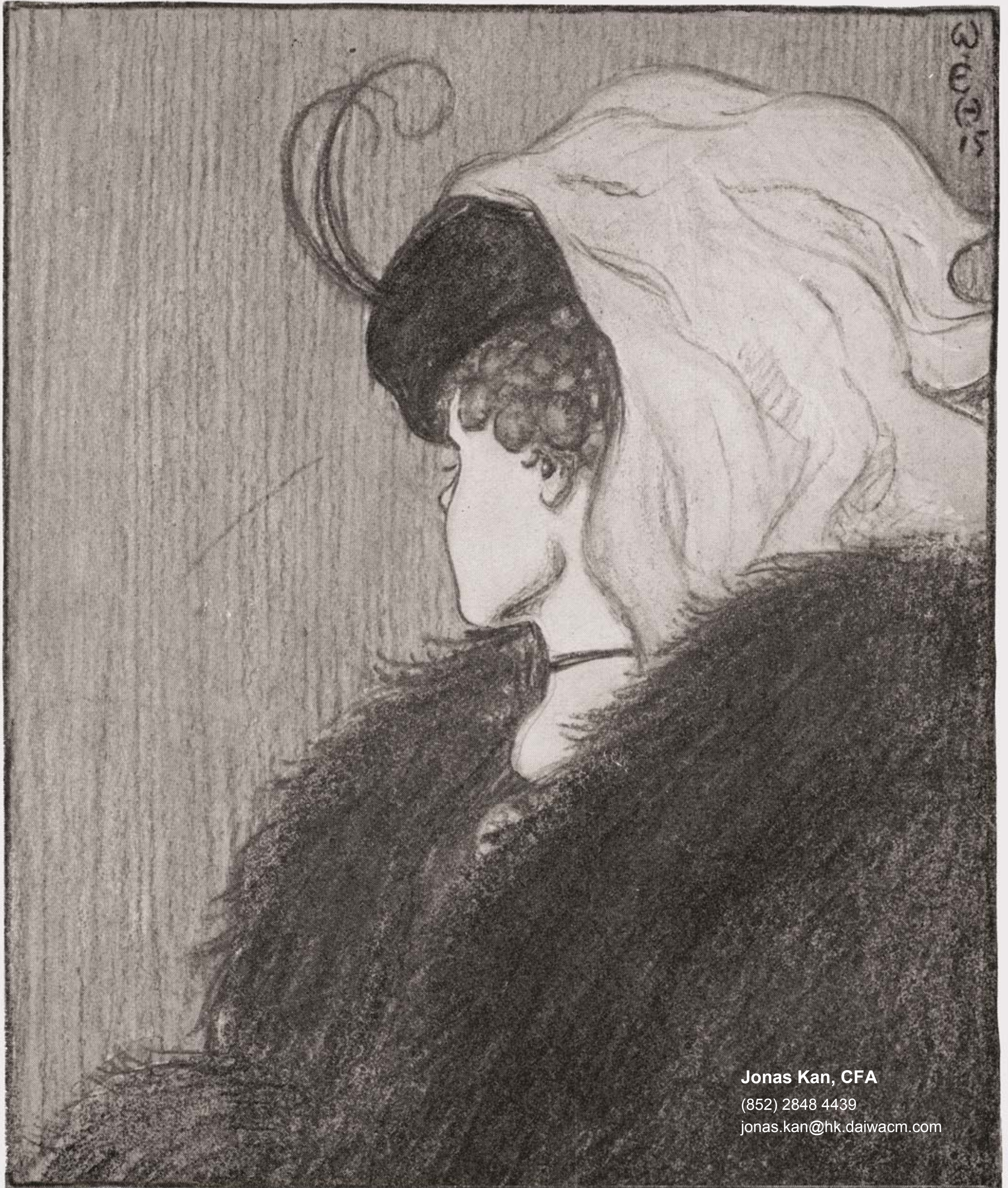
Daiwa Capital Markets

Hong Kong Property Sector

First impressions can be deceiving: another look at the contrarian case



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See important disclosures, including any required research certifications, beginning on page 55

Special Report

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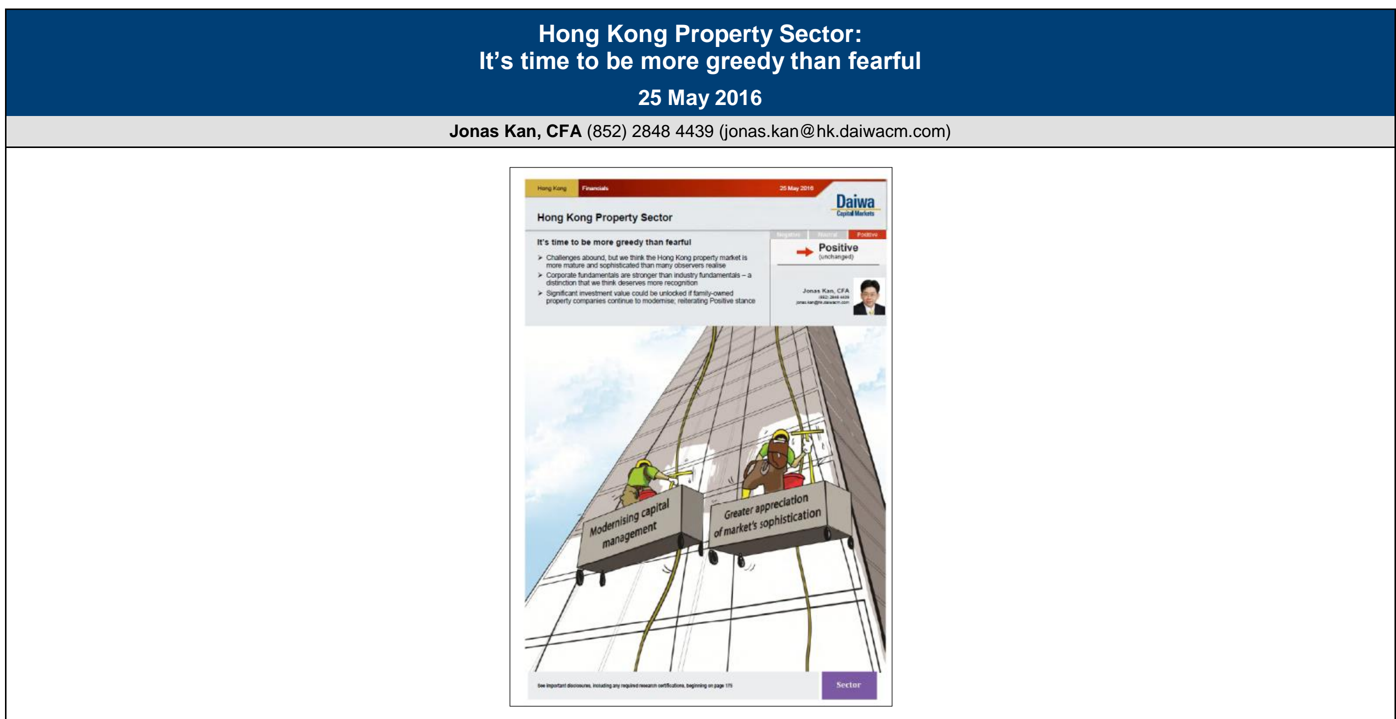
Cover illustration: *My wife and my mother-in-law. They are both in this picture - find them* by William Ely Hill, 1915.

An optical illusion showing a portrait of the artist's wife, head-and-shoulders, facing left away from the viewer, and the artist's elderly mother-in-law, head-and-shoulders, facing left, with a kerchief over her head.

Please also see:



Hong Kong Property Sector:
It's time to be more greedy than fearful
25 May 2016

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The contrarian case for Hong Kong property

Hong Kong Property stocks are not for the faint-hearted. They never have been. History shows us that these shares can be highly volatile, particularly during times when the physical market is facing challenges. But we think such volatility presents opportunity as well as risk. Buying Hong Kong property stocks at the right time can pay off handsomely, as it did in 4Q05, 4Q08 and 4Q13 when share prices saw 50-180% upside within a few months.

Apart from the usual valuation swings, Hong Kong property stocks offer an interesting and intriguing investment angle at this stage. Having evolved over the past few decades, the Hong Kong family property companies have reached a turning point in their development: continue to function like private, local family companies, or take up the challenge of progressing and ultimately be viewed by the global capital markets as modern corporations on par with the premier names in global property.

Granted, there is no immediate financial or other pressure on these companies to take up this challenge. But we think those companies with the requisite vision will be well rewarded by the longer-term advantages of modernising their businesses – not to mention that this transition would, by our reckoning, unlock up to USD100bn in investment value for the sector. In our view, the next big step in the modernisation process would see the property companies paying higher dividends and accepting share buybacks as well. This could be accompanied by a strategy to sell non-core assets at physical market prices and then using the proceeds to buy back shares that trade at a significant discount to NAV (indeed, some are already doing so).

Meanwhile, over the past few weeks, we have seen developments in the Hong Kong property market which could result in sentiment starting to turn the corner (see the Market Snapshot section on page 33). And overlaying all these developments is a potential rise in the importance of property and China for the global investing world through likely changes in sector classification and benchmark indices, as well as Chinese investment capital starting to move abroad.

In short, we see a contrarian case for Hong Kong property stocks which we urge investors not to lose sight of.

Jonas Kan, Head of Hong Kong and China Property

Question 1

Are there good reasons to look at Hong Kong property stocks right now?

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"Bull markets are born on pessimism, grow on scepticism, mature on optimism, and die on euphoria. The time of maximum pessimism is the best time to buy, and the time of maximum optimism is the best time to sell."

- Sir John Templeton

"The financial world is a mess, both in the United States and abroad. Its problems, moreover, have been leaking into the general economy, and the leaks are now turning into a gusher. In the near term, unemployment will rise, business activity will falter and headlines will continue to be scary.

So ... I've been buying American stocks……

Why?

A simple rule dictates my buying: Be fearful when others are greedy, and be greedy when others are fearful. And most certainly, fear is now widespread, gripping even seasoned investors. To be sure, investors are right to be wary of highly leveraged entities or businesses in weak competitive positions. But fears regarding the long-term prosperity of the nation's many sound companies make no sense. These businesses will indeed suffer earnings hiccups, as they always have. But most major companies will be setting new profit records 5, 10 and 20 years from now.

- Warren Buffett, 16 October 2008

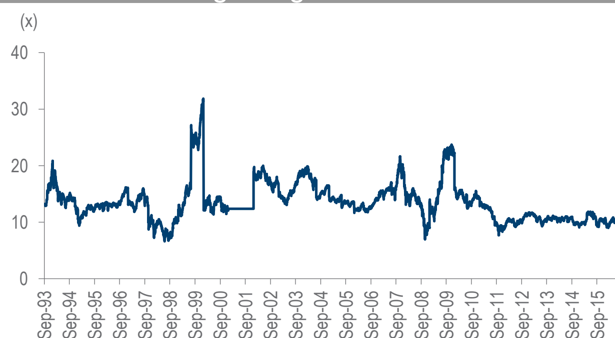
Is "bad news an investor's best friend"?

It takes courage to be a contrarian in times like now. Taking "bad news as one's best friend" is easier said than done. After all, human beings are social creatures who almost by definition are averse to being alone or different from their peers.

That said, the fact that the above statements come from Warren Buffett, one of the world's most successful investors, may mean there is reason not to disregard them too readily.

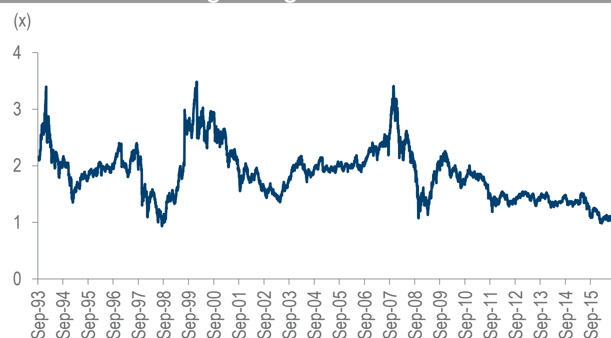
Another reason we suggest investors give one more thought to this unconventional proposition is to look at the historical performance of Hong Kong property stocks.

PER of the Hang Seng Index



Source: Bloomberg

PBR of the Hang Seng Index



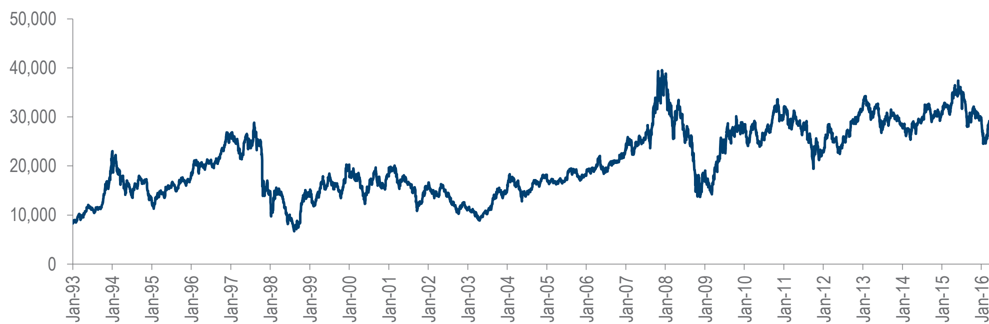
Source: Bloomberg

Historically, the Hong Kong stock market has exhibited significant volatility. Being a small city linked with 2 mega-sized economies (China and the US) and being the most liquid and open among all the emerging markets, the Hong Kong stock market is destined to be highly sensitive to global liquidity flows and easily affected by negative events around the globe, be it the US, Europe, China or any of the emerging markets.

Meanwhile, with property being widely seen as a high-beta sector and Hong Kong property prices having stayed at elevated levels by global standards for a long time, there is always a case for fearing that the Hong Kong property market is poised for a multi-year downturn at almost any time.

Against this backdrop, it's not difficult to understand why Hong Kong property stocks tend to be sold down heavily whenever some sort of crisis breaks out – be it the October crash, oil crisis, the 4 June incident, Asia financial turmoil, bursting of the dot-com bubble, 9/11, US rates hikes, GFC, debt crisis in Europe, changes in the FED monetary policy, CNY devaluation, and the UK breaking away from the EU.

The Hang Seng Property Index



Source: Bloomberg

That said, if history is anything to go by, accumulating Hong Kong property stocks during major sell-offs always pays off over time, including even during the 4Q97-2Q03 period when property prices and rents spiralled down. We note that the Hang Seng Property Index's lowest point during this cycle was in 1998 rather than 2003, and many Hong Kong property companies' share-price troughs were recorded in 1998 rather than in 2003.

It is not that the Hong Kong property companies are immune to a downturn in the sector; but rather that share prices always discount expectations and fear tends to feed on itself, which usually results in the stock market pricing in a much worse scenario than reality.

As pointed out by Warren Buffett, "*during the Depression, the Dow hit its low, 41, on July 1932. Economic conditions, though, kept deteriorating until Franklin D Roosevelt took office in March 1933. By that time, the market had already advanced 30 percent…..Again, in the early 1980s, the time to buy stocks was when inflation raged and the economy was in the tank. In short, bad news is an investor's best friend….*".

Would a bad physical market create an excellent land market for well-capitalised developers?

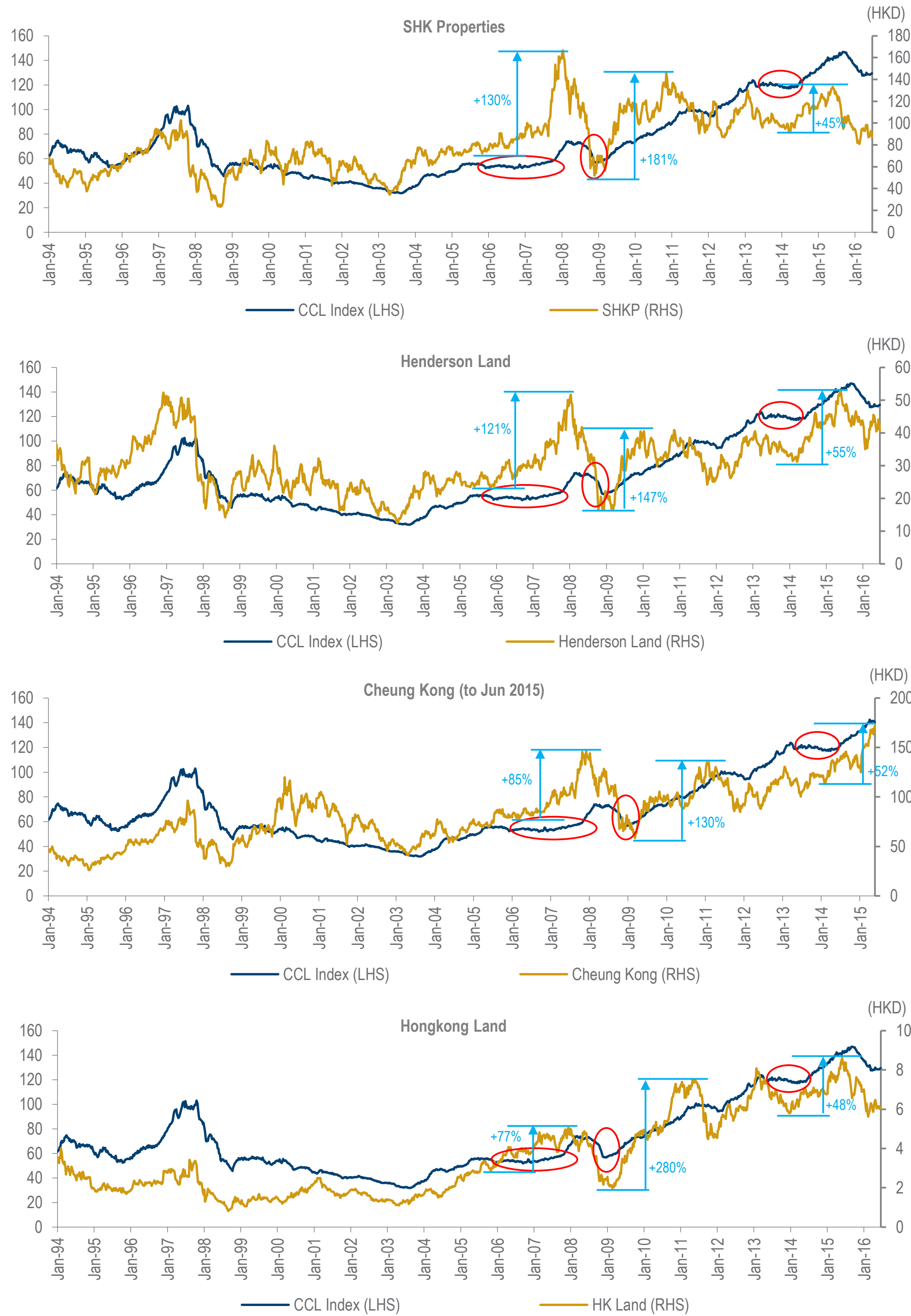
We believe property companies are dynamic corporate entities and not merely passive respondents to changes in property prices. Note that the main raw material used by a real-estate company to create value is land; and to property developers, the margin between the achieved market value of a property asset and the cost of the land required to develop it is probably more important than the absolute property price level. Contrary to popular perception, our understanding is that real-estate companies may not necessarily want property prices to go up fast. To the extent that land costs also fall during a property market downturn – generally, land prices should fall more than flat prices during a property downcycle – a bad physical market for property can mean an opportunity as well for those well-capitalised property companies.

