is almost nothing proprietary in EST. Any good idea by anyone will sooner or later be copied. Landlords will have to keep coming up with new ideas to keep the shoppers' experience fresh and fun. Such is the nature of applied technology. We strive to be among the first to the game and to build a reputation for these services, just as we have done for our physical hardware. In time, we will also learn from others, just as many others will learn from us. We will keep innovating.

Finally, let me return to the more immediate prospects of the Company. Given the toughest trading environment we have seen so far since entering the Mainland market, it will be unwise to expect too much. From the day we opened our first mall there in 1999, we have yet to see a fall in profit from rental business. We will do our best to ensure that not only top line rental revenue will grow for which we are confident, but also the bottom line.

Whether or not we will sell Hong Kong residential units will depend on market conditions. The possibility is certainly there. As I wrote last year, the local housing market is quite healthy, and the more expensive the unit price, the less likely these products will fall in value. As such, we are not too worried about the remaining 672 units at The Long Beach or the 18 semi-detached houses on Blue Pool Road. If market conditions are auspicious, we will buy more land for residential developments. We have always been looking.

Ronnie C. Chan
Chairman
Hong Kong, January 28, 2016

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