HONG KONG
NEW DIRECTIONS IN OFFICE PROPERTY
Q2 2015  DAIWA CAPITAL MARKETS | CBRE RESEARCH

See important disclosures, including any required research certifications, beginning on page 57
NEW DIRECTIONS IN OFFICE PROPERTY

STOCK CONNECT AND THE 6 STRUCTURAL TRENDS

1. Emergence of Greater China equity market
2. China’s investing capital entering global investing world
3. Internationalization of Renminbi and growing importance of offshore Renminbi (CNH)
4. Development of offshore Renminbi business
5. Overseas expansion of China’s corporations
6. Reforms in China’s securities and financial sectors

IMPLEMENTED IN NOV 2014
SH-HK STOCK CONNECT
- INTEGRATION OF MAINLAND CHINA AND HONG KONG STOCK EXCHANGES

NARROWER GAP BETWEEN CHINA & US STOCK MARKETS

THE NEW STOCK CONNECT MODEL

OCCUPIERS’ MARKET DYNAMICS

More new supply in decentralized districts
Space to be vacated in core area
Cost-sensitive MNCs in core area look for affordable spaces

ORGANIC GROWTH

PRC FIRMS AS THE NEW KEY DEMAND DRIVERS

Financial services as a high-margin industry
More PRC firms to come—currently only

Labor force 17% GDP

6% 25% 10%

PRC securities firms have presence in Hong Kong
PRC banks

STRENGTHENED TRADE TIES

STRUCTURAL GROWTH

PROPORTION OF PRC FOOTPRINT IN CBD

AVERAGE SIZE OF BANKS IN HK

CBRE & DAIWA RECOMMENDATIONS FOR POLICYMAKERS

1. Fast track the tender of commercial sites
2. Speed up the construction of infrastructure projects
3. Enhance transparency by providing long-term office supply target

CBRE GLOBAL RESEARCH
This report was prepared by Hong Kong Research Team, which forms part of CBRE Global Research—a network of preeminent researchers who collaborate to provide real estate market research and economic forecasting to real estate.

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Introduction

In September 2012, property consultant CBRE and the research arm of Daiwa Capital Markets collaborated on an in-depth report assessing the multi-year outlook for Hong Kong’s Grade-A office market. Together, we argued that Hong Kong needed more land for office development in order to maintain its robust and vibrant economy and achieve sustained GDP growth (see A 2020 Vision for Hong Kong’s Office Market).

Daiwa and CBRE have again joined forces to offer a joint view: that Hong Kong’s office sector is poised for fundamental changes resulting from the Hong Kong-Shanghai Stock Connect scheme, which was launched on 17 November 2014. Once again, CBRE has lent its commercial property expertise and Daiwa Capital Markets its financial analysis and forecasting skills to collaborate on this report, which gives investors a unique view on the significance of the Stock Connect scheme and its implications for Hong Kong’s office sector over the coming years.

On the surface, the Hong Kong office market seems to be at a crossroads: while rents and capital values are holding up, there is little evidence of fresh new demand. But Daiwa and CBRE take the view that the sector is on the brink of a breakthrough, precipitated chiefly by the Stock Connect, which provides a viable technical and regulatory model through which China can be seamlessly connected with the world. The scheme also marks the beginning of the creation of an offshore capital market for China that could lead to trading in all of China’s capital markets eventually taking place on a large scale in Hong Kong.

Hong Kong’s property market is, of course, inextricably linked with the SAR’s economy and financial sector. CBRE, with its deep understanding of commercial property markets, recognises the potential impact of major developments in the financial sector on the office property market. And Daiwa, in its research on Hong Kong Exchanges and Clearing (HKEx), as well as on the economies and financial and property sectors of Hong Kong and China, is keenly aware of the significance of the Stock Connect and the reforms under way in major financial sectors in China.

Just how big a story could the Stock Connect be for Hong Kong’s property market? The city’s capital markets today are very small relative to those of China and the US. But, if China’s banking assets grow by just 3% per year and China has a capital market whose size matches that of its banking assets by 2020, and if Hong Kong can share just 20% of the incremental expansion of China’s capital markets, we estimate China’s offshore capital markets in Hong Kong would amount to USD4.4tn — over 20% larger than Hong Kong’s capital market as at end-2014.

It is the joint view of CBRE and Daiwa that the impact of this development on Hong Kong’s financial sector, and by extension its property market, is not yet fully appreciated. With this report, we set out to assess the scheme’s long-term implications.
Setting the stage

The Stock Connect and the Hong Kong office market

Notwithstanding all the concerns related to potential interest-rate hikes, the slowdown in China’s economy, and weakness in overseas economies, the Hong Kong property market in general, and its office market in particular, has in recent years proved unusually resilient in terms of rentals and capital values. This suggests there have been important factors underpinning the sector, or that many market participants are prepared to accept the prevailing rents and prices.

But it is also true that new demand – especially in the office sector – has been relatively subdued over the past 3 years, though there was a modest pick-up in office demand in Central in 2014. Does this mean that office demand in Hong Kong has matured and the Hong Kong office sector has passed its peak? Is the city on its way to being marginalised? Or has the office market merely been searching for its next engines of growth?

Daiwa and CBRE take the view that the first, and commonly held, scenario is too pessimistic. We do not subscribe to the view that the city is being marginalised and that Hong Kong’s importance is diminishing, either as an office market or as a city serving China and the rest of the world.

Nevertheless, we do believe that Hong Kong has been riding on its role as the ‘gateway’ to China for many years, and that a number of companies have by now reached an advanced stage of expansion if Hong Kong remains only a gateway city to China.

As at end-2014, China’s equity market is only about 22% the size of its banking assets. The corresponding figure for the US is about 1.8x. The Chinese economy has been financed principally by its banking sector over the past few decades. As the Chinese government has stated that it aims to promote the development of its capital market and has already implemented many regulatory changes to this end, we think it is only reasonable to expect that, over time, China’s capital market will approach or even surpass the size of its banking assets.

But the size of China’s banking assets is anything but small, and the gap between the size of China’s capital market and its banking assets stood at USD16tn at the end of 2014. Before the commencement of the Stock Connect, China’s capital market was entirely on-shore and it is only now beginning to build an offshore component for its capital market. In this light, if the size of China’s capital market continues to grow and the offshore segment becomes an important component of the capital market, its offshore capital market could well grow into a market worth multi trillions of US dollars.

On our estimates, if China’s banking assets rise by 3% per year through to 2020, the size of its capital markets would need to increase by some USD22tn to match its banking assets at that time. If we assume China’s offshore capital markets can share 10-30% of the expansion of China’s capital markets from now on, then the size of China’s offshore capital markets could rise to USD2.2-6.5tn, compared with Hong Kong’s less-than-USD3.4tn capital market (equities plus bonds) as at end-2014.
Crucially, if China is going to have a major offshore capital market, which country or city will take up this role? Our view is that Hong Kong has solid credentials and the potential to be China’s offshore capital market. Indeed, it has been evolving along the lines of a quasi offshore capital market for China for 2 decades, since the first H-share IPO in Hong Kong in 1993. Hong Kong is already the largest capital formation centre for Mainland corporations, as the city with the largest base of offshore Renminbi deposits (CNY1tn at end-2014). In this light, it can be argued that assuming the role of the most important offshore capital market for China represents a bold but natural step forward for Hong Kong as a city.

Creating a larger and more vibrant capital market for China is easier said than done, of course. One of the biggest obstacles is how China’s financial institutional framework, with its many unique features, will be able to integrate with the rest of the world. Therein lies the beauty of the Stock Connect scheme, in our view.

**Shanghai-Hong Kong Stock Connect**

HKEx sees scope for a “Mutual Market” of Hong Kong and China

In our opinion, the greatest significance of the Stock Connect is that it signifies innovation in the financial institutional frameworks of Hong Kong and China. Essentially, it represents a new mechanism whereby investing capital in both China and the rest of the world can now enter into a large new territory without China and the rest of the world having to make fundamental changes to the institutional structures of their own systems. As such, this scheme can be seen as the first step in the establishment of what HKEx refers to as the “Mutual Market” of Hong Kong and China, as illustrated in the following graphic.
The Hong Kong-China Mutual Market

Pre-Stock Connect

HK & International

China

Now

HK & International

China

Future

HK & International

China

Source: Daiwa
We think the importance of this innovation becomes clearer when viewed from the perspective of China’s gradual integration into the global economy. Over the more than 3 decades since China opened its doors in 1978, the institutional framework governing the country’s economic activities has evolved along its own lines, especially for sectors outside trade and manufacturing. With China becoming an increasingly important component of the global economic order, how the country connects its institutional framework with the rest of the world has become a pressing issue.

How can this be achieved? Is it reasonable to expect the rest of the world to adapt to China’s standards? We think not. At the same time, can China’s institutional framework be changed to match the rest of the world’s? This would be a lengthy and difficult process, if possible and feasible at all, in our view. This brings us to the greatest importance of the Stock Connect, or the concept of Mutual Market Access advocated by HKEx: “it provides China with an interim model for opening up of its capital markets before it is completely ready for the large-scale arrivals of international investors and departures of Chinese domestic investors.”

As stated in HKEx Chief Executive Charles Li’s review of the company’s 2014 annual report:

“The interim model works like a Mutual Market* whereby investors on each side of the boundary are able to trade the products of the other market within their home time zone, relying on their home market infrastructures. With the joint oversight of the 2 regulators, capital flows from China and international markets are able to congregate and interact with each other in this Mutual Market, facilitating the gradual convergence of the Mainland and international markets.”

*There is not yet an official definition of this Mutual Market other than the explanation in the above remarks. We see the term as referring to the capital market that is being established by the Stock Connect under the joint oversight of the regulators from China and Hong Kong, and one that belongs to both China and Hong Kong.

The Stock Connect is potentially the first step toward closer integration of China and international markets

In our opinion, from the very outset, the Stock Connect has been designed to be the “first step in an ambitious journey”. Once the first step has proved to be workable, there are several initiatives in place to expand the scheme’s scope (see Daiwa’s report on Hong Kong Exchanges & Clearing (388 HK): A careful step in an ambitious journey, published on 19 June 2014, for further details). We believe this model has the potential to be extended to Shenzhen, as well as other products and asset classes, including equity derivatives, commodities, fixed income and currencies. HKEx stated in its 2014 annual report that it would pursue these initiatives, and we believe many will be forthcoming over the next 6-12 months.
Hong Kong’s special role in the Hong Kong-China Mutual Market

**Pre-Stock Connect**
HK’s role is mainly that of a Gateway to China

**Now**
HK’s role becomes more than just a Gateway to China
A special bridge linking HK and China

**Future**
HK could well have a Mutual Market which is no smaller than the current size of its capital markets
The Mutual Market could become a lot larger than it is today

Source: Daiwa
Major components of the Hong Kong China Mutual Market

While this Mutual Market is mainly about Hong Kong and China equities at this stage, the Stock Connect’s ultimate goal is to be a platform encompassing equity derivatives, commodities, fixed income, currency and international equities. In short, its size could eventually reach a scale limited only by the amount of Chinese investing capital willing to go abroad, and the amount of international investing capital willing to be invested in China assets.

Although it is hard to ascertain the future size of this Mutual Market, we provide our estimates in the following table. If we assume the size of China’s capital market matches the size of its banking assets over time, and the size of its banking assets grows by 3% per year up to 2020, the size of China’s capital market will need to expand by USD22.1tn from its level as of December 2014. The figure rises to USD28.2tn if we change the assumed CAGR from 3% to 5%.