Indeed, Hang Lung Properties' ability to make an ambitious push into China commercial property since the mid-2000s has a lot to do with the fact that it capitalised on the residential property market downturn in 4Q97 to acquire over 4m sq ft of residential landbank from 1999-2002 – the land cost for its Harbourside development was below HKD2,000/sq ft, although the highest achieved per-square-foot price for its completed units was over HKD80,000/sq ft. Meanwhile, the surge in SHK Properties' rental income and NAV since the mid 2000s has also had a lot to do with its significant investments in the Two IFC and Kowloon Station projects during the market trough – generally, it is only in difficult times that a property company can buy a large quality site at low cost.

Buying Hong Kong property stocks at times of poor market sentiment has worked well before

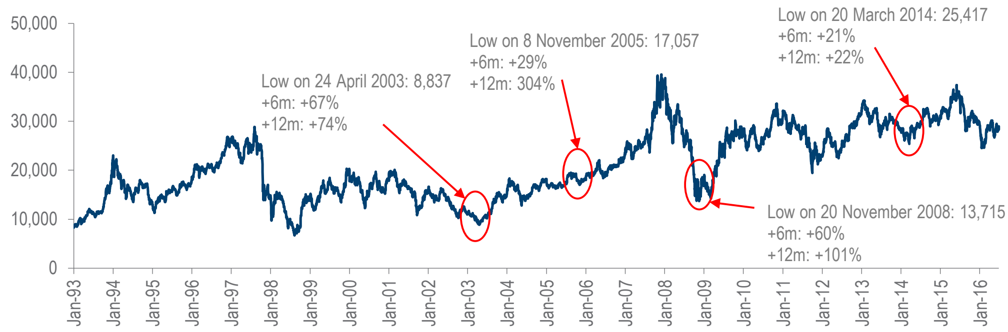
Over the past 10 years, there have been at least 3 occasions when Hong Kong property stocks were hit by bad market sentiment, and subsequently rebounded significantly when investors came to realise the stock market had over-discounted the downside risks in the physical market and the impact on property companies. Such was the case in 4Q05, 4Q08, 4Q13. As shown below, relative to the share-price troughs during these 3 periods, major property stocks have a record of subsequently seeing 50-180% upside. In the case of the Lehman crisis in 4Q08, the Hang Seng Property Index reached a trough on 20 November before the crisis was over, and then rebounded by 60% in the following 6 months and 101% after 12 months.

Performance of major HK property stocks after each crisis



Source: Bloomberg, Centaline, Daiwa

The Hang Seng Property Index



Source: Bloomberg, Daiwa

As such, we put forward an alternative perspective: that based on both the principles of value investing and the historical share-price patterns of Hong Kong property stocks, there are good reasons to consider adopting a contrarian view and accumulate Hong Kong property stocks. Is now the right time?

Question 2

Are Hong Kong property stocks cheap enough?

Are Hong Kong property stocks cheap enough?

"Bubbles", remarked former Fed Chairman Alan Greenspan, "generally are perceptible only after the fact." Greenspan is one of the few heads of the Fed who has analysed in depth the complexity and difficulties involved in spotting a bubble in advance, and reading his analysis and comments leads us to wonder whether one can be sure a bubble has existed only when one looks back in hindsight.

A similar thing might be said of market troughs. We all want to be able to identify the bottom of the market, but this is a notoriously difficult and tricky endeavour. "Price, at the margin", remarked Benjamin Graham, was set by either "the greediest buyer" or "the most distressed seller". To the extent that the share prices we see in the stock market are set by marginal buyers/sellers, then when share prices reach their troughs would depend on when the last distressed seller had left and when the "greedy buyers" had started to gain critical mass. As both would be influenced significantly by sentiment and given that market sentiment and human psychology are fickle, predictions as to when a market would bottom are usually precarious at best.

That said, while we do not claim to have a secret formula to predict share-price lows, we would make the following remarks.

First, from a value-investing perspective, an investor does not need to be able to identify the bottom for prices to justify an investing case for undervalued companies. What is needed is for the share price relative to the intrinsic value of the business to provide a large enough "margin of safety". As Warren Buffett puts it, "if I can use 40 cents to buy a business that is worth a dollar, then maybe something good will happen to me some day."

Second, if investors take the view that it is next-to-impossible to foretell share prices' lowest points and that it is hard to buy sufficient volume when share prices have bottomed, then they should start considering accumulating the shares when they deem them to be cheap enough. As Warren Buffett puts it, "so if you wait for the robins, spring will be over."

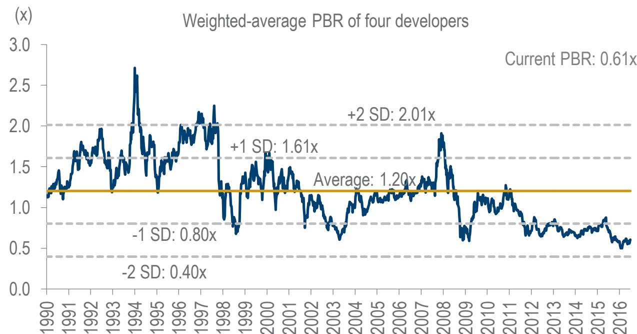
In this light, we would advise investors not to be too preoccupied with waiting for share prices to bottom before considering accumulating the shares. When share prices are cheap enough – when the margin of safety is large enough – then one should consider starting to accumulate shares. Thus, we arrive at the crux of question 2: are Hong Kong property stocks cheap enough?

First, on PBR, several Hong Kong property stocks have reached their all-time lows

In our opinion, in times of considerable uncertainty, one should always look at the book values of Hong Kong property companies. We see book value as a conservative estimate of the NAVs of these companies because, according to Hong Kong accounting rules, only investment properties are marked to market every 6 months, while other assets on the balance sheet – such as properties under development for sale, listed assets, non-property assets, etc. – are all carried at historical cost (for hotel assets, their book values are actually based on even more conservative assumptions of historical cost minus annual depreciation charges).

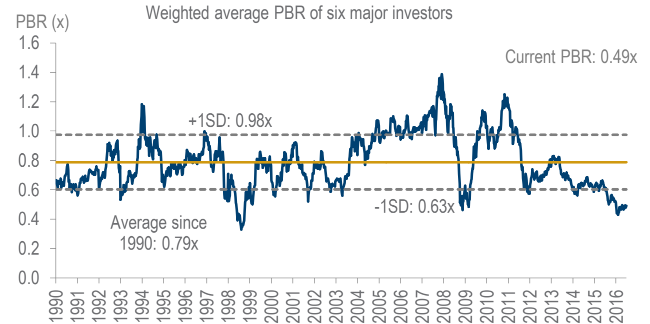
We also think the track record of many Hong Kong property companies suggests that valuers in Hong Kong tend to lean more towards the conservative side when they value the rental properties of listed property companies, so much so that, when Hong Kong property companies dispose of their property assets on their balance sheet, they almost invariably do it at prices above their revalued book values, even though the valuation was done not more than 6 months before.

Major Hong Kong property developers: PBR



Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



Source: Companies, Datastream, Daiwa

Realised prices of Hong Kong property companies' property assets vs. revalued book cost

Company	Date	Achieved price (HKDm)	Valuation (HKDm)	Profit (HKDm)	Achieved price vs book cost (x)
Sunlight REIT's disposal of 3 non-core properties	May 2015	920	586	333	1.6
Fortune REIT's disposal of Nob Hill Square	Feb 2015	648	438	210	1.5
Link REIT's 4 batches:					
Wan Tau Tong Shopping Centre	Mar/Apr 2016	810	746	64	1.1
Shek Yam Shopping Centre		880	719	161	1.2
Kam Ying Court Shopping Centre		471	411	60	1.1
Po Tin Shopping Centre		438	360	78	1.2
Tin Ma Court Comm Centre		308	264	44	1.2
Retail and Car Park in Mei Chung Court		204	179	25	1.1
Retail and Car Park in Yan Shing Court		181	135	45	1.3
Hing Man Comm Centre		209	125	83	1.7
Retail and Car Park in Po Nga Court		151	120	31	1.3
Fung Wah Estate Retail and Car Park	Oct 2015	110	97	14	1.1
Ka Fuk Shopping Centre		588	456	132	1.3
Kwong Tin Shopping Centre		407	354	53	1.2
Siu On Court Retail and Car Park		125	82	43	1.5
Tin Wan Shopping Centre		486	328	158	1.5
Retail and car park in Tung Hei Court	May 2014	73	43	30	1.7
Hing Tin Commercial Centre		210	188	22	1.1
Wah Kwai Shopping Centre		518	366	152	1.4
Kwai Hing Shopping Centre		439	299	140	1.5
Retail and Car Park within Choi Fai Estate	Sep 2014	41	38	3	1.1
Retail and Car Park within Choi Ha Estate		163	108	55	1.5
Siu Lun Shopping Centre		318	299	19	1.1
Tin Ping Shopping Centre		544	532	12	1.0
Tsui Lam Shopping Centre		650	616	34	1.1
Hang Lung Prop disposal of non-core assets	2013	6,800	4,652	2,148	1.5
Cheung Kong's disposal of Ginza Kingswood	2013	5,800	3,040	2,760	1.9

Source: Companies, Daiwa

Second, the Hong Kong stock market as a whole looks reasonably valued on various metrics

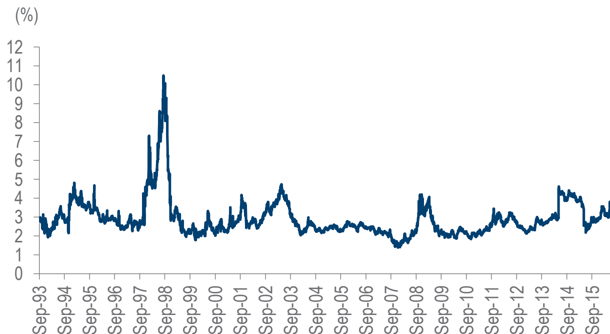
Indeed, based on both PBR and PER, the Hong Kong market as a whole is at about its lowest point in the past 25 years. Historically, with the exception of 1997-98, which we regard as a special situation, the highest dividend yield for the Hong Kong property stocks was 4.9% in 2003 and that for Hong Kong as a whole now stands at 3.8%. A number of Hong Kong property companies are now yielding over 5%, the highest in 22 years except 2008 when Hibor shot up to over 30% - Hibor in Hong Kong has stayed at below 0.5% despite the attack on the Hong Kong dollar peg in February 2016; and we think the HKMA has learnt a major lesson from the 1998 episode and has addressed the loopholes in the system so that now the amount of HK dollars needed to be shorted to shore up Hibor is much larger than in 1998.

Hong Kong's financial sector: 2016 vs 1997

Monetary base	July 1997 (HKDbn)	May 2016 (HKDbn)	Change
Aggregate balance	1.5	322	215x
Outstanding exchange fund bills and notes	99	899	9x
Total monetary base	190	1,603	8x
Foreign currency assets of the Exchange Fund	524	3,369	6x
Equity market			
Total market cap	4,607	23,130	5x
PER (HSI)	19.2x	10.3x	-46%
PBR (HSI)	2.4x	1.1x	-53%

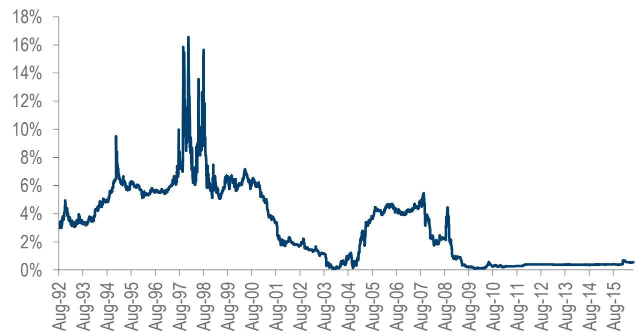
Source: HKMA, CEIC, Hang Seng Indexes Co Ltd, Bloomberg

Dividend yield of the Hang Seng Property Index



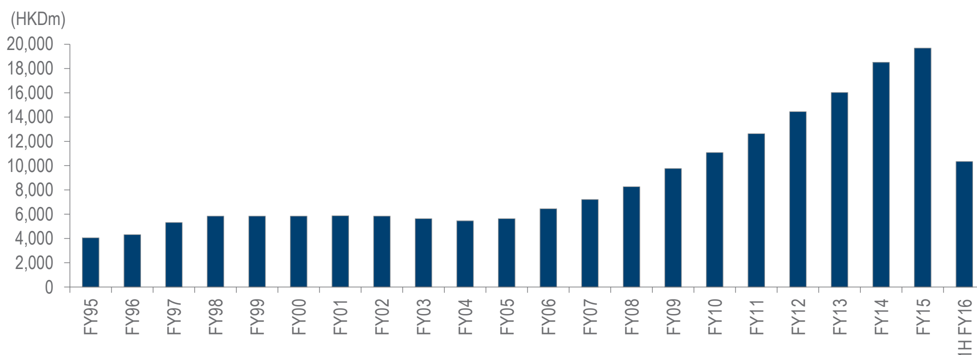
Source: Bloomberg

3-month HIBOR



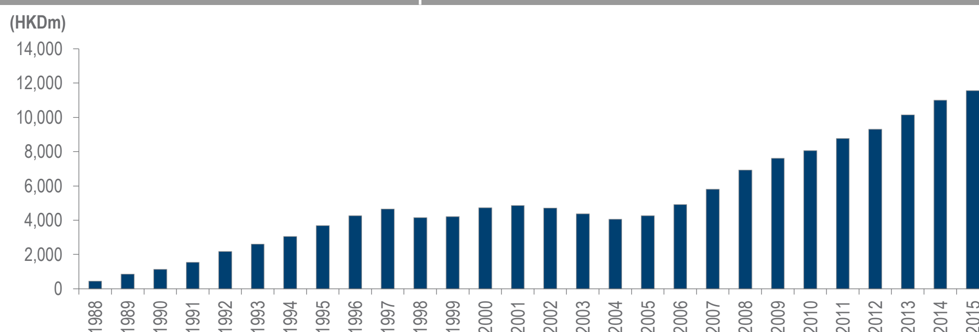
Source: Bloomberg

Gross rental income of SHK Properties



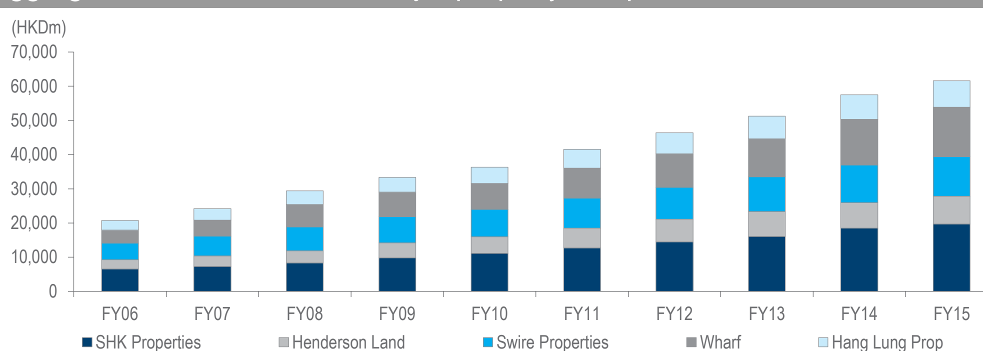
Source: Company

Gross rental income of Swire Properties



Source: Company, Daiwa

Aggregate rental income of 5 major property companies



Source: Companies

Net gearing of HK property companies

Company	Dec 2012 (%)	Dec 2013 (%)	Dec 2014 (%)	Dec 2015 (%)
Cheung Kong	7.3%	2.3%	1.1%	na
CK Property	na	na	na	5.7%
Great Eagle	Net cash	Net cash	Net cash	Net cash
Hang Lung Properties	Net cash	0.5%	Net cash	1.1%
Henderson Land	17.2%	17.2%	15.7%	16.0%
Hongkong Land	13.0%	11.0%	10.0%	8.0%
Hysan	6.2%	5.3%	4.2%	3.0%
Kerry Properties	22.4%	31.0%	28.5%	32.2%
MTRC	11.0%	11.8%	7.6%	11.3%
New World Development	35.2%	35.1%	26.1%	31.4%
SHK Properties	16.5%	12.9%	13.8%	12.4%
Sino Land	Net cash	Net cash	Net cash	Net cash
Swire Properties	15.0%	15.8%	16.3%	15.3%
Wharf	21.7%	20.4%	18.9%	14.9%
Wheelock	13.4%	21.1%	18.8%	16.0%
Average	**16.3%**	**15.4%**	**14.6%**	**13.9%**

Source: Company, Daiwa

Third, some Hong Kong property companies now have a gross yield on market capitalisation that is close to or exceeds 10%

Another metric we track is gross rental income divided by market capitalisation. Based on this calculation, a few Hong Kong property companies are now generating a gross rental yield of about 10%, which was about the level of the physical market yield we saw in the Hong Kong market during the peak of the Asia financial turmoil.

