恒隆地產
HANG LUNG PROPERTIES

25 YEARS IN RETROSPECT

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Preface

History is what makes us who we are today, its defining power gives it an immeasurable value which, with retrospection, reveals the road traveled and points to the path ahead. This volume, *25 Years in Retrospect*, presents the history of Hang Lung from the succession of Ronnie C. Chan to the chairmanship, not through rose tinted glasses, but as it happened; with a collection of the *Chairman's Letters to Shareholders* that span the period from 1990 to 2015.

Each letter, penned personally by Ronnie, gives insight into the workings of the mind that has helmed and steered the Company through storms and clear waters to where we are today. From penetrative assessments of the state of the market and its future, to policy decisions, directions, and aspirations, these letters encapsulate a vision for growth that has propelled the Company to new heights.

The letters in collection resonate with the Hang Lung business philosophy – We Do It Right – and demonstrate with clarity and detail how our present success and future growth is contingent not on external forces but on the correct interior disposition, and discernment of how to understand, anticipate, and respond to the changing environment with a single-minded focus on delivering the best possible results to our shareholders.

25 Years in Retrospect is a testament to the aspiration to build sustainably: not only the individual landmark structures that make up the Hang Lung portfolio in Hong Kong and mainland China; but to build a strong and sustainable future for the Company and all its stakeholders from our shareholders and employees, to our customers and the community at large.

Shenyang
Tianjin
Dalian
Jinan
Wuxi
Wuhan
Shanghai
Kunming
Hong Kong

Milestone

1991

- Ronnie C. Chan took over the chairmanship of Amoy Properties Limited and Hang Lung Development Company Limited

1992

- Amoy Properties Limited made its maiden investment in mainland China
- Acquired Standard Chartered Bank Building, the current headquarters of Hang Lung Properties Limited, in Hong Kong

1993

- Opening of The Peak Galleria in Hong Kong

1994

- Opening of Grand Centre in Hong Kong
- Became a Hang Seng Index constituent stock

1999

- Opening of The Grand Gateway in Shanghai

2005

- Completion of The Long Beach in Hong Kong

2009

- Land acquisition in Wuxi (to be developed as Center 66 – Phase 2)

2010

- Opening of Palace 66 in Shenyang

- 50th Anniversary of Hang Lung Group Limited

2011

- Opening of Parc 66 in Jinan

- Land acquisition in Kunming (to be developed as Spring City 66)

- The Grand Gateway renamed as Grand Gateway 66

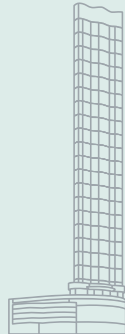
2001

- Opening of Plaza 66 in Shanghai

- Amoy Properties Limited renamed as Hang Lung Properties Limited
- Hang Lung Development Company Limited renamed as Hang Lung Group Limited

2002

- Completion of The Summit in Hong Kong



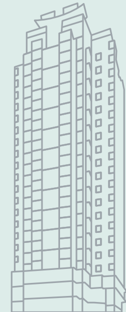
2003

- Completion of The HarbourSide in Hong Kong

- Completion of AquaMarine in Hong Kong

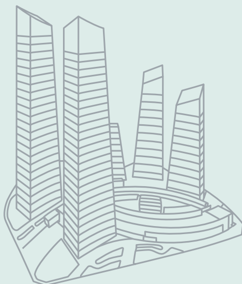
2004

- Completion of Carmel-on-the-Hill in Hong Kong



2012

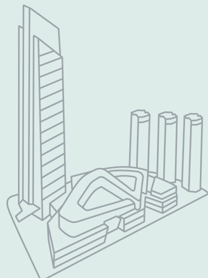
- Opening of Forum 66 in Shenyang



2013

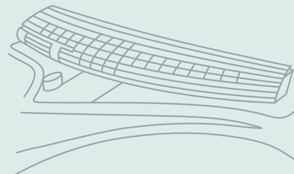
- Opening of Center 66 – Phase 1 in Wuxi

- Land acquisition in Wuhan (to be developed as Heartland 66)



2014

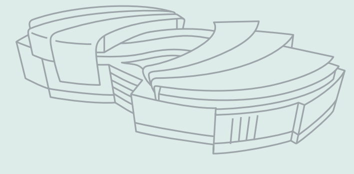
- Opening of Riverside 66 in Tianjin



- New look of Fashion Walk unveiled

2015

- Opening of Olympia 66 in Dalian



Our discerning approach to expansion is founded on a position of stability and healthy growth in our existing markets to pave the way for long-term returns. It is based on a fundamental belief in our astute management policies that view each property in our portfolio as an opportunity to add long-term value to our bottom line. Whilst improving yields in our existing portfolio with the remodeling of Food Street in Causeway Bay, this period also sees construction on Grand Centre and The Peak Galleria, and the foresighted acquisition of the Standard Chartered Bank Building in Central. But the most significant step forward for the Group was the landmark acquisition in the Xujiahui development in Shanghai, which market our providential entry into the Mainland market.

90
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91

Stability in Diversity: A Strong and Strengthening Portfolio

EXECUTIVE SUMMARY

Long-term strategic planning has built a portfolio capable of driving growth in variable economic conditions, and diverse enough to make the most out of short-term shifts in market sentiment. Existing retail properties have leveraged on broad appeal and the ability to manage tenant mix with flexibility to maintain yields on an upward trajectory. Likewise, office leasing has seen growth based on the consistent choice of strategic locations. Work in progress, including landmark site, The Peak Galleria, advances our principles for tactical and well-planned construction with a finger on the pulse of the market. And for the future, continued foresight in strategic development will enable us to extend growth through an acquisitions program propelled by favorable economic fundamentals.

Chairman Ronnie C. Chan

The various sectors of the investment property market performed differently in the period under review. Retail space and offices, for example, were at very different points in their respective market cycles. While the former sector to some extent slowed down due to moderating growth in consumption, it remained healthy for the most part. The same, however, cannot be said of the office market, at least not for class-A properties. Supply/demand imbalance caused rental rates to fall as did capital value.

Versatile Retail Appeal Taps Shift in Demographics

Furthermore, even within the same sector, differences exist due to location and target clients. For example, while vacancy rates for offices on Hong Kong Island have been high compared to a few years ago, occupancy levels in buildings in certain areas such as Mongkok have remained rather buoyant. The fact that they attract different kinds of tenants with different size requirements also contributed to the divergence.

The reason why your Company's portfolio has one of the highest yields of all the major property investment companies in Hong Kong is because: not only are we heavily concentrated on retail space (about 66 per cent of rents received), but our shopping centers also cater mainly to local customers. As a result, not only were we less affected by the fall in tourist arrivals, but we also benefited from the rise in income of the local populace. Furthermore, our shops are generally smaller in size and as such can usually command higher unit rents. This also allows management the flexibility to react quickly to changes in consumer taste by altering tenant mix.

Leading Location Leads Demand in Office Leasing

A similar situation exists with our office portfolio. Buildings in Central, for example, serve mostly major corporations, many of which are multi-national companies. They require larger space and their businesses are more subject to the economic fluctuations of other countries. Recession in the West combined with an abundance of new supply of class-A offices has caused a lowering of rents.

On the other hand, as Hong Kong's economic growth in the foreseeable future will be domestically led and as trade with China continues to improve, class-B space in convenient locations – the bulk of our office portfolio – has been spared from high vacancy rates. This, however, means that our average unit size per tenancy is much smaller than those in, say, Central. Consequently, our properties are more management intensive. However, our staff are well trained and are committed to achieving optimal results.

The fact that our properties are all well located – almost all of them are within minutes' walk from subway stations – also contributes to a higher yield and renders us more resilient to potential downturns in the market.

Driving Growth from Firm Foundations

Looking ahead, we shall strive to maintain in our future purchases those advantages already outlined. With a strong and steady cash flow and a low gearing, the expansion of our portfolio will be constrained only by the availability of good acquisition targets. Given the fact that one can generally buy good income-producing properties with a yield of 8% to 9% and with the borrowing rate standing at around or below these levels, we can afford to be more aggressive in our acquisition program, even though new purchases may not contribute significantly to the bottom line initially if leverage is used. However, we strongly believe that as rents continue to rise, capital value will go up accordingly.

Peak Performance at the Top of Hong Kong

A project which has attracted much interest, and hence worth mentioning here, is the 12,500 square meters development at the Peak, The Peak Galleria. Having worked closely with both the local architect as well as our U.S.-based consulting architect, we feel we

have arrived at a design which is quite satisfactory. The substructural work is continuing as planned and on schedule. On completion towards the end of 1992, The Peak Galleria will include retail space as well as restaurants which will have a panoramic view of Victoria Harbour. As we all know, the main constraint to receiving more tourists and domestic visitors alike to this world-class viewing point has been the limitation of parking spaces. With almost 500 parking spaces planned, visitors will be able to come and spend time at The Peak Galleria at their leisure.

In conclusion, I expect the coming year, barring any unforeseen circumstances, to be another year of growth in both revenues and profit.

Finally, I would like to extend my thanks to all our staff for their contributions to the continuing success of the Group.

Ronnie C. Chan
Chairman
Hong Kong, September 27, 1991

91–92

Foresighted Policies: Bearing the Fruit of Expansion

EXECUTIVE SUMMARY

Facilitated by the rights issue in April 1992, new acquisitions leveraged by equity financing have expanded our portfolio with quality properties earning yields that far exceed, in number and sustainability, those which could be gained using debt instruments as funding. Such acquisitions form the basis for our long-term vision of sustained and sustainable growth, which transverse transient movements in market and broader economic situations. Sharing our long-term strategies are the remodeling and construction works undertaken by the Company. With the remodeling of Food Street and the construction of The Peak Galleria continue apace with every confidence that they will contribute positively to the bottom line upon completion. It is with this positive outlook and trust in the excellent track record of our investment and management policies and priorities that we forge forward in the coming year with our expansion plans in both the local and Mainland markets.

Standard Chartered Bank Building, Hong Kong

As the year progressed, your Company became increasingly busy. We opened the exhibition hall on top of Queensway Plaza towards the end of 1991. Thereafter, we purchased the former Grand Hotel site for redevelopment into an office/shopping complex.

Entering 1992, we recognized that interest rates would be falling and anticipated an increase in capital values. Given the large size of current transactions, and the availability of quality purchases, we must constantly stand ready to act when opportunities arise. This is one reason why we wanted to strengthen our balance sheet further. We achieved this by raising HK$2.29 billion through a rights issue of three new shares for 10 existing shares in April.

The money raised enables us to expand the current portfolio by an additional HK$3 billion to HK$4 billion of properties. So far, we have acquired approximately HK$1.25 billion worth of quality buildings. With a debt level of HK$2.1 billion before the rights issue, your management would not be comfortable in making purchases of more than HK$1 billion to HK$2 billion without additional capital.

Two other factors supported our rights issue. We hold properties for the long term yet long-term borrowings in meaningful amounts on attractive terms are not readily available in Hong Kong. In other words, there is an inherent mismatch in funding our type of business with debt instruments. Equity financing, on the other hand, does not have this constraint.

Another consideration is the crowding out effect that may occur once the huge infrastructure projects such as the airport and the associated rail links are underway. To borrow or to refinance debt at that stage may entail higher pricing. Once again, this concern is irrelevant to equity financing.

Acquisitions Pave the Way for Long-term Growth

Our acquisition program started in earnest in the first quarter of 1992 and we were able to buy good investment properties offering 8% to 9% annual yields. Towards the summer, as local interest rates fell in line with U.S. rates, yields began to drop rapidly. This pace was accelerated further by the emergence of speculators (many of them from China) who saw opportunities in the residential market dissipating and turned their attention to the office, retail and industrial sectors. Yields for quality buildings reached the 5% level.

Fortunately, as speculation subsides, more attractive deals are emerging again. Our competitive advantage in this business stems from less competition for the major transactions (upwards of HK$0.2 billion to HK$0.3 billion) and our exceptionally strong balance sheet. It is also helpful that we are often the only buyer with the intention to hold on to the properties as long-term investments.

As we expanded our portfolio, we also saw the rental markets improve further. Rents for retail outlets, especially those catering to the general population have risen steadily throughout the year. Demand for class-B offices in which we have a strong presence has remained strong. While speculation drove capital value up, real demand has lifted rental rates. For these reasons, all our properties including Stanhope House, are now basically full with reversionary rents at higher levels.

The Bottom Line is Visible Growth

The present favorable rental environment is expected to continue for the foreseeable future. Rents for all our properties are expected to rise upon renewal. Given the high operating leverage of this business, practically all the increases will affect the bottom line directly. The completion of The Peak Galleria will be another source of substantial profit. Notwithstanding a slight delay in construction, costs should be within budget.

The Food Street portfolio has been undergoing systematic and comprehensive remodeling. Phase I of this remodeling project (affecting approximately 37% of the total space owned) will be completed next month. New rents received are double that of before. Phase II will be implemented as the leases for the remaining space become due.

Finally, we will continue our acquisition of new projects. We hope to buy another HK$2.0 billion to HK$2.5 billion of rental properties during the coming year. It is also our intention to expand into China where we will entertain only the best locations in population centers such as Shanghai, Beijing and Guangzhou. In line with the Company's policy, these properties will be held for rental purposes.

Healthy growth in earnings per share is expected to continue in spite of the recent rights issue as management strives to put the money raised to work by purchasing good yielding quality buildings. Your Company has consistently been able to reward those shareholders who showed confidence in all our previous fund raising exercises. There is no reason why they should be disappointed this time based on the successful acquisitions so far.

Barring any unforeseen circumstances, both turnover and profit for the year ending June 30, 1993 should be even better than those of the year just reviewed.

Your Board is pleased to announce that with immediate effect, Mr. S.S. Yin will become Vice Chairman of the Company. Mr. Nelson W.L. Yuen will assume the post of Managing Director while Mr. Alfred H.K. Li has been promoted to Executive Director in charge of finance and administration.

Ronnie C. Chan
Chairman
Hong Kong, September 25, 1992

92–93

Discerning Decisions: Qualitative Approaches to Portfolio Management

EXECUTIVE SUMMARY

The prudent expansion of our portfolio of rental properties has been achieved using the funds from the April 1992 rights issue, with further investment in high quality properties funded from internal sources and bank borrowings. Our discerning approach to acquisitions has secured exemplary long-term investments such as the Standard Chartered Bank Building in Hong Kong's CBD and the Group's 42% interest in the shopping mall portion of the Xujiahui development in Shanghai. We are committed to an ongoing program of selective acquisitions to further strengthen the quality of our portfolio. Meanwhile existing properties under development proceed towards completion on schedule and within budget including Grand Centre and The Peak Galleria. As we look forward to the year ahead with confidence in a buoyant market and wider economy, the Group maintains its conservative fiscal stance to stave off any potential crowding effects resulting from massive infrastructure works in Hong Kong, and undertakes to improve yields on our existing properties and continue making headway in the booming China market.

Grand Gateway 66, Shanghai

The Group at present has four main areas of endeavor: (1) continue our selective acquisition of rental properties, (2) complete projects under development, (3) improve the yield of our existing portfolio, and (4) increase our investment in the China market.

The stated purpose of the entire HK$2.29 billion raised through the April 1992 rights issue was for use to expand our portfolio. We successfully achieved this by December 1992. All subsequent acquisitions were financed through internal funds and bank borrowings, and we bought another HK$1.14 billion worth of high quality rental properties. Unfortunately, entry yields have dropped substantially from a year ago due to lower interest rates and increased competition.

Given these circumstances, our acquisition program has become more selective. We reviewed and turned down many deals before deciding on the few for which we made offers. Ample financial resources do not justify indiscriminate purchasing. Quality and quantity are equally important and we have every intention to maintain and indeed to improve the quality of our portfolio.

Exemplary Investments Seal Future Security

One such addition in the past year is the Standard Chartered Bank Building in Central, which is particularly beneficial to the Group. This transaction is extremely complicated. In essence, we acquired the full title of this 28,500-square-meter prime property by paying HK$0.9 billion in cash up front and by committing to make future lease payments totaling HK$2 billion over the next 20 years. Discounting this stream of payments at 6% and 8% will give net present values of approximately HK$1.1 billion and HK$0.9 billion respectively. In return, we are now entitled to market rental of the entire building, with the exception of the retail shops and two floors of offices which account for about 17% of the total lettable space. The rights to rental entitlement thereof will revert to us in 2012.

Construction of The Peak Galleria is nearing completion. Opening is now planned for December 1993. Construction cost is within budget and leasing of the shops is proceeding well. Construction of the Grand Centre, which occupies the former Grand Hotel site, is on schedule and within budget.

In Shanghai city, Amoy holds the Hang Lung Group's 42% interest in the shopping center portion of the Xujiahui development. This site of over five hectares on top of the Xujiahui subway station in Xuhui District, one of the best districts in Shanghai, was purchased in December 1992 by a consortium headed by our parent company, Hang Lung Development. The site is being cleared in record time. It will be developed into a commercial and residential complex including a 126,000-square-meter shopping center. Hang Lung is the project manager of this development. Together with Hang Lung, we are also working on certain other sizeable projects in Shanghai.

Prudence Par for Course in Forward Planning

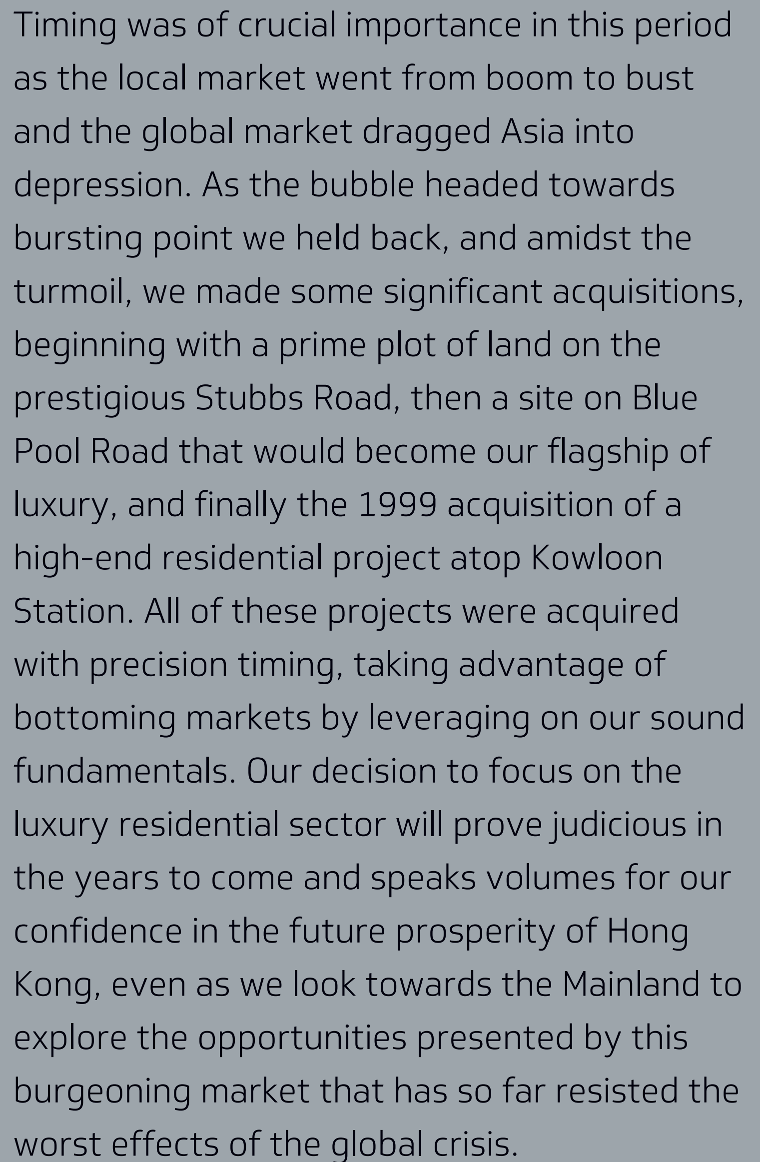
As long as rental yields are higher than interest rates and the demand/supply relationship is favorable, we will continue to buy rental properties. In the next few years, interest rates in the United States are likely to remain relatively low. Given the local currency peg to the U.S. dollar, Hong Kong interest rates are not expected to rise sharply. With rental yields well above our borrowing costs, it makes sense to gear up cautiously and buy selectively.

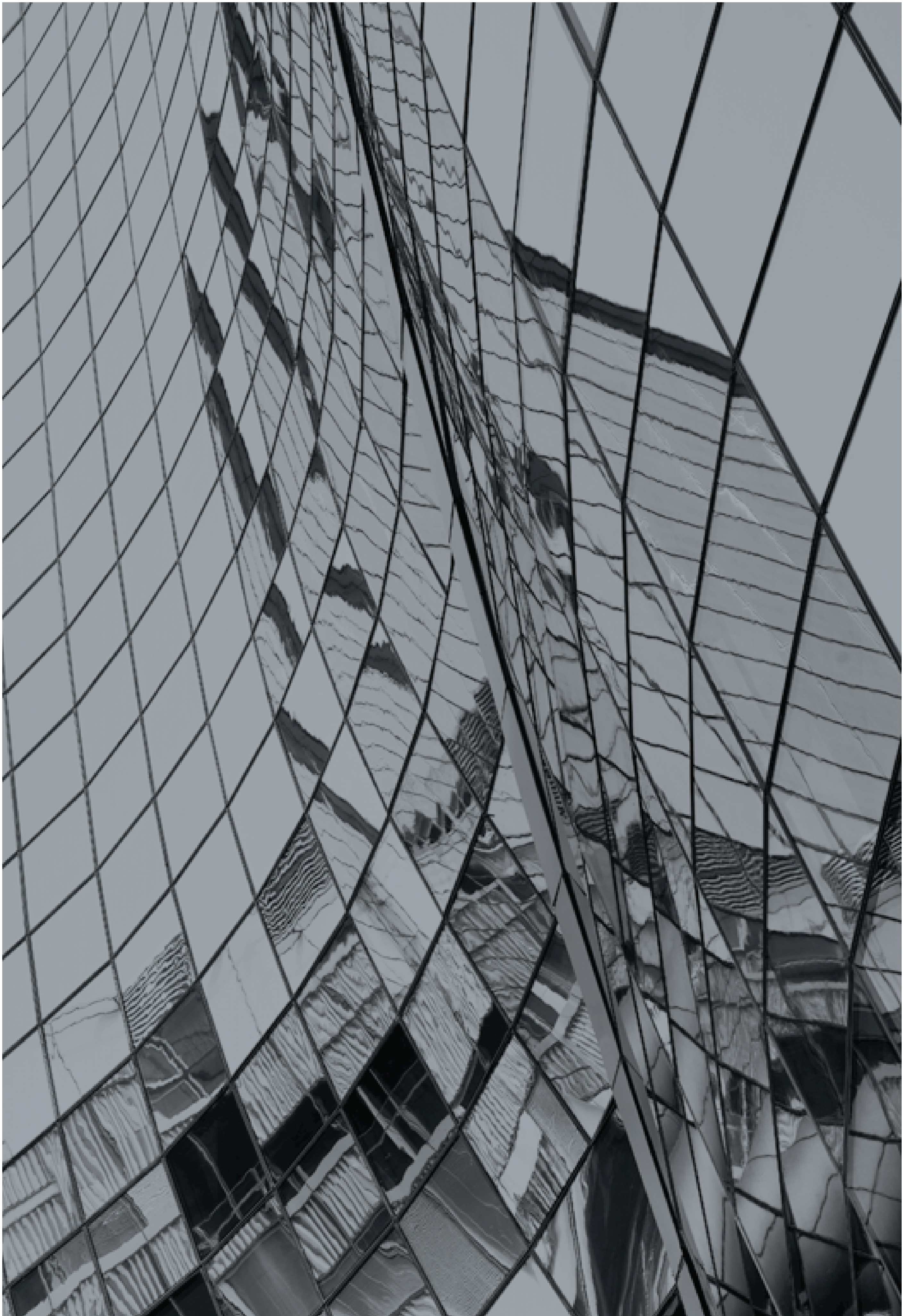
At the same time, the local economy has been quite strong, and there is a shortage of supply in most segments of the property market. These are all arguments for an expansion of the portfolio. When the annual inflation rate is at relatively high levels of 8.5% to 10%, rental rates will likely rise and this should translate to higher capital value.

In the past year, however, we have seen initial yields of transactions drop due to competition. Much of this competition comes from speculators, many of whom are from China. Now that Beijing is reining in the country's economy, hopefully, yields will begin to ease as less money is being invested in the Hong Kong property market. This will make us more comfortable when buying.

A year ago, I wrote that in the event of the massive infrastructural projects such as the new airport and associated works going ahead, there may be a crowding out effect in the market. While this has not yet come to pass, the recent events may herald its onset. For this reason your management is constantly reviewing our financial position. Fiscal conservatism will always be of paramount importance. As such, we will continue to explore various avenues of raising liquidity although another rights issue is not currently under consideration.

Ronnie C. Chan
Chairman
Hong Kong, September 17, 1993


Timing was of crucial importance in this period as the local market went from boom to bust and the global market dragged Asia into depression. As the bubble headed towards bursting point we held back, and amidst the turmoil, we made some significant acquisitions, beginning with a prime plot of land on the prestigious Stubbs Road, then a site on Blue Pool Road that would become our flagship of luxury, and finally the 1999 acquisition of a high-end residential project atop Kowloon Station. All of these projects were acquired with precision timing, taking advantage of bottoming markets by leveraging on our sound fundamentals. Our decision to focus on the luxury residential sector will prove judicious in the years to come and speaks volumes for our confidence in the future prosperity of Hong Kong, even as we look towards the Mainland to explore the opportunities presented by this burgeoning market that has so far resisted the worst effects of the global crisis.



93–94

Taming Zeal: Restraint as the Peak Emerges

EXECUTIVE SUMMARY

Pursuing a peak as it approaches is a fools' game that we will not be drawn into. Despite significant spending to expand our portfolio of quality properties, we have held fast to the principle of making judicious acquisitions that add value for our investors. The correct disposition is one of constant vigilance for the subtle indicators that reveal a yield point beyond which expansion is no longer tenable. We have thus made acquisitions of significant long-term value in anticipation of the elastic limit of the current bubble and at the same time disposed of matured and lower quality assets at significant profit levels to maintain our portfolio's momentum for continued growth. Our strategic approach to management and planning is bearing fruit in Grand Centre, The Peak Galleria and our developments in Shanghai. This, coupled with the ongoing upgrading works at key sites within our portfolio express our confidence in the direction we are taking. The Company's inclusion in the list of 33 constituent stocks of the Hang Seng Index also highlights that our management teams are not only on-track but see far ahead of it. And as we look to the future, we remain upbeat that we have prepared ourselves for the varied eventualities of the current market situation.

The Peak Galleria, Hong Kong

In March 1993, I wrote that we intended to purchase HK$2.5 billion of rental properties. In the ensuing 11 months, we have done just that – we paid HK$2.66 billion for three quality properties. Thereafter, a unique situation has risen and we spent another HK$1.2 billion to acquire the Ritz Building in Mongkok.

When we bought Park Building which is an industrial facility in Cheung Sha Wan, we intended to convert it into an industrial/office complex. Both its quality and its location argue for such an upgrading. Subsequently, we have been able to obtain approval from the government to turn it into an office building. If we can agree on the land premium to be paid, then the project will bring even better rent increase than we have anticipated.

Number 2, Garden Terrace is a well-designed and well-located high-end residential block in Mid-Levels. From the time we entered into the sale and purchase agreement to the time we closed the transaction three months later, its market value had already appreciated substantially. The same is true with our purchase of part of Shui On Centre in Wanchai which was consummated in February of this year.

Temperance and the Art of Restraint

By the end of 1993, we were increasingly uncomfortable about the high level of prices which rental properties had attained. A conscious decision was made to slow down further acquisition, if not stop it altogether. We find it foolhardy to press our luck after the lucrative deals as reported above. After all, we understand cycles and one must not go against it; its forces are far greater than any individual company. Instead, we stepped up our divestment program where we sold off matured properties, or properties of lesser quality. These have generated good profit for the Company.

In the last few months of the fiscal year, however, we detected an opportunity to assemble a sizeable plot by acquiring Ritz Building which is adjacent to our Grand Tower Arcade, and the Grand Tower Hotel owned by our sister company – Grand Hotel Holdings. An approach to the owner proved fruitful and we consummated the transaction last month. The two properties combine to form an island site of about 3,700 square meters in the heart of Mongkok. With a large development of the Land Development Corporation to our back, and with the relaxation of height restriction, this plot will prove to be very valuable if and when redeveloped. While we have paid full market price for it, it is worthy to note that we have sold off individual floors in a neighboring building not completely owned by us. Full market value was realized in those sales.

Tenacity Sees Results

After experiencing some initial difficulties, rental at The Peak Galleria is now stabilized. The problem arose mainly due to the delay in opening of the center, management remains very confident about the future of this unique property. After all, it is the only building of size at Victoria Peak, which is the most frequented spot for the nine million tourists arriving Hong Kong every year. Our other project under development, Grand Centre, is progressing as planned. Rental program has begun and the results are encouraging. The building will be ready for occupancy in December 1994.

Our two projects in Shanghai are both doing well. Substructure for phase one of The Grand Gateway in Xujiahui is almost completed and we are in the process of calling for tender for superstructure construction. The land of phase one of our Nanjing Xi Lu project is now all cleared and has been turned over to us. Design is now being finalized by a well-known U.S. architectural firm which won the job in a competition.

A Time to Sow and A Time to Reap

Over the past two and a half years, rental property value in Hong Kong has undergone a tremendous upsurge, the likes of which are seldom seen. Your Company, under its dedicated and renewed team of professionals, was able

to capitalize on the opportunity like few others did. In that period, we have paid almost HK$9.5 billion to expand our rental portfolio in Hong Kong. Thanks to excellent timing, we invariably bought before the market's sharp rise and so have enjoyed enormous price appreciation as well as rent increase.

The quality of buildings purchased is also extremely high. As a result, we have achieved an overall improvement in the quality of our portfolio. This is further enhanced by our sales of marginal properties, often at or near the top of the market cycle.

On top of the above activities, we have continuously refurbished existing properties to catch up with – and often to lead in – the market place. Although quite much has been done – Food Street, or now Vogue Alley in Causeway Bay, Amoy Plaza in Ngau Tau Kok, and Queensway Plaza in Admiralty, as well as the enlarged Printing House in Central, and the office conversion of Stanhope House in Quarry Bay – much more can be expected. Each of the above projects has resulted in a significant increase in rent and there is good reason to believe that future endeavors will produce similar results.

The combination of the above activities has made your Company a dynamic and indeed unique one in the local market. We are proud of our track record and look forward to continuing it with calculation and enthusiasm.

Strategically Positioned for Varied Scenarios

At present, almost all sectors of the real estate market have entered into a consolidation phase. Both offices and high-end residential units have seen prices peaked. Not only has capital value which may be affected by speculation, stopped rising, even rental rates which is a reflection of real demand have moderated somewhat. This is not a result of lack of demand; prices have simply risen to such an extent that they have met with resistance from the end users. Certain companies have moved their non-core operations to peripheral locations, and in certain cases, have even left Hong Kong altogether. Expatriate staff, on the other hand, have begun to invade middle-class residential locations which are traditionally the domain of local people. These phenomena, however, should not be overly alarming since new demand for space remains strong; they only confirm to us that market forces are alive and at work. The slowering and ever slight pull back of prices are good for Hong Kong's long-term competitiveness and we should support them.

As to our future plans, until the direction of the market is more clear, we shall do well to exercise patience. With the exception of unique situations such as Ritz Building, I do not expect our Company to aggressively buy properties. This, however, does not mean that we will not purchase land and build for long-term investments when opportunities avail themselves.

Analyzing the methods of profit growth for an actively managed property investment firm such as ours, there are basically three avenues. The most fundamental is rent increase as a result of either supply shortage or value creation such as improving or changing the usage of space. Inflation alone also tends to gradually push up rentals. The second way is by adding new properties to our portfolio – either through acquisition or through constructing new facilities. The third is by selling matured properties.

During times of fast price escalation, the emphasis should be on the first two avenues. Once growth in prices begins to moderate or when a plateau has been reached, one should switch to the third mode, i.e. selling properties. Fortunately, in the past few years we have taken full advantage of the rising markets. Now – at least in the coming few months – it is time to change tactics and sell. Indeed we have started the process nine months ago and will likely continue for some time.

The caveat, however, is that market conditions in Hong Kong can change rather rapidly. If that occurs and presents buying opportunities, we will not be loathed to re-enter the market quickly. After all, the financial position of your Company is extremely strong and the expected exercise of outstanding warrants next March will bring in further cash. This gives us tremendous firing power to either buy or build more rental properties.

Recognition of Strength and Discernment

Yesterday the HSI Services Limited announced that your Company has been made one of the 33 constituent stocks of the revised Hang Seng Index. We welcome this inclusion and vouch to make Amoy Properties an even better and stronger company in the coming years.

Together with our parent Hang Lung Development Company Limited, a new logo has been adopted for the Group. In accordance with the corporate colors of the three publicly listed companies, it will be presented in green for Hang Lung, in blue for Amoy, and in maroon for Grand Hotel Holdings. This logo symbolizes solidity and growth, as evidenced by our ever increasing massive hard assets and financial strength, as well as elegance and style, which befit our management skill and our emphasis on quality. It is my hope that it will further enhance the good image of the Group both in the eyes of our international investors and in the public at large.

Ronnie C. Chan
Chairman
Hong Kong, September 24, 1994

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Market Correction: Stability in the Storm of Upheaval

EXECUTIVE SUMMARY

Amid a violent market correction that has seen a price collapse of up to 35%, to have achieved year-on-year growth in profit is a testament to prudence and foresight in the Company's management. Our fundamentals remain strong and our business model has been exemplary, something recognized by our nomination, this year, as a constituent stock of the Hang Seng Index. Having our finger on the pulse of the market has enabled us to anticipate rather than react to the current downturn, exemplified by our early cessation of property acquisitions in November 1993. Now, in the midst of a hostile economic environment, we aim to maintain our tenacious bearing to navigate a path with patience while waiting for the market situation to improve, and prudence in managing our existing portfolio and resources as a company to achieve the best possible returns for our shareholders.

Grand Centre, Hong Kong

For different reasons, both office and retail markets have been extremely weak in the period under review. It is thus gratifying to know that we have managed to generate a small growth in profit. So much the more since we have done it when trading profit dropped by 80% due to unfavorable markets. This means that we have been able to grow rental profit significantly – by almost 28%.

The Constituents of Stability

Three other significant events transpired in the period. First, in November last year your Company was made a constituent stock of the Hang Seng Index.

Prior to our inclusion, we were already the largest company in the Stock Exchange outside of the Hang Seng Index stocks in terms of market capitalization. Even compared to the 33 then member stocks, we rank somewhere in the middle in terms of size. Given our profit record as well as the quality of our assets and of our earnings, it is not altogether surprising that we were chosen.

Second, in late March, nearly 98% of warrants outstanding were exercised bringing in almost HK$1.6 billion. Together with a strong cash flow, your Company is very healthy financially and has a tremendous amount of capacity to raise financing, if necessary.

Third, Mr. Alexander Siu Kee Au, J.P., Vice Chairman and Chief Executive of Hang Seng Bank has joined our Board as of January this year. His experience will no doubt prove invaluable.

The Constituents of Market Upheaval

The reason the office market is weak is three fold. First, prices – both rent and capital value – have risen so much in 1992-1993 that they are simply not sustainable. Tenants are not only forced to use space more efficiently, many of them are driven out of high rent districts such as Central into outlying areas. In certain extreme cases, companies have moved their non-essential departments or even their entire operation out of Hong Kong and into Southern China, South East Asia or even Australia. Second, the craze over China in late 1992 and throughout 1993 has subsided by the first half of 1994. Foreign companies, especially financial institutions, which rushed into Hong Kong earlier are no longer expanding. Third, the massive supply of offices related to the new airport railway is pointing towards an oversupply situation.

The combination of these factors is powerful and has driven prices down in some cases by 35% from the peak. Rents have fallen less resulting in higher yields. I welcome this development because it is good for Hong Kong's longer-term competitiveness. It also demonstrates to certain doubters in society, including some in the government, that market forces are at work and that economic means such as regulating land supply can be used to direct property prices.

Retail rents have also been weak but for different reasons. After tremendous rise in 1992 and 1993, both stock market and real estate prices have nowhere to go but down. Given the sharpness of the rise, a serious fall should not be too surprising. The only problem is that the negative wealth effect so created is powerful. When the "feel-good" factor is missing, people tend not to consume as much. The resultant slowdown in consumption is the most acute in recent memory. Nevertheless, I hasten to add that the general economy remains relatively strong due partly to the increase in transshipment trade and the spill-over effect of the building of the new airport.

Persistent Prudence Braces Us for a Soft Landing

The overall environment, nevertheless, was not conducive to selling our matured properties. As a result, before tax profit from disposal of investment properties was a meagre HK$83.9 million compared to HK$420.1 million the year before. So if we were to match the total profit of last year, rental income must grow substantially. Cost cutting measures must also be enacted. We did all of these and the result is that we match last year's net profit with a slight increase.

Given the very hostile environment, our performance in my opinion is rather satisfactory. When the market is rising, everyone can make money. It is in difficult times such as these that experience and skill are required to maintain profitability or at least to minimize the fall. In the past year or so, we had to readjust our strategies for several properties to keep rents up, and in certain cases, to prevent them from slipping. Obviously there are limits to how much we can do in this regard. Ultimately, we need to see an improvement in market conditions in order to resume growth.

Stability to Growth: Leveraging on Market Insights

There are three ways property investment companies like us can grow its bottom line. The first is rent increase which in the long run should follow inflation. The second is to increase the size of the portfolio. As long as the yields of the new properties are higher than the cost of money and other incremental expenses, then such activities will contribute to further profit. Finally, one can sell marginal or mature properties at prices that are higher than cost. Over the years, we have done all three to generate superior returns to our shareholders. In the 1990's, up to and including the period under review, our average annual growth rate has been 22% for both turnover and net profit.

The first way stated above requires much experience and knowledge of the market and of the tenants. We need to be sensitive to the market which is constantly changing. As to our tenants, we have to know about their business as much as they do. As such, we cannot be merely property experts, we must also be retailers who are involved in many sectors of retailing. Only by so doing will we be successful, especially when times are tough.

Our track record in this regard has been good. Following market trends, we change constantly our tenant mix and internal layout to create "new properties" with fresh look and redirected functionalities. Our next major project for reconfiguration will be the "Daimaru" site which will take place next spring. When it materializes, I expect an increase in rent as other similar projects have achieved in the past. The effect, however, will not be felt until fiscal year 1996-1997.

Leveraging on Discernment Amid Reactionary Moves

The second way to grow is to buy properties, which we did much in the 20 months between April 1992 and November 1993 when the market was fast rising. As history teaches us, the key to success in those times is to be tenacious. Obviously, the trick is to know when to stop, but only with experience will one gain that ability. In our case, we ceased entering into purchase contracts by November 1993 (with the exception of one unique case – the Ritz Building which completed an island site for us). Subsequent events have shown that our timing is very good.

Now that the bear market is here, the virtue to exercise is no longer "tenacity" but "patience". As far as purchasing properly is concerned, one must withstand temptation and do nothing until the market begins to rise again. By alternating between tenacious buying and patient waiting, money is made.

As to selling properties, the principle is the same although timing is of course different. Usually the correct time to sell is right before, during and shortly after the market peak. While this sounds simple, very few people can practise it properly. So far we have done well, especially on the buy side. As I have reported previously, we purchased about HK$8 billion of rental properties in 1992-1993 and all of them are still well above purchase prices although the market has dropped substantially. We bought early and we stopped buying at the right time. In hindsight, we probably could have been more tenacious in selling marginal properties when we correctly saw the market peaking.

Practicing Active Patience

Where do we go from here? I do not expect to see buying opportunities for at least another 12 months. In other words, I believe it is still time to exercise patience.

To put it in another way: of the three ways to grow the Company as I have outlined, timing is not right for the last two, i.e. add to the portfolio or sell properties for trading profit. This leaves us with only one method – that of working our existing portfolio. This is the slowest

way to grow profit and we can only use it to a certain extent. If the market remains very soft, what we can do will be limited.

The future of the office market is easier to predict – it will remain weak in the foreseeable future. Oversupply is serious and unless China's economy takes a strong turn for the better which is unlikely in the near term, I see little improvement. After 1997, the situation may change somewhat as I expect more Chinese companies opening offices here. While that may relieve the class-B office and industrial/office markets, class-A offices which will be abundant will not be helped.

The retail market is more difficult to judge because the problem is one of sentiment. The redeeming grace is that it is economically instigated and not politically incited. In time, the market will recover and I will not be surprised if that happens in the next six to nine months. Whether the benefit will accrue to our bottom line this year, however, is doubtful.

Given this reality, I am not optimistic about results of this fiscal year. We will be doing well if we can maintain profit at the current level. The wild card, of course, is whether the market will allow us to sell marginal properties. If it does, and since much of those real estates are carried at low cost on our book, maybe the result can be better than what I expect now.

Ronnie C. Chan
Chairman
Hong Kong, September 19, 1995

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Resilience: Emerging Stronger from the Storm

EXECUTIVE SUMMARY

Although far from bright, the market has passed its worst point and now is the period when many companies find themselves assessing the damage sustained during the storm. Thanks to our pre-emptive strategic planning before the worst of the crisis hit, which allowed us a degree of shelter from the harshest effects of the downturn and permitted us to adopt a policy of prudent patience without compromising our fundamentals, we are not counting losses but looking for ways to bounce back into growth. The acquisition, by government land auction, of a prime plot of land on Hong Kong's prestigious Stubbs Road, marked a significant first mover moment as we scooped a highly favorable tract of land with unobstructed views just as the market bottomed out. In keeping with the judicious management of our existing portfolio, our developments in Shanghai proceed on target and the transformation of the Daimaru Department Store into Causeway Bay's new Fashion Island is set to deliver an increase in rental income that will see revenue lost during construction recouped within a year. With plans taking shape and strategies bearing fruit, we are now poised to take advantage of growth opportunities as market conditions ease.

The Summit, Hong Kong

As I had anticipated, the past fiscal year remained a very difficult period for the property investment business. Nevertheless, we have managed to grow rental income slightly. Market condition is still hostile to selling non-core properties, and so profit therefrom has substantially decreased compared to the year before. After several years of fast growth, the Company has experienced two years of consolidation which is a reflection of market conditions. Given the exceptional slowness of the market, any increase in total profit should be considered rather acceptable.

Meeting the Trough of the Market with Renewed Vigour

Since the end of 1993 when we expected the market to peak soon and so refrained from buying more properties, we have exercised patience, watching out for the next buying cycle. On the one hand, our restraint in 1994 was proven correct – any acquisition would have seen a diminution of value as the market fell. On the other, our vigilance has finally paid off. In December of last year, the opportunity at last arrived and we beat out over 12 competitors to win a plot of land on Stubbs Road in a government land auction. The site has an excellent unobstructed view, and we plan to build a high rise luxury residential tower with 54 units which will be among the best in Hong Kong.

Our timing was very good. At the time of the purchase and at the land price paid, profit would have been minimal. But recognizing the potential of that segment of the business – there was very little new supply in the coming few years, and we were expecting the market to bottom soon – we were prepared to be aggressive in our bidding. Hindsight shows that we might have struck right at the trough of the market. Within a month or two, prices began to move up briskly and market price of similar units became much greater than our original proforma.

Vote of Confidence for Hong Kong and Hang Lung

In March this year, we have completed a HK$5 billion syndicated loan. The exercise is especially worth mentioning for several reasons. First, the facility has a five-year term which is longer than any other similar instruments the Group has ever done. This is a welcomed development. As a property investment company, longer-term loans alleviate the potential timing mismatch. Coming at a time not long before Hong Kong's return to her motherland of China, it is a strong indication of the confidence of international financial institutions on the future of Hong Kong and of our Company.

Second, not only did a total of 31 banks participate, (most of them are among the world's biggest), there were several newcomers to Hong Kong's property sector and so to our Company. In particular, more than one major U.S. bank joined for the first time. This again, in my mind, illustrates that all our bankers believe that Hong Kong will continue to thrive long after 1997. In spite of their knowledge of our Company's reputation in honoring obligations, they may still not have committed to such a loan if they have doubts regarding our legal system in enforcing contracts after 1997.

Third, we organized the banking syndicate ourselves and the loan did not require underwriting. This modus operandi is seldom practised here, if ever, but has since been copied by one or two other local companies.

Our two developments in Shanghai are progressing well. Towards the end of the fiscal year, we have acquired an additional 9% of the shares of the project on Nanjing Xi Lu called Plaza 66. As a result, we now own 79% while our parent company Hang Lung remains at 10%.

A Market Transitioning Towards Recovery

At fiscal year end, vacancy rates for both our retail and residential portfolios stood at around 3%. The number for offices is somewhat higher while that for industrial/office buildings is at a double-digit level. Given the small size of the last sector compared to the first three groups of higher value properties, the effect is very insignificant.

The retail sector has improved somewhat in the past few months. Although it is yet to be translated into conspicuous rent increases, I believe the worst is behind us. Since the main cause of the recent dull market is the contraction of consumer spending, once sentiments improve, we can expect rental activities to increase and rents to firm up.

The office market has also done somewhat better. Enquiries from prospective tenants have increased, and it is now easier to consummate leases. While this recovery is welcomed, I expect it to be mild and even short-lived. With the exception of core-Central where new supply is limited before the first half of the next decade, there will be many buildings being completed in other districts in the coming five to seven years. These outlying areas already have higher vacancy rates, and we will not see too much improvement. As a result, there will be continued pressure on rents, and expectation of a coming glut will ensure that.

What is unknown is of course demand. In the coming one year or so, it is understandable that due to Hong Kong's transition, some companies, especially foreign ones, may take a wait-and-see attitude. On the other hand, the Chinese economy is only slowly emerging out of a three year consolidation phase – banking facilities are available only to certain industries, and full recovery of the economy is yet to arrive. This is why I do not see a serious pick up in Hong Kong's office market in the near term.

Two to three years down the road, however, it is not unreasonable to forecast a rise in demand. Existing office users will realize that things are unchanged after 1997, and so may carry out their expansion plans which have been put on hold. Moreover, after the return of sovereignty, many Chinese companies will likely open offices here. By that time, China should have entered into the next cycle of increased economic activities, which will again accrue benefit to Hong Kong, and hence to our industry. The only thing is that at around that time, there will be many new buildings being completed. The amount of supply may keep rents from rising too much, if at all. This, in my view, is good for Hong Kong – it will keep our city competitive.

Positioning Ourselves for Growth

As in the past, slow market conditions will present us with buying opportunities. Because of our long-term confidence in Hong Kong, I intend to take full advantage of them. Investments made in the next few years should in time yield benefits to our shareholders.

In October, reconfiguration and renovation of the main section of our shopping center in the heart of Causeway Bay will be completed. Daimaru Department Store will remain on the second floor while the ground floor will house many name-brand boutique stores. The new mall will be named Fashion Island. Compared to before, rents will grow by approximately 40% and the loss of revenue during the refurbishment period will be recouped in one year's rise in rent.

In this fiscal year, rents can be expected to stabilize. So in the absence of sales of mature properties, profit growth will not be spectacular. However, I am hopeful that market condition will allow us to sell some. Looking further down the road, I expect to use our very strong balance sheet to generate another round of acquisition-led growth in both revenue and profit. In my opinion, we have one of the best management teams in Hong Kong for property investment companies which will make such growth possible.

Ronnie C. Chan
Chairman
Hong Kong, September 20, 1996

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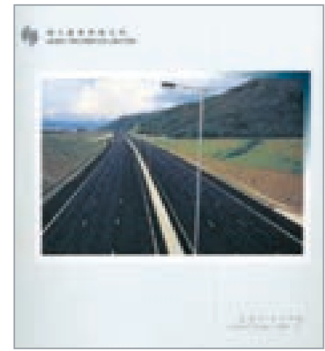

Robust Recovery: Getting in the Stride for Success

EXECUTIVE SUMMARY

We emerge from a period of consolidation into the right time for cultivating a renewed success story. Stability is returning, and while rental rates are not yet seeing exponential growth, signs of recovery are becoming evident. Taking advantage of a short-term window of opportunity, during the latter half of 1996 and early 1997, when momentum returned to the market with the reappearance of property buyers, we have strategically released matured properties to take profit for reinvestment in properties and developments that will chart a significant growth trajectory in the years to come. With a healthy balance sheet, free from debt, and with our existing portfolio maintaining high occupancy rates and significant development projects making good progress, the time has been ripe to make targeted acquisitions. The newly acquired Blue Pool Road site in Hong Kong will be our flagship of luxury in a market that is sorely lacking in this sector. At the same time, as we venture with confidence into a new era for Hong Kong, Hang Lung is poised to leverage its strong position to weather short-term ripples in sentiment and emerge with a portfolio to meet the anticipated needs of a prosperous city, particularly in office space and high-end residential units.

Plaza 66, Shanghai

After two extremely difficult years when rents stagnated and capital value either fell or went side-ways, it is good to turn in some stellar performance. What has changed which has given the good results of last year? Although rents for commercial space (i.e. shops) and for industrial buildings have recovered somewhat, those for offices and luxury residential units have basically stayed unchanged. The net effect is that overall profit from rental operation has only grown by 9.1%. What made the difference was that property buyers who had disappeared for some time had resurfaced.

Targeted Selling for Targeted Acquisitions

In the second half of 1996, sentiments for buying rental properties returned and in the process, bid up prices. Many of the purchasers were speculators whose appetites were for shops, offices and high-end residences. The market remained active until the spring of 1997 when, with the exception of shops, it quickly died down. We took advantage of this window of opportunities and sold about HK$1.2 billion worth of matured of non-core properties. The profit resulting therefrom was very good. After fiscal year end, we have continued to dispose of commercial space since buyers are still there.

Our rationale is simple: if someone is willing to buy matured properties at rental yields of 4.5%, we should sell. These are properties which are not easy to add further value and it is unlikely that yields will go much lower. And since these yields are below our cost of funds, we are not only not diluting earning, we are actually getting ahead.

Taking a longer-term view, we had spent about HK$9 billion to enlarge our rental portfolio in the first half of the 1990's when prices were low. Total space owned grew from about 400,000 square meters to over 700,000 square meters. Now that prices have risen again, it is only right that we should take some profit. After all, the hot marker will not be with us forever.

There is another reason to sell – we should prepare ourselves for buying opportunities. It was for the same reason that in November of last year, we placed 310 million shares when the stock market was strong. At HK$11.10 per share, we collected almost HK$3.4 billion which further strengthened our balance sheet.

Last month, we successfully completed the acquisition of a 6,800-square-meter site in Blue Pool Road in Happy Valley. We have worked on this project for almost 10 years and will now develop it into high-end residential units. Amoy owns 67% and our parent company Hang Lung Development holds 33%. Application has been made to the government to relax the amount of buildable space allowed. Given the utter shortage of luxury flats on Hong Kong Island, I am hopeful that we will see some leniency from the government.

Pleasing Progress Building Growth Momentum

Vacancy rates for all sectors of our portfolio remained very low. As before, the only exception is the industrial sector. The situation there, however, has definitely improved.

The two projects of Shanghai are progressing as planned. We are now actively marketing the shopping center in The Grand Gateway in Xujiahui.

After such satisfactory results, the question in the minds of shareholders must be: will we be able to maintain the performance this year? My answer is: barring any change in unforeseen circumstances, we should.

The reason for my optimism is that on the one hand, although the growth rate will not be spectacular. I expect rental income to remain steady. On the other, in the first month of this fiscal year, we have already sold almost as much matured properties in terms of sales value as all of last year. Profit arising therefrom, however has in fact exceeded that of the previous year. As such, unless the transaction falls through, satisfactory result is assured. Moreover, as long as market conditions allow, we may sell more.

The Mechanics of Adding Value

At this juncture, I would like to say a word about how we make money for shareholders. Year in and year out, we do three things. First, we actively manage our rental portfolio. We constantly examine ways to improve rental yield – by changing the tenant mix of our facilities to suit fickle consumer tastes, by redesigning the configuration of our shopping centers to reflect current conditions, and by upgrading our properties to maintain competitiveness. A recent example is the conversion of half of Daimaru Department Store of which we are landlord to what is now called the Fashion Island. After completely redoing the ground floor, we reopened it last October. The result: rental income jumped by 40%.

Second, we add to our portfolio by acquiring existing buildings, or by buying land to build new facilities. Third, we sell properties which are non-core or are matured.

My point is this: all three activities should be seen as regular operations of the Company. None of them are one-off events: they are the ordinary course of our business. Obviously we may not do all three in any one year and our ability to carry out the last two will depend on market conditions. Just as we will buy when the market is low, we will also sell when the market is high.

Charting the Right Course in Changeable Waters

So how do I see our business at this time? On the rental side, things are moving slowly. Rents for offices and for luxury residential units have not done much and that condition will continue for some time to come. In fact, it is not inconceivable that they may even drop slightly. Retail rents improved somewhat last year, but consumption is again weak this past summer. I am hopeful that this is a temporary phenomenon. The exceptionally low tourist arrival in the past few months will not impact us directly: our malls are mainly tailored to local people. However, extreme weakness in a critical industry such as tourism will inevitably affect Hong Kong's overall economy. The effect will sooner or later be felt by all, including our business.

That of course is not all bad news. Believing in the longer-term prosperity of Hong Kong, we will acquire especially offices and high-end residential units. Temporary market lulls will moderate capital value which will not only improve Hong Kong's competitiveness, but provide us with better buying opportunities. Together with the fact that many of plots for sale by the government in the coming 18 months are rather large, competition will hopefully not be as keen. With a sizable balance sheet which is debt free, financially we are capable of picking up a few large projects.

Our former Chairman and of late, Non-Executive Director Mr. Thomas T.T. Chen has decided to retire from the Board. It took effect on November 26, 1996. On April 1, 1997, Ms. Laura Chen joined as a Non-Executive Director. We all wish Mr. Chen much happiness in retirement, and all the same time, welcome Ms. Chen to her new position. I am sure that she will contribute much to the Company in the many years to come.

Ronnie C. Chan
Chairman
Hong Kong, September 23, 1997

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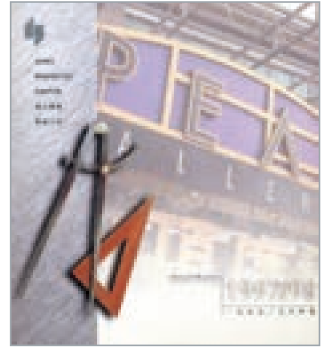

After the Calm: The Full Storm of Recession

EXECUTIVE SUMMARY

Although we have prepared in earnest for any eventuality in the development of the market, the extent of the current market collapse has entered landmark territory. The increase in profit for the year is due to insightful reading of the market and the ability of our management to initiate transactions and manage our portfolio with prudent care for maximizing profit potential. However, in the face of systemic factors that will see rental rates fall and property prices tumble, the outlook is grim. We are fortunate to be in a strong position financially through sales at the correct times which have yielded excellent profits and made the Company's cash position strong. However, utilizing this cash will require a high degree of vigilance in order to buy, not only at the right time, but also properties that present the best growth opportunities. Whilst such opportunities may or may not present themselves in the short term, we are bracing for the full effects of the storm by continuing the diligent management of our portfolio. Although two large Japanese retail tenants are withdrawing from the local market, leaving substantial retail square footage vacant, the remodeling of the affected shopping centers aims to keep vacancies at a minimum. Likewise, across our diverse portfolio of retail, office and residential properties, although rents will suffer an inevitable decline, we are committed to keep vacancies as low as possible in order to maintain a healthy cash flow to sustain operations and build our arsenal for future investment opportunities.

Fashion Walk, Hong Kong

When the past fiscal year started, we knew that the market was softening. Rents were not particularly strong and capital values were quickly disappearing in the sense that investment properties transactions were fast drying up. Speculators who fueled the buying frenzy of late 1996 and early 1997 had already pulled out of the office and luxury housing markets. Only retail space still had a few sales. We took advantage of one of the last opportunities in July 1997 and sold enough to book almost HK$850 million of profit. When completion time came in January of this year, the market was already so weak that the deal was seriously in jeopardy of not being consummated. Luckily it did.

For the 12 months ended June 30, we managed to keep rents up such that profits therefrom did not drop. Add to that the profit from the sales of properties and we have produced a bottom line which is slightly higher than that of a year ago. Given difficulties for the most of the fiscal year, we must be one of the very few major real estate companies, if not the only, in Hong Kong which has recorded a growth in profit. This is gratifying. However, as we look into the near future, there is nothing but gloom such that the present years results will in all likelihood be inferior to that of the one just passed.

Global Recession Regional Depression

The severity of today's market weakness is unlike any chat we have seen in the past two decades or more. It is not a cyclical downturn. This time it is a full-fledged recession which is threatening to turn into a depression. Asset devaluation of both real estate and stock market ranks as one of the worst in recent memory. In the property sector, more major companies are cash strapped today than in previous episodes.

There is also an international dimension which is not new. Economic trouble of 1974 was caused by the first oil shock started in the Middle East; 1987's stock market crash began on Wall Street. What is new this time, however, is the fact that the center of the hurricane is Asia. Although Hong Kong fares well compared to many of our neighbors, our success in beating back speculators in no way means that the attack we sustained on our currency and our stock market are any less serious. Its effect on our economy will linger for years to come.

This is both bad and good news for our Company. It is bad because rents will come down and we will be unable to sell matured properties for profit. As such, after growing our bottom line for 10 straight years, we will likely see our first decline this fiscal year. Diminution of asset value has also occurred and is reflected in the latest balance sheet. The magnitude of the drop can only be described as serious.

Strength to Ride Out the Storm

The good news, on the other hand, is that we have prepared ourselves very well – not only are we not hurt by the severe tight credit environment; we are cash rich and so are well equipped to take advantage of future buying opportunities. First we have raised a lot of cash since April 1992 – over HK$9.65 billion in equity money alone. The last time we tapped the capital market was in November 1996 when we placed shares for about HK$3.4 billion. Hindsight showed that we were extraordinarily lucky – the deal was done when our share price was at the highest point in recent years.

Second, whereas we spent almost HK$7 billion to acquire rental properties in 1992 and 1993, we stopped systematic purchase by November of 1993. In that same month, we raised over HK$2.3 billion through a convertible preference share issue. From then on, we have basically been accumulating cash; after maintaining a steadily growing dividend payout, of course. The only other major outlay was the two development projects in Shanghai, The Grand Gateway and Plaza 66. However the amount spent is more than balanced by monthly cash flow of about HK$200 million as well as proceeds from the sales of matured properties in Hong Kong. In 1996-1997 we felt that prices here were getting too high due mainly to speculators and so we sold. That was the right

decision and we pocketed almost HK$2 billion profit. If we erred on anything, it was that we could have sold even more, but then hindsight is always 20/20!

Our effort of actively managing the property portfolio has also borne fruit. At the least, our work had cushioned the fall when things turned nasty. For example, sensing changing market conditions in the past two years, we had reorganized several of our shopping centers. One is the Daimaru Department Store site where we had taken back quite a bit of space from the tenant and had turned it into smaller shops. So last June when the Japanese company decided to quit Hong Kong (and several other countries as well), the pain to us was not as great as it could have been. Likewise we had eliminated the cinema in Amoy Plaza and rented the space to several fast food restaurants instead. The big Chinese restaurant also at the same mall was converted into small shops. If we had not taken these precautionary actions, the trouble today would have been even greater.

Prioritizing Portfolio Management

We are in no way underestimating the difficulties of the tasks ahead of us. Two long-standing Japanese tenants have both decided earlier this year to pull out of Hong Kong. The sizeable space left behind will take time to fill. Total redesign of the two shopping centers is also necessary and work will soon begin on the Matsuzakaya Department Store site. We will do likewise once Daimaru vacates at the end of this year.

But for now, we have been able to keep vacancy rates low, especially in the retail and office sectors which account for most of our portfolio. Residential occupancy has deteriorated somewhat while industrial space has done better than before. As can be expected, rents have softened almost across the board.

Our Shanghai projects are moving along with construction and rental activities continuing in earnest.

Caution Key to Emerging Stronger

Although cash rich, we are nevertheless extremely careful. First, we do not know how long the downturn will last. Second, our future success will depend on how we deploy financial resources in the coming year or two. We want to make sure that when we buy, we get the properties which have the highest potential and at the lowest possible price. We are watching carefully if today's extremely tight credit condition may not turn up good opportunities.

The situation today seems different from that of 1992 during China's economic turmoil when we bought heavily. In those days, we were able to buy at yields of as high as 10%. That was because whereas capital values fell due to weak market sentiment, rents remained steady. This time, however, rents are down significantly. Yet sellers have not adjusted to this reality and so are still asking for prices which in my opinion are unrealistic. We will have to wait longer and let economic pain bites further. It seems that unless the larger environment improves quickly, which is highly unlikely, our patience should be rewarded one day. When there are so much "blood on the street", opportunities must sooner or later present themselves. When that happens, we will embark on another round of acquisition-led growth that I have been speaking of in the past year or two.

But for now, we will redouble effort in leasing vacant space and in working with our existing tenants. However, our best efforts will not be able to prevent a drop in profit this year. It will be difficult to maintain rental revenue and profit, and it is most likely impossible to generate sales profit. Our aim is to move as close as possible to last year's rental profit. With our stock price already down substantially and with the expected retreat of profit, dividend will have to move in tandem. Barring unforeseen circumstances, we will follow our long-standing policy of keeping a steady dividend payout ratio.

Ronnie C. Chan
Chairman
Hong Kong, September 25, 199S

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Positives Amid Negatives: Persevering Through Painful Times

EXECUTIVE SUMMARY

The financial crisis that has impacted Asia has put unprecedented pressure on the market, affecting the general economy, sentiment, demand, and consequently rental prices and property values. Amidst the turmoil we have kept a steady head and focused on sustaining our positive fundamentals in preparation for better days. The opportune acquisition of development rights for a high-end residential project atop Kowloon Station signals our confidence in a recovery that will first be seen in the luxury residential market. Meanwhile, as we ride out the storm, we have maintained rental vacancy rates are below the market average and encouraging progress has been made in recruiting tenants for our newest Mainland development, The Grand Gateway, in Shanghai. However, with no clear end to the recession in sight in the short term, our approach remains cautious and conservative in terms of fiscal policy and also in our focus on the management of our existing portfolio of rental properties. The time will come for investment, and when it arrives we will be in a good position to take full advantage. However, the time is not yet here, and with an anticipated glut in the office sector, our focus is on monitoring the market for suitable opportunities for growth in other sectors.