As shown in the following table, if Hong Kong gets 20% of the incremental expansion of China’s capital markets from now on, then the size of China’s offshore capital market in Hong Kong — the Mutual Market that HKEx has been talking
about — would be USD4.4tn, or over 20% larger than Hong Kong’s capital market as at December 2014.

The relative size of the capital markets of US, China and Hong Kong

<table>
<thead>
<tr>
<th></th>
<th>US</th>
<th>China</th>
<th>Hong Kong</th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP (USDtn)</td>
<td>17.4</td>
<td>10.2</td>
<td>0.3</td>
</tr>
<tr>
<td>Bank deposits (USDtn)</td>
<td>10.2</td>
<td>18.2</td>
<td>1.3</td>
</tr>
<tr>
<td>Banking assets (USDtn)</td>
<td>15.0</td>
<td>26.9</td>
<td>2.4</td>
</tr>
<tr>
<td>Equity market cap (USDtn)</td>
<td>26.3</td>
<td>6.0</td>
<td>3.2</td>
</tr>
<tr>
<td>Bond markets (USDtn)#</td>
<td>21.0</td>
<td>4.6</td>
<td>0.2</td>
</tr>
<tr>
<td>Size of its capital markets (bond + equities) (USDtn)</td>
<td>47.3</td>
<td>10.6</td>
<td>3.4</td>
</tr>
</tbody>
</table>

Note: As at end-2014
# excluding government bonds

Source: World Federation of Exchanges, CEIC, Daiwa

The potential size of China’s offshore capital markets

<table>
<thead>
<tr>
<th>CAGR of China’s banking assets (2014-2020)</th>
<th>1%</th>
<th>2%</th>
<th>3%</th>
<th>4%</th>
<th>5%</th>
<th>6%</th>
<th>7%</th>
<th>8%</th>
</tr>
</thead>
<tbody>
<tr>
<td>China’s banking assets by end 2020 USDtn</td>
<td>28.6</td>
<td>30.5</td>
<td>32.1</td>
<td>34.0</td>
<td>38.2</td>
<td>38.2</td>
<td>40.4</td>
<td>42.7</td>
</tr>
<tr>
<td>Size of China’s capital markets (debt + equities) at end 2014 USDtn</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
<td>10.3</td>
</tr>
<tr>
<td>The required increase in the size of China’s capital markets*</td>
<td>18.3</td>
<td>20.0</td>
<td>21.8</td>
<td>23.7</td>
<td>27.9</td>
<td>27.9</td>
<td>30.1</td>
<td>32.4</td>
</tr>
</tbody>
</table>

The incremental expansion of China’s capital markets shared by its principal offshore capital market

<table>
<thead>
<tr>
<th></th>
<th>10%</th>
<th>20%</th>
<th>30%</th>
<th>40%</th>
<th>50%</th>
</tr>
</thead>
<tbody>
<tr>
<td>CAGR of China’s capital markets shared by its principal offshore capital market</td>
<td>1.8</td>
<td>3.7</td>
<td>5.5</td>
<td>7.3</td>
<td>9.1</td>
</tr>
</tbody>
</table>

note: In order that the size of China’s capital market can match the size of its banking assets

Source: Daiwa

The emergence of a China offshore capital market is too big a theme to ignore

In this light, the potential impact of the emergence and expansion of a China offshore capital market is too big to be ignored. We note too that the amount of Hong Kong’s Grade-A office stock today is appreciably smaller than that of New York or London. By extension, if the gap between Hong Kong and London/New York in terms of their roles as international financial centres narrows, the gap between the size of their office stock should likewise narrow.

Milestones in China’s capital market development

Source: Bloomberg, Daiwa

Another perspective from which to look at the issue is the future of Hong Kong as a city. Hong Kong is arguably facing a ‘mid-life crisis’ in that it is unclear what the
territory will become a few years down the road. It has come a long way in terms of becoming the capital formation centre for China and the commercial gateway to China. What’s next?

Against this backdrop, we believe the Stock Connect has important symbolic significance because it implies that it is not the state’s plan to marginalise Hong Kong. If anything, under the Stock Connect, the exchanges of Hong Kong, Shanghai, and likely Shenzhen too, should be able to work together to create a larger pie, which in turn could open up many opportunities across various industries.

In summary, we see the Stock Connect as an innovative institutional framework, providing a wide range of opportunities for companies in various sectors, with the eventual impact depending on the imagination, foresight and creativity of the market participants in the financial sectors of Hong Kong and China.

But most of all, we see it having an important bearing on 6 ongoing structural developments in the Hong Kong-China capital markets, which in turn should have implications for the development of securities, fixed income, asset management, research, and financial products.

We highlight 6 structural factors supporting Hong Kong’s financial sector and indirectly giving impetus to the city’s Grade-A office market...

China would not necessarily need to have a large-scale offshore capital market in the next few years for our conclusion to be valid. We believe there are already 6 structural factors that have been providing support to Hong Kong’s financial sector which will also indirectly provide impetus to the city’s Grade-A office market, and whose development should only be helped by the Stock Connect. If the Stock Connect continues to improve and expand, we believe it could take these 6 structural trends to another level that would support to Hong Kong’s financial sector and office market over the next few years.

Identified below are 6 structural trends that are emerging in Hong Kong’s financial sector:

1. The emergence of a “Greater China equity market”
2. The beginning of China’s investing capital entering the global investing world
3. Internationalisation of the Renminbi and the growing importance of the CNH (ie, offshore Renminbi)
4. Development of an offshore bond and lending market for the Renminbi
5. The modernisation and overseas expansion of Chinese corporations
6. The reforms in China’s securities and financial sectors

Overall, we are optimistic about the outlook for the Hong Kong Grade-A office market in the next few years. Below are 6 developments that we expect to unfold over in the Hong Kong office market over the next few years (see pages 35-54 for details):

1. A gradual rise in new demand for office space in Hong Kong, especially for smaller space (3,000-10,000 sq ft)
2. Chinese corporations’ presence and footprint in the Hong Kong office sector catching up with those of international companies
3. Continued decentralisation and expansion in the size of the Hong Kong office sector
4. Vacant space in Central created by decentralisation being back-filled by new demand from smaller tenants, such as Chinese financial companies
5. Central maintaining its position as the premier CBD of Hong Kong
6. Kowloon East emerging as the second CBD of Hong Kong and some districts (such as Wong Chuk Hang, Cheung Sha Wan, West Kowloon) emerging as new office sub-markets, mainly for back-office operations, in the immediate future.
The Stock Connect and 6 structural trends

The scheme’s importance extends far beyond the initial quota utilisation

The Stock Connect marks the first time that investors in the markets of Hong Kong and Mainland China can enjoy Mutual Market access, giving them exposure to types of securities that were previously out of their reach.

The scheme is in its early days

Shanghai-Hong Kong Stock Connect daily turnover

While the initial utilisation of the Stock Connect quota has not been as enthusiastic as some observers had expected, we believe the scheme’s importance goes far beyond the quota utilisation. Moreover, we believe its impact will not be limited to the securities industries of Hong Kong and China.

We expect investors’ interest to continue to increase over time, backed by ongoing investor education and future refinements to the regulatory and institutional frameworks. Indeed, since early April, the quota utilisation has improved notably, especially for southbound trades.

Another important point is that the Stock Connect has not run into major technical problems. In other words, it has proven to be a viable mechanism from both a regulatory and technical perspective. We see this smooth implementation as a milestone, as it puts to rest any early concerns about the programme’s execution and paves the way for its planned expansion.
A look back at the development of H-share listings in Hong Kong is instructive. When Tsingtao Brewery became the first H-share to be listed in Hong Kong in 1993, the offering was not particularly well subscribed and there were doubts in the market as to how important H shares would become. But, in subsequent years, the Hong Kong market warmed to listings by Mainland companies, setting the stage for the big breakthrough in the mid-2000s, when China’s biggest banks queued up to list in the territory.

Since then, Hong Kong has been indisputably the most important market for Mainland companies seeking to list “overseas”. Hence, H-share listings have been the most important factor driving the transformation of Hong Kong’s equity market from HKD3tn in market cap in 1993 to HKD26tn as of end-2014.

More importantly, judging by the experience of Mainland Chinese companies that have listed shares in Hong Kong, the long-term consequences of the scheme’s future uptake and expansion should not be underestimated.

An innovative institutional framework that fits into our 6 structural trends

We see the Stock Connect as a first, measured step – the start of a process that will usher in many initiatives designed to expand both its scale and scope.

Potential areas of improvement for the Stock Connect

1. Lowering the CNY0.5m threshold for opening accounts in China to participate in the Stock Connect
2. Potential secondary listings of major China stocks listed in the US
3. Extending the Stock Connect to the Shenzhen market
4. Expanding the list of eligible stocks
5. Expanding the programme to include derivatives, futures and commodities

Source: Daiwa

In some ways, the Stock Connect can be likened to a “bridge” linking Hong Kong and China’s financial sectors. It should be clear to market participants on both sides that the bridge is in place and ready for use. The early adopters are already crossing the bridge and coming to appreciate some of the possibilities it has opened up. It is now down to the foresight and creativity of market participants to determine how to make the most productive use of this bridge.

Financial assets in China have ballooned over the past 10 years. As at end-2014, the country’s M2 and bank deposits stood at USD19.7tn and USD18.2tn, respectively, or 1.7x and 1.8x those of the US. Prior to the establishment of the Stock Connect, the flow of China’s financial assets outside the country was subject to strict regulatory controls. But with the bridge now in place, financial assets from China can flow out of the country in controlled fashion. We believe there is considerable scope to widen and improve this bridge in the coming years.
Key data on the US, China and Hong Kong financial sectors

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<tr>
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</tr>
<tr>
<td>Equity market cap (USDtn)</td>
<td>26.3</td>
<td>6.0</td>
<td>3.2</td>
</tr>
<tr>
<td>Annual stock market turnover (USDtn)</td>
<td>28.1</td>
<td>12.0</td>
<td>1.5</td>
</tr>
<tr>
<td>M2 (USDtn)</td>
<td>11.6</td>
<td>19.7</td>
<td>1.4</td>
</tr>
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</table>

Source: World Federation of Exchanges, CEIC, Daiwa
Note: As at end-2014

We believe the long-term implications of the Stock Connect cannot be underestimated, if only because the sheer size of China’s M2 and bank deposits mean the country has the potential to evolve from its historical role as a capital importer into an important capital exporter. Moreover, the scheme could allow Hong Kong to participate in the reallocation of the USD18tn-plus capital now sitting on the balance sheets of the Chinese banks.

But even in the near to medium term, we believe the programme has considerable potential because it should dovetail with — and perhaps give new impetus to — the 6 structural trends for the financial sector that we highlight in this report. These trends are ongoing but could, with the right catalysts, be taken to the next level.

If, as we expect, the Stock Connect proves to be one such catalyst, the programme has far-reaching implications for Hong Kong as a city in general and its office property market in particular.
What are the 6 trends?

1. The emergence of a “Greater China equity market”

In a conceptual sense at least, the Stock Connect signals the making of a Greater China equity market. At this stage the market covers most stocks in Hong Kong and Shanghai, but will ultimately encompass all listed stocks in both cities, as well as those listed in Shenzhen (perhaps as soon as 2H15). The combined market capitalisation of this expanded Greater China equity market would, at current prices, be almost USD12tn, which would make it the second-largest market in the world — behind only the New York stock market, larger than the Nasdaq, and almost double the size of the London stock market.