Implied gross rental yield on market cap of Hong Kong property companies

	CK Property	SHK Properties	Henderson Land	Sino Land	Wharf	Swire Properties	Hongkong Land	Hang Lung Properties	Hysan
Share price (HKD)	47.65	90.70	42.50	12.54	46.80	20.30	USD5.99	15.24	34.10
Bloomberg code	1113 HK	16 HK	12 HK	83 HK	4 HK	1972 HK	HKL SP	101 HK	14 HK
Rating	Buy	Buy	Buy	Outperform	Buy	Buy	Buy	Buy	Buy
Target price (HKD)	71.00	131.60	60.80	13.00	63.50	30.70	USD8.50	23.70	46.60
Market cap (HKDm) = (b)	183,262	262,577	154,551	77,320	141,851	118,755	109,928	68,534	35,692
2015 gross rental income* (HKDm) = (a)	7,137	21,009	8,152	3,684	14,470	11,563	7,589	7,751	3,430
Gross yield on market cap (%) = (a) / (b)	**3.9%**	**8.0%**	**5.3%**	**4.8%**	**10.2%**	**9.7%**	**6.9%**	**11.3%**	**9.6%**
Gross rental income per share (HKD)	1.9	7.3	2.2	0.6	4.8	2.0	USD3.2	1.7	3.3
DPS (HKD)	1.40	3.70	1.45	0.50	1.90	0.71	USD0.19	0.75	1.32
Dividend yield	**2.9%**	**4.1%**	**3.4%**	**4.0%**	**4.1%**	**3.5%**	**3.2%**	**4.9%**	**3.9%**

Source: Companies, Daiwa

*Prices as of 29 Jun 2016; * including attributable share of gross rental at associate or JCE level, CK P's gross rental is based on annualised gross rental from rental properties previously owned by Hutchison Whampoa*

Hong Kong property stocks: implied valuations based on current stock prices

	SHK Properties	CK Property	Henderson Land	Sino Land	Swire Properties	Wharf	Hongkong Land	Hang Lung Properties	Hysan
Share price (HKD)	90.70	47.65	42.50	12.54	20.30	46.80	USD5.99	15.24	34.10
Market cap (HKDm)	262,577	183,262	154,551	77,320	118,755	141,851	USD14,093	68,534	35,692
Size of HK landbank (m sq ft)*	52.4	31.5	15.4	13.2	16.5	13.3	6.1	4.5	5.5
Implied value of HK landbank (HKD/sq ft)^	5,011	5,827	10,044	5,862	7,201	10,650	USD2,307	15,230	6,494
Implied value of HK landbank (HKD/sq ft)*	4,758	5,443	5,680	5,862	7,201	10,315	USD2,307	15,230	6,494
Gross rental income (HKDm)^^^	19,681	8,500	8,152	3,684	10,800	14,470	7,622	7,751	3,430
Gross rental income/market cap	7.5%	4.6%	5.3%	4.8%	9.1%	10.2%	6.9%	11.3%	9.6%

Source: Companies, Daiwa estimates

*Prices as of 29 Jun 2016; Note: *excluding listed assets; ^^^ assuming full year contribution from rental properties previously owned by Hutchison Property*

In all, we believe the current valuation of the Hong Kong property stocks has built in considerable pessimism already. Indeed, even under an extreme scenario under which Hong Kong residential prices drop to zero, the Hong Kong property companies should still survive, and some would remain attractively valued, in our view – an issue to which we turn for question three. At the same time, in the past few weeks, we have started seeing signs that sentiment towards the Hong Kong property market could be turning (see Market snapshot for analysis).

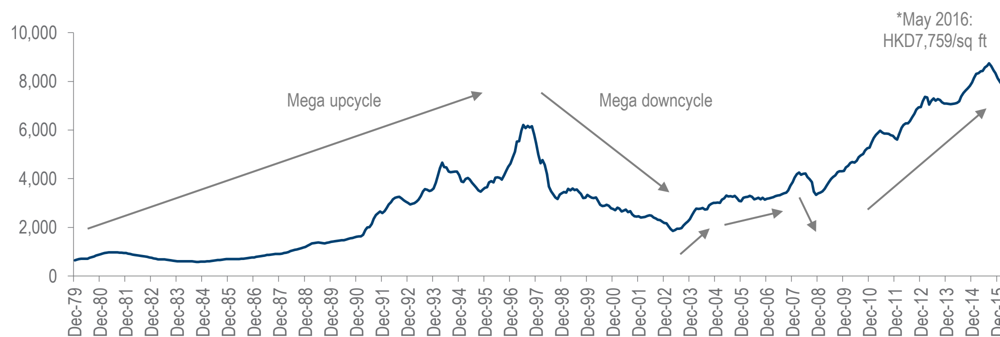
Question 3

What would happen if residential property prices in Hong Kong fell to zero?

Zero value for residential properties is an extreme scenario

We believe zero value for residential property assets is an extreme assumption. As a general rule of thumb, in property, prices can be said to be bottoming when prices fall below replacement cost. From that point onward, all rational property companies would stop initiating new projects, putting an end to the new supply in the market. Then, it would become an issue of how long would it take for natural market demand to digest the excess inventory.

Residential property prices in Hong Kong



Source: Midland, Daiwa
*Note: *provisional figure*

From this perspective, it could be argued that Hong Kong residential property prices did not reach their rock bottom levels during SARS, because at the lowest point at that time, overall residential property prices in Hong Kong were around HKD1,820/sq ft (gross), according to Midland, which was still above the construction cost of about HKD1,000/sq ft at the time.

We note that the construction cost for residential properties in Hong Kong has been rising fast in recent years, and is currently at about HKD4,000/sq ft , 4x of the level 12 years ago. Based on this benchmark, overall residential property prices in Hong Kong have about 50% further downside before they would fall below replacement cost.

From a theoretical perspective, we could say that the maximum downside for Hong Kong residential property prices is about 50%. That said, for illustrative purposes, we assume the worst-case scenario for Hong Kong residential properties would be zero residential property prices and zero property sales revenue, meaning that developers would not be able to sell even one single unit from now on.

NAV of Hong Kong property companies at zero value for residential properties

(in HKDm)	SHKP Properties	CKP Property	Henderson Land	Sino Land	Swire Properties	Wharf	Hongkong Land	Hang Lung Properties	Hysan
HK property assets									
Residential	-	-	-	-	-	-	-	-	-
Office	132,185	87,775	48,716	23,483	161,271	73,940	143,461	34,983	27,680
Retail	139,860	23,560	49,105	48,491	31,260	119,200	32,150	48,920	28,420
Industrial and others	29,710	11,250	4,346	3,200	6,932	-	-	-	-
Hotel	23,312	64,210	6,301	1,232	7,046	5,083	1,158	-	-
Agricultural land	-	-	-	-	-	-	-	-	-
	325,067	**186,795**	**108,468**	**76,406**	**206,508**	**198,223**	**176,769**	**83,903**	**56,100**
China property assets									
Investment properties	92,554	15,270	40,232	2,120	56,535	84,439	14,980	83,880	5,120
Residential properties	11,729	96,840	26,524	3,650	-	49,383	14,240	-	-
	104,283	**112,110**	**66,756**	**5,770**	**56,535**	**133,822**	**29,220**	**83,880**	**5,120**
O'seas property assets	11,890	9,248	-	2,986	10,082	-	40,150	-	-
Total property assets	**441,240**	**308,153**	**175,224**	**85,162**	**273,125**	**332,045**	**246,139**	**167,783**	**61,220**
Listed assets	14,412	11,485	72,984	-	-	4,846	-	-	-
Other assets	19,224	-	-	-	-	26,289	-	-	1,675
Gross NAV	**474,876**	**319,638**	**248,208**	**85,162**	**273,125**	**363,181**	**246,139**	**167,783**	**62,895**
Net debt	(43,623)	5,238	(29,940)	8,129	(36,047)	(65,401)	(23,291)	(3,489)	(3,139)
NAV	**431,253**	**324,876**	**218,268**	**93,291**	**237,078**	**297,780**	**222,848**	**164,294**	**59,756**
NAV/share (HKD)	**149.0**	**84.4**	**66.1**	**15.7**	**40.5**	**98.3**	**94.7**	**36.7**	**56.6**

Source: Daiwa

Could Hong Kong property companies survive if residential property prices dropped to zero? Yes

Shown above is our estimate of what the Hong Kong property companies' NAV would look like under the extreme scenario of zero value for their residential property assets. We think it is worth highlighting that the business models of the Hong Kong property companies are quite different from those of their global peers. While in global property, the rules of the game for many appear to be more about leveraging up and playing the interest-rate cycle, the business model for the Hong Kong property companies is more about using money made from residential property sales to build family wealth.

Seen in this light, one may argue that the Hong Kong property companies have long passed the threshold of having enough recurrent cash flow to cover their corporate overhead and interest burden. By way of contrast, we could say that the Chinese property companies are like the Hong Kong property companies in the 1970s, in that they are still in the phase of building up their capital and recurrent income base.

Note that the earnings and asset structures of the Hong Kong property companies have changed considerably over the past 20 years, so much so that their dependence on residential property sales profits has declined considerably. Indeed, the bulk of their NAV now comes from income-producing assets, such as rental properties or listed utilities (such as Hong Kong China Gas) and their recurrent cash flow from other businesses would cover their corporate overheads many times over, meaning that they would still have positive cash flow even if vacancies and rentals in their rental portfolios dropped by 40-50% or more.

Will the Hong Kong property market enter a multi-year downward spiral?

Admittedly, if the Hong Kong property market across-the-board is at the beginning of a multi-year downward spiral in prices, then the attractiveness of Hong Kong property stocks and their ability to survive even in an extreme crisis scenario, may not be sufficient nor compelling enough grounds for investors to take the risk to be contrarian on the sector at this point.

We concede that there are many reasons to be wary of the Hong Kong property market at this point. And we share the view of other market observers that US interest rates and the Chinese economy are important factors affecting the Hong Kong property sector – both of which do not seem to be heading in a favourable direction.

Suffice it to say, we do agree that Hong Kong property has been lifted by the 2 tidal waves – low US interest rates and the Individual Visit Scheme for Mainlanders – for over a decade. Moreover, our observation is that both factors have been receding for some time, suggesting Hong Kong property has been facing up to these challenges for well over a year.

Moreover, in our view, these 2 tidal waves have not been the only forces driving the Hong Kong property market's performance over the past 15 years. More importantly, we believe the Hong Kong property market and its major participants, by and large, responded in a sophisticated, mature and responsible manner when these 2 tidal waves were on Hong Kong's favour. They did not leverage up massively to buy land or property assets, nor did they just sit back and ride on these waves. Instead, they re-invested their "windfalls" into building up their presence in the China property sector, especially prime commercial properties in the major Chinese cities. Indeed, it appears to us that the eventual receding of these 2 tidal waves has not been totally unexpected and that the market has already been preparing for such a retreat for some time (for details, refer to our sector report of 25 May 2016: ***It's time to be more greedy than fearful***).

Have market participants been building in a cushion to prepare for the retreat of 2 tidal waves?

This does not mean that the subsiding of these 2 tidal waves won't be challenging. But just as the market did not fully embrace them when they came, it may not necessarily fall or react as much to their receding or unwinding, in our view. Our view is that the tidal waves lifted the importance of Hong Kong's commercial property market, in that they led to many international retailers viewing the Hong Kong retail market as more than merely one of 7m people, and that many companies have come to see Hong Kong as more than one of the major cities in Asia. Much would depend on how the participants in the Hong Kong property market respond to the receding or potential unwinding of the tidal waves. And we contend that the retreat of these tidal waves may not necessarily be negative. In fact, they could be positive for the longer-term development of the Hong Kong property market.

If the market participants can overcome this challenge with sophistication, professionalism and maturity, it is not inconceivable that such a challenge or potential crisis could turn out to be a catalyst that takes Hong Kong property to another level: a truly vibrant and sophisticated metropolitan property in Asia or Greater China.

Median prices are likely to fall. But the market cap of the Hong Kong physical property market could expand significantly

Under such a scenario, we think it is conceivable that the total market capitalisation of Hong Kong property assets could rise multi-fold over time, albeit that the capital value of top-end assets may not rise much further from now. However, if this situation were to take hold, we would expect the scale and volume of mid-tier property assets in Hong Kong to increase substantially over time; and when this process fully ran its course, we would expect the median prices of property assets in Hong Kong – be they residential, office or retail – to gradually converge with those in major global cities.

Importantly, what this implies is that there could be significant opportunities for the savvy, well-capitalised property companies in Hong Kong, although nothing remotely close has been discounted in their share prices yet. Put another way, the gloomy scenarios that have been suggested and seem to be being discounted into share prices would not prevail, and the market could awaken to this prospect at some point.

In any case, we would suggest investors make a distinction between the property market and property companies. As we see it, the property companies are in a much better position than the market itself and the strong players could even benefit from any downturn.

Is the business model for Hong Kong property companies essentially a kind of “crisis model”?

We would argue that, generally, the business models of many Hong Kong property companies resemble a type of crisis model in that their business models were built to enable the companies to weather crises. Indeed, we would suggest that their business models are about being able to emerge relatively stronger after each crisis.

Such business models appear uncommon among the listed global real estate stocks, which we think has something to do with the fact that the Hong Kong property companies are still family-owned and have a main objective of preserving and building family wealth. As such, they would be unlikely to risk their balance sheets for near-term profits or NAV growth, and hence have a bias towards building up their recurrent income bases. This approach tends to be seen by some investors as too long-term and asset-intensive when compared with many global peers. Hong Kong property companies also generally tend to be much more lowly geared than their global peers, which gives them a much greater ability to weather crises in the residential property sectors than many global peers. We believe this is a factor investors would be wise to take note of.

In fact, it could be said that the major Hong Kong property companies, whether consciously or subconsciously, have adopted a consolidator model in running their business. Under this model, the companies always keep their gearing low, control their average land costs, and work on building up their recurrent income bases so that in every downturn, they can benefit from late-comers running into difficulties, and then emerge relatively stronger afterward. In our opinion, this could be one of the reasons the Hong Kong property sector has become one of the most consolidated property markets in the world.

Such a situation raises the question of whether a depressed market opens more opportunities for the major Hong Kong players to consolidate the market; and we could say that their business models are about ensuring that they can be consolidators during times of market downturns.

The Hong Kong property company families have engaged in the largest insider buying activity in Hong Kong

There is a general observation in the market that during every downturn in the Hong Kong property market, the old families come out to buy prime assets, as they tend to be lowly geared and it is only during downturns that the prime assets are available for sale at reasonable prices. While such a formula may not necessarily work this time, the fact remains that such a formula has worked well for many old families and companies in the past, resulting in many of them trying to replicate the buying when the opportunity presents itself.

As such, if residential property prices were to drop to zero and developers could not sell a single unit, we think the Hong Kong property companies would still survive. While their earnings would likely take a hit, to the extent of vanishing residential property sales profits, declining rental income and provisions being made on residential property assets, their huge buffer (in the form of their large recurrent income bases relative to their fixed operating costs) allows them to be profitable going-concerns. In truth, they could even become more active in terms of seeking M&A or landbanking opportunities. A case in point is Sino Land, which has become a much stronger player in the sector since 2003 mainly because it seized upon the market downturn to aggressively buy land in 2000-02 during the property market downturn in 4Q97-mid 2003. As such, we believe many Hong Kong property companies would view a downturn as much an opportunity as a risk.

In short, we consider the Hong Kong property companies to be vehicles that can weather crises well, or even profit from them, and therein lies some of their appeal. Moreover, being such resilient vehicles serves the interests of the families, as well as those of the long-term oriented value/pension funds, which we think is one of the reasons all the major families have been raising their stakes in their listed companies over the past few years. We estimate they have spent over USD6bn over the past five years, which could be the largest-ever amount of insider purchases in Hong Kong, and is still a sizeable pool even by global standards.

Hong Kong property companies: "insider purchases"

Family	What they bought	Amount involved
Lee Shau Kee	Henderson Land	- Over USD2bn
Kwok family	SHK Properties	- Over USD500m - Over USD1.2bn for exercising their bonus warrants
Li Ka Shing	Cheung Kong	- Over USD2bn*
Cheng family	New World	- Over USD560m for the New World Development rights issue
Wheelock	Wharf	- Over USD2bn
Hang Lung Group	Hang Lung Properties	- Over USD400m

Source: Companies, Daiwa estimates
*Note: *includes swap of stakes in Husky Energy*

Can the various disconnects in the market be corrected?

In our view, that the families highly value the assets owned by their listed companies is not in doubt. Nor do we question the market value of these assets, because however much we cut our price assumptions for these assets, we estimate they are still much more valuable than what is currently implied by their share prices.

However, the property companies' share prices do not seem to reflect that they own some highly valuable income-producing property assets even though one may say that companies owning such assets could well suit many pension/endowment/value funds. Why? We think the large NAV discounts assigned to Hong Kong property companies exist for a reason (see the next chapter of this report and pages 114-118 of our 25 May sector report: ***It's time to be more greedy than fearful***); but in a free market, mispricing generally exists only for a period of time. In time, there would be rational players in the economic process coming in to unlock such value. Could this happen to the Hong Kong family property companies over time, and what could lead to a change in the large discount in their valuation change?

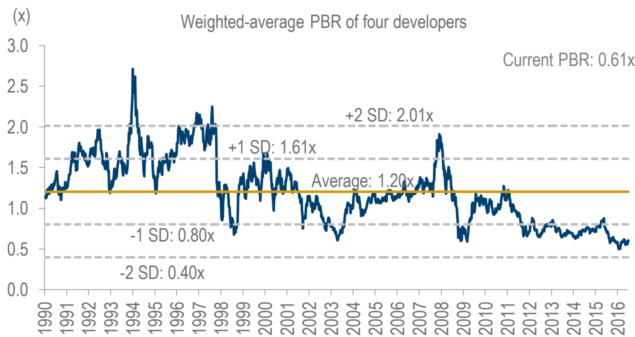
Question 4

Can the Hong Kong family property companies modernise — or at least pay higher dividends?

Can the families' interests be aligned with those of investors?

