Chair's Letter to Shareholders

Ronnie C. Chan
Chair

Results and Dividend

Despite the persistence of the coronavirus (COVID-19) pandemic, rental revenue made a new record of HK$10,919 million for the year ended December 31, 2021, or 15% more than the previous year. No property sales revenue was recorded.

Net profit attributable to shareholders amounted to HK$2,589 million against the net loss of HK$1,541 million a year ago. Earnings per share was HK$1.90.

Underlying net profit attributable to shareholders advanced 6% to HK$2,991 million if all the effects of property revaluation are excluded. Underlying earnings per share increased similarly to HK$2.20.

The Board recommends a final dividend of HK65 cents per share payable on May 19, 2022 to shareholders of record on May 4, 2022. If approved by shareholders, total dividends per share for the year ended December 31, 2021 will be HK86 cents.

Business Review

We live amidst a sea of trouble. The pandemic is still raging around the world. Here in Hong Kong, we are experiencing the fifth wave. Even in mainland China, where they have done a superb job containing the virus so far, new variants are popping up here and there. China-U.S. relations are still a huge uncertainty hanging over our heads, yet luxury spending in China remains an oasis. It helped us turn in a rather satisfactory set of results.

Whereas general personal consumption on the Mainland is not strong, high-end fashion is selling very well. This is not only the case in what I call tier-one luxury product metropolises of Beijing and Shanghai but also elsewhere. (In this business, market size of Guangzhou and Shenzhen is similar to other top tier-two cities like Hangzhou and Chengdu.) With few exceptions, in all other cities where we have high-end malls — Wuxi, Shenyang, Dalian, Kunming, and Wuhan — sales are brisk.

Rental revenue at our luxury malls was up 30% while tenant sales climbed 55%. This compares to our three sub-luxury malls where the two measures grew by 2% and 20%, respectively. Rental margin, occupancy, and average unit rent rose for all six luxury malls (excluding Heartland 66 in Wuhan which was opened in March 2021), and even for most of the three sub-luxury ones. With the exception of Grand Gateway 66 in Shanghai, at all our top-end shopping centers, occupancy cost stands at a historic low level, and turnover rent remains at a very high percentage. That means there is plenty of room for upward rent renewal. The same cannot be said of their humbler cousins.

For our Hong Kong retail rental, tenant sales have improved but are still below 2019 pre-pandemic levels. For the year under review, rental revenue was down 7%, but it is progressing in the right direction. Rents collected in the second half of 2021 were about the same as that of a year ago. Comparing the last six months of last year to the first six, revenue was up 2%. Even rental margin and occupancy are edging up a little, although unit rent and rental reversions are still weak.

Office rental remains lethargic although the first half of the year saw an uptick. With some international firms relocating out of the city, this sector cannot be strong.

There was no recognition of profit from property sales last year. Profit from the sale of the house on Blue Pool Road mid last year will be booked once the transaction is completed later in the current quarter.

Construction progress everywhere is basically on schedule, with only minor delays in certain instances.

Net debt to equity remains relatively low at 22.3%. Almost 30% of total borrowing including available facilities is categorized as Sustainable Finance, up from 11% of a year ago.

We have set a high watermark in total rents received — it broke through the HK$10 billion mark for the first time in company history. It stood at HK$10,919 million. Unless we decide to substantially sell down investment properties, which is not at the time being anticipated, it is likely that, for the foreseeable future, the total rental revenue will not fall below HK$10 billion.

Prospects

In my concurrent Hang Lung Properties (HLP) *Letter to Shareholders*, I shared my thoughts on three potentially challenging external issues which may affect our business: Beijing's recent pronouncements on common prosperity and related policies, financial debacles relating to many Mainland property developers, and the way Hong Kong is dealing with the pandemic and its economic consequences. I refer my readers to my HLP letter on our website for that discussion. Here I summarize while adding a little color.