The combined equity markets of Hong Kong, Shanghai and Shenzhen

<table>
<thead>
<tr>
<th></th>
<th>Hong Kong</th>
<th>Shanghai A shares</th>
<th>Shenzhen A shares</th>
<th>HK-Shanghai-Shenzhen combined*</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of companies</td>
<td>1,776</td>
<td>1,030</td>
<td>1,653</td>
<td>4,459</td>
</tr>
<tr>
<td>Market capitalisation (USDtn)</td>
<td>3.7</td>
<td>5.0</td>
<td>3.2</td>
<td>11.9</td>
</tr>
</tbody>
</table>

Source: HKEx
Note:*There are 88 companies dual listed (ie, with both H and A shares)
Note: As of March 2015

We note that while China’s A-share market has a hefty market capitalisation of USD8.2tn at the end of March 2015, it is not yet an integral part of the global investing world, as it is not included in the major indices followed by equity investors. Our understanding is that global investors’ hitherto limited access to the A-share market (the QFII and RQFII schemes are open only to qualified investors) is a key reason why many major index companies do not include A shares in their indices.
But the Stock Connect makes the A-share market more accessible for foreign investors

The Stock Connect is a big step forward in resolving this accessibility issue, as it allows practically all investors who can invest in Hong Kong to invest in Shanghai A shares, too. By extension, we believe the scheme should go some way towards assuaging the major index companies’ concerns over foreign investors’ limited access to the A-share market. Indeed, we believe it is only a matter of time before A shares are added to the world’s major indices. While the MSCI did not include A shares in its indices in its July 2014 review, it acknowledged the Stock Connect as an important breakthrough and declared it would review the situation in its next review (within 2015). The FTSE group also intends to revisit the issue.

While the inclusion of China A shares in the world’s major indices would likely be implemented in stages, and the weighting given to these shares would not initially match their market capitalisation, we think the development would have a far-reaching impact.

First, given that a sizeable portion of the world’s investing capital is passive, and the mandate of index funds is to replicate the world’s major indices, we would expect large sums of capital to go into China A shares through the Hong Kong Stock Exchange. Second, the resulting rise in the average daily turnover of China A shares would likely increase the importance of research, data, and other information associated with investing in the A-share market.

### Potential inclusion of A shares in the MSCI Emerging Market Index

<table>
<thead>
<tr>
<th>Index</th>
<th>Funds tracking these indices (USDbn)</th>
<th>Weight (%)</th>
<th>Partial inclusion - 5% inclusion factor Fund size (USDbn)</th>
<th>Weight (%)</th>
<th>Full inclusion - 100% inclusion factor Fund size (USDbn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI Emerging Markets</td>
<td>1,400</td>
<td>0.50%</td>
<td>7.0</td>
<td>9.40%</td>
<td>127.8</td>
</tr>
<tr>
<td>MSCI Asia ex Japan</td>
<td>370</td>
<td>0.30%</td>
<td>1.1</td>
<td>5.70%</td>
<td>22.3</td>
</tr>
<tr>
<td>MSCI World</td>
<td>1,700</td>
<td>0.65%</td>
<td>0.9</td>
<td>1.10%</td>
<td>18.7</td>
</tr>
<tr>
<td>Total</td>
<td>3,470</td>
<td>9.1</td>
<td></td>
<td></td>
<td>168.8</td>
</tr>
</tbody>
</table>

Source: Hong Kong Economic Times

Note: Based on the funds tracking these major MSCI indices; the MSCI estimates that the size of all the funds tracking its various MSCI is about USD8,400bn

If the world starts to view the stock markets of Hong Kong, Shanghai and Shenzhen as a single China equity market, then the breadth and depth of the “Greater China equity market” should improve appreciably. In several sectors, such as gaming, banks, property, and telecoms, some of the world’s largest players are already listed in Hong Kong.

Companies currently listed on the stock markets of Hong Kong, Shanghai, and Shenzhen have some differences: Hong Kong has more property and financial companies, Shanghai has more large SOEs, and Shenzhen has more technology and smaller companies. When combined, however, the variety of industries in Hong Kong and China, as well as the number of companies within each industry category and their cumulative market cap, would improve significantly.
Market cap by sector of the US and China equity markets

<table>
<thead>
<tr>
<th>Sector</th>
<th>Total market cap (USDbn)</th>
<th>Hong Kong</th>
<th>NASDAQ</th>
<th>NYSE</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Automobiles &amp; Parts</td>
<td>59</td>
<td>55</td>
<td>304</td>
<td>170</td>
<td>126</td>
<td>714</td>
<td></td>
</tr>
<tr>
<td>Banks</td>
<td>782</td>
<td>253</td>
<td>1,180</td>
<td>1,022</td>
<td>48</td>
<td>3,284</td>
<td></td>
</tr>
<tr>
<td>Basic Resources</td>
<td>186</td>
<td>23</td>
<td>187</td>
<td>400</td>
<td>179</td>
<td>976</td>
<td></td>
</tr>
<tr>
<td>Chemicals</td>
<td>28</td>
<td>27</td>
<td>503</td>
<td>156</td>
<td>204</td>
<td>918</td>
<td></td>
</tr>
<tr>
<td>Construction &amp; Materials</td>
<td>75</td>
<td>16</td>
<td>188</td>
<td>346</td>
<td>134</td>
<td>758</td>
<td></td>
</tr>
<tr>
<td>Financial Services</td>
<td>211</td>
<td>241</td>
<td>1,462</td>
<td>314</td>
<td>184</td>
<td>2,412</td>
<td></td>
</tr>
<tr>
<td>Food &amp; Beverage</td>
<td>93</td>
<td>192</td>
<td>749</td>
<td>161</td>
<td>192</td>
<td>1,387</td>
<td></td>
</tr>
<tr>
<td>Health Care</td>
<td>68</td>
<td>1,282</td>
<td>2,114</td>
<td>198</td>
<td>265</td>
<td>3,927</td>
<td></td>
</tr>
<tr>
<td>Industrial Goods &amp; Services</td>
<td>339</td>
<td>415</td>
<td>2,546</td>
<td>829</td>
<td>726</td>
<td>4,855</td>
<td></td>
</tr>
<tr>
<td>Insurance</td>
<td>324</td>
<td>53</td>
<td>1,024</td>
<td>266</td>
<td>-</td>
<td>1,668</td>
<td></td>
</tr>
<tr>
<td>Media</td>
<td>29</td>
<td>517</td>
<td>483</td>
<td>46</td>
<td>81</td>
<td>1,156</td>
<td></td>
</tr>
<tr>
<td>Oil &amp; Gas</td>
<td>193</td>
<td>77</td>
<td>2,262</td>
<td>516</td>
<td>47</td>
<td>3,096</td>
<td></td>
</tr>
<tr>
<td>Personal &amp; Household Goods</td>
<td>216</td>
<td>128</td>
<td>1,147</td>
<td>163</td>
<td>240</td>
<td>1,884</td>
<td></td>
</tr>
<tr>
<td>Real Estate</td>
<td>441</td>
<td>60</td>
<td>965</td>
<td>177</td>
<td>164</td>
<td>1,807</td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>121</td>
<td>749</td>
<td>1,518</td>
<td>108</td>
<td>83</td>
<td>2,579</td>
<td></td>
</tr>
<tr>
<td>Technology</td>
<td>288</td>
<td>3,278</td>
<td>936</td>
<td>158</td>
<td>368</td>
<td>5,027</td>
<td></td>
</tr>
<tr>
<td>Telecommunications</td>
<td>358</td>
<td>48</td>
<td>473</td>
<td>26</td>
<td>6</td>
<td>911</td>
<td></td>
</tr>
<tr>
<td>Travel &amp; Leisure</td>
<td>204</td>
<td>378</td>
<td>538</td>
<td>105</td>
<td>52</td>
<td>1,276</td>
<td></td>
</tr>
<tr>
<td>Utilities</td>
<td>176</td>
<td>12</td>
<td>736</td>
<td>225</td>
<td>63</td>
<td>1,212</td>
<td></td>
</tr>
<tr>
<td>Others</td>
<td>2</td>
<td>-</td>
<td>3</td>
<td>-</td>
<td>-</td>
<td>5</td>
<td></td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>4,194</strong></td>
<td><strong>7,805</strong></td>
<td><strong>19,315</strong></td>
<td><strong>5,385</strong></td>
<td><strong>3,162</strong></td>
<td><strong>39,861</strong></td>
<td></td>
</tr>
</tbody>
</table>

Source: Bloomberg, Daiwa

Note: 14 April 2015

We do not think the importance of China’s equity markets in the global investing world will match that of the US in the foreseeable future. But, if the Hong Kong, Shanghai and Shenzhen equity markets do effectively combine, the gap between the stock markets of China and the US should narrow considerably.

In a comparison of the US and our theoretical combined China market, there is not much difference in terms of the number of small companies listed (market cap of USD3bn or less). But, as shown in the table below, China has far fewer large companies (USD3-10bn, USD10-100bn, and USD100bn-plus) than the US.

In this context, if some of China’s small companies grow into large ones, and other companies continue to be added to the combined China equity market, the gap between the US and China should narrow still further. Hence, we argue that if the Stock Connect gains further traction, some mega-sized corporations in the US and elsewhere could consider listing in Hong Kong, Shanghai, or even both markets. Heavyweight listings such as these would underline the importance of the Greater China equity market to the global investment community, and hence create a virtuous circle.
Market cap. by size of company

<table>
<thead>
<tr>
<th>Size of companies</th>
<th>Hong Kong</th>
<th>NASDAQ</th>
<th>NYSE</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total market cap (USDbn)</td>
<td>888</td>
<td>2,802</td>
<td>6,265</td>
<td>1,199</td>
<td>-</td>
<td>11,154</td>
</tr>
<tr>
<td>&gt;USD100bn</td>
<td>1,891</td>
<td>2,724</td>
<td>9,024</td>
<td>2,100</td>
<td>532</td>
<td>16,271</td>
</tr>
<tr>
<td>USD10bn-100bn</td>
<td>652</td>
<td>1,122</td>
<td>2,707</td>
<td>1,135</td>
<td>1,010</td>
<td>6,625</td>
</tr>
<tr>
<td>USD1bn-3bn</td>
<td>420</td>
<td>704</td>
<td>964</td>
<td>744</td>
<td>1,211</td>
<td>4,043</td>
</tr>
<tr>
<td>&lt;USD1bn</td>
<td>343</td>
<td>454</td>
<td>354</td>
<td>207</td>
<td>410</td>
<td>1,768</td>
</tr>
<tr>
<td>Total</td>
<td>4,194</td>
<td>7,805</td>
<td>19,315</td>
<td>5,385</td>
<td>3,162</td>
<td>39,861</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>% share by total market cap</th>
<th>&gt;USD100bn</th>
<th>USD10bn-100bn</th>
<th>USD3bn-10bn</th>
<th>USD1bn-3bn</th>
<th>&lt;USD1bn</th>
<th>Grand Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;USD100bn</td>
<td>21%</td>
<td>36%</td>
<td>32%</td>
<td>22%</td>
<td>0%</td>
<td>28%</td>
</tr>
<tr>
<td>USD10bn-100bn</td>
<td>45%</td>
<td>35%</td>
<td>47%</td>
<td>39%</td>
<td>17%</td>
<td>41%</td>
</tr>
<tr>
<td>USD3bn-10bn</td>
<td>16%</td>
<td>14%</td>
<td>14%</td>
<td>21%</td>
<td>32%</td>
<td>17%</td>
</tr>
<tr>
<td>USD1bn-3bn</td>
<td>10%</td>
<td>9%</td>
<td>5%</td>
<td>14%</td>
<td>38%</td>
<td>10%</td>
</tr>
<tr>
<td>&lt;USD1bn</td>
<td>8%</td>
<td>6%</td>
<td>2%</td>
<td>4%</td>
<td>13%</td>
<td>4%</td>
</tr>
<tr>
<td>Grand Total</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Daiwa
Note: 14 April 2015

2. The beginning of China’s investing capital entering the global investing world

There has been substantial expansion in the deposits and financial assets held in China over the past 20 years, partly reflecting the expansion in the country’s M2 over the same period. Although household balance sheets in China tend to be skewed towards property and bank deposits, rather than stock-market investments, China-based individuals account for around 85% of A-share trading by value, and the combined average daily turnover on the Shanghai and Shenzhen markets was 5.5x that of Hong Kong in 2014. Indeed, the ADT in A shares reached a record USD286bn on 20 April 2015.