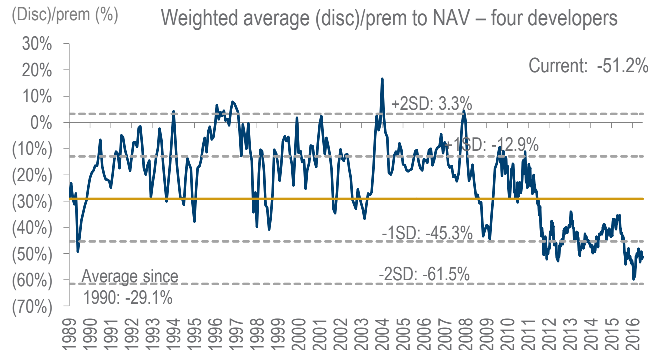
We have long argued that the NAV discounts given to the Hong Kong property stocks are a global anomaly (see our September 2013 special report: ***The Hong Kong Property Toolkit***). In no other major stock market in the world is there such a big disconnect between asset prices in the physical property market and the share prices of the property companies which own the bulk of the most prime real-estate assets in the same physical market.

PBR of major Hong Kong property developers



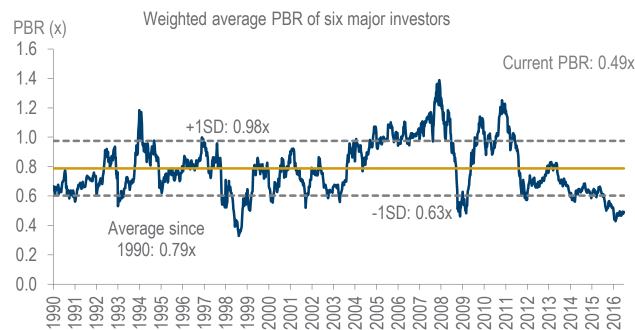
Source: Companies, Datastream, Daiwa

P/NAV of major Hong Kong property developers



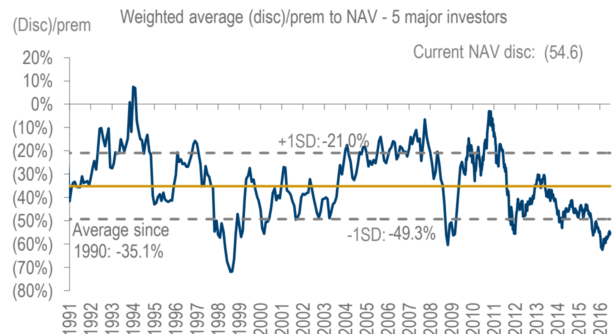
Source: Companies, Datastream, Daiwa estimates

PBR of major Hong Kong property investors



Source: Companies, Datastream, Daiwa

P/NAV of major Hong Kong property investors



Source: Companies, Datastream, Daiwa estimates

We think the Hong Kong discount has persisted for a reason. In our view, the issue stems more from how the family property companies are perceived in the global capital markets than any problems with the underlying property assets they own; and we believe it is compounded by the phase of development of the Hong Kong stock market, which is characterised by the primary market developing much faster than the secondary market (see Appendix 2 of our initiation report on Cheung Kong Property, ***Realising value- for all shareholders***, published on 25 May 2016).

Can perceptions of Hong Kong property companies change? We believe so

In our opinion, the Hong Kong discount could well persist if there is no change in the way the Hong Kong property companies are viewed by the global investing community. However, we do expect the perception of the Hong Kong property players to change. While it is hard to see the discount disappearing altogether, we believe it could well narrow as investors recognise the change in the way the Hong Kong family property companies are managing their capital.

On our estimates, the underlying assets owned by the listed Hong Kong property companies have a combined value of more than USD400bn, while the total market cap of the listed property companies in Hong Kong stands at about USD200bn. In other words, the "Hong Kong discount" has a theoretical investment value of over USD200bn. In our view, this discount is mainly a capital market issue, and to narrow it will require changes from companies and investors alike.

From the investing side, we think what it is required is a change in perception of the Hong Kong property companies, crucially, sufficient confidence among the investment community that: 1) the business models implemented by the Hong Kong property companies do have their merits in the context of the Hong Kong/China market, 2) these groups are competent players and well experienced in the Hong Kong and China property industries, and 3) investing in these companies (owners of a large part of Hong Kong/China's most prime commercial real estate assets) is a sound way to play the rise in wealth and economic importance of a large and populous country like China over time.

Listed real-estate securities in Hong Kong

Bloomberg code	Name	No. of shares (m)	Share price (HKD)	Market cap (USDbn)	Stake of major shareholder(s) (%)	Free-flow no. of shares (m)	Free-flow value (USDbn)
Property Developers							
1113 HK	CK Property	3,845	47.65	23.6	30.2	2,683	16.5
16 HK	SHK Properties	2,895	90.70	33.8	57.0	1,246	14.6
12 HK	Henderson Land	3,637	42.50	19.9	72.6	996	5.5
83 HK	Sino Land	6,166	12.54	10.0	54.1	2,832	4.6
20 HK	Wheelock	2,032	35.35	9.3	11.9	1,790	8.2
17 HK	New World	9,388	7.66	9.3	44.4	5,218	5.2
				105.9			**54.4**
Property Investors							
4 HK	Wharf	3,031	46.80	18.3	60.0	1,211	7.3
1972 HK	Swire Properties	5,850	20.30	15.3	82.0	1,053	2.8
HKL SP	HK Land	2,353	USD5.99	14.1	50.2	1,172	7.0
101 HK	Hang Lung Properties	4,497	15.24	8.8	56.0	1,978	3.9
14 HK	Hysan Development	1,046	34.10	4.6	41.6	610	2.7
683 HK	Kerry Properties	1,443	18.88	3.5	59.2	588	1.4
41 HK	Great Eagle	676	30.55	2.7	66.0	230	0.9
				67.3			**26.0**
REITs							
823 HK	Link REIT	2,243	53.95	15.6	0.2	2,239	15.6
87001 HK	Hui Xian REIT	5,429	3.16	2.6	44.9	2,989	1.4
2778 HK	Champion REIT	5,786	4.30	3.2	63.4	2,120	1.2
778 HK	Fortune REIT	1,893	9.24	2.3	28.0	1,363	1.6
1881 HK	Regal REIT	3,257	1.95	0.8	75.0	814	0.2
405 HK	Yue Xiu REIT	2,845	4.48	1.6	63.6	1,037	0.6
435 HK	Sunlight REIT	1,636	4.42	0.9	31.7	1,118	0.6
1426 HK	Spring REIT	1,125	3.37	0.5	36.2	718	0.3
808 HK	Prosperity REIT	1,446	3.18	0.6	19.1	1,170	0.5
				28.1			**22.0**
Niche property companies							
878 HK	Soundwill	283	12.72	0.5	69.8	85	0.1
173 HK	K Wah International	2,840	3.77	1.4	52.3	1,354	0.7
497 HK	CSI Properties	10,037	0.26	0.3	46.2	5,402	0.2
201 HK	Magnificent Estates	8,947	0.18	0.2	71.1	2,586	0.1
369 HK	Wing Tai Properties	1,343	4.24	0.7	59.4	546	0.3
488 HK	Lai Sun Development	30,159	0.12	0.5	67.1	9,930	0.2
				3.6			**1.5**
				204.9			**103.9**

Source: Bloomberg, Daiwa
Note: prices as of close on 29 Jun 2016

Confidence in the closer alignment of the interests of families and long-term shareholders is key

From the companies themselves, we think there needs to be a commitment to building confidence among investors that the interests of the controlling families and their long-term shareholders are aligned; that the controlling families value long-term investors and shareholders as important stakeholders, in the same way as they value their long-term business partners. In other words, investors need to trust that the portion of capital they put into the company (whether through the primary or secondary market) will be treated by the family as capital that belongs to the investors and managed as such, ie, allocated in ways that take into account the interests and priorities of shareholders and investors.

We understand there is no urgency for the family property companies to bring about a narrowing of the Hong Kong discount, which is one reason why the discount has persisted for so long. That said, we think there are many ways to improve and it is in the rational long-term interest of the families to consider these options. More importantly, companies around the world are paying more attention to corporate-governance issues, and in Asian markets such as Japan and Korea, there is now regulatory pressure on listed companies to take on board corporate governance matters.

At the same time, many Hong Kong family property companies have made efforts along these lines, even in the absence of major regulatory pressure to do so. Indeed, in terms of their transparency and disclosure, we contend that the Hong Kong property companies have improved appreciably over the past 20 years. In our view, however, the magnitude of improvement has yet to catch up fully with the expansion in these companies' earnings and market caps. In other words, we believe that the size and scale of the Hong Kong family property companies has now grown to a point where their valuations have to be supported by a much larger group of global investors. Meanwhile, we don't disagree that the improvement in these companies' capital management and business practices has not yet caught up with the global norms expected of listed companies of their size.

This brings us to the question of whether the Hong Kong family property companies want to be viewed as just major Hong Kong companies for a limited group of institutional investors or if they aspire to be considered as quality names for global investors or even premier names in global property. In terms of assets, earnings, experience in the property industry, and the quality of the property assets they own, we believe these companies are well qualified to take their place on the global stage. Whether they have the will to do so is the key point. However, we contend that rational self-interest, as well as economic and regulatory forces, should dictate that pressure is likely building in this direction, and that these companies will need to address these issues eventually. Indeed, we see signs of the Hong Kong family property companies making attempts to address some of these issues, and think investors should take note.

Simple choice: stay local or aspire to be modern and international?

On this note, one could say that very few of the major family property companies in Hong Kong really need additional equity capital, and that they won't be looking to sell their companies anytime soon. So they do not have to worry about how their companies are being priced in the capital market. In retrospect, one could say that many of these companies really did not need to be listed. Property is a local business and they have sufficient debt capital provided by the banks. As such, they could comfortably remain local plays for a long time to come.

However, having access to the global capital markets does have its appeal, and in global property there is no lack of companies that can grow rapidly as a result of being able to access capital provided by the global capital market on favourable terms (ie, when their shares can continuously trade at valuations that are close to NAV, or even at a premium to NAV). In the case of Hong Kong, the Link REIT is one such example. Although it owns arguably bottom-tier retail property assets in Hong Kong, it is trading at the highest-ever valuation (in terms of PBR) among the Hong Kong property companies (since listing in 2005, the Link REIT has been trading at an average of an 18% premium to its book NAV – its current discount to NAV is still the lowest among Hong Kong property stocks). And we think the Link REIT example also shows that the discount that is typical of Hong Kong property stocks is not an immovable object.

In some ways, some of these family property companies are still owned and managed by the founders and executives who have run them for more than 40 years. But back in their early days, these were small companies and the Hong Kong property market was a small, fringe market in the global context. Hong Kong has certainly come a long way over the past few decades, so have the international governance standards expected of publicly listed corporations. But have the governance standards and international perspectives of these family companies progressed as much? Is now the time for them to make another leap forward? And do they have the will to take that step?

Will rational self-interest and modern international practices prevail?

That is the billion dollar question. Our view is that there are no strong reasons why, over time, they won't take this step. After all, it isn't the most difficult thing to do in the world, and it should benefit all parties, perhaps most all of the companies themselves and the families that have significant shareholdings in these companies. Hong Kong is an open and international city, and it is reasonable to expect the Hong Kong companies to take on board global practices and global standards over time. Further, many of these family property companies are in the process of passing the management on to the next generation, most of which has been educated overseas. In this respect, we would think that the modernisation of Hong Kong family property companies is a logical path to take.

Indeed, based on how their equities are valued in the stock market today, one could ask whether there are many benefits associated with their listed status. From a corporate finance perspective, the situation today (in terms of valuations) is clearly not optimal and we wonder whether the Hong Kong family property companies should be either privatised or modernised. If they are visionary and ambitious enough, we think they should consider internationalising in the sense of looking beyond being only major players in Hong Kong and aspiring to be seen as major players in Greater China or even global property.

Regulatory framework may not have helped investors appreciate the value of Hong Kong property companies

Another unusual thing about Hong Kong property stocks at this stage is that the regulator, probably out of an intention to protect minority shareholders, has made it difficult to make privatisation offers. Under the current rules governing privatisation in Hong Kong, any investor that owns more than 10% of a company's free float can block a privatisation deal — a situation rarely found in other global markets. At the same time, there is a "creeper rule" whereby companies that are major shareholders with stakes of 30-50% in companies cannot increase their annual stakes by more than 2pp per annum. Ironically, while these rules are intended to protect the interests of minority shareholders, they might actually pose an obstacle to major shareholders seeking to privatise these companies.

At the same time, family ownership and the stringent privatisation rules make it difficult for private equity capital to enter the Hong Kong market in a big way. In the US, we have seen privatisation or take-over activities capitalising on merely 5-15% discounts to NAV; but in Hong Kong, there are many companies trading at over 50% discounts to NAV that could realise cash proceeds in excess of their market cap by selling just one of their major property assets.

Hong Kong property companies seem to have an old-school perspective on corporate finance

It seems there is not a culture in Hong Kong's property industry to look at the discounted valuation of their stocks from an investing and corporate finance perspective. Most property companies in Hong Kong have been listed for over four decades, and many of the families involved are far wealthier than they could have imagined 40 years ago. Indeed, one gets the impression that some Hong Kong property companies have viewed the listing status as a fact of life, in that they have long passed the stage where equity capital is crucial to them. Financially speaking, they are likely quite comfortable in viewing their listing status as a platform from which they can access equity capital when they want to.

Compared with their global peers, the Hong Kong property companies appear to be more serious about managing property projects and building property assets, but less concerned with stock prices and how they are perceived by and priced in the stock market. For long-term and value-oriented investors, the Hong Kong property companies' approach is not without its merits, since the companies own some of the highest-quality property assets in the

world and are, generally speaking, competent operators in the property business. Moreover, they tend to be very prudent financially and would not risk their balance sheets for short-term gains. They generally put great store in the long-term value and growth prospects of the company, which should closely match with the interests and priorities of long-term investors.

That said, we can appreciate why even long-term oriented value-investors can get frustrated as the stock prices of these companies do not seem to respond to improvements in the value of the underlying assets and businesses.

Is the cost of equity an important part of the business? We think so

We do not disagree that the primary focus of companies should be on the business, and that companies that are not fixated on their stock prices are often better-managed companies. That said, we do think that a company's cost of equity and cost of capital matter to the business itself, and to the extent that a company's stock price and how the company is viewed in the stock market affect its cost of capital, these aspects probably qualify as at least meaningful constituents in the overall management of the business.

In a way, one could say that the Hong Kong family property companies focus on the more difficult part of the property business. By this we mean that in global property, there is no shortage of companies that put great emphasis on getting a more favourable cost of equity, and these companies have been growing relatively quickly and easily by maximising the benefits and opportunities the capital market can offer. By contrast, the Hong Kong property companies tend to focus more on the underlying business and their property assets to the extent that they seem willing to devote years to working on large-scale property projects and funding them mainly through retained earnings and borrowings. In our view, this approach is not without its merits from an operational perspective, though one has to say that if these companies can also get their cost of capital right, they might be able to grow faster and at lower risk and could afford to be more ambitious.

The key is building mutual trust between investors and the families

We do not think that getting the cost of capital "right" necessarily means caring a lot about how the stock price is doing at any given time. JP Morgan said in Congress during the Great Depression that "finance is based on trust", and we believe that getting the cost of capital right is about building sustainable trust in the investing world. Such trust does not come easily; it needs to be built and substantiated by experience and action.

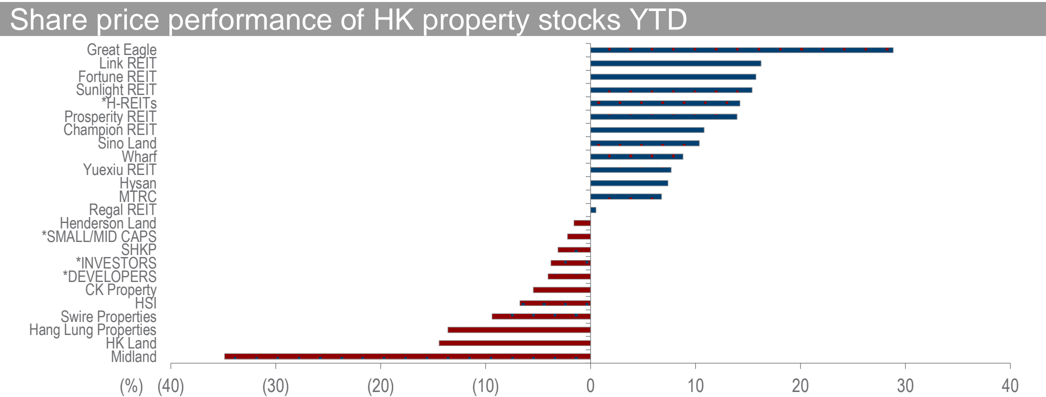
We believe it is reasonable for investors to think that even if they provide capital to the company only at the secondary market level, that at least a portion of the company's capital really belongs to equity investors and the company's capital needs to be managed with that in mind. We don't think the Hong Kong family property companies disagree on this point conceptually, though investors are probably unsure as to the extent these principles are ingrained in the culture of these companies.

And the first step in building trust is to pay higher dividends

In our opinion, the first step in building such trust is to pay higher dividends. This is what most major Hong Kong property companies have been doing over the years, and with the families now owning a greater proportion of these companies equity, we see no reason why this process won't continue.

Importantly, the share prices of companies that have paid consistently high dividends have held up much better than their peers during recent market downturns. Indeed, we have yet to find a company which has not been rewarded in terms of stock valuations for consistently paying high dividends. In the early years, the market naturally questions whether high dividends are sustainable. However, if a company can demonstrate that it has the will and ability to pay consistently high dividends to all shareholders, the shares will likely rise over time.