In a word, common prosperity is a long-standing policy. It is at least as old as the Reform and Opening Up Policy initiated by the then supreme leader Mr. Deng Xiaoping in 1978. As is the case everywhere else, government efforts always move between wealth creation and wealth redistribution. For example, after the rapid wealth accumulation in the U.S. from the mid-19th century after the Civil War until the go-go days of the 1920's, many social ills surfaced, and thus came the New Deal of the 1930's. Then in the early 1980's, President Ronald Reagan shifted the policies to the "right" again. Given the current wide wealth gap with its related social problems, I would not be surprised if changes, including possibly a serious backlash, would take place in the U.S. in the coming years.

China will chart her own path but will have the same objective as everyone else — common prosperity. It is not equal prosperity. She suffered common poverty from the 1950's to 1970's and know all too well what to avoid. In the absence of tax incentives, yes, Beijing strongly encourages the superrich to voluntarily share some of their wealth through philanthropy. Frankly, this is not a bad social practice. America does this well through fiscal incentives; Europe does not do much because the regular tax levels there are already, in general, much higher than those in the U.S. China will have to find her own way.

As I have said on several occasions in speeches on this subject, frankly a good number of Chinese entrepreneurs are very generous in giving back to society. In fact, very few economies have, at such an early developmental stage, produced so many very rich people who have already given or have pledged to give all their fortune away. Needless to say, many more need to emulate this example.

So, what does "common prosperity" mean? To lift the lower economic strata to make them truly "middle-class" by international standards. To do that, wealth redistribution is perhaps not as critical as social mobility. In the coming years, I would not be surprised if Beijing would announce more policies in this regard. It also means that the economic pie must be enlarged. Fortunately, China's economy has already reached a size and stage of development such that domestic activities are powerful enough to partly take over the former leading roles of exports and public investments for economic growth. Such is the 2020 Beijing pronouncement on dual circulation.

For a discussion on Beijing's imposition of limitations on Internet platform companies and private educational institutions, I refer readers to my HLP *Letter to Shareholders*.

The financial debacles of many Mainland property developers were altogether expected. More than most businessmen on the outside, I have repeatedly warned of the impending danger. In my keynote speeches at the annual real estate conference held in beautiful Hainan Island, the subject was repeatedly addressed. As such, there was nothing surprising. What I do not understand is why Beijing did not act earlier.

That said, the financial and related social implications of these debacles are entirely within the government's ability to handle. For pundits to say that this is a tsunami, like the collapse of Lehman Brothers was to the Western economic system, is nothing short of uninformed sensationalism. Over the past 20-some years, the West has repeatedly pointed out the perceived financial dangers in China. Their observations were, more often than not, correct. But because of a lack of understanding of the Chinese system, including its culture and society, those observers often did not have the necessary understanding of the causes, the processes involved, and so the likely outcomes. When the problems blow over and nothing detrimental to the society happened, these so-called experts apparently lack the moral courage to self-examine and to try to understand why their doomsday predictions were wrong. Consequently, they will make the same mistake again and again.

As far as our Company is concerned, these debacles are not only not harmful, but, potentially, mildly advantageous. There are many reasons they do not concern us. First, we are in very different businesses. Those companies are basically mass residential builders while we are high-end commercial complex developers and managers. They build to sell; we build to hold. Theirs is a game of size and speed; ours is one of quality and patience. They churn their cash and properties as fast as they can in order to survive; we own our malls and offices for a very long time. They are extraordinarily highly leveraged; we are rather lowly geared. Although we are both involved in land and construction, our products are totally different.

Why are others' troubles potentially beneficial to us? City governments that sell land primarily to house builders may see their coffers dry up because those firms can no longer buy land. Many are fighting for their own survival. Well, perhaps some of us commercial property developers with strong balance sheets can help. With luck, we may pick up a piece or two of choice land at reasonable prices. This is, in fact, what we have done a few times before.

My final external issue is the way Hong Kong is handling the pandemic. Its policies are inextricably tied to those on the Mainland, where they practice dynamic zero infection, while the rest of the world prefers herd immunity. While Hong Kong is economically reliant on the outside world, our relationship with the Mainland is not only economic but also intricately social. Just consider the fact that, before the pandemic, the number of travelers that cross the border with Shenzhen daily is over twice as many as the busiest border crossing in North America — between San Diego in California, U.S. and Tijuana in Mexico. This, to me, is the fundamental reason why Hong Kong has to adopt Mainland's approach.