The HarbourSide, Hong Kong

Given the severity of the Asian crisis, it was not difficult to predict 12 months ago that both turnover and profit would fall. That indeed happened, and the drop in bottom line was our first in 10 years. With an extremely weak economy, all sectors of our portfolio performed worse than last year. As a result, operating profit from rental activities retreated by 16%.

In terms of vacancy rates, the best performing sector was commercial space. It stood at around 7% at fiscal year end. The office market continued to deteriorate but we were able to keep all but less than 10% of our buildings full. Given the environment, that must be considered satisfactory. Luxury residential units were not as fortunate and vacancy rate was in the teen's. As before, industrial buildings were the weakest performer.

Major renovations had started in the sites previously occupied by Matsuzakaya and Daimaru department stores. Leasing has progressed satisfactorily, and both malls should be largely occupied and opened for business by Christmas.

After years of hard work, The Grand Gateway shopping center in Xujiahui District in Shanghai will have its soft opening in December. Because of the economic slowdown in China, it has not been easy to fill up the approximately 100,000 square meters. Nevertheless, we expect to be 70% full by the end of this year.

Poised for Development

The highlight of this fiscal year must be the acquisition of a development right in March. Realizing that attractive opportunities to buy investment properties will unlikely surface in the near future, we had turned to purchasing land for residential developments. We perceived good potential in that sector. Together with the Mass Transit Railway Corporation (MTRC), we will build 128,000 square meters of high-end units on top of the Kowloon Station. The three towers of 72 stories each will have an unobstructed view of the entire harbor.

Best of all is the price of our winning bid. Coming one month before the end of the government's self-imposed nine-month land sale moratorium, and at a low point of the market, the land cost we paid was rather reasonable.

Diagnosing the Market

Looking ahead, I see more trouble waters. The economy is weak and unemployment is high. Our citizens are afraid to lose their jobs and so are consuming less. China which is our major trading partner is still experiencing economic adjustments and is unlikely to get out of it any time soon.

Besides, industrial space which is not as significant to us, the hardest hit is the office sector. For the past five years I had been consistently singing its dirge. Whenever there was any slightly sign of activities, analysts were quick to pronounce its resurrection. I never believed them and was happy to be in the minority. So far I have been correct. Since there are considerable disagreements on this point, please allow me to put forward my case.

Prognostic Reasoning

The first problem is oversupply due to the relocation of the airport. Before, buildings on the Kowloon peninsula were limited to 20 stories. (This was why Kowloon was less visually attractive than Hong Kong Island. The view from Kowloon across the harbor was far better than the other direction.) Now the restriction is gone. Since it is not easy to assemble big pieces of land given strata title of most buildings, legislation will have to be introduced to force redevelopment. The process is already on its way and the potential additional space can only be measured in the millions of square meters.

Second, the Central district is spreading both to the east and to the west. This is not to mention the pockets of office which are springing up in traditionally industrial or residential areas such as Quarry Bay to Kwun Tong. Those buildings are becoming increasingly luxurious to lure tenants away from established office markets. With much lower rents, they will register certain successes. Both the subway and the railway companies, i.e. MTRC and KCRC respectively, have reserved sites along their routes for office developments. The mixed-use space called Industrial/Office buildings (i.e. I/O buildings) will increasingly become obsolete; economic necessities have pushed them to become pure offices, which fact the government will have to acquiesce. All these will balloon supply almost indefinitely.

In time, demand will not remain low as in the last two years, but absorption will be dwarfed by the amount of new supply. Expectation of more to come is sufficient to keep prices down. So far rents and capital values have basically fallen in tandem resulting in little change in rental yield. However, low yields of 4% to 5% are not sustainable given lackluster economic future and very high real interest rates. They will have to rise which will make offices once again interesting investment targets. Since most of them are for lease, rent is a better indication of real demand than capital values. (The latter are easily affected by speculative activities.) Such demands will serve as a floor to rents. So for yields to rise, prices will have to fall faster. We have seen that in 1992-1993 and those days will return. The only exception will be well-located class-A offices such as those in Central district where yields will remain relatively low. Vacancies will also be less of a problem due to the lack of new supply.

Charting the Correct Course

Given the above, we are in no hurry to buy in spite of being cash rich. We will wait for yields to rise. It may be surprisingly to some that prices, after having fallen by over 60% in the past few years, will have quite a way to go. Such is the cruelty of the market.

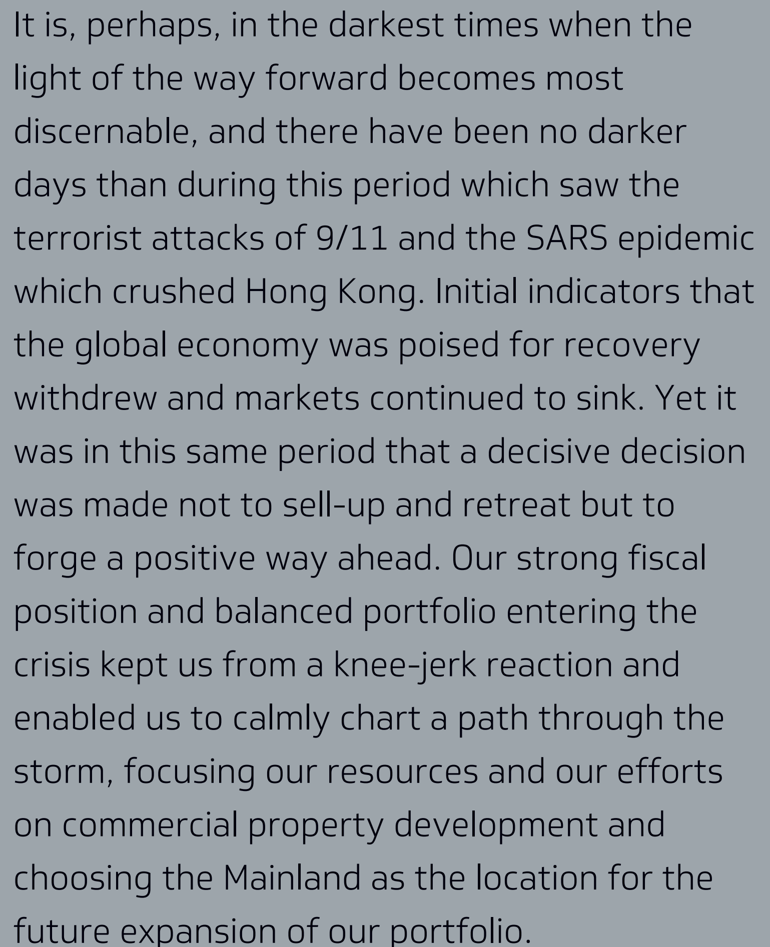
Luxury residential units will fare better. Potential supply is much smaller than offices and so will recover first once the economy improves.

After several years of weak consumer spending, commercial space has finally showed signs of bottoming. However one should be careful projecting how fast will rents move up. My guess is that it will be rather slow.

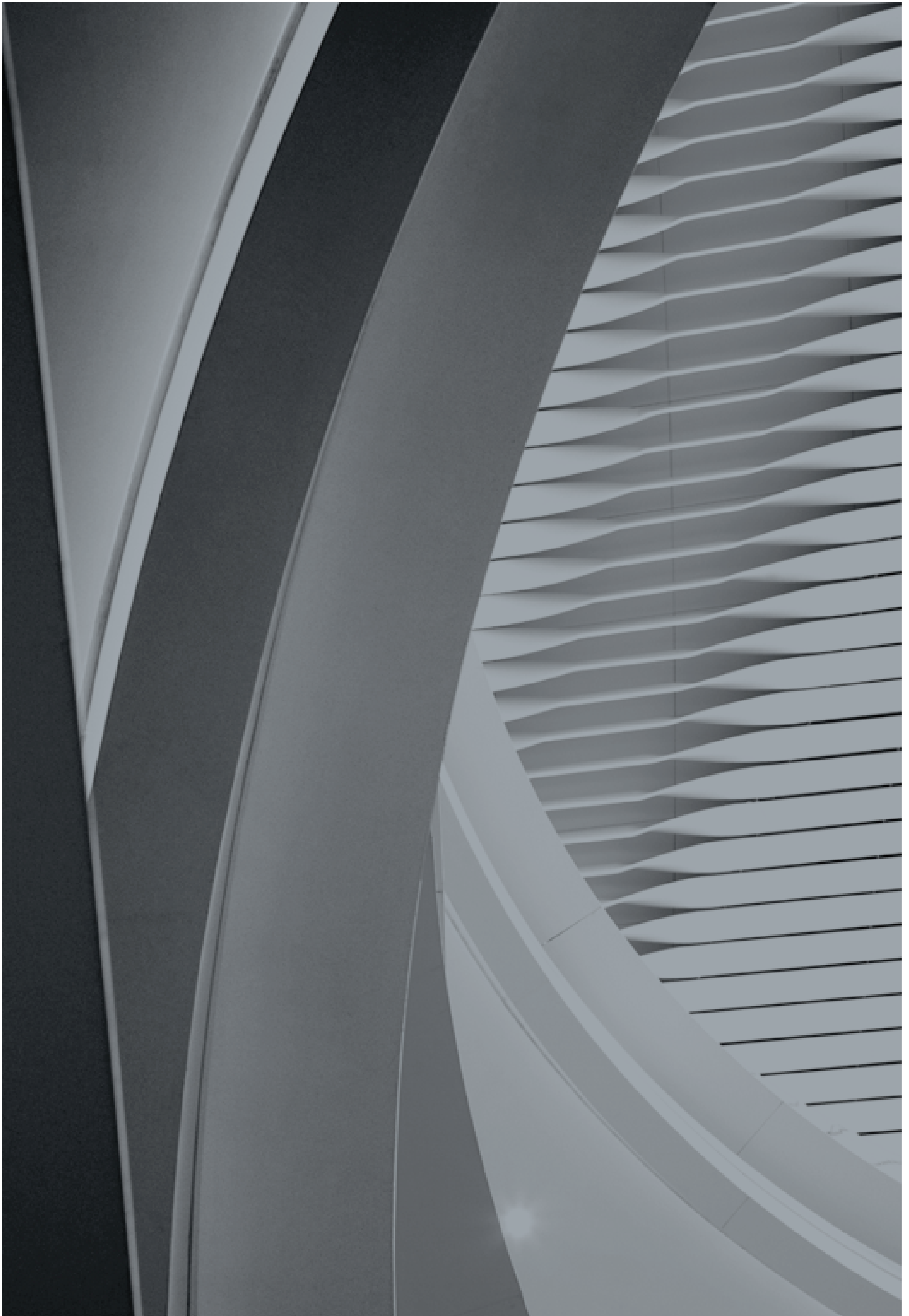
All this doom and gloom will suit us well. Arguably we are the most patient investor in town. After spending close to HK$7 billion buying investment properties in 1992-1993, we had basically stopped. We will not re-enter the market unless we deem the conditions conductive. But just as sure as we will exercise patience when it is called for, we will use tenacity when conditions to acquire are ripe. After all we have been preparing for that day for several years by building up a war chest. We repeatedly placed equity through the stick market and raised debt with banks. Even after paying for the land of the Kowloon Station project, we still have cash on hand as well as substantial borrowing capacity. That should put us in good stead once attractive deals are available. We will be monitoring the market closely.

As I have notified shareholders in the last interim report, your Board is most pleased to have Dr. Pak Wai Liu, pro-vice-chancellor of the Chinese University of Hong Kong, joined as an Independent Non-Executive Director. An economist by training, Dr. Liu brings with him deep knowledge of our economy and of its relationship to the outside world. In the 10 months since his joining, my fellow Directors and I have already benefited tremendously from his wisdom and experience. I look forward to many more years of close collaboration with and guidance from him.

Ronnie C. Chan
Chairman
Hong Kong, September 22, 1999



It is, perhaps, in the darkest times when the light of the way forward becomes most discernable, and there have been no darker days than during this period which saw the terrorist attacks of 9/11 and the SARS epidemic which crushed Hong Kong. Initial indicators that the global economy was poised for recovery withdrew and markets continued to sink. Yet it was in this same period that a decisive decision was made not to sell-up and retreat but to forge a positive way ahead. Our strong fiscal position and balanced portfolio entering the crisis kept us from a knee-jerk reaction and enabled us to calmly chart a path through the storm, focusing our resources and our efforts on commercial property development and choosing the Mainland as the location for the future expansion of our portfolio.



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Constructing Opportunities: Extending Our Reach Expanding Our Horizons

EXECUTIVE SUMMARY

The worst of the worst downturn in decades may have passed, but recovery is elusive and will likely remain sluggish in the near term. It is thus with an eye to long-term growth prospects that the Company has embraced opportunities in property development as a new direction within a hermeneutic of continuity. To this end the acquisition of two prime sites in Kowloon herald a new phase in the Company's evolution, with our sights set on the growth prospects that the residential property sector holds. Increased confidence in a potential recovery has kept occupancy rates at pleasing levels but sustainable increases in rental rates are still not materializing despite short-lived surges in demand in selective industries. Retail sentiment is proving more resilient than its business counterpart and that is reflected in the prospects for rental properties in both sectors, with office leasing forecasts not optimistic in the near future. This prognosis forms the basis for our strategic positioning in development projects for the residential sector. We have entered the market as it bottomed-out and are already in positive territory, giving hope of sustainable long-term growth in this new area of business. As the market settles and as quality opportunities present themselves, it is our intention to forge ahead in the acquisition of land for development and investment properties to build a momentum for significant growth in the coming years.

Plaza 66, Shanghai

After the date of the last interim report but before it was sent to shareholders, I inserted a short letter regarding a new direction for the Company. Your Board has decided that in addition to property investment which is so far the sole activity of the Company, we will from now on undertake development projects as well. With the strong and steady annual inflow of rents and only sporadic opportunities to buy investment properties, it makes sense to find other opportunities. Furthermore, by having almost no debt, the Company has a tremendous borrowing capacity. All things considered, property development must be the best business to get into. It is also the most natural extension of our existing operation. I believe that it will in due course add significant value to our shareholders.

Rising from the Embers

The first half of the fiscal year under review was probably the worst in decades for the property rental business. From there, things began to improve and the first noticeable sign was the withdrawal of subsidies granted to new tenants. Lease renewals were easier than before. Rents, however, did not go up during that period; in some cases they actually went down. Although higher than the previous month, rents might still be below those of say three years ago when the lease was first entered into. As a result, we did not see an increase in total rental revenues; rather, a decline was recorded.

That was certainly the case with offices. Rents continued to fall until towards the end of 1999 when an unexpected force helped to strengthen the market. Literally hundreds of small startup companies mostly related to information technology suddenly appeared. Previously concentrated in the Sheung Wan district a mile or two west of Central, dotcom craze fueled by the possibility of a stock market listing had unleashed a wave of rental activities especially on Hong Kong Island. Although it died down in late spring, overall economic recovery by then seemed certain and rents began to move up. That lasted a few months but has since quieted down.

Retail space fared slightly better. Like offices, much of the gains were recorded towards the end of the fiscal year when economic numbers turned positive – unemployment leveled off, GDP grew strongly, China's export rose powerfully, just to name a few. All these factors gave confidence to consumer spending. Good news, however, is not across the board.

Depending on location, building quality and tenant mix, some shops are recovering while others are still experiencing further diminution of rents.

Due to the shortage of new supply, high-end residential property is doing well. In line with the experiences of the past several years, industrial space is faring badly. Excluding this sector, which is insignificant to our portfolio, our overall occupancy rate was 93% at fiscal year end.

In line with the Company's new initiative, which was explained earlier, we bought two sites for residential developments in June. Totaling approximately 132,000 square meters of buildable space, they are both well located in Kowloon. The prices paid should be considered as rather reasonable.

Building Success in China

In December 1999, we opened The Grand Gateway in the Xujiahui District of Shanghai. This is a 100,000-square-meter shopping center which is the biggest in Puxi, the densely populated old part of Shanghai. It is now almost full. However, like any center of its size, the marketing plan must be refined over the first few years of its life. That is ongoing. Having personally visited almost all the major shopping malls in that city, it is not an overstatement to describe the scene as a bloodbath. We are probably doing as well as, if not better than, all our competitors.

Analyzing the situation further, location is only one of two critical differentiating factors. (Admittedly there are more department stores in our immediate neighborhood than in any other district.) A few other centers are also quite well located, but none of them approaches our

size. We are the only facility which is big enough to be a destination spot. Shoppers such as an entire family can spend the whole day on our premises and always find plenty of things to see and do.

Slow Recovery Foreseen

Although I am much happier about the rental market today than a year ago, I do not deem it wise to be overly optimistic. There are still many concerns. While economic numbers are encouraging, one must recognize that they are merely rebounding from a very low trough. More fundamentally, we are not only undergoing a cyclical adjustment but also a structural one, the outcome of which is at best unclear. Moreover, even today there are still deflationary pressures which will affect our business. Lower prices for goods and services will prevent our tenants from paying higher rents unless their unit sales are increasing substantially. That will not likely be the case in the foreseeable future.

Take for example the office market. There are several reasons for caution. First, not only has the high-tech fever died down, but many such companies are actually in trouble. They constantly need new funding and recent downturns in stock markets worldwide, particularly in technology related counters, have wrecked havoc on their future. The survival of many is in question. This will obviously affect the rental market if they go bankrupt, merge with others or are absorbed by stronger players.

Second, certain market participants might have wittingly or unwittingly exaggerated the recent rise in rents. Huge jumps existed in one or two high profile buildings which were for lease two or three years ago when the market was at the bottom. Once that wave of renewals were concluded, other rent increases were much less dramatic. Yet, those few stories were so widely reported that they created an impression of a strong market recovery. Although it is understandable why certain quarters may want to create such an impression, one should not be carried away by it. Perception is not always the reality.

All in all, I expect a very modest increase in rental revenue this year. We will have to wait until 2001/2002, if the market holds up, to see better days.

Developing Long-term Strategies for Growth

The bright spot should be in the newly added business of property development. It is not that I expect residential prices to rise substantially in the coming year or two; it is simply that we have bought at the bottom. Prices have risen since and at today's level, we should be raking in good profit for the three years starting 2001/2002. With a bit of luck, prices may even go up further which will make those projects even sweeter.

In the nearer term of one to two years, another source of profit will be the disposal of long-held assets. The process has already begun with Garden Terrace and there may be more to come.

The combination of all of the above is that total profit will steadily rise in the coming four years. Naturally we hope to buy more land for development and/or more investment properties in order to keep up the momentum beyond fiscal 2004/2005. By that time, contributions from our Shanghai projects should also become more meaningful.

Ronnie C. Chan
Chairman
Hong Kong, September 22, 2000

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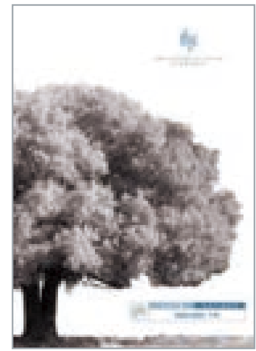

Gloom Lingers: Multi-pronged Pressures Depress Market

EXECUTIVE SUMMARY

Confounding pundits, the continued spiraling of the market has taken us into unsettling territory with empty properties abound and buyers unwilling to take the plunge despite an unprecedentedly favorable buyers' market. And the pressure on the market is unlikely to abate any time soon with the world still reeling from the terrorist attacks on the United States, sustained deflation, broadening unemployment, and depressed confidence levels. In this context, the outlook remains grim with current oversupply in the residential market being mirrored in the office leasing sector with the completion of several new buildings in Central in the coming years. Longer-term hope remains in the disposal of development properties that are being carried at low cost, allowing us to bide our time to sell when the market is favorable. China also presents opportunities for future growth, as the national economy shows itself to be resilient to the worst of the global recession's effects. Our financial position gives us the opportunity to assess all potential projects thoroughly and pause to get a feel for the market's trajectory before investing in more land, either locally or on the Mainland; maintaining a prudence that has seen us buy and sell at the most opportune moments during the volatility of the past few years.

The Long Beach, Hong Kong

This is the first full year that Amoy is engaged in both real estate development and rental of investment properties.

Contrary to previous expectations, both property sales and rental markets deteriorated further in the past few months. For the fiscal year, rental income declined by 3.9% to HK$1,760.8 million while profits therefrom eked out an increase to slightly over HK$1,500 million. The fall in rental income is due partly to the removal of units of Garden Terrace from the market in preparation for their sales. Due mainly to the disposal of investment properties, profit attributable for ordinary shareholders rose by 13.6% to HK$1,383.7 million.

Having been in the business for decades, my colleagues and I have never seen a similar environment for the sales of residential units. Developers with tens of thousands of unsold flats and local bankers awashed with cash strived to lure potential buyers into their doors. Incentive schemes never heard of before are complemented by the lowest mortgage rates in decades. A buyer can move into an apartment with no money down and will not need to repay the developer-financed second mortgage of 20% to 25% for up to four years. The seller is obviously taking tremendous default risks especially given possibly higher unemployment rates in the coming months. Even then, there are few takers! This is not to mention that much of those projects are selling at a loss. We can only count ourselves fortunate to not have anything to sell at this time, for we refrained from purchasing land at the height of the market a few years ago.

Pressures Mount on a Depressed Market

Why are potential buyers not biting? Deflation which has persisted for almost three full years must be one key reason. The terrorist attack in the U.S. two weeks ago will only make things worse. Unemployment which has mainly hit the lower economic strata in recent years is now infecting the professional class. Under these circumstances, it is difficult to have confidence on either the overall economy or on one's ability to repay mortgages, no matter how low the interest rates may be. Those few fortunate ones not affected by the above see the abundant supply of flats in the hands of the developers. It is only reasonable that they too will delay any purchase.

The same factors are affecting consumption which depresses retail rents. Only the top locations are leasing well. Offices and high-end residentials are even more hurt by the malaise of the local economy and that of our trading partners. Some will not renew their leases while others will reduce the space required. At the same time, several buildings under construction in Central will be ready in the coming two to three years. They will ensure that office rents will not rise any time soon.

Glimmers of Hope Pierce the Gloom

In December, we won at an auction a harbor-front residential site for HK$2.58 billion. About 151,000 square meters of mostly apartments will be constructed with 80% of the units having unobstructed sea views. A year ago our neighbor paid over 50% more for his plot which is smaller and inferior in shape. Catching up in construction progress, we will be very competitive when it comes time to sell.

Another bright spot comes from our two projects in Shanghai. Plaza 66 saw its soft opening in early April and was officially opened in July. From the early days, both the shopping center and the high-rise office tower were practically fully let at acceptable rents. Our list of office tenants reads like who's who in global business. At the mall, branded high fashion goods are particularly selling well. In many cases, sales rents have already kicked in and the tenants are asking for more space. To the surprise of many, although the same products are slightly more expensive in Shanghai than in Hong Kong, they move faster in Shanghai. This is yet another indication that no one should underestimate the rising purchasing power and economic prowess of China.

The larger shopping center, The Grand Gateway, is also performing well. Visitors have steadily increased such that weekday traffic can now be as much as that on the weekends when the center first opened in December 1999. Tenant mix problems have mostly been sorted out, and the mall is finding its appropriate market positioning.

Recovery Remains Elusive

It is very difficult to say when the Hong Kong property market will recover. Given the analyses presented above, it is reasonable to expect that the rest of the fiscal year will be weak. The big decision for us is whether to buy more land. Since management believes that when the market eventually recovers, prices are unlikely to rise sharply, hence, there is no particular hurry to act now. Moreover, the amount as well as diverse sizes and locations of land potentially for sale by the government in the coming years are plentiful. This is not to mention the huge supply provided by MTRC and KCRC, our subway and railway companies respectively. Nevertheless, there are one or two developers out there who have an enormous appetite to purchase. How to win the right piece at the lowest possible price will tax our wisdom.

The rental market will likely remain lethargic for the foreseeable future. It is hard to see at this stage what events will turn things around. Nevertheless since all free markets move in cycles, better days will return although they will be quite far into the future.

Conditions for Growth

To have a sustainable recovery, several things must happen. First, the China market must hold up as it has in recent years. Second, the West, particularly the U.S., must turn around economically. Third, Hong Kong's economy must find a new impetus to replace the formerly all-important real estate sector. Of the three, the last which is least important by world standards, may prove the most difficult.

One possible area for our future growth is China. Having had nine years of experience there, management is understandably cautious. Decent investments will absorb considerable financial and management resources and the return characteristics are questionable. Nevertheless we will continue our search although all potential undertakings will have to compete with Hong Kong development projects for funds.

In the meanwhile, growth in profit in the coming few years will come mainly from the sales of local development projects. Since we are not under financial pressure and given the low carrying costs due to low interest rates, we can pick the right time to sell. This is especially true of more expensive flats.

Ronnie C. Chan
Chairman
Hong Kong, September 24, 2001

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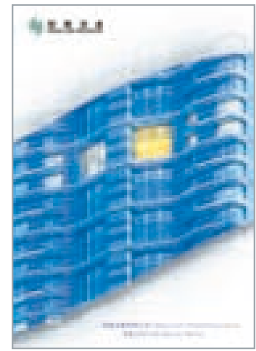

New Depths: Market Sinks Further as Bear Refuses to Loosen Grip

EXECUTIVE SUMMARY

As the market continues to sink, fueled by a vicious cycle low pricing, all-too-easy entry for young buyers who face uncertainty in the job market, and the bleak outlook painted for the economy as a whole, rents have seen further, sometimes dramatic drops, and profits have subsequently retreated. While significantly stronger than many of our competitors, our financial position needs to take into account the persistence of the current bear market and the need to invest for the future when the downturn finally bottoms out. To this end, raising equity through bond issues was adjudged the most prudent method to raise capital while protecting shareholder interests. It effectively allows us to maintain our conservative stance in terms of new investment, while supporting development projects that will drive growth locally and on the Mainland. Our 10 years on the Mainland have demonstrated that our unique approach to the market was spot-on, delivering returns that match those of our Hong Kong property investment arm. The positive news coming from our two developments in Shanghai and their contribution to the Group’s bottom line is a strong motivating factor for us to continue to leverage on our experience and expertise in expanding the Mainland side of our portfolio. Locally in Hong Kong, there are factors that point to recovery opportunities, and whilst the market has changed drastically and remains changeable, we are in a good position to take advantage of the opportunities that these crises present, and focus our attention on quality of design and construction in order to bolster our already strong and recognized brand. With our strategic positioning in both the local and Mainland markets, our cheap land banks and strong financials put us in pole position for growth ahead of our competitors as the market situation slowly eases. It is, perhaps, in the darkest moments that even the faintest glimmer of light shines bright, and we are far from faint in our direction and determination to maintain and further grow our strong presence and levels of performance in Hong Kong and mainland China.

恒隆地產
HANG LUNG
PROPERTIES

For over a decade, I have personally penned the chairman's statements for each of the public companies in the Group. A number of them after the Asian crisis probably rank among the longest of all similar letters to shareholders for Hong Kong corporates. My reasons are twofold: first, this is one of the few occasions to directly communicate with shareholders, especially those who cannot attend our Annual General Meeting in person. More significantly, I attempt, especially in the annual report of our parent company, Hang Lung Group, to present a critical analysis of the Hong Kong property market from the viewpoint of your management. It is gratifying to note that in recent times, both the investment community as well as the media have apparently taken the piece seriously. Once public, it quickly finds its way into the local press. Now that all real estate activities are concentrated in this company, I will continue the tradition here.

Hong Kong's property market continues to languish in misery. Although transaction volume of new residential units has increased since July 2001, prices actually went down by another 10% or so. Cumulatively from July 1997, they have fallen by at least 60%. Worse yet, it is possible that prices may go down further.

Contributors to the Cycle of Instability

As everyone knows, in this business cash flow is more critical than profit. In severe bear markets like today, this drives developers to dump properties at prices that will move large number of units. The idea is to pre-empt competitors from soaking up remaining purchasing power. While this may solve the immediate problem of a developer, the effect on the market is extremely negative. It creates market expectations of further drops in prices, thus reinforcing the vicious circle. Of late, even major developers who are hitherto not willing to "unnecessarily" put pressure on prices, are engaging in this practice. They can hardly be faulted, for they must generate cash to preserve shareholders' value – just in case prices keep going south which they obviously anticipate.

At the same time, while cutting prices, developers are deploying all sorts of gimmicks to attract potential buyers. Nowadays a young person can move into a new unit with no money down. In addition to a four-year interest free loan to top up the bank mortgage, a rebate will enable him or her to pay for all related expenses and have money left for furnishing the new home. As a result, there are now many young buyers who previously could not have bought. These people more likely than not have little savings and some do not even have a secure job. With laws enacted right before 1997 which make bankruptcy a lot easier, losing a job can become a quick trigger to file. One cannot help but wonder what will happen if prices fall further. Immediately, the buyer has negative equity, but the developer who grants the second mortgage is as much at risk as the buyer.

Systemic Issues Heighten Woes

At issue is not just a problem of the real estate sector but also of the entire economy, although the two are inextricably tied. Unemployment has been climbing, recently to a high of 7.8%, and deflation persists. One should also not underestimate the negative wealth effect. Watching one's biggest acquisition in life, i.e. his or her residence, drop by two-thirds in value is not fun. This fate, to a greater or a lesser degree, has befallen a sizable percentage of our population, including those who bought in recent years subsidized homes from government related bodies such as the Housing Authority and Housing Society. No wonder people do not want to consume. Daily reports in local newspapers of businesses closing and of layoffs will only exacerbate the downward price spiral.

Lower consumption affects the rental side of our business – at least the leasing of shops. In the second quarter of 2002 alone, retail rental fell by about 5%. Office rents also declined since there was hardly any new demand. A good number of small to medium size Japanese companies did arrive, but they usually took very little space. Nor did they help the luxury residential market which was the hardest hit of late – rents dropped by around 20% to 25% since the beginning of the year.

Under this tough environment, our investment properties in Hong Kong generated 2.3% less in gross rent and 8.6% less in profit from a year ago. Only with the help of our Shanghai projects did overall rent grow by 8% and profit by less than 1%. Since there were less earnings from property sales, overall bottom line for the fiscal year retreated. Drop in interest income also contributed to this result.

Strengthening our Financial Position and Adding Value for Shareholders

Two other events during the past year should be mentioned. First, in March and May, we issued two tranches of a five-year convertible bond which raised about HK$3.45 billion. Interest rate is 3.4% per annum and conversion price is HK$9 per share. It was the first Hong Kong dollar denominated convertible issue in decades and was enthusiastically received.

The rationale behind the issue deserves explanation. It is now widely accepted that Hang Lung is one of the very few major Hong Kong real estate companies which has basically consistently called the market cycles correctly for the past decade or so. Our refusal to buy properties during 1995 to 1997 and subsequent purchases between March 1999 and December 2000 of well-located land at prices cheaper than the market has seen in years, are in particular credited for our recent success. As a result, our shares are now trading at one of the highest price-earnings ratios of profitable property companies.

Calling the market correctly, however, could not by itself produce value for shareholders if it were not supplemented by prudent financial planning. During the market peak of 1995 to 1997, we sold quite a bit of in-town investment properties which gave us not only handsome profit but also cash. We had further strengthened our balance sheet by placing shares in 1996, and had locked in longer-term loans at reasonable rates around the same time. All told, we had raised over HK$10 billion cash. This gave us a totally debt-free position when the Asian crisis hit in late 1997. In fact, after repaying all debt, we still sat on HK$5 billion of cash throughout the crisis, an enviable position by all accounts. That enabled us to buy aggressively once we thought that the market had bottomed and when competitors were still struggling to recover from the shock. Those were the days when cash was king!

Our land acquisition spree lasted between March 1999 and December 2000. (As I had previously written, the timing of land purchases during that 21-month period was in itself tricky. Eventual profit margin depends a lot on those decisions and we were fortunate to have bought each time at the bottom.) Although a number of our competitors rushed into the market in 2001, we were frankly by then unsure where the market was going. In fact, we were fearful that the price recovery might not be sustainable. What we did know was that our new projects would easily cost a total of some HK$12 billion with construction expenses coming in over the next few years. As such, we were convinced that it was time to once again raise cash. If the market continues to weaken and selling of flats becomes difficult, then money in our pocket will make me sleep better. The cash crunch experienced in 1984-1985 has not been forgotten by your management. But if the market shows signs of sustainable recovery, then we better have the funds on hand to buy more land – not unlike 1999 and 2000 – before prices run away from us. Either way, we should strengthen our finances.

The easy decision was to take advantage of historic low interest rates to refinance all existing debts. That we did in the first six months of this year. More difficult, however, was to raise equity. What instrument to use is unfortunately not altogether up to us; we can only do what the capital market allows.

Management’s preference has always been straight equity in forms palatable to existing shareholders such as warrants and share placements. Convertible preference shares such as the issue we did in 1993 was also favored. Our overriding considerations are twofold: minimize the dilution, if any, to existing shareholders, and avoid currency risks.

It was partly for the second reason that in 1993 we chose convertible preference shares instead of the slightly cheaper convertible bonds, for in those days both instruments could only be denominated in U.S. dollars. As subsequent events showed, most if not all of the convertible bonds issued by others in 1993 had to be repaid in 1997 or 1998 – right at the time of the Asian crisis! With convertible preference shares which are perpetual, we escaped that fate.

In any event, throughout 2001 and for most of this year, the capital market was not cooperating. Nevertheless patience once again paid off when a window of opportunity arose. We took advantage of it in March and did the convertible bond issue. Dilution to existing shareholders is minimal, and to lock in money at 3.4% over the next five years seems reasonable. This rate is below our historic dividend yield.

Some people question why suffer dilution at all when interest rates are so low; why not issue straight debt? My answers are simple: cheaper rates are only a secondary consideration; by not pricing the issue overly aggressively, I hope not to have to repay. Given reasonable profit projections, the chances are good that the bonds will be converted. After all, the world economy is full of uncertainties and the local market fraught with danger. As one of my mottos goes: equity is the company's money while debt is the bank's – it has to be repaid! Moreover, in light of the strong arguments for raising cash presented earlier, I will gladly take the best deal available.

Any lingering Doubting Thomas is perhaps grossly underestimating the treacherousness of the market, the extent and duration of which may surprise many. As before, I trust that history will once again prove us correct.

Momentum Builds in the Mainland Market

The final issue relates to the China market. It is gratifying to watch our Shanghai properties perform and begin to make a difference to our bottom line. In terms of both gross rent and profit before taxation, Shanghai accounts for roughly 11% of our total investment portfolio. While Hong Kong rents stagnate or fall, those from Shanghai are expected to rise steadily.

This is the 10th year of our operation in China and so perhaps it is time to take stock of our Mainland strategy. Back in 1992, we decided to enter the Shanghai market after a long period of research and observation. Recognizing how difficult it must be to get things done in a transitional economy like China, and given the associated importance of human relations, it seemed prudent to concentrate on one or at most two cities. And to differentiate ourselves from the many local and overseas (mainly Hong Kong) players, we must do something that they do not or could not do.

Of the many cities studied, we picked three candidates: Guangzhou which is closest to Hong Kong, Beijing and Shanghai. We eventually determined that although it was the first region to open up since the early 1980's, Guangzhou – and for that matter, the entire Pearl River Delta – was at the time less well regulated. Every Tom, Dick and Harry from Hong Kong were clamoring for a piece of the pie. Beijing, on the other hand, was politically complicated and in any event had what seemed to us to be poor city planning. Shanghai was just opening up and several things there impressed us. While being probusiness, the government was more disciplined than most places in China. The caliber of people both inside and outside of government is good, a point which is still true today. Moreover, it seemed that the central government was bent on restoring the city's economic prominence of the pre-World War II days. If so, then we should ride that wave.

As to differentiating ourselves, we knew that we could not compete with native developers on low-end products. Hong Kong investors on the other hand would likely repeat what they had done in their home market, namely smaller buildings with average quality. Less significant players could not, or do not know how to, do otherwise, while the major ones may not have the appetite for large and first-class projects. So if our

estimation was correct in that Shanghai would one day become a city of world significance, then we should do something of world-class quality and size. Consequently, after an initial high-end residential site to learn the ropes, we embarked on two major projects which are now known as The Grand Gateway and Plaza 66.

Shanghai Success Story

The Grand Gateway in Xujiahui of Xuhui District is an almost 100,000-square-meter shopping center which is so far the biggest in Puxi, the highly densely populated older part of the city (as opposed to the new town Pudong). Fully leased, it is on top of the biggest subway station in Shanghai. On weekends and holidays, in excess of 150,000 people now frequent the mall.

Plaza 66 on Nanjing Xilu in Jingan District has an office tower of over 78,000 square meters with 66 floors, on top of a shopping center of 52,000 square meters. Both are fully leased and the office tenants read like who's who in international business. The retail mall probably has the highest concentration of European high fashion brand names anywhere in the world. There are far less visitors compared to The Grand Gateway, but the shops are doing equally excellent business. In fact, the per square meter revenue generated on the ground floor compares favorably to those in major cities in the world.

What is unique about these two developments is that they are both big and beautiful. Both are designed by world-renowned American architects and are built to high specifications. So far nothing in Shanghai approaches their size or quality which will hopefully keep them competitive for many years to come.

From a financial perspective, returns generated in Shanghai on an after-tax basis are not much different from those of our Hong Kong investment properties. The only difference is that Mainland projects have much better near-term rent appreciation potential. We are now studying how to build upon our hard-earned expertise to grow the business on the Mainland. I will return to this subject in a later section.

An Eye for Vigilance and an Appetite for Expansion

I have a short- and a longer-term view of the market – the former is very cautious, but the latter, more relaxed.

As alluded to earlier, the market since 1995 has been most perilous. Anyone who has bought land between 1995 and 1997 is now staring at the completed buildings with huge losses. While residential units on average have fallen by over 60%, land prices have dropped even more, and in some cases, by much more. (This is why I am baffled these days by the words of some investment analysts such as: a certain real estate company will not make a profit because it does not have properties to sell. They are stuck with the old paradigm that selling properties automatically makes money. The fact today is: the more one sells, the more losses are realized. As such, it is fortunate that we do not have anything to sell since the land would have been purchased at the peak.) Even some sites bought by others after the resumption of government land sales in April 1999 are under the water at today's prices. More fortunate owners like us whose projects are "in the money" are less comfortable today than a year ago. Recent market developments have shown signs of a "double-dip," with the first trough being in 1999.

In this environment, we, like all our competitors, are faced with two very difficult decisions. Should we sell flats now or later, and when should we start buying land again. The answer to the first will partially depend on one's cash flow position. We are fortunate to be healthy financially, for through the recent reorganization of group companies, holding costs of development projects are now supported by steady rental income. As such we can afford to wait. However, one cannot dismiss the possibility that a time may come when it is no longer prudent to do that. The only comfort then will be that given our much lower average land cost, the terrible market will hurt us less compared to our competitors. Needless to say, I would rather like to see them make money, knowing that we are making more.

When to buy land is even more difficult a decision since we do not know our future cash position apart from rental income. Given that, it is wise to be conservative. This was why we had not purchased anything in the past 20 months.

Disadvantaged for Prudence

Land acquisition decisions are further complicated by one factor seldom discussed in public. Since the government basically controls all land sales, it can strongly influence prices. When the market falls, it often stops selling. It does so either by declaring a moratorium such as the nine-month period between July 1998 and March 1999, or by simply putting up artificially high minimum prices when developers apply for land. After all, valuation is as much an art as a science, and the government is in any event always fearful of being criticized for selling land cheap.

For society, this is arguably desirable – it may prevent panic. Developers who have purchased expensive land will no doubt support the practice, but it is unfair to the prudent players who did not chase prices. A form of intervention which goes against the free market principle, the latter are deprived of the opportunity to buy when the market is down. Before 1997, when the overall market apparently only goes up due to high land price policy, this is perhaps acceptable. But now that the industry has fundamentally changed (i.e. sufficient land supply and transparent market, as I have in the past explained), it becomes problematic. Price of raw material, i.e. land, is administratively kept from falling while the finished product is subject to the vagaries of the market. The risk of the industry is thus enhanced. While some may erroneously argue that since there would be a floor to land prices, the risk is now less. The only problem is that no one – not even the government – can control the prices of the built-out apartments.

Having said all that, I still reluctantly support the land sales policies of the government in order to maintain societal calm. My intention of bringing up the subject is that once the market returns to normalcy, there should be a review of those policies, particularly the government's land valuation process.

But for now, we have to live with existing rules, unfair as they may be. Given the weakening market of the past months, on the surface one may justifiably question our decisions to buy land in the 21 months before December 2000. Relative to our competitors, we have bought the best plots at the lowest prices, but should we have bought at all? Given the government's policy to effectively not sell land when market sentiments are weak, we are left with no alternative. Allowing our land bank to run down to zero is unrealistic. Perhaps we should take comfort in the fact that we had bought nothing since January 2001, for any land transacted in that period was more expensive than ours.

The Unpredictability of the Current Market

Whatever the case, one thing is certain: I have never seen in all the years a more treacherous time for the industry. To recognize in 1995 that prices were too high was not that difficult; the difficult part came in resisting temptation to follow the crowd and buy. But at least your management knew then what needed to be done. Now the market is very different – none of us has seen anything like it. To see us through, I am counting on utmost caution mixed with an instinct for the market honed through long years. As always, luck will help.

Looking further down the road, however, the picture is in my opinion not as bleak. While almost no one today anymore believes that real estate prices will return to the pre-1997 heights, I see little reason to be overly pessimistic. In the past I had presented arguments for a healthier market in the longer term. Allow me to briefly summarize.

Market Fundamentals not All Doom and Gloom

Demographics are favorable to the industry. The city is projected to have about one million people added by 2010 and almost three million more by 2020. Many of the new arrivals from the Mainland will bring with them cash to immediately buy properties, rather than waiting seven to 10 years to save up for the down payment as the earlier immigrants. Just as the Pearl River Delta will be the target area for Hong Kong's lower economic strata to purchase homes, our city will attract many of the nouveau riche of the Mainland. Both phenomena have started and will likely continue for some time. Recent weakness in the market may tempt even more of our fellow countrymen to acquire here, and regulations are already being crafted to make their coming and purchasing easier.

Cheaper prices will enable many locals to exchange smaller flats for bigger ones. With the median size being around 50 square meters, the lure of more spacious units is powerful. So far the lethargy of the secondary market has prevented them, but given the opportunity, a good number will make the move.

Similarly, many who live in older apartments will relocate to newer ones. Competition in the past few years has greatly improved the quality of more recent developments. These are characterized by better design and material, more luxurious lobbies and lavish club houses with many amenities. They appeal especially to the younger buyers.

The other side of the coin is that many of our city's older buildings are fast becoming dilapidated. Built during the fast-growing years of the 1960's, the residential blocks are inefficient and outdated in style. Many of these will in time be torn down. As such, there will be a decrease in housing stock at least temporarily during construction and possibly permanently if plot ratios are lessened or if the land is used for alternative purposes such as more open space.

I have enumerated many factors for optimism, but there are obviously compensatory worries as I have written in previous reports. However, those concerns cannot altogether negate the positive forces presented above.

The Case for Cautious Optimism

Beyond all that, let me present a few more practical reasons for less pessimism. First, the present government cannot afford to and will not knowingly destroy property prices. Knowing that some 67% of our homes are owned by our citizens (with 48% in private housing and 19% in subsidized sale flats as of mid-2001), wrecking the real estate market is to damage confidence in our economy, for homeowners are pillars of any society. I am convinced that Hong Kong's Chief Executive Mr. Tung Chee Hwa and his deputies are well aware of the problem and the solution. Moreover, they recognize that at issue is not just the real estate sector; it is a problem that encompasses the entire economy and society. According to recent research of a local university, about half of the city's deflation is accounted for by the decline in property prices. As such, the economy cannot recover unless the industry improves.

In fact, all of the government's recent housing policies are on the right track. The former lack of coordination among departments and agencies is being addressed by the newly established accountability system. More clear cut pronouncement of firm policies will no doubt help. In this regard, the total abolition of the Home Ownership Scheme (HOS) will be a big step in the right direction. HOS has definitely served its historic mission and should be retired – once and for all.

A second reason for optimism is something new to our society. In the past several months, there emerged a clear consensus among all political parties that further property price deterioration was not beneficial to anyone. On the one hand, the fact that it took so long to recognize something so obvious was discomforting. Grassroot oriented politicians lack basic understanding of the economy. They are also blinded by their prejudiced protection of the group already most

benefited from existing housing policies – the 31% of the population living in public rental flats whose rents could not even cover the cost of maintenance – such that they do not see market realities. On the other hand, the likelihood of the consensus dissipating is low. Even the diehards are finally realizing the seriousness of the housing crisis. While this will hopefully serve as a basis for the government policies to take effect, the remaining danger is that politicians will bicker over how powerful should the medicine be. As someone who has been in the business for decades, there is no doubt in my mind that unless strong and decisive measures are taken, the market will not revive.

One interesting phenomenon here is that in recent months, even developers who have flats to sell are publicly admitting that the market may not have bottomed. Just as back in 1995 to 1997, we were a lone voice when we began to sound a note of caution in mid-2001. Now it is a chorus. How ironic then that at this time we should once again be the odd fellow to propose a ray of hope. In the go-go days of mid-1990's, we were considered by many as conservative and even by one major institutional investor as lazy. The same may now call us unrealistic or something worse. We call only on history to testify on our behalf, and trust that it will yet testify in our favor in the coming years.

There is, however, no place for complacency. The extremely tricky question for us operators in the business is how long will it take the market to turn around. The answer will depend to a great extent on what measure the government will take to stimulate the market. Whatever they are, the road ahead will not be easy. But, as the Chinese say, with crisis comes opportunities; and as the westerners say: when the going gets tough, the tough get going. I believe in both axioms, and so believe that if anyone will emerge stronger through this dark period, we should be one of them. Frankly, the number of winners will not be big. That too should be good news to our shareholders.

Our Task Ahead

To succeed in the next round, real estate developers must change operationally under the new market environment. In fact, we have started several years ago. Product quality both in terms of design and construction is more critical than ever. Construction speed will give marketing flexibility as well as interest saving, especially after rates return to historic norms. Product branding through company reputation will become a factor to separate the winners from the losers. Whereas location is still of foremost importance, a respected brand name will facilitate property sales in tough times and help raise prices in good times. Finally, cost control will be more critical than before. Whereas in the pre-1997 days, profit margin was predominately determined by the price of the land, now construction cost will play an increasing role. After all, land used to account for as much as 75% to 80% of total project cost, but is more like 40% to 50%.

As to our China strategy, in as much as we have performed well so far, we remain cautious. In an earlier section, I alluded to the fact that one cannot apply what works in Hong Kong to the Mainland without discretion. Both the societal and physical environments are different which necessitate a different strategy. There are few, if any, worthy models that can be emulated by non-Mainland players, and so one has to blaze a trail. Having financial resources like we do is no guarantee for success. In fact, it can work against us – one tends to be careless when money is abundant. After all, many cities and towns on the Mainland beckon for our dollars. One should never forget that it is all too easy to make investments, but extremely difficult to make them profitably.

The Shanghai market has changed considerably in the past decade. We are not convinced that to repeat what we have done in the past is the right thing to do today. Land is no longer cheap, total commitment tends to be large, and the market is volatile. Nevertheless, our search for projects is ongoing. I will not be surprised if something is done on the Mainland in the coming year or

two. The first projects that will benefit will likely be the building out of the second office tower at Plaza 66 and the remaining two residential blocks at The Grand Gateway. The former will add about 80,000 square metres of prime office space to our portfolio.

Taking Stock of Strengths

Allow me to close with an assessment of our relative market positioning – at this point which history may prove to be the darkest hour of the industry, or at least close to it. The past five years since the Asian crisis have been a rewarding and even invigorating time for us. By prudent management of land acquisition, properties sales, and financial planning, we have been recognized by institutional investors as one of the best run property companies in town. The point has been born out by the high price-earnings ratio which we now enjoy.

Today we are, of all the major real estate companies, the least burdened by expensive inventory, have the best and cheapest land bank, and have one of the strongest balance sheets. The group restructuring two years ago has enabled us to more efficiently use our resources – steady rental income to support potentially higher return development projects. Last but not least, we have a dedicated management team with leaders which have worked well together for many years. This is why I am confident that our future is bright. The market is admittedly terrible at the moment, but it has always been cyclical – since time immemorial. Though unlikely to regain its former glory – however flimsy and undeserving as history may show it to be – Hong Kong will nevertheless recover, and so will our industry. When that happens, your management will be ready for it. That is my job and I give you my undertaking to see it through.

Ronnie C. Chan
Chairman
Hong Kong, August 28, 2002

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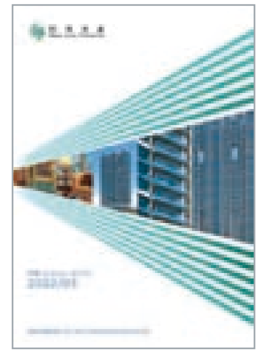


SARS Strikes Final Blow to Bottom-out Market

EXECUTIVE SUMMARY

If there was any doubt that the recession would bottom out, it was dispelled with the tragic spread of the SARS (Severe Acute Respiratory Syndrome) virus, which brought Hong Kong and the wider region to its knees. Whilst delaying the anticipated market recovery and prolonging the downward spiral, that the viral epidemic is now behind us signals a relief that will slowly lift the economy out of its long-standing depressed state. As the financial crisis reaches its bottom, we are able to more clearly see the benefits of our strategic policies over the past years. We are undoubtedly in a better position financially and in terms of our portfolio than any of our competitors. We stand strong and poised to consolidate our position with excellent growth reported from our Mainland developments and opportunities for development locally including the acquisition this year of all the shares of Grand Hotel Holdings. We have further strengthened our establishment with a clearer than ever focus on corporate governance and enhancing our management team to take advantage of the opportunities that present themselves as the market regains upward momentum. China's strength is encouraging and a positive impetus for further developing our Mainland portfolio. Meanwhile, although local government policy, with the 13-month moratorium on government land sales, is an undoubted negative for property developers, we are confident that the improving trajectory of the market will afford us the opportunity to achieve healthy profits on our investments here. Looking forward, we will maintain the balanced approach to management and expansion of our portfolio, a strategy that has proved judicious over the past decade.

Plaza 66, Shanghai

In my letter to shareholders last year, I devoted considerable coverage to both my short-term caution as well as longer-term optimism for the real estate industry. At a time which was dark indeed, I suggested "a ray of hope". Today I am more confident of that than a year ago. What I could not have anticipated then was that during the spring, Hong Kong, together with the rest of East Asia, would be hit with SARS (Severe Acute Respiratory Syndrome). The viral epidemic has further delayed recovery of the industry but is fortunately now behind us. Provided that the outbreak does not reoccur towards the end of the year as some health experts have warned, I believe the worst should be behind us as far as the property sector is concerned.

But for the past 12 months, things were still very difficult. On average, residential prices fell by almost 20%. During the SARS outbreak, property sales were virtually non-existent and rental income was hurt. Being owner of the retail complex right below the worst hit residential estate in Hong Kong, we had to grant free rents, incur expenses to combat the disease, and afterwards to revive the shopping mall. All these were done and done well.

Given market lethargy, we decided to hold back sales of all majority-owned new projects. With a healthy financial position, and unlike a good number of our competitors that have an abundance of money-losing developments, we are not in a hurry to sell. The resolve is further underpinned by our belief that prices should have bottomed, or are at least very close to it. Market trends of late have given us even greater hope.

Occupancy rate for our retail space in Hong Kong was 94.3% and for offices, 91.2%. Total rents collected as well as profit therefrom were both slightly above last year's levels. The picture in Shanghai was considerably more encouraging. It now accounts for about 15% of the Group's total rental profit.

Hong Kong Acquisition Presents Development Opportunities

A year ago this month, we proposed to shareholders to acquire all the shares of Grand Hotel Holdings (GHH) which was a fellow publicly listed subsidiary of our parent Hang Lung Group. Two months later, the transaction was almost unanimously approved by independent (i.e. non Hang Lung Group) shareholders. On February 25, we completed compulsory acquisition of the remaining shares in GHH which became a wholly-owned subsidiary of the Company. On the same day, both A and B shares of GHH were withdrawn from being listed in the Hong Kong Stock Exchange.

The rationale for the acquisition was obvious – it has always been our desire to expand our rental portfolio. The frustration over the past decade was that few high quality properties were for sale. The essence of the present transaction was that we purchased at a reasonable price about 65,000 square meters of prime commercial space – offices in the case of the former Grand Tower Hotel and serviced apartments in the case of Grand Plaza Hotel.

Moreover, we already owned the shopping malls at the podiums of the two hotels. The transaction gave us the opportunity to unify title of both buildings. This will facilitate future redevelopment or sale. Conversions from hotel rooms to their respective new usage are now underway.

Shanghai Shines as Flagship Developments Reach Landmark Status

Much has happened to our operations in Shanghai. In The Grand Gateway, our ownership interest is in the shopping center held for long-term investment. Our parent Hang Lung Group on the other hand owns shares in the offices and the residential towers which are for sale.

About a year ago, we decided to build out the project. That entails two office towers totaling 124,000 square meters, the remaining residential block of 32,300 square meters, as well as a service apartment building of almost 20,000 square meters. These will complement our existing shopping mall and one residential tower, giving the entire complex a total floor area of about 310,000 square meters.

At Plaza 66, we have started to construct the second office block of 81,400 square meters. Once completed in about three years, we will have a total of almost

160,000 square meters of the best offices in Shanghai. Adding to it the retail center, the completed project will have 211,000 square meters.

All of our existing rental space in Shanghai are basically fully let. We are gratified that both of our projects have become landmarks in that thriving commercial capital of mainland China. The Grand Gateway is not only the biggest but also likely the most frequented shopping center in all of Puxi, the crowded old part of the city where about 85% of its citizens live. The retail mall at Plaza 66 boasts the highest concentration of world renowned fashion brand names probably anywhere in the world. Our tenants are trading well, a fact which is important to both them and us. The office block above is of the highest quality in all of Shanghai and the tenant roster reads like who's who of global business. Coupled with its prestigious location, rents received are among the highest in the city. In fact, unit rent is at present higher than comparable space in Hong Kong!

Equally pleasing is the fact that the holding company of The Grand Gateway has basically locked in the sale of one of the two office towers being built. The purchaser is one of our former joint venture partners in the project. The consideration to be paid to the remaining shareholders is USD 124 million cash which should be sufficient to complete the project. The departing partner had further yielded all of its shares in the joint venture company. As a result, our shareholding has risen from 47.25% to 66.28%. This last point means that your Company benefits from the extra rents collected from the shopping mall.

Strengthening the Establishment

In the past year, we have also paid much attention to improving corporate governance and strengthening management. The Board has established a Nomination and Remuneration Committee in addition to the existing Executive Committee (comprising the four Executive Directors) and Audit Committee (comprising only Non-Executive Directors). The Board has further decided to increase the number of Non-Executive Directors, although finding appropriate people is not easy. The frequency of Board meetings has also risen and will remain that way.

Last September, Mr. Terry S.Y. Ng, our Executive Director in charge of finance and administration has taken on added responsibility to oversee all rental activities. This was a move contemplated by top management when Terry first joined. I am pleased to welcome Ms. Estella Ng to our senior management team. Coming from the Hong Kong Stock Exchange where she was Senior Vice President, Listing Division, she is now our Assistant Director in charge of finance.

The Company's financial position remains healthy, as we take every opportunity not only to lower our average borrowing cost but also to lengthen loan maturity. We are positioning ourselves for the next round of growth.

Recovery Seen in Closer Mainland Cooperation

Since mid-1997, we have had six tumultuous years. Although we have seen many economic downturns, few can be compared to the present one both in terms of severity and duration. Worse yet, the prolonged political turmoil has seldom been observed in Hong Kong. The only redeeming feature is that whereas Beijing has been disciplined not to meddle in local politics and policies, it is now much more willing to yield to our requests for better economic cooperation, as national leaders watch the weak economy compound our political problems.

For example, as part of the Closer Economic Partnership Arrangement (or CEPA), Chinese citizens from several wealthy cities and provinces who previously must join groups to visit Hong Kong as tourists, can now come as individuals. They can arrive anytime (for seven days each trip), and as often as they like. The amount of cash they can bring has been doubled and more. As success of the mall at Plaza 66 in Shanghai testifies, there are many well-to-do Mainlanders who can come and help boost our economy. After only a few weeks of the new policy, Hong Kong is already feeling the impact. Retail in traditional shopping districts such as Mongkok and Causeway Bay where we have a strong presence are especially benefited. There are even rumors that some of the visitors are buying properties. I believe that regulations will have to be relaxed further before such a phenomenon can become prevalent.

Nevertheless, we can expect other legislations to be soon enacted which will be beneficial to our industry. Closer physical ties with the Mainland will also help. For example, the construction of the first bridge linking our territory's northwest with Shekou in Shenzhen north of the border has just started. It will be completed by 2005. A second and much longer bridge connecting us to Macau and Zhuhai on the west bank of the Pearl River estuary may begin soon. Once completed possibly as early as 2008, it will only take around 20 minutes to cross it. All these are good for our economy as well as theirs.

Government Policies Risk Distorting Hong Kong Market

Not all news, however, are agreeable. While we support most of the government's initiatives announced last November to lift the real estate market, considerable uncertainties have also been introduced. In particular, the decision to stop the sales of government land for 13 months until this December is problematic. Not only are the few of us not stuck with expensive inventory unable to replenish our land banks, longer-term planning is also no longer possible. If the government can introduce such market-distorting measures with the stroke of a pen, it can with equal ease prolong them or add new ones. This has strengthened our leaning towards investing more on the Mainland, and has contributed to our decision to build out both existing projects in Shanghai. Simultaneously starting three large office towers totaling 205,500 square meters as well as two residential blocks (one of which is serviced apartments, as explained before) is not inconsequential. Once completed, we will have almost as much investment properties in Shanghai as in Hong Kong where we have labored for over four decades.

If Hong Kong government policies remain unpredictable, we may do even more on the Mainland in the future. Every company has limited financial resources as well as appetite for risks. Once they are exhausted, time will be required to replenish them. This of course does not mean that we will be careless on the Mainland or give up Hong Kong. Those who have read my past letters must know that I am extremely cautious in our motherland. We will remain so in the foreseeable future.

Balanced Approach Maintained to Consolidate Leading Edge

As I have written at length last year, management is cautiously optimistic about the longer-term future of our industry in Hong Kong. We will as before be patient to wait for good opportunities and will not jump at every short-lived market movement. As a result, there may be gaps in our profit from year to year, but hopefully our operations on the Mainland will fill at least some of them.

In the immediate term, we will concentrate on achieving best results in selling our Hong Kong projects. The next two to three years should be good ones as we hopefully sell into a rising market. In the past decade, few have read the market as accurately as we have, and we have every intention to continue that track record. According to one study, nine developers might have made losses totaling some HK$60 billion to HK$70 billion if all development projects on hand are sold at today's depressed prices. We are fortunate not to be part of that group. To be sure, we too have made mistakes but the magnitude is minuscule compared to others, and we have already written them off.

We are gratified that these facts have not been lost to the market. Since the property market peaked in 1997, we have significantly outperformed every major real estate counter in terms of share price performance. We also consistently have one of the highest dividend yields of all major property companies second only to our parent Hang Lung Group, thus yielding the best total return. All that should give our shareholders comfort that your management will make every effort to continue to create value for shareholders in the years to come.

Crisis Crafts Heroes and Heroines

Before closing, I would be remiss not to mention the heroic performance of our staff during the SARS outbreak last spring. As alluded to earlier, Amoy Gardens which was the hardest hit of any residential/retail complex in Hong Kong was managed by us, and we still own the shopping center. It was the convergence of several unfortunate events, none of which were specific to the design, construction or management of the place,

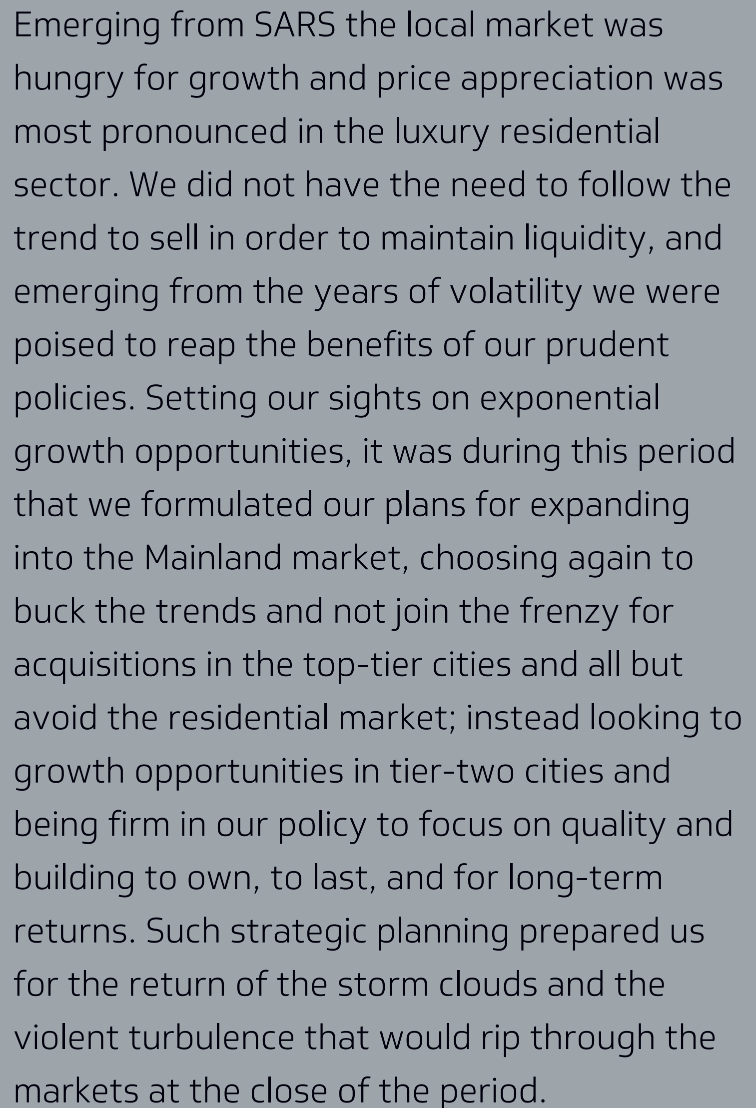
which had caused the tragedy. Financial considerations were overshadowed by the all-consuming need to contain the epidemic and to learn why this property was particularly affected. Day after day and week after week, our staff – from executive directors to the many cleaners and security guards – labored on site under tremendous risks to life as well as mental duress.

Credit should also go to the relevant government officials. I will never forget that Sunday afternoon when, anticipating the spread of the problem at Amoy Gardens, Hong Kong's Chief Executive Mr. Tung Chee Hwa called me at home. Thereafter, my staff together with civil servants under the leadership of our Secretary for Health, Welfare and Food Dr. E.K. Yeoh worked hand in hand to identify the source of the problem.