Share price performance of HK property stocks YTD



Source: Bloomberg, Datastream, Daiwa
Note: prices as of close on 29 Jun 2016

DPS of major HK property companies since 2006

Company	Year end	DPS/DPU (HKD) FY06	FY07	FY08	FY09	FY10	FY11	FY12	FY13	FY14	FY15	Change FY15/ FY06	CAGR FY06-15
Cheung Kong	Dec	2.20	2.45	2.45	2.70	2.95	3.16	3.16	3.48	3.654	na	na	na
CK Property	Dec	na	na	na	na	Na	na	na	na	na	1.40	na	na
SHK Properties	Jun	2.20	2.30	2.50	2.50	2.70	3.35	3.35	3.35	3.35	3.35	52%	5%
Sino Land	Jun	0.35	0.35	0.36	0.36	0.36	0.41	0.46	0.50	0.50	0.50	43%	4%
Wharf	Dec	0.75	0.78	0.78	0.97	0.97	1.06	1.65	1.70	1.81	1.90	153%	11%
Henderson land*	Dec	0.87	0.91	0.91	0.5	0.83	0.83	0.88	1.06	1.10	1.45	122%	9%
Hysan	Dec	0.5	0.6	0.68	0.68	0.74	0.79	0.95	1.17	1.23	1.32	164%	11%
Link REIT**	Mar	0.218	0.674	0.744	0.840	0.974	1.105	1.295	1.465	1.658	1.828	171%	13%
Hang Lung Prop	Dec	0.51	0.56	0.66	0.66	0.71	0.71	0.74	0.75	0.76	0.75	47%	4%
Fortune REIT^	Dec	na	0.351	0.370	0.302	0.244	0.263	0.324	0.360	0.417	0.469	34%	4%
MTRC	Dec	0.42	0.45	0.48	0.52	0.59	0.76	0.79	0.92	1.05	1.06	152%	11%

Source: Companies, Daiwa
*Note: *Henderson declared a 1-for-10 bonus issue in FY12, FY13, FY14, and FY15*
*^Fortune REIT's s DPU growth since FY07, ** Link REIT's DPU growth since FY07 as it was listed in November 2005*

In a relatively low-interest-rate environment, we believe that if the Hong Kong property companies can offer 4% (or even 5%)-plus — and growing — dividend yields, as well as NAV growth and other upside (such as: value realisation from the disposal of property assets; if they can become increasingly strong players in the China property sector; if they are potential beneficiaries of M&A opportunities in the Hong Kong/China property sectors; or if they become seen as a sound way for China funds to get a China weighting), then they will have sufficient appeal to the global capital markets. By extension, while the Hong Kong discount may still exist, we think it is conceivable that the discount could narrow to its post-1990 long-term historical average of 20-30%.

The biggest barriers are probably psychological and cultural

We recognise that there are psychological and cultural barriers to this process playing out. For one thing, it is about whether these companies have the vision and aspiration to be seen as modern and international. They are already strong players in Hong Kong and have a meaningful presence in China, and we think they are well placed to remain so. In a sense, there is no need for these companies to think much beyond this. That said, taking the company to another level does have its attractions. While these families are not going to sell their companies, we do think that how they are valued and priced by the capital market matters to them, if only because new players which can address these issues could pose a competitive threat over time. It is also better to remain strong in Hong Kong and to become stronger in China. And to take advantage of the opportunities in Hong Kong and China, the currency value of the equity is important, or could at least be valuable, in our view.

As things stand, an investment of USD1-2bn is affordable in terms of these companies' balance sheets if they rely only on retained earnings and borrowings. However, if an investment exceeds USD3bn, and if there are several projects, it can be quite a burden if funded only by borrowings. And there could be many such opportunities emerging in the Hong Kong and China property spaces. With many companies now being passed to second-generation family members, ensuring that these companies' governance standards evolve in line with international practices will only benefit them (ie, in terms of preserving and enriching the legacies that the founders of these companies spent their life-time building up), in our view.

Family-owned companies can also be good companies

Of course, in terms of management style, behaviours and many other aspects, family-owned companies are likely to be different from companies which are owned by institutions and have no controlling shareholders. But family ownership does not have to be a minus point. Indeed, we think a case be made that family-owned companies could be the most closely aligned with the interests of long-term investors, in that they are more likely to focus on the long-term prospects of the company than short-term issues such as quarterly earnings or the market's opinions. They may even have the most motivated owners and management teams. Note also that some of the most respected publicly listed companies in the world are family owned and some of the major companies that Berkshire Hathaway has invested in are owned and managed in a similar way to private family companies. As Warren Buffett has written in letters to his shareholders, "our long-avowed goal is to be the 'buyer of choice' for businesses - particularly those built and owned by families". Also, family ownership does not necessarily mean that the companies must be managed by the family. Central to the matter is how these companies choose to view minority shareholders and investors — are they irrelevant to the future of the companies or are they important stakeholders as well?

The business models of the Hong Kong property companies continue to evolve

In our opinion, corporate governance drives the valuation of companies, which brings us back to the issue of whether the Hong Kong family-run companies will gradually adopt more modern capital management and corporate-governance standards. And we see paying higher dividends and undertaking share buybacks as ways to get an appropriate cost of capital, which would represent a big step forward in unlocking up to USD100bn worth of investment value.

We think the 2015 results of the family-run companies, announced at a time when there was significant uncertainty in the market, demonstrated that these companies are committed to paying higher dividends to all shareholders. We also believe these companies' business models have been evolving and the companies now derive a much larger proportion of their earnings from income-producing property assets. Further, their ability to continue to raise DPS into 2017 and beyond looks well supported by their recurrent income bases.

Hong Kong property companies: DPS from most recent results

Company	Interim / Final	Dec 2014 (HKD)	Dec 2015 (HKD)	YoY
CK Property	Final	na	1.40	na
Great Eagle*	Final	0.74	0.74	0%
Hang Lung Properties	Final	0.76	0.75	-1%
Henderson Land**	Final	1.10	1.45	32%
Hongkong Land	Final	USD0.19	USD0.19	0%
Hysan	Final	1.23	1.32	7%
Kerry Properties	Final	0.90	0.90	0%
MTRC	Final	1.05	1.06	1%
New World Dev	Interim	0.12	0.13	8%
SHK Properties	Interim	0.95	1.05	11%
Sino Land	Interim	0.12	0.13	8%
Swire Properties	Final	0.66	0.71	8%
Wharf	Final	1.81	1.90	5%
Wheelock	Final	1.07	1.15	8%

Source: Companies, Daiwa
*Note: *Great Eagle - before factoring in its HKD2.0/share special dividends in FY15*
***Henderson has declared a 1-for-20 bonus for 4 consecutive years since 2012, while continuing to raise absolute DPS*

Hong Kong property companies: dividends vs gross rental income

Company	Dividends FY15 (HKDm)	Gross rental income* FY15 (HKDm)	Ratio of dividends / Gross rental income
CK Property	5,404	8,500#	64%
Hang Lung Prop	3,373	7,751	44%
Henderson Land	4,794	8,152	59%
Hongkong Land	USD447m	USD977m	46%
Hysan	1,388	3,430	40%
Kerry Properties	1,302	3,801	34%
SHK Properties	9,672	19,681	49%
Sino Land	3,040	3,684	83%
Swire Properties	4,154	11,563	36%
Wharf	5,759	14,470	40%

Source: Companies, Daiwa
*Note: *gross rental income includes contributions from JVs and associates # assuming full year contribution from rental properties previously owned by Hutchison Property*

They have started paying higher dividends. Will they come to accept share buybacks?

Importantly, if these companies continue to raise their dividends, they will sooner or later realise that buying back their shares at discounted valuations can save them considerable sums in terms of serving their existing equity base, and is beneficial to the business in the long run. CKP has pioneered share buybacks among the major local property companies, and we believe buybacks will become more widely accepted in Hong Kong over time.

CK Property: share buybacks

Date	No. of shares bought	Avg price (HKD)	Total amount (HKDm)	% of issued shares
18-Mar-16	11,525,000	46.520	536.1	0.299%
21-Mar-16	2,010,000	47.900	96.3	0.052%
23-May-16	645,500	45.237	29.2	0.017%
Total	**14,180,500**	**46.658**	**661.6**	**0.368%**

Source: HKEx, Daiwa

Given that the Hong Kong property companies now realise more than HKD100bn in annual gross rental income alone, we believe that continuous buybacks would serve as a sustainable catalyst to narrow the NAV discounts of the Hong Kong family property companies. On our estimates, every 10pp narrowing in the NAV discount of the Hong Kong property stocks would translate into over USD40bn of investment value to be unlocked.

Real-estate stocks globally could now have a new opportunity

At the same time, real estate looks set to become a more important asset class for the global investing world, given the forthcoming changes in Global Industry Classification Standard (GICS), which after close of business on 31 August 2016 will recognise Real Estate as a new, 11th sector (as opposed to being included in Financials, as currently).

Planned changes in the Global Industry Classification Standard (GICS) structure

Now				After 31 August 2016		
Code	Sector	Subcode	Industry Groups	Code	Subcode	Industry Groups
10	Energy	1010	Energy	10	1010	Energy
15	Materials	1510	Materials	15	1510	Materials
20	Industrials	2010	Capital Goods	20	2010	Capital Goods
		2020	Commercial & Professional Services		2020	Commercial & Professional Services
		2030	Transportation		2030	Transportation
25	Consumer Discretionary	2510	Automobiles & Components	25	2510	Automobiles & Components
		2520	Consumer Durables & Apparel		2520	Consumer Durables & Apparel
		2530	Consumer Services		2530	Consumer Services
		2540	Media		2540	Media
		2550	Retailing		2550	Retailing
30	Consumer Staples	3010	Food & Staples Retailing	30	3010	Food & Staples Retailing
		3020	Food, Beverage & Tobacco		3020	Food, Beverage & Tobacco
		3030	Household & Personal Products		3030	Household & Personal Products
35	Health Care	3510	Health Care Equipment & Services	35	3510	Health Care Equipment & Services
		3520	Pharmaceuticals, Biotechnology & Life Sciences		3520	Pharmaceuticals, Biotechnology & Life Sciences
40	Financials	4010	Banks	40	4010	Banks
		4020	Diversified Financials		4020	Diversified Financials
		4030	Insurance		4030	Insurance
		4040	Real Estate			
45	Information Technology	4510	Software & Services	45	4510	Software & Services
		4520	Technology Hardware & Equipment		4520	Technology Hardware & Equipment
		4530	Semiconductors & Semiconductor Equipment		4530	Semiconductors & Semiconductor Equipment
50	Telecommunicat-ion Services	5010	Telecommunication Services	50	5010	Telecommunication Services
55	Utilities	5510	Utilities	55	5510	Utilities
				60	6010	Real Estate

Source: MSCI, S&P Dow Jones Indices, Wikipedia

Developed in 1999 by MSCI and Standard & Poor's (S&P), GICS currently consists of 10 sectors, 24 industry groups, 67 industries and 156 sub-industries, into which S&P categories all major public companies. Since GICS is used as the basis for S&P and MSCI market indices, this revision should increase the importance of property stocks among global investors, as it may no longer be possible for investors to reach their targeted weightings on property through Financials stocks alone.

While real estate has become a more important asset class for equities portfolio managers over the past decade, many global equity portfolios do not yet have major weightings in property stocks, as the portfolio managers can get the weighting through Financials stocks. In a way, the forthcoming change in GICS could be seen as recognition of the rising importance of real estate as an asset class. It is likely that the initial beneficiaries of the change will be the large, well-known global property names. However, since the valuations of Hong Kong property stocks are arguably the cheapest among the developed markets, these stocks should draw more attention from the global investing world over time, especially global funds that are looking to build up their weightings in property.

The size of the Hong Kong-listed real estate securities is not small — but it's not so big in a global context

Note that while the total market cap of the listed real-estate securities in Hong Kong is not small, at about USD200bn, it is not so large in the context of the combined over USD3trn market cap of all listed real-estate securities globally or global equity investing capital of more than USD40tn (KPMG estimates). And this is before one takes into account the sovereign wealth funds and the family offices (fund management companies owned and run by private families) managing the wealth of private families around the world. Arguably, the Hong Kong family property companies might suit the sovereign world funds and family offices more as an investing class, as these funds tend to be conservative and long-term in outlook, and hence may prefer companies with solid balance sheets and asset backing over high-flyers which rely on leverage and scale expansion to drive their businesses. As yet, though, there are not yet signs that these 2 sources of capital have started to become major shareholders in the Hong Kong family property companies, and they could be potential buyers of the Hong Kong family property companies' shares, in our view.

Reasonable prospect of the value in Hong Kong family property companies being partly unlocked if they continue modernising

At the same time, though MSCI announced on 15 June that China A shares won't be included in its indices following its recent review, MSCI did acknowledge the considerable progress that has been made by the regulators in China and that it could include China A shares into its indices before the next official review 1 year later. It seems just a matter of time before A shares make their way into the MSCI indices. Hence, at some stage, global investors will need to face up to the issue of China weightings. In other words, will they put all their China weighting directly into Mainland companies, or will they get some of their China weighting through the Hong Kong family property companies, which have solid balance sheets and cashflow from Hong Kong, as well as proven ability to realise returns from their China investments?

In sum, if the Hong Kong family property companies continue to make progress in modernising their capital management, and gain investor confidence that the interests of the controlling families and long-term investors are closely aligned, then we think they should draw enough capital to narrow the "Hong Kong discount" and unlock a portion of the USD200bn investment value currently embedded in these stocks. And this is before we take into account the recent signs that concerns over the Hong Kong physical property market are easing and fears over Hong Kong property may have started to subside.

Market snapshot:

Are there signs that Hong Kong property sector is about to turn the corner?

Are the fears over Hong Kong property about to subside?

That the Hong Kong property sector is facing challenges is not in question. As we have argued, the 2 tidal waves — exceptionally low US interest rates and the outburst of outbound consumption by Mainland Chinese — clearly affected the Hong Kong property market during 2004-2014. Now that these waves are receding, the whole sector — office, retail, residential or hotels — looks beset with challenges.

Having said that, challenges are nothing new for the Hong Kong property sector. Over the past few decades, the property market has had to deal with many challenges, many large enough to crush the whole market — yet the sector pushed through each time. While luck has been a contributing factor, we believe it is the need to survive that has driven innovation and adaptation among market participants in Hong Kong, which has resulted in the market eventually overcoming these challenges. Hence, it could be argued that the Hong Kong property market has been driven by crises and even made stronger by them.

Performance of the Hong Kong property markets since 1984

	Property Price Index change during the period:		
	1984-1997	**4Q97-mid-2003**	**Mid-2003 - present**
Residential			
Overall	10.0x	-66%	4.7x
Class A	8.9x	-67%	5.3x
Class B	10.4x	-66%	4.5x
Class C	12.7x	-66%	4.1x
Class D	na	-64%	4.0x
Class E	na	-63%	3.6x
Office			
Overall	7.7x	-73%	7.4x
Grade A	8.5x	-73%	6.8x
Grade A - core districts	na	-73%	6.4x
Grade B	7.4x	-74%	8.0x
Grade C	6.1x	-72%	7.8x
Retail			
Overall	11.2x	-61%	6.7x

Source: MSCI, S&P Dow Jones Indices, Wikipedia Source: CEIC, Daiwa
Note: E - Private domestic units: larger than 160 sq m
D - Private domestic units: 100-159.9 sq m
C - Private domestic units: 70-99.9 sq m
B - Private domestic units: 40-69.9 sq m
A - Private domestic units: smaller than 39.9 sq m

Hong Kong residential property prices: major tipping points

Events that negatively affected the residential property market	Period	Maximum drop in residential property prices
4 June - Tiananmen Square	Jun 89 - Sep 89	Prices fell by 3% during this period
Gulf War	Aug 90 - Feb 91	No negative impact
Government measures to cool the property market	Aug 92 - Jan 93	Prices fell by 9.5% during this period
US rate hikes + government intervention	Apr 94 - Jan 95	Prices fell by 17% during this period
Death of Deng Xiaoping	Feb 97	No negative impact
Asia financial turmoil + government intervention	4Q97 - 2Q03	Prices fell by 70.2% from top to bottom
US rate hikes	May 05 - Nov 05	Prices fell by a maximum of 5% during this period
Global financial crisis	Jun 08 - Nov 08	Prices fell by a maximum of 20% during this period
First mortgage tightening measures implemented by the government	Jun 11 - Jan 12	Prices fell by a maximum of 4.4% during this period
The third and most severe round of government measures	Feb 13 – Apr 13	Prices fell by a maximum of 4.3% during this period
Normalisation of US interest rates + China crackdown on corruption	June 13- Feb 14	Prices fell by a maximum of 3.3% during this period

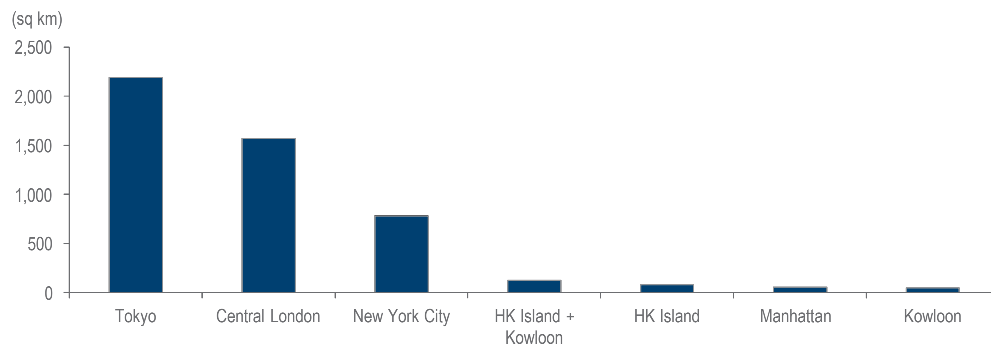
Source: Daiwa

There is no guarantee, of course, that the Hong Kong property market will overcome such challenges in the future. But we contend that one should not give up on the Hong Kong property market too easily — or, put another way, one should give it the benefit of the doubt — for the following reasons:

1. What is the primary and most important driving force for Hong Kong property?

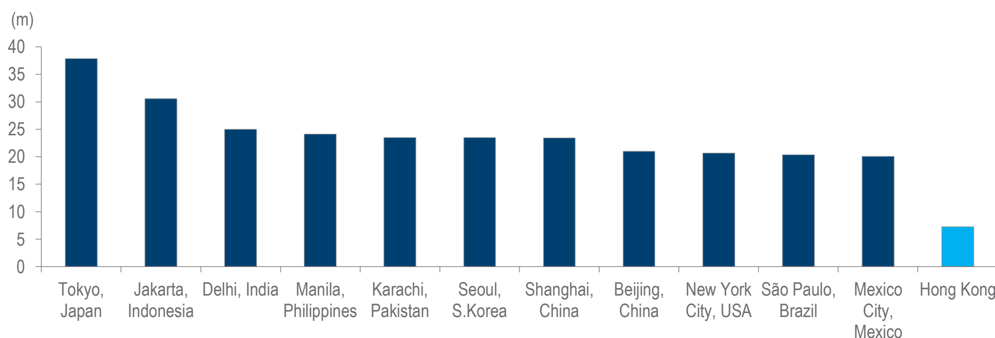
First and foremost, we are of the view that the most important driving force for Hong Kong property is not low interest rates or Chinese consumers. Rather, it is the metropolitanisation process which has seen Hong Kong go from being not much more than a fishing village several decades ago to one of Asia's major cities — one that should continue to draw net inflows of capital and talent. In this context, low interest rates and the boom in outbound consumption by Mainland consumers have reinforced Hong Kong's fundamental appeal, and hence their retreat should not fundamentally alter the market's path. If the experiences of London and New York are anything to go by, the metropolitanisation process could take several decades to unfold fully, during which the correction periods don't last long and the market's magnitude of decline is often smaller than is widely expected.