This means that Hong Kong has to institute strict quarantine protocols which effectively cut much of the personal traffic to and from the rest of the world. The economic cost to us is almost unbearable. Still worse is that we are also not yet in a position to allow free movement across the border with mainland China. The reasons for this are simple. Unlike up north, many of our citizens are overly free — they tend to care about their own choices more than the good of the community. Just look at the percentage of Hong Kong citizens who are vaccinated. Our government also lacks the capability and the determination to take wise and resolute actions. Consequently, their half-baked policies are not effective and fall short of what it takes to open borders freely with the Mainland. In contrast, Macau, the other Special Administrative Region not far from us, has done a much better job.

The Mainland is a huge continental economy. If closed off to the rest of the world for a while, it can still survive. Not so with Hong Kong. As a small (though important) entrepôt and international financial center, the lack of physical connectivity is detrimental. So soon following the seven-month riots of late 2019, we are now hit with this terrible fate. We are driving global corporations with regional headquarters here to relocate. Sadly, some will; indeed, some already have.

After the 2019 social unrest and the mishandling of the pandemic, Hong Kong is forever changed. It does not necessarily mean that the city will economically wane. With Beijing's help, we should be fine. But that said, its nature will be different from before. Perhaps this is inevitable, for, after all, no one has ever attempted "One Country, Two Systems". We all will just have to live with whatever comes.

Fortunately for us, our business on the Mainland is thriving. About 68% of all rents collected originate from there, and this number can only grow further. Barring another wave that can seriously hurt the economy like in 2020, it is possible that our Hong Kong revenue has bottomed, but the rebound will not be spectacular. I suspect that retail space will do better than offices.

Plaza 66, Shanghai

On the Mainland, our seven luxury malls will again outperform the three sub-luxury ones. After the period of two and a half months — late January to mid-April of 2020 — under the initial assault of COVID-19, the economy bounced back strongly. Luxury goods sales were particularly robust because of the repatriation of sales formerly transacted overseas.

For the rest of that year and the first half of 2021, business continued to climb briskly until the second half of last year, when adverse weather events and periodic virus flare-ups in some cities in which we operate made the situation more challenging. Once new cases were discovered, footfall and also tenant sales there took an immediate hit. Local governments invariably took decisive action to contain the spread. In all cases, they were successful. As a result, tenant sales still rose nicely throughout the year.

Nevertheless, given the highly contagious nature of the latest dominant variant, Omicron, one never knows where the next flare-up will be. In the coming months, tenant sales will likely be affected by this uncertainty. Fortunately, our rents should be protected given the quality of our tenants. But if these outbreaks become very frequent, and depending on how long it takes to contain them, our revenue at lease renewal may be negatively impacted. But for now, we do not assume that this will happen for the rest of this year.

Provided that there will not be serious trouble in this regard, how will our luxury malls fare? It seems that, with a very high base after seven quarters of almost uninterrupted strong sales, the growth rate must somehow moderate. That, I anticipate at Plaza 66 in Shanghai. However, it may not be the case in our other high-end properties. Continued strong growth should be most notable in Olympia 66 in Dalian and Heartland 66 in Wuhan. The reason being, in both cases, many of the world's top brands have just opened their stores, and more will soon do so. Double-digit increase, and not very low double digits, seems quite probable. Even Grand Gateway 66 in Shanghai, Spring City 66 in Kunming, and Center 66 in Wuxi may see rather respectable growth. As such, the omens are good.

Olympia 66, Dalian

On another challenging front, there is no denying that China-U.S. relations remain difficult, with America leading her allies to contain China. Every story spread in the West about the country is to make her look bad. As a result, investors there can easily be misled into thinking that China is "uninvestable" — the exact word used in a certain analyst's report. They muddle political rhetoric with objective reporting, which is today almost non-existent in the West. With international travel seriously curtailed due to the pandemic, investors can no longer visit China as many of them used to do. Given this set of circumstances, some would just not take the trouble or the risk. Consequently, they might easily miss many good opportunities, of which we are one. Well, this is their loss.