We do not expect there to be a dramatic change in the way Chinese households allocate their savings, but just a 2-3pp shift in their weighting towards the stock market would translate into more than USD300bn of capital, on our estimates. The sheer size of the pool of investing capital that Chinese investors can access should prompt major global companies to consider listing in Hong Kong, Shanghai, or even both markets. Hence, any change in households’ weighting towards the stock market should be seen as an important structural trend.
3. Internationalisation of the Renminbi and the growing importance of offshore Renminbi deposits (CNH)

Internationalising the Renminbi…

China has stated repeatedly that it is the state’s policy to internationalise the Renminbi and to build up offshore Renminbi centres. This process has been under way for more than 10 years, and over the years we have seen many obstacles being cleared. For example, an increasing number of China’s trading partners are now willing to accept Renminbi as the currency for trade settlement, and this has been a big factor in driving the growth of Renminbi deposits in Hong Kong. The rising number of Mainland Chinese travelling overseas is another factor that has driven the growth of offshore Renminbi deposits (CNH) in Hong Kong, which surpassed the CNY1tn mark in 2013.
In November 2014, China lifted the CNY20,000 per day limit on Renminbi brought into Hong Kong, effectively removing another obstacle to the further expansion of Renminbi deposits in Hong Kong. One additional hurdle is that there are few available avenues for Renminbi brought to Hong Kong other than being parked at the bank.

In this context, we believe the Stock Connect could serve as an additional incentive for market participants to develop Renminbi investment products in Hong Kong. When more Renminbi investment products become available in Hong Kong, this would attract more offshore Renminbi to be parked in Hong Kong as the usage would be a lot wider – aside from being put in the banks, Renminbi could be used to buy equities in China or put into the expanding pool of Renminbi investment products.

Strictly speaking, the Stock Connect will not in itself result in a direct increase in Renminbi flowing from China to Hong Kong, as Mainland Chinese investors who have used the Renminbi to buy Hong Kong-listed shares need to send Renminbi back to China after selling the securities. Nevertheless, we think the scheme will make it possible for the Chinese government to allow a much larger pool of Renminbi to flow to Hong Kong, when it decides the time is right to do so.

One of the most important aspects of the Stock Connect is that it creates a mechanism whereby Renminbi can flow out of the country without affecting the onshore currency rate. Renminbi-related trades are settled between Hong Kong and China on a net basis every day, and they are settled in Hong Kong, ie, an offshore market. For example, Renminbi for northbound trade (buying A shares) must be settled in Hong Kong; likewise, Renminbi must be exchanged into Hong Kong dollars for southbound trade. In other words, the programme is related only to CNH and hence should not affect the onshore Renminbi exchange rate. With this approach, Renminbi can flow out of the country without having a direct impact on the official Renminbi exchange rate, which is most likely an issue of considerable importance to the state.

In our opinion, the fact that the settlement currency for the Stock Connect is CNH is positive for Hong Kong’s position today and its prospects as an offshore Renminbi centre. At the very least, the CNH as a settlement currency should help to attract a larger pool of offshore Renminbi to Hong Kong and, over time, bode well for the prospect of the CNH becoming the benchmark rate for offshore Renminbi, which we believe is also the objective of China and Hong Kong governments.
Granted, there are ceilings on the Stock Connect quota (CNY13bn for northbound trades and CNY10.5bn for southbound trades on a daily basis; CNY300bn for northbound trades and CNY250bn for southbound trades in terms of the maximum aggregate quota). These ceilings will, of course, limit the amount of capital that can be mobilised by this programme. However, we believe the Stock Connect is important, given the following factors:

1. CNY10.5bn-13bn per day and CNY250-300bn are not small sums. Moreover, we believe there is scope for these quotas to be relaxed over time.

2. The daily quota is calculated on a net basis. While the actual amount of Renminbi at the end of the trading day will be smaller, the total amount involved over the course of the day could be much greater.

3. Renminbi used to buy Hong Kong shares would not have to be sent back to China if instead it could be invested in other vehicles in Hong Kong. This fact alone should stimulate the development of other Renminbi products in Hong Kong, including bonds, FICC products, and derivatives.

Our conclusion is that a continuous increase in the pool of Renminbi in Hong Kong, together with a broader range of uses for the currency once it is in Hong Kong, is central to the city’s further development as an offshore Renminbi centre. We see the Stock Connect as a big catalyst in this regard, as crucially the scheme serves as a way to manage capital outflows, which other offshore Renminbi centres such as London and Singapore cannot match. Indeed, other centres would face a big hurdle in trying to replicate this aspect of the Stock Connect because the scheme demands a high degree of trust among the regulators, as it effectively allows one regulator to enforce some of its rules in another jurisdiction.

We note, too, that under the Stock Connect, individuals from Mainland China have the option of opening accounts in Hong Kong to trade both Hong Kong shares and A shares. As a result, we believe the scheme should give a significant boost to the size and importance of CNH, while giving China a way to allow capital outflows without affecting onshore Renminbi exchange rates.

4. The development of an offshore bond and lending market for Renminbi

As we see it, having a critical mass of currency offshore is critical to the development of an offshore centre. To recall, the Eurodollar market began as a place to park excess petro dollars, but, as dollar deposits continued to expand, other development opportunities arose. As long as its execution is sound, Hong Kong could develop into an alternative market for arranging Renminbi borrowings and bonds, in our opinion.

Historically, Hong Kong has not had a large bond market, as companies in the city tend to fund their investments using bank loans or through the equity market. Nevertheless, it has been the government’s policy to encourage the development of a bond market, and Renminbi-denominated bonds have grown in prominence and value in recent years. From less than CNY20bn in 2009, Renminbi bonds outstanding in Hong Kong expanded to the CNY300bn mark in 2013.
In other words, the scale and depth of the Renminbi bond market has continued to develop, though it has a long way to go before it can be seen as mature or even established. In our opinion, to the extent that it can stimulate the flow of Renminbi to Hong Kong, both directly and indirectly, the Stock Connect should help to facilitate the emergence of an offshore bond and lending market for Renminbi in Hong Kong.

**Dim-Sum bonds outstanding**

Shown in the exhibits below are a comparison of China and other major economies in terms of equity market capitalisation, loans, and GDP, together with share of corporate bonds and equity financing in the Mainland China economy in recent years. By global standards, we think it fair to say that the Chinese economy has been over-reliant on its banking sector and its equity and bonds markets are under-developed.

**China total social finance aggregate: share of corporate bond and equity financing**

*Source: CEIC, Bloomberg, Daiwa*
There are several reasons why China’s equity and bond markets are relatively underdeveloped, including one big structural factor: China's bond market has faced continued regulatory issues as a result of the split among several authorities in terms of issuance approval and market supervision. The People’s Bank of China, China Banking Regulatory Commission, China Securities Regulatory Commission and National Development and Reform Commission are each involved in approving bond issuances and supervise multiple bond markets.

Aside from lower accessibility, we note there is a substantial interest-rate differential between China and other major markets. Hence, many Mainland Chinese companies ought to have a strong incentive to borrow from offshore markets, especially private enterprises which, more often than not, are not getting the highest priority in terms of raising capital in the Mainland.

Factors supporting growth in overseas fund-raising demand by Chinese corporates

<table>
<thead>
<tr>
<th>Reason</th>
<th>Forms of overseas financing</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Underdeveloped domestic capital markets, especially bond markets</td>
<td>Bond and equity</td>
</tr>
<tr>
<td>2 Overseas business expansion due to the slowdown of China’s economy</td>
<td>Equity, bond, and loan</td>
</tr>
<tr>
<td>3 The interest-rate spread between China and offshore markets</td>
<td>Mostly bond and loan</td>
</tr>
</tbody>
</table>

Source: Daiwa

All things considered, we believe demand exists for offshore Renminbi loans and bonds. The question is whether an offshore market can take on this role. While Hong Kong’s Renminbi bond market has expanded by 10x in the past 5 years alone, it remains very small in a global context (US$4.6tn for China in 2013, compared with US$21tn for the US). Under our base case, in the future, the largest component of China’s bond market will be made up of domestic bonds, just as it is in other countries. However, given our view that China’s bond market has ample scope to expand in the coming years, we think Hong Kong’s Renminbi bond market could likewise balloon over time. How big could it become? If the offshore Renminbi bond market were to become just 5-10% of the size of China’s domestic bond market, we would be looking at significant growth potential.

Which brings up back to our original point: while the Stock Connect won’t have a direct bearing on the offshore Renminbi bond market, it is a potential catalyst for a leap in the amount of Renminbi in Hong Kong. After all, this money has to be parked somewhere, and its presence in Hong Kong could speed up the development of the city’s Renminbi bond and lending markets. Such a development
would have important implications for companies from Mainland China, and indeed elsewhere, that need Renminbi funding, as well as capital for overseas expansion.

5. The modernisation and overseas expansion of China’s corporations

China has long talked about reforming its enterprises and encouraging its enterprises to go abroad, a process in which we believe Hong Kong has a big role to play.

CITIC Group and China Everbright Group, both controlled by the State Council, have placed great importance on the roles of their listed vehicles in Hong Kong. CITIC Group decided in 2013 to put all its major assets into a Hong Kong-listed vehicle. In addition, a number of major corporations in China (such as China Vanke, The Wanda Group, Lenovo, Tencent, Alibaba, Fosun) have been building their business presences overseas in recent years, spurred on by the state, which has been encouraging such moves. This overseas expansion could help accelerate the reform and modernisation of China’s corporations.

The Stock Connect could prompt more Mainland companies to expand their presence in Hong Kong

Although the abovementioned developments are not directly related to the Stock Connect, we believe the Stock Connect has a positive impact on this process by strengthening Hong Kong’s position as the capital formation centre for Mainland corporations. We believe that if more China corporations come to Hong Kong to explore business opportunities in the city and/or overseas, or to establish access to an alternative platform to borrow Renminbi, demand for both Renminbi deposits and borrowings would grow, further enhancing Hong Kong’s position as the largest offshore Renminbi centre.

And, as and when the Renminbi bond and borrowing market in Hong Kong becomes more developed, this could well kick-start a virtuous cycle, whereby more Mainland businesses, or the Mainland operations of international companies, could become more interested in expanding their presence in Hong Kong.