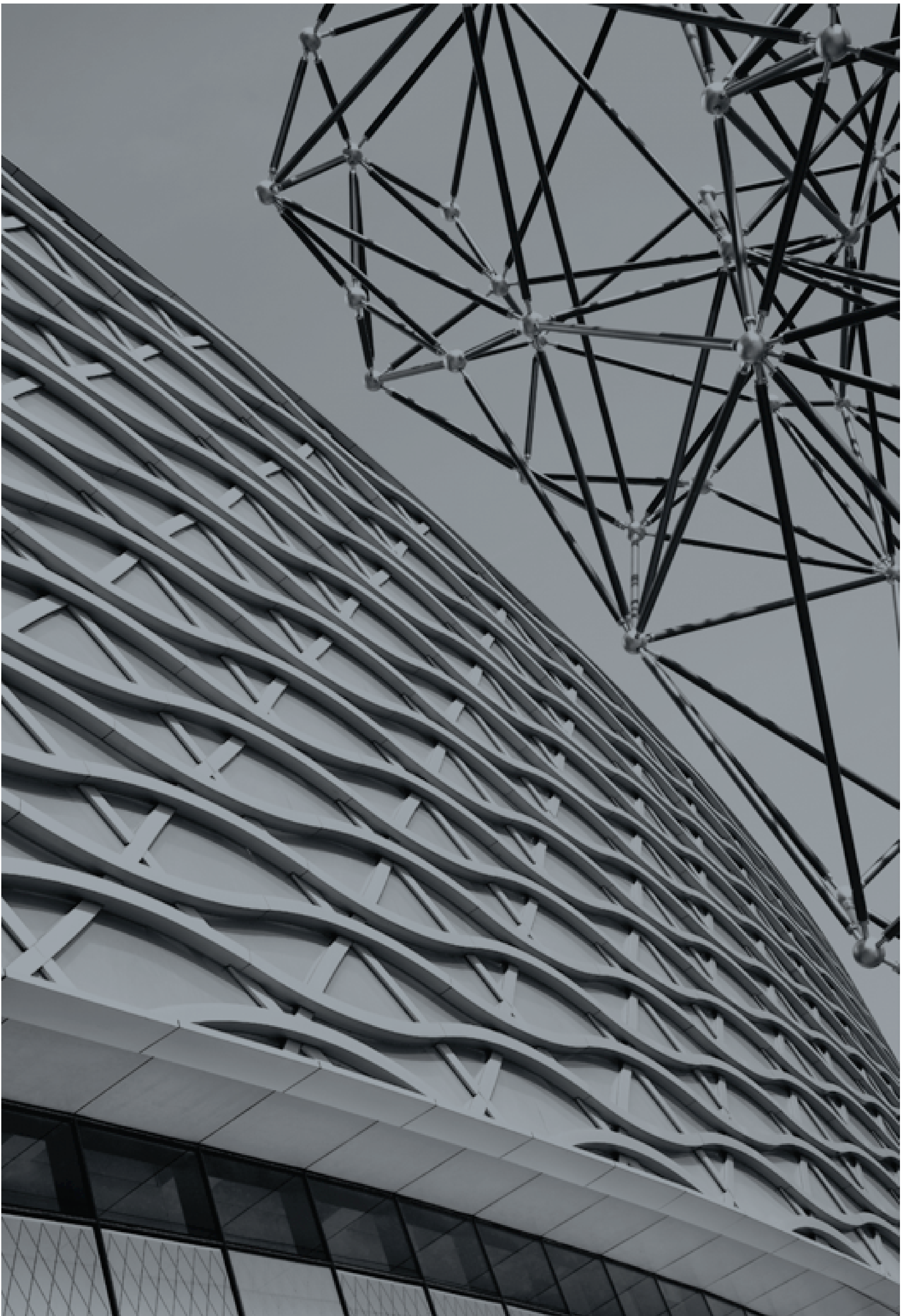
By all accounts, our staffs have done an excellent job. External confirmation of their loyalty and competence came after the incidence when we received a warm letter of appreciation from the chairperson of Amoy Gardens Owners Committee. Ultimate gratification, however, was derived from the fact that none of our employees contracted the disease.

While mourning the victims, we should also thank the heroes and heroines. Some of them are recognized by the community and we laud them. Equally, we should salute the many unsung ones, a good number of whom are working in your Company. They may very well be ordinary folks (like you and me), but they have risen to the occasion and have shone when confronted with life threatening circumstances. I know that our shareholders will join me in paying them respect and gratitude.

Ronnie C. Chan
Chairman
Hong Kong, August 28, 2003



Emerging from SARS the local market was hungry for growth and price appreciation was most pronounced in the luxury residential sector. We did not have the need to follow the trend to sell in order to maintain liquidity, and emerging from the years of volatility we were poised to reap the benefits of our prudent policies. Setting our sights on exponential growth opportunities, it was during this period that we formulated our plans for expanding into the Mainland market, choosing again to buck the trends and not join the frenzy for acquisitions in the top-tier cities and all but avoid the residential market; instead looking to growth opportunities in tier-two cities and being firm in our policy to focus on quality and building to own, to last, and for long-term returns. Such strategic planning prepared us for the return of the storm clouds and the violent turbulence that would rip through the markets at the close of the period.



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Breaking Dawn: Positioned to Prosper

EXECUTIVE SUMMARY

While many of our competitors have been counting their losses since the end of the Asian Financial Crisis, Hang Lung is fortunate to be in a position to begin seeing the fruits of our policies and strategic planning during arguably the worst economic storm in decades. Our prudence in managing our program of acquisitions and in the enhancement of our existing assets is now placing us in a prime position to reap the benefits of the positive changes taking place in the market, including the boom in the luxury residential sector and the prospect of steadily increasing rental rates in Hong Kong over the coming years. In mainland China, the success of our Shanghai projects is once again a testament to strategic foresight and gives us the confidence, experience, and network to further explore the potentials of this expansive market. Fiscal prudence has at times been snubbed conservatism but in our case there has been tremendous wisdom in our actions, which now position us to take advantage of a wide variety of options open to us. We will continue to chart a judicious course in line with the principles of management that have made us prosper even in the most difficult economic circumstances. Our keen eye for value will see more focus on the growth of our Mainland portfolio without neglect to the potential that Hong Kong holds, but with the firm understanding of where the greatest benefit lies for the Company and our shareholders. To this end, our emphasis on correct timing, preferential location, and quality of construction will be in the forefront of our decision-making, to take the doubling of profit that we have seen this year along a trajectory of sustainable growth in the years ahead.

The HarbourSide, Hong Kong

For the past several years, market conditions dictated that both turnover and profit should come overwhelmingly from rental activities. It should no longer be so in the next few years – sales of development projects are expected to increasingly impact results. Just as profit has more than doubled in the period under review, it is conceivable that barring unforeseen circumstances, it will again grow satisfactorily in the coming three years.

As predicted 12 months ago, property sales in Hong Kong have picked up. Price appreciation began in the fourth quarter of 2003 and picked up momentum in the first four months of this year before retreating slightly. Luxury apartments have especially performed well; in some cases, prices rose by over 50% in a matter of six to eight months.

Strategic Planning Prospers

Your Company is certainly one of the biggest beneficiaries of this new market condition. About 80% of the floor area for sale can be categorized as luxury. We took advantage of the price rise and began marketing our waterfront project, The HarbourSide, towards the end of last year. Actual sales commenced in February and the highest prices achieved for the penthouses were over HK$20,000 per square foot. Such numbers were unthinkable only months before. Management, however, was not keen to sell out quickly. We parted with about 181 out of the total of 1,122 units. Since all the units sold faced the harbor, the average price achieved approached HK$10,000 per square foot. Sales will continue as we see market conditions evolve which will hopefully maximize profit.

About 90% of Carmel-on-the-Hill was sold at an average price of over HK$5,000 per square foot. It is higher than our original projections. AquaMarine which is a 1,616-unit development as well as the 1,829-unit The Long Beach are both ready for sale. Again, we will time the release so as to generate the best results. AquaMarine will likely go on sale first, perhaps towards the end of the year.

Total rents collected from our Hong Kong properties have been falling since 1997-1998, but have begun to stabilize some two years ago. Growth in total rental revenue since 2001 has come almost exclusively from Shanghai. Now the situation is different. Management believes that Hong Kong rents will gradually rise in the coming year.

Occupancy rates have remained steady at 92.3% for our Hong Kong portfolio. Retail space has particularly performed well as consumer confidence returns. Mainland tourists are another source of strength underpinning the market. Our Mainland investment properties have done very well both in terms of rents and occupancy. All buildings are basically full.

Financial Planning Prospers

Success in any business must be accompanied by sound financial planning. This is especially critical in a capital intensive industry like ours. Over the past decade and more, we have performed well in this area.

In the spring of 2002, we issued convertible bonds (CB) in two tranches. They brought in almost HK$3.45 billion. The transaction stipulated that by March of this year, if our share price rises above a certain level, we can begin to basically force conversion. At the time of issue, management estimated that by early this year, the real estate market should have recovered enough to resume property sales. We know more than anyone that profit margins for all of our projects are perhaps the best in Hong Kong. That should have a positive effect on our share price which makes the CB conversion possible. History has proven us correct – 99.7% of bond holders took our common stock. Thus, the need to repay is removed, and our balance sheet is further strengthened. We have also continued to take advantage of the low interest rate environment to replace existing loan facilities with cheaper and longer-term ones.

Intuitive Insight Prospers

Last year, we saw net profit fall to barely over one billion dollars. That was the lowest since 1993. Shareholder's Fund was below that of 1994. All of these were the

direct result of the Asian crisis which started in 1997. Management believes that the tide has finally turned. Due to prudent decisions made both before and after the crisis, we have positioned ourselves well for a promising few years as long as the market holds up.

It is now common knowledge among sophisticated international investors that perhaps more than any other major Hong Kong real estate company, we have consistently called the market correctly in the past 10 years and more. We not only avoided trouble when trouble came, but we also took advantage of opportunities. Consequently, the stock market has rewarded our shareholders. Since the market height of 1997, our shares have been the best performer compared to our major competitors.

Throughout the 1990's, (and in fact the 1970's and 1980's as well), our price-earnings ratio was consistently among the lowest of the major property companies. Ostensibly it was due to our lack of a large land bank, especially of the then existing land-exchange entitlements or Letter B's. By 2001, a fundamental change took place. Now we consistently trade at the highest price-earnings ratio. This partly explains why we have enjoyed better share price appreciation than our competitors. Coupled with the fact that we have always had one of the highest dividend yields, total return to shareholders tops the list of all real estate counters.

The following numbers will illustrate the point. Take the other 13 biggest publicly listed property companies in Hong Kong and compare their respective highest share prices achieved in 1997 (before the Asian crisis was in full swing) with those of yesterday (September 7, 2004). All fell between -25% and -85%. In the same period, we were the only company which recorded a rise and that of 8%. Our parent company HLG retreated by 24% which was still better than all the others.

We also top the list when total return to shareholders is compared. When total dividends paid is added to stock price movements for the same period, we again were the only company which recorded a rise, and at an impressive 34%. All fell between -12% to -81%. Our parent company was slightly set back by -4% which again was much better than the others.

The size of a company is also important to this business. Given the large size of projects these days as well as potential opportunities in the mainland of China, bigger firms have a distinct advantage. Looking at market capitalization and again comparing the height of 1997 with yesterday, your Company grew by 23%. The best of the other 12 diminished by 10% and the worst by 75%. HLG, which did not have any increase in the number of shares in the period, fell by 25%. It was better than all but two in that group, and both of them had issued new shares.

A brief review of how such a stellar performance was achieved might be instructive for the future. First, we resisted temptation to follow the crowd back in 1995-1997 when land prices were rising. We were called conservative, and worst yet, lazy, by one western fund manager. History proved that we were prudent. Of course, we were not inactive during those years. We raised cash in every way we knew how: placed shares, took out longer-term loans, and sold investment properties at great profits. It was not luck; it was skill.

Early last year, the ability and willingness to resist pressure was again called upon, albeit in a different direction. An analyst report accused us of not selling almost-completed apartments like many of our competitors. While we are cognizant of the need to heed the advice of some analysts, we should certainly not listen to all! History shows that many developers sold units at the bottom of the market. It was doubly satisfying for us since we had products to sell after prices rose while our competitors were left with little. Many of them sold too early. In this business, following the pack can be hazardous.

Because we hoarded cash before the Asian crisis, we were financially as well as psychologically more prepared to seize opportunities when they arrived. This took place between March 1999 and December 2000. All our major projects now or soon-to-be for sale were purchased at that time. Buying land at the bottom of the market was the single most important reason for our having the best profit margin today. Certain land acquisitions by our competitors in 2001 and 2002 before the 13-month government land sale moratorium should still be

profitable. However, it was your management's judgment that the expected low return, and hence higher risks, did not justify our participation. Committing financial resources to poor yielding projects will prevent us – again both financially and psychologically – from taking full advantage of opportunities which may come later, be they in Hong Kong or on the Mainland.

Paths to Prosper the Future

Some Hong Kong analysts attribute our success to conservatism. That I disagree. Of course, there are times to be cautious in order to avoid impending danger. That, we did well. However, mere conservatism implies a rigid state of mind and thoughtlessness in action. In our case, that is farthest from the truth. We withheld from buying land or selling apartments not because we had a propensity towards inaction. Rather, it was a conscientious decision made after much analyses and internal debate, and concluding that that was the right course of action for that moment in time. Ultimately what counts is to always do the right thing at the right time. I like to think that our track record justifies past actions. The job of management is to consistently create shareholders' value at reasonable risks. This dovetails with our stated goal of becoming a major real estate company with one of the best development profit margins in the industry. We have achieved that in recent years and will continue to strive for it.

But where will the Company go from here? It is undeniable that if we fail to replenish our land bank in the next year or two, there may be a gap in our profit in three years' time. Management's response is a two-prong one. We will attack both the Hong Kong and the mainland China markets, but with very different approaches.

In Hong Kong, every potential land transaction will be evaluated employing our usual stringent standards. It must pass the test: will the project bring the minimal required return commensurate with expected risks? If we cannot find such opportunities, we will look elsewhere, namely, the mainland of China. We will not lower our standards. History shows that all too many projects (mostly done by our competitors) lost huge amounts of money. Some of them even brought the developer down with it. Even if a project manages to eke out a meager return, the risks and opportunity costs are too great to justify it. I know of a sizeable developer who because of one such major development was prevented from growing for some 10 years. Naturally a bigger company can withstand a few bad deals, but they will very soon add up to a serious impediment to corporate growth. So for us, to maintain a high profit margin for development projects is like a religion. We will only very rarely break the rule.

Given today's market conditions, it is possible that some analysts will again accuse us of conservatism. We will as before ignore them, unless management independently comes to the same conclusion that we should be more aggressive in land acquisition in Hong Kong. Those analysts were wrong in the past and may well be wrong again now.

On the Mainland, on the other hand, we will be very aggressive. We believe that we have found a niche which should create shareholders' value for the foreseeable future. For the past 12 years, we have concentrated on one city, but will now cast our net a lot wider.

In hindsight, what we did in Shanghai in the past 12 years was the right strategy at the time. Few cities in China had developed as fast and as well during that period. We capitalized on the opportunity and have done superbly – last year we collected about HK$475 million in rent from our two projects, Plaza 66 and The Grand Gateway, and netted almost HK$346 million in profit.

What we had gained from the Shanghai experience, however, went beyond mere dollars and cents. We have harvested expertise on the Mainland; learned to deal with the government; welded a competent management team; built two world-class developments whose quality, I like to think, is among the best in the country; and established Hang Lung as a highly respected brand name in the industry which is known well beyond Shanghai. All these augur well for the future.

The external environment in China has also improved substantially from the time we first entered in the early 1990's. The overall economy has been greatly strengthened; rules and regulations pertaining to real estate and related disciplines are further established; government officials everywhere are better educated and more informed; and physical infrastructure has improved tremendously. These also give us confidence to make the next big move.

We have identified some 30 major cities in China and hope to do at least seven to eight, and preferably nine or 10, sizeable projects in the coming few years. We will bring the expertise gained in Hong Kong and in Shanghai, and do first-class developments which local developers have yet to emulate. Some space may be for sale but most will be for long-term hold. With over HK$20 billion of cash flow expected in the coming two to three years, financing will not be a problem at all.

In fact, our staff have started over a year ago to search for potential sites all over China. It is hard work and finding a project which meets our stringent requirements is not easy. The good thing is that there are many big cities in China with reasonably well-to-do citizens. I believe that we have a fair chance of success.

New project developments aside, we will continue to actively manage our existing investment properties. Whereas it is likely that Hong Kong rental revenue and profit will both go up in the present financial year, growth rates will not be spectacular. Nevertheless, we can take comfort in the fact that high spending Mainland tourists are underpinning the city's retail trade, and that our shopping centers are all in excellent locations. A recent research report by a reputable international estate agency stated that Causeway Bay and Mongkok command the top two highest rents among all shopping districts in the Greater China region. (Cities studied include Beijing, Shanghai, Guangzhou and Taipei, in addition to Hong Kong.) As you may know, we have dominant positions in these two districts.

The growth rate of our Shanghai rents in the coming year is expected to slow down. After three to four years of operation, we have a better understanding of the market and of our properties. Necessary changes such as tenant mix were made and now things have stabilized. The number of rent renewals will also be limited in the coming year. The second office tower of Plaza 66 should be completed by late 2006, thus starting another round of rental growth.

Property sales will continue as discussed earlier. Since we do not have a huge portfolio, our goal as before is to maximize profit in every project. As a result, marketing campaigns may ebb and flow depending on management's view regarding market sentiments. Some people worry that there may be too many competing products in the market. That however should not be a problem since our developments are all superbly located, in addition to being well designed and constructed. In fact, many of the units in our portfolio have a sea view which is a rarity these days and is a great selling point.

All in all, the prospect for the group over the next three years should be quite favorable.

Ronnie C. Chan
Chairman
Hong Kong, September 8, 2004

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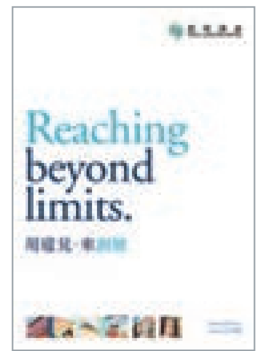


Expansion Strategies: Sights Set on Exponential Growth Opportunities

EXECUTIVE SUMMARY

We began by consolidating our property portfolio in Hong Kong to establishe a solid center of growth. Our hunger for growth and our insight into emerging opportunities took us to expanding our sights to Shanghai, whilst remaining steadfast in our commitment to our home portfolio. As a company we have ridden many storms thrown at us by the local and global economic system. We have not only weathered them but commanded them, so as to unfailingly deliver on our promise of sustainable growth. Now, as we look at the fruits of our strategies and management policies in Hong Kong and Shanghai, we are confident that there is support for an unprecedented leap into a new market, which offers us to build significantly on our past and current achievements. This new phase in our Company's development, which has seen the acquisition of a substantial piece of land in Tianjin and will continue to see our sights set on expanding our Mainland interests, does not snub the matured and successful markets of Hong Kong and Shanghai, but views them as the firm foundations of success that fuels our long-term goals with an upbeat sense of confidence. We have made strategic decisions that have gone against the current proposed by market commentators, and we have been right every time. Only recently has the wider market seen that we are never to be found wanting, be it in our discernment of timing for acquisitions and sales, or in the direction we have driven the Company. Only recently has this recognition seen the outperformance of our shares, and the clear message is to forge ahead with the instincts and expertise that has brought us where we are today.

Riverside 66, Tianjin

The past year is a watershed in the history of the Company. The purchase of a huge piece of land in Tianjin in January signaled the beginning of phase two of our Mainland investments. It also moves us closer to becoming a leading shopping center developer and owner in China.

Soon after taking over the chairmanship of your Board of Directors in January 1991, I sold off all assets outside of Hong Kong, namely North America, Southeast Asia and Australia, and concentrated on our home city. Towards the end of 1992, we bought our first piece of land on the Mainland. In the ensuing 12 years, we concentrated on one city alone – Shanghai – and built up a valuable investment portfolio. In the year under review, it accounted for almost one quarter of total rental profits. (Since development gains in Hong Kong were strong, Shanghai only accounted for some 12% of total profit.)

Whereas I had stated publicly that the Company would from now on look for projects in both Hong Kong and on the Mainland, it was also undeniable that about two years ago, management became increasingly convinced that we must strengthen our capability on the Mainland. A strategic decision was made that while concentrating so far on Shanghai alone was the right course to take, it was time to look beyond. There are two factors in our considerations – a push factor and a pull factor.

Pushing-off From our Solid Base in Hong Kong

First, the push factor has two aspects relating respectively to Hong Kong and Shanghai. There is little doubt that these two cities will for decades to come remain two of the three most dynamic metropolises in China, with the other being Beijing. In Hong Kong, we are fortunate to be among the 10 or 12 biggest real estate companies. In terms of both market capitalization and profitability, we rank around number three among the pure property counters. According to a study done by a leading U.S. investment bank late last year, we should retain first place in profit margins for development projects for at least a few more years to come.

However, the fact remains that Hong Kong is a matured economy and will in no way grow as fast as major cities on the Mainland. Fierce competition here will ensure that profit margins will at best be moderate in the next few years unless a huge bear market like that of 1998-2003 reoccurs. That possibility, in our estimation, is not high. Moreover, opportunities are limited. Hong Kong is but one city, albeit with high unit property prices, and land resources are fought over aggressively by many well capitalized companies like us.

We have no intention whatsoever to give up Hong Kong. Most people do not learn from history, and good buying opportunities will come once a bear market returns. We will be ready as we were in 1999-2000 to pounce on them. During those two years, we bought land that would likely produce profits of over HK$10 billion. Fortunately or unfortunately, present market conditions do not seem to offer similar opportunities in the next two to three years.

Gaining from our Experience and Success in Shanghai

Then why not invest more in Shanghai, a dynamic market that we already know well? First, we are in the process of constructing approximately 81,400 square meters of top quality offices. Add that to the 231,800 square meters of existing space and we will have a portfolio of about 313,200 square meters in two highly valued commercial projects. Their locations can hardly be surpassed and their quality of design and construction are almost unmatched. They command some of the highest rents in both offices and shopping malls.

Some may think that we are worried about prices peaking in Shanghai. That is not our primary concern. Who knows what prices will be in a few years if we were to buy land today and build. Even if cyclically prices were to peak soon, looking eight to 10 years down the road and beyond, I am confident that today's "high" prices will look cheap at that time. There are, however, other considerations which concern us.

Although Shanghai is among the best regulated cities on the Mainland, municipal leaders often balk at enforcing existing rules. I can sympathize with them. Shanghainese men and women are very sharp and are always ready to take advantage of opportunities for their own economic benefit.

Take for example the relocation of existing residents to clear the land. There are always families who refuse to accept the officially set compensations and cause pain to both the government and the developer. Not wanting any social disturbances, the easiest way for officials to placate them is to ask the developer to pay more than the pre-agreed sum. After all, time is money to a businessman. However, such actions have emboldened other citizens to follow suit. Together with a number of other similar problems, clearing land becomes prohibitively expensive if not impossible.

A year or two ago, a friendly developer invited us to joint venture with him on an excellently located project. With these and other considerations in mind, we declined. It was good that we did, for we recently heard that after paying hundreds of millions of dollars, he still did not have a vacant site. He was considering to forgo the money already paid and to walk away. This is by no means an isolated case.

This does not mean that we will give up Shanghai for good. Social phenomena like these tend to move in cycles and circumstances may change in a few years. I look forward to the day when we can once again buy vacant land in that wonderful city, recognizing of course that big and well-located sites are becoming increasingly rare.

Given the above factors, both Hong Kong and Shanghai seem to be pushing us to look beyond.

Targeting Sights on Best Strategies for Growth

There is a powerful pull factor from many Chinese cities. The benefits of continued economic reforms are gradually being felt outside of traditionally prosperous cities like Shanghai, Beijing, Guangzhou and Shenzhen. Many other municipalities with populations over four or five million are poised for economic take-off. Buying land now which is still relatively inexpensive and constructing for the next four years may well bring us to the point where these cities are booming. That prospect is rather enticing to management, especially since we have already gained relevant experiences in Shanghai. Commercial opportunities in China are drawing the attention of the world, and I do not see why developers like us in Hong Kong should not take advantage of them.

Our focus will be on shopping centers to capitalize on growing consumer spending. Not every major city is a good market for high-rise offices, although when appropriate, we will not hesitate to build them. The same is true for high-end residential apartments and hotels in which we also have considerable experiences. Most of our properties will be for long-term hold so we must develop products that are competitive in the long run. (That of course does not mean that we will never sell. When conditions are propitious, we will part with properties as our parent company has done in Shanghai with one of the two office towers at The Grand Gateway.)

We will invest in at least 10 major population centers that have strong purchasing power. In each city, we will identify the biggest piece of land in the best of locations with the lowest possible plot ratio. The combination of these factors, together with world-class design, superior construction, and experienced operational management, should give our developments a good chance of maintaining a leadership position in each place.

There are usually only a few good locations in each city, so we must act now and act fast. In fact, our stringent site selection criteria almost invariably demand that we work closely with local officials to identify, or more likely, assemble plots. From the decision to invest in a city to the time we take possession of the land usually requires one to two years. This highly complicated process demands many skill sets which scares off most domestic and outside developers. However, our experiences of the past two years have shown that it can be done. It is hard work but management believes that the rewards can be very attractive.

Given this strategy and as few auctioned plots meet our minimum criteria, buying vacant land at government auctions is an unlikely alternative. Developing commercial space, especially shopping centers, requires the strictest discipline in site selection which must be considered in conjunction with the design of the superstructure and future operations.

For similar reasons, buying existing buildings is also not our preference. I can hardly think of one completed development in the country that meets our standard. However, we are not religious about this. If cheap enough, we may purchase built out projects which are less than ideal. Ultimately, it is the return on investment that counts, although the long-term competitiveness of our portfolio is also extremely important to us.

As in Shanghai, we will engage world-class architects to design visually attractive and even spectacular buildings. We will also engage first rate designers for the interior layout. Since these professionals are more often than not foreigners, we will make use of their expertise but will also add our own local knowledge. After all, we have better in-depth understanding of local market conditions. The formula has worked well for us in Shanghai and should work elsewhere in China.

Only the Best Options Bear the Weight of our Scrutiny

With all this in mind, we started over two years ago to research 30 some major Mainland cities, almost all of them having a minimum population of four to five million. In that period, there was hardly a week that went by when our staff were not visiting one or more cities. We need to buy three to four big pieces of land annually from 2005 to 2007 in order to build at least 10 more large complexes outside of Shanghai. This is a daunting target that I have set for my team.

Financially we are well prepared for this strategic initiative. 10 such shopping centers costing say between HK$2 billion and HK$2.5 billion each will require HK$20 billion and HK$25 billion total. Our cash inflow from Hong Kong development projects alone in the coming four years should more than cover the entire amount. Moreover, because the Company is very low geared, we have tremendous debt capacity that will enable us to pay dividend, take on new developments in Hong Kong, and if appropriate, do even more projects on the Mainland. The fact that the expected cash inflow should arrive before outflows, will put us in an even more enviable financial position.

After much hard work, in January this year we landed our first project in Tianjin, a metropolis of over 10 million people. It is only one of four cities in the country that enjoys the status of a province and reports directly to the central government. The two other cities in which we have identified the very best sites are close to fruition. They should come through before the year is over, thus meeting the minimum target that I have set for management. We are already working on the three or four cities for 2006.

Critical to the success of this strategy is human resources. In the past year, we have hired experienced teams for Tianjin and for one other city. The process is ongoing and we should have a third team ready soon. By the middle of next year, the expansion of The Grand Gateway in Shanghai belonging to our parent company Hang Lung Group Limited should be completed. That will free up some seasoned staff. By the beginning of 2007, the second office block at Plaza 66, also in Shanghai, will be finished and the manpower there can be deployed elsewhere as well. Our experience is that many qualified professionals are happy to work for a company like us.

Engineering Favorable Financial Structures to Support Growth

Another major event of the past fiscal year – placement of 370 million shares last November at HK$12 per share yielding cash of about HK$4.4 billion – bears some comments. The first question often asked by investors and potential investors is: why do you do it when you are expecting a huge cash flow and have plenty of

borrowing capacity? After all, loans are cheap these days given relatively low interest rates. The answer is simple: company size matters greatly in a capital intensive industry like ours.

For the past decade and more, our track record for equity raising exercises – convertible preference shares in 1993, warrants due in 1995, share placement in 1996, convertible bonds in 2002 and again share placement in 2004 – has shown that we have put the money to good use each time and have greatly enhanced shareholders' value. In each case, those suspicious at first have been converted to supporters within a relatively short period. I am confident that this time it will be the same.

The history of Hong Kong's property cycles shows that great land acquisition opportunities occur in distinct spurts. They may only come once every five to six years as in 1986-1988, 1992-1994 and 1999-2000. When they arrive, developers are usually given little chance to raise equity at desirable prices. Consequently, one has to be financially prepared at each land purchasing opportunity and one must take advantage of every equity raising opportunity. Loans can of course be employed, but given severe property price volatility which has been the norm, their risks are high. Remember the serious downturns of 1983-1985, 1991-1992 and 1998-2003. Each time a number of developers bankrupted and they were invariably heavily laden with debts.

Moreover, equity can only be satisfactorily raised when the international capital market cooperates. That too is sporadic and unpredictable, thus strengthening our belief that we must catch every opportunity. So far our timing has been excellent. Since the Company came under my watch in 1991, we had taken almost every opportunity to raise equity and to subsequently buy land to great profits.

There are two other important reasons for raising equity. First, Hong Kong land transactions have become very expensive over the past decade. Since 1997, there were 14 major deals with prices ranging from HK$2.43 billion to HK$11.82 billion. Raising three or four billion dollars every few years will only allow us to keep up with the market. In other words, company size is critical to our long-term survival.

Second, opportunities in mainland China are humongous and exciting. Prices are still relatively low but will not remain so for long because the economies in many cities are taking off. This is a once in a lifetime chance, and we must seize it. How much we can grow is only limited by our resolve and our finances. We are not lacking in either. Always being careful in the latter, we prefer to use equity money supplemented with debt and not vice versa. After all, we must be vigilant about risks such as economic downturns and other mishaps. In a big and fast developing country like China, those happenings usually have serious ramifications. We do not want to forget about defensive measures even as we go all out to secure new projects.

Nevertheless, recognizing the need for a more balanced and reasonable capital structure, we signed in June 2005 an HK$8 billion syndicated loan which is partly for five years and partly for seven years. It was the single biggest borrowing we have ever done.

Climate of Growth Increases Confidence

Although the Asian Financial Crisis more or less ended in 2002, Hong Kong's real estate market did not see a strong and sustainable recovery until the beginning of 2004. Unlike most local developers, we refused to sell completed apartments until then, just as residential prices began to climb. Although the market has since gone through adjustments, we have been able to sell our products at increasingly higher prices. For example, the average price achieved at The HarbourSide during the current fiscal year was about HK$12,900 per square foot which was 34% higher than those sold in the first half of 2004.

Carmel-on-the-Hill was basically sold out at an average price of approximately HK$5,100 per square foot. The penthouse duplexes went for nearly HK$10,000 per square foot. Almost half of all units at AquaMarine were sold at an average price of about HK$4,600 per square foot. The remaining two blocks which have better views will likely go on the market towards the end of this year or early next year. The Long Beach with 1,829 flats should receive the Certificate of Compliance by the end of this year. With an impending shortage of supply, we will not be in a hurry to sell.

Grand Gateway 66, Shanghai

Hong Kong's rental market has recovered strongly. Office and retail rents have both picked up and we are beneficiaries. Last year our total rental profit grew by 13%, and overall occupancy stood at 94%, a slight improvement from the year before. As expected, shopping areas frequented by Mainland tourists did better and centrally located offices outperformed outlying ones. Our Shanghai investment properties were basically fully let, and profit grew by over 20%.

Heading Set to Stride Ahead with Confidence

With hopefully three new Mainland projects (including Tianjin) tied down before year-end, the Company can then be considered as a China play with two foci – Hong Kong and the Mainland. Management is sanguine about the former and excited about the latter. The world has discovered mainland China and so have we. After all, we are the closest geographically and culturally. With our 12 years of successful operations, it is only reasonable that we should take advantage of present opportunities. In the long run, real estate prices everywhere follow economic development. With mainland China expecting to grow at 7% to 9% annually in the coming decade, prospects there for our industry should be better than almost anywhere including Hong Kong.

Skeptics say that not many foreign companies make money in China, and few Hong Kong developers fare better. There are certain truths to both statements, but it is also correct that like us, a good number of non-Mainland firms are quietly raking in decent profits and are sending funds home regularly with little hassle. Whether one makes money in China depends largely on the industry and on the ability of management to properly understand and navigate the local system. I believe – and our past experience attests – that real estate development can be rather lucrative.

Besides local know-how, another critical success factor for our industry is company strategy, something seldom mentioned by developers and investment analysts alike. So far I have failed to discern the strategies of major Hong Kong developers on the Mainland. They should exist but are not easily identifiable. On the other hand, Hang Lung's plans are very clear and deliberate from day one and are distinct from all our competitors. In the past 12 or 13 years, for example, we only built huge, world-class commercial projects in one city alone – Shanghai.

Many of our fellow Hong Kong developers are constructing residential units for sale on the Mainland. The only way they can make money is to acquire land inexpensively and hope for the market to soar. If not, taxes will eat up much of the profit. It seems hard to imagine that we as outsiders can buy land cheaper than the locals who have avenues which we will never know. Moreover, local players can build much cheaper than we can – cheap in terms of both dollar amount and quality. So where is our competitive advantage? As to luxury apartments and houses, the market is usually small except in a handful of cities such as Beijing and Shanghai. As such, I expect our Mainland rental portfolio to comprise predominantly commercial space. This is not unlike our business in Hong Kong.

On local management, perhaps one word should be said. Many businessmen from the outside think that mainland China is not a well-regulated place and so they think they can be lax in following rules and regulations in their dealings with various parties, including the government. Almost invariably such an attitude and approach will get them into very messy situations. Our own experiences confirm this point. Because of the very fact that the country is not well regulated, it is imperative that we be self-disciplined and cautious. Moreover, China everywhere is fast changing for the better and we do not want to have our actions, perhaps acceptable at the time under a gray legal environment, to come back and haunt us later under newer and tighter rules.

Our Established Success is our Safety Net

What is the worse case scenario for our strategy? China goes into prolonged economic turmoil. While management does not foresee that any time soon, it remains a possibility. Because your Company hardly has debt and expects over HK$25 billion cash inflow from Hong Kong development projects alone in the coming three years, we will buckle down and ride out the storm.

When circumstances justify, we may even buy more. Our history shows that the Company and its stocks both perform superbly in bear markets.

(Allow me to state an observation at this juncture. Many journalists in Hong Kong keep asking the question: how much land bank does each local developer have? What they mean is: how much do we have in Hong Kong, implying that land on the Mainland is not valuable and should not be counted. Indeed, land over the border is plentiful and a good number of Hong Kong developers have bought many huge but mediocre plots. Their financial losses should not insinuate that real estate development is not a good business in China. Careful site selection can yield plots that are highly desirable both in the short and in the long term. It is high time that we view the property business just like any other industry, namely, with the Mainland border being increasingly blurred.)

Our existing businesses should trade well in the coming few years. The rise in mortgage rates is expected to be mild and should not have serious effects on property sales. In Hong Kong we will continue the harvest and sell completed flats with the goal of maximizing profit. Take The HarbourSide for example. We only have 300 or so of the harbor facing units remaining so why should we sell so quickly as long as the market is steady. Prices of such unique products will rise more in bull markets and fall less during downturns. We will take advantage of each wave and sell as we deem prudent. The higher the prices of the front units, the easier it will be to part with city facing ones at the back on better terms for us.

Hong Kong's rental market is expected to firm even further in the coming year. That should translate to higher profits for us. Shanghai should once again perform satisfactorily although the big rise in rent will only come when the second office tower at Plaza 66 is completed in early 2007.

Well before we finish selling existing Hong Kong development projects, our first three or four new Mainland complexes should be ready for rental. Any office and residential unit that are part of them can be sold. It is also possible that we may use capital markets to monetize our mainland China business. All said, our future, barring unforeseen circumstances, should be reasonably bright.

Misplaced Doubt Reverses in the Face of Sustained Success

Before closing, I want to say a word about our stock performance. Throughout the 1990's, we underperformed our competitors because the market was skeptical about our then strategy. Starting mid-2000, they began to realize the facts and our shares started to outperform significantly.

Now we are embarking on another strategy, namely, simultaneously entering many Mainland cities with force and in a deliberate fashion as outlined above. As before, our strategy is different from that of all of our competitors, and the market, once again, is not prepared for it. We will double efforts to communicate with the investment public, especially in the West. Management is confident that like the last time, the market will soon recognize the appropriateness of our latest initiative. As long as we execute it well, much value will be created for shareholders in the coming years. Consequently, it seems reasonable that our stocks should perform well.

In the past fiscal year, the Company's underlying profit rose by 20 some percent. It is hard to imagine that any Hong Kong developer will be able to consistently achieve that level of growth in the coming few years. If anyone has a chance, we should be one of them. Since the stock market in the long run is quite efficient, I expect our price earnings ratio to expand.

Today is the last day that Mr. Wilfred Ho will remain in the Company's employ. Instead of retiring completely, he has kindly agreed to stay on for 20 months as a consultant to oversee the completion of our two Shanghai projects. Wilfred joined Hang Lung from the government's architectural services back in 1977. During much of that time, he was our Project Director. A few years ago, he took on the added responsibility of managing our then budding Shanghai operation. We have all enjoyed working with him and look forward to many more years of friendship inside and outside of the Company. On behalf of the Board and of all our staff, I want to thank him for his many contributions over the past 28 years.

By order of the Board, I am pleased to announce two additions to the Board of Directors. Trained as an architect, Mr. William Ko who joined the Company 12 years ago will become Executive Director-Projects in charge of all Mainland projects outside of Shanghai. Of all the senior executives, he will have to travel the most, which has already been the case of late. Fortunately his relative youthfulness (William is 46 years of age) will serve both him and the Company well. He will report to our Managing Director Mr. Nelson Yuen.

Ms. Estella Ng came to us two years ago from the Hong Kong Stock Exchange where she was in charge of listing. An accountant by profession, Estella will be our Executive Director in charge of finance and will report to Mr. Terry Ng. While we have many female executives in the Company, Estella is the first to be elevated to the main Board.

Please join me in congratulating William and Estella. I am confident that their addition will further strengthen the Company. In particular, they will help Nelson, Terry and me execute the new strategy which I have outlined above.

Ronnie C. Chan
Chairman
Hong Kong, August 31, 2005

05–06

Growth Blueprint: Scaling New Horizons

EXECUTIVE SUMMARY

In line with our assessment of market direction in mature markets such as Hong Kong, the residential market has been dented by higher interest rates while the leasing market has shown slow but steady improvement. Shanghai, meanwhile, has continued to soar with our developments maintaining a strong growth trajectory. The results confirm the precision with which we have positioned the forward direction of the Company. Our Mainland expansion initiatives progress apace with nine projects in the pipeline. Our strategy is clear: to follow the success of our Shanghai developments with stunning world-class shopping malls and office towers in some of China's fastest growing cities. And we have the strengths to achieve these goals with a competitive advantage that will make us Mainland's leading commercial real estate developer, owner and manager. Having spent years in researching the cities poised for spectacular growth and developing the relationships that are needed to bring our plans to fruition, we are now poised to make the China market the center of our future growth and expansion plans. In this endeavor we find ourselves way ahead of Hong Kong and Mainland developers because the vision is one we have honed from scratch, based on solid experience and expertise. Market developments in Hong Kong should ease in the coming fiscal year, and we expect the strong growth in Shanghai to continue. With our portfolio strategically balanced between both Hong Kong and the Mainland, and with acquisitions in both markets made always with a view to adding substantial value to our bottom line, we are confident that our positioning offers the best growth proposition to our shareholders.

Palace 66, Shenyang

A year ago, I wrote extensively on the reasons for expanding investments in mainland China and the strategy for it. Simply put, we aim to secure land within the three years of 2005, 2006 and 2007 to build 10 to 12 sizable commercial complexes in several cities. With each project defined as investing HK$2 billion to HK$2.5 billion, the total investment would entail HK$25 billion to HK$30 billion. I am pleased to report that significant progress has been made.

To refresh shareholders' memory, after almost two years of labor, we landed our first project outside of Shanghai in Tianjin in January 2005. As anticipated last year, we signed up a second piece in September 2005. Situated on Zhongjie Road in Shenyang, we will build on the 3.5-hectare site a five-story shopping mall of almost 120,000 square meters. Completion will take about four years after land possession which should come within this year. Zhongjie Road is said to be the first pedestrian shopping street in the whole of China and is one of the two best existing commercial districts in Shenyang. As capital of the highly industrialized Liaoning Province, Shenyang is the biggest and the most economically dynamic city in Northeast China. Our mall design is as spectacular as the one in Tianjin and our two existing ones in Shanghai. Total cost approximates the Tianjin project which is about HK$2.5 billion.

Firm Purpose in Mainland Expansion

In January this year, we entered into a preliminary agreement with the city of Jinan, capital of Shandong Province, and later became the sole qualified bidder for a piece of land measuring approximately six hectares. Completion was originally planned for July once the land is cleared. Despite a minor delay, we should conclude the transaction within the coming few months.

As can be expected, the site is among the best located in the city. A six-story shopping mall is planned totaling some 150,000 square meters. Total investment is expected to be around HK$2.5 billion. Jinan is the commercial center of this second most populous province. Shandong also has the second highest economic output of all provinces, and is one of the very few that are strong in both manufacturing and agriculture.

Then within one week last month, we concluded preliminary negotiations on three more plots. None came as a surprise, for management has been working on each of them for at least a year. Two transactions have been made public and one of the two has since been completed. The third will soon be announced.

The one concluded is again in Shenyang. Measuring 9.2 hectares, the site which is historically known as Doumugong is the biggest we have so far acquired on the Mainland. Land cost is about HK$870 million so unit price is rather favorable. Total project cost is estimated at HK$8 billion. Once again, the location could not be better – it abuts the southern edge of the city's central piazza. To the west of the square is the municipal government's head office; to the north is Shenyang's only cluster of high rise offices; and to the east is the city's theatre and concert hall. Given the size, we can create a multi-purpose complex comprising a shopping mall, office towers, hotels and perhaps a few blocks of high-rise luxury apartments. This is similar to our highly successful The Grand Gateway development in Shanghai.

The second project announced last month is in Changsha, capital of Hunan Province. The location must be considered one of the very best in the city. Once the transaction is completed, a commercial complex totaling 500,000 square meters will be constructed and will have as its centerpiece a shopping center. The site is approximately seven hectares and total investment should be around HK$4 billion.

Not counting Jinan and Changsha, we now have five projects – one in Tianjin, another on Zhongjie Road in Shenyang, plus Doumugong also in Shenyang which due to its investment size, is counted as three. If we include the one in Jinan, the "two" (again by virtue of the dollar amount) in Changsha and the soon to be announced project, we will have nine.

As I have previously written, city selection is one of the critical decisions that will determine whether we will in the coming decades win or win big. Upon careful consideration, we have decided to concentrate on fewer cities. Still targeting about 12 projects outside of Shanghai, we will put them in eight or nine cities instead of strictly one per city.

The reason is primarily a pragmatic one. Our industry on the Mainland is highly relationship-intensive. Rules and regulations are at times unclear and management has to work closely with municipal leaders to clarify them. This is true before land purchase as well as during the developmental process. Negotiations with different levels of government on all too many issues take an enormous amount of time and effort. So if we determine that a city is economically vibrant, then it makes sense to do multiple projects. Shanghai and Shenyang are two such cases.

Shopping centers will remain our primary product type. We may supplement them with office towers, hotels and luxury residential blocks. Similar to The Grand Gateway in Shanghai, such large developments are typically phased. Almost always a mall will be built first and the rest later as the market matures. It is, I suppose, a way of land banking. When we started constructing the two Shanghai projects around 1994 and 1995, there were almost no class-A offices in the entire city. The situation has obviously changed. By the time our first tower was completed, it was renting briskly and at attractive rates. I anticipate a similar course of development in certain cities although reaping the same bonanza as we did in Shanghai is perhaps unrealistic. Land prices today in the other cities are, however, much less than those we had paid for Plaza 66 and The Grand Gateway in Shanghai some 13 years ago.

Strategic Planning Overview

Last year I wrote extensively on why we decided to expand on the Mainland and our strategy in general terms; here I will devote space to how we execute. After deciding on the type of products to specialize in, namely commercial complexes for rent centering on a shopping mall, the next critical decision is city selection.

China's economic opening started along the southern coast between Hong Kong and Shanghai. Many of those cities are already rather prosperous and our locating the first two Mainland projects in Shanghai was altogether a correct decision. As noted last year, outside of Hong Kong, Shanghai and Beijing are still the most economically vibrant cities in China. However it is now almost impossible to find top-located large tracts in these metropolises. Site clearance is also extremely difficult. Perhaps surprising to some, the least of my worries is the apparent high prices – what seems expensive today will look cheap tomorrow given these cities' extraordinary growth.

Consequently, we have little choice but to go to other coastal locations. The preliminary agreement signed with the city that will be announced soon is one of them. Your management will search for more projects in similar municipalities.

A coastal city that has one of the country's biggest seaports is Tianjin. It is also the geographic center of the Bohai Economic Rim (BER) which the central government has of late strongly promoted. With the Pearl River Delta (PRD) and Yangtze River Delta (YRD) already rather developed, BER which has an average per capita income less than half of the other two areas must catch up. Beijing is apparently determined to do exactly that and Tianjin will no doubt greatly benefit.

In this regard, a recent news item deserves special mention. The State Council of China has issued a paper specifically defining the relative positioning of Beijing and Tianjin, two megalopolises a little over 100 kilometers apart. Whereas the capital will continue to be an international city which is also a political and cultural center, Tianjin alone is planned to become the 'economic center of the North'. There are obviously practical considerations behind this decision such as the ports in Tianjin and intractable traffic congestion in Beijing. With more than three times as many automobiles in the capital as in either Shanghai or Hong Kong and growing at an alarming rate, certain separation of political and economic functions becomes prudent. This validates our earlier decision to enter the Tianjin market.

Another region which the government is keen to develop is the Northeast. Rich in natural resources and historically the country's foremost manufacturing center, it has fallen on hard times since the 1970's. Although things have picked up somewhat after the

country opened up some 25 years ago, it lacked central government support and lagged behind the PRD and later the YRD. Foreign direct investment for example fell far behind those two areas. A few years ago, the central government began to promote "Revive the Old Industrial Base of the Northeast", a slogan now known to all in the country. The economic center of the region is undoubtedly Shenyang followed by Harbin, Dalian and Changchun.

Confirmation of Shenyang's consumption power came somewhat as a surprise. Both fortuitously as well as through research, we have learned that sales of luxury goods per unit of shop space can actually be higher than those in Shanghai or Beijing. Of course there are less of these outlets in the Northeast but fast income growth prevalent in the South has begun to take place in cities like Shenyang. Moreover, historically people from the North are far more willing to spend whatever money they may have. As such, we are convinced that we should be there, hence the two projects of Zhongjie Road and Doumugong. We are also studying other cities in the region.

Chinese leaders have long recognized the need to close the wealth gap between the coast and the inland. While advocating that some Chinese must get rich first, Mr. Deng Xiaoping as the master architect of the country's economic reforms sought to raise the standard of living for all 1.3 billion citizens. After 20 years of economic opening mostly along the coast, the late 1990's saw the beginning of efforts to develop the Great West. In 1997 Chongqing was enlarged and given provincial status, reporting directly to the central government. In 2000, the first Western Forum of China was held in Chengdu, capital of Sichuan Province and I was one of the opening speakers. A year later, the event moved to Xian, capital of Shaanxi Province. These choices of cities by Beijing speak clearly of the foci of the push to develop the West.

We have been studying these cities for years and countless trips have been made. So far we have not succeeded but I am hopeful that something may yet open up. There are two or three other interesting cities in the region which we are also exploring.

Finally, the densely populated six provinces in South Central China – Shanxi, Henan, Hubei, Hunan, Anhui and Jiangxi with a total population of over 350 million – have been left behind economically not unlike the Great West. The central government will no doubt sooner than later turn its attention to this region. There are a few economically vibrant cities and we are working on three including Changsha.

Realizing our Strengths as a Developer of Choice

A critical question everywhere is: how to make ourselves the outside investor of choice to local governments in land acquisitions. We do have some unique competitive advantages in this regard.

First, we have two huge, highly visible and extraordinarily successful developments in Shanghai – Plaza 66 and The Grand Gateway. They are our best marketing tools. Looking around the entire country, municipal leaders can hardly find other developers with projects that approach ours in quality – in terms of design, management and profitability. Most mayors want us to duplicate them in their cities.

Second, all of our designs are invariably spectacular. My belief from day one is that China deserves the best. One should not build according to the Mainland's per capita income of today or according to the prevailing sense of aesthetics. That was exactly what we did in Shanghai in the 1990's and people were surprised. Now they understand and are appreciative. One must be foresighted and build projects for China of the 21st century.

Third, we keep almost all of our developments for rent. That is a commitment which surprises municipal officials and without exception, they like it. To be sure, we have financial considerations for not selling – mainly, taxes are a lot lower for rental properties. However, there are also compelling reasons for municipal governments to prefer us.

Our job is to make our malls and offices highly successful – like what we have done in Shanghai where we command the highest rents for both product types. The superb income we enjoy will mean more taxes to the government. Our tenants, especially at our shopping centers, are willing to pay us such rents because we have created an environment where they can sell their products. The high sales volume will also increase taxes to the city. So everyone wins.

At present, our two Shanghai complexes are yielding gross returns of approximately 15% per annum on all-cost-allocated and unleveraged bases. Not counting possible rent appreciation, in three years we will have a total return of over 50%. It is certainly not an everyday event that Mainland residential projects for sale can generate those numbers. Even if they do, developers pay taxes once and the city receives no more thereafter. With us, the rental properties are still ours after three years and will continue to generate returns to us and taxes to the city.

Furthermore, by owning our facilities, we must maintain them well and keep improving them to stay competitive. That will ensure that they do not degenerate into urban eyesores. There are all too many such failed projects everywhere and some have even become hotbeds of social ills. Obviously municipal leaders do not like such problems.

To execute such a rental strategy, one must be financially strong. That we are, and city officials know it. And very few others (mostly Hong Kong developers) may have that strength but they may not have the expertise, for none have successful projects to show for it. Moreover, management knows the risks and if comfortable with them, is not afraid to pay and to pay promptly. That too municipal leaders like. Consequently, as long as we are competitive in land price, we can easily become the preferred purchaser.

Finally, our management style and corporate culture give us a distinct advantage. Mayors of more than a few cities have told us this. We are not a company that is the easiest to deal with. Perhaps more than any local player and our Hong Kong competitors as well, we negotiate all essential details before committing. Many developers like to keep contracts vague thinking that they can gain advantages later. They forget that their counterparty is the government which has the ultimate say. Our way minimizes future unpleasant surprises for both parties, and serious municipal leaders respect us for it.

However, unlike western style companies who only know how to be legalistic, your management blends the best of both worlds – rigorously protecting ourselves including through the use of the law as in the West, while respecting Chinese culture and customs. We are diligent and careful yet courteous, respectful, upfront and honest as well. On the surface, Hong Kong companies should have an edge in this regard, but to strike the right balance is much more difficult than people think.

Our repeated experiences in similar negotiations and in managing Mainland commercial complexes have taught us what to insist and what to give. As a result, we can move with lightning speed. Serious municipal officials appreciate it, and the land acquisition in record time for the Doumugong project in Shenyang stands as a testimony of success.

All these help make us the developer of choice. Of course it does not work everywhere, for if city leaders have agendas not congruent with ours, there is nothing we can do. We will quietly walk away. I hate to lose good cities but fortunately there are many others in the vast country.

Anticipated Market Trends in Hong Kong and Shanghai Materialize

The drop in turnover and profit is due primarily to the exceptionally weak residential market starting in the third quarter of 2005. In September last year, a government land auction generated exceptionally high land prices. That temporarily stimulated home prices and we took advantage of the window to sell some 300 units of AquaMarine. Before long, the residential market fell silent once more. Selling opportunities were not to be seen again for the rest of the fiscal year.

The primary market was particularly affected. Activities have slowed since the beginning of 2004 – less than 27,000 apartments were sold that year, not quite 16,000 units in 2005, and only 4,200 in the first half of 2006. Price levels had also deteriorated in the last quarter of 2005. It was exacerbated by repeated and increasingly deeper cuts by a few major developers who perhaps needed to pump up their profit and loss accounts. The result was that potential buyers became skeptical of further price adjustments and consequently stayed away.

Successive interest rate hikes added to the pessimism. Changes in interest spread also did not help. At the beginning of 2005, mortgages were at prime minus 2.75%; less than 12 months later, they stood at prime minus 2.25%. In that period, the prime rate moved from 5% to 7.75%, meaning that mortgages more than doubled from 2.25% to 5.50%.

There were however some positive developments. Coinciding with the fall in primary market transactions which started in early 2004, secondary market activities picked up quite nicely. It is possible that the sales of new units will follow suit. There are already some signs of recovery, an expectation which is boosted by the plateauing of interest rates.

The leasing market was much more encouraging. Our total rental income grew by 11% – Hong Kong properties by 5% and Shanghai by 27%. Unit rents increased across the board. Occupancy for the key sectors of retail and offices in Hong Kong held steady. Residential fell but total income actually rose as we switched to higher paying and longer staying tenants. Shanghai facilities, both shops and offices, remain basically fully let. Their rents accounted for 27% of the Company's total rental revenue. That number stood at 23% a year ago.

From our Roots Grows a Strong Tree

When Hang Lung celebrates its 50th anniversary four years from now, it will look substantially different from what it is today and what it has been since its founding. We have always been a Hong Kong-based company and will remain so for the foreseeable future. However, as new Mainland projects are completed, we will also become China's leading commercial real estate developer, owner and manager. Once we complete the 12 planned projects, and together with the two highly successful complexes in Shanghai, we should own approximately three million square meters of the best commercial space in several of the most dynamic cities around the country.

If our Shanghai experience is any indication, then the HK$30 billion or so in new investments should yield rental profits which will easily exceed those from Hong Kong. This unreasonably assumes no further new projects beyond the 12. As long as the Chinese economy remains steady, we should do very well.

Moreover, with shopping malls as our lead product on the Mainland, to some extent we can be viewed as a consumer spending company rather than as a pure property firm. Real estate is the means to tap fast rising Chinese consumption just as a clothing or cosmetics manufacturer and retailer benefit from the country's spending explosion. I can think of few better businesses to be in than to ride the wave of the rising Chinese middle class.

In this regard, to be a commercial property owner has distinctive attractions. We do not have to worry about distribution networks like foreign retailers do. (In business matters, Hong Kong firms are considered "foreign" on the Mainland.) We can put our projects in almost any city we want. We have little issue with product obsolescence faced by manufacturers and shop owners, as long as we design and manage our facilities well. Price competition is also manageable if we build the right product in the best locations as we are doing. In the coming eight to 10 years, we are building such a "franchise", and once completed, it will bring as desirable a stream of rental income as annuities.

If the prospect is so promising, why is everyone not pursuing it?

Strategizing is Strength in Shanghai and Beyond

First, few people view the real estate business as needing a clearly defined and well-articulated strategy. We disagree. From our first day in the Mainland market, we have a definitive strategy which can of course be adjusted if necessary in response to market developments. Phase one was to concentrate on Shanghai. That we have executed successfully, frankly beyond our original expectations. The build out of The Grand Gateway recently and of Plaza 66 at the end of this year will bring this phase to a close.

Initial success in Shanghai several years ago raised the question in the minds of management: what shall we do next? Sizable expected cash flow from the sales of Hong Kong residential projects, as well as the apparent lack of new opportunities in our home city that promise reasonable returns, contributed to the urgency in our thinking. We began to travel the breadth and length of the country which led to a definitive strategy. Last year we decided to make it public in my letter to shareholders, and I have expanded upon it in this writing. Frankly we fail to see many Hong Kong property companies that have well articulated plans for the Mainland market.

Second, we are in China for the long haul. Renting properties without selling them is quite rare on the Mainland. Most local developers need to turn their capital by selling or even pre-selling before project completion. So far we have hardly seen any company with our long-term horizon. As noted above, it is partially this willingness not to sell which makes us the government's preferred land purchaser. That means we often do not have any competitor.

Moreover, with the fast-developing stock exchanges on the Mainland, not to mention the possibility of using the Hong Kong and/or overseas capital markets, it is increasingly possible to monetize our projects. We do not have such plans for the near future, but it is always good to know that it can be done.

Third, it is extremely difficult to adequately execute our strategy. There is a lot of know-how involved from site selection to conceptual and detail design, and from the management of government relations to that of tenants. Perhaps surprising to some, and not unlike manufacturing, management must be very disciplined. Mainland China is not the easiest place to do business, and the only thing that is constant, it seems, is change. No wonder why one can hardly name a nationwide successful real estate company especially in commercial developments.

One of the biggest misconceptions today in China (as in other fast developing economies) is that doing real estate projects is easy. Perhaps it is, but doing it successfully is very difficult. Just witness the many monstrous and practically empty buildings in almost every major metropolis. Inasmuch as their presence is bad for the cities, it does mean that at least for now, competition is light.

Given the many necessary success factors, quality of management becomes critical. I am gratified to report that now we have an excellent team. With William Ko and Estella Ng joining the Board last year, I like to think that as a group we are as good as any in the business. The five senior executives complement each other and work well together. We are supported by many capable staff, but for the new Mainland projects, we still need to quickly beef up local management capabilities. As mentioned last year, this is a challenge and we are working hard at it.

Some have asked if the recent tightening of the real estate market by the central government has affected us. We are obviously following the situation closely but so far there has been no impact on us. Beijing is rightly reining in residential prices in a number of cities but we do not play in that space.

Envisioning Continued Success

To further strengthen our competitiveness, I should mention that your management is very mindful of the need to conserve energy. Environmental friendliness is in accordance with government policies, and just as importantly, is good business. We have all reasons to design our new projects with conservation in mind. Energy on average accounts for almost 22% of the total cost of running our commercial complexes, and we are constantly striving to lower it by designing and managing more smartly.

Back in Hong Kong, I am again hopeful that we will sell more residential units in the present fiscal year. In the past month or so, the primary market seems to have picked up somewhat. With interest rate hikes apparently approaching the end of this cycle, there are reasons for cautious optimism. We will also look to buy land locally. Recently we have signed up a luxury residential site and hope to do more.

The rental market is expected to be a repeat of the past fiscal year, namely, rise gently in Hong Kong and sharply in Shanghai. Slated for completion end of this year, the second office tower in Plaza 66 while pre-leasing well, will not contribute significantly to the bottom line until the next fiscal year.

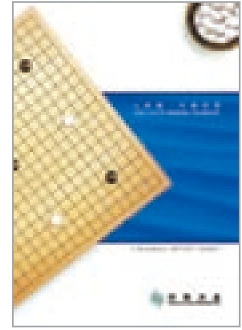
Barring unforeseen circumstances, next year should see better results. The main item to watch is the sales of residential units in Hong Kong.

Ronnie C. Chan

Chairman

Hong Kong, August 21, 2006

06–07



Shaping History: Monumental Decisions for Landmark Projects

EXECUTIVE SUMMARY

As growth is seen in our operational portfolio, in line with expectations of stable progress in the Hong Kong market and the sustained flourishing our projects in Shanghai, we have found ourselves in a favorable position to further refine our discernment of opportunities presented by our exploration of the mainland China market. Our long-term vision and confidence in the Mainland market, as well as the stability and resources that our excellent financial position affords us, has led us to expand on our initial plans for our acquisitions program based on an in-depth study of feasibility, our own capacity, and the wealth of opportunities available. Our plans retain the character of prudent and discerning selection of projects while maximizing the potential for growth based on our resources. Headway in achieving the revised goal of 18 developments across 10 to 11 cities has been made with three transactions this year accounting for six new projects in Shenyang, Wuxi, and Jinan, bringing our total of active new projects to eight with research and negotiations ongoing for the remainder. Far from being precipitous, the execution of our plans is in line with our long-standing emphasis on five fundamental principles for success: site selection, project planning and building design, construction quality, property and tenant management, and ultimately financial return. Holding fast to these principles over the years has gained the Company respect and the capacity to sit with confidence at the negotiating table. It is a status we hold dear, and the prospect of taking a leading role in the uplifting of the culture and environment of the Mainland is something we take seriously. This, along with our group-wide commitment to sustainable development and environmentally friendly policies, demonstrates our commitment to have all our operations positively impact not only our own bottom line, but also the communities we are privileged to be a part of.

Forum 66, Shenyang

As I have mentioned in the past, the two critical factors for success in mainland China real estate are strategy and execution. From what we can tell, few of our competitors have focused on them. What worked so well in Hong Kong in the past decades is unlikely to apply to the much bigger and diverse markets of the Mainland. A new paradigm must be forged. This perhaps explains why our share price has outperformed the market in the past few years.

Two years ago I wrote extensively about our strategy on the Mainland which began implementation in 2003. I analyzed the market environment and outlined what we would do to take advantage of it. Last year, I went further by detailing how we were executing that strategy. Those two annual statements are critical to the understanding of the Company's future.

Since expanding beyond Shanghai into other mainland Chinese cities is new to us, and there are few successful models to emulate, we must be cautious. Our strategy will be adjusted over time as we learn more about the different markets and gain experience in places where we have initiated projects. Thus, our original plan to build only shopping centers and only one development in each new city has been refined. A year ago I informed shareholders that we planned to develop commercial complexes, some of which will entail a mix of malls, offices, hotels and even high-end residences. We may also do multiple projects in selected cities. The rationale for such refinements was explained in considerable detail.

Process of Evolution Refines Plans

Over the past year, our thinking has further evolved. Instead of doing 12 developments in eight to nine cities outside of Shanghai in the three years between 2005 and 2007, we now plan to develop 18 in 10 or 11 cities. The number of cities may be even smaller if we undertake larger complexes. Again by defining each project as requiring RMB 2 billion to RMB 2.5 billion, our total investment will be around RMB 40 billion. We hope to buy land for all 18 developments before the end of 2009.

The reasons for the refinement are the following. First, management is now confident that the original number of 12 projects is more than feasible. Two to three years ago we were uncertain if we could successfully buy land for them because of our discipline of strictly adhering to a set of stringent criteria. Now we are assured that we can do 18.