Hong Kong: land area vs. major international cities



Source: Wikipedia

Hong Kong: population vs. major international cities



Source: Wikipedia

2. Did market participants take a full ride when the 2 tidal waves were moving in their favour?

We believe that, this time around, property-market participants in Hong Kong have shown restraint, sophistication and discipline when faced with these 2 tidal waves. They did not leverage up to the hilt, while the regulators used unprecedented administrative measures to pre-empt the emergence of system-wide over-leverage. Nor did market participants act as though these 2 tidal waves would be long-lasting. Rather, the major property companies seem to have treated the benefits associated with these tidal waves as windfalls, using them to build up China investments which are starting to provide returns.

Hence, if the Hong Kong property-market participants did not take a full ride when these tidal waves were moving in their favour, they may not necessarily plunge now that these forces are in retreat (though stock prices seem to

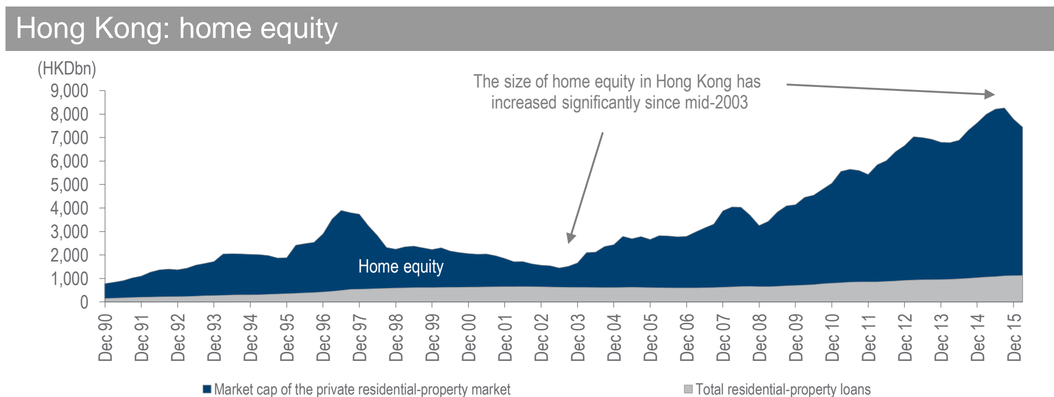
have discounted a meltdown scenario). While excesses did emerge in the Hong Kong property sector during this period, at no time were these excesses in evidence across the spectrum of the office, retail and residential sectors. Instead, they were largely confined to certain segments, such as high-street shops in prime areas for retail, prime Central buildings during 2010-2013 for offices, and smaller old units for residential since 2014.

The banking aspect of the Hong Kong residential property market

(HKDm)	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015
Transaction value for the																				
- primary market	72,119	113,378	119,679	83,812	72,500	68,451	74,512	78,549	101,024	91,442	52,402	113,971	68,338	112,961	127,695	130,990	132,207	92,448	176,948	162,221
- secondary market	319,799	563,747	155,031	135,752	110,777	91,291	78,908	71,452	173,796	215,564	177,488	318,360	276,129	312,932	433,044	311,839	323,003	207,958	254,070	255,457
Total	**391,918**	**677,125**	**274,710**	**219,564**	**183,277**	**159,742**	**153,420**	**150,001**	**274,820**	**307,006**	**229,890**	**432,331**	**344,467**	**425,893**	**560,738**	**442,829**	**455,210**	**300,406**	**431,018**	**417,678**
New loans drawn	162,957	256,306	112,414	119,205	116,462	106,515	98,545	79,482	133,548	142,814	115,117	173,508	184,754	199,295	324,216	227,775	191,854	158,604	213,831	243,809
New loans approved	182,022	274,462	125,849	141,831	137,264	122,144	107,924	84,794	155,720	156,879	140,637	213,884	224,287	311,416	413,863	270,300	256,890	195,999	278,981	284,951
Change in total mortgage loan outstanding	57,731	95,043	33,869	18,906	43,457	6,817	5,212	(11,493)	5,631	5,201	(3,711)	28,497	29,776	53,311	99,311	60,821	67,212	36,293	79,960	89,093
Total mortgage loans brought down	272,695	330,426	425,469	459,338	478,244	521,701	528,518	533,730	522,237	527,868	533,069	529,358	557,855	587,631	640,942	740,253	801,074	868,286	904,579	984,539
Total mortgage loan carried forward	**330,426**	**425,469**	**459,338**	**478,244**	**521,701**	**528,518**	**533,730**	**522,237**	**527,868**	**533,069**	**529,358**	**557,855**	**587,631**	**640,942**	**740,253**	**801,074**	**868,286**	**904,579**	**984,539**	**1,073,632**

Source: CEIC, Midland, Land Registry, Daiwa

Hong Kong: home equity



Source: Midland, CEIC, Daiwa

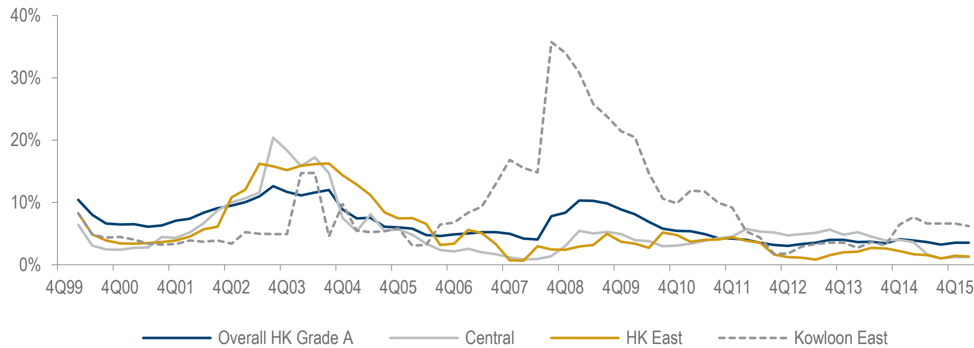
3. Has the market already created forces to counter-act the excesses?

We believe that market forces have emerged to counter-balance the excesses, which has led to the breaking down of certain entrenched psychological barriers in Hong Kong and continued changes to many districts in Hong Kong. The combined effect of these forces should be to prevent the whole sector from being carried too far and too fast by these 2 tidal waves, in our view. In other words, we have seen healthy and self-correcting market forces at work, which we think has given the Hong Kong property market more depth and sophistication than the market appreciates.

Our view is that Hong Kong property has been driven by contradictory forces, and will probably continue to be. One thing about the free market mechanism in Hong Kong is that it often leads to the emergence of balancing forces over time. Hence, when everything seems rosy in Hong Kong property, one should tread carefully. Conversely, when observers are universally gloomy about the market’s outlook, the true situation may be quite different.

All of which brings to mind what Joseph Schumpeter called “creative destruction”, in that the Hong Kong property market constantly seems to be reinventing itself, and it is the sector’s constant need to overcome the challenges it is facing that drives it to the next level.

Hong Kong: vacancy rates in the major Grade-A office locations



Source: CBRE Research, Daiwa

Along these lines, we reiterate our view that the office segment is now the healthiest and strongest among the 3 segments in Hong Kong's property market. Most importantly, we see it as the leading segment in Hong Kong property, such that its development paves the way for the broader sector.

In our opinion, the greatest achievements of the Hong Kong office sector over the past ten years are the creation of East Kowloon and the occupation of over 10m sq ft of new office space in the area since the late 2000s. Our view is that the emergence and existence of Kowloon East has helped the Hong Kong office sector to secure a solid foundation in that: 1) it's a realistic option for existing companies considering expanding their office space or managing their office rental cost for the long term, and 2) it gives newcomers a relatively low-cost option.

Indeed, we have seen a large-scale redistribution of office occupiers in various districts in Hong Kong over the past 8 years, with many companies reviewing higher- and lower-cost options before settling upon the location of their choice. We see this redistribution as forming the foundations for a more balanced development of the whole sector in the years to come.

The legacy of 2004-14: property market building the critical mass needed to move to the next level

We believe that, for all the excesses and problems the industry boom of 2004-14 might have created, it has given the market critical mass, potentially supporting a change in the way the market itself is viewed and positioned externally. Rather than being considered as a property market comprising 7m people in a medium-sized city in Asia, the Hong Kong market is potentially on the way to joining the ranks of major international cities such as London and New York, in our view.

When compared with the Hong Kong of yesterday, many features of in the Hong Kong property market today seem puzzling. There are far too many watch, jewellery and other luxury retailers on the high street; residential flats have become far more expensive than the middle class can afford; and office rents in Central are now out of the reach of most industries. As such, the newspapers are full of stories of high-street rents being slashed, companies moving out of Central, and residential flats being sold at a loss relative to the prior purchase price. However, we think these headlines should be seen as evidence that the market is clearing the excesses that have built up in the industry over the past 5-10 years.

Current position of the 3 property segments

Source: Daiwa

Also, we argue that this evidence of the free market correcting its excesses should not necessarily be taken as a bad sign. If Hong Kong property is to be viewed as a sector that is on the threshold of moving from a medium-sized regional market into one of the major international markets, then these developments should be seen as the free market's way of saying that it needs a significant increase in its physical property assets (especially mid-tier ones), and that many old property assets need to adapt to the requirements of the future Hong Kong.

Daiwa's 5 phases of the metropolitanisation process

	Features	Hallmarks	Property market implications	Manifestations in HK property
Phase 1	**Scramble for the most prime assets**	People or companies or retailers are willing to pay a premium to secure access to the most prime assets, especially high-margin corporates and retailers as well as wealthy individuals.	A surge in capital and rental values for the most prime assets.	Central office in 2005-10; high street retail rents in prime districts in 2004-13; luxury residential in 2004-13.
Phase 2	**Markets begin to respond and create substitutes**	Market resistance begins to emerge among other market participants especially when the growth momentum of the leading segments begins to lose steam.	Some districts are transformed and new districts could emerge to balance the surge in capital and rental value of the most prime assets.	HK office in 2009-14; residential entering into this phase since 2013; and retail since 2014.
			East Kowloon and the upgrading of the 4 other core areas (Wanchai, Causeway Bay, TST and Island East) can be seen as the office market's response to phase 1.	
			If market forces are allowed to operate freely, a lot of land in the New Territories would be converted into middle class housing, which could resemble the Kowloon East equivalent in residential. However, this has not been allowed to happen. Instead, the government has responded by implementing severe administrative measures to suppress demand.	The result was that the market adapted through developers changing to build a lot more small units, and the primary market significantly eating into the market share of the secondary.
			Suburban malls in the New Territories as well as horizontal and vertical expansion of the prime retail districts as well as landlords' renewed focus on locals and mid-end brands can be seen as the retail sector's response to phase 1.	
Phase 3	**Back to a more balanced growth path**	The market rests on a more solid and balanced foundation, with the top, middle and low-end segments all having their own growth drivers and each major district having their own characteristics as well as demand and supply dynamics.	Becoming a property market which is much more mature and has a lot more depth and sophistication. We would say that London is probably the closest example; while New York and Tokyo are much more advanced than HK in this respect.	HK office is just starting to enter into this phase.
Phase 4	**The city continues to expand in size and depth**	Each major segment and district tries to grow and expand. Some will grow, others may undergo a cyclical adjustment. But on the whole, the market rests on a much more solid foundation, and the city continues to expand in size and depth if talent and capital continue to come.	The market is vibrant, dynamic and energetic , with many districts continuing to change and evolve, and new districts emerging. The city's size also continues to expand.	London, New York and Tokyo are probably in this phase.
Phase 5	**The city begins to go downhill**	The virtuous cycle in the development of the property market reverses and unwinds, with talent and capital leaving the city.	The development of a city could well be a multi-decades process and one may not say that London, New York and Tokyo have reached their maximum potential.	

Source: Daiwa

Does the future of Hong Kong property lie in the scale expansion of mid-tier property assets?

If the Hong Kong property market can provide these new elements and live up to the challenges it now faces, we believe it can see an infusion of energy that could take it to the next level, ie, becoming a metropolitan property market along the lines of New York and London. As and when a lot more new and mid-tier alternatives become available, we would expect more newcomers (new companies, new retailers, expatriates as well as Mainland and overseas Chinese) to enter the market, adding to the breadth and depth of the market. The most prime property assets in Hong Kong may well remain as expensive as they are today, but we could see the emergence of more credible alternatives at prices or rents one-half or one-third of the most prime one. This development would give existing market participants and newcomers lower-cost options and a sufficient base of property assets to suit their business plans and the economics of their industries.

Hence, in our opinion, the future of Hong Kong property rests on a marked expansion in scale, especially for mid-tier properties. In this light, we propose to focus in the future on 2 areas when analysing the Hong Kong property market: 1) determining how much of the excesses have been cleared, and 2) pinpointing new sources of demand that could take up the slack created by the retreat of the 2 tidal waves, and assessing how sustainable this new demand might be.

Structural reforms in China give Hong Kong property another dimension

Alongside the changes now unfolding in the Hong Kong property market, China is also changing and adapting. It goes without saying that China, too, has many issues to address. Having been a planned economy for over 6 decades, China has lacked – and indeed still lacks – a robust mechanism like the free market to allocate capital. As such, the misallocation of capital has been widespread, which has probably been aggravated by the country's rapid and significant credit expansion since 2009.

Having said that, China does not seem unaware of these challenges or that its credit expansion and fixed-asset-investment-led growth model cannot be sustained indefinitely. The Chinese government has declared that it will pursue widespread structural reforms, and focus more on the qualitative than quantitative aspects of economic growth. More importantly, finance is a key area of the structural reforms now under way in China. However, we believe that China may not necessarily have to succeed in its structural reforms to create economic and commercial opportunities for Hong Kong. Indeed, as long as China is determined to experiment along these lines, we think Hong Kong, China's only international financial centre with the institutional framework needed to link up with the rest of the world, will be presented with related opportunities. Given the size of China's economy and considering that these reforms will take many years to unfold, we think these opportunities will last for years.

Comparison: US, China and Hong Kong financial sectors

	US	China	Hong Kong
GDP (USDtn)	17.9	10.8	0.3
Bank deposits (USDtn)	10.9	20.9	1.4
Banking assets (USDtn)	15.7	30.9	2.5
Equity market cap (USDtn)	25.1	8.2	3.2
Annual stock market turnover (USDtn)	30.0	41.0	2.1
M2 (USDtn)	12.3	21.4	1.5

Source: World Federation of Exchanges, CEIC, Daiwa
Note: As at the end of 2015

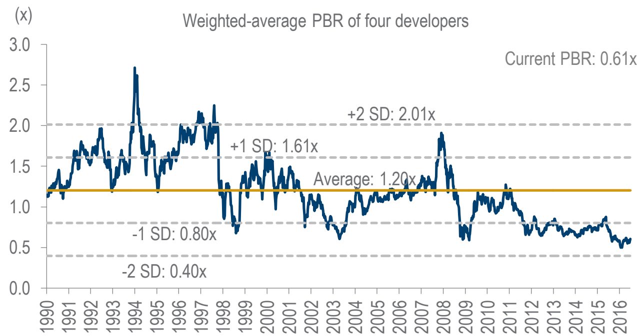
In a tug of war, which side will win?

We have established our view that the Hong Kong property market is in ferment and going through potentially major changes. While challenges abound, there are also new opportunities in the making. In a sense, a tug of war is playing out: on the one hand, the excesses in the sector need to be wiped out, and on the other, we are seeing some factors that could bring considerable opportunities to the market in the years to come.

It is hard to foretell which side will win out. However, stock prices appear to have discounted the negative aspects to the point they reflect a meltdown scenario, in our view. The turning point for stock prices will likely be when the momentum of the negatives appears to be declining while the impact of the new, positive forces is becoming more visible. In this light, the key to the outlook of Hong Kong property market is how well market participants can face the challenges created by the retreat of the 2 tidal waves and seize the potential opportunities that lie ahead.

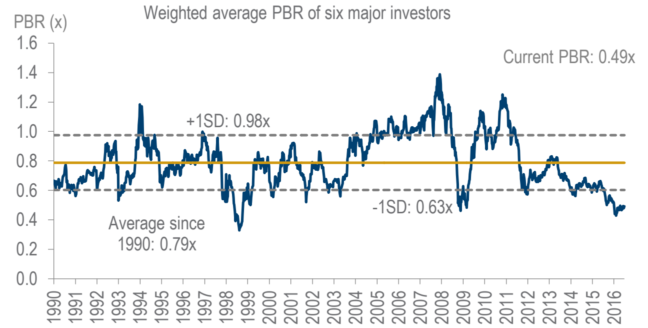
In our view, it is possible the Hong Kong property market is set to move to another level. For stock investors, this possibility is especially important and timely, as prices could be set for a meaningful rebound if these opportunities materialise or even if the true situation of the market turns out to be not as bad as many people expect it to be.

Major Hong Kong property developers: PBR



Source: Companies, Datastream, Daiwa

Major Hong Kong property investors: PBR



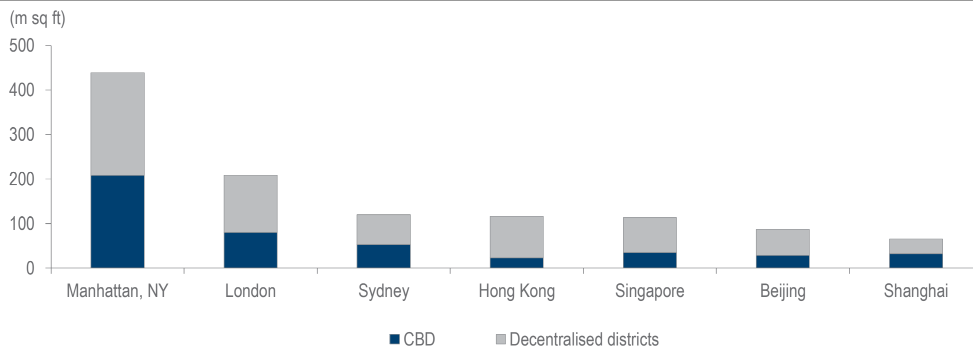
Source: Companies, Datastream, Daiwa

We highlight the following 3 points:

First, many psychological barriers are being broken, setting the stage for the next phase

First, various psychological barriers have been broken or are in the process of being broken. In our opinion, the existing stock of the Hong Kong property market looks sub-scale if the city is to move along the path of London and New York, where the entire stock of physical property assets could easily be at least double that of Hong Kong.