Examples of overseas investments by China corporations

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Industry</th>
<th>Time</th>
<th>Remarks</th>
<th>Consideration</th>
</tr>
</thead>
<tbody>
<tr>
<td>Haitong Securities</td>
<td>Finance</td>
<td>2014</td>
<td>Investment banking unit of Banco Espirito Santo Investimento (BESI)</td>
<td>EUR400m</td>
</tr>
<tr>
<td>Lenovo</td>
<td>Computer</td>
<td>2014</td>
<td>Acquiring Motorola Mobility (server business)</td>
<td>USD2.3bn</td>
</tr>
<tr>
<td>Anbang Insurance</td>
<td>Hotel</td>
<td>2014</td>
<td>Acquiring Waldorf Astoria Hotel in New York</td>
<td>USD1.95bn</td>
</tr>
<tr>
<td>China Life</td>
<td>Property</td>
<td>2014</td>
<td>Acquiring a 70% stake in an office building along Canary Wharf, London</td>
<td>USD1.35bn</td>
</tr>
<tr>
<td>Chinalco</td>
<td>Resources</td>
<td>2009</td>
<td>Raising its stake in Australian mining company Rio Tinto from 9% to 18%</td>
<td>USD19.5bn</td>
</tr>
<tr>
<td>Lenovo</td>
<td>Computer</td>
<td>2005</td>
<td>Acquired IBM's PC business</td>
<td>USD5bn</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Google, Daiwa
6. The reforms in China’s securities and financial sectors

China’s securities sector, along with other financial sectors, has been undergoing major reforms in recent years, which we see as a structural trend that dovetails with the Stock Connect. In the past, China’s securities industry focused mainly on the brokerage business. While such an orientation minimised the risk posed by the sector from a regulatory standpoint, it limited the development and potential of China’s capital market.

We believe the state has attempted to address the situation by introducing a slew of deregulatory measures designed to boost the development of the securities sector.

In recent years, China securities companies have been adjusting their business models, moving gradually from operating income-statement-driven models to adopting balance-sheet-driven models (see also Daiwa’s initiation report on the China Securities Sector entitled China Securities Sector: Initiation: great transformation).

Against this backdrop is the Stock Connect, which plays into this trend by providing the sector with new opportunities, helped by the fact that many of China’s securities firms have been actively raising equity capital over the past 12 months.

As the Stock Connect would allow Mainland investors to invest in companies listed in Hong Kong, we think it is possible that a number of China’s securities firms will decide to launch their IPOs in Hong Kong or both Hong Kong and China, instead of in China only. We note too that several China securities firms have already made use of Hong Kong’s more flexible and efficient equity fund-raising platform to raise equity capital in Hong Kong since the start of 2015.

<table>
<thead>
<tr>
<th>Date</th>
<th>Company</th>
<th>Amount raised (USDbn)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2 Jan 2015</td>
<td>Haitong Securities</td>
<td>3.8</td>
</tr>
<tr>
<td>2 Jan 2015</td>
<td>CITIC Securities</td>
<td>4.4</td>
</tr>
<tr>
<td>20 Jan 2015</td>
<td>China Galaxy Securities</td>
<td>2.4</td>
</tr>
<tr>
<td>10 Apr 2015</td>
<td>GF Securities</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: Bloomberg, Daiwa

With their enhanced capital bases, the China securities firms will likely continue to explore new businesses in addition to their traditional brokerage businesses. And potential opportunities opened up by the Stock Connect could be a big focus for these firms, in our view.
**New business matrix of China securities companies**

<table>
<thead>
<tr>
<th>Brokerage</th>
<th>Investment banking</th>
<th>Asset management</th>
<th>Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Traditional intermediary</td>
<td>Retail mass market</td>
<td>Equity</td>
<td>Collective Asset Management (CAM)</td>
</tr>
<tr>
<td></td>
<td>Institutional QFII</td>
<td>Bond (corporate bond)</td>
<td>Target Asset Management (TAM)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Bond (notes)</td>
<td>Special Asset Management (SAM)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Financial advisory</td>
<td>Customer deposit mgmt.</td>
</tr>
<tr>
<td>Capital intermediary</td>
<td>OTC market-making</td>
<td>Asset-backed securities</td>
<td>Prop trading</td>
</tr>
<tr>
<td></td>
<td>Equity market-making</td>
<td>Fixed-income market-making</td>
<td>Principal investment</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Buyout fund</td>
</tr>
<tr>
<td>Capital-based</td>
<td>Margin finance</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Securities repo</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: CITIC Securities, Haitong Securities, Daiwa

Note: New business areas are highlighted in blue. CAM is Collective Asset Management, TAM is Target Asset Management, SAM is Special Asset Management

**The securities-sector reforms are part of a broader package of measures**

More importantly, we believe the reform in China’s securities sector should be seen as part of the broader package of financial reforms in China. Our view is that China will continue to pursue reforms in its financial sectors and we have identified 7 areas on which we think the state will focus over the coming years (see Daiwa’s report, *China / Hong Kong Financials: Financial reforms: state of play*). These are:

1. Internet finance
2. Relaxation of LDR to better allocate credit
3. Serving the private economy
4. Pension reform
5. Deregulation of investment rules
6. Overseas fund-raising
7. Capital account liberalisation

In our view, the impact of these reforms could be far-reaching, and they will open up opportunities for many segments of the financial sector, including banks, insurance companies, and securities firms.

Daiwa is of the opinion that many of China’s major financial sectors, such as insurance, banks, and asset management, are undergoing important structural changes. In August 2014, China’s State Council issued guidelines on the development of China’s insurance industry, known as the “New Ten Guidelines.” For the first time ever, the Chinese government laid out a set of concrete targets for the development of the insurance industry.

In our opinion, China’s insurance sector is poised to enter a period of stronger premium growth, helped by government policies, the potential introduction of several favourable policies on annuity products, as well as the lowering of interest rates in China. These developments should lead to the insurance companies having a growing amount of capital for investments.
China Insurance Sector: annual insurance premium forecasts

Source: CEIC, Daiwa forecasts

Chinese insurers are now free to allocate more capital to new investments at home and abroad.

China's insurance companies have historically had only a limited ability to make overseas investments. However, the situation changed with the deregulation of insurance investment rules announced in February 2014. As such, the Stock Connect could well ride on the trend of China's insurance companies gradually allocating more capital to new investments in China and overseas.

Deregulation of insurance investment rules (February 2014)

<table>
<thead>
<tr>
<th>Asset class</th>
<th>Percentage allowed *</th>
</tr>
</thead>
<tbody>
<tr>
<td>Liquid asset</td>
<td>No restriction</td>
</tr>
<tr>
<td>Bond</td>
<td>No restriction</td>
</tr>
<tr>
<td>Equity</td>
<td>&lt;=30%</td>
</tr>
<tr>
<td>Property</td>
<td>&lt;=30%</td>
</tr>
<tr>
<td>Other assets (trusts, WMPs, credit-backed securities, special asset management products, debt/equity investment schemes)</td>
<td>&lt;=25%</td>
</tr>
<tr>
<td>Overseas investments</td>
<td>&lt;=15%</td>
</tr>
</tbody>
</table>

Source: CIRC, Daiwa

Note: * percentage as of total assets as at last quarter-end

China Insurance Sector: allocation of investment assets

Source: CIRC, Daiwa
Meanwhile, we believe the transformation taking place in China’s insurance sector will have significant implications for other sectors, such as asset management. The “New Ten Guidelines” issued in August 2014 also encouraged insurance companies to set up mutual fund management and asset management companies, and invest in private equity funds, M&A funds, real estate funds, and asset-backed securities.

Another important development is the structural changes taking place in the pension system of China. Prior to 1997, China’s state-owned enterprises provided pensions to their employees though fiscal funds. In 1997, China established a multi-pillar nationwide pension system covering all urban residents. The National Social Security Fund (NSSF) was established three years later. Then, in 2004, the Enterprise Annuity system was launched. A rural resident pension scheme was established in 2009 and then was gradually unified into the urban system. By the end of 2013, China’s national pension scheme had grown to cover roughly 820m individuals. Nowadays, similar to Western nations, there are 3 pillars in China’s national pension system.

**China Insurance Sector: 3-pillar pension system**

<table>
<thead>
<tr>
<th>Structure</th>
<th>First pillar</th>
<th>Second pillar</th>
<th>Third pillar</th>
</tr>
</thead>
<tbody>
<tr>
<td>Name</td>
<td>State Pension</td>
<td>Enterprise Annuity (including Occupational annuity)</td>
<td>Commercial Annuity (Supplementary pension system)</td>
</tr>
<tr>
<td>Mandatory/ voluntary</td>
<td>Mostly mandatory, self-employed individuals can voluntarily join</td>
<td>Voluntary</td>
<td>Voluntary</td>
</tr>
<tr>
<td>Defined-benefit/ Defined-contribution</td>
<td>Defined-benefit</td>
<td>Defined-Contribution</td>
<td>Defined-benefit and Defined-contribution</td>
</tr>
<tr>
<td>Funding contributor</td>
<td>Employers, employees, and fiscal subsidy</td>
<td>Employers and employees</td>
<td>Individuals</td>
</tr>
<tr>
<td>Amount of contribution</td>
<td>Employer: 20% of monthly income; Employee: 8% of monthly income</td>
<td>Voluntary contributions</td>
<td>Voluntary contributions</td>
</tr>
<tr>
<td>Product flexibility</td>
<td>No flexibility</td>
<td>Set by employer</td>
<td>Flexible</td>
</tr>
<tr>
<td>Tax policy</td>
<td>Free</td>
<td>Deferred tax (since 2014)</td>
<td>Fully taxable currently</td>
</tr>
<tr>
<td>Coverage population (m people)*</td>
<td>820</td>
<td>22</td>
<td>5</td>
</tr>
</tbody>
</table>

Source: Ministry of Human Resources and Social Security, Daiwa

Note: Data for first and second pillars as at end-3Q14 according to the Ministry of Human Resources and Social Security; data for third pillar are Daiwa estimates

Our view is that the Enterprise Annuity plan is China’s version of the US’s standard 401(k) defined contribution pensions. And if the US experience is anything to go by, the growth in size of such a scheme could have real implications for the development of China’s asset management industry.

China’s Enterprise Annuity plan had total AUM of CNY607bn as of end-June 2014, according to the Ministry of Human Resources and Social Security. Based on our industry research, the mutual fund industry in the US has an aggregate AUM of over USD20tn.

We think the process related to the modernisation and emergence of China’s asset management industry will take multi decades to unfold. But we see the Stock Connect as a mechanism that will only lend support to this trend. At the very least, it opens up a new market for Mainland individuals and investors. There has been talk about similar Mutual Market access in the fund management industry as well, which would allow fund management companies in respective markets to raise funds from each other’s markets.

In this regard, the fund management and wealth management industry in Hong Kong has been growing in recent years and we believe the Stock Connect can provide additional impetus to the expansion of this industry.
Asset management product size comparison in China (2014)

Source: CBRC, CSRC, CIRC, Trust Association of China, WIND, Daiwa

AUM of China’s mutual fund industry

Source: WIND, Daiwa
The Stock Connect gives new impetus to the Hong Kong office market

Expanding financial sector seen as providing key support for Grade-A office demand

The prospect of more businesses from Mainland China and overseas establishing operations (or expanding existing ones) in Hong Kong in the upcoming years suggests a potential surge in the number of employees in the financial sector. This expansion in the sector’s headcount would, in our view, reinforce the city’s role as one of Asia’s most mature financial and professional services hubs.

CBRE and Daiwa expect to see increased demand for financial product development, stock trading, wealth management, legal and compliance and other professional services in Hong Kong over the next 5 years. In addition to increased real-estate requirements stemming from the organic growth of established enterprises, office landlords should continue to enjoy sustained demand for office space from Chinese financial-sector companies, while also receiving enquiries from international companies seeking to establish a presence in Hong Kong because of the enhanced access to China’s capital markets.

The past 3 decades have seen Hong Kong’s economy transition from being manufacturing-dominated to being heavily services sector-based. The rapid development of the banking and finance sector has been instrumental in this transformation. The financial services sector is the second-largest pillar of the economy, contributing around 17% of GDP in 2013 (see the following chart).