Second, team building efforts in recent years have born fruit. We are confident that the enlarged number of projects is within our capability to execute.

Third, opportunities are plentiful. There are so many economically vibrant cities in China that are ready to take off in the coming few years. If we do not enter those markets now and secure the best sites, promising opportunities may be lost forever. Prices may run away from us, but far worse is the prospect that the best pieces will have been snapped up by others. As such, there is a considerable urgency to land acquisitions.

Fourth, doing larger projects in fewer cities has several critical benefits. Property development on the Mainland is management time intensive. Concentrating on a smaller number of cities will make managing easier, so we should be able to do a better job. Larger developments on the other hand will be phased which means that we are legally land banking. Over time, I expect Chinese real estate prices to rise, a phenomenon which is increasingly clear to all. That also implies that initiating 18 projects will only see construction start in a fewer number of sites. Theoretically we can take on more than 18, but this is a decision we will only make later.

Finally, our financial position is very strong and we can easily handle more than 12 projects. Expected cash flow mainly from completed Hong Kong residential developments for sale should be able to pay for much of the new activities on the Mainland. Timing wise, inflow will likely take place within the coming three years while outflow will be stretched over a much longer period of time. The larger complexes will in fact take well over 10 years to complete. Cash shortfall, if any, will be financed by bank loans and as appropriate, through capital markets. With the Company being basically debt free, our borrowing capacity is huge.

China: A Powerhouse for Growth

China's economic growth is monumental and history will show that it is the biggest commercial opportunity of the 21st century. The last time such a situation existed was probably between 1890 and 1910 when the western part of the United States was opening up. The difference is that today China has 1.3 billion people instead of the 50 million or so a century ago in the U.S. Chinese people nowadays are all striving to improve their livelihoods and are taking advantage of the globalized economy. Wealth formation is tremendous – perhaps more than any country at any time in history. This is true both in terms of the absolute amount gained as well as the speed of accumulation. All this wealth creation is happening in the absence of natural resources except brains and muscles. Neither did China resort to illegal seizure of its neighbors' resources as Japan did in the last century and as the West did through colonization.

Given China's extraordinary economic growth, real estate must be an appealing business to be in. Frankly, I can think of few better opportunities at this unique historic juncture. Nevertheless, not all sectors of this industry are equally attractive, and we have deliberately chosen what we consider to be the best. With a wise strategy and careful execution, I am confident that we will be among the big winners.

In recent years, and especially since the beginning of 2007, our share price has outperformed the overall stock market and the real estate sector sub-index. Where will it lead is unbeknown to us, but what is true is that the amount of capital everywhere – from the U.S. to Europe, and from the Middle East with its tremendous windfall in oil revenue to the accumulated wealth within China – is mind boggling. Many funds are looking to invest in China and there are limited attractive opportunities. Hang Lung is one of the very few real estate companies which is creating value in the form of building world-class commercial complexes. Being listed on the Hong Kong Stock Exchange gives foreign investors a healthy measure of confidence. An added impetus to share price movements is mainland Chinese money which will soon be allowed to invest directly in Hong Kong's public companies. All these factors will impact our share price.

Our Strategy for Growing with China

Several more points relating to our strategy and operation are worth mentioning. Many say buying land in China is easy and boast of their millions if not tens of millions of square meters. However, it all depends on the type of land one owns. Our strategy calls for the biggest piece in the best location in economically dynamic cities. We only buy in the busiest existing commercial districts.

By way of illustration, suppose we were to build in Manhattan using our criteria. We would only purchase land on Fifth Avenue between 42nd Street and 59th Street. Madison Avenue is good but too narrow; Park Avenue is excellent for offices but not for shops. Strict discipline in land acquisition makes the process difficult and unit land cost higher than most. In a sense, we boast owning what is perhaps the most expensive land portfolio among our competitors. But as we shall see, the plots we own produce the best value even if we do not pay the lowest unit price.

Nonetheless, we do not overpay. In fact, through shrewd operations, we have been able to buy top-located land at very reasonable prices. The 9.2 hectares Doumugong project in Shenyang is a case in point. Purchased a year after the Zhongjie site in the same city, the unit land cost is only about 18% that of the earlier piece.

To assemble such plots is extremely difficult. Local planning regulations may not fit with our strategy of erecting world-class complexes. In such instances, we can only withdraw and go elsewhere. Fortunately we are finding sufficient opportunities in metropolises we like.

Our Shanghai experience shows that it makes economic sense to find top-located plots of size and build the highest quality facilities. We rigorously control costs but within limits. Our construction expenditures may be somewhat higher than those of our competitors, but we want to make sure that our quality is also among the highest.

The Five Pillars for Building Success

As the old adage goes: the proof of the pudding is in the eating. Notwithstanding having one of the highest unit land prices and a slightly higher construction cost, who has a higher return on investment than we do on the Mainland? I suspect not many. In fact investors have told us that they could not find another commercial real estate developer-cum-owner which excels in all five areas – site selection, project planning and building design, construction quality, property and tenant management, and ultimately financial return. We constantly measure ourselves according to these five dimensions and want to ensure that we stay well ahead of our competitors.

Our leadership role in the first four areas is amply illustrated by the following. Four national organizations in Beijing recently chose China's top 100 office buildings. Our Shanghai Plaza 66 was picked as number one. Another institution in Shanghai ranked the city's best shopping centers. Our The Grand Gateway came in second while the mall at Plaza 66 was again number one. In recent years, both in Shanghai and in Hong Kong, several of our projects have been honored for design or technical excellence by renowned international organizations. We have for the first time listed some of these accolades in another section of this annual report. Such superior quality will ensure the competitiveness of our facilities for a long period of time. It is also a useful tool to help make us the land purchaser of choice to municipal leaders whose cities we are interested.

(It should be noted that in Asia, I have witnessed repeatedly that developers who sponsor conferences organized by certain international business magazines will soon find themselves recipients of one honor or another given by those magazines. We consider this practice a farce and refuse to participate in that game.)

Our superior financial return should be viewed two ways – in numerical terms and in the quality of income and return. Having approximately 18% unleveraged return on investment for our two Shanghai projects seven or eight years after their completion seems respectable. Annual returns have been growing at double digits from the beginning and are expected to continue for at least another two or three years

Equally important is the quality of these numbers. They come from rental income which is recurrent. With tenants for our malls and offices reading like who's who in high fashion and in international business respectively, and given tenancies of two to three years or longer, we should be able to withstand most economic downturns almost unaffected.

Building to sell may in the short-term yield a higher return than our rent-and-hold strategy. Paying much higher taxes is however but one negative of that strategy. Once they sell, they will have to find land for the next project. With unit land cost fast approaching if not already exceeding the unit sale price of the completed building, the ability of those developers to consistently turn out profit, let alone rich profit, is questionable. We do not have that problem. Our completed facilities for rent will bring us profit come rain or shine. Given our proven return on investment mentioned above, whatever most other developers can achieve in net return from selling properties can be duplicated by us in a few short years. Thereafter we will still own our income producing complexes while others will have to scramble to find new sources of income. This situation is at least theoretically more serious in places like China where according to regulations the government can take back land from owners if they do not start construction two years after acquisition. The fact that the government does not strictly enforce this rule today does not mean that it will not tomorrow. Our strategy avoids all those problems and gives more consistent quality income.

Constructing More Than Buildings: Building Civilization

Now let me turn to something which is somewhat altruistic. I do not see ourselves only as a real estate developer but also as a public educator. For about two hundred years, China has been a weak and struggling

nation. Most citizens counted themselves fortunate if they found adequate food and shelter let alone proper healthcare and education. In such conditions, aesthetics are ignored. For a civilization with a long and glorious history in the arts from poetry to porcelain and from painting to calligraphy, this situation is sad. Now for the first time in over a century, the Chinese people are enjoying a relatively prolonged period of prosperity, but the sense of aesthetics will take longer to rebuild. As a property developer, I see ourselves as creator of public art in the form of superbly designed and constructed buildings. Over time, these structures will heighten the sense of beauty for millions of ordinary citizens who encounter them daily. Gradually, a discernment for quality will result.

As expected, mainland Chinese cities like many in other developing economies are filled with inferior buildings, especially skyscrapers. The sad thing is that once constructed, they will last for fifty if not a hundred years. The only silver lining is that it is easy to differentiate ourselves in such a landscape, with our two Shanghai projects easily winning top honors as an example. However, we do not want to be merely marginally better than the rest. We build world-class developments which will excel even if they are located in global metropolises such as New York City, London, Paris or Tokyo. Only in doing so will we adequately fulfill our desire to educate the general public.

In the end, such efforts are beneficial to ourselves as well. Landmark buildings like ours are more desirable to tenants and potential tenants, and we have a waiting list of world-class companies for our offices and leading brands for our malls. Hang Lung itself is now a brand name on the Mainland and the superior quality of all our coming developments will only strengthen that position. It is a win-win strategy.

Constructing More Than Buildings: Building a Sustainable Future

A year ago I wrote briefly about energy conservation. Indeed the broader need for sustainable development has been our concern for some time. A while ago a staff team was formed to study and implement changes, and considerable achievements have since been attained. The initiative and its leadership however come from the very top of the Company – the Executive Committee of the Board.

Why should we be concerned? First, such efforts make economic sense. For every dollar we spend operating our rental properties, approximately 22 cents goes toward electricity. The benefit is thus obvious. But there are other compelling reasons. China is short of oil and gas as well as water and forests. The country's top leaders are keenly aware of all the immense pollution problems in China. Sustainable development targets are increasingly set and enforced. In the past, local officials ruthlessly sought economic growth for their cities and provinces. It generated tax revenues as well as less immediate but equally tangible benefits like personal promotion. Now the central government has adjusted the yardstick to measure success. “Green development” is gradually coming into the picture. Beijing’s top leaders know they cannot compromise their children’s future by blindly seeking progress.

I have long believed that the government will soon clamp down on property developers and owners to conserve energy and limit pollutants. This is the right thing to do. In the U.S., buildings account for 38% of all energy consumption; the world’s average is approximately 32% and the number for China is probably less. Yet, China has 1.3 billion people and is undergoing the greatest urbanization the world has ever seen. Skyscrapers are going up everywhere. In May of this year, eight ministries jointly organized special inspection teams to go around the country checking on violations in energy-intensive and high-polluting industries. I was frankly surprised that our sector was not included, but that day will surely come. Public buildings are already coming under scrutiny and the private sector cannot expect to be exempted for too long.

On the other hand, given global trends many corporations around the world are setting self imposed green standards. The day will soon arrive when a potential tenant cannot sign a lease with a landlord unless the building meets certain environmental benchmarks. As a matter of principle, we welcome such standards. They will affect many of our local competitors who have inferior products.

In other words, pressure will pile up on developers from both directions – government and tenants. Even putting aside personal interest on the subject, Hang Lung must for our own good – cost savings or otherwise – be a leader in this regard. For some time now we have been quietly making strides.

Our efforts have focused on two areas: retrofitting existing premises in Hong Kong and designing environmentally friendly new buildings on the Mainland. In all, we are looking into several dozen programs. Given readily available technology, considerable achievements have been made in retrofitting. They entail energy saving, water reduction, waste management, and air quality control among others. For our new Mainland projects, we are studying many alternatives from the simple to the cutting edge. Such endeavors must become part of our corporate culture, and training and education should over time be extended to our tenants.

Needless to say, a balance needs to be struck between such green pursuits and economics. Up to a certain point, diminishing marginal return sets in. We also need to take into account building aesthetics and other business considerations. Whatever the case, we will always look for ways to maintain a high standard of sustainability. We are committed to creating a built environment which at once gives end-users quality of experience but without unnecessarily borrowing from the future.

Headway Made in Mainland Operations

Our efforts to purchase land on the Mainland have continued to bear fruit. Within the fiscal year, we concluded three transactions which due to their size, are considered six projects. We have also broken ground on two sites.

In August 2006, we bought the Doumugong plot in Shenyang. The present plan calls for about 800,000 square meters to be constructed on this 9.2 hectares piece. Total investment is estimated at RMB 8 billion which means that it can be considered as three or four projects, using our definition. In this case, we will count it as three. The exceptionally favorable unit land cost is the direct result of our track record in the form of our two world-class Shanghai developments and of our management style in handling our first Shenyang project. To the credit of municipal leaders, such a huge site was cleared for construction within eight months from the signing of the land purchase agreement.

The location cannot be better. It is situated immediately south of the City Center Square within the Shenyang CBD along Qingnian Street, the city's main thoroughfare. To the west of the large square is the municipal government's headquarters which is housed in a historic building. To the east is the provincial museum and the opera house; to the north will be high-rise offices, beyond which is the city's main train station.

In December we concluded a global architecture competition for the Doumugong development. The winner is KPF of New York City, which beat out world renowned firms, one each from the two sides of the Atlantic. It is the same firm responsible for Plaza 66 in Shanghai and for planning the Zhongjie project. KPF's design for Tianjin Hang Lung Plaza won international recognition earlier this year. The Doumugong masterplan is stunning with twin towers of over 300 meters each facing the City Center Square. There will be at least one other office block, a shopping center, a five-star hotel, plus two or three other high-rise buildings. Depending on market conditions, they can be additional offices or a combination of office-cum-serviced apartments.

We broke ground in April, a mere five months after the same ceremony was performed for the Zhongjie site in November 2006. These are our first two projects to commence construction. It is reasonable to expect that the smaller of the two will become the first completed shopping mall owned by your Company on the Mainland outside of Shanghai.

In December we concluded the acquisition of a 3.7-hectare piece in Wuxi, Jiangsu Province. Last year I indicated that we were searching for land in several cities along China's southern coast. This is a worthy answer to that effort. Besides a mall, there will be an office block and a hotel totaling some 255,000 square meters. Land cost was about RMB 685 million and anticipated total investment should be around RMB 3.5 billion. We consider it as two out of the 18 new projects.

In February we finally concluded the land purchase of the development in Jinan, Shandong Province.

Besides the above six projects, in July 2006 we signed a preliminary agreement to purchase a top-located piece in Changsha, Hunan Province. It is quite big and technical details are being worked out.

Not counting Changsha, we have so far purchased land for eight projects. That was the number I promised shareholders of our parent company Hang Lung Group 12 months ago. In the coming year, I hope to have more acquisitions to announce.

Positive Growth Trends Seen in Operational Portfolio

As expected, property leasing was once again the bright spot this past fiscal year. Overall rent revenue grew by 16% exceeding HK$3 billion. The Hong Kong portfolio improved by 10% and Shanghai by 31%. The latter was helped by the addition of the second office tower at Plaza 66 in the second half of the fiscal year. Excluding it, rent still rose by over 23% for the Shanghai properties. Two years ago Shanghai accounted for 23% of total rents collected; last year it was almost 28%, and now it exceeds 31%.

Offices in Hong Kong have done well with rents rising 22% and retail moving up 6%. The shopping center in The Grand Gateway did 20% better than a year ago; the one in Plaza 66 saw an increase of 37%. Office rents at Plaza 66 shot up 41% due to the new tower. Taking that out, the figure is still very respectable at 17%. Since occupancies for retail and offices in both cities have remained basically unchanged, i.e. full or nearly full, turnover increase came almost exclusively from upward rent reversion.

In the past two years, our Hong Kong sales program mainly concentrated on the 1,616-unit AquaMarine which is now almost sold out. Its clientele has slightly higher incomes than the average middle class. All of our remaining residential projects are for the even more affluent where profit margins should be even better. I am confident that in all product categories, our margin is among the best in Hong Kong. It is especially true in the luxury sector such as The HarbourSide and The Long Beach.

410 condos at AquaMarine were sold, an improvement of about 100 units from the year before. We parted with more since fiscal year end and are now left with only about 60. We also sold a smidgen of other properties left over in our portfolio from years past, the totality of which is insignificant.

Building on Proven Strategic Successes

In the past few years, your Company has been quietly buying centrally located land in economically vibrant Chinese cities. Some transactions have been completed and more can be expected. I have repeatedly stated how difficult the process is, a point which cannot be overemphasized. One hears of our successes but behind them are countless frustrations and thwarted opportunities. To find a piece that meets our most stringent requirements is rare. Yet often after working on it for a year or two with increasing hopes of success, the deal suddenly dissipates for whatever reason such as a technicality.

So my colleagues and I are constantly exploring new markets as well as revisiting cities with the hope that new opportunities may have arisen. I can assure you that to purchase land from government auctions or to buy large tracts outside of the very heart of a city are far easier. We have never done either because we do not believe that the returns those projects can generate will come close to what we have achieved and can achieve. As explained in past annual statements to shareholders, there are other reasons why our strategy is superior.

Management is left with no choice but to forge ahead on the course that we have chosen. We are encouraged by our successes – eight projects so far with an anticipated total investment of RMB 19 billion. The expectation remains that we will have 18 by the end of 2009. We are at present working on several sizable pieces, the fruition of which will quickly bring us to that number. To win every

case may be unrealistic, but once in a while, luck is with those who work hard – and hard we work!

We have of late seen reputable people bringing us what appear to be fine opportunities. Invariably they approach us because people know that we are perhaps the only group that has a track record. Equally significant is that this record was achieved by the same team of professionals which created world-class developments excelling in all five areas of site selection, design, construction, property management, and financial return.

Previously we never entertained unsolicited approaches, believing that no good deal comes that way. But as a leading Mainland real estate magazine editor told me recently, many industry players and watchers are now studying the Hang Lung Phenomenon. While this may in the long run attract copycats or even one day spawn worthy competitors, in the immediate term it may bring benefits in the form of unsolicited opportunities. If it is attractive enough, we may even consider having a partner. That will of course depend on who that entity is and their willingness to let us control the development process as well as ownership of the final product. We are not interested in taking a minority position while contributing our rather unique know-how.

There is a phenomenon worth noticing for it may impact our business. Namely, the amount of foreign money entering the China property market is increasing. Not unlike the ballooning of capital pouring into private equity vehicles in the West, real estate funds are mushrooming albeit in smaller amounts but growing just as fast. Sources are not limited to the U.S. and Western Europe but also include the Middle East, Australia and Southeast Asia, primarily Singapore. I would not be surprised if the Japanese soon jump in.

Consider the amount of money in the Middle East. The world is marveling at the new phenomenon of a wealthy China. 1.3 billion people toiled for 28 years since economic opening depositing USD 2.3 trillion in savings in the banking system. On top of that are corporate savings and foreign reserves; the latter number USD 1.3 trillion. Given government regulations, only a small percentage of individual savings will find their way into real estate investments other than home ownership. But in the Middle East, the windfall alone from high oil and gas prices of the past three years is said to approach USD 3 trillion. Unlike the money in China, much of it will go into investments outside of the region, and China is a target. I would not be surprised if a good proportion of the billions of US dollars raised recently for Asian real estate by two New York City investment banks came from the Middle East.

These geographic and industry specific funds are to be invested either into listed property companies like ourselves, or directly into bricks and mortar. Previously property funds mainly did the former which was beneficial to us as a public company. The new capital will raise price-earning-ratios and narrow discounts to net asset values. It will also add liquidity to the market. Now with the latter, local developers with weak finances can link up with one or more of these funds. They will become our competitors. The fact that many of them produce inferior products is not all good news. While they will make our complexes stand out, in time some of those players will improve. But even before that time, increasing supply will bring down overall rents.

What is our response to this expected onslaught? Stick strictly to what we do but do it even better and faster. In particular, our target of buying land for 18 commercial projects should not slip. Your management has always had a keen sense of urgency and the new competitive landscape only further heightens that sense. The temptation is to lower our self-imposed standards for site selection. That we will not do, but we may have to take on slightly more risks to get the job done on time. We will act swiftly, but we will also always act cautiously. By tying down the best plots (as defined by location, size and shape) in outstanding cities, our competitiveness becomes secure. Few can design as well as we can, and our quality in construction and in the management of tenants and of physical facilities is as good as any in the business. This means that in the markets which we have chosen to play, few if any can dislodge our leadership position.

What will help in this regard is brand building. Apparently few in our industry have so far focused on it. Without doubt, Hang Lung is today a top brand in China's real estate business, but this is something that we must constantly strengthen and renew.

Our property leasing business should again trade well this year. Full year contribution of the second office tower in Plaza 66 should ensure that numbers from Shanghai will be particularly pleasing. Even without the new space, rent increase alone should see double-digit growth. That has been the case from the first day since we completed the two existing projects. Given the relative health of the Hong Kong economy, investment properties here should also do satisfactorily.

With AquaMarine almost sold out, we will focus on the even higher profit margin projects, namely The HarbourSide and The Long Beach. Sales activities in the former have picked up in the past two months and unit prices achieved have edged upward, reaching new heights. We will continue to manage that process to maximize profit. Hong Kong's tallest building of 118 stories, the International Commerce Centre, housing offices and a five-star hotel will soon be completed right next door, and the one million square feet shopping center called Elements behind us will soon commence operations. That was why we were not in a hurry to sell in the past few years. As the area matures, our units should become even more attractive to potential purchasers. So far almost 80% of the units have been held back from the market. We may also begin marketing The Long Beach with 1,829 units located not far from The HarbourSide.

Expecting to sell more Hong Kong condos this year and barring unforeseen circumstances, underlying net profit should be even better than the 12 months under review.

Ronnie C. Chan

Chairman

Hong Kong, August 15, 2007

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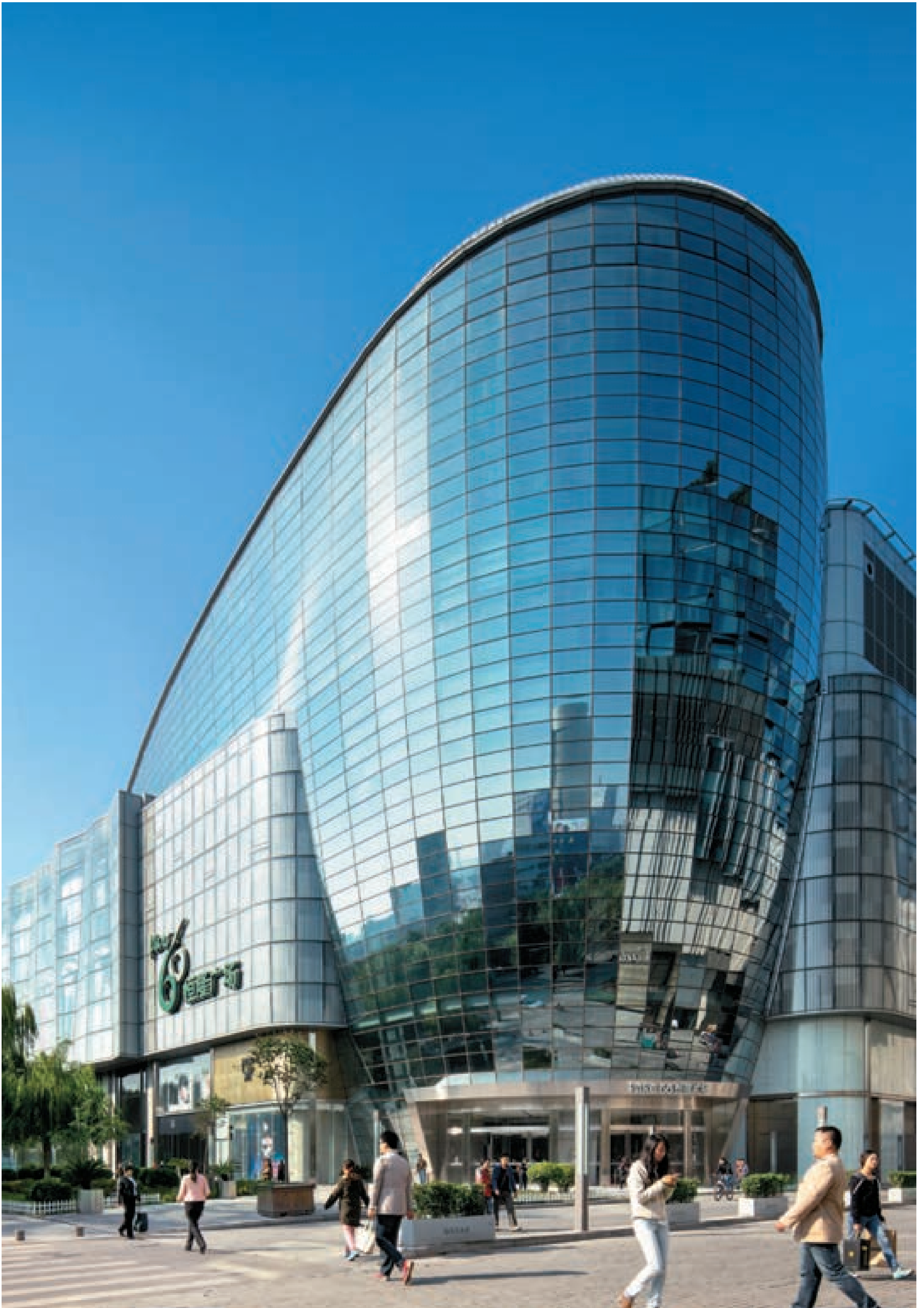
08

Prudence Wins: Tenacious Policies Demonstrate the Value of Patience

EXECUTIVE SUMMARY

Our success today is set within a strategic masterplan that has been narrated by these letters from your Chairman over the past decade. They speak consistently of a well defined strategy for the Company's growth and development and define the management policies which have cultivated a patient tenacity and confidence in the direction discerned by arguably the most foresighted team in the industry. Today we stand on the brink of a new era, where our understanding of the workings of the markets we are in is defying the trends that our competitors are subject to. We had a vision for China before others rushed in blindly, and that strategy of incorporating Hang Lung's characteristic emphasis on quality into a buy-build-sell model has not only seen success through the market's storms and passing undercurrents but, in making us resilient to them, has positioned us as leaders in our markets and exemplars of profitability in the industry. There is every confidence that the outstanding performance of our Shanghai portfolio will be mirrored in our new acquisitions across China when they come online. And as our trademark patience saw us slow buying during the recent short-lived bubble, while players frantically vied at a premium for their place in the China market. Now it has burst, our refusal to get caught-up in the frenzy once again stands us in good stead as the market cools. In Hong Kong, too, our insight has proven sagacious. While the mass residential market shrinks, our investment in the luxury sector has paid off several fold. And whilst the leasing sector has encountered volatility, our emphasis on quality management has meant that stable, long-term tenants have renewed their relationship with us and kept our performance way above the trends. Today, as fresh stormclouds gather on the economic horizon, our shareholders can rest assured that, come rain or shine, we are in the best position to thrive under any conditions.



Parc 66, Jinan

We have had a stellar year. For the first time in the Company's history, underlying net profit broke through the HK$5 billion mark and total net profit surpassed HK$13 billion. Turnover was also at an all time high exceeding HK$10 billion. Our rental business especially in Shanghai has performed superbly but it is the sales of residential units in Hong Kong which boosted these numbers.

At the beginning of the fiscal year, we had approximately 2,800 completed residential units in Hong Kong available for sale. We parted with 800 and collected revenues of over HK$6.3 billion. Profit margins were excellent, most likely the best for similar products in all of Hong Kong. Prices achieved were much higher than those sold in previous periods. All these were accomplished because the last quarter of 2007 saw a surge in the market and we took advantage of it. Since then prices have fallen especially in the past few months. Again we accurately read the market and thus attained the pleasing results.

Our rental portfolio also performed magnificently. We collected 25% more rents than last year with Hong Kong rising by 11% and Shanghai by a whopping 54%. Full year rental for the second office tower at Plaza 66 contributed to the last number, but even without it, office rents still increased by 19% and retail by 38%. It is just a matter of time before total rental income from Shanghai exceeds that of Hong Kong.

Refusing to Enter the Fray

Our Company's long-term future, however, rests with our ability to buy large pieces of top-located land in economically vibrant cities in mainland China. That process was started in 2003 and we completed our first purchase outside of Shanghai in early 2005 in Tianjin. Using our definition of a project, i.e. an investment of HK$2 billion to HK$2.5 billion, we have acquired nine in Tianjin, Shenyang, Jinan and Wuxi. Total investments are expected to be slightly over HK$20 billion which is half of our planned HK$40 billion in 18 projects. We have been actively working on many more but it usually takes nine months to three years from the identification of a plot to the successful transfer of title. Consequently it is difficult to predict when there will be another announcement of an acquisition. Whereas we can always somewhat slow down the process say if the market is too hot and we prefer a cooler market before concluding negotiations, it is almost impossible to unilaterally hasten the course. Detailed negotiations are tedious and time-consuming.

This explains what has happened to our land purchase or lack thereof in 2007. The last time we signed a purchase agreement was in Jinan in February of that year. The land was actually "purchased" the previous year but we had to wait for the clearing of existing tenants before officially completing the transfer. The acquisition immediately beforehand was in Wuxi in December 2006.

Beyond those, simply no transactions came to fruition since the beginning of 2007. If there could have been and if the local government had demanded higher prices than previously discussed due to the overheated market, we would have deliberately slowed down the process. We knew the market was becoming irrational and there was no reason to hurry and buy. The sharper the rise in prices, the faster the fall.

History has once again proven us correct. By late summer last year, the market had become truly crazy, reasons for which we could only surmise. First, in the past year or two, the central government was obviously trying to cool residential prices. However, land and housing prices kept rising which prompted Beijing to take increasingly tougher measures. Many local residential developers decided to migrate to commercial properties. Most of them I suspect have no idea that the skill sets required are considerably more and in any event, different.

There may be a second reason. It does not take too much imagination to conjecture that some developers in Hong Kong and on the Mainland may attribute Hang Lung's having the highest price-earnings ratio in Hong Kong to our concentrating almost exclusively on Mainland commercial properties.

Additionally, there were businessmen of different ilks joining the fray, thinking mistakenly that this business is easy. They forgot the fact that in most Mainland cities, there are far more failed commercial developments of size than successful ones.

The whole episode came to a head in August. A piece of land on the same street and not far from Plaza 66 was sold at an accommodation value (or AV, i.e. land price per unit of buildable space) of 10 times more than that of Plaza 66. A month later, another plot in Chengdu was auctioned at an AV that was about 20 times that of a similar piece we bought in Shenyang a year ago. Those numbers were truly staggering.

Bubbles Burst along with Inflated Egos but Forbearance Pays

While some friends congratulated us for the "steals" that we had achieved in the previous two years, we were frankly unhappy. Fortunately none of those ridiculously high prices have affected any of our projects under negotiation. It speaks of the maturity of municipal leaders we deal with – they knew that those prices were aberrations and unsustainable. Contrasting their sanity with the insanity of developers from both the Mainland and Hong Kong makes for an interesting observation. Moreover, within a few short months the commercial land market cooled rapidly, and those who purchased at the peak were wallowing in regret.

As 2008 rolled in, market conditions went from cool to cold. Now we are happy. Not only did we avoid getting stuck with expensive land, we are hopeful that future acquisitions will be somewhat easier. There will be less competition. With luck, we may even buy on the cheap although we are not counting on that. The prices we have been discussing with municipal leaders in several cities are for the most part reasonable and we are happy to buy at those levels. What we would really like to see is a more expeditious conclusion of negotiations. That I am hopeful.

If it happens, then we will have a fair chance of completing in the next 16 or so months the nine remaining land acquisitions out of the planned 18 projects. After all, we seem to have the habit of swooping in quietly for the kill; this is the only way we like to buy real estate. In 1992-1993 we snapped up many Hong Kong investment properties including our present head office, the Standard Chartered Bank Building; in 1999-2000 in the absence of any credible competitor we bought Hong Kong residential plots which later became The HarbourSide, The Long Beach and AquaMarine to great profit; and in 2005-2006 we purchased under the radar screen the best-located commercial land in several dynamic Mainland cities. Prices paid for all of the above were well below those acquired by our competitors. Now as the market once again cools and few have the heart and the money to buy, we will come in and pick up the choicest pieces at reasonable prices.

This habit of ours partially explains why our stocks in the past several years have been one of the best if not the best performer in the property sector. A good number of analysts believe that our true net asset value far exceeds what most people think. Even if one greatly discounts the highly inflated land prices of a year ago, it is still true that the prices we paid for our recent acquisitions must be a fraction of their present market value. For all the projects not yet completed and hence not yet income producing, the land is always carried at cost on our balance sheet.

As to our completed and income producing properties, some investors also think that they too are undervalued. That is because of the way the annual professional valuations are done. Whereas the capitalization rate (i.e. cap rate) used for prime Hong Kong income producing properties is around 5%, our two Shanghai facilities are valued with a cap rate of around 10%. The fact is that we will not sell them even if given a cap rate of 2% since they are irreplaceable assets which are still growing strongly in terms of their income generating abilities. So if only a cap rate of 5% is used in Shanghai as in Hong Kong, their value would double. And those are big numbers indeed! Nevertheless we respect the valuations of outside professionals. We can rationally understand why 10% is used for Mainland developments, although we realize that there are equally convincing arguments for a much lower cap rate and hence far higher valuations.

Set within the Context of a Strategic Masterplan

A brief review of my recent annual statement to shareholders may be a meaningful exercise. Last year, we published a small volume *Ten Years in Retrospect* containing excerpts of the past 10 such letters. Shareholders who are interested can write to the Company Secretary for copies or access them on the Company website: http://www.hanglung.com/10years.

Our present strategy was put in place in 2003. The original idea came about as a result of two forces. First, the experiment with real estate in mainland China which started in 1992 began to bear fruit soon after the completion of our two Shanghai commercial complexes – The Grand Gateway and Plaza 66 – respectively in 1999 and 2000. By 2002, we knew that we had done well and that our success might be replicable in other major Mainland cities. Second, at around the same time, it became obvious that land in Hong Kong purchased at the nadir of the Asian Financial Crisis in 1999 and 2000 would bring tremendous profit and cash flow. This made possible the contemplated expansion on the Mainland.

In 2003 and as stated in my 2003/2004 statement to shareholders, I wrote for the first time about our plans for the huge market north of Hong Kong. If Shanghai is considered phase one of that effort, then we started phase two at that point. In the three years to fiscal 2006/2007, our strategy underwent refinements as we learned more about various cities. The progression was documented in my annual letter to shareholders.

In the 2004/2005 report, I explained in detail why we would henceforth focus on the Mainland. That year we bought our first piece of land outside of Shanghai in Tianjin. We also placed shares to prepare for further acquisitions.

In the 2005/2006 statement, I clearly outlined how management planned to execute the strategy. I also wrote about our efforts in sustainable development. Whereas by that time we had already done much to retrofit all our Hong Kong rental properties for energy conservation, the new projects on the Mainland called for serious efforts in design and construction for the longer term. That aspect of our work was further communicated to shareholders the following year.

The present plan to construct 18 commercial complexes in say eight cities was enunciated in the 2006/2007 report. How our business relates to society at large was described. I also examined changes in the competitive landscape with new sources of capital in the form of real estate funds as well as our responses.

As our shareholders know, management plans to buy land for 18 projects between 2005 and 2009. I am still hopeful that as the market is now softening, we will be able to achieve the target or hit close to it. One may reasonably ask: what is next? Management obviously has ideas for 2010 and beyond, and I will write about this later. It suffices now to say that the future will likely be an extension of the present strategy. As such, I deem it appropriate to focus this year's discussion on the risks associated with our chosen course. It is management's job to effectively communicate the critical facets of our strategy.

A 360-degree View of our Strategic Reasoning

I am often asked this question: what will Hang Lung do as overbuilding sets in on the Mainland? The answer is not readily understood by even the most sophisticated investors. It bears some explaining.

As the old adage goes, the three most critical success factors for real estate are location, location and location. I do not disagree, although there are other important factors. The significance of location is especially true for commercial developments, and even more so for world-class complexes. Where one puts a Wal-Mart or a Carrefour is obviously less consequential than shops for leading fashion brands. Since we only develop landmark projects, the choice of location is paramount.

What is amazing is that few developers in mainland China follow this golden rule. But not your management – we practice what we preach and will not veer from it, a point to which I will return. Moreover, as I have previously

written, we want the biggest possible piece of land in the heart of economically dynamic cities. Realistically, it is very difficult to find such plots, for most of them are occupied or are already divided into smaller parcels. Our choice is further limited because we insist on the pieces having a certain integrity in shape such that it is possible to build products that meet the dual criteria of functionality and aesthetics. That makes our job extremely challenging for there may only be a few such lots in each city.

This means that we must as soon as possible own such land, for ownership will bring first mover advantage. Once world-class buildings are properly designed and constructed, together with satisfactory property management, the owner's position is almost unassailable. Combined with the fact that we only rent and do not sell our properties is the crux of our strategy. In city after city, we are systematically executing it, and so far so good.

Once we finish carrying out this strategy, what will be our competitive landscape? It will not give us a monopolistic position in each city but it will be almost as pleasing. Let me explain.

In the market niche in which we have chosen, namely the highest end commercial complexes in each city, there is a strong tendency towards “winner-takes-all”. Being in the best part of town will undoubtedly attract competitors but how shall we view them? All things else being equal, obviously we prefer not to have them, but that would be unrealistic. However, competitors can have a positive effect as well. They create critical mass for the area. When consumers go shopping, they usually choose the district which will give them the most choices. Competitors will provide those choices. But once shoppers arrive in the neighborhood, which mall they will enter depends mainly on its location, size, design, and hence types and variety of shops and goods, as well as management. Our goal is to build, own and operate malls that are the first choice of shoppers.

The other side of the coin is that leading fashion brands will usually have only one store in each district. Like their customers, they too will choose according to location, size, design and management. This in turn will attract lesser brands which want to be identified by proximity with the more prestigious names. Consequently, the best mall in the area will have the “crème de la crème” of the best tenants and best shoppers, thus “winner-takes-all”. Inasmuch as no one likes competitors, it can in some instances – like in our case – help. For the top-end commercial complexes we build, overbuilding is less of an issue.

This is clearly the case with our two projects in Shanghai. Before completion, there were already similar developments around them. Since our opening, even more shopping malls have been constructed. We are truly surrounded by competitors. Yet the rent differential between us and our neighbors is staggering. Current retail rent at Plaza 66 is twice as much as those in the same district. Office rent is 25% more. For The Grand Gateway, our shopping center rent is 1.25 times that of our neighbors while our office rent is 50% more. A similar phenomenon is expected in all our new projects outside of Shanghai.

Given the above, it is imperative that we move fast to buy the very best land in each chosen city. In a few metropolises, we are already too late. The best-located large plots are already sold or subdivided into smaller parcels. In those cases, we will go to other cities. We will not easily compromise our site selection criteria. After all, there are many metropolitan areas that are at once economically dynamic and have a big population. By one count, of the 658 cities in the country, 171 have more than one million people, 83 have more than three million and 55 have over five million. We have choices.

While we are going full steam in constructing new projects, we remain relentless in our search for new cities and new sites. Only the best plots deserve our erecting world-class buildings. Once we do that and manage the properties well, our long-term competitive position is almost untouchable. By that time the risks of this strategy will be among the lowest in the industry while the consistent financial returns may well be among the highest.

This sounds almost too good to be true, but it can be a reality as we have amply demonstrated in Shanghai. With the “buy land, build and sell” strategy, one’s profit is only as assured as the last successful project. Both

land and building prices can fluctuate wildly in a developing economy like China – just as we have repeatedly witnessed in Hong Kong and in Southeast Asia in past decades. The risks one takes in that strategy are considerably greater. But by adhering to "buy land, build and lease" as we do, revenue is locked in for at least several years through leases with reputable companies. Even when the economy is down, our profit is rather protected. In other words, the quality of our income is far better. This is true of our shopping centers as well as our offices.

Moreover, your management is conscientious to build long-term symbiotic relations with desirable tenants. We do not squeeze every last penny in rent out of them when the market is good, nor are we ruthless when times are bad. Coupled with the fact that retailers have hardly seen such quality buildings like ours in China, they often fight to get in or stay in our properties. This way we get to select the choicest tenants. Several of our institutional shareholders have told me that Hang Lung has one of the best investor relations. We also strive to do the same in tenant relations, especially with those whom we deem long-term "partners". So although we have yet to open facilities outside of Shanghai, many of them have expressed a strong desire to go with us wherever we build. They like the quality of our developments as well as the style of our management.

However, we must also consider the possibility of a prolonged market trough. I have written before that as long as the down-turn is cyclical and not systemic, we may well buy more land for future expansion. At the same time, we can be as competitive as anyone in terms of tenant retention. Our retail clients know that if they do not rent from us when the market is down, we may exclude them when the market recovers. More than one retailer has experienced this first hand with our two Shanghai properties. After all, we are not unrealistic with the asking rent and have no intention to overplay our strong position vis-à-vis good tenants. In a word, we are a friendly landlord who likes to build long-term "partnerships".

A slightly different dynamic exists with offices. Location is still important, but equally so are building design which determines the ratio of net usable space, construction quality which affects energy consumption, and management services. All of these, if done well, will give an office building prestige which is important to corporate clients.

Hang Lung is also among the strongest landlords in terms of finance. We are debt free and have a sizeable and steady annual rental income. If the market is down or if one of our new projects is completed during a market lull, we can compete on rent with anyone. We will keep choice tenants and will reap high rents once the market recovers. By that time, some of the weaker property owners may not be around anymore.

In the longer term, it is reasonable to expect that prime land in major Chinese cities will rise in value. This means that latecomers will have higher land costs. From what we can determine, not only is the land we purchased in recent years probably the best in quality as defined by location, size and shape, we also paid by far the least. For example, the price of a five- to six-hectare plot in Chengdu auctioned last September by the government was more than the total cost of all the land we have ever purchased on the Mainland in the past 16 years.

In the early 2000's, the general rule of thumb is that land price should be around 30% to 35% of total project cost. The numbers gradually climbed to 40% to 45% until last autumn when they became irrationally high. For land we bought in 2005 and 2006 outside of Shanghai, prices hovered around 17% to 18%. That is why knowledgeable analysts consider those purchases "steals". That situation is however not sustainable. I will be happy if in the longer run, land price remains around one-third of total project cost which has always been our goal.

Wise acquisition of land is however only part of the reason for our assuming lower risks and obtaining superior consistent financial returns. Another critical factor is that perhaps more than any of our competitors, we create much more value through project planning and building design, construction, as well as tenant and property management. In other words, unlike many amateur developers who leave their financial returns to – and at times blame their poor performance on –

the vagaries of the market, our risk mitigation and return enhancement are mainly derived from the application of experience and knowledge.

All of the above explain why we have perhaps one of the lowest risk profiles among all real estate developers in China. Yet our return may be among the best both in terms of magnitude and consistency. By the third three-year lease term, our Shanghai properties are yielding unleveraged returns of approximately 20%. It is reasonable to expect similar results for our new projects elsewhere. In the case of our Shanghai malls, annual revenue and profit growth have both averaged in the double digits, often upwards of 20%. As long as China's economy remains relatively healthy, consumption which is still at a rather low level will inevitably increase. That means shopping center rents should gradually rise in the coming decade or two as they have in the past several years. Office rents are less easy to predict but overall, I do expect a decent return from all our Mainland projects old and new.

Not Just a Competitor but a Leader

If our track record as well as forecast are that attractive, why are others not emulating Hang Lung's strategy? It is not for lack of trying; many have but so far apparently few if any have succeeded. One day worthy competitors will arrive but by then we will have established ourselves such that our first mover advantage will make our position very defendable. Such is the beauty of our strategy. China is a big country and there will be room for many to play, but we will hopefully be the best and have the highest returns.

It is instructive to examine why so few have succeeded in high-end commercial developments. A superficial reason is that tremendous financial strength is required to build and hold properties without selling. Most major mainland Chinese real estate companies only went public within the past 10 years. Prior to that they did not have the financial means, and even now, many of them still do not. A few of them, like many of their Hong Kong competitors, however do. So there must be deeper reasons.

As I alluded to before, there are four steps in the development process and the successful execution of all four will automatically lead to the ultimate goal of superior financial return. Again they are: site selection, project design, construction and property management. None of these are particularly high-tech in nature. Rather, all four require accumulation of know-how through hard-earned experience. In other words, the key to success is not high-tech but high-experience or high-knowledge. This implies that management continuity is paramount. In turn, it depends on corporate culture which takes years to develop. We know of Hong Kong developers whose Mainland team is like a revolving door. More often than not, this phenomenon is the result of their corporate culture. And without management continuity, there is no possibility of knowledge retention. The result is that financial returns will suffer.

Mainland companies for the most part have not had the years to accumulate the necessary expertise. Perhaps surprising to some, neither do most Hong Kong players on the Mainland. Some of them were afraid of the market until they were forced by circumstances in the past two to three years to enter. Those who went in early occupied themselves with different product types in many cities. We were the only major firm which from day one concentrated on commercial real estate. We also limited ourselves to one place – Shanghai – so we could build a team and learn. While certain fundamentals are the same everywhere, the Mainland market in many critical aspects is very different from Hong Kong. To merely bring Hong Kong experience to the north can be dangerous.

Take project design as an example. It is highly likely that our top management team spends much more time working with world-class architects than any of our competitors. Those outside experts design like none of us can. But at the same time, they are artists at heart and have no knowledge of local commercial conditions. We spent many long years learning and working collaboratively with them. Only by doing so will the resulting products meet market needs and bring superior financial returns.

Due to the enormous size of the Mainland market, another important criterion must be discipline which plays an inherent part of the development process. History has shown that Hang Lung is the most disciplined real estate company in buying land. This is manifested in the actual site selection as well as in negotiating detailed terms with municipal governments before we commit. Again such an approach requires a certain corporate culture and management style.

Discipline is also seen in our adherence to our strategy. Unless we are convinced that there is a better way forward, we will not veer from our winning formula. In developing economies such as China where money can be made in all kinds of ways, it takes discipline to stick to a prescribed path. History shows that in the long run, the market will reward those companies who only do one thing and are the best in class, rather than those who dabble in many things. As described above, our strategy is potentially low risk and high return, and so far we have had little competition. Why should we trade it for something else?!

To further mitigate risks and enhance our continued success, we have long recognized the value of brand building. It is a great tool to draw both potential tenants and shoppers. Perhaps as a sign of our success in this regard, copycat Mainland real estate companies called Hang Lung have been discovered on occasion, and buildings in several cities have been found to bear our name. On the one hand, this is troublesome and we will not treat such infringements lightly. On the other hand, we understand that imitation is the highest form of flattery.

Quantity Versus Quality and the Success Quotient

Before concluding this section, let me summarize the mainland Chinese real estate industry this way. It is a relatively new business with only about 20 years of history. During that period, many developers from both the Mainland and Hong Kong tried different things. What has emerged are two models which have seen success and enduring promise. They differ greatly from one another and I will define them according to what I consider as the most representative company of each model – Vanke and Hang Lung.

Listed on the Shenzhen Stock Exchange, Vanke is the biggest residential developer in China and indeed in the world. Last year it produced and sold over 60,000 units. Its biggest markets are the Pearl River Delta and the Yangtze River Delta, two of China's most populous and economically exciting regions. Vanke's model is to buy tracts of land, build residential units and sell or pre-sell as soon as possible. The company is not overly concerned with market timing. Volume or quantity is the name of the game. It is like being a product manufacturer and it is operationally intensive. To better control quality and speed, Vanke's chairman Mr. Wang Shi told me at my office a few months ago that his company was beginning to work with several of the world's best pre-fab home builders, which really makes sense.

Finance management wise, a company of this model needs capital but not necessarily a huge amount as long as banks are willing to fund projects. What is important to the company is cash flow. Speed is essential so as to beat neighboring projects to the market and to generate cash for loan repayment and reinvestment.

Risks associated with this model relate mainly to market cycles. A company is only as profitable as its last project. There is no guarantee that it will continue to make money in the next round. Rather there is the distinct possibility that the firm may lose big in the next cycle such that all previous profits vanish. In fact, if there is a prolonged bear market, cash flow shortage may very well bankrupt the firm.

Moreover, in fast-developing economies like China and for that matter, like Hong Kong in the 1970's to the 1990's, both land and building prices can fluctuate wildly. Even a big and prolonged bull market can be fraught with danger where land and building prices chase each other on the way up. Since the price of land is far more elastic than that of the completed building which needs ultimate end users, the former can leave the latter in the dust. As we have repeatedly witnessed in Hong Kong and more recently on the Mainland until the end of last year, the land element of each unit of

buildable space can be more expensive than the existing market building unit price, i.e. land and building together. Hong Kong people describe this phenomenon as "flour is more expensive than the bread that it makes". This saying was widely adopted in China during the Mainland bull market of 2007. It is like doubling a bet at the gambling table after each win. All it takes is for the player to lose once and he gives back everything he has ever made – and perhaps more if he is leveraged.

The other model is championed by your Company so I will call it the Hang Lung model. There is little need to describe it here since shareholders who have read this annual statement in the past should be very well versed. Suffice to contrast it briefly with the other strategy.

If what Vanke emphasizes is quantity, then ours must be quality. What they need is speed and what we need is first mover advantage. While their profit can at times be very attractive, it is highly cyclical. Ours on the other hand is incredibly steady once the commercial complexes are leased. In other words, the quality of our income is superior and our profit is generated with a much lower level of risk. And since we lease properties and do not sell, our tax rate is far more acceptable.

Take for example our two Shanghai developments. At present they are receiving unleveraged returns of over 20% and rising. If say 60% of the total project cost is borrowed at a reasonable interest rate, that equates to a leveraged return of over 40%. Even if we were to be unreasonably conservative and project no growth in rents in the coming period, we are still getting 20% plus cash-on-cash return. It is highly doubtful if the other model can consistently produce that level of profit. Frankly I can hardly think of another industry which is as attractive as ours – giving relatively high steady returns with fairly low risks.

Here is an interesting question: can a company excel in both strategies? After all, both are real estate. I believe that it is not easy. Basketball and gymnastics are both sports but one can hardly become world-class athletes in both. As mentioned earlier, many traditionally in the Vanke vein have tried to enter the commercial real estate world. So far we cannot find too many successful cases. The two models require very different mindsets and skill sets. If anything, it is particularly difficult for the other model to migrate to ours given the much higher expertise that is required. It is conceivable nevertheless that some of the Hang Lung ilk, especially those of us who have had extensive experience in Hong Kong building apartments for sale, may be able to successfully cross over.

In the long run, however, it is likely that those who win big are the ones who stick to one thing. This is the case in the West where the property market is far more developed. In China where heated competition will sooner or later arrive, the winners must be world-class. This also argues for specialization. I believe that in the coming decades, almost all highly successful developers in that enormous market will belong to either of the two models or derivatives thereof.

Strategies that Anticipate the Waxing and Waning of the Markets

For years I have publicly stated that it is much easier to predict difficulties in the Chinese economy than otherwise. Many of the institutions involved in financial activities from banking regulation to capital market supervision are newly established and untested. Inasmuch as senior government officials in charge of the economy are apparently very competent, they have not experienced major market fluctuations. Dealing with future troubles will present challenges as they are likely to be quite different from those of the 1990's when the Chinese economy was a lot smaller and simpler. The extent of globalization then was much less. Administrative measures to correct mistakes may now be more difficult and less effective. Nowadays a misstep in policy formulation or execution may have much wider consequences beyond pure economics. As the bull market continuously expanded in the past decade or so, the potential dangers seemed to increase.

So far none of my worries have materialized. However, the market appears to have naturally entered into an adjustment phase. The bull market has been running for quite a long time and a gradual slow down now is much better than a sharp decline later. This is the best scenario for no market can defy gravity indefinitely. Chinese leaders appear to be able, at least so far, to

keep the economic ship on even keel. Real estate prices which are of consequences to the overall economy finally fell after increasingly severe government measures.

Much of the rest of the world, especially the U.S., is faring worse. American subprime mortgage and CDO (collateralized debt obligations) problems will greatly impact their economy. Global commodity prices have risen exponentially and inflation is once again rearing its ugly head. A period of troubled waters ahead seems certain.

With China being a major world manufacturer, the combination of domestic and international problems as mentioned above will take a toll on economic growth. Management believes that the worst is yet to come, and this must somehow affect our business.

There is no denying that the Chinese government does not want residential prices to rise too fast. Consequently foreign investments (including those from Hong Kong) therein for the past year or two were discouraged. Social harmony is of foremost importance to China so these measures are understandable. This is precisely the reason from day one why we have avoided residential developments. The developer bears all the risks but the upside may be capped. The only way to play that game is by volume.

While pricing for commercial real estate in China is much more determined by market forces, that does not make it any less volatile than for residential units. Hence we saw the insane land prices of last autumn which fell as fast as the rise. We conserved capital and bought nothing in the past 20 months. We are well prepared for the coming bear market and, in fact, welcome it. There are however other reasons for our pleasure.

First, the bear market will knock off some of our competitors. We are already hearing about troubles from some of the Mainland players. Completed, half-completed and yet-to-start-construction projects are now seeking buyers. We are open-minded and will look although the chances of our buying are not great. We have yet to see designs that meet our high standards. However, if such a development is superbly located, then we will consider it. After all, everything can be boiled down to pricing.

Second, we are hopeful that now with less competition, we will be able to conclude land purchases easier. Obviously we always like lower prices but price is not our only consideration. Many other deal terms may be of more value to us in the long run than merely lower dollars. When the market is hot, the municipal government selling the land may have more incentive to wait in hope of higher price tags. Now when the economy is slow and tax revenues are down, the government may want to sell land to make up for the deficit. They also know that there are fewer potential buyers out there so we are hopeful of closing transactions slightly faster.

Third, a slower economy will most likely translate to a cooler stock market. In the past, our parent company Hang Lung Group (HLG) always purchased our scripts when others dumped. In the last year or so, for example, HLG's shareholding has gone from a little over 50% to about 52%. The bull market will one day return and we will once again be able to place shares for further expansion. Given the almost unlimited opportunities on the Mainland, our winning strategy and our solid track record, we should continue to grow.

Finally, as I have written in previous years, we care very much for our employees, especially our professional staff. To remain successful will require keeping our excellent team happy. This is why we are one of the very few if not the only major property company in Hong Kong that has a well defined stock option incentive scheme. A depressed stock price will enable us to issue more attractive options to our employees.

Discerning the Mainland Horizon

As the fiscal year's second half results show, rental growth has remained strong. This trend is expected to persist in the coming months. It is however conceivable that if the economy weakens, consumption will one day be affected. Our position is nevertheless protected to a good extent by term leases with strong tenants, although growth in turnover rent may slow somewhat. Yet compared to the benefits we enjoy in a bear market as explained above, we still welcome it.

Looking ahead, it seems reasonable to expect that the returns achieved in Shanghai over the past eight to nine years can be repeated in our new projects in other cities. This conclusion is based on several factors.

First, we have yet to buy land as expensive as Plaza 66 in Shanghai. There is a common misunderstanding among the investment public that the successes of our two Shanghai projects are due to our early entrance into the Mainland and hence our buying land cheaply. The fact is that a good number of Hong Kong developers jumped in before us. It is just that few have made as much money as we. It is not because they were too early, for many local Mainland developers in the same period made out like bandits. Rather, the reason is the same as to why they are not so profitable today. Namely, they did not and still do not have a clearly defined strategy that makes sense. The opportunistic approach they have practiced in small Hong Kong will not work on the much bigger Mainland market. The system there is also very different from here. Unless one is willing to learn over time how to execute properly, he or she will not be successful there.

The land prices we paid for The Grand Gateway and Plaza 66 in 1992 and 1993 respectively were frankly not cheap. The fact that we are now able to generate over 20% unleveraged annual return on investment speaks to the strong market as well as our seasoned expertise. It also tells us that the potential of the Mainland market is great.

Lower land prices compared to the two Shanghai developments are but one reason why the new projects should do well. It is very possible that by the time the latter are ready for leasing in the coming few years, the local consumer markets will be stronger than Shanghai was nine years ago when we opened our first shopping center. Back then, many of the world-class fashion brands were new to Shanghai. Since then they have opened numerous stores all over China and certainly in all the cities where we are presently building. Merrill Lynch estimates that by 2014, China will account for a quarter of all global sales of luxury brands. Thanks to a decade of exceptionally rapid accumulation of wealth, the country has in the past few years entered into a fast growth period for such goods. But beyond high fashion products, other consumer items likely to find their way to our malls are experiencing strong increases in sales. Our many new malls will come just in time to capture those markets.

As mentioned already, at present many of the international brands are already in the cities where we have projects. However, there are hardly any first-class shopping centers of size for them. As a result, they are for the most part scattered all over town, in stand alone stores in hotel lobbies for example. Our well-located and sizeable world-class malls will become the “aggregator” of such brands. Many of them are already our tenants in Shanghai and we have in the past few years been in discussions with them regarding our coming developments. The majority of them have expressed strong intent to go with us everywhere because they have confidence in our buildings and in our management. They know that whatever we build will be landmarks in the respective cities.

Discerning the Hong Kong Horizon

Back in Hong Kong, the residential market remains highly bifurcated. Whereas mass residential units have yet to see prices reaching the heights of 1997, luxury apartments have exceeded the prices from a decade ago by several fold. Foreseeing this in 1999 and 2000, we only bought land for the latter category. The 2,000 remaining unsold units in our inventory are all superbly located. I expect that they will outperform their lower unit price cousins.

Some of our shareholders wonder why we are not buying land in Hong Kong. I can assure you that we will, but only when the market is really weak. For now, the government is not keen to sell land, thus making way for local railway company MTRC to first part with theirs. Real estate helps the latter stay in the black and remain financially independent from the government. The MTRC after obtaining land from the government at a discount to the market price will joint venture with private developers like us and split the profits. After operating in that model for about three decades, they well know how to squeeze their partners. Whereas in the 1970’s and 1980’s we were among the biggest if not the biggest joint venture partner of theirs, with few exceptions we have stopped doing that. The lack of other local opportunities has sent developers in that direction, but

competition has made those transactions unattractive. The private developer assumes all the risks while giving up the lion's share of profit to MTRC. In other words, one is asked to take on a developer's risk while getting a contractor's return.

Beyond that, the consumption of capital is another reason for our not playing that game. We have much better places to deploy our money – on the Mainland. The opportunity cost of not concentrating on that much bigger and highly lucrative market is something we cannot afford.

Moreover, the Hong Kong residential market is not growing. In fact it has been shrinking. Last year barely 10,000 new apartments were completed and sold, compared to about 23,000 annual units a decade ago (In the past year or so, the secondary market has been very active but that does not benefit developers). The reason for the shrinkage was extensively analyzed in my letter to Hang Lung Group shareholders last year so I will not repeat it here. Suffice to say that the phenomenon has been exacerbated in recent years. Whether it will continue is however not as clear. But even if volume picks up one day, the market is still very small compared to opportunities on the Mainland. Furthermore, there are a dozen or more well capitalized developers fighting for each project which further squeezes margins. Your management deems it a much better usage of our time and resources laboring in the vast and almost unlimited market north of us.

Opportunities for sizeable commercial developments in Hong Kong are extraordinarily rare. There are also very few chances to buy at reasonable prices large existing class A office buildings. One exception was Standard Chartered Bank Building in Central which we bought, but that was over 15 years ago.

Because of the small size of Hong Kong, big plots of land for new commercial projects are very limited. Looking back almost 40 years, there were usually only one or two major opportunities each decade. In the 1970's, there was the Connaught Center (now called Jardine House) and Admiralty Center. In the 1980's we had Exchange Square. The 1990's saw the completion of Pacific Place and Festival Walk. In the new millennium, we have IFC and the soon to be completed ICC. It is interesting to observe that there was a clear changing of the guards from decade to decade. In the 1970's it was Hongkong Land and Cheung Kong. The former was active into the 1980's then stopped. The 1990's belonged to Swire Properties while in the present Sun Hung Kai Properties reigns.

Preparing for a New Era of Market Leadership

The million dollar question is: what about the next decade and where will be the opportunities? The answer seems obvious enough – mainland China and whoever has expertise therein. There may yet be opportunities in Hong Kong but I believe that they will pale before Mainland projects in terms of scale.

So we will continue to maximize profit from selling residential units in Hong Kong and pour the money earned into the Mainland. Just like last October, good selling opportunities will come periodically and we will as before try to catch them. We are in no great hurry to sell and see no reason to short change ourselves. Hong Kong's economy is expected to quietly move along. This means that property prices will not collapse. On the supply side, we do not own a single inch in areas such as the New Territories where profit margin is usually low. All of our units for sale are in highly desirable districts and mostly have a sea view. On the demand side, given Hong Kong's low tax rate, rule of law and desirable life style, there will always be buyers of quality apartments. The convergence of supply and demand should bring us further handsome profits, and the Mainland projects into which the money will go should ensure our longer-term success.

Finally, our rental operations in both Hong Kong and Shanghai should perform acceptably in this fiscal year. While there are some clouds on the economic horizons in both China and the U.S., their impact on our business is however expected to be manageable.

Ronnie C. Chan
Chairman
Hong Kong, August 13, 2008

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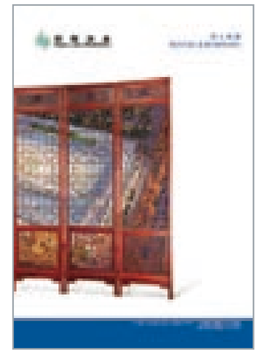


Outlive Outlast: Holding Steady during a Precipitous Fall

EXECUTIVE SUMMARY

Amidst a precipitous collapse of the global economy, heralding a downturn to rival the Great Depression of 1929, our preparedness has not only shielded us from the worst effects of the crash, but enabled us to maintain healthy albeit reduced profits from our strong leasing portfolio. The story for the wider industry players was entirely different with some barely staving off insolvency. With both Hong Kong and the Mainland affected, we once again proved that the commercial and office leasing option was the correct strategic decision. As the Mainland market eased into recovery at the start of the second quarter of 2009, developers scrambled in the residential market and pushed up prices unrealistically there, while we maintained our strategic stance and acquired two excellent commercial plots of land in Dalian and Wuxi. With Hong Kong mirroring the V-shaped progression on the Mainland, and with supply decreasing in the coming years, we see no reason to rush sales that do not realize intrinsic value. It would be true to say that Asia has seen a period of sustained uncertainty since the Asian Financial Crisis of 1997 and that recovery has been slow, particularly in Hong Kong, whose international exposure makes it more susceptible to global jitters. Despite this backdrop we have embarked on a program of prudent expansion that has seen us maintain one of the healthiest bottom lines and balance sheets in the industry while industriously building a sustainable future for the Company. Our success may be attributed to the astute management of our teams on both sides of the border, as well as to our uncompromising emphasis on simultaneously building to our own quality specifications and building-in unparalleled return for our shareholders. It may have only been in recent years that the wider market has recognized the insightfulness of our strategic direction, but they are now far too entrenched to catch up with us. We believe with confidence that in terms of building and managing quality landmark commercial properties across the Mainland, we lead the market by a long shot. And as the international community views the growth of China's luxury retail market with such great potential for growth, we may comfortably say that our own reach concurred years ago and that is why we now await the fruits of our endeavors as our Mainland portfolio comes online. Although only slow growth is likely as the global market stutters to re-start, we find ourselves in positive territory with increasing revenue from our leasing arm providing the solid basis for a return to growth in profit.