Comparison: office stock in selected financial centres' core CBD areas



Source: Knight Frank

In a way, one could argue that the extraordinarily high prices commanded by some of Hong Kong's most prime property assets reflect that the supply of land has been too constrained and that many market participants' definition of core Hong Kong is too narrow and small. In this light, some major psychological barriers seem to have been broken in the past 10 years, and that process looks to be continuing. Simply put, we believe that a metropolitan city with scale cannot be confined to a few districts and areas within a 30-minute commute from the centre.

Our view is that market participants' psychological acceptance of Hong Kong as a larger-scale city is a pre-requisite for Hong Kong being able to progress along the lines of a metropolitan city. We believe that market forces over the past 10 years have gradually enabled or compelled market participants to come to terms with this reality. The next step: how well market participants can capitalise on it.

The breaking of various psychological barriers in Hong Kong property (2004-2014)

Sectors	The breaking of the psychological barriers	Hallmarks
Office	MNCs accepting that moving across the harbour is normal and rational	Rent in ICC and Kowloon East's emergence as another office hub
Retail	International retailers accepting to open new stores and expand in the New Territories	The presence of international retailers in major suburban malls such as New Town Plaza and Tuen Mun Town Plaza
Residential	Middle class accepting Tseung Kwan O and Northwest New Territories as desirable residential locations	ASPs commanded by premier estates in these areas such as The Wings, Century Gateway etc.

Source: Daiwa

We consider 2008 to have been a watershed year in Hong Kong office property, as it was the year that ICC secured 3 major investment banks as its anchor tenants, thus breaking the decades-long psychological barrier associated with companies moving across the harbour. We see this as a classic example of how market participants have succeeded in steering the market, in this case by creating West Kowloon as an extension to Central. And we continue to see Island East and Kowloon East as growing in importance as new commercial hubs.

Along these lines, we also see international retailers' acceptance of suburban malls as a critical step in expanding Hong Kong retail to beyond the Tsimshatsui-Causeway Bay-Mongkok axis. For the residential property sector, we are seeing: West Kowloon's emergence as a luxury residential location; Tseung Kwan O's rise as a mid-to-high end residential location; and the emergence of Tuen Mun/Yuen Long as acceptable locations for the middle class, ie, they become to the residential equivalents what Kowloon East now is to the office sector. In this light, the forthcoming launch of SHKP's Grand Yoho in 2H16 could play a similar role to ICC in the office sector, ie, it could be the project that signals that Hong Kong end-users have finally accepted 40- to 60-minute commutes and are prepared to move to the Northwest New Territories for more living space.

Second, new forces are in the making that look set to become more prominent

Second, we see new positive undercurrents emerging. While these are not yet very prominent or visible, we believe they will develop into sustainable forces that become more apparent over time.

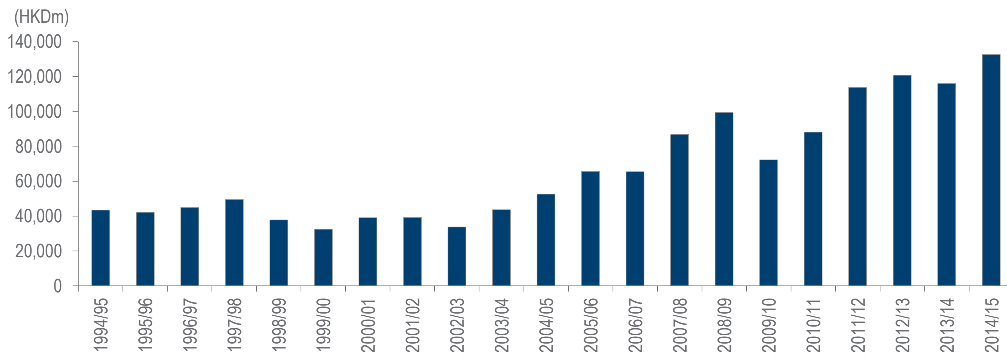
One of these clearest examples of this trend is in the office sector. Although there has been a lack of major demand for large-floor-plate office buildings in Hong Kong in recent years, we think the market has underestimated the strength of office demand in Hong Kong. After all, despite all the examples of firms relocating to lower-cost areas and investment banks downsizing, the vacancy rate in Central is still below 3% currently.

Meanwhile, the 10m-plus sq ft of new supply that has come on stream in East Kowloon since the late 2000s has been largely absorbed. At the same time, we are seeing fringe locations such as Kwai Chung, Wong Chunk Hang, and Sheung Wan becoming increasingly accepted by tenants, with achieved rents appreciably higher than they were 10 years ago.

There has been a structural change in office demand in Hong Kong

In our opinion, the prevailing view of the office sector has not yet grasped the implications of the structural changes in office demand that we have seen in recent years. In our view, there has been a clear shift in drivers: from the previous cycle of large-scale expansion by multinationals (recall all those headlines of major companies taking up multiple floors in high-profile buildings) to the current one, which is characterised by the piecemeal, gradual but sustainable expansion of a broad range of existing and new corporations. Importantly, we believe this trend is well supported by fundamental factors, as evidenced by a sustained rise in the corporate profit tax paid in Hong Kong in recent years. In other words, while there may be some investment banks that are struggling, some of the smaller companies and newcomers have been doing well.

Hong Kong: corporate profit tax paid



Source: HKSAR Government

There are new forces at play in the office market

We highlight the recent move by WeWork, a US-based company specialising in co-working and shared workspaces, to take up of 90,000 sq ft of office space in Tower 535, Causeway Bay. We believe WeWork's approach is a new concept for the local office sector, though WeWork has become a prominent force in international office markets such as New York, London, and San Francisco in recent years. Meanwhile, we believe that business centres have become sizeable occupiers of office space in Hong Kong, as have health & beauty and medical centres (see following table).

WeWork locations around the world

Source: WeWork.com

Tower 535 in Causeway Bay

Source: Phoenix Property

Leased office spaces of major business centre companies in Hong Kong

Companies	Leased floor areas	Buildings where major business centre companies have presence	Districts where major business centre companies have offices
Regus Business Centre	over 300,000 sq ft	One IFC, Central Plaza, Shui On Centre, ICC, Miramar Tower etc.	Central, Wanchai, Causeway bay, Quarry Bay, Sheung Wan, Tsimshatsui, Mongkok, Kowloon Station
Compass Offices	over 330,000 sq ft	Citibank Tower, Lee Gardens, Langham Place, Infinitus Plaza, Man Yee Building, AIA Tower, Worldwide House etc.	Central, Wanchai, Causeway bay, North Point, Sheung Wan, Tsimshatsui, Mongkok
The Executive Centre	over 140,000 sq ft	Two Exchange Square, Wheelock House, 28 Hennessy Road, Three Pacific Place, Nexxus Building etc.	Central, Wanchai, Quarry Bay
Jumpstart	over 40,000 sq ft	Wheelock House, Times Square, Millennium City, Silvercord Tower etc.	Central, Causeway Bay, Tsimshatsui, Kwun Tong
Servcorp	over 4,000 sq ft	Two IFC, HK Club Building, One Peking Road etc.	Central, Tsimshatsui

Source: Knight Frank

The sustainability of Mainland demand should not be underestimated

We believe Hong Kong is still in the early stages of a trend whereby companies from Mainland China establish operations in the Hong Kong. In this context, we reiterate that China's financial reforms extend well beyond the equities market and, in our view, will likely encompass commodities, FICC, private equity, banking and insurance. Hence, we see considerable scope for Mainland companies to expand their presence in Hong Kong.

According to a recent study by CBRE, some 23% of the Grade-A office space in Central was occupied by US companies and 22% by European ones as at end-2014. This compares with 19% for Chinese corporations today and up to 29% for European companies back in 2008. With China's continued reform in the financial sector and Chinese corporations eager to expand internationally, we see ample room for Mainland corporations to increase their presence in Central in particular.

It is too early to call an end to Hong Kong retail

Separately, for all the gloomy sentiment that surrounds the local retail segment, it is worth highlighting that new retailers continue to arrive in the city. Indeed, the luxury brands have been rationalising their stores rather than withdrawing from Hong Kong altogether. And the retail space left behind by the luxury brands, as well as the watch and jewellery shops, is being taken up by mid-tier mass market retailers such as Adidas and Sa Sa.

Moreover, the suburban malls are still doing well (Link REIT's most recent results indicate that its achieved rental reversion in the fiscal year ended March 2016 reached a post-IPO record high of 25.9%) and some trades (including F&B and sports) are still expanding in suburban malls and urban areas alike. Also, according to a recent study by CBRE, Hong Kong led the world in 2015 in terms of the number of new retailers establishing a presence in the city.

New retailers coming to establish a presence in Hong Kong

Retailers	Types	Background	Rented spaces	District	Size (GFA)
LEGO flagship store	Toys	German	Langham Place mall	Mongkok	7,000 sq.ft.
Hooters	F&B	US	Wydham Street	Central	3,300 sq.ft.
Seafood Room	F&B	Russian	Tower 535	Causeway Bay	8,000 sq.ft.

Source: Hong Kong Economic Times

In our opinion, a genuine retail hub cannot rely solely on luxury brands, which in any case are limited in number. Rather, a vibrant retail hub's appeal rests on a number of factors, including efficiency, service, variety, convenience, and availability of the most fashionable items.

In this light, we think the Hong Kong retail market still has considerable room for improvement, chiefly by continuing to broaden its focus from watches, jewellery and luxury brands. With the correction in luxury retail spending having been under way for more than 2 years, we think it is a matter of time before the expensive retail space previously leased by luxury brands and watch & jewellery shops is taken up by new, more "energetic" brands.

Hence, we recommend monitoring whether the retail market can continue to attract newcomers that enrich the city's retail scene. For as long as it continues to do so, we think the Hong Kong retail market will be better placed than it is widely perceived to be.

Could Hong Kong residential property prices stabilise earlier than expected?

Finally, on the residential front, we are also seeing signs of change. Sales of recently launched high-end projects such as SHK Properties' Ultima II and Swire Properties' Alassio have gone well, and we continue to see major transactions being made on the super-luxury front, suggesting that at least some wealthy market participants view the downturn in market sentiment as an opportunity to buy quality assets.

Sales performance of major projects

	Ocean Wings	Ultima phase 2*	ALASSIO
Developer	SHK Properties	SHK Properties	Swire Properties
District	Tseung Kwan O	Ho Man Tin	Mid-levels
Total no. of units	628	271	197
Net sizes (sq ft)	363 - 1,655	994 - 2,957	544-1,007 for the standard units / 1,149-3,118 for the special units
Layout	1- to 4-bedrooms (evenly distributed), plus 3 houses	Mostly 3- to 4-bedrooms	Various
Est'd completion	4Q17	3Q16	2Q17
Units with prices published	554	230	194
Per units price range (HKD)	5m - 35m	20m - 125m	15m - 77m
Psf price range (HKD)	12,411 - 29,330	18,327 - 55,180	24,208 - 45,212
Max. discount / tax rebates	9% plus 75-100% stamp duty rebate	12% plus 75-100% stamp duty rebate (partly cancelled from 28 April)	12%
Total units launched	535	232	194
Sales start date	2 April	23 March	13 April
Units sold	505	219	184
Sales proceeds (HKD)	4.7bn	9.3bn	4.3bn
Sales through rate (%)	94%	94%	95%

Source: Companies, Hong Kong Economic Times, Daiwa
*Note * we think the pricing of Ultima II is low only when compared with Ultima I, which was priced much higher than prices elsewhere in the area. We think the pricing strategy for Ultima II is to bring prices for the lower floors back into line with prices elsewhere in the area.*

Hong Kong: luxury unit transactions since 4Q15

Date	District	Project	Developer(s)	Unit	Net area (sq ft)	Transaction price Total (HKDm)	Transaction price Psf (HKD)
Jun 2016	The Peak	Severn Villa	Secondary market	Top floor	1,361	232	170,463
Jun 2016	Jardine's Lookout	6 Goldsmith Road	Secondary market	House	5,809	505	86,934
Jun 2016	The Peak	15 Gough Road	Chuang's Consortium	Under construction	9,212 (GFA)	2,100	227,964
Apr 2016	The Peak	Mount Nicholson	Wheelock	House 5	9,173	740	80,672
Feb 2016	Repulse Bay	2 Headland Road	Secondary market	House	16,829	1,020	60,610
Feb 2016	The Peak	Mount Nicholson	Wheelock	House 6	9,455	830	87,784
Dec 2015	Mid-levels	39 Conduit Road	Henderson Land	46/F Unit A	5,732	595	103,800
Nov 2015	The Peak	28 Barker Road	CK Property	House 6	6,856	698	101,809
Nov 2015	The Peak	28 Barker Road	CK Property	House 5	5,700	542	95,088
Nov 2015	Mid-levels	OPUS Hong Kong	Swire Pacific	12/F	5,444	510	93,608
Oct 2015	Repulse Bay	20 South Bay Road	Secondary market	Vacant land	18,651	1,300	68,629
Aug 2015	The Peak	22 Barker Road	Secondary market	House	9,890	1,500	151,700

Source: Hong Kong Economic Times, Apple Daily

Moreover, in recent weeks, we have projects targeting home-starters, such as SAVANNAH and Commune Modern, draw a good response, indicating to us that home-starter demand could be picking up.

Response to recent primary market launches

Project	Developer	Sales commenced	Units launched	Units sold	Proceeds (HKD)
Ultima phase 2	SHKP	23 Mar	232	219	9.3bn
Ocean Wings	SHKP	2 Apr	535	505	4.7bn
ALASSIO	Swire Prop	13 Apr	194	184	4.3bn
SAVANNAH	Wheelock	14 May	671	548	3.0bn
The Long Beach	Hang Lung	16 Apr	229	227	2.4bn
PARK YOHO Venezia	SHKP	25 Jun	191	182	1.3bn
Commune Modern	Sino Land	8 Jun	296	284	1.3bn
Bohemian House	New World Dev	29 Apr	155	142	1.1bn

Source: Companies, Hong Kong Economic Times, Daiwa

In this context, we flag the coming launches of SHKP's Grand Yoho in Yuen Long and Victoria Harbour in North Point as well worth watching. Both projects are to be launched in 2H16.

SHKP's Grand YOHO project in Yuen Long

Project name	Grand YOHO Phase 1
Location	Yuen Long
Residential GFA (sq ft)	740,000
No. of units	1,128
Layout	About half will be 2-bedroom units, the rest being 3- to 4-bedroom units
Est'd completion	1Q17
Pre-sale	Pending approval

Source: Company, Hong Kong Economic Times, Daiwa

SHKP's Victoria Harbour project in North Point

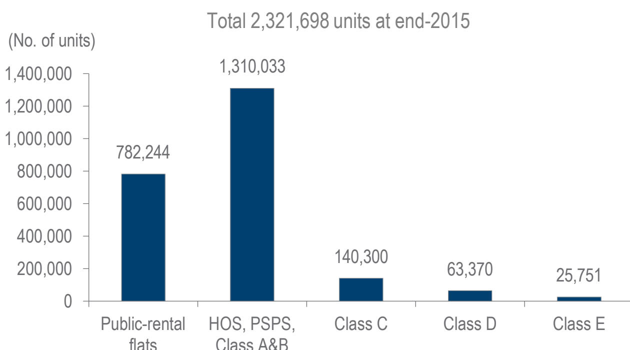
Project name	Victoria Harbour
Location	North Point (part of the integrated development of the former North Point Estate site at the harbourfront)
Residential GFA (sq ft)	320,000
No. of units	355
Layout	From studios to 4-bedroom units
Est'd completion	2Q17
Pre-sale	Pending approval

Source: Company, Hong Kong Economic Times, Daiwa

Yuen Long used to be considered a remote part of the New Territories. Hence, the ASP commanded by Grand Yoho will likely be viewed by market participants as a benchmark for other developments in the New Territories. Meanwhile, Victoria Harbour's location, North Point, is not generally regarded as an established luxury residential location. As such, the ASP commanded by Victoria Harbour could be seen as a benchmark for luxury as well as higher-end developments on Hong Kong Island.

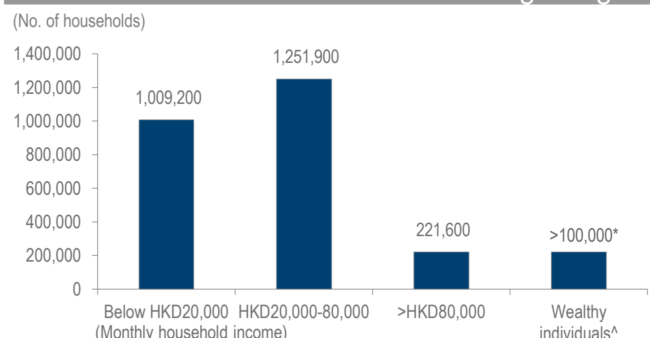
In our opinion, the ASP commanded by Grand Yoho will be especially important. Our view is that the residential property sector also needs a Kowloon East equivalent to establish a benchmark prices for the sector going forward. We are not convinced that all the psychological barriers related to living in the New Territories have yet been removed. Hence, under an optimistic scenario, it is conceivable that Grand Yoho will become the ICC equivalent in the residential market, ie, the project that breaks the psychological barriers related to living in the Northwest New Territories.

Structure of Hong Kong housing stock



Source: CEIC
Note: E - Private domestic units: more than 160 sq m
D - Private domestic units: 100-159.9 sq m
C - Private domestic units: 70-99.9 sq m
B - Private domestic units: 40-69.9 sq m
A - Private domestic units: less than 39.9 sq m
HOS, PSPS, etc - Home Ownership Scheme, Private-Sector Participation Scheme, Urban Improvement, Flat For Sale and Sandwich Class Housing Scheme

Structure of household incomes in Hong Kong



Source: CEIC, Daiwa estimates
*Note: *Daiwa estimates*
^people who own assets or businesses who do not have reported salaries but have wealth (according to government statistics, there are about 200,000 self-employed persons in Hong)

Third, long-running concerns about Hong Kong property could start to fade

Even if these positive undercurrents in the Hong Kong property sector do not become highly visible in the near term, we think it is important to watch for any change in the market's perceptions of established concerns about the market.