**Hong Kong GDP by key sector (2013)**

![GDP Chart](chart.png)

Source: Census and Statistics Department, HKSAR Government, Apr 2015

We see a potential surge in the number of workers in Hong Kong’s financial sector.
Indeed, financial services, though not as labour-intensive as the trading and logistics sectors, employed close to 231,700 people in 2013, equivalent to 6.2% of the labour force in Hong Kong. From a headcount of 167,900 employees in 2003, the number of people involved in financial services has seen a CAGR of 3.3%, highlighting the steady growth in the sector over the past decade. It is, however, the most value-added sector among the 4 key industries (financial services, tourism, trading & logistics, and professional services), generating HKD1.5m per year in GDP per person employed.

### Hong Kong employment by key sector (2013)

<table>
<thead>
<tr>
<th>Sector</th>
<th>Employment 2013 (% of total employment)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial services</td>
<td>6%</td>
</tr>
<tr>
<td>Tourism</td>
<td>7%</td>
</tr>
<tr>
<td>Trading and logistics</td>
<td>21%</td>
</tr>
<tr>
<td>Professional services</td>
<td>13%</td>
</tr>
<tr>
<td>Others</td>
<td>53%</td>
</tr>
</tbody>
</table>

*Source: Census and Statistics Department, HKSAR Government, Apr 2015*

The high-margin nature of the financial services sector has supported demand growth for Grade-A office space in Hong Kong. According to CBRE Research, the banking and finance sector is now the largest occupier group, leasing around 15m sq ft (NFA) or 24% of the Grade-A office space across the territory. The footprint of tenants from this sector is even larger in the CBD, where 45% of the space leased in Core Central (about 6m sq ft NFA, Grade-A) is occupied by banks and other financial institutions.

### Breakdown of Grade A office occupancy by key sector

**Hong Kong Overall**

- Banking & financial services: 24%
- Other sectors: 76%

**Central**

- Banking & financial services: 45%
- Other sectors: 55%

*Source: CBRE Research, 2014*
A bond therefore exists between the scale of the financial services employee pool and occupied Grade-A office space in Hong Kong – Central in particular – while hiring needs for the sector are also closely correlated with office rental growth. As such, the anticipated growth in financial-sector activity stemming directly and indirectly from the Stock Connect and related future policies leads CBRE and Daiwa to expect long-term sustainable demand for Grade-A office space in Hong Kong.

Relationship between Grade A office net take-up and financial services sector employment – Overall vs Central

From traditional MNCs to rising stars from Mainland China

A closer bond with China’s capital markets will almost certainly attract fund flows into Hong Kong, both from Mainland China and overseas, which in turn should boost demand for investment banking, fund and wealth management services in Hong Kong. The prospect of more public listings and other fund-raising activity, together with a larger pool of offshore Renminbi will likely push banks and investment agencies to add resources to product development, wealth management, sales and marketing, market research, as well as legal and compliance — all of which will need support from office space growth.

Traditionally, US-based and European MNCs have been perceived to be the driving force behind Grade-A office space demand in Hong Kong. During the decade-long ‘golden years’ before the GFC in 2008, foreign corporations expanded aggressively, which pulled down vacancy rates and pushed Central CBD rents to sky-high levels. Thereafter, global banks and financial institutions reached a certain scale of operations in Hong Kong, and in recent years have stabilised their headcount growth and office space requirements. Indeed, many have downsized since the GFC and become more cost-conscious and prudent toward expansion.

The more prudent corporate real-estate strategies witnessed in the aftermath of the GFC, however, did not lead to vacancy reaching unmanageable levels. In Central, where most financial sector firms are based, vacancy rates were at or below 5.0% in 74 of the 84 months between January 2008 and December 2014. The remaining 10 months saw the vacancy rate peak at 5.8%.

US and European multinationals have historically driven Grade-A office space demand in Hong Kong
The questions we have are: 1) who was there to support the office market when traditional big occupiers were downsizing and/or relocating, and 2) while financial-sector firms from overseas still represent the largest office tenant group, they are maturing in terms of scale of operations, so will Hong Kong’s office market lose steam as a result?

Long-term Grade A office vacancy trend – Overall vs Central

![Vacancy Trend Graph]

Source: CBRE Research, Q1 2015

Companies from Mainland China are now more actively seeking space in Hong Kong

Recent years have seen companies from Mainland China turn more active in seeking space in the Hong Kong office market as they expand operations in the territory. These companies originate from different regions of China and are involved in a diverse range of industries, with banking and finance as well as general trading comprising the dominant share. According to figures published by the Census & Statistics Department, there were over 950 Mainland Chinese firms in Hong Kong in 2014, a rise of 51% over the past decade — the strongest such growth rate among companies by country of origin.

For many Mainland Chinese firms, Central is the preferred office location, given its status as the city’s premier CBD. Mainland Chinese firms’ presence extends to other Hong Kong Island submarkets, including Admiralty, Sheung Wan and Wan Chai, but thus far they have relatively little exposure in Kowloon. In mid-2014, about 19% of the floorspace (c2.6m sq ft NFA) in the top 25 Grade-A office buildings in Greater Central (Core Central, Sheung Wan and Admiralty) was occupied by companies from Mainland China. This compares to just 12% (c1.6m sq ft NFA) in 2008.

The same period saw occupancy by European firms in Greater Central contract from 3.9m sq ft NFA to 3.0m sq ft NFA, with some firms downsizing and others relocating to decentralised locations for reasons of cost and space availability. Credit Suisse and Deutsche Bank, for instance, have both moved from Exchange Square and Cheung Kong Centre respectively to International Commerce Centre (ICC) in Tsim Sha Tsui since 2008.

The expansion trend of Mainland Chinese firms stands in contrast to that of international companies. In recent years, Hong Kong office landlords have become more proactive in meeting the office needs of companies from Mainland China. CBRE estimates that at least half of the Chinese firms in Central are banking and finance sector related (9.5pp of the 19% of Grade-A office floorspace in Greater Central occupied by Mainland Chinese companies). The future will likely see more financial-sector firms from China expanding into Hong Kong, and as such, we expect Mainland Chinese companies to gradually increase their occupancy in the Greater Central Grade-A office market to circa 23% in 2-3 years’ time.
With the Stock Connect, mainland banking and finance companies have considerable organic growth potential. While about half of the Mainland Chinese firms in Central are engaged in banking and finance, they could not be described as large occupiers compared with MNCs. Most of the Mainland Chinese companies have a footprint of a mere few thousand square feet, though there is potential for them to become larger-sized tenants over time. CBRE has been dealing with many occupiers from Mainland China and there are instances where such companies have expanded their footprints from around 3,000 sq ft a few years ago to over 20,000 sq ft. Hence, with enormous business opportunities stemming directly and indirectly from the Stock Connect, we believe there is considerable organic growth potential for the more recent new entrants.

### Key leasing deals of Mainland Chinese firms since 2014

<table>
<thead>
<tr>
<th>Area (NFA sf)</th>
<th>Building</th>
<th>Floor / Unit</th>
<th>Occupiers</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>34,800</td>
<td>Cityplaza 1</td>
<td>Entire 13/F &amp; part 17/F</td>
<td>Bank of China Life Assurance</td>
<td>3Q14</td>
</tr>
<tr>
<td>32,000</td>
<td>ICC</td>
<td>Entire 96/F</td>
<td>Reignwood Group</td>
<td>2014</td>
</tr>
<tr>
<td>23,800</td>
<td>Manulife Financial Centre - Tower B</td>
<td>Entire 16/F</td>
<td>Bogart Lingerie Ltd / Brunet Infl (HK) Ltd</td>
<td>2014</td>
</tr>
<tr>
<td>19,900</td>
<td>Two Pacific Place</td>
<td>Entire 35/F</td>
<td>China UCF Group</td>
<td>2014</td>
</tr>
<tr>
<td>14,300</td>
<td>Two Exchange Square</td>
<td>Entire 45/F</td>
<td>China Merchants Securities</td>
<td>1Q14</td>
</tr>
<tr>
<td>13,700</td>
<td>Two IFC</td>
<td>Portion 29/F</td>
<td>Bank of Beijing</td>
<td>1Q15</td>
</tr>
<tr>
<td>13,100</td>
<td>Two Exchange Square</td>
<td>Entire 18/F</td>
<td>China Securities</td>
<td>2014</td>
</tr>
<tr>
<td>11,600</td>
<td>The Center</td>
<td>Portion 42/F</td>
<td>Huatai Financial Group</td>
<td>1Q14</td>
</tr>
<tr>
<td>5,070</td>
<td>Three Exchange Square</td>
<td>Portion 12/F</td>
<td>China Re Asset Management</td>
<td>1Q15</td>
</tr>
<tr>
<td>4,000</td>
<td>Two IFC</td>
<td>Portion 37/F</td>
<td>China Universal Asset Management</td>
<td>2014</td>
</tr>
</tbody>
</table>

Source: CBRE Research, Q1 2015

Firms from China have not only been taking up more leasing space from office landlords, they have also been actively securing investment opportunities. The past 5 years have seen HKD14bn worth of Grade-A office assets being purchased by Chinese enterprises, with much of the space involved now used for corporate headquarters in Hong Kong. This is very different from MNCs whose traditional preference is to lease space from landlords rather than own their office premises.
Key office acquisitions of Mainland Chinese firms since 2010

<table>
<thead>
<tr>
<th>Price</th>
<th>Property</th>
<th>Floor / Unit</th>
<th>Area</th>
<th>Buyer</th>
<th>Usage</th>
<th>Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>4,880</td>
<td>50 Connaught Rd</td>
<td>En-bloc</td>
<td>175,480</td>
<td>Agricultural Bank of China</td>
<td>Owner-occupied &amp; investment</td>
<td>2Q12</td>
</tr>
<tr>
<td>2,427</td>
<td>18 Kowloon East</td>
<td>En-bloc</td>
<td>348,750</td>
<td>China Construction Bank</td>
<td>Owner-occupied</td>
<td>1Q12</td>
</tr>
<tr>
<td>1,106</td>
<td>Kowloon Commerce Centre, Tower A</td>
<td>12/F, 19/F, 20/F, 29/F, 30/F</td>
<td>126,670</td>
<td>China Mobile</td>
<td>Owner-occupied</td>
<td>2Q13</td>
</tr>
<tr>
<td>1,068</td>
<td>C-Bons International Center</td>
<td>18/F-23/F, 25/F-28/F, with naming right</td>
<td>157,060</td>
<td>C-Bons International</td>
<td>Owner-occupied &amp; investment</td>
<td>1Q10</td>
</tr>
<tr>
<td>760</td>
<td>Kowloon Commerce Centre, Tower B</td>
<td>30-33/F</td>
<td>104,400</td>
<td>China Shipping Container Lines Co</td>
<td>Owner-occupied</td>
<td>2Q12</td>
</tr>
</tbody>
</table>

Source: CBRE Research, Q1 2015

New forces to drive future office demand in Hong Kong

We believe the Stock Connect, backed by the potential for the scheme to expand, will result in a growing need for office space in Hong Kong. Across all sectors, CBRE and Daiwa view stock trading and wealth management as the biggest beneficiaries of the Stock Connect scheme. The likelihood of increased space requirements from these firms is therefore expected to be high. In particular, the latest removal of the CNY conversion daily limit for Hong Kong residents is set to deepen the offshore CNY pool in Hong Kong and stimulate the appetite for financial products for investment and currency hedging purposes. Banks and other financial institutions are likely to invest in these areas.

Along with the organic growth of financial-sector firms already established in Hong Kong, new arrivals from Mainland China should provide an additional impetus for Hong Kong’s office market, continuing a trend that has emerged in recent years. At present, only 25% of the 100 Mainland-based securities firms registered with the China Securities Regulatory Commission, and only 10% of the 150 Mainland-based commercial banks licensed under China Banking Regulatory Commission, have a presence in Hong Kong. The absentees represent just one of many new potential sources of demand for office space in Hong Kong.