Center 66, Wuxi

We have just experienced an amazing 12 months. The global economy and hence the Chinese one were teetering at the beginning of the fiscal year and fell precipitously in the closing months of 2008. Only in the second quarter of 2009 were there signs of stabilization. Most people believe that it will take many quarters if not years to fully recover. This is doubtless the worst downturn since the Great Depression of 1929.

The residential market on the Mainland started to drop in early 2008. Due to overleveraging and excess commitments to expensive land, many local developers were by fall at the brink of insolvency. Technically speaking, I believe that many were bankrupt. Bank credit totally dried up and the market was dead. The government relaxed many regulations relating to our industry, and in December 2008 began to pump huge amounts of money into the economy. By one count, on average RMB 1.2 trillion per month were injected in the ensuing six months. As expected, some of that money found its way into the real estate market in the form of loans to developers and mortgages to buyers. By March, both prices and transaction volume went up and Mainland developers were once again alive and well.

At the beginning of this year when Beijing targeted 10 industries for revival, real estate was not on the list. It was unnecessary, for enough had already been quietly done. Excluding the industry also avoided the negative societal impression that the government was helping developers. But as I had then said, what the government should have bailed out was the real estate market and not real estate developers who had unwisely brought their companies to technical bankruptcy. Otherwise we face a moral hazard – developers have a one-sided bet in their favor. Namely, if the business wins, they benefit; if the company goes bust, there are no consequences to them. This is not unlike the asymmetric reward system of many international investment funds which contributes to the recent global economic ills. It encourages reckless expansion when the market is favorable.

Sure enough, as soon as the residential market recovered in the second quarter, developers once again rushed in to buy land. In city after city, price shattering transactions took place in the past few months. So only half a year from the brink of insolvency, the same people are now once again bidding up prices. All along, the underlying economy is not strong.

Moral issues aside, the past year has also shown us something which we should have recognized. In the past I have written that the government will try to put a cap on home prices which is one reason for our not engaging in that sector. For the same reason, namely to maintain social stability, Beijing will also provide a floor. That is good news for both home-owners and developers. But for reasons that I have enunciated in previous years such as competitive landscape and tax rate differential, your Company still prefers commercial properties for rental. To us, the risk-reward ratio is better.

The Hong Kong residential market went through a similar V-shaped progression. As we moved from the third quarter of 2008 to the fourth, both price and volume turned from weak to dead. Mortgage lending by banks became tight, and prices fell by 22% in the last six months of the year. But beginning this March, bank attitudes changed and prices rose some 20% by the end of last month. That the supply of new units in the coming few years will be tight is, I believe, more an explanation after the fact than the cause. At least on one count, the recovery here is even more amazing than that on the Mainland – there second quarter economic figures turned positive while Hong Kong still recorded negative growth.

Precision Timing in Acquisitions Continues

Set against this background, we again struck out and bought excellent commercial land on the Mainland. This is in accordance with my prediction a year ago. Towards the end of 2008, attitudes of municipal leaders began to change; the seller's market was turned in favor of buyers, if they could be found. We were one of the very few, if not the only! In May this year, two plots – one each in Dalian and Wuxi – for which we had been negotiating for some time, were purchased within one week of each other. Many of the terms on which we had long insisted and which the city had always resisted were granted. The prices were also acceptable.

The land in Dalian measures 6.3 hectares and we will construct a shopping center of over 220,000 square meters. It will be the biggest that we have ever done, and is at a location which is highly visible. Land cost was about RMB 1,236 million.

Measuring 1.7 hectares, the plot in Wuxi can be considered as an add-on to our existing piece which is just across the street. Costing approximately RMB 415 million, we can erect 113,000 square meters on it. The total buildable area for the two lots together will be over 376,000 square meters. The uniqueness of the latest purchase is that we have considerable flexibility in terms of when and what to construct – from shops, offices and hotels to serviced apartments. With less pressure to commence work, we will have time to complete our first phase which is now under construction.

To remind shareholders, we bought five sites in 2005 and 2006 but nothing in the two plus years of 2007 and 2008 until this May. For the first half of this stretch of almost two and a half years, land prices in many major Chinese cities went through the roof. While lots of developers from both Hong Kong and the Mainland rushed in to buy, we stayed out of the game. Then when the market began to cool last summer, we ramped up negotiations that consummated the two acquisitions two months ago. As I have previously reported, many municipal governments rely heavily on the sales of land for their annual budget. Months if not a year of no transaction must be painful. We came in at that juncture and picked up choice pieces. Since property prices in a good number of second-tier cities have yet to move up, I am hopeful that we will close one or two more good deals in the months ahead.

Our purchase of the land in Tianjin in January 2005 officially launched Phase 2 of our Mainland investments which are primarily outside of Shanghai. The idea is to invest HK$40 billion and build 18 commercial projects in seven or eight cities. As always, each project is defined as requiring HK$2 billion to HK$2.5 billion. Our immediate target was to buy land for all of them by the end of 2009. Since we are very close to achieving that, and since the five-year land-acquisition period will soon conclude, this is an opportune time to present to shareholders a progress report.

With all but the two latest lots now under construction, we have a better idea of the design and hence the exact size of each project as well as construction costs. The practice on the Mainland is that the basement is not counted in the buildable area when calculating land cost. Consequently, certain figures circulating around such as total buildable space and unit construction costs may have been confusing.

Mainland Project Figures Impacted by Rising Renminbi

Another consideration is currency movements. Since the beginning of 2005 when we bought our first plot of land outside Shanghai, Renminbi has appreciated against the Hong Kong dollar by approximately 21%. So whereas Renminbi denominated rentals from Shanghai boost our profit in Hong Kong dollar terms, the purchasing power of our home currency has also deteriorated on the Mainland. So our goal to invest HK$40 billion now only translates to approximately RMB 35 billion.

Taking all these into consideration, to completely build out our seven sites will cost a total of approximately RMB 33.6 billion or HK$38.3 billion at today's exchange rate. That is very close to the targeted amount of HK$40 billion. In terms of the number of projects as previously defined (i.e. on average each one costing HK$2.25 billion), we have bought land for 17 of the 18 planned. It is possible that one or two more plots will be added in the coming 12 months. But irrespective, management has basically met the target.

Using today's proforma numbers, it is interesting to contrast the two Shanghai complexes with the seven new sites elsewhere, namely, one each in Tianjin, Jinan and Dalian, and two each in Shenyang and Wuxi. Land as a percentage of total project cost is far lower in the recent acquisitions. Average land cost per unit buildable area is likewise much cheaper. These facts may surprise many and speak of management's ability to buy wisely, usually in the absence of competition. We enter markets before others; we stay out when the sentiment is hot; and we quietly swoop in when everyone is gone. We are also confident that the quality of plots purchased is second to none. By that I mean their location, size,

shape as well as – and very importantly – building regulations specific to each, are all near optimal. In fact, more than one competitor after systematically examining our portfolio have recognized its unparalleled worth. Such a feat can only be accomplished through a combination of discipline and agility.

Construction cost however will be more expensive than in the past in Shanghai. World commodity prices have risen over the past 10 to 15 years. The same is true for labor cost in China. Nevertheless, on balance I expect all-in unit cost for the new developments to be only marginally higher than our two existing facilities. This should be quite acceptable since the latter started construction almost 15 years ago. In the interim, rental has gone up manyfold. All these should bode well for our future.

Depressed Market Slows Sales but Rents Hold Firm

Back to the fiscal year under review: given unfavorable market conditions for much of the period, we did not sell many completed apartments in Hong Kong. That is the only reason for the drop in revenue and profit. All other sectors of our business have performed acceptably, although severe global economic difficulties have slowed rental growth somewhat.

Hong Kong rents held up fairly well. In Shanghai, those from shopping centers and offices recorded double digits growth of 18% and 13% respectively. Sales rent for the two malls fell but was well compensated by positive rent renewals to produce the near 20% increase mentioned above. The two office towers at Plaza 66 came under some pressure in the second half of the fiscal year.

Strategic Review of Asia's Decade-long Rebound

Let me begin with a sobering fact. A 19% increase in lettable space notwithstanding, total rent received in Hong Kong by the Group is only now, after 12 long years, approaching the peak level of 1997. That spoke of the severity of the Asian Financial Crisis which began in July 1997 and lasted some five years. Fortunately, we had started to invest in Shanghai before the crisis hit, and beginning in 2000 saw a steady and frankly rather dramatic rise in rents therefrom.

Public documents showed that the stagnation experienced in our home market was common to other local property owners. Imagine if we had not entered the Mainland market and scored a success, our share price would have languished. That was precisely the case with some of our competitors. Certain firms with market capitalization almost exactly the same as ours back in 1997 are now a fraction that of ours. Some of them were absent on the Mainland; others did not play that market well.

History is always instructive for the future. If one were to look back at the Hong Kong real estate industry of the past 40 some years, it would have quickly become clear that until mid-1990's, anyone who stuck exclusively with the local market and did a decent job would have made money – most likely a lot of money. And the company which did the best became king. Conversely, anyone who ventured overseas or into other businesses would more likely than not have performed less well. Exceptions were few and far between.

But as the Hong Kong property market, and indeed our entire economy, gradually matured, and as mainland China began to roar ahead, the industry landscape changed. The market in our motherland is far bigger and grows at a much faster pace. Anyone who neglects it or does not get it right will be left behind. We are fortunate to have successfully established ourselves there since the early 1990's. Now almost everyone is frenziedly struggling to get in and to learn. We definitely have an edge over most if not all.

(Here it will be useful to dispel a market misconception. Many investors thought that Hang Lung entered the Mainland market early and so bought land inexpensively. The fact was that many went in before us. It is just that they have perhaps not performed as well. In fact, the land we purchased in Shanghai in 1992 and 1993 was

very costly. The market soon fell and it took almost a decade for prices to recover to the level we paid. On a unit cost basis, the land under Plaza 66 is still higher than any that we have bought since that time. Our subsequent success was in spite of the land cost we paid and not because of it. We made money the hard way – by conscientiously and systematically applying knowledge and skill to create value through superior project design and property management. Experiences gained this way are applicable to future developments.)

To do the correct thing on the Mainland is more easily said than done, for that huge market is very different from that of Hong Kong. There is no guarantee whatsoever that one who is successful here will be successful there. In fact one can rightfully query if most Hong Kong developers are making a reasonable return on the Mainland given the risks undertaken and the amount of capital employed. Yet try they must, for the king of tomorrow is the one who gets that market right.

Continuing to win in Hong Kong will not be easy because there are a dozen or so well capitalized companies all experienced in the local market. But even if one makes a success here, its magnitude cannot be compared to the winners on the Mainland. Just consider the following: for the past few years, there were probably half a dozen Mainland companies, each of which annually produced more residential units than the entire new stock in Hong Kong for the same period. So far there is a distinct differential in unit price but its movement is clearly in favor of the Mainland. Annual sales of such Chinese companies both in terms of transaction volume and dollar amount are staggering. Already few Hong Kong developers can match their profits. In time, only the largest of our players can be in their league.

The Strategies and Growth Phases of my Chairmanship

In the last interim report to shareholders, I reviewed briefly my chairmanship of the past 18 years. Here I would like to develop that thought further. It should shed light on our present as well as the future. The last 18 years together with the next few can more of less be divided into three phases of seven years each.

When I took over the chairmanship in January 1991, Hang Lung unlike many major competitors did not have any cheap land bank such as in the form of Letter B or Land Exchange Entitlements. So in the first seven years, we had to do two things right, and fortunately we did. First, buy land judiciously as we could not afford to make mistakes. There was no cheap inventory to average up prices. Second, we had to somehow prepare ourselves for the big break if and when it came. This I call the Preparatory Phase.

Luckily the golden opportunity arrived in July 1997 in the unexpected guise of the Asian Financial Crisis. Again different from our competitors, we were not saddled by expensive land and so conserved cash. Equally significant were our capital market exercises in the previous year which gave us some HK$5 billion in the banks at the beginning of the crisis. Those were the days when cash was king, and king we were! We waited for another 21 months and then struck out – we bought the best land at the cheapest price in the absence of any credible competitor. Those projects yielded – and are continuing to yield – tremendous profits and cash flow.

In the latter part of this period, our foray into the Mainland market began to bear fruit. With the two developments in Shanghai, we laid the foundation for a national rollout of commercial complexes. The money made in Hong Kong will ensure their funding with limited debt. This period I consider the Catch Up Phase which lasted also seven years and ended with the plan to go nationwide in 2004.

During much of this time, international investors paid little attention to us. All the adroit actions that prepared us best for the Asian Financial Crisis apparently went unnoticed. Successes in Shanghai that were beginning to manifest themselves were not yet convincing enough. The differential in market capitalization between us and our bigger competitors was the widest towards the end of 1999 and at the beginning of 2000. But by 2004 or the last year of this phase, institutional investors began to recognize our many achievements. The gap began to narrow and gone were the days of obscurity.

We are now in the third period of another seven years which can be termed the Take Off Phase. I expect it to end around 2011 as the first two new commercial complexes begin to be leased up.

During this time we will have finished buying the land, cleared the sites, and started construction for all 18 "projects" in seven locations. Anticipated initial successes should soon manifest themselves. Apparently the international investment community has endorsed our strategy – in the past two to three years, our market capitalization has overtaken several previously larger competitors. Later I will discuss what is required to solidify this lead.

Building Our Way to a Golden Era

For now, one may rightly wonder: what will be next? I believe that the 2010's may well be a golden era for us. Beginning next year, we will have at least one project reaching the market annually. Because of size, some of them will be phased. This means that for the coming decade and more, steady growth in income is all but assured. This highly desirable and almost unique stream of rising rental revenue is the culmination of some 20 years of hard work. It will not be easy to find a parallel in any industry. As long as China's economy is not seriously derailed which possibility obviously exists, Hang Lung should do very well indeed. All along, we will continue to seek further land acquisitions to enrich our portfolio.

But for now, optimism must be backed by solid actions. For almost two decades, our operation at all levels was marked by thorough considerations and deliberate execution. Adhering to such will strengthen our leadership position in the industry for years to come. Let me explain.

Unfailing Focus on Shareholder Returns

It has been management's long-held belief and practice to make every invested dollar work the hardest for us. The objective is to have one of the highest sustainable returns to shareholders. Here I emphasize the word "sustainable" as much as I do "highest". Strategy – perhaps a rare word for real estate developers in this part of the world – must serve this goal. I firmly believe that ours is one which can deliver.

On the operational level, we also do not lose sight of this aim. Every contemplated project is measured against all alternatives so as to achieve this. Decisions at all levels must be guided by it. When we do all things right, then the sum total should be one of the highest sustainable returns to shareholders. I will first use three measures relating to the Mainland rental market to illustrate.

First, in terms of annual return on invested capital, our two Shanghai properties are receiving approximately 27% on an unleveraged basis since the Company is basically debt free. Given reasonable gearing, the number should be in the 40% range. Since this is accomplished through long-term rental income alone, such returns are not only "high" but also "sustainable". I do not believe that so far any of our Hong Kong (or for that matter, Mainland) competitors has a sustained return that comes close to this. Anyone getting half as much would be considered highly satisfactory by the market. Moreover, our annual growth in investment return since the opening of the Shanghai facilities has consistently been double digits. We work our capital harder than anyone.

Second, from available public information, one can easily determine that our average rent per square meter is by far the highest in the industry. If our numbers are correct, then the best firm other than ourselves gets less than half of ours. We receive at least two to three times higher unit rent than all other competitors. In other words, we work each square meter of space we own at least two to three times harder than any competitor. This is not merely superiority in property management; it begins with discipline in location selection and excellence in site planning and building design. It is tough work but very rewarding!

Third, among all Hong Kong public companies, our rental margin is by far the best – we achieve between 15% and 45% higher than anyone who cares to publish such figures. We accomplished this by having the second largest portfolio square meter wise and by far the biggest rental turnover and hence profit. This means that we also work each dollar of rent received the hardest.

Distinguished Performance on Both Sides of the Border

With the goal to maximizing sustainable return to shareholders, and by making every invested dollar, every square meter owned, and every rental dollar work the hardest for us, we are well on our way to becoming China's premier developer, owner and manager of world-class commercial properties. Perhaps we are already there.

Excellence is by no means limited to our Mainland team; our Hong Kong colleagues are likewise outstanding. Our Hong Kong rental margin and average unit rent approach the highest in the industry. This is achieved against considerable odds. For historic reasons, our rental portfolio is the most diverse and complex among local companies. Much of the properties are located in older and disparate locations. The average age of our facilities is also higher than most, for we have been in the business longer than most.

Our property development team in Hong Kong is equally distinguished. It is doubtful if any company could match our profit margin in the past 15 years. We consistently buy land rightly and sell completed products rightly – more so than perhaps anyone.

Finally, our turnover and profit per employee consistently rank at the top of all Hong Kong real estate counters. The distance between us and the next player is usually very wide. For example, last year our turnover per employee was three times that of the second placed. Our staff are hardworking but that has limits. Perhaps they just work smarter than others.

Proceeding from Acquisitions to Construction and Launch

Now that we have basically completed land acquisitions for this phase of investments on the Mainland, attention will increasingly turn to building out the seven sites. Except the two newly acquired in Dalian and Wuxi, the other five are all under construction. We have over the past five years built teams of project managers who are mostly architects. Our Shanghai colleagues have led the effort to train up leasing and finance staff in each of the new cities. Our management structure has metamorphosed considerably.

The first property to reach the market will be Palace 66 on Zhongjie Lu in Shenyang in 2010. (The mall is very close to the old Qing Dynasty Palace, hence the name.) It will be followed the next year by the design-award-winning shopping center Parc 66 in Jinan. (It abuts the huge municipal square or "park" in the middle of downtown.) 2012 will see the completion of the shopping facility at Forum 66 on Qingnian Da Jie in Shenyang. (Our site borders the central city piazza or Forum, if you will.) 2013 may prove particularly busy with three developments opening – the first office tower at Forum 66, the shopping center at Center 66 in Wuxi (our first lot is in the dead "center" of that city right next to the corner where the two major thoroughfares meet), as well as Riverside 66, another design-award-winning mall, in Tianjin (not far from the river Hai He which courses through downtown). The first office building of Center 66 should be ready by 2014. The following year, the huge mall Olympia 66 in Dalian (next to the municipal Olympic Park) will likely open.

Depending on market conditions, the remaining portions of Forum 66 and of Center 66 should become available in 2016 and beyond.

This schedule makes clear that even without further new projects (which assumption is obviously unrealistic), each year we will on average add close to 200,000 square meters of new world-class commercial space to our rental portfolio for the next decade and beyond. Barring unforeseen circumstances, the additional annual recurrent income therefrom can only be described as powerful.

Leasing of Palace 66 is well on its way. Roughly 40% of the space are already accounted for. We expect at least 80% full when it opens in the second quarter of next year. Initial yield should be around 5% to 6% which is in line with expectation.

In a sense, leasing started years ago. Before we searched for land in a particular city, we were already in discussion with many of our tenants in Shanghai. Some brands which we deem long-term partners in various cities have long expressed interest in principle in our new shopping centers. In fact we repeatedly consult with them during the developmental process. This way we have the best chance of building what retailers want and of maximizing rental income to us thereafter.

Luxury Market Evaluation Presents Encouraging Data for Hang Lung

Earlier this month, a report was released on luxury goods markets on the Mainland. It was authored by Ruder Finn Asia, one of the world's leading public relations firms, and Albatross Global Solutions, a reputable market research company. Surveys were conducted in April and May of this year in 20 cities plus Hong Kong. Results were very encouraging to us for both the short and the long terms. In the former, Mainland consumers are far more optimistic, i.e. more willing to continue consuming, than those in Hong Kong. Our home city is intricately integrated with the rest of the world and so is more affected by global economic woes. In the latter, Shanghai is said to be "the luxury center on the Mainland".

Far more interesting to us however is the conclusion regarding second-tier cities versus first-tier ones. The latter are defined as Beijing, Shanghai and Guangzhou; the cities in which we are building all fit into the former.

The report concludes "that the difference in luxury goods' purchasing pattern between China's first and second-tier cities was marginal". It says that second-tier cities "have witnessed a rapid development trend in luxury goods since 2007" and "are anticipated to be key to their (fashion brands') long-term and sustained success". Our own research in the past have borne out the same, but it is gratifying to learn of reputable third party confirmation. Our decision to build in those cities is both correct and timely.

Our Own Research Concurs and Extrapolates Further

When an economy is taking off from a very low base, relatively fast growth can last for decades. I believe that it is the case with China. The first to benefit are top tier cities such as Guangzhou, Shenzhen, Shanghai and Beijing. These, especially the last two, will always be the best commercial megalopolises in the country.

However, for economic reasons (such as manufacturers seeking cheaper land and salary) or political ones (like the government's need to narrow wealth differentials between regions for the sake of social harmony and national cohesion), sooner rather than later other municipalities, especially provincial capitals, will begin to catch up. Many such metropolises, each having a population of six million or more, are at present perhaps eight to 10 years behind Beijing and Shanghai in terms of development. These will provide the impetus for continued economic increase, including consumer spending, for decades to come. Even if first-tier cities become saturated in terms of consumption, these will take the baton for further national growth and development. All of our new locations will no doubt benefit from this trend.

Moreover, China is undergoing the greatest urbanization that mankind has ever seen. Each year, close to 20 million farmers move into the cities looking for jobs and a better living. Annually there are about six million university graduates, many coming originally from the countryside and are no longer willing to return home, the government's urging and incentivizing notwithstanding. These powerful forces will ensure the continued growth of major cities everywhere in the country.

On top of that, the national policy of food security dictates the maintenance of 1.8 billion Chinese acres (or approximately 120 million hectares, each Chinese acre equaling approximately 666 square meters) of farmland. This ensures that cities will have to grow vertically like Hong Kong and Tokyo. High population density becomes inevitable and is highly beneficial to our centrally located commercial complexes.

Experiences of the past 20 some years indicate that after a migrant settles in a city for 10 to 15 years, he or she will likely enter the ranks of the middle class. Such "outsiders" are usually more motivated to work hard and succeed, and so are upwardly mobile. They will become the new blood to shop in our malls and to work in our offices. All these are reasons why I believe that our many new developments in the so-called second-tier cities will have excellent prospects.

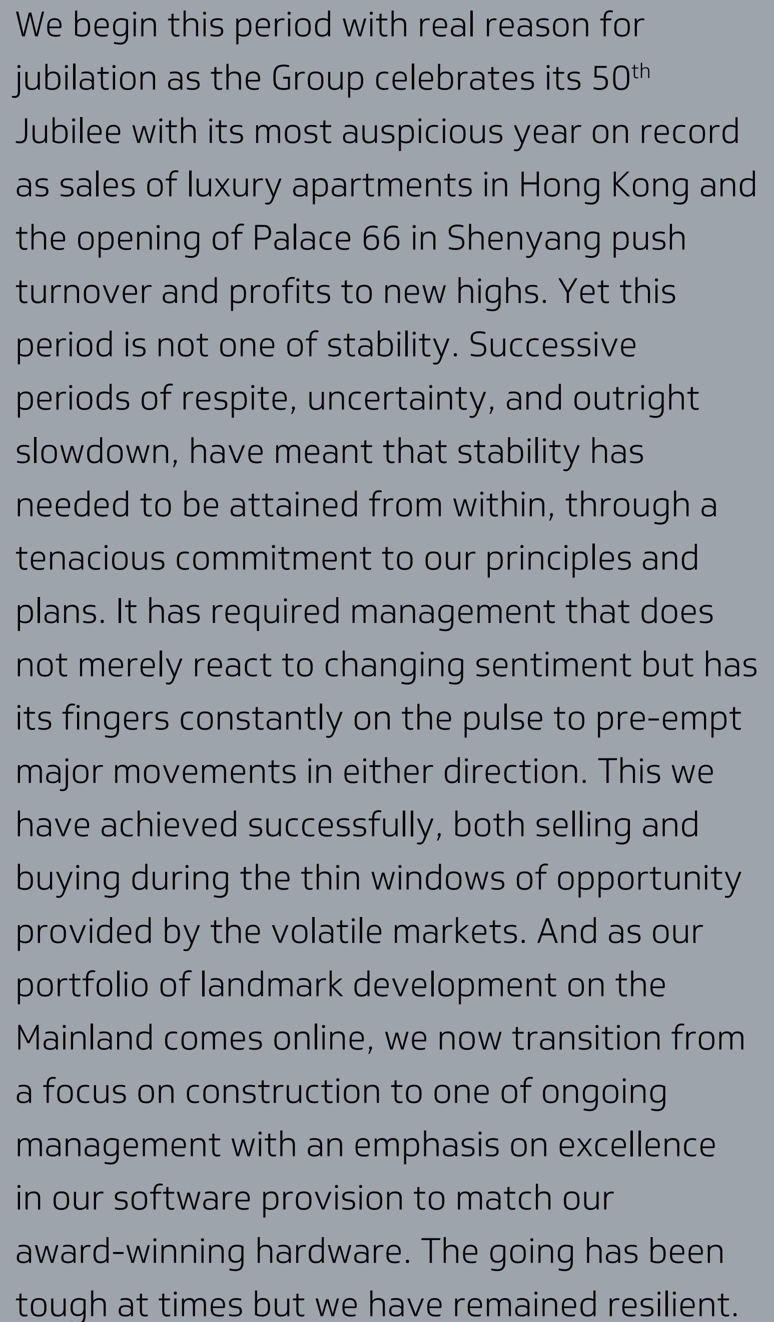
Mixed Economic Outlook Only Poses Question of How Much Profit Growth

Besides focusing on building out existing developments, we will continue to search for new sites. Our gearing will still be comfortable after taking into consideration construction expenses and selling down completed apartments in Hong Kong. Given strong residential market in recent months, there is a good chance that we will relaunch our sales campaign before the year is over.

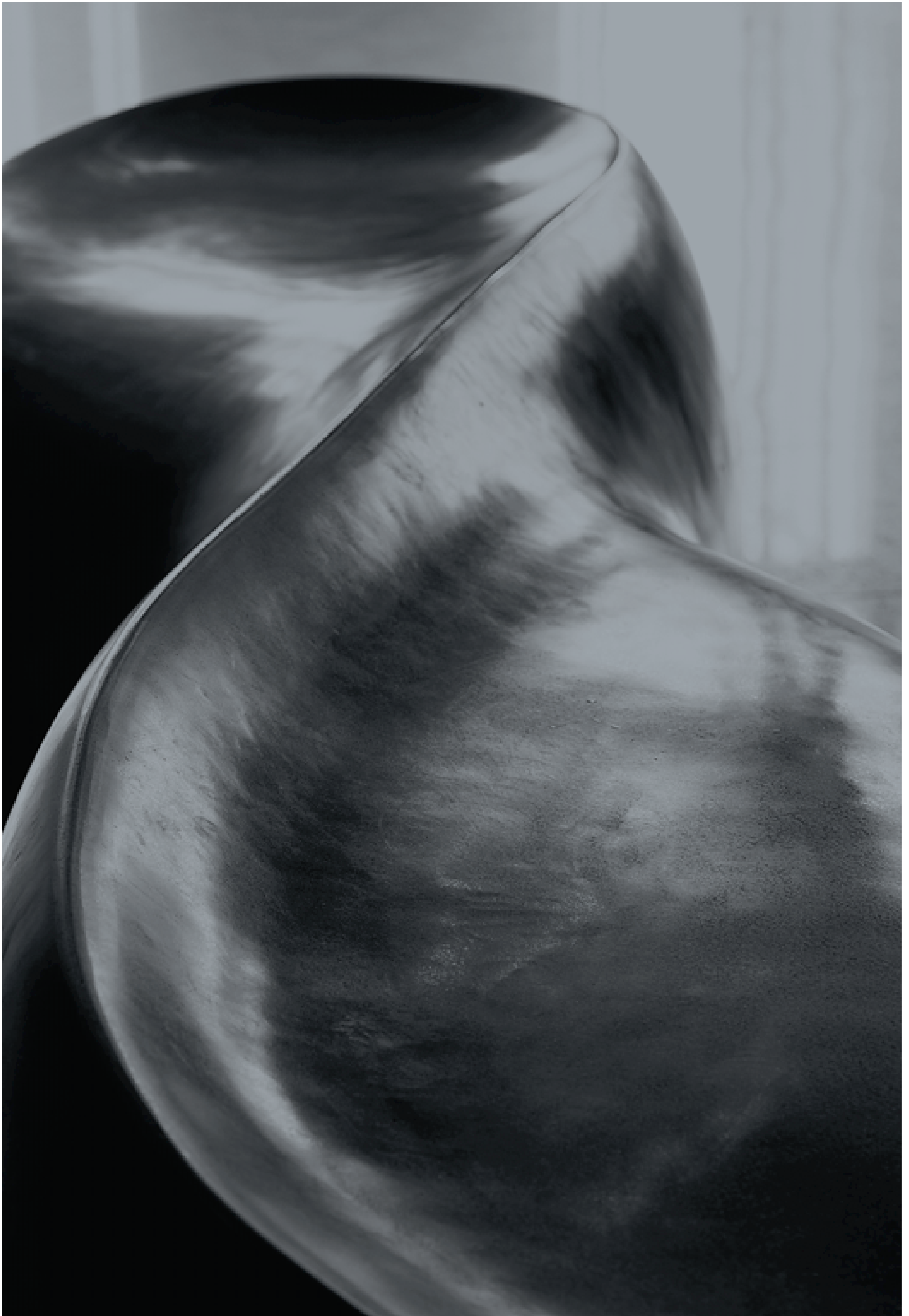
We expect Hong Kong rental this fiscal year to be similar to that of the last, namely growing at single digit. Shanghai may for the first time experience the same. Since we opened the two facilities almost 10 years ago, annual increase in rental income, until this year, has been upward of 20% with the exception of 2005 which was 19%. Even excluding the addition of new space, growth has been solidly in the double digits. The market has been favorable all along. Now for the first time, China, especially Shanghai, is undergoing slower growth. However, I believe that the phenomenon may be a temporary one. The market should recover in a year or two.

The critical determinant of the level of income is our ability to sell Hong Kong flats. If successful, profit should be considerably better than last year. If not, then we will again rely on rental income alone. In that eventuality, we should still record profit growth but it will be modest.

Ronnie C. Chan
Chairman
Hong Kong, July 31, 2009



We begin this period with real reason for jubilation as the Group celebrates its 50th Jubilee with its most auspicious year on record as sales of luxury apartments in Hong Kong and the opening of Palace 66 in Shenyang push turnover and profits to new highs. Yet this period is not one of stability. Successive periods of respite, uncertainty, and outright slowdown, have meant that stability has needed to be attained from within, through a tenacious commitment to our principles and plans. It has required management that does not merely react to changing sentiment but has its fingers constantly on the pulse to pre-empt major movements in either direction. This we have achieved successfully, both selling and buying during the thin windows of opportunity provided by the volatile markets. And as our portfolio of landmark development on the Mainland comes online, we now transition from a focus on construction to one of ongoing management with an emphasis on excellence in our software provision to match our award-winning hardware. The going has been tough at times but we have remained resilient.



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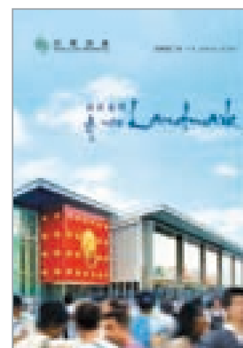

Jubilation: A Jubilee Year with Real Reasons to Rejoice

EXECUTIVE SUMMARY

The jubilee celebrating Hang Lung's 50th year began and closed with fanfares of success in Hong Kong and Shenyang to frame the most auspicious year for the Company on record. Our teams in Hong Kong again managed to take advantage of a rare and slim window of opportunity to release and sell 425 units of our luxury residential development, The HarbourSide, within one week at the beginning of the year, netting us almost HK$5.3 billion in profit. The launch of Palace 66 in Shenyang at year end marked the completion of the first in our series of Mainland developments outside Shanghai. Fully leased at launch, it is a propitious start to a new era for the Company, and confirms that the replication of this successful business model begun in Shanghai a decade ago, is the roadmap for our continued growth in the future. With China taking center stage in the global commercial market, our position is firm as a respected developer in the field of quality design, construction, and management, which has won us numerous awards. The commercial leasing sector is also buoyant in Hong Kong, which along with the luxury residential market is bearing the fruits of our strategic planning of a decade ago. Meanwhile, the markets that we deliberately distanced ourselves from are languishing along with the developers that rushed into them. Our strategic planning has been critical to our success and this is a credit to sound management and execution. As our horizons expand, we are committed to reinforcing the high caliber fabric of our team from board level down, reiterating our commitment to quality in every area of our operations. And as growth in our markets is set in a stable path, we will continue to explore ways to enhance our capacity for growth along the models that have driven our current success.

Olympia 66, Dalian

It is gratifying that at this 50th year of our parent Hang Lung Group Limited (originally called Hang Lung Development Company Limited), we as its primary subsidiary should reach new heights in both net profit attributable to shareholders as well as dividend, if approved.

The two highlights of this fiscal year were the successful sales of completed Hong Kong apartments at the beginning and the opening of Palace 66 in Shenyang towards the very end. The former is a further reaping of correct decisions made in the past and the latter signals a new era for the Company.

Tiny Windows of Opportunity Leverage Huge Accomplishment in Hong Kong

The latest opportunity to sell luxury condos in quantity came last August. We took advantage of it and parted with 425 garden-facing units at The HarbourSide. We sold about HK$7.5 billion worth and reaped almost HK$5.3 billion in profit. This margin of 70% was never achieved before for this development and was probably the highest in Hong Kong for similar products. The fact that there were few, if any, projects which sold as much in the following few months seemed to indicate that we had absorbed most of the market demand for the time being.

It is impossible to predict when the next big opportunity will come. The time prior to last August was almost two years before in October of 2007. Management believes that the bull market will one day return especially for luxury apartments like those in our portfolio.

A recent report estimates that about 20% of Hong Kong's high-end housing is already purchased by our fellow Chinese north of the border. (For our latest batch, the percentage was far lower since we had to surprise the market by suddenly announcing the sales. It took about 24 hours to launch the campaign and almost all of the 425 units were sold within one week. As such, potential Mainland purchasers were not given enough time to respond.) Their purchasing power can only be described as enormous especially in relation to the relatively small Hong Kong luxury sector. This was one reason we did not rush to sell in the past several years, and progressively higher profit margins achieved were a confirmation that our decision was correct.

Shenyang Palace 66 Ushers in New Era

Inasmuch as the developmental profit is gratifying, I am even more excited about the opening of our first shopping center on the Mainland outside of Shanghai. Shenyang Palace 66 heralds an era where we will open one or more new world-class commercial complexes each year. Even if we do not buy more land, which is highly unlikely, this streak will still continue for many years.

The completion of this design-award-winning mall is in itself meaningful – our team has successfully executed a sizable construction project outside of Shanghai. Of more importance will be the delivery of satisfactory financial return. Initial indication is that first year performance will be slightly better than that of our Shanghai developments when they first opened some 10 years ago. Management is hopeful that the rapid growth in rent experienced in Shanghai will be repeated. A decade or so after inauguration, Plaza 66 and The Grand Gateway are now commanding approximately 31% unleveraged annual gross yield on historic costs. That is almost eight times the equivalent number at the opening.

The expected starting yield of Palace 66 would have been even better if not for several factors. First, construction cost since the purchase of the land five years ago has gone up tremendously. The extraordinarily rapid increase in infrastructure developments all over the country and the explosion of new building activities in city after city were unprecedented in human history. Construction relating to the Beijing Olympics and reconstruction after the May 2008 Sichuan earthquake added tremendous pressure to both material and especially labor costs. Workers were simply siphoned off to those two regions leaving us in a very difficult position.

To illustrate: during the four years between 2005 and 2008 when construction contracts for Shenyang Palace 66 were awarded, China's CPI (Consumer Price Index) increased by 14%, while the government's Construction and Building Services Installation Index nationwide rose by 22%, whereas the equivalent latter number for Liaoning Province where Shenyang is the capital city leapt by 28%! This was exactly twice the pace of CPI growth and 27% more than the national average for the industry. The comparable figures for the more matured markets of Beijing, Shanghai and Guangzhou were respectively 16%, 17% and 16%. As such, we are paying for the faster economic growth of Shenyang and of the Northeastern region of the country. Fortunately, the rise in GDP for our two cities in Liaoning province, Shenyang and Dalian, respectively at 14.1% and 15.1%, is almost 70% faster than the national average of 8.7%. Increase in retail sales for the two metropolises is also substantially higher than that of the country as a whole.

Second, in the past five years, the Renminbi has appreciated by about 20% and construction costs were translated into that much more in our home currency. The omen is that it will rise even further and we are taking measures, to the extent possible, to protect ourselves. For in the coming years, we will have many construction bills to settle. The compensating factor is that once completed, our properties which collect rents in Renminbi will convert into more Hong Kong dollars.

Third, there were a host of design-related issues. With Palace 66 being our first Mainland project after Shanghai, we want to ensure the highest quality. Originally designed to the standard of The Grand Gateway, we decided, after construction commenced, to upgrade it to be more akin to Plaza 66 in Shanghai. That is for long-term competitiveness considerations. Because of its proximity to the Qing Dynasty Palace, the Shenyang government requested that we eliminate one floor after the construction contract was awarded. We also encountered two very severe winters where building work had to be halted altogether. For the above-mentioned and for commercial reasons, we decided to speed up construction towards the last stretch which added a lot to labor cost.

Whatever the case, Palace 66 is now completed. Unlike most of our competitors on the Mainland, at the opening we were fully leased and almost all tenants were ready for business on June 26 when the ceremony was held. Initial response – both pedestrian traffic and sales volume – was favorable although I would like to observe further before declaring victory. Previous experiences show that in the first few years of any mall, many adjustments from tenant mix to physical details will have to be made in order to arrive at an optimal state of affairs. Such is the nature of the business.

Architectural and Environmental Design Leadership

There is other encouraging news worth reporting. So far Hang Lung may well be the only real estate company where all the projects under construction on the Mainland have received gold precertification of the LEED standard (Leadership in Energy and Environmental Design) of the U.S. Green Building Council. In the case of the newly completed Palace 66, it has in fact obtained the actual gold certificate, perhaps the first shopping center in China to be so honored.

Besides sustainable development, our building designs are also virtually unmatched in China. Like Shanghai Plaza 66, many of our new projects such as Palace 66 in Shenyang, Parc 66 in Jinan, and Riverside 66 in Tianjin have garnered international awards. Earlier this year, the last named was further recognized by The American Institute of Architects, or AIA, in New York City. That too was a breakthrough for Hong Kong firms operating on the Mainland.

Recovery Most Evident in Leasing Sector

For the past fiscal year, rental income rose by 9%. For Hong Kong it was 6%, and Shanghai, 14%. In our home city, both retail and offices held steady while the residential sector, albeit improved from before, was still weak. In Shanghai, office rent basically kept pace with that of last year. To our delight, increase in retail rent was strong – 19% for The Grand Gateway and 30% for Plaza 66 giving a blended rate of 24%. A year ago I

anticipated slower growth in the higher-end mall due to economic lethargy. The opposite happened, which was a pleasant surprise.

There is no question that China has recovered faster than other major economies in the world. Even export has picked up considerably. Domestically the government has strongly encouraged personal consumption which will account for an increasingly higher percentage of GDP. That must be good for our retail business. Moreover, this is a secular trend and not merely a cyclical one.

China's residential real estate market has gone through some rather incredible times. As I had previously reported, tactical missteps on the part of the government had driven prices of both land and housing last year to heights never seen before. Now Beijing is taking determined measures to cool them. Transaction volume has shrunk significantly and prices are beginning to fall. Unlike 2007 when high home price had driven some developers to the commercial sector, this is less likely this time. Their near bankruptcy in the second half of 2008 and the exorbitant land prices paid in 2009 have left some developers in a financially weakened position. Apartments were sold briskly last year but for the past few months, volume had all but disappeared. In face of many uncertainties, they will likely take a conservative stance.

For us, we went from quietly "stealing" all the best commercial land deals in 2005 and 2006 to being totally shut out of the market due to overheating in 2007 and 2008. The crash came but the bear market lasted not much more than six months. Fortunately when the residential sector rose sharply in 2009, commercial land was virtually left untouched. For us that was perfect and we resumed acquisitions consummating in the two purchases in May that year. The only reason for our not completing more transactions was our insistence on resolving all essential issues before committing. Negotiations on several cities are progressing and there is no serious competition. I am hopeful that one or more announcements will be made in the coming 12 months.

In the past year, much effort has been devoted to building out the four developments under construction. Local conditions differ from city to city and we are adjusting well to each. In the order of expected completion, they are Jinan Parc 66, the mall at Shenyang Forum 66, the retail space at Wuxi Center 66 followed by one of its office towers, and Tianjin Riverside 66. Land clearance at Dalian Olympia 66 has also been uneventful. This huge shopping center may in fact catch up with the one in Tianjin and both should be ready for business around 2015. Tianjin is the only city where we are experiencing delay. The city government has yet to turn over a small sliver of land in the middle of the piece which accounts for approximately 10% of the site. Substructure work is in progress except this strip.

The Story Unfolds from a Tale of Two Cities

Last year I began the discussion on Strategic Initiatives with a sobering fact: that in spite of an increase of some 24% (and not 19% as previously reported) in leasable space since 1997, total rent received in Hong Kong that year was still slightly below that of 1997. The past 12 months were the first time that we had exceeded the height recorded 13 years ago. Let me supply further data to bring out a point: it was fortuitous that we have branched out to second-tier cities six or seven years ago.

For the decade beginning in 2000, our Hong Kong rental revenue had a compounded annual growth rate (CAGR) of 3.6%. The first two years saw negative growth as a result of the Asian Financial Crisis which began in July 1997. But even considering only the eight years since 2002 when the market had bottomed, the CAGR was merely 5.5%. Over the same period in Shanghai which was our first 10 years there, we achieved a CAGR of 41.3%, albeit from a very low base.

Looking ahead into the next decade, it is safe to assume that our Hong Kong portfolio will barely see rent increases of say 5% per annum. For a matured market, this is already quite respectable. As explained two years ago, sizable acquisition opportunities almost do not exist. These facts clearly tell us that it is impossible to significantly raise rental income in Hong Kong.

Fortunately we entered the Shanghai market some 18 years ago and invested wisely. However, even that city is beginning to mature as a rental market. Fresh supplies of commercial space in the coming years will be enormous. Purchasing existing buildings or buying land satisfactory to us to build upon are both expensive undertakings. Because of the quality of our two developments in terms of location, size and design, we should remain highly competitive. But if new space keeps coming, then return will sooner or later be driven lower. Prior to 2008, we never had a year where rental increase was less than 19.3%; the past two years only recorded 16% and 14.4% respectively.

All that validates our decision in 2003/2004 to enter other cities starting with Tianjin. In order to continually expand both top and bottom lines, we must be able to meaningfully add space each year which will yield fast rental growth. Such is the promise of the five cities (beyond Shanghai) where we have bought seven pieces of land between 2005 and 2009.

If Shanghai is considered Phase 1 of our Mainland strategy, then these seven would be Phase 2. For now, I like to focus management on successfully constructing and leasing the developments on hand. After so doing for the first two of the seven – Shenyang Palace 66 which opened last month and Jinan Parc 66 in September next year – then we will have adequately demonstrated the validity of the strategy. That would be the auspicious time to announce Phase 3. Management is in fact already executing that plan, but it is perhaps prudent to quantify things later. After all, we must carefully consider all possibilities and should not over-promise.

Matching Our Hunger to Grow with Our Growth Capacity

Suffice it to say that given our unmatched financial position, we can do much more than what is on our plate today. The Mainland market is enormous, and there is no reason whatsoever for us to stop expanding. It would have been unconscionable!

To further grow, we will need finances. In the past few years we have been in a net cash position. We have as much as HK$20 billion worth of housing in Hong Kong to be sold. Since the six remaining new projects of Phase 2 (excluding Palace 66 which is already opened) will require well over HK$30 billion to construct, sooner or later we will have to take on some debt. But because two of the six (Shenyang Forum 66 and Wuxi Center 66) are enormous and will likely take 10 to 15 years to build out in phases, annual capital expenditure will be manageable. Moreover, the present HK$4.5 billion annual rents should increase nicely over time, and so our overall financial position should remain healthy in the foreseeable future. We will cautiously leverage up as we enter Phase 3 for further land acquisitions and construction. Whether the need exists in the coming year will depend on how much we will receive from the sales of Hong Kong apartments.

There are at least three other avenues for fresh funds. First, we can tap the capital markets when conditions are auspicious. Since 1992, we had done it seven times and collected a total of HK$24 billion. Their timing, size and pricing were all deemed favorable by the market. Second, we can sell low yielding and slow growing Hong Kong investment properties and deploy the money in Mainland projects with potentially higher returns. Finally, we can monetize our Mainland rental properties as they become mature. Given any combination of the three, capital funding should not be an impediment to expansion. We are known to the market as shrewd financial operators and will do our best to maintain that reputation.

While on this topic, I may add that we have not deployed serious capital in Hong Kong for close to a decade, i.e. we have not bought a single piece of land. We are not bearish about the city; it is just that the risk-reward ratio was in our opinion unfavorable. It takes a lot of capital to produce limited profit. Only a major downturn in land prices will tempt us to return. By not buying here, we have conserved cash for what promises to be much more lucrative Mainland opportunities.

Future Success in Business Model Replication

In the coming years, we will take on more projects. A sizable mall will always be at the center and in that sense, we can be considered a consumer spending company. At present, there is tremendous pressure inside China to raise the average man's salary. This phenomenon will continue and must be positive for our business.

To take maximum advantage of this favorable environment, we have over the years devised the present strategy – build world-class commercial complexes for long-term hold. It is difficult to find another business model which is as attractive. Consider the following seven highly desirable characteristics associated with it.

First, it is possible to have rather high return on investment. As mentioned earlier, our gross yield from Shanghai rental on unleveraged investment cost stands at approximately 31%. Given reasonable gearing, the number approaches 50%. That means all invested dollars will be recouped in less than two years.

Such a high figure of course does not happen on day one. In fact the investment period is long such that the less disciplined or less financially endowed will not be able to imitate. It usually takes at least two to three years from the identification of a plot of land to acquisition, and construction will add another three to four years. Once the mall is ready for business, the expected initial yield is about 4% to 5%. Then it takes about nine years or three three-year lease terms to build up the rental income to the 30% level. What we have witnessed so far is that this tortuous process is sufficient to scare off potential copy cats or stop those who attempt.

Second, the quality of income is excellent. Once leased, rent is recurrent and will not easily disappear. Compared to the highly volatile revenue of the build-and-sell strategy, companies like ours should command a much higher price-earning-ratio. That has indeed been the case.

Third, the market is humongous. Our highly successful developments in Shanghai are by no means one-off situations. They can be duplicated in many metropolises, and Shenyang Palace 66 is just the beginning. We have identified 75 cities of which almost half have been studied. So far, we only have projects in six of them. As China is now undergoing the biggest urbanization mankind has seen, more cities may yet show up on our screen.

Fourth, our business model is very defendable. As I wrote two years ago, once we build the best mall at a top location and of the right size and design, then our competitive position is almost unassailable. This is why first-mover advantage is critical to us. Once that is established, the only one that can defeat us will be ourselves. As long as we are vigilant, we should be safe.

Fifth, the concept of our strategy is extraordinarily simple, although its execution is extremely difficult. I believe in parsimony – the fewer moving parts, the less chance there is for things to go wrong. This was why for years we were able to run such a sizable organization with less than 2,000 staff. Of those, only one-third or about 700 were office workers. About 10% of them are executives who have stock options and so are part owners of the Company. (Total staff count has gone up recently and will continue to climb as we open new complexes on the Mainland. In order to maintain the highest standard, each mall will require over 300 staff to run. Most of them are security and maintenance personnel.)

The tremendous difficulties in execution relate not just to hard skills but even more to the mindset that permeates an organization. For example, I have in the past written about "discipline" that is required to succeed in our business. It comes from a certain corporate culture which produces the right mindset. Without these qualities, one can never implement our strategy. I will return to this point later.

Suffice it to say here that the conceptual simplicity means that the barrier to entering our business is not too high. The difficulties in execution however present an almost insurmountable impediment to success. This explains why China is full of failed shopping malls of all sizes. In fact, having traveled the country far and wide, I can hardly find one that approaches our overall quality. Some of them have financially performed well merely because of the lack of worthy competition.

If possible, it is always wiser to avoid competition than to confront it. When forced to face it, we should find a way to differentiate ourselves that will render competitors ineffective. That way we will stand out, thus virtually putting us in a position of having no competition. This is exactly our experience and is the sixth favorable characteristics of our strategy. Let me elaborate.

Because there are so many economically vibrant cities in China each having a huge population, we can go for the ones with few or no competitors. We usually enter markets ahead of others anyway, so we seldom encounter any of them. However, we can never be sure that no one at all is competing for the land that we want. And even if there is none, we still need to convince the seller, i.e. the municipal government, that they should meet our terms, financial-wise and on other specifics.

An effective tool is our track record in Shanghai. We have built and still own complexes that generate the highest tax revenue (including all types of taxes) of any commercial property in the city and likely in the whole country. According to government figures, there were years when our two developments annually contributed a total of RMB 3 billion of tax dollars – most of them by our tenants and some by us. Such a figure will make any municipal leader salivate. That together with our superior building design and financial strength to hold for the long term are usually sufficient to make us the land purchaser of choice to the municipal government. And if there are actual competitors out there, they are rendered ineffective in the face of our unmatched track record.

Experience, Tenacity, and Strategy Mitigate Variable Factors for Success

Finally, to the extent that the future of any real estate business model is predictable, ours must be one. Once the right pieces of land are purchased, then there are only two major variables to worry about – design and construction, and rental income projections.

Our experienced and stable management team mitigates to a large measure the former risk – we know how to design well and construct correctly. Rental income, on the other hand, will be in the hands of our property management team which is excellent. Nevertheless, just as critical is the social stability of the country, which depends on the way economic affairs are handled by the government and on geopolitics. These two areas are obviously beyond our control. This is why I devote considerable time to understanding them. But given a plausible scenario, namely, the absence of catastrophic dislocations whether domestic or international, our rental income stream can be more or less projected. That has been attempted by your management, and preliminary results have been very encouraging.

Anticipation can be nice but one must be able to execute in order to convert projections to actual profit. This is where many companies stumble. They think that hard skills are all they need to succeed. I do not believe so. They are necessary but not sufficient. Just as critical if not more is a proper mindset towards the business and its component parts.

For example, there are two main steps to the developmental process – buying land and constructing buildings. What is an appropriate attitude and understanding regarding these two? How do we see their relationship? Without the right view, one may still fail, having the best business model notwithstanding.

Many developers play the real estate game mainly relying on the appreciation of land price. To them the key is to correctly time the market for land purchase, or if you will, to buy low and sell high. As a result, not sufficient attention is paid to perfecting professional

and managerial skills, the exercise of which alone creates value. To my mind, such players are as much speculators as they are developers. Such a mindset is dangerous and any success, if it comes, cannot be sustainable.

At Hang Lung we view real estate development very differently. There is no denying that we too time the market and have in fact done it better than most. Yet to us, that is simply prudence, for why should anyone buy high and sell low!? Our attention and efforts are as much on creating value as on market timing. We strive to bring know-how, experience and hard work to bear.

In Hong Kong, land often accounts for 70% to 80% if not more of total project cost. Consequently, buying land at the right time – and also selling buildings at the propitious moment which many developers forget or ignore – are the most important decisions. Other avenues to improve profitability become insignificant for they at most account for 20% to 30% of total expenditure. People who are accustomed to such markets may become rather lazy – just buy land correctly and you will make money. At least that is what they think.

Such developers will have a hard time when they enter Mainland markets. There, land cost only accounts for roughly 30% of the development. (For our new projects, the average is well below 20%.) Intellectual or managerial capital, if I may so describe it, is far more crucial. Examples include design flair and construction expertise where creativity and good operating systems are essential qualities for success. Even buying land correctly does not entail only calling the market. The choice of plots is not as simple as one thinks. For example, developmental terms associated with each piece are of utmost importance. They will predetermine the success or failure of the project. This is especially true of large high-end commercial complexes.

Perhaps that explains why many Hong Kong developers are not so comfortable with such projects up north. On the other hand, Mainland companies are on the whole not yet sophisticated enough for luxury malls and offices. That gives us a window of opportunity which we shall exploit as much as possible. Until worthy competitors arrive and we assume that they will, we shall continue to be a rather unique player in the China market.

It will be useful at this point to dispel a misunderstanding of our strategy. Some in the market think that Hang Lung only develops the highest-end shopping centers. That we do and have done it well, but we also do something else. There is no denying that Plaza 66 in Shanghai has been so successful that it has become a brand. It is synonymous with luxury and high fashion and has made Hang Lung well known nationwide. We have even used “66” in the English names of our new developments. (The number originates from the facts that the first skyscraper in Plaza 66 – chosen as the number one office tower in all of China – has 66 floors and its street number is 1266.)

However, as hard-nosed businessmen, we are pragmatic and cautious. We should always keep our heads cool and refuse to be carried away by our own successes. While appreciating the prestige and high unit rent of top-end malls, we also love the slightly lower price-point facilities such as The Grand Gateway. If all shopping centers are graded according to expensiveness and luxuriousness of goods sold and that level 5 is the most pricey, then Plaza 66 is certainly a “5” while The Grand Gateway would be a solid “4.” We do not only build level 5’s; in some ways we like level 4’s even better. We should not limit ourselves to one product type. Let me explain.

Of all people we should know the potential of the deluxe fashion market. There will always be such a niche which will only grow in China as wealth is spread from the top cities to the second-tier ones. Until not too long ago, the wealthy in the latter had to travel to the former to shop. There is no reason why that should continue. All we do is to follow top international brands and enter the new markets. As previously written, we are just the aggregator that provides world-class retail space for them and for their shoppers. It is really that simple.

However, we ask ourselves one question: once a level 5 facility succeeds such as Shanghai Plaza 66, how do we further improve the top and bottom lines? All that can

be done is to bring in more of the right kind of shoppers. There will always be a percentage of population who crave the luxury brands and this number will increase in the foreseeable future. Nevertheless, such a market is not indefinite in size. It is also impossible to predict if one day there may not be a change in taste and hence shopping habits of the populace.

On the other hand, consider the dynamics of the level 4's such as The Grand Gateway. Those who can afford to shop therein are much greater in number than the luxury brand seekers. They are the upwardly mobile upper middle class whose quantity is rapidly rising throughout the country. They are becoming increasingly discerning and so demand high-caliber buildings, ambience and service. Yet today there are hardly any quality malls anywhere in the country. In time some of them will amass enough wealth to frequent the level 5's, or the likes of Plaza 66. Our level 4 shopping centers will prime them for even higher tastes.

From the perspective of a mall operator, rents from the level 4's can increase in two ways against the one for level 5's. We can bring in more shoppers but we can also replace existing tenants with more luxurious shops. The latter is capable of paying more rent because of higher profit margin. When The Grand Gateway first opened a decade ago, we were lucky to have attracted one single Hong Kong name. There was no international brand whatsoever. Now they are the majority – almost 75% of the 448 shops. This kind of tenant upgrade is almost impossible in Plaza 66. According to one study, Plaza 66 already has more of the world's top 100 luxury brands than any other mall in the entire country.

Coincidentally, there is good news from The Grand Gateway in terms of increase in foot traffic. Whereas there was only one subway line below when we opened in 1999, now we have two. By 2013, a third will be added. This is significant because approximately two-thirds of the shoppers enter our property through the underground. Already over 500,000 visitors frequent this mall each weekend and more can be expected. Given optimal size and attractive and functional design, the future of The Grand Gateway and indeed of other shopping centers of this mode should be bright.

All that is to say that we will continue to build both types of products. Depending on the city and the location, we will design a "Plaza 66" or a "The Grand Gateway." For example, the newly inaugurated Shenyang Palace 66 is a level 4 (albeit with close to level 5 finishings) while Forum 66 scheduled to open in 2012 in the same city will be a level 5. Nevertheless, all of our level 4 malls have designed into them the flexibility for upgrading. As the local citizens become more affluent, the need to move up will become obvious. The Grand Gateway is a case in point – it is creeping up in that direction.

There is yet another type of shopping centers in our portfolio. In cases where the facility is particularly large, say over 150,000 square meters, the design may incorporate two sections – a level 4 and a level 5 – at least on the first one or two floors. Jinan Parc 66 opening next year and Dalian Olympia 66 scheduled for 2015 are examples.

No Secret Recipe for Success, but One Hard to Master

If our business model is so elegant, why are there not more imitators? Long lead time, weak financial position, and the lack of required skill set are among the chief reasons. After studying us, a few had attempted but all soon gave up.

There is still another critical success factor beyond all that is tangible or technical; the lack of it is a hidden cause for the failure of those who tried. Yet real estate companies almost never talk about it and more often than not disregard or violate it, that of corporate culture which undergirds good governance. I will devote the rest of this section to this.

It is often said that real estate is an entrepreneurial industry. One has to be nimble in order to buy low and sell high. I do not disagree. In fact our track record of the past two decades has amply demonstrated that we are quite good at it. Both in terms of buying land and selling properties in Hong Kong and Shanghai, and of tapping the capital market, we have always called the timing well. Or if you will, we consistently buy low and sell high.

However, being entrepreneurial should not in any way contradict with building a strong and appropriate corporate culture and exercising good governance. I like to think that we also excel in these areas. To be sure, we are far from perfect and so must improve further, but I trust that we compare favorably within our industry. Last November the Hong Kong Institute of Directors together with a local university studied the governance of 146 publicly listed companies in Hong Kong. Our parent Hang Lung Group was the only real estate firm among the 10 best.

(Of the other nine, five can be generally grouped as utilities and infrastructure, three are banks, and one is a government regulated entity. This study differed from those organized by commercial enterprises such as business magazines which may not be objective.)

Since corporate culture and governance are broad issues, I can only touch upon certain salient aspects of each. To begin with, the two are intimately related. Good governance is not just a matter of checking off boxes in assessments and surveys. It must be embedded in a proper culture. One may even say that a healthy corporate culture is the soul of good governance.

It seems likely that in recent years, some companies have learned to check off the right boxes in surveys after making minor adjustments within the organization. As a result, they fare well. One cannot say that they are dishonest, but anyone who knows them knows that their governance is at best weak. Their so-called good governance is not rooted in a corporate culture which ensures constant proper practices. Time will one day reveal their true color.

Good governance must start at the top – the Board of Directors. Its composition and function are equally important. For example, how are the Non-Executive Directors (NED) related to the majority shareholder family whose members also serve in senior management? How truly independent are the NED's, or are they really Independent Non-Executive Directors or INED's? Most Asian publicly listed companies have a major shareholder, and it is of course acceptable for him or her to have a representative or even representatives on the Board. But are there enough INED's to protect the interests of the minority shareholders? If there are, are they doing their job?

Building a Corporate Culture for Success through Good Governance

Allow me to relate an anecdote in this regard. In Asia, it is common that the top person of a company, especially if he is also the major shareholder, would solely dictate staff compensation. That was also our practice before 2003. As chairman and representative of the major shareholder of Hang Lung Group, I for years alone made such determinations.

By choice, I for well over a decade since assuming the chairmanship in 1991 gave myself a rather low salary. I took no bonuses and voluntarily excluded myself from stock options which program I initiated for our executives in 2000. But by 2003, I recognized the need to improve governance in this regard and so proposed to the Board the establishment of a Nomination and Remuneration Committee (NRC) comprising only INED's. I will never forget the day that the NRC was officially formed. Recognizing that a power which I solely exercised previously would forever be relinquished, I was viscerally moved! I felt that part of me was gone.

Now seven years have passed and there is no doubt in my mind that I made the right decision. It has nothing whatsoever to do with the fact that to my total surprise, the NRC did not deem it appropriate for me to receive a low salary not commensurate with the nature and scope of the job, to not receive year-end bonuses, or to not participate in the stock option scheme. That action back in 2003 has helped make us a better governed company.

It was also precisely for good governance that towards the end of 2008, we were the first and maybe the only major listed real estate company in Hong Kong to publicly support the Stock Exchange's proposal to shorten the period between fiscal year-end and public reporting. It frankly baffled me how other firms could object and object so vehemently – perhaps including one or two which had repeatedly won the so-called

corporate governance awards. There can only be two reasons – poor management and financial self-interest on the part of senior executives. Both violate good governance.

Among the excuses, some companies complained that they could not close the books fast enough. But if much larger and complicated Western firms can comply with more stringent rules say of the New York Stock Exchange, why can we not in Hong Kong!? Inability must mean poor management and weak operating systems. To demonstrate that it can be done, we now regularly hold our Board meeting for interim and final result announcements within one month of the financial period end. Frankly the only difficulty is to find a date that all Directors can attend.

The only other reason for objection is that senior executives can use the longer period to buy and sell their own company shares. This too is bad governance, for during that period, management possesses information not known to the investment public.

In matters of governance, the West is more advanced. There are aspects where they have gone too far but in many more fundamental areas, Asia should humbly learn. Good governance can be a constraint to management, but is also its protection.

I would like to mention that this Company and its parent Hang Lung Group have been blessed with very active Boards. Directors repeatedly raised the right issues with management and followed through until there were satisfactory answers or results. They are diligent and proactive in guiding as well as supervising the two entities. As one of the Executives, I am grateful.

I for one do not object to having the majority shareholder double up as a senior executive. In fact I have publicly spoken in its defense. With proven governance, it can give a company tremendous edge. In the case of Hang Lung, my family's trust is the ultimate controlling shareholder, but the Company has been for years professionally managed. There is hardly any family member other than myself in management.

Now let me turn to corporate culture. From the beginning of my chairmanship, I have, with the help of Mr. Nelson Yuen, our long serving Managing Director whom I early on appointed, strived to build an organization that is collegial and transparent, as well as lean and flat. We enshrine our core values in the acronym SAIL – Simplicity, Authority, Integrity and Loyalty. We advocate open communications, treasure team work and discourage office politics. We make sure that everyone works for the overall good of the Company rather than for petty self-interests. One plus one should be greater than two. We maintain minimal layers of organization; we prefer a few good staff to many mediocre ones. We encourage entrepreneurship; everyone should know his or her responsibilities and exercise initiatives with commensurate authority. Our atmosphere is egalitarian and we disdain sycophantic behavior. We want to be a learning entity; we are careful not to make mistakes but when we do, we make sure that we learn from them. We treat all staff with respect, and in return demand loyalty. And above all, we strive for the highest ethical standards at all levels of the Company.