For example, the office sector has been addressing the issue of investment bank downsizing for years, and at this stage we do not expect the trend to have a significant impact, even in the event of another major round of downsizing in the coming months. For the office sector, therefore, we think concerns over banks' downsizing and the sustainability of Mainland demand will continue to recede

As for retail, while the overall environment remains challenging, we note that low base effects should come into play over time. After all, the decline in luxury spending in Hong Kong dates back to 2014. As and when the high-rent leases in high-street shops that were contracted in 2014 and before are fully renewed, we expect sentiment and news flow related to the retail property sector to stabilise.

On the residential front, we have already seen initial signs of stabilisation, with the sustained decline in the Centa-City Leading Index coming to an end in March 2016 (see chart below). Also, we have seen modest upward pressure on rents for the major housing estates emerging in recent weeks. Finally, the units made available on the secondary market since 4Q15 had been largely taken up by 1Q16, and we haven't seen a big increase in selling in the secondary market for several months.

Hong Kong: rentals in the 10 main secondary residential estates (May 2016)

	No. of transactions			Rent (HKD/sq ft/month, NFA)		
Estate	**May 2016**	**April 2016**	**MoM chg**	**May 2016**	**April 2016**	**MoM chg**
Taikoo Shing	57	61	-7%	37.8	37.0	2%
Kornhill	30	24	25%	34	34	0%
South Horizons	42	43	-2%	30	28	7%
Mei Foo Sun Chuen	48	48	0%	30	30	0%
Laguna City	24	22	9%	29	28	4%
Whampoa Garden	46	60	-23%	32	31	3%
Metro City	16	33	-52%	32	32	0%
City One Shatin	40	42	-5%	35	34	3%
Kingswood Villas	56	50	12%	19	19	0%
Caribbean Coast	45	47	-4%	23	23	0%
	404	**430**	**-6%**			

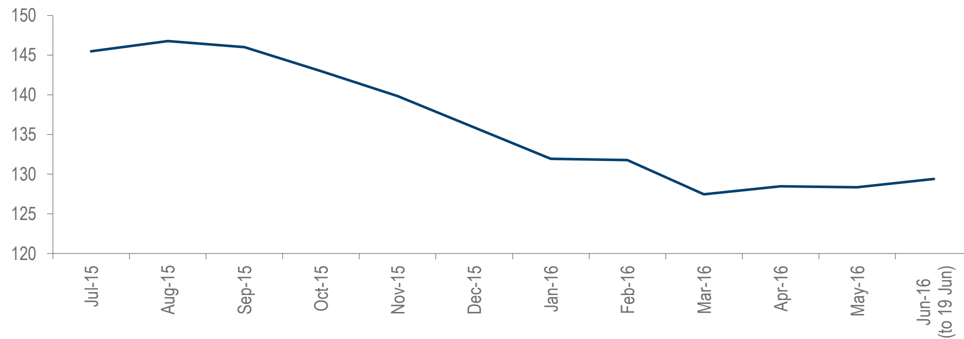
Source: Hong Kong Economic Times, Daiwa

Meanwhile, the response to recent new launches such as SAVANNAH and Commune Modern has been satisfactory, in our view. We believe the indications are there that the residential property sector will stabilise in the coming weeks, though our base case still calls for a further 5% decline in residential property prices in the remainder of 2016 (for a full-year decline of 10% YoY). Given our view that the market has been discounting a much worse scenario, and it has likely not taken into account the possibility of a stabilisation in residential property prices over the coming weeks, we can see the ingredients for a positive surprise and share-price catalyst.

In conclusion, we expect the concerns over the Hong Kong property sector to lose momentum and believe the physical market is now awaiting positive catalysts that drive a change in sentiment.

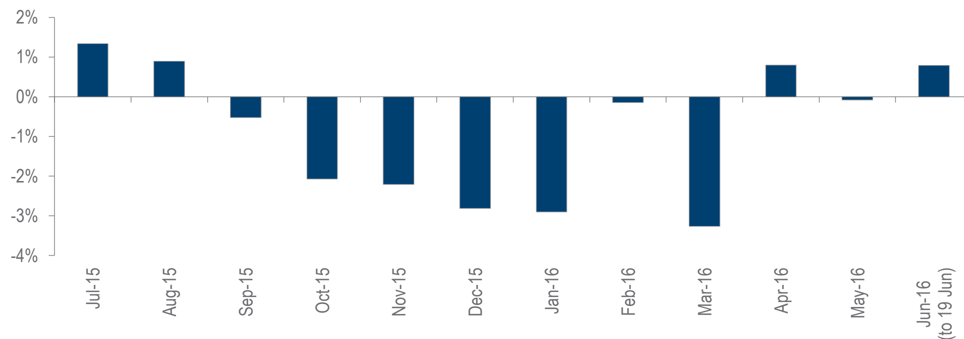
Over the next few pages we show some potential catalysts to conclude our contrarian case for the Hong Kong property sector, and recommend that investors position themselves ahead of this possible swing in market sentiment.

Centa-City Leading Index since August 2015



Source: Centaline, Daiwa

MoM change in the Centa-City Leading Index since July 2015



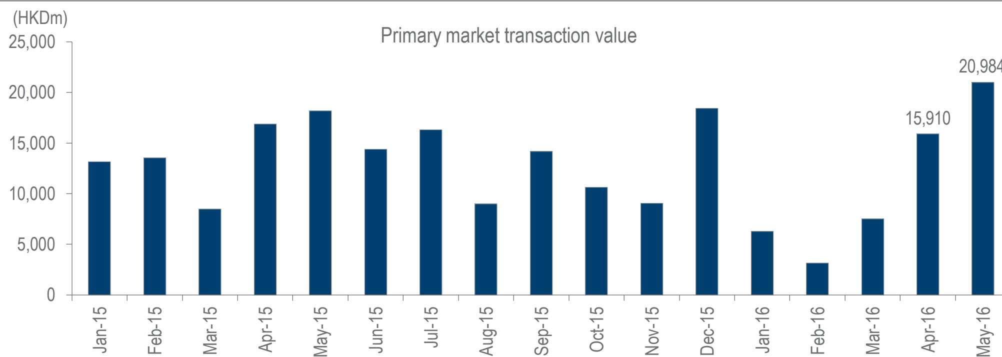
Source: Centaline, Daiwa

Change in the Centa-City Leading Index since January 2016

Month	MoM change	YTD change
Jan-16	-2.9%	-2.9%
Feb-16	-0.1%	-3.0%
Mar-16	-3.3%	-6.2%
Apr-16	0.8%	-5.5%
May-16	-0.1%	-5.5%
Jun-16 (to 19 Jun)	0.8%	-4.8%

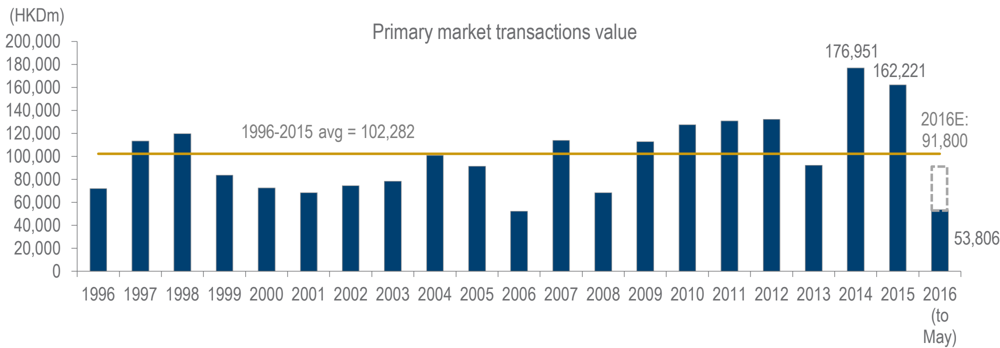
Source: Centaline, Daiwa

Monthly primary market sales since January 2015



Source: Midland

Annual primary market sales in terms of value



Source: Midland, Daiwa forecasts

Possible catalysts for the HK property sector in the coming months

Sector	Events	Significance	Comments
Residential	Launch of Grand Yoho in Yuen Long	Achieved ASPs could become benchmark for premier estates in the New Territories	Yuen Long is currently seen as a more remote part of the New Territories
		Could be a catalyst to drive increased acceptance of New Territories as a residential location for the middle class and above	
	Major transactions in the luxury and super-luxury segments	Symbolic significance in the wealthy's interest in parking capital in Hong Kong residential market	The wealthy's influence on the HK residential property market is disproportionate to their number
Office	En-bloc sale of major office buildings	Symbolic significance on mainland and foreign corporations' long-term commitment to Hong Kong	Given the scarcity of en-bloc office buildings in Hong Kong, achieved prices are likely to surprise on the upside
	Major leasing deals by prominent PRC or foreign corporations	Should help to dispel concerns on the strength of office demand in Hong Kong	We still see considerable room for PRC corporations to expand their presence in Central and Hong Kong as a whole
			MNCs might still take up large spaces though more likely to be in non-Central areas
Retailers	Major leasing deals by international retailers	Symbolic significance on international retailers' confidence on Hong Kong as a retail hub	While HK will no longer be like a monopoly, it should remain one of the important markets to access the PRC consumers

Source: Daiwa

Various scenarios for the Hong Kong residential property market

	Very pessimistic case	Pessimistic case	Base case	Optimistic Case	Very optimistic case
Keen sellers in the secondary market	More units come on to the market and the total number exceeds 50,000.	More units come on to the market and the total number reaches 20-50,000.	More units come on to the market but the total number is still within 20,000.	More units come on to the market but the total number is still within a few thousand, as many such units are either sold or changed to be rented.	Units from the first round of keen sellers were largely absorbed during 4Q15-1Q16. More come on to the market over time, but such units are taken up quickly.
Long-term investors	Determined to offload their units asap. Determined to move overseas and do not plan a future in Hong Kong.	Gradually offload their units to raise funds to invest overseas.	Keep renting out units and sell only when prices are attractive enough, as there are no more attractive alternatives available.	Selectively accumulate quality units.	Keen on bargain-hunting as they see the current correction as a potential repeat of 4Q08-2Q09, 2H05-2H06 or 2H03.
People who bought Class A and B units in 2015 at peak prices	Cannot service the mortgage, resulting in units being taken up by the banks or other financial institutions, which then would dispose of those units at whatever prices the market accepts.	Offload them asap and accept moderate losses.	Offload them once the opportunity arises as the developers are clearly supplying small units at favourable payment terms.	Continue to service the mortgage.	Continue to service the mortgages, and buy small units in developers' new projects.
Home-starters	Abandon the aspiration of owning their own flat.	Postpone home purchase decisions until the market situation improves.	Focus on buying mainly small units in developers' new projects.	Focus on opportunities for small units in both the primary and secondary markets.	Other than the new launches, also focus on bargains in the secondary market.
Upgraders	Determined to sell existing units; switch to rent or move out of Hong Kong.	Abandon the aspiration of upgrading.	Postpone upgrade decisions.	Focus mainly on opportunities in the primary market.	Other than the new launches, also focus on units in the secondary market which are reasonably priced.
Investors	Determined to offload existing units.	Abandon the-idea to invest further in flats in Hong Kong.	Adopt a wait-and-see stance.	Focus on new projects in the primary market which generally offer flexible and attractive payment terms.	Keen about looking for bargains in both the primary and secondary markets.
Developers' sales strategy for new launches	Price new projects at a notable discount to peers to attract market attention.	Offer notable discounts on the first batch of new launches and aim at selling all units asap.	Price new projects at a comparable level to newer units in the secondary market, with some units priced at a discount to attract market attention.	Able to gradually raise prices for selected projects.	Become more and more confident that their new launches can still sell well even if they are priced at a notable premium to the secondary market.
Government measures	HKMA introduces new measures to tighten the LTV on mortgage loans while the government comes out with measures to reduce investor participation in the residential property market.	HKMA introduces new measures to tighten the LTV on mortgage loans to reduce the banking sector's exposure to economic uncertainties.	No change in any of its measures.	HKMA slightly relaxes the requirements related to the LTV of residential units.	HKMA relaxes its LTV requirements and the government also reduces the special stamp duties and double stamp duties.
Overall	A meltdown scenario.	A scenario between a correction and meltdown.	A correction scenario.	An adjustment/ normalisation scenario.	A breakthrough scenario characterised by robust volume for units in suburban areas and firm prices for those in urban areas.

Source: Daiwa

Various scenarios for the Hong Kong retail property market

	Very pessimistic case	Pessimistic case	Base case	Optimistic case	Very optimistic Case
Luxury retailers	Some decide to exit the Hong Kong market.	Keep just 1 or 2 stores in Hong Kong.	Still keep their presence in Hong Kong but rationalise and optimise it, with a reduced number of stores and reduction in floor area in some stores.	Expand and strengthen a few key stores which are crucial to their longer-term prospects.	Take up prime retail space at levels similar to the asking rents.
Mid-end retailers	Some decide to exit the Hong Kong market.	Reduce their presence in Hong Kong.	Keep their existing presence in Hong Kong	Gradually expand their presence in Hong Kong.	See the current environment as an opportunity to secure prime retail space at reasonable rent.
Other retailers new to HK	Abandon the idea of potentially coming to Hong Kong.	Decide not to come to Hong Kong.	Adopt a wait-and-see stance as to whether to come to Hong Kong.	Some see the current environment as an opportunity to build up their presence in Hong Kong.	Actively pursue opportunities related to expanding their presence in Hong Kong.
Mainland visitors	Many decide to shop in other global cities instead of going to Hong Kong.	Some abandon the idea of coming to Hong Kong.	The overall pie continues to expand although Hong Kong now becomes just one of the key markets.	New visitors still see Hong Kong as one of the first markets to visit, and some of the visitors return after having tried many other markets.	Infrastructural improvements result in a notable increase in the number of mainland visitors coming to Hong Kong.
Visitors from other countries	Many abandon the idea of coming to Hong Kong.	The numbers coming to Hong Kong fall notably.	Gradually fewer come to Hong Kong due to the rise in HKD exchange rate versus other major cities.	More come to visit Hong Kong.	Visitors from overseas become an increasingly important component of HK's tourist arrivals.
Local consumers	Continue to reduce retail spending in Hong Kong and see overseas countries as the main destination for shopping.	Cut retail spending and prefer to shop more overseas.	Become more cautious on private consumption due to economic uncertainties.	Return to shop more in Hong Kong after trying overseas shopping a few times; and find that the strong USD/ HKD no longer makes goods bought overseas cheaper, with many global retailers having adopted a global pricing strategy to equalise prices in HK versus other cities	Regain the appetite to spend in Hong Kong, after finding that the Hong Kong retail market has become more interesting and vibrant than before.
Retail landlords	Faced a shrinking retail pie in the Hong Kong retail property market.	Not able to come up with ways to enhance the attraction of their malls to shoppers from China and overseas.	Put greater emphasis on local shoppers and attract new retailers to come to Hong Kong.	Strengthen their retail offerings in Hong Kong and make malls more attractive to customers from Hong Kong, China and overseas.	Significantly strengthen their retail offerings in Hong Kong, with many new and upcoming retailers and shoppers coming to Hong Kong.
Overall	A meltdown scenario, characterised by Hong Kong returning to a 7m people retail market.	A scenario between a correction and a meltdown.	A correction scenario.	An adjustment/ normalisation scenario, characterised by the retail market resuming sustainable growth, albeit at a rate that does not match that for 2004-14.	A breakthrough scenario, characterised by Hong Kong becoming a truly global retail hub, on its way to match London or Tokyo in terms of the depth, size, breadth and sophistication of its retail property market.

Source: Daiwa

Various scenarios for the Hong Kong office property market

	Very pessimistic case	Pessimistic case	Base case	Optimistic Case	Very optimistic case
Mainland corporations	Decide to close down their Hong Kong operations.	Postpone their expansion in Hong Kong.	Gradually increase their presence in Hong Kong.	Become keen to establish a larger presence in Hong Kong.	Determined to build a larger presence in Hong Kong which also becomes the main centre for them to manage their growing international businesses.
Financial sectors	Continue to downsize and some close down their businesses in Hong Kong, including some from China.	Continue to downsize and some close down their businesses in Hong Kong.	Investment banks continue to downsize and seek ways to reduce operating costs.	Reforms in China's financial sectors result in Chinese financial institutions continuing to come to Hong Kong which offsets the weaknesses in the investment banking industry.	Chinese financial institutions seek major expansion in Hong Kong which more than offsets the impact of the weakness in the investment banking industry.
Other existing corporations in Hong Kong	Downsize their operations in Hong Kong.	Postpone their expansion plans in Hong Kong due to economic uncertainties.	Continue their gradual expansion.	Scale up their presence in Hong Kong after several years and given that there are now more office options available in non-Central areas and that there are new opportunities associated with the reforms in China's financial and other sectors.	Further scale up their expansion plans in Hong Kong to seize opportunities related to reforms in China's financial and other sectors and Hong Kong's position as an important link between China and the rest of the world.
Corporations which have not come to Hong Kong	None bother exploring the idea of having a presence in Hong Kong.	Some abandon the idea of coming to Hong Kong.	Some explore the option of establishing an initial presence in Hong Kong.	More become keen about coming to Hong Kong given that there are now more office options available in non-Central areas and that there are new opportunities associated with the reform of China's financial and other sectors.	Many companies from China and overseas come to Hong Kong which further reinforces Hong Kong's role as the link between China and the rest of the world. The gradual acceptance of new office ideas (such as work stations, business centres etc.) and continued development of the technology/Internet sectors also provide impetus for new office demand.
Overall	A meltdown scenario.	A scenario between a correction and a meltdown.	A correction scenario.	An adjustment/normalisation scenario, characterised by a large and growing mid-end segment in the Hong Kong office market.	A breakthrough scenario, characterised by Hong Kong becoming a vibrant office hub, underpinned by continuous and sustainable expansion by existing corporations and new ones from Hong Kong, China and the rest of the world. Under such a scenario, the Hong Kong office market is on its way to match those of London and New York in terms of size, breadth, depth and sophistication.

Source: Daiwa

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