Indeed, we also highlight the prospect of Hong Kong welcoming more overseas enterprises to engage in fund-raising activity, given the city is probably now the most convenient place in the world to access Chinese capital. This activity may not trigger huge and immediate new office space demand from the newly arrived enterprises, but we could see additional space requirements for existing banking and finance-sector tenants as well as professional services firms seeking to expand their headcount for new businesses.

In particular, the underlying growth potential for the office space requirements of Mainland Chinese banks should not be overlooked. Our close examination of the footprints of major office occupiers reveals a large gap between the size of banks from China and those from the US in Hong Kong. Of the 50 largest banks in the world by market cap, US banks occupy an average of 310,000 sq ft (NFA) in Hong Kong, compared with an average of 190,000 sq ft (NFA) for the major Mainland Chinese banks. Given the relatively short history of Mainland Chinese banks in Hong Kong, there is a high likelihood that their footprint will ultimately catch up with those of the international banks in Hong Kong.

We see stock trading and wealth management as the biggest beneficiaries of the Stock Connect scheme

Mainland banks are likely to need bigger footprints in Hong Kong
Can Hong Kong fulfil office demand in the years ahead?

Recent developments in the Hong Kong office market

Office submarkets are now at near-historical-low vacancy levels

As the city has transformed into a key financial and services centre for Asia Pacific, Hong Kong has evolved into one of the world’s most expensive and mature Grade-A office markets. And, in spite of the interruption from external economic uncertainties over the past few years, the vacancy rate of the Hong Kong Grade-A office market has remained at relatively tight levels compared with many other global cities, with its overall vacancy rate falling from around 10% in late-2008/early-2009 to 4% in December 2014. Indeed, most office submarkets are now at near-historical-low vacancy levels, according to CBRE.

Office landlords remain in a strong position

The fact that many MNCs have taken a cautious line on expansion in recent years has not put a lot of pressure on Hong Kong’s office landlords. Of course, some tenants have downsized and office space has been surrendered to landlords, but low space availability has prevented office rents from free-falling. In particular, larger tenants have found it difficult to secure contiguous space (both in and outside of the Central CBD) and, in many cases, they were faced with limited choices elsewhere and renewal was the most sensible decision. As at March 2015, only 6 of the 215 Grade-A buildings across Hong Kong had contiguous space of 50,000 sq ft and more, highlighting the strong position of Hong Kong’s office landlords.

Overall Grade-A office vacancy rate vs. rental change

Source: CBRE Research, Q1 2015
The 5 years to 2014 saw an average new completion of 1.2m sq ft (NFA) per year, roughly half of the equivalent figure for the 15 years between 1995 and 2009. The next 5 years will see a relative rebound in terms of new Grade-A office supply, averaging 1.9m sq ft (NFA) per year over 2015-19 — but this will just bring the level back to the 20-year long-term average. In our view, this is just enough to match the long-term average net absorption of 1.9m sq ft (NFA) pa and highlights the need for Hong Kong to have a broader supply pipeline in order to cope with the expected growth of financial-sector activity as the Stock Connect platform expands which supports the city’s long-term economic development.

In light of the limited amount of land available for development on Hong Kong Island, and Central CBD in particular, part of the future demand will have to be met in locations outside Central.

Hong Kong needs a broader supply pipeline if it is to cope with the likely growth in financial-sector activity

Grade A office vacant space vs. rental levels by key submarkets

Source: CBRE Research, Q1 2015

Grade-A office space completions (1995-2019F)

Source: CBRE Research, Q1 2015
Growth areas for the next decade

Hong Kong needs more new office space for 2 main reasons: 1) to accommodate the future growth of the corporate sector as discussed throughout this report, and 2) to keep up with tenants’ ever-growing demand for better building quality, with many existing CBD buildings already out-of-date.

The government has sold a total of 168 sites in the past 10 years (2005-14), either through public auction or tender, providing 70m sq ft of gross developable area. Of these, only 35 sites (providing 19.5m sq ft of gross developable area) were for non-residential use. CBRE estimates that just 6m sq ft of this total was for office space.

Government land sale breakdown by usage (2005-14)

Despite the growing requirements for office space, commercial land-supply policies are little changed.

CBRE and Daiwa’s 2012 report, A 2020 Vision for Hong Kong’s Office Market, highlighted the need for sufficient office infrastructure to cater to corporates’ growing requirements for office space in Hong Kong.

Since the publication of that report, there has been little change to commercial land-supply policies, despite the fact that 7 commercial sites (excluding designated hotel sites) have been sold to the private sector since 2013. Some of these sites were more suitable for offices than others, and only the Middle Road site in Tsim Sha Tsui was in an established core district. The developer, however, has indicated that the site will be developed for retail use.
Details of the 7 commercial sites sold since 2013

<table>
<thead>
<tr>
<th>Year sold</th>
<th>Lot No.</th>
<th>Estimated use</th>
<th>Location</th>
<th>Site area (sq ft)</th>
<th>Max GFA (sq ft)</th>
<th>Price (HKDm)</th>
<th>AV (HKD/ sq ft)</th>
<th>Purchaser</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013 Q4</td>
<td>NKIL 6312</td>
<td>Office</td>
<td>Junction of Wang Chiu Road and Lam Lee Street, Kowloon Bay</td>
<td>46,253</td>
<td>555,035</td>
<td>2,638</td>
<td>4,753</td>
<td>Swire Properties</td>
</tr>
<tr>
<td>2013 Q2</td>
<td>STTL 482</td>
<td>Hotel/Retail</td>
<td>Site 11, Area 77, Ma On Shan, Shatin</td>
<td>54,789</td>
<td>164,366</td>
<td>662</td>
<td>4,027</td>
<td>Paliburg Group &amp; Regal Hotels International</td>
</tr>
<tr>
<td>2013 Q1</td>
<td>TCTL 11</td>
<td>Retail</td>
<td>Junction of Tat Tung Road and Mei Tung Street, Tung Chung, Lantau Island</td>
<td>107,920</td>
<td>539,599</td>
<td>2,328</td>
<td>4,314</td>
<td>Citygate Consortium (Swire Properties, SHKP, New World, Henderson &amp; Hang Lung)</td>
</tr>
<tr>
<td>2014 Q3</td>
<td>KIL 11237</td>
<td>Retail</td>
<td>15 Middle Road, Tsim Sha Tsui</td>
<td>28,309</td>
<td>339,708</td>
<td>4,688</td>
<td>13,800</td>
<td>Henderson Land Development</td>
</tr>
<tr>
<td>2014 Q2</td>
<td>NKIL 6410</td>
<td>Office</td>
<td>650 Cheung Sha Wan Road, Cheung Sha Wan</td>
<td>16,146</td>
<td>193,537</td>
<td>1,002</td>
<td>5,177</td>
<td>First Group Holdings Ltd.</td>
</tr>
<tr>
<td>2014 Q1</td>
<td>KTIL 761</td>
<td>Office</td>
<td>Junction of Hang Yip Street, Wai Yip Street and Kwun Tong Road, Kwun Tong</td>
<td>55,026</td>
<td>660,307</td>
<td>3,769</td>
<td>5,708</td>
<td>Mapletree Investments</td>
</tr>
<tr>
<td>2015 Q1</td>
<td>NKIL 6512</td>
<td>Office</td>
<td>Junction of Hung Yip Street, Wai Yip Street, Shun Yip Street and Hoi Bun Road, Kwun Tong</td>
<td>73,660</td>
<td>883,900</td>
<td>5,860</td>
<td>6,630</td>
<td>The Link and Nam Fung</td>
</tr>
</tbody>
</table>

Source: CBRE Research, Lands Department, Q1 2015

CBRE recently completed a comprehensive study of Hong Kong’s long-term future Grade-A office supply. The findings suggest that a maximum of up to 30m sq ft (NFA) of space can potentially be made available to office occupiers in the next 10 to 15 years. This is a rather optimistic estimation which would require the government to take a very proactive approach in launching commercial development sites for sale in the next few years. The lack of a government blueprint for office space development has led to greater uncertainty over potential supply that goes beyond a 5-year horizon. In addition, the relatively slow pace of the government in making available commercial development land for sale in the past decade leads CBRE to believe that actual completion in due course will be lower than this estimated amount, and is more likely to fall within the 20-25m sq ft bracket.

Taking into account all potential government sites for commercial development in and around Central, CBRE estimates only a total of around 2m sq ft of Grade-A office space will be delivered over the next decade; about 750,000 sq ft in Core Central.

Future supply in the Central CBD looks set to remain limited
The government has placed strong emphasis on promoting Kowloon East over the past few years, aiming to position the district as Hong Kong’s next-generation CBD, and one that has the potential to provide Hong Kong with over 40m sq ft in commercial GFA. The availability of a significant proportion of this space, however, will depend on the pace of private-sector redevelopment of old industrial buildings in Kwun Tong and Kowloon Bay – something over which the government has little control.

The past 10 years have seen Kowloon East Grade-A office stock grow by 7m sq ft (NFA). CBRE expects supply to continue to grow in the area, reaching 16m sq ft by the end of 2019. This will lead Kowloon East to grow beyond the size of Core Central and become the largest single office submarket in Hong Kong. In the run-up to 2019, Kowloon East will remain a major source of new office stock, with about half of the city’s Grade-A office supply being built in Kowloon East over 2015-19.

Going beyond 2019, part of the focus will be on the Kai Tak development site where an estimated 3m sq ft (NFA) of private Grade-A office space will potentially become available. Including other government identified commercial sites outside of Kai Tak in Kwun Tong, Ngau Tau Kok and Kowloon Bay, CBRE estimates that a total of up to 12m sq ft (NFA) of Grade-A office space could potentially be built in Kowloon East, although this depends on how proactive the government is towards launching the relevant sites for sale. By then, Kowloon East will already have a total stock even larger than Greater Central (including Core Central, Sheung Wan and Admiralty), before taking into account other private-sector redevelopment projects.
Grade-A office stock growth in Kowloon East – 2004 to 2020+

Source: CBRE Research, Q1 2015

Future development sites in Kowloon East

Legend

<table>
<thead>
<tr>
<th></th>
<th>Estimated NFA (sq ft)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Grade A Office</td>
<td>12,019,800</td>
</tr>
<tr>
<td>Short-to-medium Term Future Supply 2015 – 2019 (*)</td>
<td>4,405,400</td>
</tr>
<tr>
<td>Long Term Potential Supply 2020+ (*)</td>
<td>12,574,800</td>
</tr>
<tr>
<td>Government Site to be sold in FY15-16</td>
<td>337,000</td>
</tr>
</tbody>
</table>

Note: Some sites may only have portion of the NFA for offices
(*): Estimated project completion time, which also includes estimated timeline beyond 2024

In addition to Kowloon East, Wong Chuk Hang, in the south of Hong Kong Island, and West Kowloon are fast emerging as feasible decentralised office locations.

Several industrial revitalisation and redevelopment projects are under way in Wong Chuk Hang, an area which in recent years has emerged as a potential cluster for SMEs and the back-office operations of larger corporations. However, the area is characterised by piecemeal development and lacks a single dominant developer capable of creating a coordinated and integrated offering of business amenities. The area could potentially offer a total of 9m sq ft (NFA) of commercial space upon completion. Five buildings, providing a total NFA of 821,000 sq ft, are scheduled for completion by the end of 2019.