All these qualities, as far as I am concerned, have much to do with our past successes. Without them, we would not have been able to execute our strategy. The reason was alluded to two years ago in my letter to shareholders. Here I will expound on it.

At that time I stated that real estate is not a high-tech business although we use technology. Instead, the industry demands much experiential knowledge accumulated through long years. No company, no matter how skillful or smart its staffs are, does not make mistakes in the developmental process. They are unavoidable because no two projects are identical. This is especially true of large commercial complexes. The key is to learn from previous errors and improve. In the process, the company will gain experiential knowledge which will help it succeed in the future. An enterprise which is more capable of retaining such knowledge will be a winner in the longer term.

So what determines if a company can learn? Its culture. A firm with the right kind of culture is far more apt to learn and improve while others may not even know that mistakes are committed, let alone to benefit from them.

Since experiential knowledge is lodged inside the individuals, the ability to retain experienced staffs becomes paramount. Such institutional memory will safeguard the company from repeating the same errors. For this, high salary is a necessity but is not in itself sufficient. For there are always other people who are willing to pay more.

Good and decent people desire a sense of ownership. They cherish the satisfaction derived therefrom and the realization that their efforts will make a measurable difference. This is why Hang Lung is one of the very few, if not the only, of the major Hong Kong real estate firms that has an effective stock option scheme for our top 70 or so executives. The amount permitted to be issued each year is strictly controlled by the NRC. There is no allowance for the excesses commonly found in Western companies, namely management issuing an exorbitant number of options to itself. In cases like us where there is a major shareholder, he or she would certainly object in order to contain share dilution.

Many Asian companies do not have stock option plans precisely because of that worry. For us, the problem can be partially mitigated through shrewd operations in the stock market. While options for Hang Lung Properties stocks are issued to executives, our parent Hang Lung Group periodically purchases our shares when prices are favorable.

However, even the best option scheme is still not sufficient. The value of any option can be quantified in monetary terms and so can be bested. This is where a proper corporate culture comes in. Most of the outstanding individuals do not just want money; they want respect as well. They have choices on where they work and only companies with a propitious culture can bring and keep them together.

Moreover, the developmental process has many stages and components. It is difficult if not impossible for any single individual to master all the tricks. Consequently, in real estate companies in particular, silos should not be allowed; team work is critical. For groups of people to work synergistically, unnecessary friction must be minimized. Only so will a company operate smoothly and efficiently. All these qualities can hardly be quantified, but they are absolutely essential to success.

A flat organizational structure is also useful and I am a firm believer in it. With minimal bottleneck, decision making can be very fast. And if staffs are open and transparent to one another, the necessary safeguards from individual rash behavior and personal impulse will be in place.

Let me present another anecdote to illustrate. Because of the explosion of new projects in the past five years, we had to hire many new managerial staff. Recognizing that not all of them will be good enough to remain with us, we actually employ more than what we immediately need.

Once a manager so hired went to his superior for a decision on a task at hand. To his surprise, he was asked to make the decision himself, albeit under supervision. It was a challenge to him for in his own words, such a responsibility would never be required of him at his former employer. Previously he would have to submit a written report to his boss who would then add his own. A few weeks later, an edict might be handed down. Such is not how Hang Lung works. We try to find people who are at once competent professionally and managerially. Because of our culture, we probably make decisions much faster than our competitors. Mainland municipal leaders with whom we deal can attest to that. It gives us yet another edge.

Corporate culture must be built from the top; it will not work otherwise. Inevitably an institution is a reflection of its leaders. Good culture must also be constantly reaffirmed and strengthened. If not, human nature dictates that it will dissipate over time. As invisible and as intangible it may seem, culture is the soul of an organization and will determine its long-term success. It is perhaps less critical to those operating in smaller and simpler economies such as Hong Kong. But for the Mainland market which is huge and complicated, no company can sustain a winning streak without it. No

doubt every firm and strategy is different and so there is no single culture which is one-size-fits-all. Nevertheless there are core values which must be present if a business is to succeed in the long run. We have those values, and we must sustain and enhance them.

In previous years, I have presented our many success factors. They all deal with strategies and execution which are tangible. Unseen behind them and which makes them work is a corporate culture. It embodies certain values and brings good governance. Many of those values were openly espoused or implicitly practiced by the late Mr. T.H. Chan who founded our parent Hang Lung Group exactly 50 years ago. I am thankful to him for the moral foundation which he had so ably laid. Hang Lung is still enjoying it today.

Beyond the Fragile Recovery: Reasons for Optimism

In the aftermath of the 2008/2009 financial debacle, the global economy is still tenuous. Systemic weaknesses abound in both the U.S. and Europe. The Chinese economy which is conceptually even more fragile has held up much better. Nevertheless, no one should underestimate the myriads of challenges, both domestic and international, facing the country.

A more optimistic view says that China has in the past 30 years faced many daunting troubles and has emerged stable and ever more prosperous. The question confronting us is: provided that the country can keep on an even keel say for the next two decades, can we afford not to be in that market? As a Hong Kong based company, frankly we have very few strategic options. Since our city, as explained earlier, is not at present and in the foreseeable future a desirable place to invest as far as we are concerned, we have no choice but to go north. Fortunately, the Mainland market offers the best opportunities to those who play their cards right. In fact it is hard to imagine a more auspicious environment.

In the past few years we had done well in land acquisitions and will do more of it. Barrier does not mainly come from competition; frankly there is very little of it. Rather it is to work with sellers, i.e. city governments, to remove impediments to potential projects. The process is very tedious and rules are constantly evolving. We must convince them to accept our price and developmental conditions that will allow us to build world-class commercial complexes. Since such high quality facilities are hardly existent in those municipalities, local building regulations are more often than not antiquated. To accommodate us, i.e. to allow top-class facilities to be built, outdated regulations must be reviewed and fine-tuned.

A simple case in point is that we insist on lower plot ratios, i.e. the building space allowed relative to the size of the land. Officials are often perplexed since local developers always ask for the highest possible. All of them mistakenly think that to build more is to make more money. Yet it is difficult if not impossible to develop world-class complexes if plot ratio is too high. So we must convince municipal leaders to lower it which often means lower land price received. The more thoughtful mayors usually understand and accept our argument, but I certainly cannot say that of everyone.

In more complicated issues, we often have to bring officials to meet their counterparts in cities where we already have projects and let the latter explain to them. A side benefit of this exercise is that in their discussions often in our absence, the topic of our management style may come up. Inevitably our reputation is enhanced in that process which increases our chance of land acquisition.

So city after city, we have to undergo this educational process on many aspects of related government regulations. It is tiring but when successful, we are allowed to build what we want – world-class complexes with potentialities of high financial returns. Moreover, having gone through the process in detail with officials, they know exactly what we are trying to accomplish. Such a meeting of the mind will remove much of the possible disagreements which are so common in other people's projects. The construction phase will progress much faster and smoother. In other words, we are front-loading all potential problems. Slow as it may be, to us this is the only way to go. I am hopeful that through hard work, persistence and luck, we will score even more impressive wins.

Surveying the Competitive Landscape

It is interesting to examine why the competitive landscape is so favorable. For that we need to study who the players are and their respective strengths and weaknesses.

As we all know, large malls first found their modern expression in the United States soon after the Second World War. Since then, improvements have been incremental; recently built facilities do not look too different from those of a half a century ago. Some of the best in America are perhaps found in Las Vegas. Their interior is glamorous but for some reasons, less attention is paid to the exterior.

Possibly due to limited supply of bigger tracts of land, malls in Europe are usually not spectacular. Japan and South Korea have experimented somewhat but not many really stand out. Quite impressive are a few in Dubai.

My criteria for judgment are location, size, design – exterior and interior, functionality and aesthetics – as well as management. The ultimate test should include financial return, but those numbers are not readily available. This is unfortunate because as businessmen, return on investment must be top in our minds.

Few shopping center developers are truly global. American firms have a huge domestic market and so do not have the urge to go overseas. Those who do often lack local knowledge as well as the determination to persist. Rather, developers from smaller countries like Australia (population-wise) where the home market is limited, are forced to go abroad. Certain of them have scored impressive successes.

So who is tackling the huge developing market of mainland China? Basically there are three groups – local, Hong Kong and foreigners. Until a few years ago, domestic firms did not have the financial resources to hold for the long term which is imperative for the success of any mall. Now some of them do especially the State-Owned Enterprises. What they lack are skills and experience necessary for luxury malls. In time a few will learn and will become worthy competitors. Fortunately, as I have explained before, firstmover advantage will keep us ahead and safe. This is why these few years are critical to our longer-term success.

The second group of players are major Hong Kong developers. Some of them lack commitment to the Mainland market and so are less likely to succeed. Even if they do, the win will not be big. Several others are determined, yet most of these still consider it secondary to their home market. The lack of focus might have caused them not to pick up the necessary expertise unique to the Mainland. Moreover, it is difficult to discern clear-cut strategies among them. As a result, we do not know who exactly from this group are our competitors. What we can safely say is that very few specialize in commercial properties.

Then there are a crowd of foreign players. Most of them are financial operators who lack expertise, their proclamation to the contrary notwithstanding. They may think that they are shrewd market timers. Perhaps they are, for they left town recently at the first sign of trouble. It was highly doubtful if in the past few years they had made much money. Nevertheless, in this category are a few truly professional developers with great track records overseas. Their home markets are already saturated and they can only grow through mergers and acquisitions. Consequently they are tempted to try the world's largest developing economy. However, most of them underestimated the difficulties and as a result, ended up retreating.

This is the competitive landscape which is frankly quite favorable. As long as we cautiously and diligently execute the stated strategy, our future should be bright. Hiccups are inevitable but the environment seems to provide some margin for error.

Our Position as China Takes the Center of the Global Commercial Stage

I believe that in the next decade or two, much of the best shopping centers in the world will be built in China. The fact that at least a substantial portion of them will be products of Hang Lung is coincidental. The U.S. and European markets are saturated already and their

overall economies are slow at best. Even if someone would try to build, financing will not be easy. Dubai on the other hand has suffered serious economic setbacks in the past year or two. It is doubtful if there will be new malls rising in the near future. After all, a huge one has just opened and business is not spectacular. Most major developers elsewhere are in a similar dilemma.

It takes a fast-growing economy to sustain many new malls. The United States experienced that in the 1960's and 1970's and now it is China's turn. Of all firms we are best positioned to benefit from it. I dare say that we are the only one which has built a successful track record.

Although Jinan Parc 66 will not open until September of next year at the earliest, pre-leasing has been ongoing in earnest. Our reputation for building and managing top-located and best-designed malls has attracted many retailers to sign up for space before construction is completed. This is unusual in the industry. So far over 25% of leasable area has been accounted for and for almost that much have lease deposits been received. It will not surprise me if we reach 70% to 80% by calendar year-end. This shopping center is huge at over 170,000 square meters; it is bigger than any we have done so far. Consequently, success in pre-leasing is particularly pleasing. Initial indication is that rents of similar space is higher than that of Shenyang Palace 66. But because Parc 66 is over 50% larger, overall average unit rent many be similar.

Given the lack of shopping centers of size and quality, and given our uniquely prominent location at the heart of Jinan, Parc 66 should, once open, quickly become an attraction to the entire city. As our only Mainland development designed by a Hong Kong architect, it has already won international recognitions. I am obviously biased but nonetheless think that the design is outstanding.

The shopping center in Shenyang Forum 66 is scheduled to open in 2012. As a level 5 facility after the mode of Shanghai's Plaza 66, it will have many top luxury brands. There will be competition in the city but we should open ahead of all of them. In the past year or two, several developers seem to have slowed construction or have stopped altogether. But for us it has always been full steam ahead. Our location, size, design as well as timing should seal our position as a market leader.

Construction of the first office tower in Shenyang Forum 66 is on hold. City officials will have to sort out the height restriction issue before we can proceed. There are many office projects in the city but we will again likely be the first. We have already completed foundation work and can begin building the superstructure at short notice. Together with our location and design which are frankly the best, we should be very competitive. It will be the most outstanding landmark in Shenyang and indeed in the entire Northeastern China.

Near-term Prospects

For the present fiscal year, rental income in Hong Kong is expected to rise moderately. Neither do I foresee dramatic changes in Shanghai. Retail growth there may slow down a bit but should nevertheless perform acceptably. Office rents will again stagnate although the worst should be behind us.

Despite the fact that Shenyang Palace 66 is fully leased at satisfactory rates, its contribution to the bottom line for the first few years will not be spectacular. Operating expenses are always high relative to rental income and will take time to taper off. That was exactly our experience with the two malls in Shanghai a decade ago.

In the meantime, our marketing campaign in Shenyang will become more focused. We are unquestionably the best shopping center in a district not traditionally frequented by high-end shoppers. Fortuitously, a few new facilities in similar market niches will open around us within the next 14 months or so. Together we will upgrade the entire district. This is another example of how, as I have written two years ago, competition can be helpful. Given smaller size and mediocre design, they will not be a serious threat.

That which will swing the financial results of this fiscal year are again the prospects of selling completed apartments in Hong Kong. Opportunities may come, but no one can be sure at this time. We will as before exercise patience while constantly keeping our antennas up. Once they are here, we will be ready.

Calibrating the Team with High Caliber Individuals

Finally, I need to make an important announcement to all shareholders. Mr. Nelson Yuen, my partner of the past 20 years and our Managing Director for almost that long, retired two weeks ago. He told me 18 years ago when I asked him to move from the Finance Director post to the managing directorship, that he would retire at age 60. This year he turns 60. As I have repeatedly told people inside and outside of the Company, Nelson is one of the key reasons Hang Lung is so successful. His integrity is beyond question; he knows the business intimately; he has the uncanny ability to get to the crux of issues quickly and is an excellent tactician. He is not the most ambitious man I know, but is certainly one of the finest.

I do not want to see Nelson retire, but he will not change his mind. Fortunately the Company is blessed with two things. First, at the Board's invitation, Nelson has agreed to remain as my special adviser. Once his successor is settled in say within six to 12 months, Nelson will rejoin the Board as a Non-Executive Director. As such, his wealth of experience will still be at the disposal of the Company.

We are equally blessed with the appointment of a competent successor to Nelson in the person of Mr. Philip Nan Lok Chen. Nelson, and especially I, have known him for decades. As many of you know, he has had an extraordinarily successful career with The Swire Group which includes Cathay Pacific Airways, Hong Kong's dominant airline. At one point the Chief Executive of Cathay, Philip has had rich and diverse business experiences and knows well mainland China where he has lived and worked for several years. He is affable, highly ethical, and has good judgments. Few Chinese executives in the whole of Hong Kong have enjoyed as excellent a reputation. He has been warmly received by our colleagues and will doubtless fit effortlessly into our culture. Philip took up the post of Managing Director on July 15, the day after Nelson officially retired.

The past year has been a momentous one for Hang Lung and for me personally. It was your Board's unanimous decision to go outside of the Company for a new leader and Philip's appointment was likewise. I firmly believe that we have found a solution that will best ensure continued success. For that I want to thank all members of the Board.

I also understand that it is customary to wish Nelson good health and happiness in retirement. Of course all my best wishes go to him but I will not publicly express them here since he will soon rejoin the Board.

In February, your Directors had elected Mr. Henry Yiu to the main Board. He is in charge of project construction. Henry joined Hang Lung in 1986 and has been responsible for some of our most significant developments. His success in Hong Kong was transplanted to Shanghai and more recently to other cities as well. A solid manager, Henry is professionally competent and company-wise, loyal. I warmly welcome him to the top management.

Mr. Terry Ng, former Executive Director in charge of our leasing business and investor relations has resigned officially on July 21, exactly a week after he and I first spoke about that eventuality. I wish him success in his future endeavors.

Before closing, I should explain why the Board has chosen a new Managing Director not from the property sector. This question was raised by some in Hong Kong. To be sure, real estate is not the most complicated industry. Anyone with business sense, good judgment and managerial skills should be able to do the job. Industry-specific knowledge can easily be learned. After all, the Company is already full of property experts. What we need is a true leader and a strong manager. That beyond doubt is what Philip brings.

Moreover, the Hong Kong real estate sector while sizable in dollar amount is not that big in terms of the pool of top talents. Since we have outperformed every major player over the past decade, logic seems to indicate that we should not look within the circle.

Of all people, I like to think that I know what is required to make Hang Lung an even better company. My assessment is that Philip's skill set dovetails very well. We also want someone who will not only not destroy our

corporate culture but will rather strengthen it. In my opinion and that of the Board, we have found the right person.

As mentioned earlier, this is the 50th year of Hang Lung – my late father Mr. T.H. Chan founded Hang Lung Group, then called Hang Lung Development Company Limited, on September 13, 1960. For the first 32 years, we operated almost exclusively in Hong Kong. 18 years ago we began to have two foci with the addition of Shanghai. In 2005, more cities were added and we began to have many offices. With the inauguration of Shenyang Palace 66 last month, our operation has gone to another level of complication. This progression will continue as we open more facilities in other cities. Before long, we will be a truly national company.

On the one hand, Philip's experience running one of the world's most profitable airlines with dozens of locations, will help us make the transition. On the other, we have been hiring and training executives for each of our departments over the past several years. We have systematically prepared ourselves for the corporate transformation.

During that process, we will return again and again to the basics, that is, to the values and corporate culture that we treasure. Their strengthening will in turn help ensure our continued success. Five years later when Hang Lung turns 55, it will be a very different company. One thing that should remain unchanged is that our loyal shareholders should continue to enjoy satisfactory investment returns.

As we celebrate our jubilee, I can confidently say that a golden era is ahead of us. But for now, it remains my pleasant task to thank all loyal staff of the Company, present and past, who together have made Hang Lung successful.

Ronnie C. Chan
Chairman
Hong Kong, July 28, 2010

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Stable Progress: Positive Trends Amidst Mixed Bag of Results

EXECUTIVE SUMMARY

The mixed bag of results is representative of a market undergoing the uncertainty of an adjustment period resulting from systemic, local, and global influences. The luxury residential market in Hong Kong has once again dipped below levels where we feel it prudent to release completed properties for sale. The resulting fall in profit numbers is reflective of this but mitigated by positive performance in our investment properties on both sides of the border. Luxury commercial developments continue to lead the growth trajectory in our China portfolio. Additionally, the imminent launch of the already fully-leased Jinan Parc 66 development increases expectations of further growth in our retail portfolio. However, changes in the competitive environment in the commercial sector have given us cause to pause our new acquisitions as players escaping the saturated residential market attempt to emulate our well-established business model. This situation has been exacerbated by a central government policy decision to flood the residential market with 10 million subsidized, social housing apartments. Under such circumstances our long-standing policy to ease off acquisitions to allow the market to cool before investing is once again a necessary step for securing future growth. Although previously criticized as inaction, our policy has consistently borne fruit with excellent timing securing acquisitions on the best possible terms, and we are confident that it will do so once again. As we stay true to the reasons for our success, it is apt to note that our steady advancement in the rankings of local property developers over the years is attributable to exactly this strategy, and that what external commentators have called “conservative” is in fact a prudence that has kept us from the damage done to developers who have joined the frenzy of short-lived spikes in market activity. Taking the long-term view has been and remains solidly our business focus, and the intervening period of inactivity is actually far from being inactive but rather preparing the ground for continued growth when market conditions change, through ongoing negotiations for land acquisitions and enhancing our management and corporate structures to be prepared for the changing environment. It is this judicious management of our resources that has seen us build a portfolio to match China’s epic rise as a global economic powerhouse, and which will continue to see us rise above the peaks and troughs of the market to sustainable long-term growth.

Parc 66, Jinan

Because management did not deem market conditions hot enough, we did not sell any completed apartments in Hong Kong. As a result, profit only came from rental which explains the fall. Two years ago we experienced exactly the same. Nevertheless, just like that time, investment properties have performed well with almost all property types in both Hong Kong and the Mainland recording increases at satisfactory levels.

45% of total rent is contributed by the Mainland operation while the rest is from our home market. With the exception of Hong Kong serviced apartments which are insignificant to us, all product types everywhere remained basically full.

Growth rates for rental turnover and profit were very similar to those at mid-year. We received 14% more rents than the year before, with Hong Kong properties coming in at 8% and Mainland properties at 21%. In our home market, both retail and offices turned in a 7% rise while other buildings advanced by 15%.

In Shanghai, the five-star mall Plaza 66 continued a fast pace growth at 28% while the four-star Grand Gateway 66 increased by 13%. From information at hand, it is likely that the same top brands in the former generate at least two to three times more sales than their other stores in the same city. Although office rents received from Plaza 66 went up slightly, competition remains severe. It would be unrealistic to expect meaningful growth say in the next two years. Turnover at Shenyang Palace 66 met the target.

Rental margin in Hong Kong rose to almost 83% while that on the Mainland fell slightly to 80%. The latter was anticipated since the addition of any new facility will have that effect. Profit contribution for the one year old Shenyang Palace 66 was still limited but will improve. This is the nature of the business.

Branding for Burgeoning Chinese Luxury Market

We have changed the name “The Grand Gateway” to “Grand Gateway 66”. In daily usage, it can be simply “Gateway 66”. This is to unify the brand and the logo, for even many Shanghai residents do not know that this popular mall and the legendary Plaza 66 have a common owner. One marvel of goodwill and brand equity is that not only will they not diminish when shared, they in fact grow. As Grand Gateway 66 moves further upscale, the association with what is considered by many to be the most prestigious luxury shopping center in the country can only help.

It is interesting to compare our Shanghai malls with our Hong Kong shops in terms of productivity defined as sales per unit space. On average Plaza 66 is twice as productive as Grand Gateway 66. Whereas our best retail space in Hong Kong (in Mongkok district) is still two times more productive than the average of Plaza 66, the top brands in the latter are in the stratosphere! They can be almost four times more productive than our Hong Kong best and 10 times that of Queensway Plaza, one of our busiest malls in terms of footfall.

Another way to look at Shanghai’s amazing luxury market is that the shopping center at Plaza 66 now generates annual sales which is some 26% more than that of Grand Gateway 66 although the latter has almost twice the leasable space. Yet the higher sales is accomplished by a footfall which on average is only 11% that of the bigger facility. That illustrates how different the clienteles are – one boasts high net worth clients while the other excels in the huge number of shoppers. It is indeed impressive that Grand Gateway 66 now has almost 80 million visitors each year! That may be a record for any mall in Shanghai and perhaps even in the country.

A unique measure used by the Shanghai government to measure commercial activities of a building complex is the tax collected through all activities associated with it. For example, a company with headquarters in one of our office towers will have all the taxes it pays accrued to that complex. Official records show that some RMB 2.4 billion of taxes were paid by our tenants and ourselves at Plaza 66 and over RMB 1.7 billion at Grand Gateway 66. The fact that “we” can generate more than RMB 4 billion of taxes annually from our two Shanghai properties is an astonishment to municipal officials everywhere. Several of them from other cities have told me that they would be pleased if Hang Lung were to build in their city and pay them a fraction of that. Such numbers help build our brand in China.

Upbeat on Prospective Hits and Even Misses

The huge 171,000 square meters shopping center Jinan Parc 66 is fully leased up. We achieved that six months ahead of the August 26, 2011 official opening. Even without factoring in sales rent which for a new facility should be minimal, the initial unleveraged gross return on invested capital will likely exceed all our previous experiences. For reasons explained in detail in my letter to shareholders a year ago, Shenyang Palace 66 barely matched the opening yield of our two Shanghai properties when they hit the market over a decade ago. I would not be surprised if Parc 66 will in the first year do 50% better. I will leave the explanation to after the new mall is opened and after actual numbers are in. Suffice it to say here that with all space leased at pleasing rents, the omen is auspicious indeed.

Some shareholders may remember that we have been working on a site in Changsha for over six years. For tactical reasons, we even announced the possible transaction back in 2006. However, in January this year the piece was auctioned by the municipal government and we lost it. To me it was a disappointing but not necessarily a sad outcome.

First, the winning bid was obviously higher than what we were willing to pay. Another reason was that instead of the plot ratio we discussed with the city, it was eventually raised to a much higher level thus cramming a lot of buildable space onto the limited plot of land. Several office towers and perhaps a hotel will have to be built. The top location notwithstanding, it would have become more difficult to design a world-class complex which could command the highest rent.

The fact that there are three existing high rise residential buildings on the island site is not ideal from a design perspective. However, we would have been willing to live with them if not for another uncertainty relating to the plot. It sits on what was the original city center when Changsha was founded some 2,500 years ago. When its neighboring piece was developed some time ago, many valuable cultural relics were unearthed. It was a lot easier to deal with such an issue then, but not now. So all things considered, we exercised discipline in our bidding. The chapter is now closed.

Commercial Sector Upset from Residential Player Encroachment

This brings me to what I consider the most critical event of the past year. It relates to the serious change in the competitive landscape which I touched upon six months ago. Even more has happened since which may affect our business for years to come. If the change of managing directorship exercised my mind the most a year ago, this new market reality has had the same effect in the past 12 months. The fortunate thing is that my previous problem was most satisfactorily resolved through the coming on board of Mr. Philip Chen. I trust that the present difficulty will also in time be overcome.

Once Philip decided to join, I told him that his most critical task was to buy land on the Mainland. Over a year has passed and my views have evolved. It now seems possible that we may not do that for another year or two. I may be proven wrong (and it will not be the first time) for the market may yet change suddenly. Irrespectively, we will still push ahead on many potential land acquisitions. If we do not, there will be no possibility to conclude transactions once the market becomes favorable again. That was exactly our experience in early 2009 – two plots we had been negotiating for some time suddenly came to fruition once liquidity dried up for our competitors and perhaps also for the sellers, i.e. municipal governments.

In the past I had written about Mainland home builders invading the space of commercial real estate. Many reasons were presented which I will not repeat here. Suffice it to say that a good number of developers have apparently come around to our views regarding the residential sector – volatile markets, lack of recurrent income, government intervention, and high taxes, just to name a few.

It is said that contributing to the shift, albeit in a very small way, is the so called Hang Lung Phenomenon. Many developers on the Mainland have in the past years noticed our achievements and tried to emulate them. Our assessment that few will succeed will not

stop them. Property arms of huge State-Owned Enterprises as well as large non-government owned real estate companies are entering the fray to supplement their residential projects. A few Hong Kong players have recently turned aggressive in the same space thus further crowding the field.

Then came the game changer. In February this year, the central government announced the building of 36 million units of subsidized or social housing for sale or rent over the next five years. In 2011 alone, 10 million apartments must begin construction. After years of managing demand and failing, Beijing now feels obliged to address the supply side as well. It is one thing to provide a massive amount of land for the private sector to build apartments whose sales prices are restricted by land lease from the government; it is quite another for the municipalities to build and sell themselves. Their respective effects on the market are very different.

Even if the government does not accomplish all it sets out to do, there is no denying that to a residential developer, this equates to a serious shrinkage of the pie. In 2010, the entire new stock of commercially built residential units numbered 9.3 million, but next year alone, the government may complete 10 million apartments, 40% of which could be for lease. Given present statistics of slightly over three people to a dwelling, 36 million units in the next five years mean that they will house over 110 million residents. This is some 17% of all city dwellers on the Mainland! No wonder so many home builders are moving into the commercial property sphere.

This will undoubtedly drive up commercial land prices. A country already full of substandard malls and offices will see even more of the same. Many will eventually fail but that will not deter developers. Due partly to their weak financial positions as well as a desire to churn their capital, almost all such buildings will be cut up into small units and sold, often before completion. History everywhere shows that once condominiumized, the condition of such already poorly designed facilities can only quickly deteriorate. China will inevitably become – if it has not already become so – a country of "junk malls" and "junk offices." This is a tremendous waste of resources, land and building materials, and will condemn Chinese cities and their citizens to such "visual pollution".

In a later section, I will discuss Hang Lung's response to this new competitive landscape.

Tactical Currency Acquisitions for Mainland Capital Expenditure

At mid-year, I wrote about two events that took place during the first half of the fiscal year – breaking ground at Dalian Olympia 66 last September and the share placement last November. Rationale for the latter was clearly enunciated and I will not repeat it here. There is however one other development which bears explanation.

Since the rule changed exactly a year ago, we began to accumulate Renminbi. So far we have bought about RMB 20 billion worth. At times we were one of the biggest purchasers in the open market. None of this is for speculation; we never do that. Rather the acquisitions are for capital expenditure needs. In the coming three years, we will spend approximately RMB 15 billion in construction on the Mainland. This does not take into consideration land that we may purchase. Judging from recent transactions, to spend RMB 5 billion in a day for that is rather easy!

Moreover, we always hold on to our completed projects for long-term rent rather than for a quick sale. That means returns will come in slowly though surely. Yet construction must be paid for upfront in sums far exceeding the annual rent intake. This is especially true in the earlier years of a completed complex. So although strictly speaking we do not have a currency mismatch – both outgoings and rents received are in Renminbi – there is a time gap. Consequently, management with blessing from your Board decided to buy now what we need. After all, most people believe that at least in the coming year or so, the chance of that currency going up is greater than the chance of its fall. Interest from Renminbi deposits is also higher than for Hong Kong dollars.

One argument against acting so is that present regulations on the Mainland make transmitting offshore Renminbi onshore difficult if not impossible. But even in the worst case scenario where we have to reconvert Renminbi to Hong Kong dollars before sending into the Mainland, we are still ahead because of the deposit rate differential. What we may gain in currency appreciation will be a side benefit.

This is not to mention our belief that Renminbi deregulation is ongoing. China now has perhaps too much foreign currency and Beijing does not like to see its own rise too fast. Consequently, it is plausible that one day soon, outside companies will be allowed to directly wire in Renminbi. As it so happened, in one of our projects permission to do just that was recently granted. This is not yet a national phenomenon, but that possibility is definitely there.

Successful Management Succession Paves Way for Realignment of Corporate Structures

As I told shareholders when we went through management succession a year ago, the Company was undergoing a major shift. We are moving from a two-city operation to a national one with multiple locations. We were never an operation intensive company, but with the construction of two million square meters of high-end commercial complexes in the coming decade or so, the orientation of management will by necessity change. For years we prided ourselves as being a lean company with one of the highest per staff profits – last year on average each employee contributed about HK$10 million to the bottom line of over HK$23 billion. Now our staff count will increase by 10% to 20% per annum for the coming few years.

The first step to prepare for the change is to find a leader who is strong in operational management. That is the single most critical decision and we are fortunate to have secured the service of Philip. After his first full year as Managing Director, I am pleased to report that we have found the right person.

Philip has quickly picked up the real estate industry specific knowledge which frankly is not difficult. He has worked expeditiously to build out a stronger management team. At the top, so far we have five Executive Directors (ED's) including the Chairman and the Managing Director. Two were promoted internally in 2010 – one before Philip joined and one after.

Of the six original Assistant Directors (AD's), two were elevated as mentioned and one resigned. Adding to the three remaining AD's, three were promoted from within and we hired four from the outside making a total of 10. To round out the leadership team, we need one more ED and candidates are being interviewed. Once appointed, he or she will be the only ED, not counting our Managing Director, who is not "home-grown". Whatever the case, by that time the six ED's plus 10 AD's will together form the very heart of the organization who should be able to continue delivering satisfactory results to shareholders.

As reported in previous letters to shareholders, we have been hiring many senior managers and managers to meet the varied needs of the expanding business. Like ED's and AD's, they are all stock option holders of the Company. We started with 38 when we first bought land outside of Shanghai in early 2005; now the number stands at 98. I present a few statistics just to give some indication of what changes have taken place. Beyond mere numbers, much is being done to shape and coalesce the team to make it even more effective.

Management system wise, many improvements and adjustments are being made. Weaknesses have been identified and measures to augment or even alter have been put in place or set in motion. For example, we now have – or in some cases, soon will have – better systems in internal auditing, budgeting and review, IT, and corporate communications, just to name a few. In many respects, we are now a better company than we were a year ago.

With a new leader, we also benefit from a set of unbiased eyes. Things that have always been may need reexamination. Questioning long traditions and challenging existing concepts, precepts and procedures

can bring desirable changes. All in all, Philip's many contributions are already bearing tangible fruits. Much more needs to be done and we will take advantage of the next year or two to complete the tasks.

I recognize that management issues are not of immediate concern to many investors. Rather, one could not but notice that in the past, every time we bought land on the Mainland, our share price went up. However, we will never pander to such short-term desires of some. We are here to maximize sustainable, longer-term, risk-adjusted returns to shareholders. With that objective, all management improvements make sense.

Some may even sell our shares upon hearing my assessment that the likelihood of land acquisition is not high for the next year or two. My response is of course: go right ahead. We cannot stop such action anyway. However, we really do not mind because when our share price reaches certain lower limits, our parent Hang Lung Group always buys. In fact, in recent months it started to do just that as evidenced in a public filing.

Staying True to the Reasons for Our Success Amidst Spike in Competition

To know how to respond to the new competitive environment, we need to learn from history. A good place to begin is 14 years ago at the onset of the Asian Financial Crisis which coincided with Hong Kong's return to her motherland.

If one were to use 2010 year-end share prices of all major publicly listed local Hong Kong property companies and work backwards for four to 14 years inclusive, our total return (share price performance plus dividend paid) or that of our parent Hang Lung Group has been the best in all but one year. That time we came in a close second. (In the past three years, we have done acceptably though not as stellarly as a few others.) It's even more impressive if one uses the market peak of 1997 say June 30 as a base and moves forward until June 30 this year. In all but one year, your Company has been the top performer in total return. More often than not, Hang Lung Group came in second. We achieved all this while already being among the biggest players.

The question is: how did we achieve that? The answer should shed light on the path forward. A critical success factor is I believe our timing the market as well as anyone. In fact we are religious in acting only according to what the market tells us. If you will, we respect the market more than most if not all – we only buy when we think the market is down and we only sell when we think the market is high. Yes, a year ago I wrote that unlike many of our competitors, the Hang Lung way to grow and so being our corporate mindset is always to rely on know-how, experience and hard work. We do not merely count on price movements to make money. That is true, but it is also true that we time the market and time it well. Our past shows that we are extraordinarily disciplined about it. Consider the following historic fact which even the most sophisticated of our investors may find surprising.

In the past 20 years, our ability to deliberately stay out of the market was uncanny. (For ease of communication, all the dates presented below are approximations.) For the three years between 1992 and 1994, we purchased many properties in Hong Kong and Shanghai. As our home market heated up ahead of the City's return to China, we for the next four years from 1995 to 1998 refrained from buying. That was one of several ways we prepared ourselves so well ahead of the Asian Financial Crisis. (In the past, I had written this to shareholders in some detail.) Even after the trouble started in July 1997, we still kept ourselves away for another 21 months. Once the time we deemed appropriate arrived, we acquired land. We did it in the absence of competition throughout 1999 and 2000. Then we stopped for another four years from 2001 to 2004. Between 2005 and 2006, we quietly snapped up large tracts of top-located commercial land in second-tier Mainland cities when no one was looking. When that market heated up, we stopped for two years. That was in 2007 and 2008. As I often say, thank God for the global economic tsunami which began in 2008. It provided us with an excellent opportunity to acquire land in 2009. From the last purchase made in May that year, it has now been another two plus years in which we bought nothing.

It is highly doubtful that there is another real estate company anywhere that is like us – buying for three years, stopping for four years, buying for two, stopping for four, buying for two, stopping for two, buying for one and having stopped again now for over two years. As I have said to some institutional investors, many years shareholders pay me a salary for doing nothing – in terms of not acquiring new material for our business. But it is precisely by knowing when not to buy that one will know when to buy. It is after all not the acquisition of land that brings shareholders return; it is purchasing the right plot at the right time and at the right price that matters.

We do not only time our market entrance, i.e. acquisitions, we also time our market exits, i.e. when to sell. Those familiar with our history know that in the market peak of 1997, we parted with certain investment properties at great profit. In more recent years, we have also been known to hold on to our completed Hong Kong apartments selling only at very hot market conditions to maximize profit. So far we have repeatedly called the market correctly.

I firmly believe that it is this disciplined approach to reading the cycles – or respecting the market, if you will – that is a major factor for our past successes. Recognizing the immutable nature of real estate cycles, there is no reason to change. We will continue to do the only sensible thing – buy low and sell high.

It is important to mention here that Hang Lung is in the business for the long term. The industry demands that orientation, for real estate cycles are relatively long. Only with such a mindset will a practitioner allow himself or herself the time to capitalize on market movements. Cycles can bankrupt players, usually those with a short-term outlook, and yet the same cycles are precisely what make others successful.

Because property cycles are in general long, getting them correct or not may not be obvious to all in the short run, but time will surely tell. Similarly, buying land expensively does not necessarily mean that one will lose money, for prices may continue to climb for some time. Nevertheless, the risks that are assumed may not make the acquisition prudent. There will be little or no cushion when prices eventually fall.

There is of course the possibility that since China is on a systemic up swing, even future market corrections may not see property prices fall to one's entry cost. That is however a dangerous assumption. Japan's land prices for example had been basically rising for four decades until 1989. However, there were still sizable fluctuations within that mega growth trend. The early 1970's for example saw property prices drop significantly.

Moreover, China today is very different from Japan of the post-World War II era. The geopolitical condition then was unlike that of nowadays. The present prevailing global economic condition is as well much more complicated and fragile than in the decades past, as "modern finance" continues to wreak havoc on the system. Then somewhat unique to China, these days there are considerable uncertainties within that society which cause serious concerns. All that tends to make cycle amplitudes shorter than before and magnitudes greater than before. If so, then buying opportunities may sooner rather than later appear.

One argument against our not chasing prices is that given Hang Lung's strategy of only buying the best-located commercial land, some such plots will practically be alienated from us forever. My answer is as follows: the consequences of being stuck with expensive land are far worse than missing a few good pieces. After all, China is huge with many economically dynamic cities in which we can play. Moreover, by keeping our powder dry, we should be able to purchase much more when the market falls. That was the case in Hong Kong in 1999-2000 and on the Mainland in 2009.

As all experienced business executives know, some mistakes are especially expensive and must be avoided at all costs. Since land is such a major element in the real estate business, its prudent acquisition can make or break a company. History is full of such incidents, and we in Hong Kong should know it particularly well. Even if a firm is not broken, its future prospects can be seriously dampened. Let me illustrate by drawing from Hang Lung's past.

Throughout the 1960's, we were perhaps the fastest growing real estate company in Hong Kong. By some measures, we might even have been the second largest by the middle of the decade. Yet we totally misread the market in the 1970's. When buying land aggressively was the right thing to do, we did almost nothing. By 1981-1982, management tried to catch up and bought much land only to be caught out by the precipitous fall of 1983-1984. Like anyone who has survived an ordeal with extreme difficulties – such as reaching the brink of bankruptcy – we were psychologically unprepared if not financially unable to grab opportunities that accompanied market recovery starting in mid-1980's. Thus we missed the 20 golden years of Hong Kong real estate. We fell from being one of the largest in the 1960's to an also-ran when I took over the Company in 1991.

What has happened since makes for a meaningful case study and it encourages us to stay the course in face of today's new competitive landscape.

Steady Climb Speaks for Consistency of Management Policies

Using year-end share prices for market capitalization calculations and starting in 1994 with Hong Kong's nine largest listed property counters – that year Hang Lung Group ranked number 10 – your Company has advanced consistently. Properly timing the market is again a key success factor. Before 1997, we were basically the eighth in market size. Between 1997 and 1999, we were number seven. Then for six years we occupied the sixth spot. In 2006 we rose to number five, in 2007 to number four and since 2008 to number three until the last week of 2010. (A company overtook us at 2010 year-end.)

Comparing ourselves to the three largest property players of the 1990's also yields interesting findings. The biggest distance between us and each of them came in 1999/2000. At that point, the investing public apparently began to recognize our series of correct decisions in the previous decade. Since then, the gaps between us have consistently narrowed. Whereas they were respectively 12 times, 10 times and 4.5 times our size then, now they are 1.7 times, 2 times and 0.7 times our size. All three of them have grown nicely since 2000, but we have grown much faster. Putting it in graphic terms, our growth curve was far steeper.

Will the gap with the two players consistently larger than us continue to shrink? It will depend on how steep our growth curves are. What will also make a real difference is if one makes a serious blunder. The law of compounding dictates that to then catch up will be doubly difficult. But even without major mistakes, the gradient of the curve is significant. It seems innocuous enough but if the differential between two players is wide yet the gradient is consistently in favor of the smaller one, then over time the gap will close, as illustrated by our past experience.

To have a steadily steeper climb, one must do the right thing at all times. Buying land at high prices may flatten the curve. This is why we unlike certain competitors do not chase prices. They may well make money but we prefer to wait for better opportunities. Cycles are inevitable and we keep our nerves steady. We try not to jump the market prematurely. The patient will in the end win.

To be sure, the mindset of your management is never to compete with other players. We only respond to the market and not so much to what others may or may not be doing. Strive to always do the right thing vis-à-vis the market and it will eventually reward you. Our history of catching up in the past two decades attests to that.

Neither Conservative nor Reckless, but Consistently Judicious

I suspect that many people conceptually agree with our modus operandi. However, how few there are who actually practice it! And the fewer there are who do, the tougher it is to stick to it. It is a lonely road. Unspokenly, almost all of us like to follow the crowd; it is uncomfortable to be different.

There will also be many controversial views from the investing public. One who dares to practice what we do is liable of being accused of many things, the most benign of which will be to have missed opportunities. That we are accustomed to hearing. From 1995 to mid-1997, many international institutional investors faulted us for being conservative. Eventually, one of the world's biggest investment management companies told people that I was plain lazy. But lazy we were not, for to not act (such as not buying land) can be – and in our case, is – in itself a most deliberate act! It is not brainless inaction; it is a calculated course of action.

It turned out that back in 1995 to mid-1997, we in fact did a lot. The only thing we did not do was to buy land. Instead we sold matured investment properties; we traded shorter dated debt with longer ones; and we tapped the capital market to raise equity. All such actions went unnoticed; instead, many derided us for not acquiring land like our competitors. Our share price suffered and we became the laughing-stock of the market – until the Asian Financial Crisis struck. All contempt ceased, and your management alone, it seemed, was smiling. By and by, we were joined by a few shrewd investors who stealthily collected our shares. We in turn ended up purchasing some of Hong Kong's best pieces of land for a song. Eventually these shareholders of ours made a lot of money and so did we. Even today we are still benefitting from the aftermath.

With hindsight, the Asian Financial Crisis gave us our biggest break; it was a turning point for our shares which have not looked back. The global economic tsunami of 2008 and 2009 provided us with a similar, albeit smaller, opportunity to buy Mainland land on the cheap. We should have been able to win much bigger but as I have explained before, a tactical decision on the part of the Chinese government prevented us. There is no doubt in my mind that in time, other opportunities will arise. We just have to be patient.

Some say that Hang Lung's strategy is countercyclical. I only agree to some extent, for there are times that we must go with the flow. For example, whereas we may hold back for some time from selling Hong Kong apartments, sooner or later we will join the crowd. Once the crescendo created by the competitors is loud enough, we will strike. It is just that we usually catch the apex of a trend, i.e. the end of an up cycle. As such, our courtship with the crowd is by definition short-lived. Most of the time the market does not even notice us. So be it, for we are happy to take our money and once again disappear from public sight. Back at home, preparation begins for the next assault, the timing of which we will not know beforehand. To the outside world, we do nothing again. We simply wait.

The fact is that it takes a lot to wait. Perhaps more courage is required for that than for action. Having a lot of cash on hand like we do is an easy way to make mistakes. Few can withstand the temptation, for it is all too easy for itchy hands to buy. Imagine what it is like to sit on your hands for four years. Our supporters say that it takes courage and self confidence which can only come through conviction. The truth however is that we can never have enough conviction, for who but God knows about tomorrow! In fact, your management is full of self doubt rather than self confidence. We constantly debate internally if the external environment might not have changed so much that it calls for a different path. We engage our Non-Executive Directors in dialog, especially those who have operated on mainland China. We strive to understand the many factors inside and outside of China which may alter the face of the country or of our industry.

As I sometimes think, I am neither the CEO, CFO, CRO (risk), CTO (technology) nor CMO (marketing) of the company but the CPO or Chief Political Officer. Here there are no experts; frankly there can be none. We can only do our best drawing upon observations, experiences and analyses and hope that we get it right. China is not exactly a purely market driven economy. Policy changes can come swiftly and unannounced. In face of such an environment, we all must be humble. There is no courage to speak of. We are driven as much by the fear of mistakes and failures as by the desire to succeed.

Realizing Hang Lung: Sustained Prosperity

From the outside, we look good – we have done well in the past two decades. Today we are sitting on a commercial land portfolio that is perhaps second to none – some of the best pieces at the lowest unit cost. What is the real price of that? A tormented management which is full of self doubt. The environment is changing too fast for comfort. At the end, all we can rely on is our reading of human nature. As long as that does not change – and it cannot change – then whether in economics or politics, there will be cycles. For it is human nature – particularly greed and fear – which makes waves and cycles in the world. That is the ultimate conviction that we have. We do not only deem ourselves insignificant when confronting the market, even more so we consider ourselves helpless in face of human nature. Never fight the market or human nature; just try to understand them and go along with them. In the long run, only such will win, and only such will survive. I trust that Hang Lung will be one of them. After all, our Company name in Chinese means "sustained prosperity". May it be so!

From the perspective of catching cycles, an individual practitioner may only encounter six or seven sizable ones in one's entire career. Get those right and one will be highly successful. The rest of the time is mainly a waiting game. Those who are too smart and frequently jump in and out of the market will run the risk of being whacked by it. History tends to prove that it is far wiser to only try to capture the big movements. This is not unlike surfing – much of the time is spent paddling against the tide and waiting for the big wave. Surfing every little one may cause you to miss the mega one. And at Hang Lung, we are patient and go for the kill. For the past 20 years, we have done it well and it is truly fun.

Perceived as Inaction but in Reality Working Hard to Build the Future

While waiting, there is much that we should do; necessary activities fall into two categories. The first is to improve every aspect of management which will enable us to capitalize on the land that we have already purchased. The benefit will go beyond just the projects on hand. The second is to press ahead with land acquisition. It is useful to examine here the prevailing market environment and how we should respond to it.

Outside of Shanghai, so far we are expending about HK$50 billion to build seven projects (including Shenyang Palace 66). Financially speaking we can double that investment amount and still be quite comfortable. However, given the latest market conditions, an equal sum will likely buy a lot less buildable space than we were able to between 2005 and 2009. The relocation of existing tenants which is by far the biggest part of land price has escalated substantially. A plot of land with less buildable square footage than Shenyang Forum 66 can easily cost much more than the total land price we paid for the seven projects on hand. Given the magnitude of infrastructure works in the country, construction costs can also only move up. Thus the trend towards much more expensive developments now seems inevitable.

While we adjust mentally to this new reality, two issues should be kept in mind. The first is that China is not a monolithic place and huge differences exist from city to city. That gives us hope that we may be able to find superb pieces of land at acceptable prices. The second is that the Chinese economy will increasingly rely on domestic consumption as a growth engine (along with exports and public investments mainly in the form of infrastructure developments). As Premier WEN Jiabao told the nation earlier this year, the average salary will increase by at least 13% per annum for the coming few years. Disposable income especially of city dwellers can only rise rapidly and citizens are encouraged to spend. For us, this should somehow compensate for the higher costs of new projects and hopefully still gives us a healthy return on investments.

After much study, we have come to the conclusion that our Mainland strategy of the past two decades should still be the winning formula for the coming many years. What may need adjustment in response to periodic changes to the market is our tactic. That we will do. In fact we are already experimenting with a few models and I am hopeful that some pleasing results will follow.

Systemic Uncertainty at Home and Abroad Calls for Prudence

There is no denying that in the past year we have turned even more cautious. Besides changes in the Mainland competitive environment as described earlier, there are other reasons to slow down land acquisition in the near term. In recent years, there have been social developments which have become increasingly worrisome. Anything can happen which means that there are considerable uncertainties in the system. So when in doubt, it is better to wait. That may just be simple prudence. Let us hope that nothing untoward will happen, but if it does, we will not be stuck with expensive land. Prices will likely fall and we should be able to pick up some good pieces on the cheap.

Both the domestic and international economies leave much to be desired. Continued weakness in the U.S. and Europe will sooner or later affect China's exports. Within its own border, inflation has been rampant; official figures do not begin to tell the true picture. The rise in the price of food stuff is particularly alarming. Like everywhere else, economic woes have a way of being translated into societal troubles. The ubiquity of technology will almost ensure contagion. All these seem to indicate that the risks today may be greater than the potential reward.

There are also industry specific concerns. For years now the central government and the developers have had very different opinions regarding the effects of government regulations on the real estate market. So far the latter seem to have had the upper hand in that prices have continued to climb. However, societal voices of discontent on high prices together with serious inflation are forcing the powers that be to take increasingly stronger measures. A clear proof is the social housing scheme mentioned earlier. Unless there are drastic new developments, we do not see how the government will lightly let up the pressure, for stable prices are critical to maintaining the all important social harmony. Two things then may happen to the property market.

In the 14 months prior to this May, 23 Mainland developers alone borrowed over HK$120 billion from the debt market in Hong Kong. Two-thirds are for five years or shorter and some as high as 14% per annum interest rates. This is but one source of debt creation and these borrowers are usually stronger companies since they are publicly listed and are regional if not national players. Many more local operators are struggling for funding at costs that are not sustainable, and frankly usurious. Sooner or later some of these will be bought while others may be allowed to go bankrupt. The latter, especially if there is contagion, will have ripple effects on the entire industry. If so, then I wonder if this is the right time to acquire land.

The other scenario is less dramatic in the short run and will take some time to play out. Namely no firm goes bankrupt or if some do, contagion is contained. Then some of these surviving residential developers will speed up their migration to the commercial side thus intensifying competition in that arena. In some cities, a period of Warring States, to borrow a term from Chinese history, will ensue.

While most of the participants will operate in the space of lower end smaller projects, enough of them, including many subsidiaries of State-Owned Enterprises, will play in our league – higher end large facilities in major cities. Whether big or small, there will be severe competition in certain cities. Eventually the weaker ones will be forced out and the sector will consolidate with a smaller number of stronger players remaining.

The Established Strength to Succeed in Shifting Scenarios

The determining factors for the battle will be financial strength as well as industry knowhow comprising knowledge and experience. We are certainly among the strongest in all these areas.

Due to the size of the country – almost 200 municipalities with a population of over one million – huge differences exist between them in terms of the degree of development in commercial real estate. We still find excellent metropolises which are for various

reasons overlooked by competitors. We will try to buy land there. Frankly the number of cities with reasonably designed and built complexes is very limited, and fewer yet have severe competition.

Among the hotly contested markets, Shenyang may be the worst. To be sure, we were among the first to buy top commercial land there but thereafter, local officials sold much more to those who cared to follow in our footsteps. Nevertheless, this will not be the first time that we face competition. When Grand Gateway 66 opened in Xuhui District in Shanghai a little over a decade ago, there were already five or six shopping centers or department stores of size in the immediate neighborhood. The fight was so fierce that one of them which had many locations across the nation threatened their tenants not to open in our facility. But in a few short years, by sheer superiority in product, i.e. design and size, and management, we beat back all competitors. Now players can be divided into two categories – the winners and the losers. There are two in the former group with Grand Gateway 66 being the clear leader.

In all five cities where we have projects under construction – Shenyang, Jinan, Wuxi, Tianjin and Dalian – there is little doubt that we will be an ultimate winner. The only question is how big our win will be. In Shanghai, the score has been settled; it is frankly difficult to find a similar complex which yields half of our annual unleveraged return of about 35% and rising. Similarly in the other cities, our locations are among the very best yet our land costs are a fraction of what they would fetch today. Admittedly our construction is more expensive because we do not sell and are very conscientious about sustainability issues. All things considered, we believe that we should have a healthy return on investments.

A Portfolio to Match China's Emergence as a Global Economic Powerhouse

By the time we complete all our Mainland rental properties of almost 2.7 million square meters (with Hang Lung Group owning another about 150,000 square meters in Grand Gateway 66), the portfolio can only be described as awesome. It should be among the highest yielding of anyone in China. We will be a prime beneficiary of the country's march towards becoming a global economic powerhouse.

While challenges will abound in the process of building out the remaining six projects (not counting Shenyang Palace 66), we may periodically benefit from some tailwind as the government continues to encourage domestic consumption. An earlier event may be the lowering of import duties for luxury goods. Right now approximately 56% of all such purchases are made outside of the Mainland and why should the country drive its citizens overseas to buy? Today a dominant language spoken in stores such as Louis Vuitton and Chanel in Hong Kong, Paris or New York City is already Mandarin Chinese.

There may come a time when such import duties collected by China will not be worth the sales tax lost. When that happens, we will be a key beneficiary. There are other potentially pleasing developments of which we are less sure. One relates to how land is sold by Mainland municipalities. In the 1990's, it was done in a most unregulated fashion. As a result, corruption abounded. (That was one of two main reasons why in 1992 we bought in Shanghai and not in certain other cities. It was then the cleanest major market. The other reason is our positive assessment of the city's economic prospect.)

Then Premier ZHU Rongji was forced to step in and regulated the land sales procedure. In a word, price is all that matters – the highest bidder wins. That was a welcome development for it leveled the playing field for honest players like ourselves. But after practicing this for some years, a serious flaw began to surface. A developer with a total disregard for the environment or little experience in low-carbon projects can beat someone like us if they are willing to pay a dollar more. All things being equal, such a company will always win because their construction will be cheaper, not being burdened by sustainability related expenses. That means all our experience and extra efforts in this regard are not worth a dollar. This is obviously not reasonable.

Take another example which is less quantitative in nature. Each of our new Mainland projects has received design awards by reputable international organizations. Both the exteriors and interiors are aesthetically pleasing while maintaining excellent functionality. This is in stark contrast to many of our competitors especially those from within the Mainland. What value, if any, is attached to the superior design which usually costs more money and time? The answer is: none. Frankly such land policies not only do not encourage sustainable development and excellent design; they plainly discourage them. Disincentives for good behavior must stop. Given how keen the Chinese government at least at senior levels is to protect the environment (although there are many constraints in implementation), it is possible that new directives from the top may soon be introduced. Indeed some city leaders are beginning to recognize the problem and are taking steps to address it. Technically, such issues should be able to be satisfactorily resolved while balancing the needs for financial fairness and corruption prevention. This trend should be welcomed by quality developers like ourselves. Our hope is that changes will come sooner rather than later. Two years ago I analyzed our recent 20 year history and divided it into three phases of seven years each – Preparatory, Catch Up and Take Off. I further anticipated that beginning around 2012, we may well enter into a golden era. We will harvest the good efforts since 2005 when we ventured into cities beyond Hong Kong and Shanghai. My confidence was based on five factors – an experienced team, the brand equity of the Hang Lung name especially on the Mainland, an unmatched track record in Shanghai, an extraordinarily strong balance sheet, and the superb pieces of land acquired between 2005 and 2009. The first four factors will enable us to capitalize on the last thus delivering pleasing financial results. These have also laid a solid foundation for us to succeed beyond the land that we have already purchased.

Prudent Planning Prepares Us to Ride Above the Peaks and Troughs

Looking back over the past two decades, it is abundantly clear that nothing goes in a straight line. Market fluctuations abound and one must react prudently to both peaks and troughs in order to win. So as the fourth seven-year period is about to dawn upon us, we apparently find ourselves in yet another tough market condition – not in terms of fallen prices but in the abundance of uncertainties. Such uncertainties come in three levels – societal, economical and industry-specific, as I have to varying degrees written above.

It is obviously not up to us what the environment will be when we begin our next phase of seven years. But if we are at all worthy of shareholders' confidence, then we should know how to act in different kinds of market conditions. I trust that our past has prepared us well for the future. As long as China's economy does not enter into a prolonged period of serious difficulties, we should thrive. But if it does, then we will assess how long it will take for the economy to recover. Whether long or short, in time there will be plenty of good opportunities to buy land for further developments. Speaking selfishly, an economic downturn would not be a bad outcome for our shareholders.

Returning to the immediate term, it is unclear whether we will be able to sell completed apartments in Hong Kong this fiscal year. Even if not, increases in rental income should yield a healthy growth in profit. As the market in Shanghai gradually matures, it is likely that things will slow down a little, but the addition of Shenyang Palace 66 and Jinan Parc 66 will greatly help the top line. In time, the bottom line will follow.

Ronnie C. Chan
Chairman
Hong Kong, July 29, 2011

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Position Strengthens: Competition Eases Favoring the Prudent

EXECUTIVE SUMMARY

In the current six-month reporting period, we have again proved that a stern refusal to follow competitors into markets that are spiraling in either direction is not conservative slanted inaction but the most prudent form of action we could take. Our position is strengthened while competition thins due to the collective imagination's stress on the need for constant action without forethought. As a result, a prime plot of land in Kunming that we have been engaged in negotiations to acquire for several years is now ours at a reasonable cost, as competing bids all but evaporated. This has been the strategy that has enabled us to build our Mainland portfolio on our terms to the grand stature it has obtained today. We will continue to track this path of growth using the same strategic principles, which are founded on integrity, quality, sound management, and adhering to the basic tenets of our industry without being distracted by the fray. Even as regulatory requirements extend our general policy of focusing on commercial properties into the realm of mixed developments, we will apply the same strategic rigor in discerning the best course of action to maximize the potential of new office and residential components. In the context of stable growth prospects in our markets, to achieve our long-term goals, we will maintain the fiscal prudence required to complete our existing developments in the time and to the quality that our principles demand. And as our operations expand to include a greater focus on property management, so will we continue to enhance our strategic capabilities to meet those needs.

Spring City 66, Kunming

The law in mainland China dictates that all limited liability companies have the calendar year end as financial year end. Since the majority of our new projects of the past decade are on the Mainland, resulting in an increasing percentage of our business there, it makes eminent sense to change our financial year-end date from June 30 to December 31. It will eliminate much unnecessary accounting translations and administrative work which are tedious and costly. As such, this report can be considered the financial year end of 2011 although it only covers a six-month period.

After a considerable time of managing down Mainland residential prices by the central government employing many market and administrative measures, transaction volume finally shrank around August. Soon thereafter, prices began to fall. By the fourth quarter of last year, many real estate companies – not only the smaller players but also some major ones – were experiencing financial difficulties. We were expecting this development but it came perhaps earlier than we would have thought.

We were nevertheless pleased, for once again we were in a great financial state as the bear market descended upon us. We were, and probably still are, financially speaking one of the strongest real estate companies anywhere. When we placed shares and raised HK$11 billion in November 2010, there were plenty of skeptics. Being already cash rich, why do you need more, they sneered. Anyone who asked such a question was obviously not a real estate professional, at least not a good one. One should know that the bear will sooner or later return and we want to be prepared to buy land on the cheap. Having more money on hand will give us a psychological edge as we go to bid.

Moreover, even if we do not add to our land bank, construction costs from existing projects in the coming years will not be inconsequential. The fact that today we have less net cash than the amount raised 14 months ago, means that without that exercise, we would already be in a net debt position. Yet we may be at the cusp of another round of good land purchase opportunities.

Reaping the Fruits of Tenacity in Kunming

We began to do exactly that. In late September, we bought one of the best-located plots in Kunming, the biggest city in the southwest. When it was first put up for auction in June, four local and two overseas firms including ourselves signed up for the fight. Frankly we did not think that we could win, for we never won when there was serious competition. Fortunately for technical reasons the municipal government canceled the auction before it began. By the end of September when the piece was again made available, all the local players were gone. The market had begun to fall and financing became tight. Only a Singaporean entity and ourselves were left in the fray. With that, we knew that we had a fair chance although the eventual deal, if won, would not be a steal. If the auction had been held several months later, the only other bidder might have disappeared as well thus yielding an even better deal. But the timing was not up to us; the government which owned the land dictated it.

One attraction of this tract is that it does not have a land clearance risk. It was home to the municipal government which had already relocated. Moreover, we know the plot well; we have been eyeing it for many years. In fact about two years ago, your Board met in Kunming and I had shown it to the Directors. Such a gem in an economically exciting city like Kunming would have forever been alienated from us if we had not gotten it at that time. So we bid and we won, at a price which was quite acceptable.

Some shareholders may not be familiar with Kunming. First, it is the economic center of the southwestern part of the country. Just as Shenyang is the most significant city in the northeast, Kunming occupies that position in the southwest. The strategic significance of its location cannot be overstated. To keep a friendly relationship with Southeast Asian nations is politically and economically critical to China. Trade with neighboring countries is growing very fast. In the not too distant future, one can drive a car or take a train from Singapore to Amsterdam and the first major city within China's border is Kunming. It is truly an important gateway city.

Besides being a rail and highway crossroads, Kunming is also an air hub. It already has the seventh busiest airport in the country. Once the new airport is opened later this year, it will likely become the fourth. It is said that Kunming has been designated by the central government as one of four major international air transport gateway cities of China, with the other three being Beijing, Shanghai and Guangzhou.

Kunming is unique among major Chinese cities in that the weather is mild. From time immemorial, it has been called the Spring City where flowers bloom year round. That makes it a vibrant tourist destination and a choice location for second homes for the well-to-do.

Kunming is the capital of Yunnan Province. Due to the weather and geological formation, its biodiversity is unmatched. 53% of the country's fauna and 48% of the flora can be found in this region. As a result, certain industries and research institutions like to be located there. It is also one of the provinces which have the highest percentage of ethnic minorities who historically have lived peacefully with each other.

When all is said and done, everything must be translated into dollars and cents. The price we paid was quite acceptable. Compared to the land underneath Palace 66 in Shenyang purchased six years ago that was at its time the most expensive purchase we ever made on the Mainland, the unit cost is now 20% higher. In the past six years, land value, inflation, retail sales volume as well as rental have all risen sharply. In that light, the price we now pay is reasonable.

Our price is HK$4.3 billion and the piece has an allowable buildable space of about 430,000 square meters including the basement. Estimated total investment is around HK$12.5 billion.

Preliminary plans call for a sizable mall, at least one office tower, and 60,000 square meters of residential blocks. The rest of the space can be offices and/or hotels. At present, we are conducting an international architectural competition. Every commercial complex we build is a piece of public art which combines aesthetics and functionality, and it should be the same in Kunming. We are confident that the financial return from the project should be quite pleasing.

Many investors over the years have wondered why Hang Lung only built in coastal cities. Now they may well ask, why finally in the inland with Kunming. The fact is that back in the early 2000's when we began to look outside of Shanghai, we did not discriminate against municipalities away from the ocean. It was just that opening and reform first took place along the eastern seaboard. At that time, mayors and other leaders there were not only better educated but also much more open-minded. As a result, it was easier to negotiate and to consummate transactions. In fact, for almost a decade we never stopped searching in the central and western parts of the country. Fortunately, over the past several years we have detected a gradual upgrade of the caliber of city leaders in major cities in western China. As they gained experience in dealing with outside investors like us, conditions for doing business have improved. Some officials in the middle part of the country are still somewhat behind but it is only a matter of time that the situation will change. We welcome that development.