Then there are those investors and analysts who understand the vast potential in China's consumerism. They are correct, but some of them are worried about the keen competition that we may face. This fear is not justified. Allow me to explain.

Take Shanghai as an example. It is estimated that there are a total of some 26.5 million square meters of retail space. In terms of the number of developments that boast a minimum size of at least 30,000 square meters in gross floor area (GFA), there are 347. In the coming few years, these numbers are expected to reach 32.8 million square meters and 417 properties, respectively.

The other eight cities where we have a presence (including Hangzhou, where Westlake 66 is being built) can be divided into two groups. The first group has, in each city, over 10 million square meters of retail space with at least 100 malls. They are, in descending order, Hangzhou, Wuhan, and Tianjin. The second group has 8.2 million square meters to 4.2 million square meters with 75 to 46 shopping centers. Again, in descending order, they are Shenyang, Wuxi, Kunming, Jinan, and Dalian. The increase in space in the coming few years will be about 25%, except Wuhan and Kunming with, respectively, 43% and 46% more.

In my 2017 HLP annual *Letter to Shareholders* I wrote about per capita retail space among advanced economies. The highest are the U.S. with over 2.2 square meters and Canada with 1.5. Major Asian cities like Hong Kong and Singapore are at around 1.1. Western European countries tend to have a lot less, and range from the U.K.'s 0.5 to Germany's not even 0.2. China at the time had less than 0.3, but that number probably included all cities in mainland China.

If we look only at the nine metropolises where we have a presence (again, including Westlake 66 in Hangzhou which is being constructed), the number last year was 0.84, ranging from Shanghai's 1.06 and Hangzhou's 1.04 to Jinan's 0.57 and Dalian's 0.56. This range is to be expected, since the more affluent cities will attract a lot more investments. Shanghai and Hangzhou are almost on par with Hong Kong and Singapore. Our other cities hover at around 0.70 to 0.90. With economic growth rates and salary increases considerably higher in these Mainland cities, the competitive landscapes are, in fact, not adverse. However, these numbers only tell part of the story.

Simple statistics belie an important industry characteristic that I have written about in this letter years ago. Namely, that business, as measured by tenant sales, and hence rents received, is highly unevenly distributed. First, in general, luxury malls are far fewer in number but much more lucrative. The reason is that very few developers know how to do it right. There are, perhaps, half a dozen in the entire country who have the expertise. Second, within a city, the number one luxury property almost always takes the lion's share of the business. Only in two megalopolises, Beijing and Shanghai, can two or more facilities both make very good sales.

In all but one of the better tier-two cities where we have a presence — Wuxi, Kunming, Dalian, and Wuhan — our luxury facilities are by far the strongest. In fact, the distance between us and our closest competitor is still widening. This means we are enlarging our market share. More tenant sales will surely bring even higher rents. To be sure, defending the number one spot is far easier than overtaking the leader from an also-run position. This is why I am confident of our future.

There is a good possibility that our three sub-luxury malls will also improve in tenant sales, albeit at a much slower pace.

Westlake 66, Hangzhou

Heartland 66, Wuhan

The biggest uncertainty this year remains the pandemic. The Omicron variant is reckoned to be highly contagious but not so virulent. From the perspective of fighting the virus, this is not welcome news for a zero infection policy, even of the dynamic kind. It may be challenging.

Like last year, I expect our new Mainland office towers to continue to lease-up at satisfactory rates.

Later this year, we will try to presell our first ever luxury apartments on the Mainland at Heartland 66 in Wuhan. Thereafter, we hope to do the same at Center 66 in Wuxi, and then, not too long, at Grand Hyatt Residences Kunming, which is part of our Spring City 66.

The pandemic may also affect construction progress. We will just have to see and do our best, as such events are beyond all of us.

To be sure, our land hunt will continue. Over the decades, we have honed our skill in catching down cycles to advance ourselves. Now, amidst a sea of trouble, yet given our positive long-term outlook on China's economy, particularly its luxury goods sector, there is the possibility of, again, taking advantage of the situation.

Against this backdrop, and with Hong Kong rents expected to recover, pandemic permitting, 2022 should be a good year for us.

Ronnie C. Chan
Chair
Hong Kong, January 27, 2022