Wong Chuk Hang and West Kowloon are also emerging as decentralised office locations.
Future development sites in Wong Chuk Hang

The pace of development in West Kowloon has lagged behind that of Kowloon East, due mainly to the slow progress in the building of the West Kowloon Cultural District and the delayed delivery of the Express Rail Link Terminal. The office space involved in these projects is expected to integrate seamlessly with ICC and the existing commercial cluster alongside Canton Road and form a larger Core Tsim Sha Tsui office market upon completion in beyond 2020. A combined total of around 3m sq ft (NFA) of Grade-A office space is planned in this area to the east and southeast of ICC. The close proximity of this new office cluster to Tsim Sha Tsui and Central is likely to make it a feasible option for large occupiers that see the need to grow but have not found many suitable options available in the Central CBD.

While recent years have seen piecemeal redevelopment projects in the Cheung Sha Wan area offering smaller enterprises affordable office options, Kowloon West is less likely to be the preference of larger corporates until the aforementioned development cluster close to ICC is completed.
Future development sites in Kowloon West

Source: CBRE Research, Q1 2015
Note: Some sites may only have portion of the NFA for offices
(*) Estimated project completion time, which also includes estimated timeline beyond 2024

Legend

<table>
<thead>
<tr>
<th>Location</th>
<th>Estimated NFA (sq ft)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Existing Grade A Office</td>
<td>7,693,500</td>
</tr>
<tr>
<td>Short-to-medium Term Future Supply 2015 – 2019 (*)</td>
<td>305,400</td>
</tr>
<tr>
<td>Long Term Potential Supply 2020+ (*)</td>
<td>2,883,200</td>
</tr>
</tbody>
</table>

Distribution of estimated future Grade A office supply for 2015-19

Source: CBRE Research, Q1 2015
Changes in future Grade A office supply distribution (2014-2025+)

Source: CBRE Research, Q1 2015
The case for decentralisation

The banking and finance industry has become increasingly regulated since the GFC. This has kept many global banks and financial institutions away from high-margin businesses, a trend which has led occupiers from this industry to adopt a more prudent approach towards office space requirements and capital expenditure. It is unlikely this trend will be reversed in the foreseeable future and therefore CBRE expects to see a growing need for decentralised office space in Hong Kong.

At present, rents in decentralised locations such as Hong Kong East and Kowloon East are a fraction of those in the Central CBD. While rents in decentralised office submarkets are expected to continue to climb as the new clusters mature and as connectivity improves, CBRE predicts Central will continue to run on premium rental levels. This makes a strong case for office decentralisation. The broad trend does not suggest that financial-sector tenants will completely disappear from the CBD. However, relocating at least some of their back-to-middle office operations to more cost-effective places is feasible. In addition to costs, the recent Occupy Central movement has given corporates a risk-management reason to have split-office operations across Hong Kong, thereby boosting demand for cost-effective options in decentralised locations (see The Case for Decentralized Offices: A Cost and Risk Management Perspective, CBRE 2014).

Rental discounts between Central and other office submarkets

We believe the transformation of decentralised locations, such as Kowloon East, will provide a good solution to meet the growing occupier demand for cost-effective and high-specification office stock. In addition to cost and space availability, the dated specifications of many of the Grade-A office buildings in established office submarkets are becoming less appealing to more sophisticated occupiers. This is fuelling their desire to lease space in newly built high-specification buildings, even in decentralised areas where the majority of future supply is concentrated.

The relocation and expansion of global investment banks including Morgan Stanley, Deutsche Bank and Credit Suisse from Central to ICC in the late 2000s highlights this trend. The more recent acquisition of 2 office towers in One Bay East by Citi and Manulife reinforces the need for new and sizeable office premises in decentralised locations.
Major examples of office decentralisation in recent years

<table>
<thead>
<tr>
<th>Company</th>
<th>Original Central premises</th>
<th>Original Central footprint (sq ft net)</th>
<th>Moved to</th>
<th>Footprint in new location (sq ft net)</th>
<th>Year of decentralisation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit Suisse</td>
<td>Three Exchange Square</td>
<td>110,100</td>
<td>ICC</td>
<td>279,800</td>
<td>2010</td>
</tr>
<tr>
<td></td>
<td>Two Exchange Square</td>
<td>37,300</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deutsche Bank</td>
<td>Chater House</td>
<td>3,000</td>
<td>ICC</td>
<td>358,900</td>
<td>2009</td>
</tr>
<tr>
<td></td>
<td>Cheung Kong Center</td>
<td>118,000</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Morgan Stanley</td>
<td>Edinburgh Tower</td>
<td>33,300</td>
<td>ICC</td>
<td>334,700</td>
<td>2008</td>
</tr>
<tr>
<td></td>
<td>Three Exchange Square</td>
<td>88,200</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Two Exchange Square</td>
<td>15,900</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>EY</td>
<td>2IFC</td>
<td>128,400</td>
<td>CITIC Tower</td>
<td>144,700</td>
<td>2010</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>One Island East</td>
<td>60,000</td>
<td></td>
</tr>
</tbody>
</table>

Source: CBRE Research, Q1 2015

The growth of decentralised office supply should be a good match for the rising demand for cost-effective high-specification buildings, but not to the extent that it will completely solve the difficulties facing many larger occupiers, at least in the short to medium term.

An examination of the supply pipeline reveals a lack of suitable options for large occupiers in the next few years that typically prefer single-owned buildings with large floor plates. CBRE estimates a total of 7m sq ft of space (73% of the 9.6m sq ft of total supply currently) will be built in decentralised locations between 2015 and 2019, but only 5m sq ft of this decentralised space has been planned for single-owned leasing stock. Of these single-owned leasing spaces, only 3.5m sq ft of this has a floor plate of over 15,000 sq ft NFA, suggesting that suitable space for larger occupiers will remain limited.

The growth of decentralised office supply should be a good match for the rising demand for cost-effective high-specification buildings.
In reality, there could be even fewer available options for the largest occupiers. The fact that experienced landlords tend to accommodate no more than 1-2 anchor tenants in mid-scale Grade-A office buildings will limit the choice for occupiers with a footprint of say 200,000 sq ft and over. There are currently 7 mid-scale Grade-A office development projects in the pipeline due to be completed by 2019, each with a total NFA broadly in the range of 400,000-900,000 sq ft. The other projects in the pipeline are smaller. We expect these projects to be top quality and all located in decentralised locations, mainly Kowloon East.

Also, most of these projects are likely to be leased at discounted rentals compared to those in the core office districts of Central, Wan Chai/Causeway Bay and Tsim Sha Tsui. Competition for new, suitable and affordable options among the large occupiers will therefore remain fierce.

As discussed earlier, this situation will likely improve as potential space in the longer-term (beyond 5 years) supply pipeline becomes available.

*Source: CBRE Research, Q1 2015*
Many large occupiers are bringing forward their space-planning exercises

Indeed, we believe that large occupiers are fully aware of the limited suitable development options in the supply pipeline. In order not to face a situation where they would have limited choices when their office leases expire, many of them are reviewing their long-term real-estate strategies in Hong Kong. They are bringing forward their space-planning exercises, well ahead of their leases expiring, in anticipation of being able to secure the best available options in the leasing and/or investment markets.

Thus, growing demand for new and cost-effective space and the limited availability of such options in the core office submarkets point to more decentralisation activity over the next 5 years and beyond. The question is: will there be a net outflow of tenants in core submarkets and who is going to fill the vacant space in the CBD?
As discussed, we believe the new financial market policies between Hong Kong and Mainland China will continue to drive demand for offices from Chinese companies in the financial services sector. Central is still the preferred office location for Chinese companies, although an increasing number of Mainland occupiers now also have addresses in new iconic buildings, such as ICC. These new entrants are forming a new group of office occupiers that will reabsorb space being returned by MNC occupiers that see the need to move to decentralised locations for cost, space availability and risk-management reasons.

Meanwhile, the global trend of having split-office operations is pointing to rising demand for corporates to maintain client-facing functions in the CBD but gradually accommodating middle-to-back office operations in cost-effective decentralised locations. The clustering of government headquarters, the High Court and other regulatory bodies in and around Central should also ensure the district’s status as Hong Kong’s premier CBD is maintained.
The way forward

We think it is most appropriate to see the introduction of the Stock Connect as part of Hong Kong’s development as an international financial centre as well as part of China’s overall financial reforms. The unveiling of the Stock Connect in November 2014 is a first step, with many improvements and expansions likely to follow in the next few years. Much depends on whether investors in China, Hong Kong and overseas can make the most of this new “bridge”. The scheme opens up new opportunities for many different industries, and for Hong Kong’s role as a city, and its longer-term potential and ramifications should not be underestimated. Equally important is that the Stock Connect sets an example as to how Hong Kong can do in terms of facilitating China connecting with the rest of the world, and the rest of the world connecting with China.

Effectively, the Stock Connect has created what the CEO of HKEx calls a Mutual Market. This term currently applies only to the stock market, but conceptually it could serve as a template for other financial-services segments. Industry participants and regulators from Hong Kong and the Mainland have spoken publicly for some time about “mutual recognition” for the fund-management industry. We believe the Hong Kong Stock Exchange has been looking into how to extend the Stock Connect model to futures, derivatives, commodities, and probably other areas as well. With this in mind, we think Hong Kong could eventually provide a bridge between China’s otherwise incompatible financial institutional structure and the rest of the world.

The future is likely to see other pioneering policies introduced, promoting a high level of financial-sector activity (in terms of equity fund-raising, larger pool of investing capital from overseas and China coming to Hong Kong, more Renminbi loans and debts being issued, more Mainland corporations coming to Hong Kong, etc). All of these activities would require office space.

The present lack of appropriate space and land available for development in established core office clusters in Hong Kong implies that much of the future office demand will have to be met by properties in emerging districts (it will remain difficult for large occupiers to find a single-roof address in and around Central). The years ahead will likely see large occupiers gradually increase their office footprints in decentralised submarkets, while new entrants from Mainland China and overseas fill some of the vacated space in the CBD. This should ensure a good demand-supply balance is maintained in core districts, ensuring stable vacancy levels, and forming a sound platform for long-term rental growth.

Without a clear direction from the government as to when the future commercial sites will be launched, it is not possible to come up with a meaningful rental forecast for the medium to long term. However, the demand side of the equation is expected to skew towards the strong side. The growth magnitude will depend on how much competition is in the market in due course. The rental gap between core and decentralised office submarkets will probably narrow, but prime districts such as Central will likely continue to enjoy rental premiums for an extended period.

The Stock Connect is in only its early stages…

…and further related developments will call for more office space

Occupiers are likely to increase their footprints in decentralised submarkets while new entrants fill some vacated space in the CBD
However, regardless of the emergence of new office projects in decentralised areas, we see a clear and urgent need for more cost-effective and high-specification office space in Hong Kong. The short-to-medium term new supply of such space is limited both in core and decentralised locations. The corporate sector is also unclear about the timeline of the city’s longer-term office supply, and this could negatively impact its long-term confidence in maintaining offices in Hong Kong. There is no shortage of office space in the supply pipeline, but the government needs to communicate to the business sector as to when those identified commercial development sites will become available for development.

If these issues are not addressed, corporates are likely to seriously consider relocating their operations outside of Hong Kong due to the lack of adequate, affordable, and appropriate commercial office space. This situation could be exacerbated by potential instability in Hong Kong and China’s political environment, which could hamper business and economic growth.

In our view, to maintain Hong Kong’s long-term competitiveness in terms of occupancy costs and office-space availability, the Hong Kong government needs to:

1) fast track the auctions/tenders of designated commercial sites in Central, as well as those in and around the Kai Tak development area,

2) speed up the construction of infrastructure projects that connect Kowloon East with the established CBDs on Hong Kong Island and in Kowloon, and

3) enhance the transparency of the city’s supply of commercial land by giving the public an outline as to the city’s long-term office supply target, in order to facilitate better long-term real-estate planning within the corporate sector.
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