Differing Degrees of the Same Success in our Operational Portfolio

In Shanghai we detected a weakening of retail sales. As a result, growth in rent, while continuing, has slowed. Office rental has improved somewhat. Margins remain high and again we are basically fully occupied. The mall in Plaza 66 has seen several major tenants expanding their shops, so some space is temporarily taken out of the market.

Turnover in Shenyang Palace 66 grew by 15%. Rental margin as well as operating profit have both improved. Occupancy is at 94% and newly signed unit rents are on average 10% better than previous ones. That shows that tenants are confident for the days ahead. All that was achieved in very tough and unfortunate circumstances. The three better sides of this island site were all but closed off to traffic for many months: two sides were due to underground road work and the third borders on a new construction site. We became almost totally inaccessible to pedestrian traffic. Fortunately the more serious of these problems are now resolved and we can look forward to further improvements.

Parc 66 in Jinan is clearly a success story. We expect a first year unleveraged gross rental return of approximately 7%. This far exceeds our initial hurdle of 4%. As rental margin continues to rise, the bottom line will look even better in the coming year.

I will not be too surprised if Forum 66 in Shenyang is similarly successful. We are already 70% leased up with deposits received for a majority of them. (There is a slight time gap between signing up and the first payment of deposits.) Many of the tenants are top-tier global brand names. Contracted rents should yield investment return numbers that are much more akin to Parc 66 than to Palace 66. We expect to open the shopping center in late September this year, the low-zone of the first office tower next year, and the high-zone the year thereafter.

Hong Kong Rents Remain Steady and All Properties are Basically Fully Occupied

We only sold two units at The HarbourSide in the past six months. Unit price was however much higher than what we had achieved before. Once again, we mainly relied on rental income which performed well. Turnover increased 14% with Hong Kong advancing 7% and the Mainland 23%. This is basically the same as in the previous six months. 48% of total rents received now come from outside of Hong Kong.

Molding Mixed Developments to a Winning Strategy

With the addition of the Kunming site, it may become clear to some shareholders that while continuing to develop stand-alone shopping center projects like Shenyang Palace 66, Jinan Parc 66, Tianjin Riverside 66 and Dalian Olympia 66, we will increasingly take on mixed-use projects. This is nothing new to us, for our first two efforts in Shanghai, Plaza 66 and Grand Gateway 66, are both of that class, as are Shenyang Forum 66 and Wuxi Center 66. What was never discussed in my previous letters is how to treat their residential elements.

Approximately half of China's vast population are now city dwellers, more so than at any time in the long history of the country. The magnitude and speed of urbanization of the past two decades were the biggest and fastest that mankind has ever seen. Yet the process is expected to continue. While new cities are being built, population growth of existing ones will exert tremendous physical and social pressure of all sorts. From a land utilization perspective, building upward becomes inevitable. This is in fact not bad for if done right like in Hong Kong, it can be very energy efficient.

On the part of municipal leaders, because public finance relies so much on land sales, having a higher plot ratio (i.e. allowable buildable space as a multiple of the size of the land) will yield more money. Consequently, there are multiple reasons why they like to see mixed-use projects encompassing many skyscrapers. Experiences in many Asian cities show that residents get used to them and in fact often prefer them.

All that means that for our future, finding land for standalone malls like Palace 66 or Parc 66 will become the exception rather than the rule. There are many reasons why we do not mind this. With mixed-use projects which are by definition large in total buildable area, the land cost will of necessity be high. That cuts out the smaller developers. In other words, such plots when sold will attract fewer competitors, for few developers will have the financial strength like us to play.

Some of these mixed-use projects will only entail retail space and offices like Plaza 66 in Shanghai. Others will have added residential blocks like Grand Gateway 66.

As our shareholders know, we have been cautious in developing office towers in many cities. In the U.S., there are about 10 metropolises that have a sizable downtown with numerous high-rise offices. China will for sure have more of such cities, but we should not be blindly optimistic for this product type. And in the cities that we choose to construct them, we must be sure that the location is the best and the product world-class. This is exactly what we have done in Shanghai, what we are doing with Shenyang Forum 66 and Wuxi Center 66, and what we will do in Kunming.

Since we consider hotels a terrible business for the owners and will only do so when constrained by the need of the project, residential units become the only other major product class for us. Our long-term shareholders may remember my past writings explaining why we are not in residential development. We still strongly hold that view in the traditional sense of a home builder – buy large tracks of land and build tens of millions of square meters of apartments. That is a game of size and speed which is not our forte. We only want to compete in quality and in high unit prices.

On mixed-use projects in city centers, the residential element falls squarely on our side. Consider this: what will be the unit price of luxury apartments built on top of or abutting a world-class mall and right next to the city's most prestigious office skyscrapers? The answer is: among the highest in the city. That we do not mind doing, either for rent as serviced apartments or for sale.

Look at it another way. Again as I have previously written, for years we recognized that by developing a city's best shopping center, we are creating tremendous value for the immediate neighborhood and indeed for the entire district. That is in fact a key reason why municipal leaders consider Hang Lung the preferred buyer of their land because the land value surrounding us will inevitably go up. That will bring further income to the city's coffers.

After much internal debate, we have hitherto decided to focus on what we do best, i.e. commercial developments, leaving the added value for others to enjoy. But now, doing mixed-use projects is increasingly becoming the government's stipulation, thus forcing us to take some of those potential values for ourselves. We will be happy to oblige! After all, having more people living right next door to our shopping center will only bring more retail sales. It seems we shall win whichever way we look.

Our question is whether we should sell or rent these apartments. It will depend on the project. Take the case of Grand Gateway 66. Because it is in Shanghai where land of superb location is limited and because we only have 624 units, we will keep them for long-term hold, at least for the foreseeable future. But in the case of Shenyang Forum 66, we may have 300,000 to 400,000 square meters with perhaps over two thousand units, so selling becomes much more likely.

Moreover, whereas top-located residences in cities like Beijing and Shanghai have in recent years witnessed substantial increase in sales price, the rise in secondary cities like Shenyang, Wuxi and Kunming has been more modest. It is quite possible that a sharper rise may be had in the coming years, although it is unlikely that the growth curve will be as steep as in the first-tier cities. For that reason, we have recently reviewed all such projects in our portfolio and are making plans to capitalize on the coming opportunities.

As market conditions warrant, we may have all design work done, government approvals obtained, and in some cases the foundation work completed when we are doing the same for the mall and for the office towers. Then we sit and wait. Once we detect winds of rising residential prices, we can quickly do the superstructure which is not that complicated. In a relatively short period of time, we should be able to hit the market, hopefully catching an updraft.

That we will do. For our shareholders, this initiative should represent a new area of value creation that was hitherto untapped and even unspoken. Yet to your management, it represents something we have always known. In our existing portfolio, we have approximately 500,000 to 600,000 square meters that we can work with. There are as yet many uncertainties affecting our decision on how much and when to build. For example, if demand for offices in one of our cities heats up, we may build more offices and less apartments. The determination can only be made as market conditions evolve.

Shareholders may remember that one reason we previously did not like to build properties for sale was the much higher taxes that such an activity attracts. However, if apartment prices rise substantially resulting in very rich margins, then sharing part of it with the government may still make sense to us. As in our commercial development business, we are not interested in high volume-low margin activities.

Fiscal Prudence Paints Picture of the Future that can Support Strategic Vision

Back in Hong Kong, there are also new developments worth reporting. As I have previously told shareholders, our matured rental properties here can be sold to unlock hidden value because the periodic revaluation of our investment portfolio by third-party professionals is perhaps among the most conservative of our peers. In the past we did not sell because we wanted to first make sure that we knew how to grow the rent roll on the Mainland. Now with our Shenyang and Jinan malls successfully opened and performing well, it is time to seriously look into it. As always, we will be patient and watchful for the right moment in order to maximize profit. After all, we can only sell each property once! We are still in a net cash position and so are not under pressure to act. Frankly that is the only way to part with valuable assets.

Since expanding beyond Shanghai in 2005, we have so far committed about HK$67 billion in projects in six cities. If we were to count the two adjoining plots of land in Wuxi as one, then we have seven projects (with two in Shenyang). Almost all land premiums have been paid for and construction for Shenyang Palace 66 and Jinan Parc 66 has been completed. All other developments, with the exception of Kunming which is in the planning stage, are being built. So far HK$42 billion of construction remains to be paid.

Given the size of Shenyang Forum 66 and Wuxi Center 66 which like Kunming are huge, each of these may take a decade (from land purchase) if not longer to complete. With a total of about 2.9 million square meters to be built (including car parks), finishing them in the next 10 years will mean an average of 290,000 square meters per year. That is equivalent to completing one Empire State Building and more each year for 10 years. Some say that Hang Lung is conservative but that seems quite progressive to me! Financial conservatism which we insist on does not necessarily mean strategic conservatism.

How to maintain fiscal prudence while being strategically aggressive to grasp the best opportunities in a fast expanding market is an interesting question. We do it by honoring the old adage of the real estate industry, namely, insisting to buy-low-sell-high. This is easier said than done. Most players buy high expecting to sell higher. We are not so self-confident to do that, for there is little cushion in case the often fickle market turns south. For the past two decades we have honed our skill in calling market cycles correctly and so far we have done superbly. That, together with our utter respect for the other time honored principle in the industry of "location, location, location" (i.e. buying only the best-located properties), have differentiated us from many of our competitors. It is truly amazing how few developers abide by these two cardinal rules!

Being disciplined to keep to the two adages is however still not sufficient to win in the longer term unless one manages one's finances wisely. That we have done in the past two decades and more. In fact for the last six years, we have had a net cash position. The main reason for this is that we have consistently made correct decisions not only on the Mainland but also in our home market. Our Hong Kong residential developments for sale have by far the lowest cost basis compared to our competitors, and we always time our sales well to maximize profit. It is the cash therefrom that has put us in this enviable financial position and that to a good extent feeds our new Mainland projects.

Some have questioned our financial conservatism and suggest that we return money to shareholders such as in the form of a special cash dividend. For several reasons management should not do that. In fact, I have told those proponents to sell our stock if we do that. Conceptually speaking, we are in a privileged position – having gained experience, and having built a team as well as a brand – to take advantage of one of the biggest commercial opportunities mankind has seen in the beginning part of this century, namely to ride the wave of urbanization and domestic consumption in China. Returning money to shareholders means that management is incapable of converting those opportunities, a great reason to dump our shares!

But there are very practical reasons as well. Some of them were laid out a year ago in my letter to shareholders (i.e. the Interim Report of 2010-2011) where I gave the rationale for the share placement of November 2010. I shall not repeat them here. Suffice it to say that real estate markets in developing economies like China are more often than not volatile. Downward price movements can be sudden and sharp. Having cash on hand is essential to keeping the ship afloat in such an eventuality. Conversely, such bear markets sooner or later present excellent buying opportunities for those who have cash.

Nevertheless, from a capital structure perspective, having net cash consistently is not optimal; that position should be the exception rather than the rule. Leverage should be carefully employed so as to enhance investment return. So with the latest addition of Kunming whose land premium was paid off before calendar (and now also fiscal) year end, we will later this year return to a condition of having a low level of debt. Until we can sell Hong Kong apartments in a meaningful amount, that situation will remain.

Moreover, construction cost in the foreseeable future will be substantial. Unless we have good reasons to slow down progress, otherwise the amount needed in the coming four years will be about HK$27 billion.

To finance this growth, we have as much as HK$20 billion worth of completed or near completed apartments in Hong Kong that can be sold. But in line with our practice to buy-low-sell-high, we will wait for higher prices. Our portfolio is unique among our competitors – almost all units have a view of the harbor which is one of the most beautiful in the world. History shows that it is difficult for such luxury products to fall seriously in value. When market is slow such as in the past two years, transaction volume shrinks but price tends to hold up. Then when times are good, room for price hikes is plentiful. With plenty of potential buyers both locally and from the Mainland, the chance of price appreciation far exceeds that of depreciation. The cost to upkeep the empty units is miniscule compared to the upside potential.

Since the timing of sales is uncertain, we will need alternative funding sources. Placement of shares will be unlikely for the coming few years not only because the stock market may not cooperate, but also for technical reasons. Our parent company Hang Lung Group prefers not to dilute its shareholding in us to below 50%. It did after the last placement in November 2010 and was then by Securities and Futures Ordinance barred from buying our shares for some time.

Moreover, our last issuance of scrips coincided with a peak in our share price. Thereafter, the stock market as a whole including our counter went down. History shows that in all previous share placements of ours, any taker with say a three-year investment horizon is pleased with their decision. For unlike some of our competitors, each issuance was at a price higher than all previous exercises of the same kind. As much as possible, we have all intentions to maintain that tradition. We want our shareholders to be happy with us.

We are thus left with debt financing as the only alternative to fund growth. At present we have bank facilities, drawn or undrawn, of over HK$26 billion. This is roughly matched by about HK$24 billion of cash on hand, mostly kept as RMB deposits.

Our present basic attitude towards bank financing is one of mistrust. We do not like the way global financial markets are developing. There is hardly a bank of size which is not under pressure of one sort or another. At times we are even skeptical about how “committed” is a so-called “committed bank line”. So once such a loan is secured, we unlike in the old days right away draw down. Converting HK dollar loan proceeds to RMB deposits can at times generate an interest income.

Partly due to this mistrust for banks and bank loans, over a year ago we put in place the Medium Term Note (MTN) program so that we as an unrated borrower can tap the bond market if we so choose. Again because of concerns over the financial market, we are only interested in longer dated instruments. Given our financial strength and the fact that we do not now need the funds, the yield we have to pay should be among the lowest in the industry. From this source, we should be able to raise about HK$15 billion.

Mapping Success: From Where We Are to Where We Want To Be

With five sizable projects under construction, we will redouble efforts to ensure their timely completion. Besides maintaining our usual high standard of design and construction, there are areas of project management which can use improvements. We will strive to strengthen property management as well in order to maximize tenant as well as shopper satisfaction. We are also conscientious to enhance our brand equity especially on the Mainland where all of our new businesses are. Already Hang Lung is considered by many there as China's best commercial property developer. A wider acceptance should not hurt and will help us as we later move into new markets.

As to buying more land on the Mainland, it is hard to judge at this stage if there are better opportunities in the coming months. We are rather pleased with our present portfolio and will only add to it if what we consider very attractive deals come along.

The main reason for the present uncertainty is that where the market will go will more than in recent years depend on the central government's actions. Just like in the few years before mid-2008, the government has since the second half of 2009 been attempting to rein in residential prices. Increasingly severe measures finally took hold last August and the plights of local developers became obvious. By the second half of December, however, there seemed to be signs of relaxation as banks began to lend again. Yet since the New Year, top government officials have repeatedly stated that tightening would continue. In other words, signals are mixed.

Nevertheless, what seems likely is that now with the price hike under control and the government preferring to avoid big market swings, things will remain relatively quiet. Transaction volume may recover somewhat but prices may not rise much. That, together with renewed lending from banks, means that most major Mainland developers will survive but with some difficulties. Consequently, their ambition to enter the commercial property market will be put on hold for the time being. This is evidenced by the Kunming land auction mentioned earlier – whereas four Mainland players were among those who signed up to bid last June which contest was later called off, they all disappeared when it eventually went ahead in September.

That is good news for us – if there is any land we want that is up for sale, competition will not be as keen. What we do not know is when municipal governments will be financially desperate enough to sell at prices acceptable to us. That happened in early 2009 and we are hopeful that it will be repeated. However, we are not overly eager for that to happen, for we are a very patient player. Sometimes the longer we wait, the better the price.

Back in Hong Kong, it is doubtful if in the coming months we will be able to sell a lot of apartments at prices we want. That said, we will part with the top-end The HarbourSide units as buyers willing to pay emerge. We saw a few cases in recent months which gave us a profit margin of some 78%. We should not expect that to be the norm.

In our bread and butter business of leasing commercial space, growth in Hong Kong rent for the first half of 2012 should be similar to that of the past six months. For the Mainland market, we have detected a slowdown in domestic consumption. Although slow to be translated to rents received, sooner or later it will, unless sentiments quickly turn to the better. Given dullness in the global and to a lesser extent the Chinese economies, this is unlikely to happen. Rental increase rate should be similar to that of the past six months. Fortunately we will see the opening of Shenyang Forum 66 this September. We expect a first year gross yield on investment of around 6% which will help top line growth.

Taking a longer-term view, our future should be bright indeed. As long as the Mainland economy holds up reasonably, domestic consumption will sooner or later account for a bigger share of the pie. In the U.S., it accounts for over 70% of all economic activities while the number is less than 35% in China. If the latter were to close half of that gap in an ever expanding economy, it will be a bonanza for our mall business.

To put it in numeric terms: if one day the gross yield of the new investments of HK$67 billion approaches what we are receiving today in Shanghai, the annual profit therefrom will be impressive indeed. Some 12 years after opening our two properties in that city, they are annually yielding on an unleveraged basis close to 40%. I believe that this level of return can be repeated. If so, then the mathematics indicates a very promising future as we successfully open new complexes one by one and grow rental. I like to think that few real estate companies anywhere have that level of certainty or of magnitude, in sustained profit growth.

Enhancing Our Strategic Capacities for New Demands

To execute our strategy, property management is a critical element. I am pleased to report that we have employed a seasoned executive Ms. Prudence Chan to head that activity. Although not an Executive Director of the main Board, this is a Director grade hire. She will report directly to our Managing Director Mr. Philip Chen.

It is my belief that our entire Board including the Non-Executive Directors should continually learn in areas critical to the success of the Company. This is why we visited Dubai in 2010 and Las Vegas last November. The choices of location are deliberate and here are the reasons.

It is my observation that the best malls in the world are perhaps in three places: in the U.S. especially in Las Vegas, in Dubai, and now in mainland China. Much of the innovative ideas come from Las Vegas which are frequently copied by the Gulf region Emirate. More often than not, the latter improves upon them and builds them bigger. With China coming to the game later, it has the benefit of learning from everyone. For example, our Dalian Olympia 66 last month won a global design competition held in London. In fact, all of our new projects of the past decade have won one contest or another in the international arena.

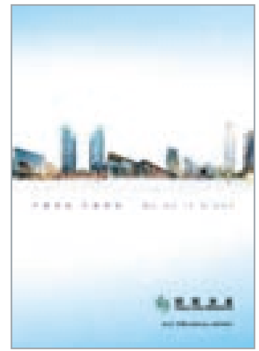
More significantly, the economics of the Chinese malls are by far the best. The U.S. has an oversupply of retail space in a slow growing economy. In Las Vegas, shopping will always play second fiddle to gambling. As a result, most of the shopping centers there are not that big. Dubai on the other hand relies heavily on tourists; there are just not enough locals to fill the abundance of mall space. Tourists can be repeat retail customers but only periodically if not rarely. Recent turmoil in the region also does not help business.

The situation in China is much more encouraging. So far society has been peaceful, the economy consistently expands by 8% to 10% per annum, and personal income growth is powerful. Last year, overall domestic consumption rose by 17% and that for luxury goods which is of particular interest to us, by 30%. Unlike in the West, shopping centers are a relatively new phenomenon in most big cities. Because population density is invariably high, the pool of repeat customers is huge and consistent. Given all these favorable factors, your Company is truly in a market sweet spot, the likes of which are rare in the world!

Barring unforeseen circumstances and excluding developmental profit from Hong Kong which is unpredictable, this year we strive to produce a bottom line growth rate in the low double digits similar to that of the past 12 months.

Ronnie C. Chan
Chairman
Hong Kong, January 19, 2012

2012



From the Trough: Sustaining Positive Growth in Disquieting Times

EXECUTIVE SUMMARY

We have successfully maintained our growth trajectory throughout the successive cycles of instability in the local, regional, and global markets for the last two decades, and the current trough is no exception. Our strategy has been unwavering and our management tenacious in its execution and this has afforded us the luxury of finding ourselves in the position we are in today. Early on, we made sense of wider industry confusion over the dynamics of the markets in which we sought to operate, and more recently we understood that the nature of the new competitive challenges in the Mainland market and how to address them with the stoic determination for which we have been criticized and yet are now admired. Our vision for the future will see our Company transition within the hermeneutic of continuity to a more operations-focused model as our vast expansion into the Mainland bears the fruit of long-term stability. Without a doubt we will continue to expand and grow our market, but it will not be a flippant or wanton stretching of our principles. We will continue to buy at the right time and built with right-minded intentions to add quality, sustainable developments to our portfolio for the lasting benefit of our loyal shareholders. Our stance has always been based on an integrity of vision and action that permeates down through our corporate structures to every relationship and transaction. This, as the market shows the first tentative signs of stabilization, and as our short-term prospects remain a healthy indicator of our capacity for growth, will be our stronghold for continuing to forge ahead with the resolve that has brought us to the brink of our very own golden era.

Forum 66, Shenyang

From the perspective of our business, global economic conditions have not changed substantially in the past six months. Europe remains in the doldrums and America's recovery, while progressing, is still somewhat tenuous. China's growth rate has moderated from the high 9% to 10% per annum and it is difficult to predict if and when it will pick up.

Nevertheless we took advantage of opportunities to part with several mature, non-core investment properties in Hong Kong. Together with the sales of completed apartments and increase in rental income, we produced turnover and net profit attributable to shareholders which were much higher than those of a year ago.

None of these should be surprising to our shareholders, as we have for some time been waiting for an auspicious moment to sell. Moreover, I had repeatedly pointed out that semi-annual revaluations of our rental portfolio were rather conservative. Latest transactions have proven those words correct – we achieved a surplus of sales proceeds over valuation of 74%. Buildings sold accounted for about 11% of our Hong Kong rents. These efforts have had the effect of enhancing the average quality of our investment portfolio.

In the coming year, such activities will slow down considerably if not altogether. We have all intentions to keep the better investment properties in our fold in the long haul.

Sales of 108 apartments of The Long Beach achieved a profit margin of 63% while that of 9 units of The HarbourSide was 73%. Both are historic highs. As mentioned before, we are more than happy to sell a lot more flats at similar price levels. The market however will have to cooperate.

Mainland China's retail business remained weak. As the year progressed, it had gotten worse. Deceleration in sales growth of luxury goods in which we are strong far exceeded that of general consumer products.

Investment Portfolio Safe Haven in Uncertain Climate

Tough conditions notwithstanding, there are areas for optimism. For example, retail sales at Grand Gateway 66 increased due to the introduction of higher price point brands. For the first six months of 2012, rents at the Plaza 66 shopping center barely eked out a 2% rise. However, the full-year number was up 4% implying that rental growth for the second half was about 6%. The reopening of three major tenants after shop refurbishment and enlargement was just one reason. The fact that many top global fashion brands have expanded their operations further confirms the vibrancy of that mall.

Total retail rents received on the Mainland rose by 24%. Taking out the two newer properties with less than two full years of operations, the increase was 8%. When offices were added in, the year-on-year growth in overall rental turnover was 18%.

In all projects and in almost all product types, rental margins have improved. The most marked change came in Shenyang Palace 66 which more than doubled from 12% to 27%, and in Jinan Parc 66 from 34% to 51%. Being newer facilities, such an outcome is to be expected, and numbers will likely get even better.

With the exception of Palace 66, occupancy everywhere approached 100%. In this first mall of ours outside Shanghai, surrounding road works stopped only for a short period at the beginning of the year, but digging soon resumed and had continued for the rest of the year. We took advantage of this slow period to revamp tenant mix as I had previously written. The process is almost complete and we should achieve 95% to 96% occupancy later this year. Like all our other properties, unit rents have been rising.

In terms of unleveraged gross rental yield on investment cost, the two Shanghai properties have reached approximately 40%. Shenyang Palace 66, after almost 2.5 years of operations, stayed at 5%, a level achieved in the first year of our two Shanghai properties over a decade ago. The primary reason for the underperformance is no doubt the aforementioned road works which has been ongoing for the better part of the past two years.

The picture in our other new facilities was far more positive. 16 months after inauguration, Jinan Parc 66 has achieved an unleveraged gross rental yield of 8%. This is slightly ahead of our corresponding experience in Shanghai. Shenyang Forum 66 was even more encouraging. Barely three months old, the projected full year is about 10%. In Shanghai, only in the fourth year did we see this figure!

In Hong Kong, all segments in our investment portfolio performed satisfactorily. Retail did the best where rental turnover advanced by 11%, while those for offices rose by 7% and for other miscellaneous buildings 2%. On the surface, total rents received grew only 3%, but comparing like with like by taking out discontinued properties, rent actually increased by 9%. With the exception of serviced apartments, all space is basically fully let.

Putting Mainland and Hong Kong together, we collected 10% more rent while operating profit advanced by 11%. Mainland now accounts for 50.5% of total rental turnover and 48.4% of operating rental profits. The corresponding Hong Kong numbers were thus 49.5% and 51.6%.

In the past year, we saw the departure of two executive directors. We must always do the right thing as enshrined in the tagline adopted early last year. I firmly believe that the Company is today a better and stronger one. The two vacancies were immediately filled by former deputies to the two positions whom we have groomed for some time. Needless to say, we will continue to build out our senior management team.

Strategic Survey of Competition and Industry Dynamics

There is a common misunderstanding regarding mainland China's shopping center business which warrants some discussion. It is often said that competition is extremely keen and the increasingly crowded market will be troublesome. Even the most sophisticated institutional investors succumb to this mantra which is fundamentally flawed. It shows a lack of understanding of the market as well as industry dynamics.

Consider the fact that perhaps 95% of all shopping centers of reasonable size are strata-titled. Mainly due to financial weakness, almost all developers must cut up a mall into "bite-size" shops and sell them off piecemeal, sometimes before building completion.

Management of such facilities becomes difficult and quality of the facility inevitably deteriorates. No one can control what goods will be sold in the neighbor's space and degeneration happens almost the day the development opens. This is not to mention the fact that more often than not, the project is poorly designed, hastily constructed and in mediocre locations.

To regard such properties as competitors of well-designed shopping centers in top locations with a single owner is frankly ridiculous. While new, the former may for a period affect the pricing power of proper malls, but the effect will not and cannot last.

In the whole Mainland market, there are probably not more than half a dozen players who have the financial wherewithal to not "condominiumize" the malls. The majority of them are from Hong Kong, and those from the Mainland are understandably all state-owned enterprises. Frankly, hardly any non-government linked developer has had the time to build up sufficient financial strength, not to mention the necessary experience, to become proper commercial developers. And given the enormity of the Mainland market, what are half a dozen developers?! This was why in the past few years, we had only encountered one or two competitors when bidding for sites.

Moreover, besides the lack of expertise in designing retail complexes on the part of most Mainland developers, there is also the propensity to construct all too hastily. City officials as sellers of the land often want to see buildings completed in a very short period of time. The existence of numerous skyscrapers and humongous malls in their cities somehow becomes a proof of modernity and hence the officials' competency, which may in turn lead to their future career promotions.

Recognizing this mindset of the government, developers gladly oblige and promise to open malls in say 18 months from the time of land acquisitions. As anyone experienced in the design process knows, for large and otherwise complicated projects, that time period is barely sufficient to arrive at a reasonably optimal design, let alone to complete construction! No wonder the end products are suboptimal if not outright horrendous. Even if such properties are not strata-titled, they can hardly be considered as competitors.

There is also a general misunderstanding of industry dynamics. Malls are not commodities which are fungible; they are highly differentiated assets. Not only is the market highly tiered or segmented – luxury centers with the likes of Chanel and Louis Vuitton do not compete with mass facilities with say a Walmart – it is also location specific. Once a well-situated, well-designed and well-constructed shopping center is built and succeeds in attracting the right clientele, it tends to retain customers. Loyalty is obviously not as strong as seen in high fashion brands but a good measure of it does exist.

In other words, once a shopping center is successfully established, it will not be easy for newcomers to dislodge it. That of course assumes that the leader is vigilant and continuously upgrades and changes according to the latest consumer trends. Such is our challenge in Shanghai and soon also elsewhere.

As I have written several years ago, the result of all that is the bifurcation of market participants – there will be clear winners and losers. On the Mainland, there will be far more of the latter than the former. We have seen it happen in first-tier metropolises like Shanghai, and the same is emerging in tier-two cities. Our goal for each and every property of ours is to be among the very few winners in each city – in fact to be the best – for such will take the lion's share of consumer dollars. Higher unit rents will then follow.

Given the above, the conclusion can only be that the market for commercial real estate in mainland China is wide open. It is far from being saturated.

The Centrality of Integrity: In Relationships

A second issue that I would like to address relates to our relationship with Chinese government officials. Recently a few institutional investors have asked me about it and here is our position on this important aspect of doing business on the Mainland.

It is said that the now globally famous Chinese phrase "guanxi" or relationship is paramount to business success on the Mainland. There is certain truth to it, but I submit that the same is true for anyone wanting to do business in Brooklyn or the Bronx in New York City, in Chicago or almost anywhere else. But since it is probably correct that corruption is more prevalent in developing China than in the developed West, so much the more we have to use "guanxi" cautiously and judiciously.

Our basic premise everywhere is that unless there is an actual legitimate need, we do not approach government officials. This is true for us in Hong Kong and especially true on the Mainland. We do not unnecessarily befriend local leaders or those in Beijing. We never give gifts except inexpensive ones. One example is that we designed a chess board with chess pieces bearing either the Chinese character for "Hang" or "Lung" – both being auspicious words in that language. Made locally in China, the value is not much more than a few hundred Hong Kong dollars. Nor do we entertain officials at expensive places; we always do what is proper and reasonable. We do not only abhor evil but also avoid the appearance of evil.

Fortunately, being a sizable company of repute, doors that we need to open are always open to us. In the past 20 years on the Mainland, we have never once failed to reach a city or provincial official whom we need to reach. Having established our reputation of being a straight shooter, corrupt officials probably know better than to ask us for favors.

The Centrality of Integrity: In Transactions

One interesting case happened about 20 years ago when I was asked to approach a senior government official who supposedly could help us in a land transaction. The one meeting so arranged did not leave me with a comfortable feeling. That, together with other

reasons, caused us to give up that excellent city. Later the person I met was arrested and imprisoned for corruption, so my instinct was correct. We have not been successful there ever since, but at no time would we yield on ethical principles just for a good deal. That to us is not a good deal at all for it will leave us vulnerable and, conscience-wise, compromised.

Our standard of ethics goes beyond mere avoidance of corruption. At times Chinese officials would ask businessmen like us to sign MOU (memorandum of understanding) for transactions which they have no intention to proceed forward. Such signed documents are only meant to make those government leaders look good before their superiors. We always refuse to sign unless we have genuine interest in the actual project. It is not so much because we do not like the risk in case the government changes its mind and try to consummate the deal, but because of the inherent hypocrisy. As a result, we have probably lost a few friends but frankly those "friends" are not the kind we want. In one particular case, I might have been personally ostracized by certain leaders but I am willing to pay the price to maintain a high standard of ethics.

I trust that my shareholders are on my side on this point. If not, please sell Hang Lung shares, for we will not change.

That said, neither are we foolish. Through developing iconic projects such as the two in Shanghai and through a number of meaningful and even unique community services on the Mainland, we are known to many top leaders of the country and of the provinces. All these have earned us the respect of local officials and have opened many doors for us.

The Centrality of Integrity: In Corporate Governance

What we practice on the Mainland is in principle no different from what we have always done in Hong Kong. For example, we must be one of the very few companies if not the only one in our industry which have a stated policy of not hiring former senior government officials. We do not object to others doing this as long as the process is legal and transparent. But for us, it is simply in our Company genes to uphold a higher standard.

For many years I have believed that we have one of the best corporate governance in the industry. For example, it is hard to find a company that has independent non-executive directors which are as active and as independent as Hang Lung's. They probably exercise more power than most if not all their peers. Few firms are as transparent as we are not only in terms of financial disclosures but also our strategy and management thinking. This is why I personally pen all *Chairman's Letters to Shareholders,* most of which of the past decade are far longer than this present writing.

Yet we are deeply aware of our need to improve further. As management transits from strategy-focused to operationally-intensive, challenges abound. Working on the Mainland, especially for the lower echelon of the Company, is fraught with pitfalls. We need to strengthen our systems and build an even stronger culture of ethics at all levels of the organization. That we have begun and will continue. We will always strive to live up to the tagline adopted by management early last year and which I communicated to shareholders six months ago, namely "We Do It Right!". We consider this as a strategically significant competitive advantage which must be further enhanced.

Indicators Suggest Cautious Optimism for End to Slowing Growth

Chinese government statistics show that annual growth in retail sales of consumer goods has slowed to 14.3% in 2012. The year before, it was 17.1%. The second half of last year saw further deterioration. A better approximation to our mall business however is the luxury sector. According to a December 2012 report by a reputable international consulting firm, growth has decelerated from 30% a year ago to an estimated 7% for 2012. The picture seems clear: reversal of the slow down has yet to happen.

Nevertheless, there are two economic phenomena which cause one to wonder if the worst might be behind us. First, the stock market, a leading indicator for the economy, has been rising in the past few months, after languishing for quite a long time. Second, residential prices and transaction volume which went nowhere for almost a year have exploded during the last quarter of 2012. The wealth effect created therefrom may help reverse the slowing retail sales. Moreover, one should be reminded that things can move very fast in China. Once sentiment changes, the speed may surprise many.

Execution Begun or Complete on Entire Land Bank

With the late November groundbreaking of Kunming Spring City 66, all seven projects with land acquired since 2005 are now under construction or are already completed. Total cost is estimated to be approximately HK$70 billion, of which HK$30 billion have already been spent. The outstanding amount of HK$40 billion will likely be expensed over the next decade or so. In Hong Kong, as we sell off the remaining completed apartments valued today at over HK$25 billion, and having already parted with certain non-core assets, cash inflow will cover a good portion of the expected capital expenditures, leaving the Company still in a comfortable financial position. This means we can take on further projects whether they are on the Mainland or in Hong Kong as market conditions allow. As always, we will be patient and wait for an auspicious time to purchase. Nevertheless we should not try too hard to time the entry point, for no one is so smart as to know when the market will bottom.

Transparency on Strategy Lifts Confidence, Confounds Competitors

About a decade ago I made a conscientious decision to articulate through this letter to shareholders our strategies and the thinking that led to them. The worry then was that others would imitate us, thus negating any competitive edge that we might have built. The advantage for writing however was that only by doing so would our share price have a chance of being properly reflected. At that time, our counter had had perhaps three decades of underperformance. Even all the correct decisions made in the 1990s went unnoticed.

Eventually what convinced us to open up was our assessment that even if we let the world know our strategy, it would not be easy for our competitors in the near future to gain the expertise needed. By the time they do – and if they do – we would have amassed one of the best land banks in economically vibrant cities that would assure us continued success. Once we have secured the best-located plots, we will have acquired a commanding competitive advantage. After all, given financial constraints we can only play in a limited number of municipalities, and opportunities on the Mainland far exceed the resources of any company. There is plenty of room for many developers, and we should not run into each other too much.

Those decisions of ours led me to write some of the longest chairman's letters I have known, the record being in 2009/2010 with over 11,000 words. Each year, I covered one or more critical aspects of the Company that were not only pertinent at the time but would also affect our long-term health. For management, it was a useful exercise because putting thoughts on paper forced us to think through market conditions and our strategic response. Of course we recognize that quality of information cannot be measured only by the length of writing. Nevertheless, we are gratified that many shareholders have expressed their appreciation for the clarity of thoughts, and our share price has had an almost 10-year run of out-performance compared to our peers. We turned from being ignored to a counter which is – allow me to say – respected.

Maintaining Leading Edge as We Enter a Golden Era

As to the competitive landscape, a few Mainland players in commercial real estate have in the past decade improved somewhat, although in our assessment we still hold a considerable lead. Naturally what is of actual significance to us are only the cities in which we have developments. Fortunately, there we were able to purchase some of the best-located land. As long as we

build out those projects to our highest standards and provided that the Mainland market holds up, our future should be bright.

As mentioned previously, now the Company has entered a new phase of progress. For the coming years, while continuing to hunt for more land, we will increasingly concentrate on operations. As such, there will be less need to pen lengthy pieces to shareholders although I will not hesitate to revert to my old habit when necessary.

In mid-2009, I wrote that the 2010's should herald Hang Lung's golden era. We still hold strongly to that view. The reason is that all our efforts on the Mainland since 2005 are beginning to bear fruit. Years of land acquisitions and construction have paved way for world-class commercial complexes to be erected and rented. As projects will be progressively opened over the years and it usually takes one to two rental cycles to stabilize a new facility especially a mall, the golden era will dawn upon us gradually over this decade. In other words, full harvest is ahead.

There is no denying that we are beginning to taste the fruits of our efforts. New developments are being successfully completed and overall rents have been rising. Rental margin has improved and rental yield is coming through. Better yet, much more can be expected. As long as we hold our course steady and diligently execute, we shall have a bountiful harvest.

Short-term Prospects Lend Optimism to Long-term Goals

In the more immediate term, our investment income from Hong Kong should perform satisfactorily. Rental growth rate should approximate that of the past year which is quite acceptable. On the Mainland, we are hopeful that retail sales will pick up and rents from all our facilities will rise somewhat. Operational efficiencies for the newer malls are anticipated to be further enhanced thus strengthening the bottom line.

This September we should see the inauguration of the 120,000 square meters mall at Wuxi Center 66. Leasing is progressing well and we expect full occupancy at opening. Contracted unit rent so far is rather satisfactory.

Our first office building to be completed outside Shanghai, the first of two towers at Wuxi Center 66, will be handed over to tenants from the first quarter of next year. Pre-leasing has started and the signs are encouraging.

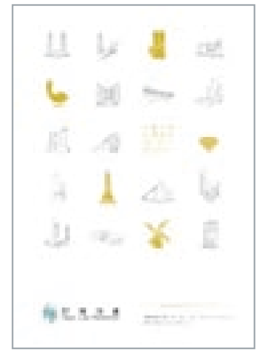
For some time we had explored the possibility of first occupying the lower floors of the first office tower at Shenyang Forum 66 later this year. Such a phased completion of a skyscraper has never been done on the Mainland, and the practical and technical difficulties are not easily overcome. At the end, challenges and associated risks prove too plentiful for the city and for us to accept, and the idea was dropped. Now the entire building is slated to open in early 2015 as originally planned.

As explained earlier, we do not foresee much selling of Hong Kong non-core investment properties this year, but we are hopeful of parting with completed apartments. Subject to market conditions, our Blue Pool Road project in Happy Valley should be ready for release by the third quarter of this year. Although only 18 semi-detached houses of some 450 square meters each, unit price may be rather pleasing resulting in good profits.

Overall results for 2013 will obviously depend on our ability to sell Hong Kong apartments which in turn will depend on market conditions. If we only look at rental income, there is reasonable anticipation that we will see some healthy increase.

Ronnie C. Chan
Chairman
Hong Kong, January 31, 2013

2013



Still Waters: Generating Opportunities for Growth in a Stagnant Market

EXECUTIVE SUMMARY

In the context of a stagnant economy, growth in rental turnover has continued at a steady pace in our mature portfolio in Hong Kong and mainland China. Our newer developments on the Mainland are on the right course but require time to settle into their stride after the first cycle of leases end and a certain degree of tenant mix adjustment needs to be made. Nonetheless, this group of properties have maintained their revenue levels and are set for growth as they reach maturity. Positive growth is seen despite central government anti-corruption and anti-opulence measures, which have taken a toll on the luxury retail sector. However, in the long term, our focus on this sector will prove fruitful as integral growth in the economy fuels affluence that does not rely on irregular practices. In any slowdown we have always remained active in sealing acquisitions at the best prices. This year is no exception with the acquisition of an 8.26-hectare plot in the busiest shopping district of Wuhan at a favorable price. Although it cannot be denied that there is currently at least a short-term run on the Mainland as a destination for international investment, we do not perceive this to dent the long-term potential of this massive global economy. And whilst our share prices have retreated as a result, we take confidence in the fact that our fundamentals are excellent due not only to the exceptional value of our portfolio and land bank but also our excellent track record in strategic planning and execution. Our business model is only beginning to bear fruit and as it does, our strategic choices are being recognized as valid. Even the explosion of e-commerce activity that threatens malls with lower level tenants in less well developed cities can be turned into an advantage for our well-placed developments, as we prepare ourselves to take full advantage of how the internet can enhance the excellence of our hardware offering. Even if the economic environment continues to stagnate, as we expect it will, as our developments reach completion each year over the next decade or so, our position can only strengthen.

Heartland 66, Wuhan

Growth in Our Mature Portfolio

Excluding the effect of alienated Hong Kong investment assets, overall rental turnover and operating profit both rose by 12%. Even with a smaller Hong Kong portfolio, the two numbers still grew by 9% each. Looking at our home market alone, turnover and operating profit respectively advanced by 10% and 11% on a like-for-like basis and by 3% and 5% otherwise.

On the Mainland, rental turnover rose 14% and operating profit 13%. On retail space alone, turnover grew 17%. If we exclude Shenyang Forum 66 and Wuxi Center 66, rent advanced by 5%. The equivalent number for offices was 7%. Comparing these figures to those of 12 and six months earlier reveals a deceleration from a year ago and a pick-up in the immediate past six months.

Focusing on the mature market of Shanghai, both shopping centers – Plaza 66 and Grand Gateway 66 – recorded a 6% increase in rent. Offices at Plaza 66 collected 7% more rent. Gross yield on unleveraged investment cost was about 42%. Mall occupancy was 99% and for offices, 95%.

Growth in Our Newer Additions Observed in Retail Sales

In our newer cities – Shenyang and Jinan (not counting Wuxi which is only three to four months old) – we have observed an interesting phenomenon: namely, as occupancy fell somewhat due to first-time lease renewal and hence tenant remixing, retail sales actually rose nicely from a year ago. The increase from the first half of the year to the second half was also evident. This should be the result of management efforts rather than market improvement. The fact was: the market went nowhere as the year progressed.

Most of our retail leases are for two or three years. By 2013, Shenyang Palace 66 has been open for three years and Jinan Parc 66 two. Some tenant changes were inevitable resulting in higher vacancy levels. This is the nature of the business which is necessary for the long-term health of the malls. Consequently occupancy remained at 88% for both properties. Rent collected was about the same as that received a year ago, but retail sales of our tenants have risen – year-on-year Palace 66 moved up 9% and Parc 66, 8%. Comparing the second half of the year versus the first half, the rate of increase was respectively 20% and 7% for the two malls.

Common sense tells us that retail sales figures are as significant as the rents we received, for growth of the former is a prerequisite and will inevitably lead to that of the latter. Recent numbers indicated that our tenant remixing was bearing fruit. Weaker shops were moved out and stronger ones capable of generating more sales were being introduced. I am also gratified to observe that the new management teams that we have put in place are performing. Although the improvement in occupancy at Palace 66 has not been as fast as we had hoped, much of the vacant space has been leased, so occupancy will rise in the coming months.

The newer Shenyang Forum 66 is for now performing well. Because it only has slightly more than one year of history, a meaningful way to measure progress is by using per diem numbers. For example, average daily rental turnover was 4% higher in 2013 over 2012. Retail sales generated per day were 15% better in the same period. However, as the facility enters its first lease renewal period in the coming year or two, what happened at Palace 66 and Parc 66 will doubtless repeat itself – occupancy will temporarily fall. Hopefully tenant sales will continue to rise and so will our rental turnover.

All “vital signs” for Wuxi Center 66 which was three and a half months old at year end were positive. It is 95% full and the number is rising.

In terms of rental margin, Palace 66 remained at 22% to 23%; Parc 66 was still at around 54% which was the same number for Forum 66. Center 66 stood at 16%.

The initial unleveraged gross rental return on investment cost is a meaningful measure. It is intriguing to learn from several institutional investors that certain market players promised around 9% but actually delivered only 1% to 2% on a rather non-transparent definition of cost. Whereas we always tell shareholders that we aim for 4% to 5%, all but one newly opened

malls of the past four years have significantly outperformed the threshold. Parc 66 yielded 7.9% in its first year, Forum 66 had about 10% and Center 66 at today's run rate should approximate that of Parc 66. In other words, we doubled what we told investors. Due to very weak market conditions, these properties have yet to see brisk improvements in this regard but they surely will. In fact the greatest progress in the coming year or two may well come from the laggard Palace 66, whose number still stands at about 5%.

Government Crackdown Sends Luxury Retail Market into Retreat

Now let me turn to a more general review of the market condition for our Mainland rental business. 18 months ago, I wrote that although the 2008/2009 financial crisis was much more severe, recovery of the present downturn in Chinese luxury goods sales may in fact take longer. I have unfortunately been proven correct. One reason is that besides normal economic cyclicalities, the market lull today is partly government induced. Anti-corruption and anti-opulence measures instituted by the new government and targeting officials are biting hard.

While these policies have negatively affected our business in the short term, we fully support them. Any sector such as ours should not rely on irregular practices. If it does, the resulting degradation of social moral values will undoubtedly haunt the economy. We are a long-term player and want to see a healthy and clean economy. Moreover, given our extraordinarily strong financial position, the market slowdown probably hurts our competitors more. History also shows that we can better take advantage of bear markets.

Economic Slowdown Awakens Our Acquisitions Team

As our shareholders know, whenever the economy is down, our project development team tasked with land acquisition will be particularly busy. City governments may not be able to sell land and so their coffers are strained. Here comes Hang Lung! We know that opportunities are beckoning as municipal leaders from many corners of the country begin to stalk us. Counting the number of city leaders represented at our public events such as a project groundbreaking or a mall opening is one way to gauge how slow the market is.

With this background in view, last February we bought an excellent plot of land in the biggest city in central China, Wuhan. It is located in the busiest shopping district and is sizable, measuring 8.26 hectares. This is so far the second largest piece of land that we have purchased on the Mainland after the 9.2-hectare Shenyang Forum 66. We shall first construct a mall followed by an office tower and blocks of serviced apartments that can be sold by individual units. Buildable space is 4.9 million square feet; including car parks, it will be 7 million square feet.

Consider our timing. 2012 was a slow time for home builders so they did not have money to buy land. Consequently, many municipal governments were in financial difficulties. That was when we struck the Wuhan deal. As 2013 arrived, the market turned. Developers sold their residential units and so needed to replenish their land bank. The finances of cities improved and so they were less eager to part with land. Prices rose and previous highest records were repeatedly broken. Under these circumstances, seven months after we bought ours, a piece of similar size, close by but much inferior in location, shape and permitted usage, was sold for twice our unit price. This demonstrates again that our timing, like that for our other acquisitions, was excellent.

Run on China Sees Share Price Retreat

Some investors have recently asked about our share price. Perhaps they are used to our outperforming our peers. It is true that for much of the 2000's and until early 2011, our stocks have had a powerful run-up. Our total return, mainly buoyed by the share price rise, surpassed most if not all real estate counters. Why then has our price retreated of late?

There are several reasons. First, China has fallen out of favor for many institutional investors. In particular, retail sales, especially luxury products like those in our malls, were even harder hit. The market behavior is understandable, for after all, there was previously a certain amount of irrational exuberance. The latest round of the anti-corruption and anti-opulence drive had added frost.

There is no denying that for the first time in a long while, the sales of luxury goods lag behind general consumption. Although many of our malls such as Shanghai Grand Gateway 66, Shenyang Palace 66, and parts of Jinan Parc 66 and Wuxi Center 66, are not tailored to high fashion brand seekers, our reputation for being developers of world-class luxury malls has been so ingrained that investors might have forgotten our other businesses.

Then there is a market perception that of all the Hong Kong real estate counters, Hang Lung is the purest Mainland play. There is a certain truth to that, although some 47% of all rents received and so far 100% of property sales proceeds are still derived from our home market. But that does not matter – when China fell out of favor, our share price suffered.

The perception existed probably because of three factors. First, we were perhaps the first among top-tier Hong Kong developers to publicly state that our future is on the Mainland. Second, we were among the earliest to have made sizable amounts of profits from the Mainland market. Third, we have hardly bought any land in Hong Kong since 2001 while we have acquired several rather large pieces in several cities on the Mainland.

A common misconception here is that Hang Lung was the first to enter the Mainland market and so bought land cheap, thus the good profit. The fact was that many Hong Kong companies invested north of the border well before we did – as early as 1979 or 1980 – while we only started to research the market in 1991 and made our first land acquisition in December 1992. Because we were a novice in those days, the two Shanghai plots were in fact bought at the peak of the cycle. It took some 10 years for prices to return to our purchase level. We have succeeded in spite of a high land price!

Besides external market factors, there are also issues relating to our operations. First and foremost were the difficulties encountered at Shenyang Palace 66. Challenges abounded during construction and there were more to come after the opening in late 2010. I have written extensively about them and so will not repeat them here. Suffice to say that with that facility being the first outside of Shanghai on the Mainland, shareholders rightfully question if our huge success in Shanghai can be duplicated elsewhere. The sustained market slowdown presently experienced also cast a negative light on our business.

From the perspective of management, we are not that worried about our share price. We are here to manage the Company and not the price of its scripts. We know that our business model is excellent and we have taken many correct decisions (such as land acquisitions and building designs) which will sooner or later bear fruit. Operational challenges which take time to improve are not perennial. They are nothing more than teething problems.

Sustainable Growth and Profit Demands Tenacity

That said, we are well aware of the frustration that some shareholders, especially those with a short-term horizon, may feel. Perhaps that was why from time to time shareholders would ask if we plan to buy back our own shares. My standard answer is: the day you see Hang Lung Properties buy back its own shares is the day when you should sell. We are facing one of mankind's biggest and best economic opportunities of the 21st century – the rise of China with seemingly unending urbanization and consumption growth. In such a favorable environment, we have found a niche (i.e. developing, owning and managing world-class commercial complexes) which is not fiercely competitive due to the lack of expertise on the part of market

practitioners. With 85 cities having a population of five million or more and another 91 with three to five million, the market seems unlimited.

At the same time, Hang Lung has through hard work over long years built a top-notch reputation backed by successful developments and a solid management team. Together with our uncannily strong financial position, it seems that few people are as well positioned as we are to take advantage of these humongous opportunities.

When unsatisfied market demand far exceeds our financial capabilities, we should expand our balance sheet, for size matters. Given that, why should we buy back our own shares which has the effect of shrinking the balance sheet!? That would be a clear signal to the investment community that we do not know how to beneficially deploy our cash.

Nevertheless, in our opinion it is altogether reasonable, indeed prudent, for our parent company Hang Lung Group to buy Hang Lung Properties' scripts. Public information indicates that such has been ongoing.

Judging Books by Their Covers Underestimates Their True Value

Indeed it is not a difficult case to make that the shares of Hang Lung Properties are today inexpensive. One only needs to take a cursory look at the main asset classes in our balance sheet – properties for sale and for lease in Hong Kong and on the Mainland.

First, our completed Hong Kong apartments for sale are recorded at cost according to accounting rules. On the books the value is around HK$5.7 billion. At today's somewhat weak market sentiment, they should still be worth perhaps HK$20 billion.

Second, when we sold approximately HK$5.3 billion of Hong Kong non-core investment properties in 2012, prices fetched were on average 74% higher than book. And since we revaluate those properties every six months, the value indicated on the account cannot be significantly more than half a year old. This indicates that there is much hidden value.

Then consider our investment properties on the Mainland. For the two mature developments in Shanghai, the cap rate chosen by a third party expert valuer is between 7.5% and 8.2%. About two years ago, another mall developer/owner with much less profitable projects (according to public records) went public with a cap rate of around 4.5%. We believe that their growth prospects are inferior to ours.

As illustrated earlier, all the land that we have bought outside of Shanghai has appreciated substantially. It is common knowledge in the industry that our sites, while being best located, cost the least among our peers. Our timing is consistently among the best. As a percentage of total project cost, the land element for us is below 20% while the norm for the industry is likely 40% to 50%. As such, it seems obvious that our assets are worth much more than what is on the book.

Finally, we have as much as eight million square feet of luxury residential condominiums that can be sold unit by unit. They are located in Shenyang, Wuxi, Kunming and Wuhan. Once built and sold, it is conceivable that the net after-tax profit therefrom can easily exceed HK$10 billion. What are they valued on our books today? Only at land cost. These are all public information, yet hardly any analyst has pointed them out.

While the stock market in the long term is rather efficient, it can misprice in the short term. We know best the underlying value of the Company as well as its potential. Since our time horizon is very long, we will always outperform almost all short-term stock traders. If our parent company Hang Lung Group continues to buy our scripts, I can hardly think of a scenario which is not advantageous to both their shareholders and ours.

Assessing the Impact of e-Commerce

For several years now management has been following developments in e-commerce. We have invited Chinese experts to address our Board, (including Non-Executive Directors) and to educate our executives. Our tentative conclusion is as follows:

There is no question that retail e-commerce – B2C+C2C – will take an increasingly larger share of the private consumption pie. Between 2009 and 2012, it grew at approximately 70% annually and is projected to rise by 32% per year up to 2015. Between 2008 and 2012, China's non-online retail expanded 1.8 times in volume while retail online leapt 19 times, albeit from a very low base. By 2015, online retail volume is expected to account for over 10% of all consumer retail sales. Transactions at physical shops will inevitably be affected.

E-commerce is fast becoming a way of life, not unlike telephones a century ago and smartphones almost a decade ago. Just as these earlier transformative inventions did not replace automobiles or airplanes because people still have the need to physically interact, neither will online shopping displace malls. After all, humans are social beings who have the need not only to see and hear but also to feel, touch, smell and otherwise physically meet with their fellowmen. As far as I am concerned, anyone who thinks otherwise is from another planet!

Certain types of goods are more vulnerable to online shopping than others. Standardized and commodity-like products will be the first to be affected. Electronic appliances and lower price-point clothes and shoes are prime examples. On the other hand, fast consumables like fresh fruits, customized long tail or high-touch products like high fashion, and experience-based shops like restaurants are less affected or are not affected at all. In this regard, our long-standing focus on high-end malls has made us less exposed.

One phenomenon of Chinese e-commerce supports this assertion: namely, the less developed a city is, the more it is affected by it. So first-tier Chinese cities are less dependent on it than second-tier cities, and so on. The reason is simple. In less developed places with poor distribution channels such as the lack of department stores and shopping centers, citizens have little choice but to resort to the Internet for shopping. In metropolises like Beijing and Shanghai where physical stores abound, there is less need for it, even though their citizens are on average better educated and so in general more active online. This explains why e-shopping is less prevalent in places like Hong Kong even though it has a citizenry of high Internet dependence.

The same phenomenon seems to indicate that there is an upper limit to retail e-commerce although that point is still quite far away. Every community will sooner or later find its steady-state level for a particular category of products in terms of the percentage of total sales that will take place through the Internet.

A corollary to increased online shopping is that some brands will no longer need to open as many stores as they otherwise would. For example, they may only have 30 strategically chosen locations around China rather than say 100 or more. To be sure, physical stores are almost always required. In answer to the question on CNN: "What should be the first step for a Western brand desiring to enter the Chinese online retail space?" A Shanghai-based e-commerce expert advised the brand to look for the best-located bricks and mortar!

So far we only have 10 malls – six operating and four being built – in eight Chinese cities not counting Hong Kong. Since they invariably have occupied the best locations in top commercial cities, our ability to attract the reduced number of tenants is perhaps unmatched. Consequently, retail e-commerce should not negatively impact us that much. On the contrary, as I have previously explained, the reduction of the number of stores for a particular brand in any city will only lead to city-wide sales being concentrated in fewer shops. Our being one of them will actually be a benefit.

Some have expressed concern that e-commerce will reduce the remaining shops to nothing more than an advertisement space where few sales actually take place. A curious case in this regard is the Apple stores. The technology company does not expect their chic-looking shops teeming with young staff to generate much sales. They are there for customer experience and product familiarization, besides advertising value. Much of the resulting sales may well take place through the Internet. The reason is that Apple basically sells standardized products. As mentioned earlier, long tail or high-touch goods are much less affected.

Securing Optimal Base Rents

In this regard, it is fortuitous that Hang Lung has from the beginning insisted on charging all tenants a healthy base rent. This is quite unlike many of our competitors. The ability to negotiate a solid guaranteed rent depends of course on the bargaining power of the landlord relative to that of the tenant. It has always been our practice to put ourselves in a position where the desirable tenants need us as much as we need them. We accomplish this by insisting on the four competitive advantages mentioned in my previous reports for all of our malls, namely top location, adequate size, superior design and quality construction.

This leads me to comment briefly on the occupancy cost for tenants. In the extreme case of the Apple stores mentioned above, it can be extraordinarily high. Given the purpose of their stores, the model is more than sustainable.

Some analysts are dogmatic about this, saying that if the cost is too high, the landlord's ability to raise rent is limited. Generally speaking this is correct. However, it is hard to determine what the optimal level is. Notice that the general level in one city can differ substantially from that of another. For example, occupancy cost in Hong Kong for the same brand is in general considerably higher than that on the Mainland. Even in the same city, multiple stores of the same brand will inevitably have different acceptable levels. This is because many factors are at play – the prestige of the mall, current and prospective sales volume, advertising value of the shop, relationship between the lessor and the lessee, etc. As such, one should be careful not to generalize too much. Conceptually speaking, occupancy cost should be higher in better malls like ours.

From Threat to Asset: Leveraging the Internet to Enhance Our Offering

There is no denying that the Internet has revolutionized our lives. For the shopping center business, its significance is much more than just taking some business away through online shopping. It can also help us generate sales. It is an enabler whose effects are indeed profound. By influencing how a person – any customer of ours – relates to another person and to the world around him or her, it can have the effect of warping time and space. It has revolutionized much of our lives and will yet revolutionize our shopping experience.

This is why we recently instituted an in-house program that we call EST. It stands for Experience, Service and Technology. From management's perspective, the order is the reverse. We begin with technology, especially Internet technology, which enables us to provide services heretofore not possible. As a result, shopping at our facilities becomes a pleasant experience. All these are the software of our business.

In our business, no software, irrespective of how good it is, will be effective unless the hardware is adequate. After all, the former can always be installed, changed or improved. The latter however, once built, can never be altered. This is why I coin the term "real estate genetics". Let us not go so far – and be so foolish – as to think that hardware is less important. To the contrary!

We are of the opinion, and many people will agree with us, that Hang Lung has some of the best hardware in the industry. I have now challenged my team to also be among the top in software. If not, the market leadership that we have built will not be secure. Conversely, by introducing superior services enabled by technology which bring about desirable customer experiences, our position in the industry will be unshakable. Your management has been working on many programs in this regard and will gradually introduce them to our shopping centers. Some will be quite subtle while others may be more easily felt. All of them should have the effect of improving customer experience and, eventually, our bottom line.

Surveying the Breadth of Our Portfolio

With the latest land acquisition in Wuhan, we will have a total of almost 42 million square feet of world-class commercial space on the Mainland not counting the two Shanghai complexes. Of that, a little over 10 million square feet have been completed and the rest are under

construction at varying stages. The eight developments are in seven cities with two in Shenyang. The total cost including reasonable finance expenses is about HK$92 billion, almost half of which has been expensed. The unpaid portion comprises mainly construction.

In the past four years, we have completed the equivalent of one New York Empire State Building annually. At this speed, it will take 12 to 13 years to build out the 32 million square feet still under construction. This will be a very aggressive program.

Once we are all done and not counting any new projects yet to be undertaken, we will own close to 47 million square feet of China's best commercial real estate. Add to that the seven million square feet of Hong Kong investment properties (provided that we do not take up more or sell off any), we will have a portfolio of about 54 million square feet. 87% of it will be on the Mainland as compared to 68% now. Hong Kong's share will be reduced from today's 32% to 13%.

In the third quarter of this year we will open Tianjin Riverside 66, a large freestanding mall of 1.6 million square feet plus 800 car parking spaces. The underlying land was our first acquisition outside of Shanghai back in 2005. Four plots acquired later – two in Shenyang and one each in Jinan and Wuxi – have all had their shopping centers completed. In fact Shenyang Palace 66 was completed over three years ago. Neither size nor construction complexity could be used as an excuse for Tianjin to be so slow. In fact, Jinan Parc 66 is similar on both counts. There could only be one explanation – the complicated and prolonged procedures in seeking various approvals from the municipal government.

Because of the delay, a huge mall associated with the local government opened some 18 months ago. Although its location, design and construction are all seriously inferior to ours, many top luxury brands are now housed there. It is for the time being the only game in town. For this reason, Riverside 66 will initially be akin to Shanghai Grand Gateway 66, i.e. a four-star mall comprising mostly sub-luxury names. However, our location is among the best in the city; the design is very beautiful, and our hardware is excellent. It is conceivable that one day the mall can easily be transformed into a five-star facility.

So far around 50% of the space has been leased, and I expect that by the third quarter, the figure should be over 90%. As always, we are targeting an initial gross yield of 4% to 5%.

In Hong Kong, we will continue to sell completed apartments as the market allows. What we have witnessed in the past three months is that there is pent-up demand. At the same time many developers are also eager to unload their inventory. Although not in a hurry to sell, at today's price we shall be happy to part with them.

The luxury development, 23-39 Blue Pool Road, is near completion. It is the first residential project in the world to have received the Gold Level certification under the Leadership in Energy and Environmental Design (LEED) for Homes of the U.S. Green Building Council. We will primarily lease them out, but will also consider selling if the price is right.

Market Lethargy to Continue but So Will Our Growth

As for our bread and butter business of property leasing, the Mainland market may remain slow for some time. For us, however, I anticipate better financial numbers this year due to improved operations. The teething problems at Palace 66 are basically behind us; Parc 66 will soon follow suit. As we all know, it takes one to two leasing cycles for a property to mature. Just as we have had a rolling schedule of opening one mall per year in the past four years, now one by one these malls will enter adolescence. This is always an exciting time of change which should bring improved results.

In our home market, I expect our rental properties to perform not unlike the year just reviewed.

I am gratified that over the years, this letter has received a warm reception from shareholders. As my faithful readers know, this Company has in the past two to three years undergone a tremendous management

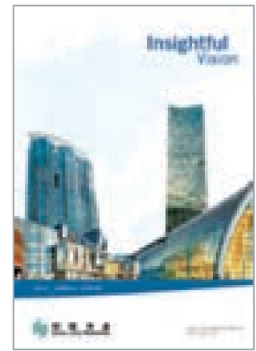
upgrade. I have been working closely on it with our Managing Director Philip Chen and I firmly believe that today we have a much better team which is prepared to tackle new realities. Yet more needs to be done.

Consider this: we are now a fast-growing multi-location company. Since late 2010, our investment portfolio has grown from 13 million square feet to around 23 million square feet, and total rents received have risen from HK$4.8 billion to HK$6.6 billion. We used to be in two cities, now we are in five and will add one per year for the coming few years. To execute the construction and then leasing and management of the added space will require not only an expanded but also an improved team. Coupled with the aging of long-serving senior executives, we have out of necessity gone through a management rejuvenation process. A number have retired, and more have been hired and will be hired.

Philip and I did not for a moment underestimate the difficulties associated with such an exercise. Indeed the process could be painful at times. Nevertheless I believe that the most challenging part should be behind us. There is still the need to add to the squad especially as new projects like Wuhan are brought on board. All these efforts should enable us to realize the potential of the excellent strategy put in place by Philip's predecessor. I am encouraged by what has been done and look forward to seeing better days ahead. There will always be market fluctuations like the lull of late, but as long as our strategic direction is proper and our management team is prepared – and now we have both in place – our future should be bright.

Ronnie C. Chan
Chairman
Hong Kong, January 23, 2014

2014



The Luster of Luxury: Hong Kong Residential Units Peak

EXECUTIVE SUMMARY

Riding high on a surge in Hong Kong's luxury residential market, we have again taken advantage of our policy to wait for the correct time to sell, and released our exclusive properties at The HarbourSide and The Long Beach, making substantial gains at the peak of the market and boosting our turnover to a new historic high. Our remarkable gains have helped to offset the continuing stagnant market in the commercial sector which has seen a mixed-bag of results for our investment properties on both sides of the border. With the "Occupy" movement affecting two key districts on Hong Kong Island and Kowloon, the drop in footfall and resultant slide in retail revenues have had a negative impact on our tenants. Fortunately, the situation resolved before transferring the worst of its effects to the rental situation. On the Mainland, the central government's ongoing corruption crackdown coupled with general economic lethargy has continued to depress consumer spending in the luxury goods sector. This has naturally brought a degree of instability to our high-end establishments. However, we maintained moderate levels of growth across our portfolio as a whole, with only one development recording a year-on-year drop in rental revenue. Whilst it is unclear how long this market situation will subsist, as it is the result of both external economic factors and internal policies, it has afforded us the opportunity to take stock of how we need to transform ourselves to meet the demands of our business model as it makes the transition from an acquisitions- and construction-based focus to a more operations-based business model. Having striven for decades to build a reputation of excellence in the provision of hardware, we now need to focus our attention on building our capacity to deliver our software to the same high levels. With our hardware already in place, we will make use of this period of stagnation in the market to fine-tune our corporate culture and prepare our human capital for the rise of China and the blossoming of our Mainland strategy.

23-39 Blue Pool Road, Hong Kong

I told shareholders six months ago that I intended to lengthen the letter at mid-year while at times slightly shorten the year-end one in order to better communicate with them. In so doing, management thinking will be shared twice yearly in a more timely manner. A few shareholders, both institutional and individual, have expressed the value they place on this letter and their wish that the amount of information will not be diminished as a result of this change. I can assure them that they have nothing to worry about. The same effort will be given as before except they would now hear from me more fully on the same substance – economic and market analysis as well as company strategy – every six months instead of every twelve.

We recorded the highest turnover and underlying net profit attributable to shareholders in the history of the Company. Net profit attributable to shareholders was not the highest because of low revaluation gains. While our rental business performed barely acceptably, property sales in Hong Kong was strong. We took advantage of market opportunities and parted with 261 units at The HarbourSide and 151 at The Long Beach together with 93 car parks. All in all, we brought in about HK$9.8 billion. Profit therefrom was over HK$7.4 billion, yielding a blended margin of 76%. For The HarbourSide, the margin achieved was 78% and for The Long Beach, 62%.

From Beginning to End, Precision Timing is the Key

With only 10 units and 153 car parks left at The HarbourSide, it is perhaps time to take stock of the events over the past decade or two. After the Asian Financial Crisis struck on July 2, 1997, property prices began to plummet in early 1998. A land sales moratorium was imposed by the HKSAR government. Once it was lifted in the spring of 1999, MTR Corporation, the railway company, was the first to sell land. As a pure property concern, we prepared well our finances before the crisis, and so we sat on a lot of cash. Only one other developer was in that enviable position. That company had non-real estate businesses which provided liquidity, although they incurred much loss in property developments. Consequently, they were perhaps psychologically less prepared than we were to buy land. We won auction after auction at very reasonable land prices.

The HarbourSide piece was the first, and subsequent events have proven the price to be the most reasonable, especially given the waterfront location with one of the world's best harbor views.

When we first sold The HarbourSide apartments in 2004, the market was just recovering. The effects of the Asian Financial Crisis lingered until 2002, which was followed by SARS in 2003. Being financially strong, we saw little reason to hurry the sales program. Then a most amazing thing happened.

By 2004/2005, the effects of the Asian Financial Crisis and SARS had subsided. However, the government was determined not to release land for sale. For reasons given above, I could understand why it did so in the years between 1998 and 2004, but to continue for another 6 to 7 years was inexplicable. Some of us petitioned the government to release land but that fell on deaf ears. Without land supply, housing prices had nowhere to go but up.

We responded to this externality, which was totally out of our control, by withholding completed apartments from the market. We simply waited for the inevitable higher prices, as holding costs should not exceed the rate of value increase. Only in the past few years when the new government reversed its policy did we release the bulk of the units onto the market. The result was that profit margins kept rising until the last batch when it peaked at 78%.

We dare not say that prices for our unique harbor view apartments will not continue to rise. But as I had written two years ago, we should not be overly greedy, hence the parting of basically all the units. We also foresaw that the present government will sooner or later massively sell land to catch up, as higher residential prices have already become a huge social problem. This has now come to pass.

All told, the entire project of 1,122 units once sold out at today's prevailing prices will bring a pre-tax profit of over HK$17 billion net to the Company. It is unlikely that I will in my career witness a more lucrative project. It was a convergence of factors, some within our control such as buying land at the right time and the decision to withhold selling, and others not, like erroneous government land policies, which have contributed to making this one of the most profitable real estate projects in the history of Hong Kong.

In local circles, there has been some public debate on the merits of our slow sales program. Different companies have different strategies and there is no single correct answer. Most firms treat housing development more or less as a production line. They buy raw material (i.e. land) in order to keep churning out products (apartments). They are not as keen as we are to time land purchase or apartment sales. Maximizing profit of any particular development is only one of their several considerations and may not be the chief one. Keeping the pipeline flowing to generate cash flow may be more important. We just happen to have a different strategy.

With very few new projects in Hong Kong, and judging that home prices would keep rising, we simply took our time selling The HarbourSide and The Long Beach. Our aim was to maximize profit and we have done well so far.

Hong Kong Retail Dented by Protests

Our emphasis over the past decade has increasingly shifted to commercial property development and investment on the Mainland. We deem the Hong Kong property sales market to be less attractive and so we will only buy land when there are exceptional bargains. To be sure, we are not bearish about Hong Kong; we are constantly waiting for possible market changes which will lure us back. In the meantime, we are very busy constructing world-class commercial complexes for rent on the Mainland. We started to acquire land outside of Shanghai in 2005 and completed products began to hit the market in 2010.

Let me turn now to our investment property business. Total turnover was over HK$7.2 billion – 46% from Hong Kong and 54% from the Mainland. In terms of operating profit, it was about 50/50. Overall rents received advanced by 9%, 6% in Hong Kong and 11% on the Mainland. If we exclude the two newest malls of Wuxi Center 66 and Tianjin Riverside 66, organic growth on the Mainland was 3%.

The 79-day Occupy Central protests in Hong Kong has hurt tenant sales. We are major property owners in two of the affected districts of Mongkok and Causeway Bay. Shops have reported an 18% drop in business. As landlords, we are protected by property leases, but the impact on our innocent tenants was immediate. If the protests were allowed to continue, they would sooner or later affect our rental income. Fortunately they ended, and ended in a peaceful way.

Mainland Mixed-bag Ekes Our Profit Growth Amid Market Instability

The Mainland market had a different kind of challenge. Before analyzing our performance, let us first take a look at the overall economy.

Objectively speaking, the economic situation is not that bad. It is just that many foreign experts have, in recent years, somehow written China off because of its slower growth. Your management believes that there may soon come a time when they will be proven overly bearish. The present pessimism is in my opinion partly justifiable and partly misjudged. For example, local government debt and the weak residential market are both troubling, but neither has had a serious detrimental effect on the wider economy. These problems are not as big as some investors or analysts have thought. Yet many of them have oversold the market.

Consider some of the fundamentals. As the U.S. economy recovers, Chinese exports will follow suit. This will help work off some of the excess inventory. The process will be slow since Europe, traditionally the other major and in fact the biggest importer of Chinese manufactured goods, is not growing. The weakening yen will not boost exports to Japan in the near term. Hopefully Southeast Asia, Latin America, the Middle East and Africa will take up some slack. Overall, exports are steady and, in any event, growing faster than imports. Given recent oil price declines, China's trade surplus will remain high.

Believing that excess liquidity, which is a legacy of the 2008/2009 trauma, has been substantially worked off, Beijing is once again loosening credit, albeit cautiously. Interest rates of late have been lowered. Public investments are running strong.

Unlike the first three quarters of last year, residential sales volume, and in some cases even prices, have of late risen nicely. So much so that in first-tier cities, land auctions are again breaking records. Full-year home sales, both in terms of total units and dollar amount, have surpassed those of 2013. Four months ago, few would have predicted this. By historical standards, the balance sheets of property companies are relatively healthy.

In this not-too-bad economic state of affairs, high-end consumption is a weak link. The effects of the continued anti-corruption efforts may yet last for some time. While lower price point products are easily sold through the Internet, sales of luxury goods are affected for the time being due to government policy. Since factors affecting our luxury brand tenants are not primarily economic but political, it is hard to predict when we will reach a "new normal". We are definitely facing the most challenging years for our Mainland investment property business in 15 years. Two and a half years ago, I wrote that our industry would take longer to recover from the present downturn than it did after the 2008/2009 financial crisis. The prediction was correct, but the time to recovery might be even longer than we had expected. Frankly, we cannot see the end of it at this stage.

On the surface, our full-year results were quite acceptable. We saw rental growth in all but one mall. Careful examination, however, reveals certain concerns. What is critical here is to understand their fundamental causes, something which I will address later.

Rental turnover grew in all of our Mainland properties except one – Jinan Parc 66. In Shenyang, Forum 66 where rents increased, the rate has slowed down from the year before. In Shanghai, Plaza 66 held steady and Grand Gateway 66 went up a little, while in Shenyang, Palace 66 registered another rental growth at 4%.

With the exception of Parc 66, average unit rent went up in all our developments. Management however is cautious about the short-term outlook especially for Shenyang Forum 66 and the offices in Shanghai Plaza 66. In the latter facility, oversupply in Puxi, especially in our neighborhood, has put pressure on rent renewals.

In the newer malls of Wuxi Center 66 and Tianjin Riverside 66, occupancy is still rising as more shops commit. Those who have signed up are moving in. The two shopping centers in Shanghai are fine while Palace 66 will improve further. Parc 66 and Forum 66 are struggling a bit, while Center 66 will continue to find its optimal tenant mix.

Rental margins in non-mature facilities (i.e. those outside of Shanghai) have yet to improve. Marketing expenses and other costs related to a newer mall are still necessary, and it will take the second lease cycle to gradually improve.

Tenant retail sales showed a mixed picture. Palace 66 grew by 12% but Plaza 66 fell by 4% and Parc 66 by 2%. Grand Gateway 66 and Forum 66 both improved slightly.

Footfall numbers also vary from mall to mall. Parc 66 is an interesting case: while results above indicate that it is still undergoing teething problems, the number of visitors is holding up. This means shoppers are spending less, which is the case almost everywhere in the country.

Recent public information on global luxury brands confirms a difficult trading environment. Hardly any of them did well in China. This is different from fast retailing which has performed much better.

An area where management was somewhat pleasantly surprised was office leasing in Wuxi Center 66. The first of the two towers has a gross floor area of almost 90,000 square meters. When it opened during the fourth quarter of last year, occupancy stood at 29%. Now about 50% of the space is committed. The number is expected to climb further in the coming months. Rental rates are acceptable.

The first office tower in Shenyang Forum 66 is much larger, a gross floor area of over 191,000 square meters, of which slightly less than 50,000 square meters will be a five-star hotel. We are now in final negotiations with international hotel management chains. When the office portion opens later this quarter, it is expected to be 20% committed. Rents are slightly higher than those in Center 66.

As to the unleveraged gross rental return on investment cost, the two Shanghai properties achieved 44%. In Shenyang, Palace 66 improved to 5% and Forum 66 between 9% and 10%. Jinan Parc 66's rental yield was between 7% and 8%, and Wuxi Center 66 over 9%. When the first Wuxi office tower is fully leased, the blended number for the entire development should be around 6% to 7%.

In terms of tenant mix, the two mature Shanghai malls have experienced a phenomenon considerably different from the other centers. As I have previously written, on the Mainland, luxury brands continue to concentrate in fewer stores and locations. For example, at Plaza 66, Chanel, Celine, Tod's and Escada have just completed their expansion plans, while Prada and Bottega Veneta are underway. As for our newer four-star malls, we are bringing in more non-conventional shops, entertainment outfits and lifestyle luxury names. Jinan Parc 66 is a prime example and management expects an improved performance not unlike what Shenyang Palace 66 has experienced in the past two years.

Finances Strong as We Await Mainland's Economic Advancement

Our financial position remains extremely strong. The Company is basically debt-free (i.e. zero net debt) at year end for the ninth consecutive year except 2013. During that period, we have committed to invest some HK$92 billion in new projects on the Mainland (i.e. everything outside of Shanghai), of which approximately 54% has been expensed. This may be unheard of anywhere in the real estate industry. Yet the magic of a volatile and extraordinarily high unit price environment of Hong Kong coupled with the huge and fast-evolving market of the Mainland have made this possible.

I consider it my great fortune to be in this sector for the past 20 some years to capture this once-in-a-lifetime opportunity. To top it off, vacillating market sentiments notwithstanding, no other economic phenomenon will be more certain than the continued rise of China's consumers. This plays well into the mainstay of our business. The solid foundation we have built over the past two decades should carry the company forward powerfully.

Market Prospects Flat as Cues for Recovery Sought

It is not easy to foresee a situation where government policy or market forces will significantly change the retail scene both in Hong Kong and on the Mainland. As a result, it is safe to expect a rental prospect for the coming year to be similar to that of 2014.

We still have 708 units at The Long Beach which remain unsold. Market sentiments permitting, we will sell what we can. The same goes for the remaining units at The HarbourSide and elsewhere. If the price is right, we can also part with the 18 highly coveted luxury homes on Blue Pool Road. However, we are not in a hurry. Unlike low unit cost products, the price for deluxe housing can be very elastic. As before, we look to maximize profit.

If we manage to sell out all of these, turnover and profit may surpass that of 2014. This, however, is not a realistic prospect, which means this year's profit will likely be lower than that of the year under review.

Share Price Yet to Catch Up with Pace of Expansion and Intrinsic Vale

Next, I want to discuss the important subject of changes in management orientation to meet evolving market conditions. However, I will take an approach which my loyal readers know is atypical of me. I will first review our share price which is the main concern of investors but less so of management. As I have always maintained, we are here to manage the Company and not share price movements. I am a firm believer that as long as the Company is strategically sound, operationally healthy and sustainably profitable given acceptable risks, its stock price will sooner or later reflect reality.

When Hang Lung Development, the predecessor entity to our parent Hang Lung Group, was first listed on the Hong Kong Stock Exchange in 1972, we had one of the biggest market capitalizations among all local real estate companies. In the ensuing two decades, we underperformed because of over-conservatism which led to strategic mistakes and missed opportunities. By the time I took over the chairmanship in January 1991, we were way down in the size-league table of local developers.

The 1990's was a time when then new Managing Director Mr. Nelson Yuen and I strived to reorient the business. Many changes were introduced which led to what almost became a brand new company. For one, we led the firm into mainland China. We also timed the market in Hong Kong and tried to avoid making serious mistakes. We took every opportunity to strengthen our financial position and waited for the big break. Opportunity finally came in the form of the Asian Financial Crisis in 1997-2002, and we capitalized on it well.

Before the early 2000's, very few equity analysts covered our stock. By around 2003, our share price began to rise. We became the darling of many analysts and institutional investors. With the exception of 2008 during the global economic crisis, we had an almost uninterrupted run of some eight years until early 2011. Since then we have slightly underperformed in the sector. A year ago, I wrote about its causes and will expand on them later.

In any event, at the beginning of the millennium, our Mainland strategy, then limited to one city, together with our Hong Kong maneuvers began to pay off. Initial success in Shanghai has blazed the trail for second-tier cities since 2005. We purchased some of the best commercial land at among the lowest unit prices in the industry. In Hong Kong, we bought land at the bottom of the market and turned these projects into some of the most profitable the city has ever seen.

Also worth mentioning is that we paid high prices for our two pieces of land in Shanghai. We bought them at the top of the market and it took 10 years for prices to return to costs. Nevertheless, it might not have been a mistake since similar excellent plots would not have been available for purchase at market bottom. The completion of the two developments also coincided with the demand for luxury goods taking off in the country and we caught it perfectly. Was that luck or brilliance of management? I think it was more the former.

It was obvious that our success in Shanghai was not because of buying land on the cheap. Frankly, unlike residential development for sale in Hong Kong, land price should not be the deciding factor in the success or failure of a commercial property investment project on the Mainland. The reasons are two: construction is more expensive than land, and consumer spending is rapidly rising such that rents will follow suit. Buying the wrong plot, such as in a poor location, is far more serious than overpaying for the right piece. We did the latter in Shanghai. In more recent years, all land acquisitions in second-tier cities were right and inexpensive.

Why then did our share price remain stagnant for the past four years? A year ago I suggested both exogenous and endogenous factors which are still valid today. Here I want to expand on an important point which deserves further attention. Namely, we have grown so fast since 2005 that the management team, despite having expanded rapidly in the past decade, has had a difficult time catching up.

Consider the following statistics: in less than five years from mid-2010 until now, our Mainland rental portfolio has grown by 3.5 times. Rents collected have more than doubled, rising from HK$1.9 billion to HK$3.9 billion. On average we added over 300,000 square meters per year of world-class commercial properties, which, as I have said before, is larger than one New York Empire State Building. If we continue to move forward at the same rate, it will take another decade to exhaust the existing land bank. I suspect few developers anywhere can match this magnitude of growth.

Putting the House in Order: Transitioning from Construction to Operations

Likewise, staff count has climbed as a result of business expansion. In the same five-year period, the number of executives who received stock options has increased by 3.2 times. Once we started to buy land outside of

Shanghai in 2005, we have begun to enlarge the team. Counting Hong Kong-based executives alone, we doubled the number in the first six years. Since opening our first mall outside of Shanghai in 2010, we have seen a 2.5 times increase in the past four years.

Constant influx of new executives notwithstanding, it seems we are unable to meet the ever-growing demands. What made it doubly hard was the departure of our long-serving Managing Director. 18 years prior, Mr. Nelson Yuen had informed me personally that he would retire in 2010 and had reminded me of it in 2008. As such, I could hardly fault him for the timing. Fortunately, he and I together with the strong guidance from the Board have found a most capable successor in Mr. Philip Chen. Philip joined in July 2010.

Yet challenges seemed never-ending. Around that time, we had a number of long-serving senior staff who reached retirement age or otherwise resigned. Much more troubling was the need to replace several of our senior executives, a subject which I had previously reported. Management orientation at that time was evolving from a strategy-intensive focus to an operation-intensive one. Among other things, resistance to change had to be stopped and top management had to do what had to be done. Those tough decisions were resolutely taken. Since Philip had only just joined us, I had to personally step in to execute some of those key changes. Having spent much of his earlier career in the airline industry, Philip put it best: it was like we had to change the plane's engine in mid-air!

Consider the following: not counting the retirement of Mr. Nelson Yuen, in the 3.5 years prior to January 2014, we saw the departure of four director-level executives, three of whom were long-serving. At the next level of management called Assistant Directors, we saw the departure of six, of which only one was due to retirement. Among the four current director-level executives, I am the only one who has held the same position for more than 4.5 years. Of the present 12 Assistant Directors, only one predated Philip.

Almost all of these personnel changes were necessary. Although we have been hiring all along, the expansion rate of our operation was overwhelming, resulting in a lack of bench strength to support organizational growth. Our management team was stretched to the limit.

Finding very senior people is never easy. If nothing else, it takes time. Of the three major functional heads in areas of finance, construction and leasing, only the first was internally promoted; the other two had to be hired externally. Construction involves huge sums of money and many mistakes can have devastating financial and reputational consequences. We are fortunate to have finally engaged several highly qualified professionals. Teams have been built under them and are performing satisfactorily.

In the longer run, however, leasing is our bread and butter. This is an area where we are still struggling. Unlike construction which can bring catastrophic and sudden troubles, inadequacies in the leasing team will sow seeds of problems that may take years to reverse. This, I believe, is the crux of our present challenge. Tough market conditions aside, a shortage of experienced hands in the past few years has been the source of our struggle.

It was not for the lack of trying, but we do not always get the personnel issues right. A mistake can potentially cost us 2 to 3 years. Fortunately, we have found a pair of experienced hands in our Leasing Director. Even so, building an adequate team under him is still a challenge. A lot has already been done but much more is required.

Until we fix this problem, our performance will be affected and this will be reflected in our share price. Management is keenly aware of this, and we are doing our best to build a team of operational excellence.

How much longer will it take to build up our leasing team? My estimate starts at two years. Once accomplished, our Company will thrive again. My optimism is grounded solidly on the nature of high-end shopping center business. Namely, the single most critical factor for success is the hardware, or real estate "genetics" as I have called it – location, size, design and construction. They are the most critical because once determined, they cannot be changed. Lacking any of the four elements may permanently remove that facility from the competitive race. There is no room for failure in

getting the hardware right. Fortunately all of our properties have all four success factors.

Achieving Excellence in Hardware and Software

What about software such as management and corporate culture? Management is of course very important. A shopping center with excellent hardware complemented by a strong team will ensure its top spot in the market. Shanghai Plaza 66 has so far achieved that status. A mall that has superb hardware but lacks adequate management will still perform acceptably, but it will not realize its potential. It will also leave room for competitors to exploit. And if management is weak over a prolonged period, the facility will gradually lose its competitiveness. However, it will unlikely die a sudden death. But even in such a case, a change or improvement in management should be able to revive the property because of its superior hardware.

Then there is the case of poor genetics. If it is bad enough – and many malls in China are – even the best manager will not be able to salvage it. To put it bluntly: a short man (i.e. one with the wrong genetics) can never play basketball – at least not in the major league, and we are only interested in the major league.

Looking at the competitive landscape, there are very few shopping centers in China which have good, let alone excellent, hardware. Yet few will dispute that your Company has some of the very best. We are now working hard to build the best software – management – to match it. We already have it in finance and construction. The only area that needs work is the operation of rental properties. We will get it right.

For fear of being accused of overstating my case, let me quickly add that we do have many competent staff in managing investment properties. Our success in Hong Kong and Shanghai over the long years was certainly not built on luck, for luck by definition cannot be with us over a prolonged period of time. It is just that our rate of business growth is unprecedented and for reasons given above, we find ourselves short-handed. I am confident that on the basis of what we already have, we can build a first-class team to match our world-class properties.

Cultivating a Culture of Excellence

A few years ago I wrote about corporate culture. Traditionally, Hang Lung is a company with a very strong culture. But as we expand, it was difficult to maintain, let alone strengthen it. When we added Shanghai and became a two-city organization, frankly we began to dilute it. Over time, counterproductive systems and norms began to set in. This was a major reason for the difficulties experienced some five years ago as I have earlier described. At the same time, we were expanding at a rate of one new city per year with a shortage of experienced staff. One can imagine the speed with which even a long established corporate culture can be strained.

As we are now building out our team, corporate culture is an area which management must revisit. It needs to be reaffirmed, strengthened and propagated throughout the organization. This is now being executed although much more work is needed. No corporation can have sustainable success without a proper culture.

Some analysts think that oversupply of retail space is our main woe. To a good extent, I disagree. The fact is that in each of our second-tier cities, our luxury malls usually have at most one direct competitor, and there is room for at least two such facilities. As for our sub-luxury shopping centers, there are usually no more than two direct competitors, but the market can absorb many. As always, our stated goal is to be the very best in each market in which we play. All things considered, each of our malls is already number one or at least number two in their respective markets.

A Powerful Symbol of a Strong Reality

On a slightly lighter note, I should say a word about our Company logo. It relates to what I have just discussed. People have expressed to me its elegance but I have never explained to shareholders its meaning, although it has been in use for 22 years.

For the first 33 years of our history – Hang Lung was founded in 1960 by my late father Mr. T.H. Chan – we only used a particular rendering of the two characters of our Chinese name. It looked solid if not a little heavy and

old-fashioned. Recognizing the need for a new logo in an increasingly globalized world with shareholders from many parts of the world, I, in the third year of my chairmanship, engaged a design firm. The first time I saw our current logo, I picked it from among many alternatives. I considered it both elegant and meaningful.

First, the two groups of three columns each linked by a flowing ribbon form the alphabet "H" as in "Hang Lung". Columns or pillars denote solidity and are emblematic of our real estate industry. At that time, because of the old Hong Kong Kai Tak Airport, buildings were limited to 20 stories on one side of the harbor, the Kowloon side. So Kowloon is represented by the flat top on the right side of the logo, while Hong Kong Island, without such restrictions and hence having much taller buildings of varying heights, is represented on the left side of the logo.

Second, the ribbon denotes the software which ties the six pillars of hardware together. Strategy, construction, and finance are examples of hardware, while management and corporate culture represent software. The best hardware together with the best software will make our business thrive.

Transitioning from Strength to Strength

Within the Company, we have some very promising young staff in their 30's. Many of them will likely be with the Company for the next 20 to 30 years. They have inherited the best hardware in the industry. This is a legacy of decades of sound strategy and hard work. As the young future leaders gradually step to the fore, they should realize that for the Company to move forward and maximize its potential, different critical skills will be required. In the foreseeable future, operational excellence will be the key.

As we transit from concentrating on strategy, land acquisition and building design to building out the land bank and leasing and managing the space, future leaders of this Company must know how to run a tight ship. As long as we do this well, our future is rather secure for many years to come. We will ride the rising tide of consumerism in China, and expect to become a big beneficiary.

In times of transition like this, someone like Mr. Philip Chen is critical. If he can successfully run a complicated business like an airline and help make it into one of the world's most profitable, he can surely manage a real estate concern. He knows how to build an efficient organization. What he and I have to do in the next 2 to 3 years is to build the top management team with people who can succeed us. The process has in fact started four years ago and I look forward to seeing it bear fruit.

Readying our Capabilities to Greet the Rise of China

Of more immediate concern to shareholders are two issues: when will the Chinese consumer market recover, and when will Hang Lung share price rise again. Although I do not know the answer to either, let me nevertheless share with my readers how I see the future.

As I said earlier, the present downturn for luxury goods may take some time to recover, or to find its "new normal". In the interim, we will finish building our management team, especially on the leasing side. Once done, if the market has not yet recovered, we will simply sit tight and wait. Nothing is more certain on the Mainland than the rise of consumption in the medium to longer term. While we wait, we will resort to hunting more land. So far we have done superbly in this regard and there is no reason to believe that we cannot continue to do so going forward.

Sooner or later the stock market will recompense us for all the right things that we have been doing. Between 1991 and 1997, we waited and were hugely rewarded in Hong Kong when the Asian Financial Crisis came. Now we shall wait again while building a team that can take great advantage of China's rising consumerism.

To achieve all this, we need a blue-ribbon Board. We have one, and I am proud of it. While not yet perfect in corporate governance, our Board is nonetheless by far the best in the industry in Hong Kong by many measures. I firmly believe in this, and will challenge anyone who questions it. For example, I know of none of our peers whose Independent Non-Executive Directors wield so much power in critical company affairs as ours do, nor work so diligently to fulfill their obligations.

This has been true for well over a decade. Perhaps due to lack of self-marketing – or rather, others promoting themselves better than we have in this regard – for years we did not catch the attention of experts who survey companies on corporate governance. But as is always my belief, as long as we do the right thing each step of the way, sooner or later the market will recognize us. This is true of our governance standard and our stock price.

In terms of corporate governance, in recent years we have more often than not garnered most of the top awards for our industry. Certain practices on which we alone have for years insisted, such as announcing interim and final results within one month of financial period end, have now been adopted by certain competitors who have previously vehemently resisted them. We are pleased to contribute to the improvement of corporate governance in the property sector.

As to our share price, we saw a rerating in the 2000's after a decade of doing the right things. My belief is that it will happen again for we have again been quietly preparing the Company for the next wave of growth.

It is with mixed feelings that I announce the retirement of two long-serving Directors Mr. S.S. Yin and Dr. H.K. Cheng. They serve on the Board of this Company and of our parent Hang Lung Group. Both gentlemen have expressed their desire to not stand for re-election of the Hang Lung Group Board at its coming Annual General Meeting on April 29. As a result, they will also step down from this Board. On behalf of all my fellow Directors, I thank them for their long years of loyal service.

A banker by training, Mr. S.S. Yin is a former Executive Director and later Managing Director of the original Hang Lung entity called Hang Lung Development Company Limited founded in 1960. He joined in 1971 when the Company was preparing to go public the following year. Since his retirement from active management in 1992, he has served as Non-Executive Vice Chairman of this Company and of Hang Lung Group.

Dr. H.K. Cheng, a distinguished engineer and civic leader, joined as Non-Executive Director in 1993. He ably chaired committees and hardly missed any meeting – exemplary to all of us!

Fortunately, another equally distinguished engineer joined our Board last October. Before retirement last year, Dr. Andrew Chan was global vice chair of the world-renowned London-headquartered multi-disciplinary engineering firm, Arup. Not only is he most experienced in his profession, he is also a dynamic thinker. His out-of-the-box thinking always blends pragmatism of an engineer and creativity of a business leader. It is indeed our good fortune – for both management and shareholders – to have Andrew as a Director. I look forward to working with him in the years to come.

The Board has agreed upon certain guidelines for tenure of directorship. They relate to term limit and age limit. While not set in stone, they are nevertheless useful to help direct future actions. In my opinion, there are no hard and fast rules to handle these issues. Any model adopted must take into account many factors and strike a balance. Being dogmatic is unwise, just as it is imprudent to not have reasonable guidelines. I refer readers to my letter to Hang Lung Group shareholders for further discussions.

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

2015

From the Depths: Keeping Confidence in Deepening Crisis

EXECUTIVE SUMMARY

Defying all models and pundits, the economic crisis facing China deepens with each sign of bottoming out giving way to new lows. We may say with certainty that our business interests have never faced such challenges as confront us at this time. And yet, with equal certainty, we must believe that there will be a turnaround, and that with the necessary structural reforms, China will not only recover but attain its promised stature on the world stage without necessarily conceding to Western 'norms'. We are, without a doubt, subject to the effects of the economic fallout from the weakening market, but our excellent financial position has sheltered us from its worst excesses and continues to give us the latitude to remain in a state of readiness to take advantage of the recovery when it comes. To this end, we continue to remain on top of market movements to release units of our landmark Hong Kong luxury residential properties at the most opportune times to maximize profits. By the same token, our finger will maintain firmly on the pulse of market sentiment on the ground, and will respond to such changes as the impact of technology on the way people shop with decisive initiatives such as our EST (Experience, Service, and Technology) Program. The stability of our financials also allows us to be ready to take advantage of the bottom of this sustained bear market, when it arrives, with prudent acquisitions that will continue to enhance our long-term growth prospects into the future.

Fashion Walk, Hong Kong

20
15

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 Making of the Perfect Economic Storm

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.

Conditions for China's Economic Recovery

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.

Our View from the Eye of the Storm

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.

Our Preparedness for Recovery

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

2015

Diagnoses Abound: Yet Only One Correct Prognosis

EXECUTIVE SUMMARY

All manner of voices may be heard on the subject of the Mainland's economy and its future prospects, naysayers among them who are only now accepting what we had warned of four years ago. And yet, although their diagnoses are catching up with ours, many still refuse to accept our prognosis, which has been the basis for our strategic planning in the midst of this bear market. And our prognosis first acknowledges the positive aspects of the Mainland market, which underpin its ability to respond well to central policy reforms that will eventually guide it into more stable waters. For sure we can expect a prolonged period of painful adjustment, but not one that will fundamentally shake the great economic powerhouse that is China, nor the portfolio we have built on the basis of strategies that leverage on the Mainland's greatest potential: tier-two cities with a thirst for growth. To this end we will not retreat from the bear but tame it as we have in the past, with strategic policies that hone our edge to meet the changing demands of the market. Our strong financial position means that we do not and will not shy away from investing to bolster the competitive advantage of our existing portfolio and to make prudent acquisitions when the right time presents itself. By the same token, the strength of our teams, invites us to explore and implement new strategies that will boost our software offering to the high levels that our hardware has already achieved, and to further enhance our corporate culture of excellence that time and again has been a recognized hallmark of our success.

Olympia 66, Dalian

For the past quarter century, I have personally penned this letter twice a year to shareholders. Beginning 15 years ago, I decided to go beyond the standard reporting of facts as previously practiced. Rather, the Chairman's Letter should be an appropriate platform to communicate with our shareholders and the market at large the views of the management on the economy, our industry, and our strategy. As much as possible, we should be transparent.

In the past few years, instead of a very long year-end letter and a much shorter mid-year one, I have beefed up the latter. This way, readers receive more timely information from management every six months. I trust this is well received by shareholders.

An Opportunity for Full, Frank Analysis

To our surprise, my last interim report, the longest that I have written at mid-year, went viral on the Mainland Internet as soon as it was released. The reason was unclear to me as it has always been my practice to comment on the Chinese economy. Naturally my views cannot be correct all the time but at least they were always honest, be they optimistic or pessimistic. Besides, I like to point out that my letters are primarily for our shareholders and potential shareholders and not the general public. We never lose sight of that. What bears repeating here is the difference between the two letters respectively for this Company and for our parent Hang Lung Group (HLGL). Long-term readers of both should realize that for Hang Lung Properties, I devote more time to discussing the overall economy and our strategy. Analyses of the real estate industry of both Hong Kong and the Mainland are usually covered in the other letter.

This I again did six months ago. Whereas what I wrote here received much attention, the industry review in the other letter did not. Of late I happen to hold views on both Hong Kong and the Mainland's residential markets which are not shared by most in the market. Since they are important to our business, I will repeat some of them here. My opinion in this regard has not changed in the past six months.

This brings me to another point regarding this letter. When there are particularly critical developments in the economy, in our industry or our Company, more emphasis will of course be given to them. Beyond that, as much as possible, my practice is to pick an important aspect of the Company and give an in-depth review at year-end. Topics covered in recent years included corporate governance, sustainability, human resources and corporate culture.

In these areas, I have so far avoided repeating what have previously been covered. This is certainly my preference. However, new or potential shareholders may be unaware of these discussions. One way is to refer them to my former letters, which are available online. Nevertheless, management thinking progresses over time and it may be worthwhile to revisit some of these issues every so often.

We Knew it was Never just a Cold Spell

Now let me turn to the year under review. When I first wrote in July 2012 that China was in for a prolonged economic winter, few were convinced like me. The same was true even as late as my last interim letter six months ago. Now I doubt if anyone will hold a contrary view, for things have gone from bad to worse. Will China recover? My answer is a most definite yes. However, given the structural causes of the downturn and how intransigent they are, recovery will be slow.

The crux of China's present economic challenge is the need to reform many of its systems. This is an evolutionary and not a revolutionary process, for reform has been ongoing for some 30 years. Just look at the country over that period and one cannot but marvel at the structural changes that had taken place. Nevertheless, Beijing is very aware of the need for further reform, but there are constraints. Spurred by necessity, nothing will focus the minds of top leaders more than urgent if not existential threats. In this regard, I find proposals by certain Western pundits amusing. Whereas many of their diagnoses are correct, their prescriptions are often unrealistic. Some of them think that Chinese leaders are deaf or dumb, but these pundits are unaware of the internal difficulties

confronting Beijing. Nothing is more certain than the fact that the country is more complicated than anyone can comprehend, and no one has ever faced such challenges in such a big country. One can only hope that officials are wise enough to adapt the needed reform policies to local situations.

To be sure, success in reform in the short run is by no means assured. But as is always the case in China and as Mr. Deng Xiaoping said some 30 years ago, the country will "cross the river by feeling the stones". To think that there is a silver bullet is frankly naive. What can be done is to draw on international as well as domestic experiences of the past 30 years and chart a course which will yield a higher probability of success.

Beijing will continue to use public investments to spur the economy, but there are serious limits. After years of fast growth, the economic base is much larger now such that the same amount of investment input will produce a smaller percentage of increase. Government debt is now higher than before, thus rendering massive new investments more difficult. Public-private partnership may be one way to go.

In some areas, infrastructure developments are already plentiful if not overbuilt. Nevertheless, there are still other projects which are sorely needed. For example, subway developments in many cities have been announced recently. Investments to improve the environment from air to water to soil will be good for both the short- and the long-term. Frankly the government will have to use all there is within its power to stimulate the economy.

In a recent conference session that I chaired in Hong Kong and was attended by some 2,800 people from around the world, all the speakers from both inside and outside of the Chinese government agreed that the best hope to lift the economy is to stimulate private consumption. I expect more policy initiatives in this regard. It was said that the stock market stimulation several months ago by the government was one such effort. The hope was presumably to create a wealth effect and so spur consumption. It was a wrong thing to do and it backfired. But it does not mean that there are no other ways to get the job done.

Realizing the Potential of Private Consumption

Room for increasing private consumption is considerable, and continued urbanization is but one way to achieve this. As a percentage of GDP, China's private consumption is much smaller than that of the United States. On the other hand, China's GDP growth is three times faster and salary growth is even more. Unlike developed economies such as North America, Europe and Japan where the size of the middle class is rather stable, China's middle class is expanding quickly. Whereas many in those countries already have basically all they need, the same cannot be said for China. For certain goods, the Chinese prefer to purchase overseas, hence to bring part of that market onshore will boost retail sales. The service sector is particularly underdeveloped and we expect to see explosive growth especially in first- and second-tier cities. That market is almost limitless.

Moreover, as everyone knows, Chinese people are compulsive savers. Policies can be introduced which will help turn some of the personal savings into consumption dollars. To be sure, the Chinese should not pick up the bad habits of the West – overspending and result in high personal debt. But neither should they remain at the other extreme. A sensible middle point should be found. Given structural problems in the society, from an unreasonable healthcare regime to an inadequate educational system, and from the lack of social security to the lack of personal credits, overspending by individuals is frankly unlikely for now.

Whatever the case, it seems certain that as reform progresses, no matter how slow it may be, a higher percentage of disposable income will go towards consumption. After all, as a result of 30 years of rapid economic development, many Mainland citizens have accumulated considerable wealth. A case in point: in one of our shopping centers in a second-tier city, a car dealer of expensive European brands is said to have sold over 200 units last year. Wealth is not an issue; Chinese city dwellers now accounting for about 54% of the population just need a little encouragement to spend.

Grounding Generally Depressed Sentiment: Highlighting the Positives

Given today's terrible market conditions, it seems out of place to speak of anything but bad news. But objectively speaking, there are many positive societal developments which bode well for the economy. Some of them are of a short-term while others are of a long-term horizon. One of them is that the housing markets in the most important second-tier cities are by and large quite healthy. I will return to this point later.

Even without government encouragement, entrepreneurship especially in the high-tech sector is alive and well. As recent history shows, technology can create jobs and not just destroy them. During the "robber baron" days in the United States a century ago when regulations were lax, many businesses flourished, thus creating employment and raising the standard of living. Fortunately, its social culture, unlike that of Europe, ensures the enterprising spirit continues.

In China, such a spirit is alive and well. Its "robber baron" days might have been moderated as regulations are introduced, but they are far from being over. Compared to their predecessors, today's entrepreneurs are younger, better educated and more worldly. They are as sophisticated as I have seen anywhere in the world, and their learning curve is as steep as any. They travel the world and learn from the best. Herd instinct ensures that competition at home is severe, which will only lift the standard for all. It is an exciting scene to behold.

The legal environment is slowly improving, yet due to the size of the country, business opportunities remain plentiful. Like everywhere else, many startups will fail but a good number will not only survive but, to different degrees, thrive. Some will have international ambitions; there will be many more "Alibabas" to come. They will in time contribute greatly to the next phase of China's economic growth.

There are other positive factors. As a net energy importer, significantly lower oil price can only be favorable to China. The One Belt, One Road or Belt and Road initiative should also in time bear fruit. A drag to the present Chinese economy is the oversupply and overcapacity of many commodities like cement and steel. Infrastructural projects in the new Silk Road will digest some of the excesses. This should help position the country for the next phase of growth.

There are far more critical geo-economic and geo-political reasons to initiate the transcontinental effort. One is to secure long-term supply of energy and other natural resources. It also opens new markets for the country's massive manufacturing apparatus. As I had written six months ago, frankly the new Silk Road is inevitable. It is a natural extension of globalization which started some 2,000 years ago in exactly the same place: the original Silk Road. Yet today it is arguably the least globalized part of the world – between Western China and Eastern Europe. It matters little who raised the issue today. It merely completes a human experiment of two millennia which historically has brought prosperity to its participants. So no matter how one looks at Belt and Road, it seems that the upside outweighs the downside. This is true for China and for all other participants.

When history is written, all the geo-economic and even geo-political considerations will have retreated to the background. What may be remembered are two aspects: the embracing of the last bit of humanity into the globalized world, as well as the enrichment of cultures when different people interact. In the end, it may well be culture for which the Belt and Road initiative will be best remembered. This was certainly the case with the old Silk Road.

While enumerating some of the recent positive developments, let no one underestimate the immediate difficulties facing the economy. The global economy, with the exception of the United States, is not encouraging. Demand for Chinese goods is not as strong as before. Currency devaluation by many competitors will make China's exports more challenging.

Challenges on the Mainland are Systemic but Not Insurmountable

More troubling however are domestic issues. While the anti-corruption campaign is necessary and is supported by the general populace, it has also crippled the government. Officials simply stop making decisions which

is the safest posture to take – when you do nothing, no one can accuse you of corruption. As a result, the already slow economy will stall further. Equally troubling are legacy issues which I will address later.

Regarding the likely future of China's economy, let me first jump to the conclusion and then explain the reasons for it. My best guess is that it will muddle through for the next several years. Beijing leaders should have the tools to prevent a drastic fall, but its policy options to stimulate the economy are becoming limited. It is not easy to find a quick fix. China began its long march to reform in 1978. The most dangerous period was before 1993 when the old ideology had to be overturned. Failure to do so would have scuttled the entire reform crafted by the then supreme leader Mr. Deng Xiaoping. It almost happened after the debacle of 1989, but Mr. Deng single-handedly rescued it.

Since the early 1990's, the economy has seen many ups and downs. There was no roadmap anywhere that leaders could follow. Laws were antiquated or outright missing; rules and regulations that were common in other countries were never seen before in China. Those were truly difficult years, but in my opinion not as precarious as the 1980's when ingrained ideology had to be radically altered.

When the new millennium arrived, China began a prolonged period of crisp rise. Just as the Asian Financial Crisis that began in 1997 did not hurt China, the country was also spared from serious trouble during the Global Great Recession of 2008-2009. The reason that China was spared from the earlier incident was that back then its economy was not that integrated with its neighbors. The more recent case was due to China's decisive actions. Nevertheless, a number of mostly international experts did point out that besides structural deficiencies, government actions taken to avert disaster in 2008 also sowed the seeds of economic problems. However, at the time they were considered manageable, and Beijing seemed capable of resolving most if not all difficulties.

Subsequent events showed that the cumulative side effects of less-than-ideal policies began to surface a few years ago. What China is facing today is a direct consequence of the excesses of the go-go years of the 2000's and of medicines taken in 2008. The problems were years in the making and it will take years to correct them.

Whereas it seemed that previously Beijing could do no wrong, now she can do nothing right. Undoubtedly the Western media in the past had inadvertently hyped up China's rise. While the present pessimistic reporting may be closer to the truth, it may be concerned about the wrong things. For example, what transpired a few months ago in the Shanghai stock market and later in the Renminbi currency movement made China a laughing stock of the world. Embarrassing as these incidents may be, they are not detrimental and do not have long-term consequences. China is like a farm girl thrust upon the global stage. Mistakes are inevitable but Chinese regulators will learn from them. As such, they are not my main concern. Instead, I am worried about something else.

Striking the Right Balance of Power in the World's Largest Economic Ecosystem

Conceptually there are two main ways to manage any social system such as an economy. Briefly stated, they are laissez-faire versus control. The dominant practice of the free market in the world today is in the former category. Let the market comprised of many millions of individuals choose what it wants. The government is only responsible for maintaining order through rules and regulations supplemented by social norms. The other way is exemplified by the centrally controlled economy. Between the two, there is a continuum of many shades.

History of the 20th century has shown that the free market is more conducive to unleashing human productivity and hence wealth creation. But if taken to the extreme, chaos will inevitably result. Uneven wealth distribution may necessitate government actions to maintain societal order. The libertarian way must be somehow moderated.

And since almost all attempts at a centrally controlled economy ended in disaster, the ideal, if there is such a thing, must rest somewhere in the middle but much closer to the free market side.

After decades of experiment, China has discovered the above the hard way. The economic opening and reform since 1978 attested to that. The critical question now is how far and how fast it should go.

Beijing leaders are well aware that in order to pull China out of poverty, it must have a strong central government. The rise of other East Asian countries in the post-World War II era has amply demonstrated that, and there is no exception. In the first few decades of economic development, some form of government leadership is almost indispensable. This is true in Japan and in the Four Tigers – South Korea, Taiwan, Hong Kong and Singapore, with the then Colonial government of Hong Kong having the lightest touch. Beijing has followed that path and has so far been successful beyond imagination.

But as most people would agree, as the economy develops, involvement of the government must lighten up. Beijing understands it well and has already embarked on that direction. However, there are two unique challenges.

First, for over 4,000 years the Chinese have always lived under a hierarchical society where considerable control was exercised from the center. It is ingrained in the Chinese psyche and has become part of the Chinese culture. No other civilization has had so long a history of continued – and mostly successfully – rule under one governance principle. While it has its strengths such as efficiency and relative social harmony, it also has considerable weaknesses. The lack of legal infrastructure including the judiciary is one. Another is that mistakes made by the central government can be magnified and not easily corrected.

The other challenge is that China is a huge country like no other – it has almost 1.4 billion citizens. It also has one of the biggest peasant populations in the world of about 650 million. The wealth gap between cities and rural areas is huge. The reform needed in one place may not work in another; in fact, another place may require an opposite policy!

All these factors make reform complicated. Moreover, China is fast integrating with the global economy. What happens elsewhere in the world may impact the Chinese economy in profound ways. Increasing dependency on imported energy is just one often-cited example.

China today is no longer a centrally controlled economy like it once was; it is moving towards a government-guided one like Singapore. In fact, China's State-Owned Enterprises probably control a smaller percentage of the country's economy than their counterparts in the small island state. However, there is no denying that Beijing still plays a critical role in all important decisions that affect the economy. Herein lies my main concern for the country – the unintended consequences of government actions. As the system becomes exponentially more complicated, this risk similarly rises.

Since it is unlikely, if not impossible, and not necessarily desirable for the country to move quickly and become like the West, it will have to find a hybrid model which fits its own circumstances. Until a relative optimum is found and is somewhat tested, periodic blunders will seem inevitable. One can only hope that it does not happen too often and when it does, the effect is not too detrimental. Frankly it is quite amazing that the economy has risen to today's level without more disasters. The way ahead however will become even more operationally challenging as systemic complexities grow exponentially. In the more immediate term, a question sometimes asked is whether the present downturn is systemic or cyclical in nature. The former means that there are structural problems in the economy which will take a long time to address, hence recovery, if it comes, will be very slow. The latter refers to normal market fluctuations where an upturn can be expected within a more or less predictable time frame.

While confident that China's economy will rise again, I fear that recovery will be lethargic, for there are so many structural issues which are not easily resolved. As I wrote as early as July 2012, unlike the sharp economic drop and quick recovery during the 2008-2009 financial crisis, the present downturn seems less severe but will take much longer to recover. Your management is certainly preparing for the worst.

China Residential Sector: A Realistic Appraisal

Now let me turn to our real estate industry. I will begin with the residential sector on the Mainland. Although we do not build many apartment units and those that we do are only very high-end ones next to our malls, this area of the economy does affect our overall business. I wrote about it six months ago to HLGL shareholders and will summarize it here.

Contrary to almost everyone I know in the industry, I am of the opinion that China's housing market is quite healthy today. With a little hyperbole, it is the healthiest the country has seen in generations. This is particularly true in the most important tier-two cities. The predominant view, especially in the West, is that there will be a hard landing. I never believed that.

Consider the following: the prevailing problem of the past 20 some years was runaway prices. This called for drastic government actions which inevitably killed the market until the next cycle arrives. Seldom do we see a somewhat ideal condition: prices not rising or falling precipitously while transaction volume and land sales are both moderately robust. This is basically the case today in most tier-two cities. Developers are for the most part still highly geared but not particularly bad from a historical perspective. Many of them have tapped the bond market of late which provides stable and long-term funding.

Tier-one cities are still hot, but as I have previously written, those markets are the most desirable, and money tends to flow in from everywhere. And to be sure, tier-three and -four cities have serious oversupply which only time, perhaps in four to five years, can resolve. In monetary terms, however, by far the greatest sales amount comes from tier-two cities.

Overall, their supply and demand are much more in balance. I know of developers who expect a pretty good year for 2016. Given this set of facts, I fail to see how there will be a hard landing.

China Commercial Sector: A Realistic Appraisal

Closer to our heart are retail properties. We have always maintained that while there are too many malls in certain cities, there are always too few good ones. The latter phenomenon is what gives us great opportunities.

A leading European bank recently published an extensive report which says that China is short of retail space rather than having an oversupply. Per capita square footage in the cities is only 70% that in the United States. Malls of equivalent quality in China have far higher footfall than their American and European counterparts but much lower spending per person. This implies that there is much room for better malls and more growth in per capita spending. While I am not convinced that the findings are correct in every respect, nevertheless the study deserves consideration.

Our experience so far tells us that the challenge does not come mainly from our so-called competitors but from a very weak market. This seems to agree with the above findings.

Now let me turn to our performance. On the Mainland, our two Shanghai properties performed well due mostly to management efforts. So far they are like two pillars that make up for the weak or negative growth elsewhere. However, Plaza 66 has embarked on a comprehensive asset enhancement initiative and Grand Gateway 66 is expected to follow suit later this year. While we will do our best to minimize the adverse effect, it cannot be eliminated altogether. A slow market is definitely the right time to undertake such an endeavor, but it will make growing revenue even harder.

There are other worrying signs. With the exception of Shanghai, negative reversion pressure is strong. We are even detecting some at Grand Gateway 66. With the exception of Shenyang Palace 66, all retail facilities collected less rent in the second half of 2015 than in the first. And with the exception of Forum 66, our tenants did less business in the later part of the year when compared to the earlier. Traditionally the last six months of the year, with the summer vacation and more extended holidays like the National Day, perform better

than the first six months. The latest numbers are a strong proof that the retail market is still weakening.

Looking at our malls in tier-two cities in order of their completion, Shenyang Palace 66 performed satisfactorily. Jinan Parc 66 held its own. If not for the extraordinarily difficult trading environment, this four-year-plus property should be well on its way to stabilizing. Shenyang Forum 66 and Wuxi Center 66 are facing strong challenges. Unlike Palace 66 or even Parc 66, these two newer additions have to deal with teething problems under the worst of all circumstances.

We are still observing Tianjin Riverside 66. The new property syndrome is likely unavoidable; we only hope that the hit will not be as severe as the previous two.

Dalian Olympia 66 had its soft opening in mid-December. Various vital signs are so far acceptable but it is way too early to jump to conclusions. Challenges do not come solely from the weak market but also from government actions or inactions. We will have a better idea by the time of its official inauguration in May.

Offices in our two Shanghai complexes were basically fully leased. The two towers in Plaza 66 were again weaker than that in Grand Gateway 66. We had to sacrifice a little rent to keep them fully let.

The high-rise office in Center 66 attained over 70% commitment by space and about 60% has been occupied. In Forum 66, we were only able to have 44% of the space leased and 40% of our tenants moved in. These numbers are below expectation. The main reason is of course the weak economy – we actually had tenants whose leases were voluntarily or involuntarily terminated soon after moving in. In other words, in a few cases we had to vacate tenants. Rental rate in both projects remained steady.

As expected, office tenant quality is not as high as that in our Shanghai facilities. Nevertheless, since we have invariably the best location, the best design and among the best constructed high-rise buildings in the respective cities, we should be able to attract the best possible tenants. We have not been aggressive in demanding rents because to us, tenant quality is as important as short-term unit rent.

Home Ground Evaluation

Although the Hong Kong retail environment has deteriorated further, we have done well – rental revenue and like-for-like retail sales both rose. Recent efforts to upgrade premises have borne fruit in an otherwise difficult market. Results from offices were equally pleasing. Basically all properties remained fully let. The only exception was residential and serviced apartments which performed about the same as the year before.

Nevertheless, because we sold far fewer completed apartments than in the same period a year ago, revenue fell 88%. There was no way that the 7% overall increase in rents could have compensated for this. Moreover, with a very small revaluation gain, net profit attributable to shareholders was down 56%. Underlying net profit attributable to shareholders as well as underlying earnings per share likewise retreated by the same percentage.

It is only right that I should say a word about currency movement. For the past few years, we have held a lot of RMB, and in the second half of 2015, it fell by about 5%. Three points should be made here. First, we do not speculate in any currency. We bought RMB in the past because we have many projects under development on the Mainland. Construction, for example, has to be paid for in the local currency. In that sense, we are hedged. Since we report results in Hong Kong Dollars, translation gains and losses are recognized in the reserve account.

Second, as China seeks to increase convertibility of its currency, its range of movement will be broadened with concomitant increase in volatility. We will be prudent and will minimize risks to the extent possible.

Third, it is your Board and management's views that while the RMB has dropped quite a bit of late, we are not negative about its future in the longer run. It does not appear to us that it will fall significantly further. Relatively speaking, the Chinese economy is still much stronger than most major countries. Barring unforeseen circumstances, this should underpin the RMB.

The Bears We Have Tamed

It must have been a very wise investor who once said that no one should waste a bear market, but most people do. First and foremost, one must not only survive the bear attack but also be well prepared for it. If not, one will see opportunities go by without being able to capitalize on them. Only the disciplined will earn the right. As many in the West now know, the Chinese characters for "crisis" mean "danger" as well as "opportunities". The Chinese economy today is certainly in a crisis.

In the past 20 some years, your Company has thrived on numerous crises. Major ones included: the near collapse of China's reform in 1989 and its reversal in 1991; the Asian Financial Crisis that began in 1997; the tech bubble of 2000; and the Global Great Recession of 2008 brought on by global financial meltdown. The present slowdown is thus at least the fifth serious one in some 25 years. One commonality as far as Hang Lung is concerned is that we avoided danger and took advantage of market troubles each time.

In 1991 China was in serious turmoil and we began to study its economy. This led to our entrance into its market in 1992 and we formulated a strategy that is still in place today, namely that we shall build, own and manage world-class commercial properties in economically vibrant cities. In Hong Kong, we took advantage of the slow market conditions around that time and bought investment properties including our present headquarters, the Standard Chartered Bank Building. Beginning in 1994 we also bought land for residential developments in our home city but stopped a year later when we determined that the market would soon reach unsustainable heights. Instead, we put our finances in the best shape possible and then waited.

What we did not know then was how big the bear market would be. It turned out that the financial crisis that started in 1997 swept through much of East Asia. Then in the depth of that crisis, we bought land in Hong Kong in the absence of competition. Plots on which we built The HarbourSide, The Long Beach and more were all purchased within 21 months beginning April 1999. They have brought us over HK$26 billion of pre-tax profit.

Around the same time, a strong wind of high-tech startups blew our way from the United States. Many of our local competitors were caught up in it instead of buying land. We also experimented with it for a while but decided that the best opportunities then were to stick with what we knew best.

Then ahead of the Global Great Recession that hit in 2008, we quietly bought many plots on the Mainland in 2005-2006 when no one was looking at prime land in second-tier cities. Due to sound financial management, we avoided the troubles that followed and further acquired land amidst the market lull. The bear was thus kind to us.

Not Bracing for Impact But Fortifying for Growth

Now the market is again weak. As I had written before, unlike in 2008 when the fall was steep and the recovery quick, this time it is a U-shaped experience which is much more painful. But as in all previous downturns, we are well prepared for it – in the past 10 years, we were basically debt-free. Net debt today is negligible.

Our preparation for the bear market was not limited to the area of finance. As the market was stalling, we undertook many asset enhancement initiatives – first in Hong Kong and now also in Shanghai. This was why we were able to maintain rental growth in our home market which was in an unfavorable environment. Some question how we can defy gravity. We do not; we just prepared ourselves well ahead of the market fall. Others predict a drop in our Mainland rental revenue like some of our competitors. I do not believe so, at least not this year.

How to capture opportunities presented in a bear market is something I had written about previously. Here I will only summarize.

As long as finances allow which certainly is in our case, a tough trading environment should be used for property upgrade. This we are doing in our two Shanghai properties. It will slightly hurt business but it is preferable to hurt at bad times than at good times. Most property owners hold back from spending money

especially on capital expenditures when the market is down. We do the opposite. This will position us well for the next growth cycle.

In due course we may buy more land on the cheap. But because the downturn is expected to last for some time, we are not in a hurry. We will continue to monitor various cities, as we always do.

We will complete building our management team. Weaker players shed staff during market lulls; we try to attract the best that the marketplace can offer. The focus will mainly be on our leasing and commercial operations team. We will also continue rebuilding an appropriate corporate culture.

Under the leadership of the Board, my colleagues are completing a multi-year project on enterprise risk management. This is an area that we will revisit from time to time.

History shows that whenever our share price is low, our parent company HLGL will buy our scripts. I expect more of the same as long as conditions are right. We will also issue stock options to executives whose ranks have ballooned in numbers in recent years. We should keep our cadres motivated especially when the market is down.

Honing the Edge of Our Software as We Have with Our Hardware

There is one other critical area that we will attempt to build up during the slow market. Previously I have only alluded to it. Namely, in addition to our B2B (Business-to-Business) model, we will add a B2C (Business-to-Consumer) dimension to the way we conduct our business. This plan was recently affirmed at a Board retreat on risk and strategy.

Most landlords think of themselves as dealing only with brands and shop owners. After all, shoppers do not visit our malls to buy from Hang Lung; they transact directly with Chanel, Louis Vuitton, Apple or a restaurant. Our job is to build and manage the best environment, both physical and atmospheric, so that customers will continue to return to our malls, but our orientation is mostly towards our tenants. Our direct outreach to visitors is not robust.

However, consider the case when a female customer wants to buy an Hermes or a Prada product, she does not tell her driver to take her to those stores. Instead, she asks to be taken to Plaza 66 or Forum 66. We have always worked hard to attract the right kind of visitors to our malls but this effort will have to be deepened and broadened. Deepen in the sense that we must see ourselves as a marketing and customer-oriented company and not merely a property rental outfit. Our thinking must change. Broaden means that we must have much more direct interaction with shoppers. With the latest technology, what we can do directly and meaningfully with them has grown substantially. We will also have to work closer than ever with our tenants, especially the key ones, in a more symbiotic way.

This is why two years ago I wrote about an in-house initiative that we called EST, or Experience, Service and Technology. We apply technology of varying degrees of sophistication – from the very simple to the more complicated – in order to provide services that were previously not supported. The goal is to enhance and enrich a positive experience for our shoppers so as to foster long-term loyalty. In the short run, certain new services can be expected to directly increase sales to our tenants. In so doing we are not only luring shoppers to our malls but also bonding our tenants with us.

We already have some of the best hardware in the industry. We hope to also have the most effective software. To be sure, the number one critical success factor in our business is the hardware, or what I call "real estate genetics" of location, size, design and construction. It is almost impossible to win in the long-term without them. We already have them, and the superior software will further cement our leadership position in each of the markets we have chosen to play.

Many are concerned about the impact of e-commerce on physical stores, and I wrote extensively on the subject two years ago. Simply put, the former will definitely not replace the latter, and the few malls that have good "genes" like ours will continue to thrive.

What most people are less aware of are the changes that are quietly taking place in the physical facilities. The overall experience of a shopper at a mall will in say five

years be very different from that of today. We want to position ourselves well for that revolution. When the market is hot, we may not have the capacity to focus on such changes. But now with a chilly winter upon us, it is the right time to put in place measures that will ensure our long-term competitiveness.

Given such changes and the role that technology will play, younger minds are needed. We do have some excellent executives in their 30's who should be able to lead the transformation and, one day, the Company. After all, the baby boomers are now at their retirement age or close to it. The bulk of the spending power is moving to a rising generation closer to the age of our younger colleagues. So from many perspectives, developing younger talent is critical to our continued success. This we are most conscious of and are taking steps to prepare for the future.

A Tip of the Hat to Excellence in Sustainability, Corporate Governance and Design

Six months ago I promised to report on the many awards that we have garnered. There are frankly too many to enunciate one by one. At one count, in 2015 alone we received over 20 prizes of many sorts from reputable international as well as local organizations. Here I will only summarize by roughly categorizing them into three broad groups: sustainability, corporate governance and design. Some honors may fall under more than one category.

On the issue of sustainability, we have been known for our excellent corporate social responsibility. This is a broad term that can include many aspects and we have been cited in many of them. Environmental sensitivity is one such area where we excel. For example, all of our completed Mainland malls have achieved the Gold Level of the LEED (Leadership in Energy and Environmental Design) certification from the U.S. Green Building Council. Not many commercial projects anywhere in the world can attain this but for us it is the minimum.

We have been singled out repeatedly for our efforts in human resources. Examples include: best employer award, best employee training and development program, high employee engagement, best knowledge management, and so forth. Marketing is yet another area for third party endorsement.

Regular readers of this letter will know why we are considered among the very best in corporate governance. For those who know anything about Hong Kong's public companies, especially in our industry, they will recognize that we absolutely stand out – we maintain the highest standard in terms of transparency and accountability. The prizes bestowed on us testified to this. We are also considered superb in investor relations. Even this Annual Report has garnered many awards.

In the area of design, no one should be surprised if he or she has visited our shopping centers on the Mainland. Every project has received high accolades from respectable international organizations. Each is a piece of art which adorns the cityscape. In a land populated with substandard building design, we see it our mission to raise the citizens' standards in appreciating good architecture. Needless to say, we always strive to balance aesthetics with functionality.

As we like to maintain, in all things "We Do It Right"!

Ronnie C. Chan
Chairman
Hong Kong, January 28, 2015

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